

# Investment Strategy: Q1 2012 Tactical Call

January 13, 2012

Please refer to Appendix – Important Disclosures.

*In this piece, we provide a series of near-term tactical calls within our longer-term strategic framework. We begin by offering commentary on our outlook for the financial markets. Operating from this premise, we then offer a series of tactical allocation calls, beginning with a macro call on stocks versus bonds versus cash. On the next page, these calls are further distilled. For example, we make distinctions from a size, style and sector perspective for domestic equities, and suggest tilts toward or away from the various satellite asset classes. These calls are made in light of the long-term outlook and summarize our expectations for the coming quarter.*

## MARKET COMMENTARY

Following is a summary of the views we expressed in our 2012 Economic & Stock Market Outlook: Through the Looking Glass, Heading Toward a Better Tomorrow.

We see changes just over the horizon that could reflect a secular shift for the economy and the financial markets. Right now, the need for change is being recognized primarily at the grass-roots level, so figuring out the exact scope and timing of that change will take more time. The major grass-roots efforts that have emerged over the past couple of years are, in our view, different manifestations of a similar sentiment: that the current political/economic/corporate structure needs massive reform, beginning with a disentangling of special interests and entrenched politicians. Aspects of this change include: Tax Reform, Monetary Policy Shift, Government Spending and Entitlement Reform, and Energy Policy Development.

Changes along these lines can help build a base for the economy from which a robust, self-sustaining recovery can emerge. That is the better tomorrow that we see. We will get there, but patience along the way is required. Admittedly, the election of 2012 may delay near-term progress, but it may also

help crystallize, in the electorate and politicians, long-term goals.

For now, our basic premise remains this: the secular bear market that has been in place for over a decade is intact. Cyclical trends emerge and fade. The cyclical bull market that emerged off of the March 2009 lows ended in 2011. The pertinent question now is whether the cyclical bear market that was in place in the middle part of 2011 has run its course. From its April peak at 1364 to its October trough at 1099, the S&P 500 fell more than 19%. The small-cap Russell 2000 fell nearly 30% in that time period. Has the rally seen since early October been a bear market rally or has it represented a new cyclical bull market? For now the jury is still out, but absent conclusive broad market evidence we assume that the previous trend is intact. For 2012, our working assumption is that the cyclical bear may re-emerge in the first half, with market conditions growing more favorable in the second half of the year. These ongoing cyclical swings accompanied by unrelenting volatility represent a period of secular base building. As we make progress on the secular issues outlined above, the probability of a meaningful secular low emerging increases.

While we have expectations of what might happen, we need to balance this with our observable reality, relying on our weight-of-the-evidence approach. Heading into 2012, the weight of the evidence is mildly bullish. Federal Reserve policy, sentiment, and seasonal trends support higher stock prices, while poor economic fundamentals and broad market divergences could weigh on stocks. Valuations are neutral. Putting this into context for our 2012 outlook, stocks could work higher into January, but the path forward from there will rely on the evolution of the sentiment and broad market. A surge in optimism could reduce the opportunity for rally, while improvements in the broad market could help fuel further gains and signal confirmation of a cyclical bull market.

Tactical Investment Decision	Baird's Call <sup>1</sup>	Date of First Call <sup>2</sup>	Level of Conviction <sup>3</sup>	Rationale
<b>Stocks vs. Bonds vs. Cash?</b>	Stocks over Cash and Bonds	Q1 12	Low	<ul style="list-style-type: none"> <li>Seasonal patterns and improving trends support stock market gains.</li> <li>Lack of breadth confirmation and rising optimism could limit rally.</li> </ul>

<sup>1</sup> Tactical over- or under-weight relative to Baird's strategic asset allocation models. Please ask your Baird advisor for more information on the strategic model most applicable to you.

<sup>2</sup> Date when Baird first made this call.

<sup>3</sup> Level of conviction in the tactical investment call: low, medium, high.

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Tactical Investment Decision	Baird's Call <sup>1</sup>	Date of First Call <sup>2</sup>	Level of Conviction <sup>3</sup>	Notes
<b>Domestic Stocks: Size</b>	Mid and Large-caps over Small	Q1 12	Medium	<ul style="list-style-type: none"> <li>Relative strength leadership coming from large-cap groups.</li> <li>Lagging breadth indicators argue for large-cap leadership</li> </ul>
<b>Domestic Stocks: Style</b>	Growth over Value	Q4 10	Low	<ul style="list-style-type: none"> <li>Earnings slowdown could focus emphasis on quality growth.</li> <li>Indicators largely neutral between growth and value.</li> </ul>
<b>Domestic Stocks: Sector</b>	Technology Health Care Industrials	Q4 11 Q4 11 Q1 12	Medium	<ul style="list-style-type: none"> <li>Focus on quality growth areas that have priced in recession, and defensive leaders.</li> <li>Health Care and Industrials have moved to the top of our relative strength rankings</li> </ul>
<b>Global Stocks: Region</b>	United States	Q3 11	Medium	<ul style="list-style-type: none"> <li>Regional leadership coming from United States.</li> <li>Dollar-issuing countries (Canada, Australia, Hong Kong) are generally preferred as lower-risk havens.</li> </ul>
<b>Global Stocks: Developed vs. Emerging Markets</b>	Emerging	Q1 12	Medium	<ul style="list-style-type: none"> <li>Emerging market soft-landing evidence is emerging.</li> <li>Decline in correlations could allow emerging market fundamentals to carry more weight than their beta.</li> </ul>
<b>Global Developed Stocks: Domestic vs. International</b>	Domestic	Q1 10	High	<ul style="list-style-type: none"> <li>Recession and policy uncertainty in Europe is still a headwind for international markets.</li> <li>Non-European developed markets more attractive (particularly the dollar issuing markets).</li> </ul>
<b>Bonds: Treasury vs. Spread Product</b>	Spread Product	Q1 11	High	<ul style="list-style-type: none"> <li>Spreads have widened as Treasury yields have moved lower.</li> <li>Persistently low yields in Treasuries supports increased demand for spread product.</li> </ul>
<b>Bonds: Intermediate vs. Short-Term</b>	Intermediate-Term	Q1 12	Low	<ul style="list-style-type: none"> <li>Fed increasingly committed to keeping interest rates low for a considerable period of time.</li> <li>Moderating inflation removing argument for higher rates.</li> </ul>
<b>Bonds: High-Grade vs. High-Yield</b>	High-Yield	Q4 11	Medium	<ul style="list-style-type: none"> <li>Spreads remain wide for high-yield, suggesting a domestic recession has been discounted.</li> <li>Fed efforts to support nominal growth could help this sector.</li> </ul>
<b>International Real Estate</b>	Tilt Toward Real Estate	Q4 11	Low	<ul style="list-style-type: none"> <li>Credit conditions improving, and housing may be bottoming.</li> <li>Asset class could gain interest from investors needing yield/income.</li> </ul>

<b>Commodities</b>	Tilt Away From Commodities	Q4 11	Medium	<ul style="list-style-type: none"> <li>Global economic slowdown is reducing demand for commodities.</li> <li>Prices remain too volatile to suggest that risk is ebbing.</li> </ul>
<b>Currencies</b>	U.S. Dollar Over Other Major Currencies	Q1 11	Medium	<ul style="list-style-type: none"> <li>Dollar breaking out as investors lose confidence in Euro.</li> <li>Non-U.S. dollars remain attractive, in part for income generation.</li> </ul>
<b>Gold</b>	Overweight	Q3 11	High	<ul style="list-style-type: none"> <li>Pessimism around gold is at an extreme.</li> <li>Multi-year up-trend has moderated, but is still rising and further Fed easing could re-ignite rally.</li> </ul>

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

## **Appendix – Important Disclosures and Analyst Certification**

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

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