



Market Commentary

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Downgrading Outlook Based on Credit Freeze

We have re-evaluated our portfolio posture in light of new information that suggests the current downturn in the economy may persist longer than even our original recessionary forecast. We now know, based on new data from the Federal Reserve, that credit creation in the United States effectively seized in the second quarter as net new borrowing by households fell to \$197 billion. This level of credit creation is \$750 billion less than a year ago and \$1.2 trillion less than the peak levels seen two years ago. Said another way, the current annualized growth rate in credit, at 1.4%, is the lowest growth rate for this statistic on record, with data going back to 1952. Even those growth rates for government and business have slowed materially in recent quarters, leaving total borrowing growth near 3.5% — a level not seen since 1991.

In short, we believe that the massive increase in leverage from 2000-2006 that occurred at both the household level and within the financial system must now be reduced. With aggregate U.S. household debt-to-income ratios near 140% and some large financial firms' asset leverage ratios near 30-40X equity, the current stresses in the economy now will likely require forced liquidation of assets over time that may result in further downward pressure on asset prices and may cause both corporate and individual borrowers to seek to adopt a more risk-averse, and more liquid, posture.

While we had been hopeful that the current slump in the economy would follow earlier cycles, we now must confront the cold facts that directly point toward de-leveraging and asset price deflation. As a result, we have adjusted our investment posture and recommended tactical asset exposure to recognize these new facts. The changes made to our recommended allocations do three things:

1) Raise more cash: Reduce portfolio risk exposure in light of the above facts and increase potential buying power in the event of further market declines.

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2) More evenly distribute U.S. equity portfolio: Create a more even distribution of U.S. common equity exposure by increasing the relative exposure to smaller and value segments of the markets within portfolios. We also acknowledge the emerging leadership of small capitalization stocks in recent months, and we are recognizing the relative shift in valuations that have occurred between growth and value over the past year.

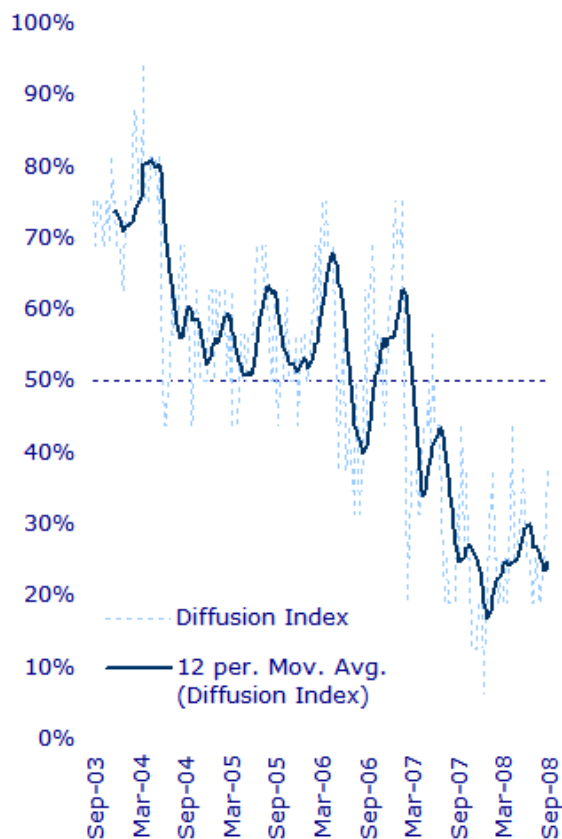
3) Reduce exposure to higher volatility foreign markets: We are broadening our exposure within the developed markets and continue to avoid emerging and BRIC economies.

Tactical Direction Still Tied to Credit

While we expected to see an improving credit environment by now, this is simply not the case. Our original work on credit cycles, that suggests that economies and markets have become increasingly tied to trends in credit creation (versus traditional inventory adjustment models), remains valid in our view. Therefore, we now are formalizing our analysis on credit trends and relating these trends to our tactical recommendations for asset allocation. To help with this, we are introducing a new indicator for monitoring changes in credit markets and their impact on the economy. This index combines a variety of forward-looking and real-time market inputs that we believe are relevant to today's credit conditions. In short, it can be thought of as a thermometer that gauges whether the current credit environment is warming up or becoming more deeply frozen. It also provides us with a quantitative and unbiased measure for assessing and benchmarking our overall equity exposure in the weeks and months ahead. We will refer to this diffusion-style indicator in the future as we discuss our top-down tactical asset allocation decisions.

As you can see from the chart below, the composite takeaway is that conditions remain more hostile to risk-taking at this time than during the 2003-2006 timeframe. Further deterioration could suggest that even greater cuts in equity exposure are warranted, while improvement could suggest that additions to equity exposure are becoming more appropriate. These observations will continue to be an important contributor to our overall outlook for financial markets given the special set of conditions now confronted by financial markets.

WCA Credit Thermometer



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Credit Thermometer

There are many inputs to the index. In general, they are designed to be relevant to today's highly unusual set of financial conditions. The index seeks to take a week-to-week and month-to-month point of view rather than a day-to-day point of view. In addition, the inputs are intended to give us forward-looking information that may directly impact the outlook for the economy and equity markets. This index is a diffusion-style index comprised of several equally weighted components. The components include:

Libor-OIS Spread: An indicator of the banking systems' ability to get short-term funding from one another.

Term Spread: Represents the difference between long-term U.S. government interest rates and short-term cost of funding for banks. A widening spread typically signals an improving environment for banks who traditionally seek to profit from "borrowing short" and "lending long."

Treasury / Moody's Baa Spread: An indicator of credit risk among domestic industrial companies.

Homebuilders Index Relative Performance: A market-based indicator focused on housing.

Financial Sector Index Relative Performance: A market-based indicator focused on banking and finance.

Stock / Bond Relative Performance: A measure of sentiment and risk preference among investors.

Trade-Weighted Performance of Dollar: Measures perceptions about the health of the U.S. economy.

Weekly Jobless Claims: A weekly indicator that reflects the health of the overall economy from the viewpoint of employment.

At present, we conclude that credit conditions remain poor as evidenced by an index reading in the 20-30% range. We will continue to monitor conditions and make changes accordingly.

Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	25%	50%	75%
DOMESTIC BONDS	21%	41%	62%
Money Market	1%	2%	3%
Short-Term Treasuries	7%	14%	21%
Intermediate Term Treasuries	3%	5%	8%
Inflation Protected Treasuries	2%	3%	5%
Investment Grade Corp Bonds	6%	12%	18%
High Yield Corporate Bonds	3%	5%	8%
COMMODITIES & OTHER	5%	9%	14%
Preferred Equity	1%	2%	3%
REITs	1%	2%	3%
Gold	3%	5%	8%
COMMON STOCKS	75%	50%	25%
DOMESTIC COMMON STOCKS	60%	40%	20%
U.S. SIZE & STYLE	60%	40%	20%
Large Cap Growth	18%	12%	6%
Large Cap Value	15%	10%	5%
Mid Cap Growth	9%	6%	3%
Mid Cap Value	6%	4%	2%
Small Cap Growth	8%	5%	3%
Small Cap Value	5%	3%	2%
FOREIGN	15%	10%	5%
DEVELOPED	15%	3%	5%
EAFE Growth	11%	7%	4%
EAFE Value	5%	3%	2%
TOTAL PORTFOLIO	100%	100%	100%

Recommended Sector Allocation

	Suggested S&P 500 Weight	
U.S. Equity Sectors		
Energy	5%	13%
Technology	17%	17%
Materials	3%	3%
Industrials	8%	12%
Consumer Discretionary	6%	8%
Health Care	24%	12%
Utilities	3%	4%
Consumer Staples	13%	10%
Telecommunications	8%	4%
Financials	15%	18%
Total	100%	100%

* Source: Bloomberg

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