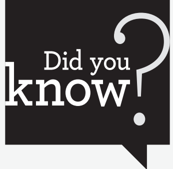
January 2013

Ten things investors should know today



1. The stock market is up over 100% since the recession ended in 2009.
2. Fixed income carries higher risk than usual.
3. The U.S. economy continues to grow.
4. Municipal bankruptcies are not widespread.
5. Successful market timing is seldom a viable strategy.
6. International markets are improving.
7. It's never too late to start saving for retirement.
8. Cash is expensive.
9. Asset allocation is critical.
10. Diversification is key.

It's true for all of us: Our perception influences our decisions. However, what we perceive isn't always what's really going on. Today many investors seem to be acting based on their perceptions of what's happening in the economy and the markets, but those notions don't necessarily match up with what our top strategists are observing in the markets and economy. On the following pages, our goal is to set the record straight on 10 issues that we believe are critical for investors to understand. Intelligent planning and investing are essential for investors to realize their financial goals.

Together we'll go far

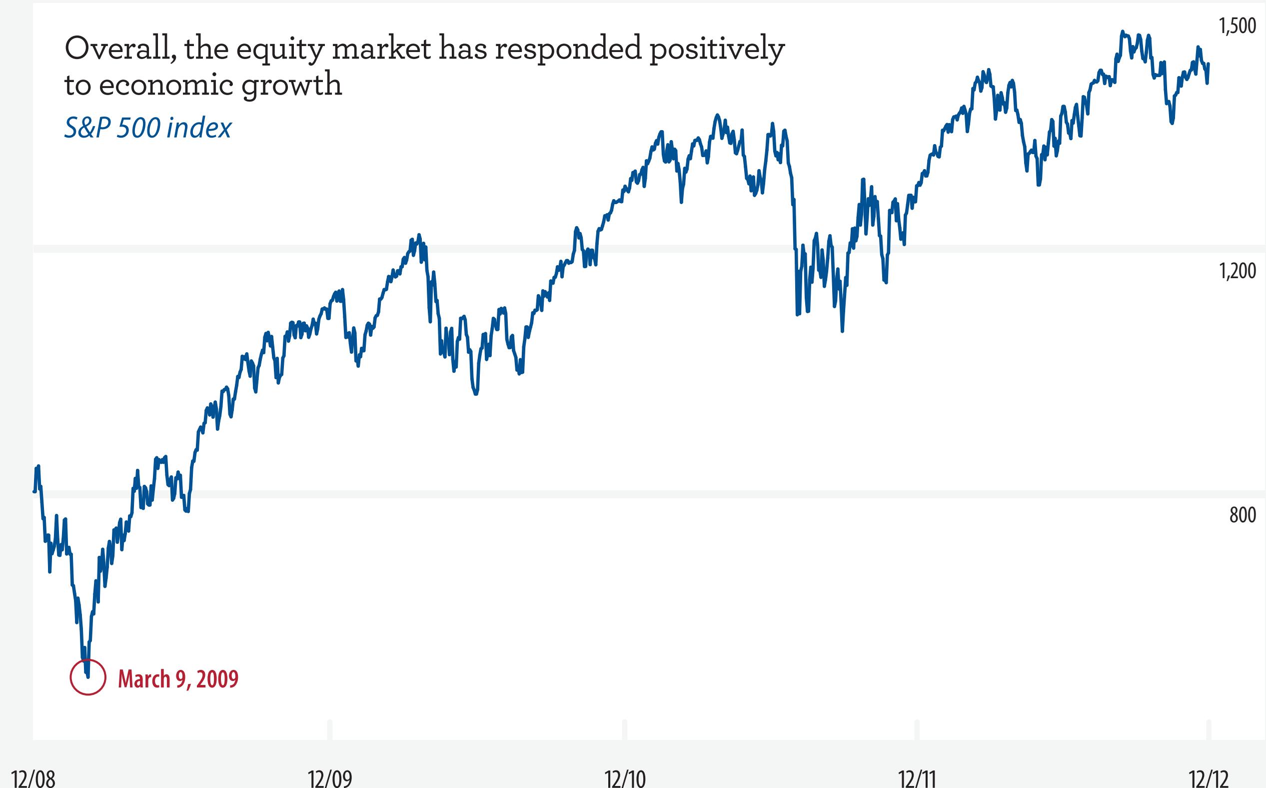
The stock market is up since the recession ended in 2009

However, fearful investors have flocked from equities

Investors have remained fairly cautious, particularly in light of uncertainties related to the Fiscal Cliff. However, the stock market has been responding favorably to modestly positive domestic economic growth and Federal Reserve liquidity efforts. The S&P 500 index, on a total-return basis,* was up 16.0% in 2012 and nearly 129% since the March 9, 2009, low (as of December 31, 2012). For months now, we have seen better market breadth as well as a lean toward more cyclical (or economically sensitive) stocks (relative to defensive stocks), which is typically an indication that investors are anticipating better economic growth.

Markets are not a one way street. Many investors seem to be acting as though the stock market has been stumbling, but that simply isn't the case. We continue to believe that one of the best ways for many individuals to accumulate wealth over time is through having an appropriate asset allocation (investment mix) that includes allocations to stocks.

History tends to show that the most attractive periods for investors to acquire stocks often occur during periods of fear and uncertainty and when stock valuations appear attractive. Looking ahead, we continue to see opportunity for the stock market to move higher and forecast a year-end 2013 target range for the S&P 500 of 1,525 – 1,575. We believe investors should continue to accumulate stocks and use market pullbacks as more aggressive buying opportunities.



*Total return takes into consideration capital gains or losses as well as dividend or interest income.

Source: Bloomberg and Wells Fargo Advisors

Fixed income carries higher risk than in the past

But investors still gravitate toward fixed income as a potential safe haven

Fixed-income investments have performed well both recently and over the longer-term. Strong positive returns have been fueled by lower rates, which are near historically low levels. After 30 years in which interest rate trends provided fixed-income investors with a strong tailwind, rates do not have much further to fall. Unfortunately, we continue to see many investors chasing past performance, continuing to purchase longer-term fixed-income positions and locking in historically low income streams for significant time periods.

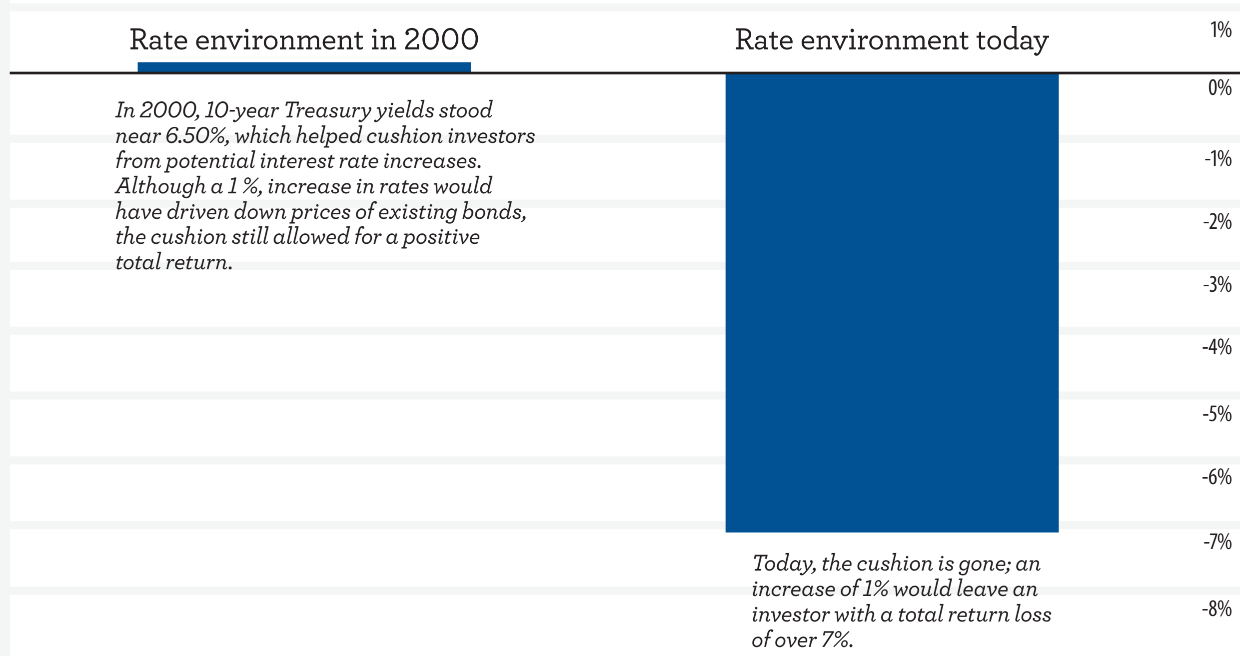
The Fed recently announced it will purchase additional long-term Treasury securities at a pace of $45 billion per month. This is in addition to the ongoing monthly purchases of mortgage-backed securities (MBS) at a pace of $40 billion per month.

The Fed continues to dominate the fixed-income landscape, and should continue to do so through most of 2013. We would be very cautious about locking in a long-term fixed-income stream for a significant time period while the Fed is undertaking policy actions that could be inflationary over the long term. Should the Fed fail to effectively control future inflation, investors will see a significant decline in the purchasing power of a fixed-income stream.

We anticipate that interest rates will remain at low levels in the near term; investors purchasing longer-dated bonds will face an investment horizon that may include significantly higher yields, which would negatively impact existing bond prices. It is important that investors not become complacent as the timing of significant rate moves often takes the market by surprise.

Fixed-income securities have lost their cushion against rising interest rates

Hypothetical one-year total return of 10-year Treasuries if interest rates increase by 1%



Source: Wells Fargo Advisors

The U.S. economy continues to grow

Although investors remain pessimistic

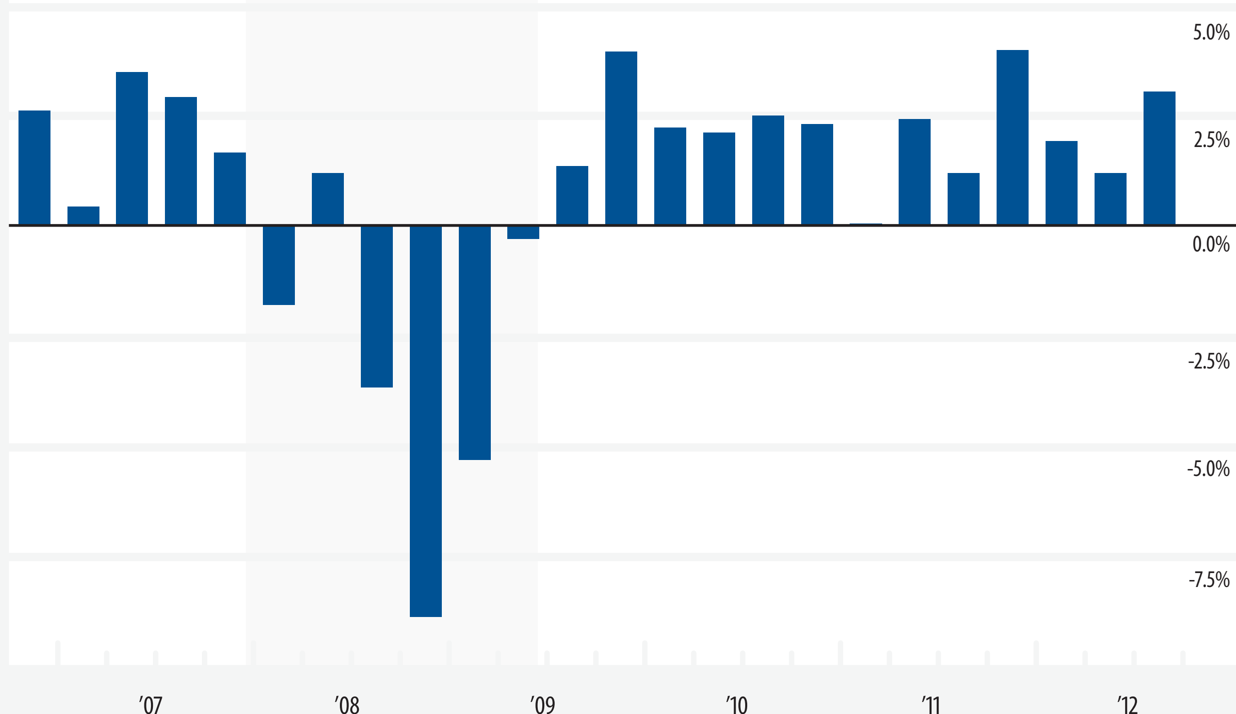
For most of 2012, investor sentiment was poor. Investors turned defensive as they dealt with uncertainties, such as the elections and the Fiscal Cliff. We believe it is good that investors are somewhat worried about potential market volatility ahead of uncertainty because that means they are generally discounting what could go wrong and are less likely to be surprised if events do not go smoothly.

What many people fail to realize is that, although it has been at a slow pace, the U.S. economy has been in recovery mode for over three years and is actually doing modestly better. While gross domestic product (GDP) — the value of all the products and services the economy produces — expansion has been roughly half of the average of the last 10 recoveries, the economy still continues on an upward path.

We have already started to see some rebound in the housing and auto markets, and there continues to be room for more expansion if job growth continues through 2013. In addition, consumer confidence has made meaningful progress over the course of the last few years. Looking ahead, we continue to believe the underlying fundamentals for the economy remain positive.

The economy has grown — albeit slowly — since the fourth quarter of 2009

Gross domestic product growth, 2006 – 2012



Source: Bureau of Economic Analysis/Haver Analytics, Wells Fargo Advisors

Municipal bankruptcies have been few

They are not widespread as some investors may believe

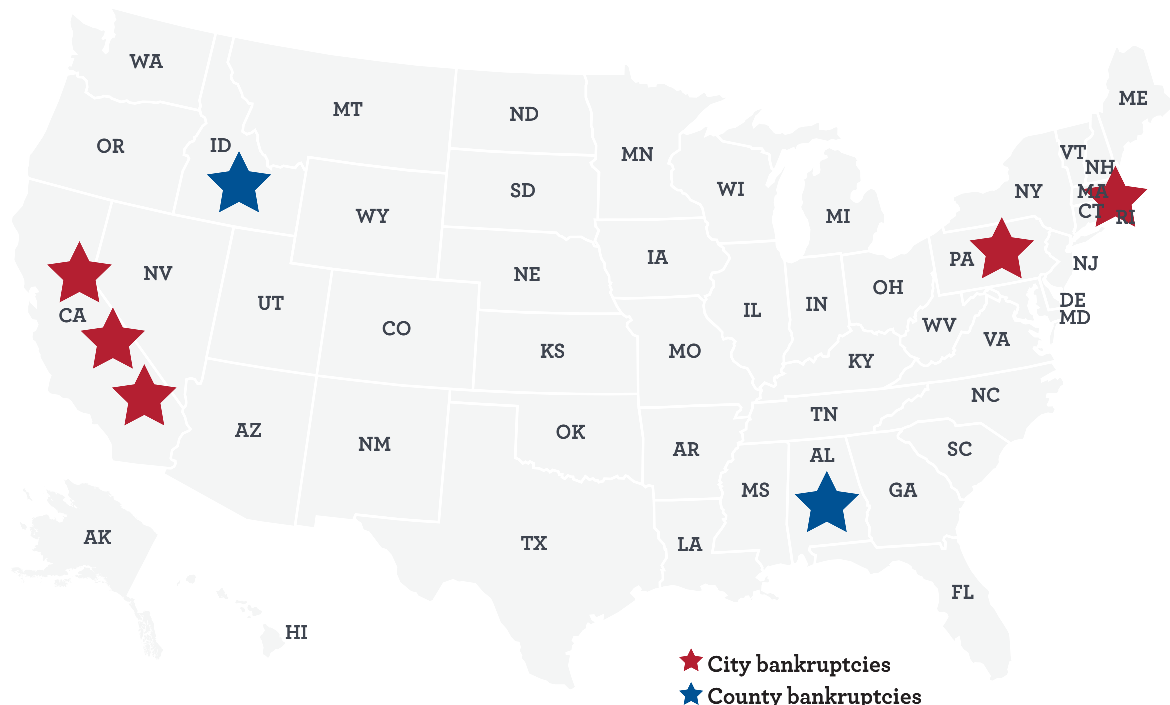
Municipal bankruptcy filings in 2012 have raised some concern among investors. Although this might appear to be a trend, we believe that municipal bankruptcies will continue to be a rare event. Since 1937 (through December 2012) there have been 640 municipal bankruptcies, or 8.5 per year on average. Of those, many were utility districts. More recently, there were three bankruptcy filings by cities or counties in 2011 and four in 2012.

There has been a concern in light of the recent handful of California municipality filings that bankruptcy might turn out to be a common tool to allow issuers to break contracts and default on debt. However, we note that a Chapter 9 bankruptcy filing requires an issuer be insolvent and a significant level of bondholder acceptance for court approval of any plan the issuer presents. In other words, declaring bankruptcy is not as easy as simply filing paperwork and walking away from debt and other obligations.

Bottom line, municipal bankruptcy is a time-consuming, expensive process that does not necessarily yield the results a municipality might hope for or expect. We do not believe that recent municipal bankruptcy filings in states such as California point to a developing trend of mass municipal bankruptcies.

U.S. municipal bankruptcies continue to be rare and have been concentrated in a few areas

January 2011 – December 2012



Source: Wells Fargo Advisors

Successfully timing the market is difficult

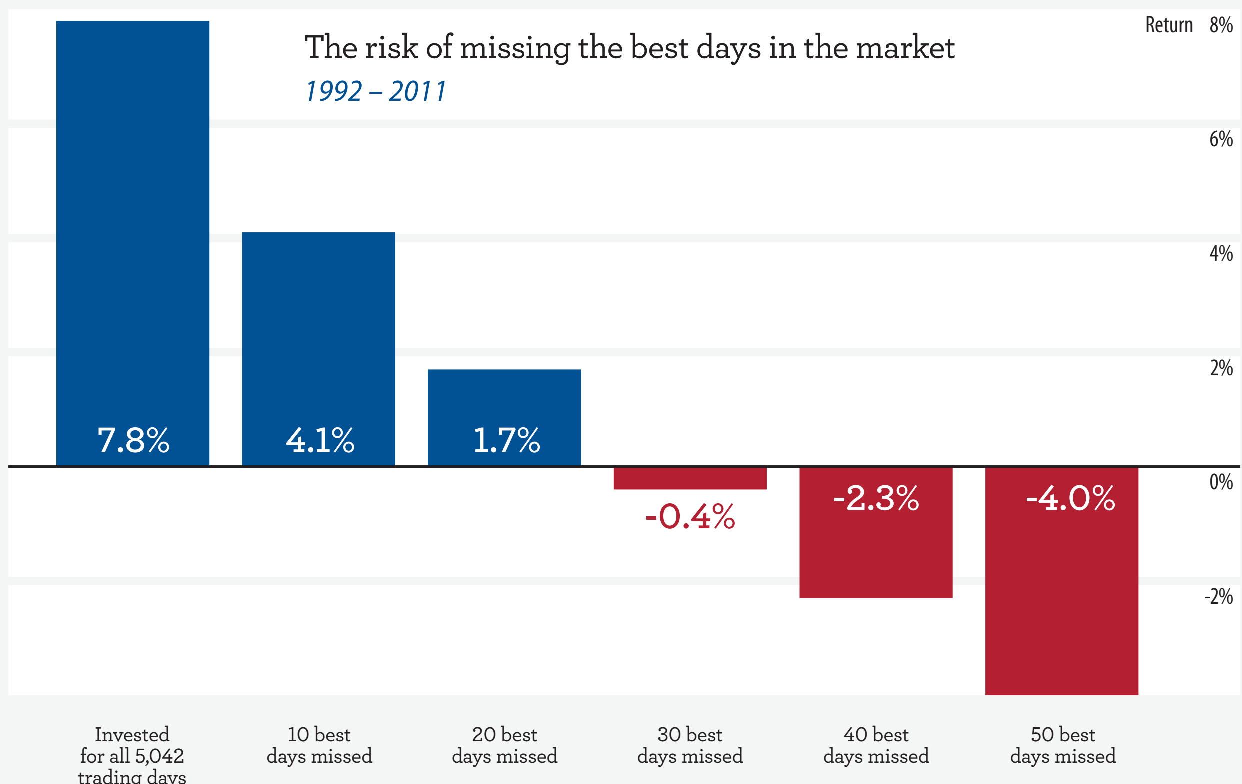
Although investors find it tempting

Poor-performing and/or volatile markets often tempt investors to just pull out of stocks completely. But then what? When do you invest again? Other investors with cash may sit on the sidelines waiting for the market to go down before investing at all. But how low does the market have to go before you finally jump in? What if the market continues to climb?

We all know market action is difficult to predict and the unexpected can happen at any time, moving the market significantly in either direction. In our opinion, an investor should not spend his or her time trying to predict short-term market swings. Market timing involves two independent decisions: when to get out of the market and when to get back in.

The odds of even the most seasoned investor accurately predicting when to do both with any reasonable regularity is very small, in our opinion. Therefore, we believe the risks associated with trying to time short-term market moves far outweigh any potential benefits. In fact, as the chart below illustrates, the portfolio impact of being out of the market (not invested) for just a few of the market's best days can be significant.

Investors should look past short-term market swings, focus on the longer-term picture and maintain a well-diversifed portfolio.



Source: ©2012 Morningstar,® Inc. All rights reserved. This hypothetical illustration is based on the Standard & Poor's 500 index with dividends reinvested over the 20-year period between 1992–2011. This example does not include fees or commissions. Past performance is no guarantee of future results. This chart is for illustrative purposes only and is not indicative of the performance of any specific investment. An investor cannot invest directly in an index.

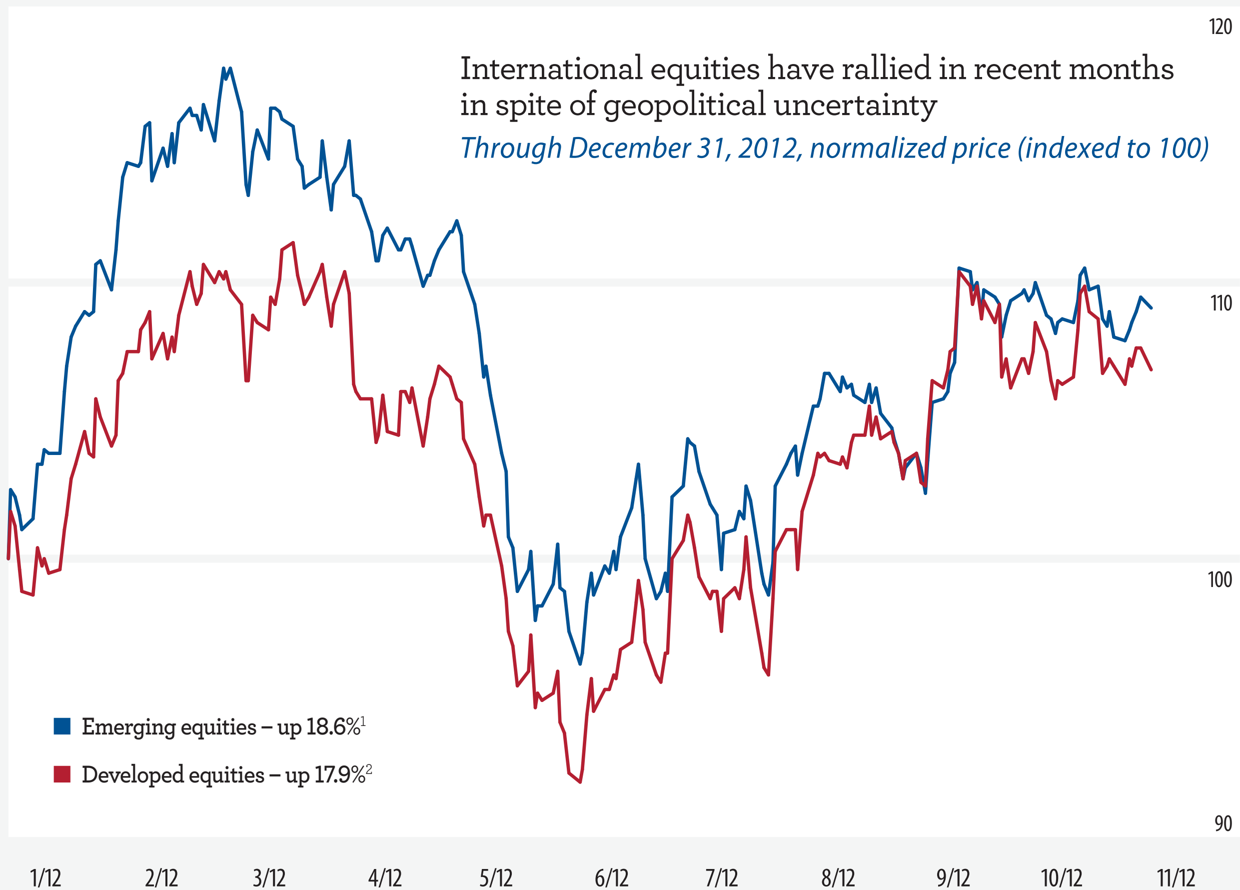
Returns and principal invested in stocks are not guaranteed. Holding a portfolio of securities for long-term does not ensure a profitable outcome, and investing in securities involves risk of loss.

International markets continue to slowly improve

Despite all of the turmoil overseas

There have been plenty of international issues to worry about over the last three years, given the European debt crisis, unrest in the Middle East and problems in China to name just a few. However, international markets generally improved in the second half of 2012 and were up double-digits for the year. Positive catalysts, including further stimulus by U.S., European and Japanese central banks, are largely responsible for these moves.

In the near-term, we maintain our cautious international approach as markets have rallied and investors have grown complacent. This leaves markets and investors vulnerable to disappointment as uncertainty will be heightened in the near term around issues such as U.S. debt, ongoing fiscal discussions in Europe and the Chinese leadership transition. However, we see international markets continuing to trend higher longer-term as economic growth in the developed markets stabilizes and economic growth in emerging markets accelerates.



Source: Bloomberg and Wells Fargo Advisors

Data sample: Daily, from December 31, 2011, through December 31, 2012. Indexed to 100 on December 31, 2011.

[1]Morgan Stanley Capital International (MSCI) Emerging Markets Index

[2]Morgan Stanley Capital International (MSCI) Europe, Australasia, and Far East Index

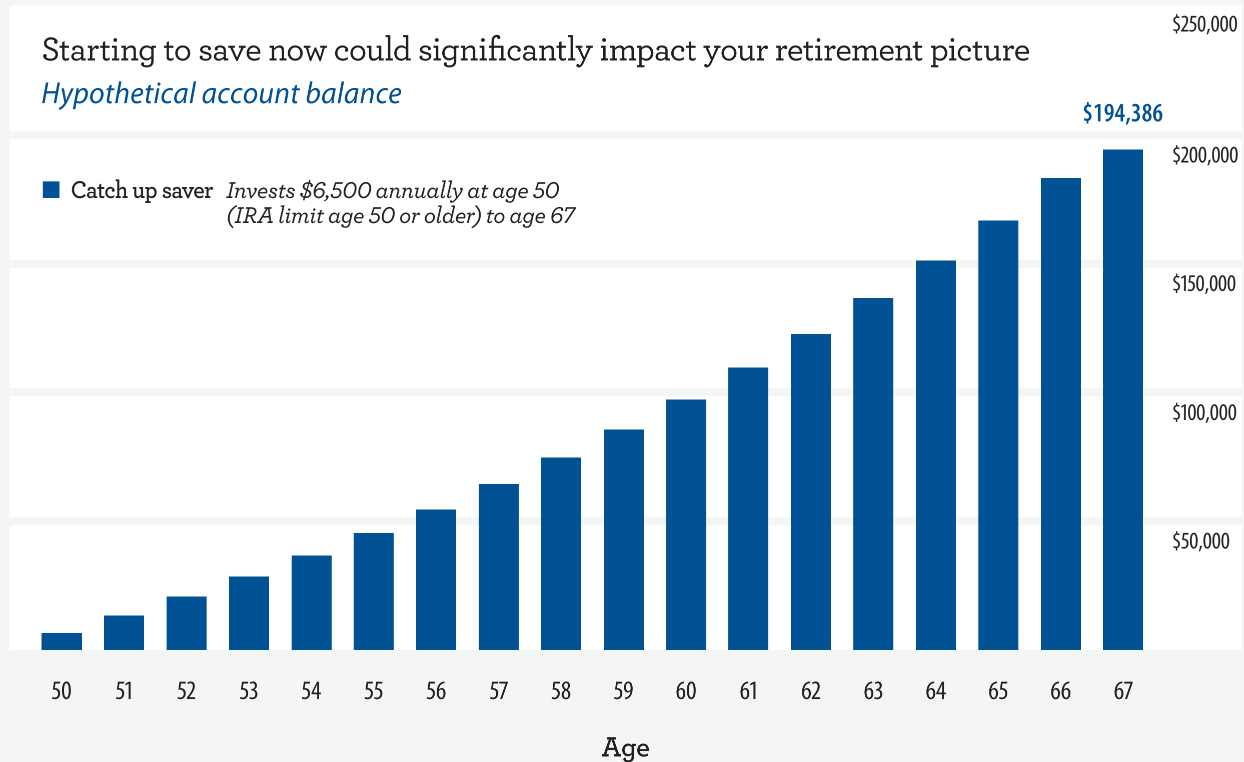
It’s never too late to start saving for retirement

Even starting at age 50, you can accumulate a significant amount

In the 2012 Wells Fargo Retirement Study, Americans ages 25 to 75 with 2011 household investable assets of $100,000 to $250,000 had a median $150,000 saved for retirement. This figure is 30% of the $500,000 respondents estimated they would need in retirement. Without other sources of retirement income, and with the rising cost of out-of-pocket health care expenses in retirement, the actual amount needed to fund retirement could be more.

The key to getting more from your money is to start saving reasonable amounts as soon as possible to take advantage of the value of time and the potential power of compounded returns. You’ve put the kids through college, and the nest is empty (at least for now). It’s time to catch up on your retirement savings.

The “catch up” saver in the graph below invests his or her annual IRA contribution amount plus the catch-up amount (currently $1,000 for those age 50 and older) beginning at age 50 up to age 67. The catch-up saver in this example adds $194,386 to his or her retirement balance just in the final working years leading up to retirement. If you can also contribute to an employer-sponsored plan [such as a 401(k)], you may be able to significantly boost the amount you accumulate for retirement.



Source: Wells Fargo Advisors

*Assumes a 6% compounded growth rate. For illustrative purposes only, chart is not reflective of the performance of any particular investment and does not take the effects of taxes into consideration, nor is it indicative of future results.

Holding cash can be costly

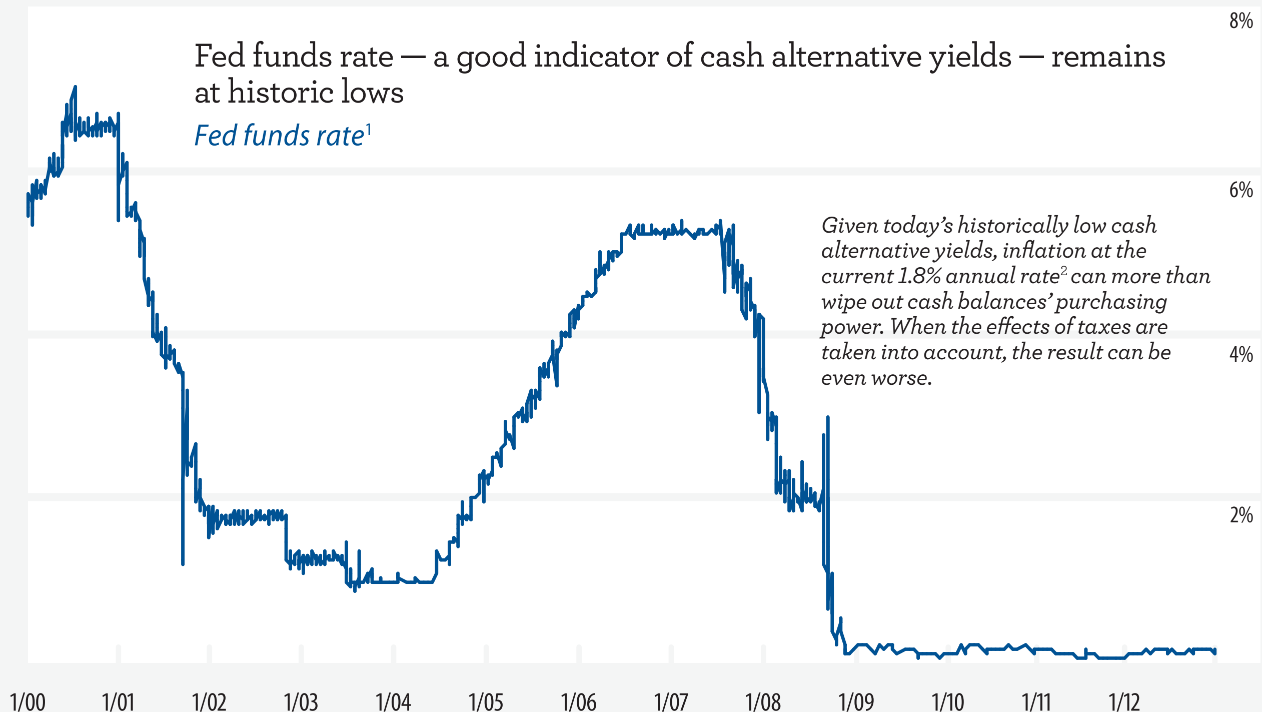
But few investors consider impact of low returns and inflation

Until late 2008, investors historically enjoyed a reasonable return on cash balances. However, this value proposition has changed. Investors, fearful that we are destined to repeat 2008, continue to build cash alternative balances. This strategy is potentially more costly than you might think.

If you look at almost any other investment sector over the last three years, you will find that performance has been strong with positive returns almost across the board. By holding cash, not only are investors potentially missing out on strong investment returns (opportunity cost), but cash alternatives has turned out to be one of the more expensive assets.

Most cash and cash alternative investments provide little if any return in the current environment. Furthermore, there is the potential erosion of purchasing power due to the impact of inflation. And this potential cost (erosion of purchasing power) is anticipated to increase in the future as the Fed attempts to support the economic recovery, which may fuel inflation.

Finally, given that the return on most cash alternatives is in some way tied to Fed policy and the Fed has indicated it plans to keep rates exceptionally low **at least** as long as unemployment remains above 6.5%, and inflation one to two years ahead is projected to be no more than 2.50%. We are unlikely to see such an environment before mid-2015. As a result, investors should not expect cash alternative yields to improve in the foreseeable future. So unless cash is necessary to meet near-term liquidity needs, we would not overweight this asset class in today's environment.



Source: Bloomberg and Wells Fargo Advisors

[1]Rate banks charge each other for short-term loans.

[2]Year-over-year change in the consumer price index (CPI) as of November 2012.

Asset allocation is critical

A majority of investment returns often comes from asset allocation alone

A 1986[1] study set out to determine which investment decisions (investment policy, timing, security selection, etc.) had the greatest impact on total return and variability of returns for 91 large pension funds from 1974 to 1983. The study found that strategic asset allocation determined 93.6% of the variability of returns. A follow-up study in 1991[2] produced similar results (91.5%), indicating the importance of setting a strategic asset allocation investment policy and sticking to it.

Wells Fargo Wealth Management conducted a similar study[3] and also found that asset allocation tends to explain the majority of the variation of returns. Its findings indicated asset allocation accounted for an average of 78.7% of the variation of returns over a 38-year period from 1970-2008 with other factors, such as timing and security selection, accounting for the remainder.

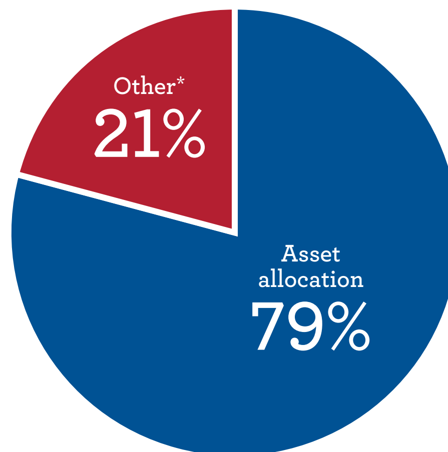
Asset allocation can be an effective way for investors to balance a portfolio among various types of investments. The key is to determine the right mix of investments based on an investor's risk tolerance and investment objectives. Wells Fargo Advisors offers nine asset allocation models that range from conservative income to long-term growth for our Financial Advisors to use with investors as a starting point for creating an asset allocation strategy.

[1] *Brinson, Gary P.L.; Hood, Randolph; and Beebower, Gilbert L., "Determinants of Portfolio Performance,"* Financial Analysts Journal, *Vol. 42, No. 4 (July/August, 1986), pp. 39-48*

[2] *Brinson, Singer and Beebower,* Financial Analysts Journal, *May/June 1991*

[3] *Wells Fargo;* The Journal of Wealth Management, *Vol. 8, No. 3, "Strategic Asset Allocation and Other Determinants of Portfolio Returns," August 2005, data updated February 2010*

Key drivers of investment return variability



Source: Wells Fargo; *The Journal of Wealth Management*, Vol. 8, No. 3, "Strategic Asset Allocation and Other Determinants of Portfolio Returns," August 2005, data updated February 2010

*Includes factors such as timing, security selection, etc.

Diversification is key

Managing risk and return requires planning

A significant part of developing an asset allocation strategy is having a diversification plan. Diversification does not prevent losses but spreads out investment capital to help reduce the effect of a loss in a single market. Let's look at an example for the 2008–2009 time period using a sample diversified portfolio invested in 40% U.S. stocks[1], 45% domestic fixed income[2] and 15% international equities/debt[3]. The S&P 500 was down 37% in 2008, then rebounded and was up 26% in 2009. For this same time period, this diversified sample portfolio would have been down 21.50% in 2008 and up 19.56% in 2009. So while a diversified portfolio may not give you the highest absolute return in a given year, it most likely won't give you the biggest loss either. Diversification is a strategy designed to work over time to reduce the tendency of a portfolio to make extreme moves, whether down or up, so that investors can focus on making progress toward their long-term goals.

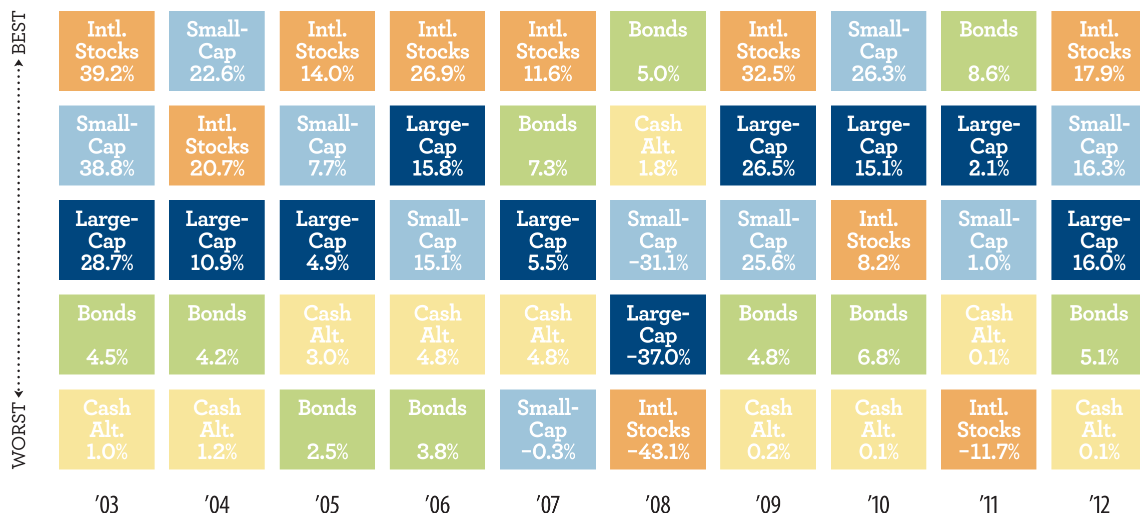
[1]Represented by the S&P 500 index, which consists of 500 industrial, financial, utility and transportation companies with market capitalizations of $4 billion or more.

[2]Represented by the Barclay's U.S. Aggregate index, which is an unmanaged index composed of securities from the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization.

[3]Represented by the MSCI All Country World Index ex-USA Index (gross return), which is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the United States. The index consists of 45 country indices comprising 22 developed and 23 emerging-market country indices.

The value of diversification

2003 – 2012



- **Barclays Capital U.S. Treasury Bills (1-3M)** – An index that is representative of money markets.
- **Merrill Lynch U.S. Government/Corporate Master Index** – A statistical composite tracking the performance of the entire U.S. corporate bond market over time.
- **S&P SmallCap 600 Index** – The 600 smallest U.S. companies on the S&P Composite 1500 index as measured by market capitalization.
- **MSCI EAFE** – Represents all of the Morgan Stanley Capital International (MSCI) developed markets outside of North America.
- **S&P 500** – Covers 500 industrial, utility, transportation and financial companies in the U.S. markets.

As of Dec. 31, 2012. Past performance is no guarantee of future results. You cannot invest directly in an index.

Planning is at the heart of it all

When developing an investment plan, you must consider your goals, concerns, risk tolerance and financial circumstances. Having this investment plan helps you to feel confident in your future, effectively monitor where you stand in relation to your goals and track your progress toward them. Life can be full of surprises, so your goals may change over time or markets may throw your investment plan off track.

With the constant barrage of information available in today's 24/7 world, the key is to not get caught up in the day-to-day market volatility and news headlines. During times of volatility, it is often easy to make investment decisions based on emotions. However, making investment decisions based on short-term market activity can make it more difficult for you to work toward your long-term goals. Having an investment plan allows you to focus on the long-term while still giving you the flexibility to make changes when necessary.

To help with investment planning, Wells Fargo Advisors offers the Envison® *process. For more information, please contact your Financial Advisor.*

An index is not managed and is unavailable for direct investment.

Diversification does not guarantee a profit or protect against loss.

The prices of small 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.

While stocks generally have a greater potential return than government bonds and treasury bills, they involve a higher degree of risk. Government bonds and treasury bills, unlike stocks, are guaranteed as to payment of principal and interest by the U.S. Government if held to maturity. Although treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate inversely to a change in interest rates.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

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 share price volatility. These risks are heightened in emerging markets.

Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than original cost upon redemption or maturity. In general, when interest rates rise, bond values fall and investors may lose principal value.

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