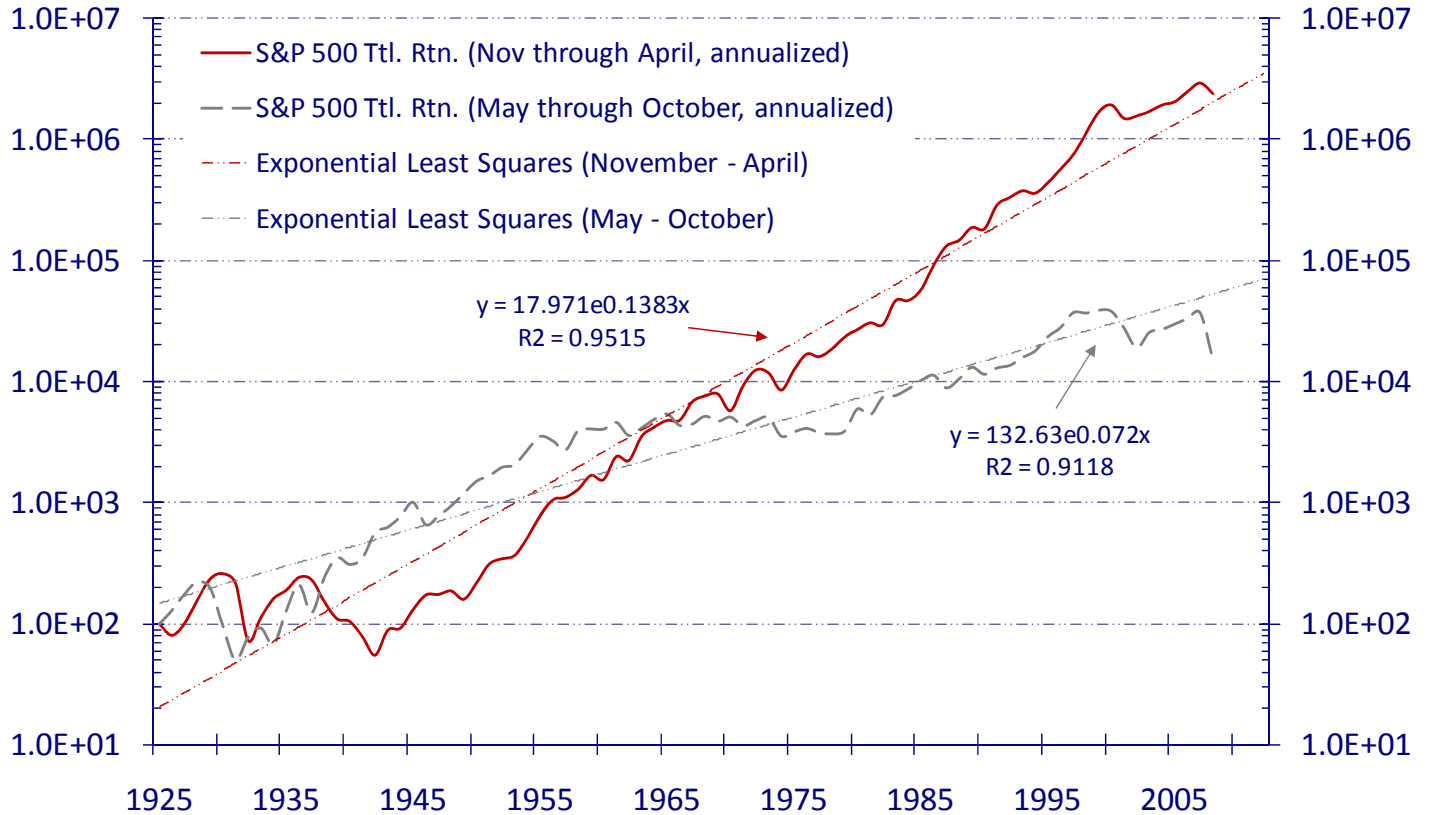


Looking Ahead to Better Returns

- As we approach the end of October, it seems likely that it will be remembered as one of the worst months for investment returns in modern history. At Friday's close, the Standard & Poor's 500 index has ceded one-fourth of its value in only 18 trading days, while indexes comprised of smaller domestic companies are off about -30%. These results come in the wake of already-substantial losses in recent months. Homebuilder stocks started to roll over in the summer of 2005, while banks, brokerage companies and a wide range of companies dependent on consumers' discretionary spending began breaking down about 20 months ago. While those key sectors were pointing the way to more difficult times ahead for the economy, other sectors – those dependent on rising commodity prices and continuing strength outside the US – were bucking the trend and masking the damage to the popular market indexes. Market weakness since the summer – and in particular, during the month of October – reflects the realization that US economic weakness has undermined prospects for growth around the world.
- Nor have international equities provided investors any safe haven; a developed markets index (MSCI's EAFE, representing markets in Europe, Australasia and the Far East) is lower by -30%, while a sister index based on 22 emerging markets has lost over -40% since September 30. Some international markets – like Japan – have been declining throughout 2008, because many key companies are dependent on discretionary spending by US consumers, while others – such as Russia – were posting all-time highs as recently as May 2008 ... pushed there by skyrocketing commodity prices, which have flamed out spectacularly of late.
- Bond investors, too, have suffered mightily in October. High grade corporate bond yields have risen about 1 percentage point (to around 8%) over the past month, while yields on lower quality bonds have risen even faster. One index we track shows the average hi-yield bond now offers a yield of 17.8%, up over 5 percentage points in October alone. Even municipal obligations -- one area that has proven to be relatively immune from defaults in prior cycles – are experiencing significant upward pressure on their yields. AAA-rated bonds maturing in 10 years are priced to yield 4.76%, according to Bloomberg. Meanwhile, the same group was yielding only 4.15% at the end of September.
- Of course, these increases in bond yields appear even worse when compared to Treasuries of similar maturity, whose performance has been boosted by a near maniacal (in our opinion) flight to quality. The 10-year US T-note was priced Friday to yield 3.68% to maturity, close to – or slightly lower than – its yield at the end of September. That resilience in the face of such widespread capital destruction may be partly the result of liquidity, but it seems clear that fears of rising defaults are responsible for the significant widening in spreads, a.k.a. risk premia.
- Why are investors being hurt so badly, and what are the prospects for some better times ahead? We agree with those who posit that interest rates were held too low for too long in the last cycle (2003-04), and were raised too slowly and too transparently from 2004-06. In 2002, most agreed with the need to lower interest rates during the last recession to the lowest in a generation; thus preventing two key sectors – housing and autos – from suffering sharp downturns ... as was typical during prior recessions. In our opinion, it is no coincidence that these are the areas of greatest economic weakness today.
- Human nature – the tendency to extrapolate recent returns and trends in volatility, combined with the willingness to employ excessive leverage in search of even higher returns – underlies current problems in the financial sector, in our view. At least one can take heart in the view that market no longer tolerates the same mistakes ... for now.

History Shows U.S. Equities Have Performed MUCH Better From November Through April



Note: Annualized total returns plotted on a log scale. Exponential regression formulae and R-squared statistics are shown. Source: Standard & Poor's.

Past Performance is no guarantee of future results.

We caution investors from putting too much faith in anyone's ability to identify the ultimate bottom for the market until after it occurs, nor do we subscribe to the view that one must be invested at the bottom else risk missing the bulk of the market's potential long-term return. We often hear some observers point out that most of the returns in the market are made in very few days, as if all one needed to do was to identify these key dates and be fully invested ahead of time. We believe investors should resist the temptation to shun stocks at current levels, and suggest those that have reduced their exposure should keep a sharp eye out for opportunities to reenter the fray.

One mystery of the market's long-term historical record is why have stocks performed so much better in the period from November through April than they have from May through October? Various theories exist that try to explain this "seasonal" investment phenomenon, sometimes referred to as the "Halloween indicator," which encourages investors to "Sell in May and go away ...," but only if they remember to come back into the market near the end of October. The above chart shows the performance of two theoretical portfolios: one (solid red line) was invested in the S&P 500 each year from 1926 through 2008 – ONLY from November through April – and the second (dashed grey line) was invested ONLY from May through October. The returns were annualized to make them comparable to a "buy and hold" portfolio.

One can easily see that the November-April portfolio strategy significantly outperformed the May-October portfolio (the compound trend growth rate is nearly twice as great for the former as compared to the latter ... see the statistics on the chart). The r-squared figures over 90% show the model has a very good fit with the historical data, while the coefficients immediately before the "x" approximate the compound annual growth rates for the relevant trend lines. What we believe is remarkable is how reliable this simple strategy has been over time, even decades after its existence has been noted by various observers. Some academic research published in 2001 found the same seasonal effect to be evident in 36 of the 37 different countries studied, and that UK equity returns seem to show the pattern is noticeable as far back as 1694. Is the existence of this pattern sufficient to become more optimistic? Probably not in isolation, but in combination with some of the other economic, valuation and sentiment indicators we follow, we believe this pattern provides further support for boosting equity exposure now.

Tom McManus

Important Disclosures and Disclaimers

The prices of small 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.

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 price of these bonds may be volatile, and they are generally only suitable for aggressive investors.

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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Additional Information Available Upon Request

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