

The Week

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Strategic investing and long-term secular trends

- During the past few weeks, this report has discussed the increase in market volatility since the beginning of the year. Sentiment appears to have shifted with many investors now looking at the glass as half empty rather than half full like late last year. We suggested last week that tactical investors may want to be more defensive in this environment while long-term strategic investors should probably look at recent equity market weakness as a buying opportunity. In this week's report we look at some of the benefits and pitfalls of long-term strategic investing.
- Long-term investing is often more complex than short-term-buy-low-sell-high tactical strategies. Long-term investing requires understanding secular trends that can persist for long periods of time. For example, in our 2010 outlook, we discussed our favored emerging markets which included Brazil, India and Mexico. These markets can be cyclical like U.S. markets, going up during periods of growth and going down during periods of economic weakness. Nonetheless, our work shows that in recent years these three equity markets declined less than many others in down cycles and rallied more than others in up cycles. This is because of long-term favorable secular trends toward faster economic growth in emerging economies than in developed economies. Of course, past performance does not guarantee similar results.
- A secular trend is one that persists over many years and often over more than one market cycle. A cyclical trend usually exists for only one cycle. These long-term secular trends can help strategic investors build wealth but it is important to recognize that volatility may still exist within secular trends. Assets with favorable trends can have bad years too.
- This week's chart looks at the yearly performance of several different asset classes during the past 15 years. It is updated with the latest 2009 performance numbers. The new data show that investors were willing to take risk last year after the fears of depression faded. Consequently, emerging market stocks were on top in this ranking while conservative investments like cash and investment grade bonds were near the low end.
- Looking back further, it is easy to see that returns can be very volatile. However, this volatility is not cyclical or predictable. In other words, the best performing asset one year is not always the worst performing one the next year. If volatility was this predictable, you could easily sell the winners each year and then buy the losers. Unfortunately, investing is not that simple.
- Volatility may not be predictable but it is not completely random either. Some asset classes tend to have more consistent performance, holding near the highs or lows in ranking against other assets for several years. These are often the assets with long-term secular trends. During the late 1990s, a secular trend favoring large-cap U.S. stocks existed. A secular trend favoring emerging market stocks has persisted through much of the past decade. Cash is often near the low end of the ranking except during years of recession when investors prefer a low return on cash to a negative return on other assets.
- One important observation from this "quilt" of returns is that diversification can help reduce downside risk. The even-weighted blend portfolio in this chart tends to have average returns with less volatility than many individual assets. This simplified example of diversification is a useful illustration of the value of asset allocation. The good news is individual investors may be able to do even better than the simple blend of all assets. Investors can diversify more effectively by holding an asset allocation representing their specific risk tolerance and

investment objectives. That is why we have nine recommended diversified strategic portfolios consistent with differing long-term needs and risk tolerance. These long-term strategic allocations are designed to capture secular trends as well as provide diversification that can diminish volatility compared to more concentrated portfolios with only a few assets.

- Long-term strategic investors need to review their specific allocation periodically to ensure that it is still appropriate for their risk tolerance and long-term goals. Short-term tactical investors may also want to review their portfolios and consider varying positions slightly from the long-term strategy when market conditions warrant temporary moves.
- Finally, diversified asset allocation usually provides more consistent returns over time than trying to pick the winners and avoid the losers each and every year. That is nearly impossible to do because the world is not that predictable. Unexpected events happen all the time causing a great deal of market volatility. If the world was predictable and volatility did not exist, this quilt would look more like a flag with each stripe a different color representing the steady long-term growth rate of each asset. Instead, with unexpected events and market volatility, growth rates are not steady over time, and there is a jumble of multi-colored pieces arrayed across the quilt.

Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.

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The value of asset allocation

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Best	Large-Cap Stocks 37.6%	Real Estate Securities 35.9%	Large-Cap Stocks 33.4%	Large-Cap Stocks 28.6%	Emerg-Mkt Stocks 66.4%	Real Estate Securities 26.8%	Real Estate Securities 12.8%	Commodities 23.9%	Emerg-Mkt Stocks 56.3%	Real Estate Securities 31.5%	Emerg-Mkt Stocks 34.5%	Emerg-Mkt Stocks 32.6%	Emerg-Mkt Stocks 39.8%	Inv-Grade Bonds 5.0%	Emerg-Mkt Stocks 79.0%
	Mid-Cap Stocks 30.9%	Large-Cap Stocks 23.0%	Mid-Cap Stocks 32.2%	Intl Stocks 20.3%	Intl Stocks 27.3%	Commodities 24.2%	Inv-Grade Bonds 8.5%	Emerg-Mkt Bonds 12.2%	Intl Stocks 39.2%	Emerg-Mkt Stocks 26.0%	Commodities 17.5%	Real Estate Securities 30.2%	Intl Stocks 11.6%	Cash Alternatives 1.8%	High-Yield Bonds 46.1%
	Small-Cap Stocks 30.0%	Small-Cap Stocks 21.3%	Small-Cap Stocks 25.6%	Mid-Cap Stocks 19.1%	Emerg-Mkt Bonds 26.9%	Mid-Cap Stocks 17.5%	Small-Cap Stocks 6.5%	Inv-Grade Bonds 10.9%	Small-Cap Stocks 38.8%	Small-Cap Stocks 22.6%	Intl Stocks 14.0%	Intl Stocks 26.9%	Commodities 11.1%	Emerg-Mkt Bonds -15.4%	Mid-Cap Stocks 37.4%
	Asset Class Blend 20.1%	Mid-Cap Stocks 19.2%	Real Estate Securities 18.6%	Inv-Grade Bonds 9.5%	Large-Cap Stocks 21.0%	Emerg-Mkt Bonds 14.9%	High-Yield Bonds 5.5%	Real Estate Securities 3.6%	Real Estate Securities 36.7%	Intl Stocks 20.7%	Emerg-Mkt Bonds 12.9%	Large-Cap Stocks 15.8%	Mid-Cap Stocks 8.0%	High-Yield Bonds -23.3%	Emerg-Mkt Bonds 34.8%
	Inv-Grade Bonds 19.2%	Asset Class Blend 15.0%	Emerg-Mkt Bonds 15.8%	Cash Alternatives 5.1%	Asset Class Blend 16.9%	Inv-Grade Bonds 11.9%	Cash Alternatives 4.1%	Cash Alternatives 1.7%	Mid-Cap Stocks 35.6%	Mid-Cap Stocks 16.5%	Mid-Cap Stocks 12.6%	Small-Cap Stocks 15.1%	Inv-Grade Bonds 7.3%	Asset Class Blend -28.2%	Intl Stocks 32.5%
	Intl Stocks 11.6%	Intl Stocks 6.4%	Asset Class Blend 14.4%	High-Yield Bonds 3.9%	Mid-Cap Stocks 14.7%	Small-Cap Stocks 11.8%	Emerg-Mkt Bonds 3.5%	High-Yield Bonds 1.1%	Emerg-Mkt Bonds 34.1%	Asset Class Blend 14.9%	Asset Class Blend 11.1%	Asset Class Blend 14.4%	Asset Class Blend 7.0%	Small-Cap Stocks -31.1%	Asset Class Blend 29.7%
	Cash Alternatives 5.9%	Emerg-Mkt Stocks 6.0%	High-Yield Bonds 12.8%	Asset Class Blend 2.5%	Small-Cap Stocks 12.4%	Cash Alternatives 6.1%	Mid-Cap Stocks -0.6%	Asset Class Blend -1.8%	Asset Class Blend 29.1%	Emerg-Mkt Bonds 12.9%	Real Estate Securities 8.9%	Emerg-Mkt Bonds 12.7%	Emerg-Mkt Bonds 6.2%	Mid-Cap Stocks -36.2%	Large-Cap Stocks 26.5%
	Emerg-Mkt Stocks -5.2%	Cash Alternatives 5.3%	Inv-Grade Bonds 9.8%	Small-Cap Stocks -1.3%	Cash Alternatives 4.8%	Asset Class Blend 5.0%	Asset Class Blend -1.6%	Emerg-Mkt Stocks -6.0%	Large-Cap Stocks 28.7%	Large-Cap Stocks 10.9%	Small-Cap Stocks 7.7%	Mid-Cap Stocks 10.3%	Large-Cap Stocks 5.5%	Commodities -36.6%	Small-Cap Stocks 25.6%
		Inv-Grade Bonds 2.9%	Cash Alternatives 5.3%	Real Estate Securities -16.9%	High-Yield Bonds 2.5%	High-Yield Bonds -4.0%	Emerg-Mkt Stocks -2.4%	Mid-Cap Stocks -14.5%	High-Yield Bonds 22.9%	High-Yield Bonds 9.9%	Large-Cap Stocks 4.9%	High-Yield Bonds 9.3%	Cash Alternatives 4.8%	Large-Cap Stocks -37.0%	Real Estate Securities 21.0%
			Intl Stocks 2.1%	Emerg-Mkt Bonds -17.6%	Inv-Grade Bonds -2.1%	Large-Cap Stocks -9.1%	Large-Cap Stocks -11.9%	Small-Cap Stocks -14.6%	Commodities 22.7%	Commodities 7.6%	High-Yield Bonds 3.4%	Cash Alternatives 4.8%	High-Yield Bonds 3.2%	Real Estate Securities -41.5%	Commodities 18.7%
			Emerg-Mkt Stocks -11.6%	Emerg-Mkt Stocks -25.3%	Real Estate Securities -4.6%	Intl Stocks -14.0%	Intl Stocks -21.2%	Intl Stocks -15.7%	Inv-Grade Bonds 4.5%	Inv-Grade Bonds 4.2%	Cash Alternatives 3.0%	Inv-Grade Bonds 3.8%	Small-Cap Stocks -0.3%	Intl Stocks -43.1%	Inv-Grade Bonds 4.8%
						Emerg-Mkt Stocks -30.6%	Commodities -22.3%	Large-Cap Stocks -22.1%	Cash Alternatives 1.0%	Cash Alternatives 1.2%	Inv-Grade Bonds 2.5%	Commodities -2.7%	Real Estate Securities -20.2%	Emerg-Mkt Stocks -53.2%	Cash Alternatives 0.2%
Worst															

Recessions

See the following page for asset class definitions and important disclosures.

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Asset class definitions

□ Asset Class Blend

Return on an equal blend of all indexes.

■ Cash Alternatives

Barclays Capital U.S. Treasury Bills (1-3M) – An index that is representative of money markets.

■ Commodities

Dow Jones-UBS Commodity Index – Reflects the return of underlying commodity futures for commodities traded on the U.S. exchanges and London Metal Exchange.

■ Investment-Grade Bonds

(1995-1996) Barclays Govt./Credit Bond Index – Based on all publicly issued intermediate- and long-term government and corporate debt securities.

(1997-2009) Merrill U.S. Government/Corporate Master Index – A statistical composite tracking the performance of the entire U.S. corporate bond market over time.

■ High-Yield Bonds

Merrill U.S. High-Yield Constrained (BB-B) – A broad measure of the high-yield fixed-income market that caps the allocation of any one issuer at 2%.

■ Emerging Market Bonds

Merrill Emerging Market Sovereigns – Tracks the performance of sovereign debt issued and backed by more than 20 emerging market countries.

■ Emerging Market Stocks

MSCI Emerging Markets Index – Designed to measure equity market performance of 22 emerging markets.

■ International Stocks

MSCI EAFE – Represents all of the MSCI developed markets outside of North America.

■ Real Estate Securities

MSCI REIT Index – Represents equity real estate investment trusts (REITs) that generate the majority of their revenue and income from real estate rental and leasing. The index represents approximately 85% of the U.S. REIT universe.

■ Large-Cap Stocks

S&P 500 – Covers 500 industrial, utility, transportation and financial companies in the U.S. markets.

■ Mid-Cap Stocks

S&P MidCap 400 – The 400 U.S. companies on the S&P Composite 1500 index with market capitalization that is greater than that of companies on the S&P SmallCap 600 and less than that of companies on the S&P 500.

■ Small-Cap Stocks

S&P SmallCap 600 – The 600 smallest U.S. companies on the S&P Composite 1500 index as measured by market capitalization.

■ Recessions

As defined by the National Bureau of Economic Research.

This chart is provided for illustrative purposes only and is not indicative of any specific investment; individual investment results will vary. Information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. The data assumes the reinvestment of all income and dividends and does not account for taxes and transaction costs. Investment manager performance relative to the different asset class indexes has varied widely across the asset classes during the past 15 years. Returns for asset classes shown reflect inception of benchmarks used.

Asset allocation/investment timing cannot eliminate the risk of fluctuating prices and uncertain returns. Past performance is no guarantee of future results.

Please note that all indexes are unmanaged and do not take into account any fees or expenses of investing in the individual securities they track, and that individuals cannot invest directly in an index. Investments in stocks and bonds are subject to risk, including market and interest-rate fluctuations.

Stocks of mid-cap and small-cap companies are typically more volatile than stocks of larger companies. They often involve higher risks as they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Global/international investing involves risks not typically associated with U.S. investing, including currency fluctuations, political instability, uncertain economic conditions and different accounting standards.

High-yield bonds, commonly known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher rated bonds. The prices of these bonds may be volatile, and they are generally only suitable for aggressive investors.

There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.

Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

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