



July 28, 2008

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Positioning For Better Equity Markets

- In this report, we are detailing changes to our tactical tilts in the Asset Allocation Models. Tactical adjustments are made in response to short-term conditions where we move to overweight or underweight assets classes compared to our long-term benchmarks.
- Two weeks ago, we reduced our commodity exposure due to expectations that global economic weakness will weigh on commodity consumption and weaken prices. So far that move has panned out. Commodity prices have eased by 10%, based on the CRB index, over the past fortnight.
- As commodity prices have declined and the dollar has started to recover, equity markets have reacted positively. This makes sense to us as; the decline in commodity prices and the lift in the dollar should reduce inflation concerns. As inflation worries subside, investors should become more favorable towards equities.
- In the equity markets, we have seen financial stocks, which have been under pressure, recover despite continued weak earnings. This is a positive sign; when a market rises despite lackluster news, it suggests the worst of the bad news has been discounted. This isn't to say that we are signaling an "all clear" for stocks. However, recent market action does suggest the worst may be over and so we believe adjusting our exposure within our equity allocations is appropriate.

Thus, we are moving to a more balanced position within our equity recommendations within our asset allocation models. Because small caps tend to outperform the overall market coming out of bear markets we are moving to evenweight from underweight across all the models. We are also moving to evenweight from underweight in midcap equities. We have been overweight large cap growth stocks as a defensive position. We are reducing this sector to evenweight from overweight. *The prices of small-cap and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.*

- In all, we still remain somewhat defensive in the portfolio, with the total equity position remaining underweight and holding overweight positions in short-and-intermediate term investment grade debt. This is due to our continued caution over the state of the economy. However, if market action continues to improve, our equity positions are better positioned to potentially take advantage of such strength. We view these adjustments as consistent with transitioning from a bear market in equities.

Chart of the Week:

ASSET ALLOCATION MODELS

Tactical Tilt as of 7/28/2008 (last adjusted on 7/28/08)

	CONSERVATIVE			MODERATE			LONG-TERM		
	New BM	Tactical	Difference	New BM	Tactical	Difference	New BM	Tactical	Difference
	INCOME								
CASH	10.0%	7.0%	-3.0%	2.0%	2.0%	0.0%	2.0%	2.0%	0.0%
TRADITIONAL FIXED INCOME	80.0%	84.0%	4.0%	57.0%	60.0%	3.0%	32.0%	35.0%	3.0%
Short-term Inv Grade	40.0%	44.0%	4.0%	20.0%	23.0%	3.0%		3.0%	3.0%
Intermediate Inv Grade	40.0%	40.0%	0.0%	23.0%	25.0%	2.0%	16.0%	18.0%	2.0%
Long-term Inv Grade				14.0%	12.0%	-2.0%	16.0%	14.0%	-2.0%
ALTERNATIVE INCOME	10.0%	9.0%	-1.0%	26.0%	25.0%	-1.0%	46.0%	45.0%	-1.0%
Hi-yield	7.0%	6.0%	-1.0%	18.0%	17.0%	-1.0%	30.0%	29.0%	-1.0%
Emerging Market Debt	3.0%	3.0%		8.0%	8.0%		16.0%	16.0%	
REITs									
COMMODITIES									
STOCKS				15.0%	13.0%	-2.0%	20.0%	18.0%	-2.0%
LargeCap Value				10.0%	8.0%	-2.0%	10.0%	8.0%	-2.0%
Large Cap Growth					2.0%	2.0%	5.0%	7.0%	2.0%
Mid Cap Blend									
Small Cap Blend									
International				5.0%	3.0%	-2.0%	5.0%	3.0%	-2.0%
Emerging Market									

	CONSERVATIVE			MODERATE			LONG-TERM		
	New BM	Tactical	Difference	New BM	Tactical	Difference	New BM	Tactical	Difference
	GROWTH AND INCOME								
CASH	2.0%	2.0%		2.0%	2.0%		2.0%	2.0%	
TRADITIONAL FIXED INCOME	48.0%	51.0%	3.0%	27.0%	30.0%	3.0%	10.0%	13.0%	3.0%
Short-term Inv Grade	14.0%	18.0%	4.0%	7.0%	11.0%	4.0%		4.0%	4.0%
Intermediate Inv Grade	26.0%	27.0%	1.0%	15.0%	16.0%	1.0%		1.0%	1.0%
Long-term Inv Grade	8.0%	6.0%	-2.0%	5.0%	3.0%	-2.0%	10.0%	8.0%	-2.0%
ALTERNATIVE INCOME	14.0%	13.0%	-1.0%	21.0%	20.0%	-1.0%	21.0%	20.0%	-1.0%
Hi-yield	10.0%	9.0%	-1.0%	15.0%	14.0%	-1.0%	15.0%	14.0%	-1.0%
Emerging Market Debt	4.0%	4.0%		6.0%	6.0%		6.0%	6.0%	
REITs									
COMMODITIES		0.0%	0.0%		0.0%	0.0%		0.0%	0.0%
STOCKS	36.0%	34.0%	-2.0%	50.0%	48.0%	-2.0%	67.0%	65.0%	-2.0%
LargeCap Value	20.0%	20.0%		20.0%	20.0%		20.0%	20.0%	
Large Cap Growth	5.0%	5.0%	0.0%	8.0%	8.0%	0.0%	11.0%	11.0%	0.0%
Mid Cap Blend	3.0%	3.0%	0.0%	6.0%	6.0%	0.0%	13.0%	13.0%	0.0%
Small Cap Blend	2.0%	2.0%	0.0%	4.0%	4.0%	0.0%	10.0%	10.0%	0.0%
International	5.0%	3.0%	-2.0%	10.0%	8.0%	-2.0%	10.0%	8.0%	-2.0%
Emerging Market	1.0%	1.0%		2.0%	2.0%		3.0%	3.0%	

	CONSERVATIVE			MODERATE			LONG-TERM		
	New BM	Tactical	Difference	New BM	Tactical	Difference	New BM	Tactical	Difference
	GROWTH								
CASH	2.0%	2.0%		2.0%	2.0%		2.0%	2.0%	
TRADITIONAL FIXED INCOME	35.0%	40.0%	5.0%	15.0%	20.0%	5.0%		4.0%	4.0%
Short-term Inv Grade	15.0%	20.0%	5.0%	6.5%	11.5%	5.0%		4.0%	4.0%
Intermediate Inv Grade	16.0%	18.0%	2.0%	7.0%	8.5%	1.5%			
Long-term Inv Grade	4.0%	2.0%	-2.0%	1.5%	0.0%	-1.5%			
ALTERNATIVE INCOME	3.0%	2.0%	-1.0%	3.0%	2.0%	-1.0%			
Hi-yield	3.0%	2.0%	-1.0%	3.0%	2.0%	-1.0%			
Emerging Market Debt									
REITs									
COMMODITIES	2.0%	0.0%	-2.0%	3.0%	1.0%	-2.0%	3.0%	1.0%	-2.0%
STOCKS	58.0%	56.0%	-2.0%	77.0%	75.0%	-2.0%	95.0%	93.0%	-2.0%
LargeCap Value	11.5%	11.5%		13.0%	13.0%		16.5%	16.5%	
Large Cap Growth	13.5%	13.5%	0.0%	15.0%	15.0%	0.0%	17.5%	17.5%	0.0%
Mid Cap Value	4.5%	4.5%	0.0%	7.0%	7.0%	0.0%	9.0%	9.0%	0.0%
Mid Cap Growth	4.5%	4.5%	0.0%	7.0%	7.0%	0.0%	9.0%	9.0%	0.0%
Small Cap Value	3.0%	3.0%	0.0%	5.5%	5.5%	0.0%	7.0%	7.0%	0.0%
Small Cap Growth	3.0%	3.0%	0.0%	5.5%	5.5%	0.0%	7.0%	7.0%	0.0%
International	15.0%	13.0%	-2.0%	20.0%	18.0%	-2.0%	24.0%	22.0%	-2.0%
Emerging Market	3.0%	3.0%		4.0%	4.0%		5.0%	5.0%	

Numbers in **bold black** indicate a tactical tilt higher than the benchmark. Numbers in **bold blue** indicate a tactical tilt lower than the benchmark. Blank fields indicate a value of zero.

Asset Class Definitions

(The definitions below are consistent with the asset classification used by the firm's Envision™ planning tool. Please contact your Financial Advisor for further information about this product.)

Short-term Fixed Income: Fixed Income instruments that mature in 1 to 3 years.

Intermediate Term Fixed Income: Fixed Income instruments that mature in 3 to 10 years.

Long Term Fixed Income: Fixed Income instruments whose maturities are longer than 10 years.

High Yield: Non-investment grade fixed income securities (rated Ba1 or lower by Moody's and/or BB+ or lower by S&P). *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.*

Emerging Markets: Financial markets in countries with developing economies. These markets are typically immature compared to those of the world's major financial centers, but are becoming increasingly sophisticated and integrated into international markets; they provide potentially higher returns but are intensely volatile. *Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility.*

REITs: Real estate investment trusts (REITs) trade on the major exchanges and invest in real estate directly, either through properties or mortgages. *There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.*

Large Cap Growth: Stocks that have a market cap greater than \$8 billion and a price-to-book ratio greater than 3.3.

Large Cap Value: Stocks that have a market cap greater than \$8 billion and a price-to-book ratio less than or equal to than 3.3.

Mid-Cap Growth: Stocks that have a market cap between \$1.87 - \$8 billion and a price-to-book ratio greater than 3.3.

Mid-Cap Value: Stocks that have a market cap between \$1.87 - \$8 billion and a price-to-book ratio less than or equal to 3.3.

Small-Cap Growth: Stocks that have a market cap less than \$1.87 billion and a price-to-book ratio greater than 3.3.

Small-Cap Value: Stocks that have a market cap less than \$1.87 billion and a price-to-book ratio less than or equal to 3.3.

The prices of small-cap and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Commodities: Basic goods used in commerce that are generally interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services. *Buying commodity based investments 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.*

Our Asset Allocation Model Benchmarks

Traditionally, asset allocation models have focused primarily on the needs of growth investors. We believe that our asset allocation models fill the gap by defining a more comprehensive set of client objectives. As a result, our new models include allocations specifically tailored for Income and Growth & Income objectives as well as Growth.

In the past, investors requiring cash flow have sometimes been encouraged to make systematic withdrawals from a growth-oriented portfolio. We think this can be dangerous because systematic withdrawal strategies are subject to significant risks in a volatile market environment. When asset prices decline, systematic withdrawal may result in selling at depressed prices, requiring the liquidation of a larger amount of assets to meet cash flow needs. Assets sold near market cycle lows will not participate when the market recovers. Repeating this process through several market cycles could

significantly erode portfolio value. Thus, investors may fail to meet their goals even if assets' average returns are close to expectations.

We believe that a growing number of our clients will need comprehensive income strategies in the coming years. Given the potential risks we perceive in systematic withdrawal plans, we believe that income clients should be able to use portfolio-generated interest and dividends to provide a significant proportion of their cash flow needs. Since we believe an income investor's optimal asset allocation is different from the optimal asset mix for a growth investor, we designed asset allocation models that are optimized for the specific needs of three different investor objectives:

Income: Income investors need the maximum amount of income given their risk tolerance from their portfolio and are willing to forgo a portion of capital appreciation and growth of income in order to seek maximum current income.

Growth & Income: Growth & Income investors need to receive current income, but they are equally concerned that income and capital grow over time. These investors are typically willing to forgo a portion of current income in order to provide for longer term growth.

Growth: Growth investors generally have little need for account income. These investors seek the maximum capital appreciation consistent with their risk tolerance.

We recognize that investors with similar investment objectives may have substantially different risk tolerances. Although all investments involve some degree of risk, including the potential loss of principal, some securities, such as emerging market equities and high yield bonds, have more risks than other alternatives. Higher risk investments have a greater potential for losses, but usually offer the potential for higher long-term returns. Investors with lower risk tolerance give up some of the potential for higher returns in exchange for lower risk. Investors with a higher risk tolerance pursue higher returns through investment in higher risk securities. Consequently, our new asset allocation models provide allocation recommendations for investors across three degrees of risk tolerance — Conservative, Moderate and Long-term — for each of our three investment objectives (Income, Growth & Income, and Growth).

Our asset allocation models are detailed in the table above. Moving left to right or down the table shows allocation recommendations with higher levels of portfolio risk and correspondingly higher levels of expected return.

Asset Categories

Traditionally assets were allocated between Stocks, Bonds and Cash. Since our models are tailored to better serve the needs of income-oriented investors with differing levels of risk tolerance, we segregated Traditional Fixed Income, which includes all investment-grade debt, from a new category called Alternative Income. Alternative Income includes Hi-Yield Debt, Emerging Markets Debt and REITS. These three assets classes offer greater income potential, but they also entail higher levels of investment risk. Historically, they have tended to have some degree of correlation with both the stock and bond markets, but are not closely correlated with either. Portfolios that require income and can tolerate greater risk have higher Alternative Income weightings in our models.

Tactical Allocations

Our model portfolio benchmarks incorporate our strategic capital market assumptions for each asset's five- to ten-year return and risk characteristics. Thus these benchmarks already reflect our strategic preference for stocks over bonds and small/mid caps over large caps. Against these benchmarks we make tactical tilts that reflect our current preference for certain assets.

Bill O'Grady

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The S&P 500 is an unmanaged, weighted index of 500 stocks providing a broad indicator of price movement. The Reuters-CRB Continuous Commodity Index is an unweighted geometric average of 17 individual commodity prices. Individual investors cannot directly purchase an index. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that these movements or trends can or will be duplicated in the future. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

Additional Information Available Upon Request

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