

ECONOMY IN REVIEW

4th Quarter – December, 2011



Friends of TCK,

We have recently made allocation changes in TCK's Philosophies. The following update by Phil Orlando offers insight into those changes

While the allocations addressed below are specifically for TCK's Moderate Philosophy, the same reasoning applies for the allocations to TCK's other Philosophies as well.

From Phil Orlando Chairman of Federated's PRISM Asset Allocation Committee:

Current Views

Stocks vs. Bonds: We raised the equity weighting in our moderate asset-allocation model by a tick to 58%—which is 60% of our maximum overweight vs. a neutral 52% allocation—due to both attractive relative valuations and improving domestic and emerging-market economic fundamentals, which we believe will outweigh the ongoing sovereign-debt issues confronting Europe and investor concerns surrounding the dysfunctional congressional Super Committee. Our proprietary quantitative model for stocks vs. bonds now sits at a 7% equity overweight in November, down a tick from October.

To be sure, we are not downplaying our legitimate concerns about the euro zone. We remain at a 2% underweight in our allocation to international developed equities, largely on worries that the European Union's struggles to right its fiscal ship will be painful and prolonged and could very well result in a euro-wide recession. But we're encouraged by recent steps taken by the so-called troika—the EU leaders, the European Central Bank (ECB) and the International Monetary Fund (IMF)—as well by Greece, Italy and Ireland, to mitigate the fallout and lessen the impact of the potential economic contraction. In our view, if Europe manages to avoid a full-blown economic meltdown, then equity markets here could bounce from oversold levels going into year-end.

Back home, it's hard to ignore yet another quarter of strong corporate earnings that rose by 20% year-over-year and largely surprised to the upside; an improving labor market; a high-end consumer who continues to spend; and an expanding manufacturing sector. Similarly, recent data suggests that China, Brazil and other emerging markets are headed for a soft landing—rather than the dreaded hard landing that the financial markets have already discounted—as their respective central banks have managed to successfully reduce inflationary pressures without derailing economic growth. While we added a tick to bonds, we remain at a significant underweight at 18% (vs. a neutral 27%) in the fixed-income allocation in our model, and at an underweight 13% (vs. a neutral 22%) in domestic bonds, largely on our belief that the current environment favors equities over bonds and that the rally in Treasury securities has ended. Within domestic bonds, however, we have shifted to a slight overweight position in investment-grade corporate bonds, due to improving economic conditions and healthy corporate balance sheets. We also remain overweight in high-yield bonds for similar reasons, and have lowered duration to 95% of benchmark from 105%, believing that Treasury yields have bottomed with a bias toward rising—as long as the euro-zone's ills remain relatively contained.

At TCK, we take pride in doing our part to help our clients reach their financial goals. We continue to believe that our focus on the long-term and our total return prospective will provide superior returns for our clients.

Please visit our website for more information.

www.TCKansas.com

Equities

Growth vs. value: We remain overweight domestic large-cap growth, which we kept unchanged at 14% vs. an 11% neutral reading, compared with large-cap value stocks, which heavily consist of financial stocks that are confronting the potential headwinds of further regulatory reforms and possible European contagion. So we reduced our recommended allocation to large-cap value from a 17% overweight to a neutral 14%.

- **Large vs. small:** We remain overweight in large-cap stocks, which we expect will continue to perform well given attractive relative valuations, high dividend yields and strong corporate fundamentals. But our proprietary quantitative model for small-cap vs. large-cap stocks changed significantly over the past month, as small-cap stocks shifted from a 2% underweight in October to a 10% overweight in November. Consequently, we shifted to overweights in both small-cap growth and small-cap value stocks by a tick each, to 3% and 4%, respectively, to capitalize on the risk-on trade inherent in our improving economic outlook. We kept our mid-cap allocation unchanged at a neutral 5%.

- **Domestic vs. international:** Because of the reduced allocation in large-cap value, our domestic allocation was lowered by a tick to 40%, still a 4% overweight, while our international developed exposure remained at 12%, vs. a neutral 14%, due to our PIIGS-related concerns. But we raised our emerging-markets allocation by two ticks, from a neutral 2% to 4%, which is just a tick below the maximum, on attractive valuations and expectations for a soft vs. a hard landing in emerging-market countries. We kept our international small-cap position at a 2% overweight, so our overall international allocation rose from a neutral 16% to 18%, a 2% overweight.

Fixed income

- **Investment Grade Bonds:** Even though our recommended allocation to investment-grade bonds was raised a tick to 13%, it still represents a severe underweight relative to our neutral position of 22%. We shifted this 1% change out of Treasury securities, due to expectations that yields are more likely to rise than fall from here, and into corporate bonds, which should benefit from stronger economic growth and healthy corporate balance sheets. We also lowered our duration target from 105% to 95%.

- **High yield:** We kept our allocation at an overweight 3%, vs. 2% neutral, for reasons similar to those benefitting investment-grade corporates, and because of the relative value that should be created as easing concerns about the domestic economy and rising yields on Treasuries cause spreads to narrow. Companies are generally flush with cash, and defaults are trending lower.

Alternatives/Cash

We have shifted to an overweight allocation of 24% to Alternatives (vs. a neutral 16%) and an underweight 0% allocation to Cash (vs. a neutral 5%).

- **Treasury Inflation-Protected Securities (TIPS):** We significantly raised our allocation from an underweight 6% back to an overweight 10% (vs. neutral at 8%) on expectations that the TIPS market has bottomed, given our bias toward rising inflation and the reemergence of the risk-on trade.

- **Absolute Return:** We maintained an overweight 6% vs. a zero neutral allocation. Given very low yields on cash, we continue to place some of our normal cash allocation into this asset class. While it should underperform equities in our base case, it should outperform cash and possibly bonds, with less downside risk, and serve as an effective hedge to declining stocks during pullbacks, as it did during the recent third-quarter equity-market meltdown.

- **Net Short Equity:** As we are constructive on the equity market currently, we currently have no allocation to this category.

- **Real Estate:** We maintained a neutral 4% position.

- **Commodities:** We lowered our allocation from an overweight 6% to a neutral 4%, reflecting the surge in crude oil prices from \$75 to \$100 per barrel over the past two months and in gold from \$1,540 to \$1,800 per troy ounce, against the fundamental backdrop of slower global growth and concerns about the euro zone. Agricultural products such as corn, wheat and soy beans remain relatively attractively priced.

- **Cash:** We are now avoiding cash because of its low yields and relatively better returns elsewhere. We had a defensive 4% allocation to cash during the volatile summer months—compared with a neutral 5% allocation—to both protect our clients during the third quarter's waterfall collapse in stock prices and to keep some powder dry to re-invest at a more propitious point in the economic and stock-market cycle. We believe that we are there now, and we have moved that 4% cash position into small-cap and emerging-market stocks, corporate bonds and Tips.