Asset Allocation

Adjusting Our Cash Reserve

Background

We proactively manage our recommended asset allocation based on our perspectives on current market conditions and our outlook for the period ahead. Last summer, global risks grew as the European sovereign debt crisis intensified, the U.S. government was on the verge of shutting down, Standard & Poor's downgraded the U.S. credit rating for the first time in history, and the global economy appeared to be moving toward a broad slowdown.

At that time, we increased our cash position, which proved protective as markets swooned from June to September. It hindered our results, however, in the October market rally.

Outlook

Now we see several reasons to increase our exposure to equity markets — where stresses and uncertainties are allowing investors to find compelling opportunities — and several reasons not to.

On the side of deploying our cash position are the following three main factors:

- Newly elected "technocrats" in Greece, Ireland, Italy, Portugal, and Spain are taking some needed steps, including raising retirement ages and bolstering tax collection. Moreover, Mario Draghi, the new head of the European Central Bank, has cut interest rates twice since assuming leadership and has adopted non-standard methods of pumping liquidity into the system. In our view, this substantially reduces the probability of the euro zone collapsing.
- Improvements in U.S. economic data, including jobless claims, purchasing manager surveys, and new home traffic, suggest the U.S. economy will grow modestly in 2012.
- Equity valuations are reasonable, especially versus bond yields.

Yet challenges remain:

- The European crisis is far from over, as evidenced by elevated bond yields in Italy and Spain, as well as the large deposits banks are placing with the central bank instead of with each other.
- U.S. fiscal problems require meaningful action to reform entitlement programs, the defense budget, and the tax code — none of which will be easy.
- Greater global growth is needed to solve the sovereign debt problems on both sides of the Atlantic. Recent data, though, suggests many of the major countries outside the U.S. will struggle in 2012, with Europe and Japan likely slipping into recession and emerging-market growth falling short of prior targets.

We will share more information about our outlook in the upcoming *Quarterly Investment Perspective*, which we will publish later this month.

Action

We believe it is not a time for bold directional moves given the heightened level of uncertainty today. Instead, we have decided to gradually deploy our cash reserve into both growth-oriented and defensive strategies. Although it's likely that one approach or the other will do well this year depending on market conditions, it's unlikely that they both will.

Growth. We are increasing our equity exposure in Large Cap Core, our portfolio designed to deliver strong returns with less volatility than its benchmark. Until now, this portfolio has held our cash reserve. However, we are finding attractive opportunities in companies whose share prices don't fully reflect the strengths we see, whether because their assets are undervalued, markets haven't recognized a business turnaround, the company is experiencing an overlooked cyclical recovery, investors are excessively pessimistic, or the companies' franchises are underappreciated.

Defensive. We are shifting some cash into Global Opportunities, which has defensive growth strategies such as high-yield bonds, convertible bonds, and covered calls (an options strategy that involves buying a stock while simultaneously selling someone the right to buy it from you at a certain price). These types of investments typically offer investors more protection than stocks during downturns.

We are also building a small position in 30-year Treasury bonds. Although we generally find the low yields on these bonds less attractive than the return potential of equities, long-dated Treasury bonds provide higher yields than cash and will likely appreciate if fear escalates. The risk to this position is that global conditions improve and yields move higher, causing the value of the bonds to decline. However, in this case, equities and other growth-oriented assets will likely perform well. Any potential loss from this investment is essentially the cost of hedging against deteriorating market conditions.

Overall Positioning

These moves are consistent with our overall approach of balancing a mix of defensive and growth-oriented strategies within our Balanced Growth portfolio (Exhibit 1). A higher-than-normal 42% of the portfolio is allocated to high-quality bonds, cash, currencies, and credit investments. At the same time, we have 46% of Balanced Growth in equity and commodity markets, as well as 12% in hedge funds.

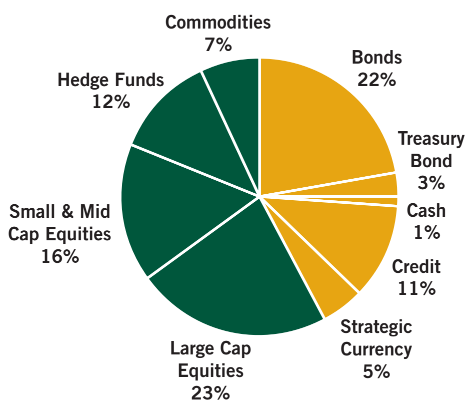
We believe this positioning will provide protection if fundamentals deteriorate while offering upside participation if risk aversion moderates.

Additional information is available from your client account manager.

Exhibit 1: A Balance of Protection and Growth

Growth Attributes

- Underweight high-quality bonds
- Overweight industrials, consumer discretionary, materials
- Exposure to commodities and hedge funds



Protective Attributes

- Overweight credit/ underweight equities
- Emphasis on lower-volatility equities
- Underweight financials
- Long Treasury bond exposure
- Underweight euro

Reflects pro forma Balanced Growth allocation.