

The Week

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Worth noting

- Long-term investors need to focus on developing trends and opportunities in order to invest successfully and work toward their financial goals.
- The new Wells Fargo Advisors' forward-looking 2010 capital market assumptions show that investors should expect lower returns and less volatility than last year's CMAs.
- Moreover, new strategic asset allocations are less defensive and more diversified than last year's recommended portfolios.
- We expect deleveraging, divergence and differentiation will be the long-term trends that impact inflation and investment returns in coming years.

New 2010 Capital Market Assumptions and Strategic Asset Allocations

Successful investing requires evaluating new trends that are likely to affect the economy and the markets going forward. The new CMAs are forward-looking expectations based on long-term asset relationships, known as the building block approach, rather than return-to-historic-trend projections. History can be a useful guide, but the world is changing faster all the time. Therefore, it is more important today for the capital market assumptions to reflect developing trends, not old trends.

The global economy and the financial markets have been through a very difficult period since the financial crisis hit in 2008. Businesses and consumers are adjusting to this new environment by deleveraging and spending more cautiously. This hurts the economy in the short run but sets the stage for healthier, although slower, economic growth over the long run. The United States still faces many problems, including big government deficits and high debt levels that are likely to lead to higher taxes and moderate economic growth in the future. We expect American companies to adapt to this changing business climate and benefit from faster economic growth in other parts of the world.

The good news is many countries are not facing the same debt problems confronting the United States and several European countries. Consequently, this divergence of economic conditions will likely create new global investment opportunities. The new strategic asset allocations are more diversified than last year, including larger allocations to international markets. Specifically, several of the new recommended allocations include a greater weighting to foreign-developed debt and emerging market equities, while recommending less concentrated positions in large-cap U.S. equities, high-yield debt and emerging-market debt.

Last year's CMAs were derived during the depths of the financial crisis when the financial markets were deeply depressed and volatility was substantially above the long-term rate. The new capital market assumptions reflect lower expected returns in a less extreme economic environment than during the past few years. We expect volatility to be lower because cautious consumers and investors will not want to repeat the mistakes of overleveraging and mispricing

risk like they did during the years leading up to the financial crisis. In addition, policymakers are likely to enact measures that are designed to avoid a repeat of the crisis. All capital market assumptions are estimates. No one knows for sure what will happen in the future. Nevertheless, we expect volatility of asset returns to be closer to the long-term rate during the past forty years, rather than the extremely high volatility of the past few years.

The new CMAs also incorporate our view that interest rates are currently near a secular low and are likely to rise modestly during the next 10-15 years. Therefore, the strategic asset allocations have heavier weightings for intermediate fixed-income assets than long-term fixed-income assets. Looking ahead, we expect inflation will average 2.5% during this period because efforts to pay down private debts as well as government efforts to reduce the deficit through increased taxes and/or spending cuts will probably dampen economic growth, keeping inflationary pressures moderate. Inflation is often caused by easy credit, allowing people to live beyond their means. We do not expect consumers and businesses to take on debt and spend more than they earn, like they did during the past decade when inflation started to rise and home prices soared to unaffordable levels. Instead, tempered spending is likely to keep inflation relatively moderate.

The United States faces many challenges including higher taxes, more regulation, and stiff foreign competition. But American businesses have adapted to similar problems during the past and still increased profits. We believe that flexibility and innovation will keep American businesses competitive and profitable, despite the hurdles ahead. Therefore, we expect the long-term upward trend in U.S. corporate profits to continue. Investors are very cautious and pessimistic now, creating attractive valuations for equities, both here and overseas. Therefore, returns are less likely to disappoint even though they are likely to be moderate.

In summary, the new 2010 CMAs are more moderate, expecting lower returns and less volatility than the 2009 assumptions. In addition, the new strategic asset allocations are less defensive, more diversified than the 2009 allocations recommended during the extreme uncertainty of the financial crisis. We expect deleveraging will restrain spending in the United States. However, not all countries are going to experience the same problems. Therefore, a larger international allocation may allow investors to take advantage of developing trends in the rapidly changing global economy.

Strategic allocation

	Average return	Downside risk *
Conservative income	5.0%	-1.5%
Moderate income	6.2	-3.2
Long-term income	6.9	-5.2
Conservative growth & income	6.8	-4.1
Moderate growth & income	7.8	-7.1
Long-term growth & income	8.8	-10.4
Conservative growth	8.3	-8.3
Moderate growth	9.1	-11.0
Long-term growth	9.7	-12.8

The Average return is an estimate over the next 10 to 15 years.

**The return threshold that one would expect returns to fall below only once in 20 years (5% probability); The average returns above are estimate returns over the next 10-15 years.*

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- Diversification does not guarantee a profit or protect against loss.
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- 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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