The asset-allocation investment process

Investment strategies that balance investment objective and risk tolerance

Over the years, financial experts have provided investors with many theories and ideas on how to invest money effectively. The one concept that almost everyone seems to agree on is the need to diversify.

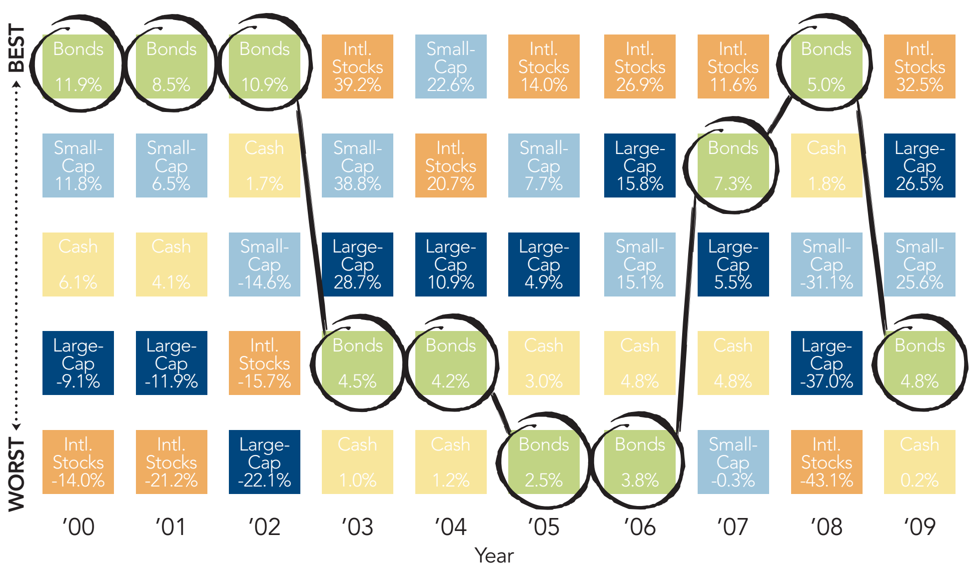
Understanding asset allocation

Although the stock market has historically trended up over time – making it an attractive investment vehicle for the long-term investor – bear markets and market slides come and go just the same. An ill-timed market dip, for instance, could easily send an aggressively allocated retirement portfolio spiraling downward. The challenge, of course, is trying to figure out when one cycle will end and another begin.

Thankfully, that's not necessary. Timing the market, it turns out, rarely works — and there's a better way. The practice and market approach known as asset allocation is the best way for most investors to balance an investment portfolio among various types of investments and shield it against offsetting losses. As most investors realize, the three main asset classes – stocks, bonds and cash alternatives – are often co-classified (in the same descending order) as higher-risk, lower-risk and lowest-risk investments. Within each asset class, investment risk can be further broken down.

The need for asset allocation

There's no telling which investment will perform better or worse from one year to the next. One year's leader can be the next year's laggard, and vice versa. This chart shows how various asset classes have performed during the past 10 years. For example, notice how bonds — a relatively stable asset class — have been both the best and worst performer as well as everything in between.



- **Barclays Capital U.S. Treasury Bills (1-3M) –** An index that is representative of money markets.
- **Merrill 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 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, 2009. Past performance is no guarantee of future results. You cannot invest directly in an index.

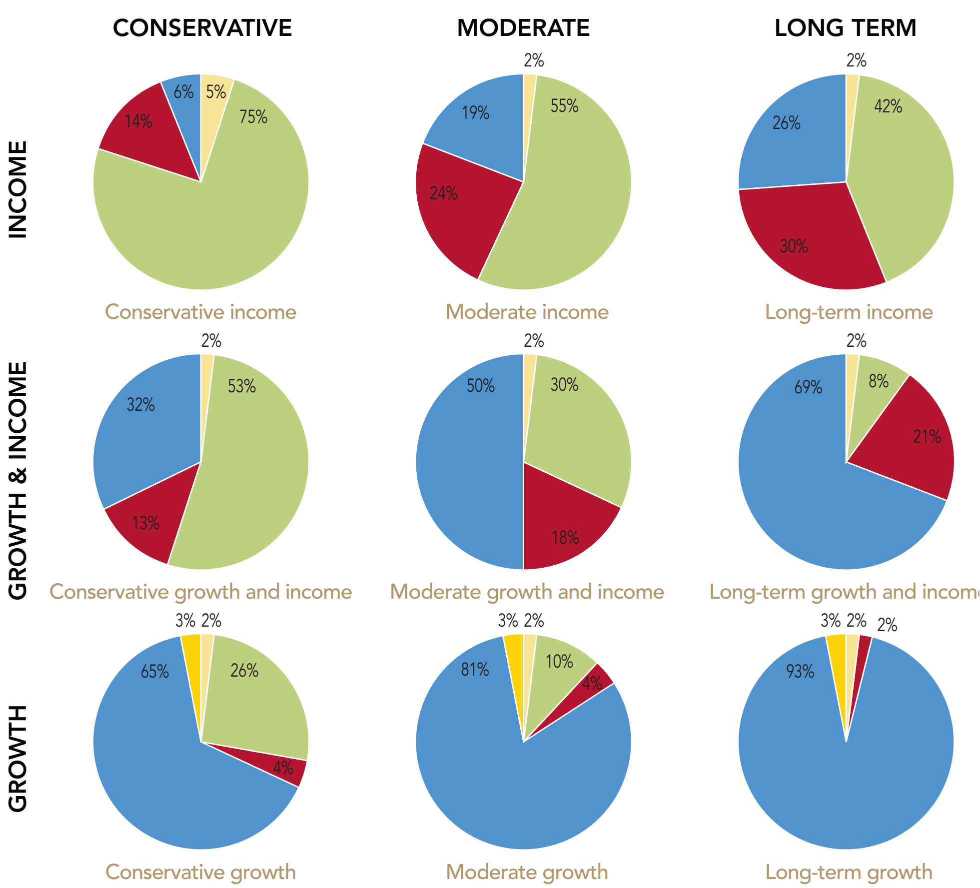
For instance, a large-cap stock from a major corporation with a track record for stability is usually considered a lower-risk investment than a stock issued by a lesser-known company with a smaller market capitalization. On the other hand, the small-cap stock generally carries the potential for higher returns if the issuing company experiences considerable growth. In the cash alternatives asset class, a T-bill or money market fund is lower on the risk scale.

Strategies based on objective and risk

After deciding that asset allocation makes sense, the primary objective is to decide how to diversify the portfolio. For this task, and for the ongoing maintenance it will require, your financial professional is an invaluable resource. We can help you develop an asset-allocation strategy that matches up to your investment objectives and risk-tolerance level.

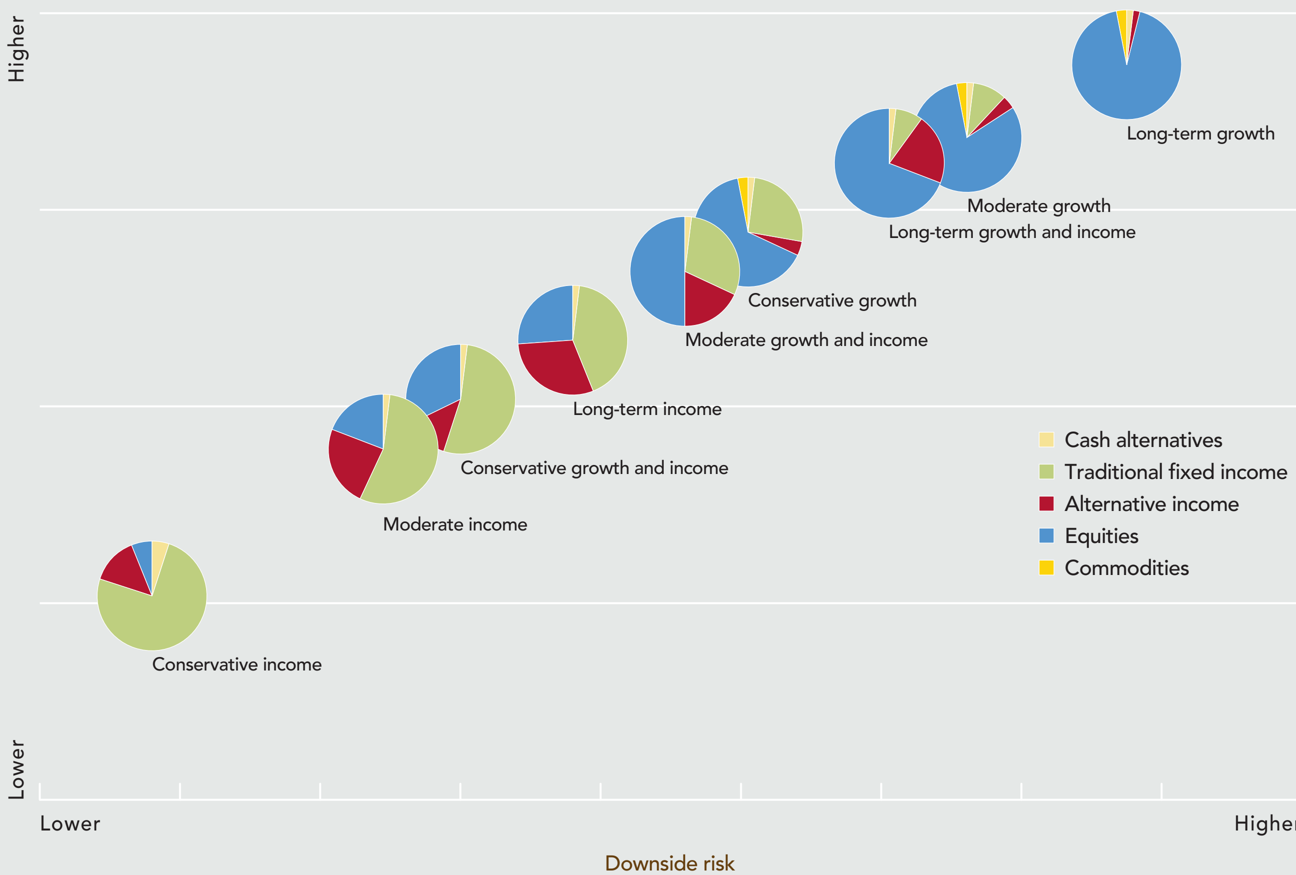
To make the process easier, Wells Fargo Advisors has developed nine strategy models that cover a wide spectrum of asset-allocation approaches and serve as a visual guide to asset-class breakdowns for various investment styles. For instance, as shown on the chart below, investors seeking growth and income with a moderate risk tolerance would want approximately half of their portfolio invested in stocks, one-third in traditional fixed-income investments and the remainder in alternative-income investments with a marginal amount in cash alternatives. A growth-oriented long-term investor, on the other hand, would be almost entirely invested in stocks.

The nine asset-allocation strategy models graphically break down typical portfolio holdings by asset class for each of nine investment approaches.



See pages 4-5 for model definitions and page 6 for disclosures and asset-class definitions.

Modern portfolio theory's efficient frontier



Source: Wells Fargo Advisors

Diversification as a theoretical concept is easy to understand but until the last 20 years has been difficult to implement. Most of us understand the need to diversify our investments among stocks, bonds and cash alternatives. But how do you determine what percentages to allocate among them? In the 1950s a concept was developed called "modern portfolio theory."

Modern portfolio theory has two major tenants:

- Investors are risk averse. That means given the choice between investments with the same general returns, they will choose the least risky.
- The more risk an investment has, the greater the return potential should be. Because investors are risk averse, they will not choose investments with greater risk without the possibility of greater return.

Portfolio managers use these tenants in the development of portfolios for investors. Wells Fargo Advisors' asset-allocation models are indicated in the chart above. Moving left to right, the chart shows allocation recommendations with higher levels of portfolio risk and correspondingly higher levels of expected return. Investors with similar investment objectives may have different risk tolerances, therefore our asset-allocation models provide allocation recommendations for investors with different degrees of risk tolerance.

Past performance is not a guarantee of future results. Diversification does not guarantee a profit or protect against loss. Return is measured by projected compound annual growth rates based on Wells Fargo Advisors 2010 Capital Market Assumptions for the associated asset class. Downside risk is the return threshold that one would expect returns to fall below only once in 20 years. This means there is a 1-in-20 risk (5% probability) that the loss over a one-year period could be greater than the downside risk calculation.

What kind of investor are you?

As you and your financial professional examine your savings, life circumstances, income needs, risk tolerance and investment horizon, you'll discuss which investment approach – growth investing, growth-and-income investing, or income investing – suits your present objectives. When putting together your asset allocation, each of the three investment approaches are matched up to one of three risk-tolerance levels: conservative (or highly risk-averse), moderate and long term (for investors with an investment horizon of at least five years who seek the highest potential returns).

Growth

Younger investors are generally well-suited for portfolios weighted heavily toward growth. People in their prime working years typically do not need their investments to provide current income and would rather watch their portfolios grow.

The bulk of a growth investor's portfolio should be composed of equity asset classes (large-cap stocks, small-cap stocks, international stocks, etc.) Equities have historically provided the best long-term growth within the markets. Traditional fixed-income investments generally offer low growth potential; in growth portfolios, they serve primarily to reduce risk. The higher the growth investor's risk tolerance, the lower the amount that should be invested in fixed-income investments.

Many investors blend growth and income approaches as they near retirement or settle into retirement, but not everyone. Retirees with ample income from pensions, rental property or other sources may remain growth investors all their lives.

Growth and income

Even in retirement, baby boomers are increasingly starting second careers, and these careers are often launched as opportunities for the retiree to seek personal fulfillment or give back to the community rather than as a major source of income.

Whatever their personal circumstances, growth-and-income investors have two defining characteristics: (1) They need their portfolios to provide income to supplement Social Security, pensions and other sources of income, and (2) They are young enough and healthy enough to expect to live many years in retirement. This extended time horizon means that these investors need their investment income to grow in order to offset inflation. Otherwise, over a 20-year time frame, even a modest 2% inflation rate would cut their standard of living by a third. As a result, growth-and-income investors seek a balance of current income and long-term growth.

Like pure growth investors, growth-and-income investors need considerable exposure to equities – but to a lesser degree. Dividend-paying stocks offer current income and the prospect for that income to grow over time, especially as a growth-and-income investor begins shifting more emphasis to the income side of the equation. Traditional fixed-income investments can add current income and reduce portfolio risk.

Since the added income helps achieve the investment objective, bond weightings will typically be higher in growth-and-income portfolios than in growth portfolios. As with growth portfolios, however, the higher the growth-and-income investor's risk tolerance, generally the lower the amount of money that should be in bonds.

Addressing risk tolerance

Investors with the same objectives do not automatically have the same risk tolerance. The personality and preferences of each investor combine with the investment objective to determine the appropriate level of risk for their portfolios. At Wells Fargo Advisors, we define three levels of risk tolerance within each investment objective:

- **Conservative –** These investors assume the least risk for a given investment objective, so they have lower expected returns. Still even conservative investors may experience losses.
- **Moderate –** Investors with a moderate tolerance for risk are willing to accept a higher degree of risk in exchange for the potential to receive higher returns.
- **Long term –** Long-term investors seek the highest potential returns within a given investment objective. Generally, investors assuming this level of investment risk should have a relatively long investment time frame. An investor who does not intend to leave money invested for at least five years is probably better off in a lower risk category.

Income

Income investors often have a shorter time horizon than growth-and-income investors. They seek to maximize current portfolio income, even at the expense of potential growth. They may want the additional income to fund more travel in their later years, to offset increasing health care costs, or for any number of other reasons. The key judgment for these investors is that their need for current income is greater than their need for long-term growth.

Fixed-income assets typically provide more reliable current income than equity investments and play the dominant role in a portfolio weighted toward income. High-yield bonds, bonds with very long maturities and emerging-market bonds all tend to offer higher current income than lower-risk bonds. As income investors' risk tolerance increases, their exposure to these higher-risk, higher-yielding sectors of the market may also increase along with their exposure to income-oriented equities like REITs.

The more risk income investors can assume, the more current income they may be able to generate. Keep in mind that as interest rates generally rise, bond prices will generally decline.

Asset allocation using our *Envision®* process

Our life-planning *Envision* process is a great start toward successful asset allocation in your investment portfolio. It starts with a comprehensive analysis of your goals and dreams and helps determine your ability to make them happen.

Through an advanced simulation methodology, our *Envision* tool displays the statistical probability of achieving the right portfolio allocation to avoid unnecessary investment risk while helping you reach your goals. Through regular updates and monitoring your progress, it can help you adjust your investment strategy to reflect both realistic expectations and your own comfort level.

IMPORTANT: The projections or other information generated by the *Envision* tool regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Results may vary with each use and over time.

Envision methodology, selection criteria and key assumptions

The *Envision* simulation model incorporates assumptions on inflation, financial market returns and relationships between these variables based on an analysis of historical data. Using Monte Carlo simulation and data provided by the Center for Research in Securities Pricing, the *Envision* process simulates thousands of potential outcomes over a lifetime of investing. The varying historical risk, return and correlation between the assets is based on indexes over several market cycles. If the indexes do not provide enough historical data to gauge asset-class performance, we may use the data of related asset classes. Elements of this report's presentation and simulation results are under license from Financeware, Inc., patents pending. ©2009 Financeware, Inc. All rights reserved.

Tailor your portfolio to your life

If you have a sense of what you'd like life to hold for you and your loved ones, your financial professional can help you develop an asset-allocation strategy that fits your circumstances. If you've not already synchronized your life plans and investment strategy through an Envision plan, ask your advisor to help you accomplish that as well. It's a great way to keep track of the progress you're making toward meeting your most important goals and living a retirement that meets your expectations.

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