The Week

WACHOVIA SECURITIES

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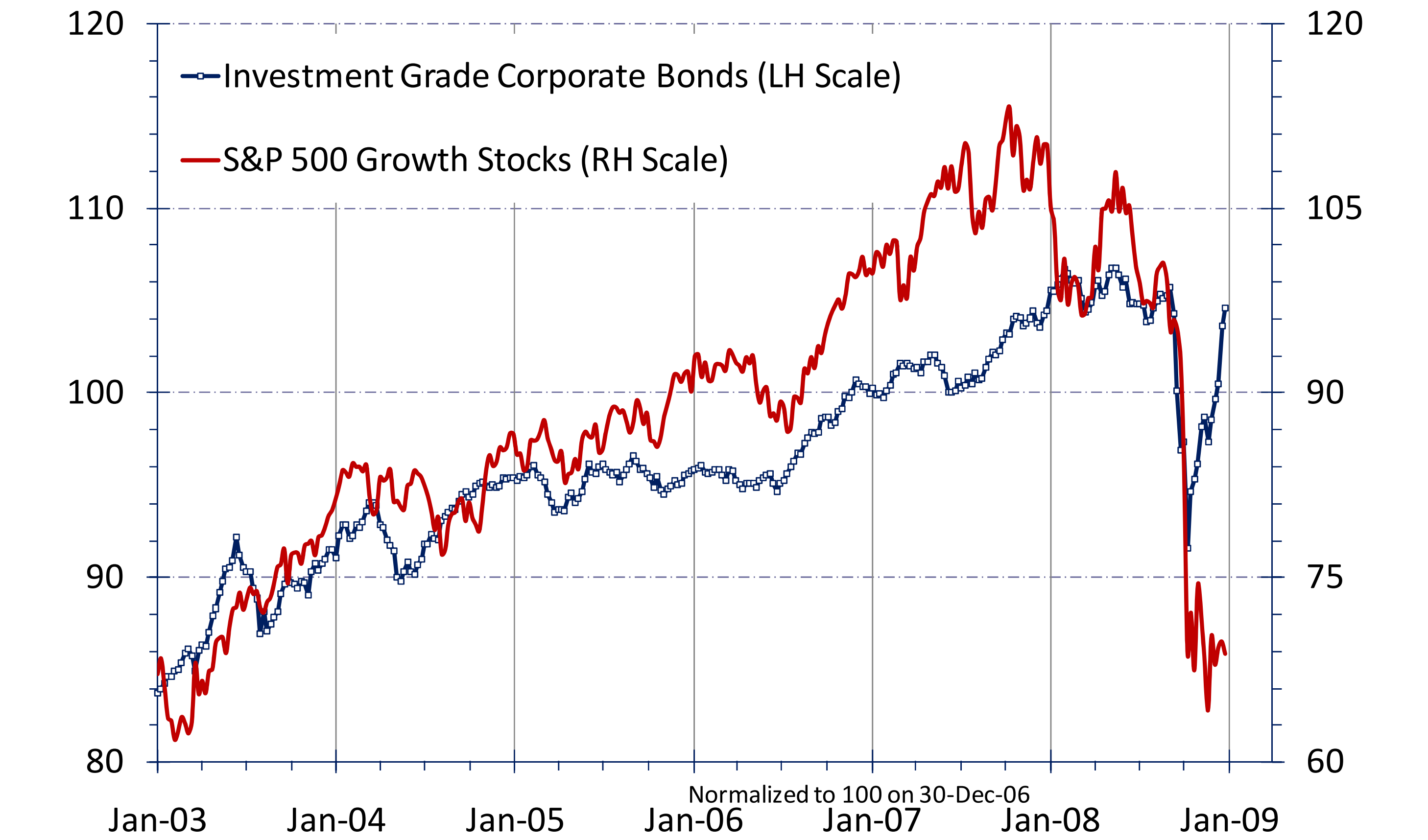
Large, Quality Growth Stocks are Good Value Now

- It was Will Rogers who used to say – when describing his investment strategy – that he was more interested in the return "of" his money than the return "on" his money. Well, it seems nearly everyone is heeding Will's advice now. Weak economic trends, an extremely easy money stance by the Federal Reserve and a flight to conservative investments have driven yields on U.S. government bonds to historic lows – levels that we consider unattractive for investors with an intermediate to longer-term horizon. One commentator recently quipped, "Treasuries usually provide savers with risk-free return, but at today's prices, they offer nothing but return-free risk." We agree.
- Despite the risks, yields may remain depressed in the short-term by the sheer weight of demand for a guaranteed "return of principal," offered by Treasuries even as more investors are expressing concern about the potential inflationary implications of the central banks' loose money policies atop a number of large spending packages around the world.

  *Guarantees apply to the timely payment of interest and principal if held to maturity. Yields and market value will fluctuate if sold prior to maturity so it is possible to receive less than your original investment amount.
- In the past few weeks, corporate bonds – especially those of higher (investment grade) quality companies have performed very well. The chart overleaf shows that a broad index of investment grade bonds lost almost −15% from the outset of September until mid-October. Since then, it has recovered all of its steep losses, and – including interest payments – is now just about back to where it started at the beginning of 2008.
- Stocks have not performed as well as bonds. We are confident, but not certain, that the U.S. economy will hit bottom sometime before the end of 2009, and the recovery will be slow and uneven. In this environment, a portfolio bias toward large, quality growth companies makes good sense, as earnings are likely to suffer less than more economically-sensitive sectors of the market, and the strength of the growth companies' balance sheets should help them weather the storms of even an extended credit cycle.
- Individual investors are not the only ones responsible for a "flight to safety." Institutions, too, feel an urge to reduce risk after their portfolios have declined. Today, South Korea's National Pension Service, the world's fifth-largest pension fund, announced that it would be reducing the portion of its assets dedicated to global equities, and increasing the portion allocated to bonds.
- We expect we will see more institutions shifting their asset allocation toward more conservative (bonds) and less risk (equity), as sponsoring organizations lash back at some of the more creative strategies (hedge funds, among other alternative investments) employed in the past decade, and force adoption of a more conservative approach. Hedge funds are losing assets to redemptions and also losing access to sources of cheap funding that they utilized to magnify their returns.
- Despite these anticipated shifts, we think individual investors should view their allocation to large capitalization quality growth stocks as the "core" of their equity strategy now. The defensive nature of well-established growth businesses, their low debt load and exposure to global markets are all key to long-term success. Stocks in this category are attractively valued when compared to "lower-risk assets" like Treasuries and also when compared to "conservative assets" like corporate bonds issued by the same companies. Their dividend payouts are less subject to cuts or elimination than more cyclical companies. The next step would be to add some smaller companies to the portfolio, but we have a preference for growth over value there, too.

  * 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.
- Investors who have more confidence in a quick rebound for the U.S. economy should consider a more aggressive equity portfolio mix, including value equity, international developed and emerging market stocks, in our view. * 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.

The Investment Grade Corporate Debt Market Has Recovered All of Its Third Quarter Loss, But Large Capitalization Quality Growth Stocks Are Still Languishing Near Their Lows



Note: Indexes are shown on separate scales to enhance the comparison/contrast of their performance. Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Source: Financial Industry Regulation Authority, Standard & Poor's.

Investors increasing their allocation to corporate bonds should be careful about the benchmarks and portfolios they use, in our opinion. The investment-grade universe of liquid bonds is dominated (more than 55%) by the financial sector, and while many of these companies now enjoy a federal guarantee on their new issues, many of their bonds already reflect that backstop. Meanwhile, another 25% is in bonds of media, telecom and consumer cyclical businesses, which are not as well-positioned in a difficult economic environment as the established growth companies we prefer. That leaves only 20% of the universe in technology, health care, staples, energy, utilities, industrials and materials. By contrast, those 7 sectors comprise 87% of the S&P 500 growth index, leaving only 13% in financials, telecom and consumer cyclical companies.

Of course, equity can be wiped out in the case of a default and thus equity holders must be compensated for the risk of total loss. But a number of the companies that comprise the growth index have little or no debt, so there is no active market in protecting their debt against default. Meanwhile, prospective earnings yields are a good deal higher than company bond yields (where they exist). In some cases, even the dividend yields[2] are higher than a 5-year debt proxy.

Tom McManus