



August 2, 2010

Edward Bellamy put it in context: “One can look back a thousand years easier than forward fifty.”

The equity markets this week finished relatively flat after the Commerce Department reported that the recent recession was much deeper than originally reported and that economic recovery was progressing at a slower rate. Despite the equity markets having their best month in nearly a year, investors took a breather after looking backward at economic activity and getting a little gun shy. What was overlooked in all the parsing of the revisions was the good news – that we technically avoided another recession within a year of the previous one, or we avoided the dreaded double-dip.

The Commerce Department reported on Friday that the economy grew at a 2.4% annual rate during the second quarter, and the first quarter rate was revised to a 3.7% gain that was previously reported as a 2.7% gain. Most notable was the recognition that the U.S. economy contracted 4.1% from the fourth quarter of 2007 through the second quarter of 2009, compared with the 3.7% decline previously reported. At the same time, the Commerce Department reported that household spending dropped 1.2% in 2009 – double what had been previously forecasted and the largest decline since 1942.

In other economic releases, the ABC Consumer Comfort Index fell 3.9 points to 50.4 in July. Economists expected a slightly smaller decline to 51. But the prior

| | Key Market Data | | |
|------------------------------------|-----------------|-----------|-----------------|
| | Week ending... | | |
| | 7/30/10 | 7/23/10 | Change |
| Dow Jones Industrial Average Index | 10,465.94 | 10,424.62 | +0.40% |
| S&P 500 Index | 1,101.60 | 1,102.66 | -0.10% |
| NASDAQ Composite Index | 2,254.70 | 2,269.47 | -0.65% |
| 10-Year Treasury Note Rate | 2.91% | 2.99% | -0.08 pct. pts. |
| NYMEX Crude Future (Barrel) | \$78.95 | \$78.98 | +0.03 |
| Euro/U.S. Dollar | \$1.3033 | \$1.2917 | +0.0116 |

month's reading was upwardly revised to 54.3 from 52.9. On the housing front, the S&P/Case-Shiller Composite Index advanced 0.5% in May, on a seasonally adjusted basis. Prices were at their highest since December 2008, with 14 of the 20 metro areas surveyed posting gains. At the same time, the Commerce Department reported that new single-family home sales rebounded 23.6% in June to a 330,000-unit annual rate. It was the largest increase since May 1980, but from a record low level, resulting in the second lowest reading ever. Economists expected a much smaller increase of 3.7% to a 310,000-unit rate. While the housing market still faces substantial headwinds going forward, there appear to be some signs of stabilization unfolding.

Purchases of big-ticket items such as autos, home appliances and electronic equipment decreased 1.0% in June, down for the second straight month and by the most since August 2009. Analysts surveyed by Bloomberg were looking for a 1.0% increase in durable goods orders.

According to the latest Federal Reserve Beige Book report, released Wednesday, economic activity through mid-July "continued to increase" modestly across most Federal Reserve Districts. Consumer spending increased modestly and the outlook for retail sales was mixed-to-cautious. Manufacturing activity continued to expand, but the pace of growth moderated in half the Districts. The housing market was sluggish across the country, mainly resulting from the expiration of the first-time homebuyer tax credit at the end of April. Banks continued to have tight lending standards. One bright spot was that the Fed noticed that labor market conditions improved slightly or held steady.

The broader view

This is the last of three short reports on some of the investment strategies we use at Northwestern Mutual. On July 19, we covered capital market expectations and last week we addressed investing in global and emerging markets. This week, we'll end the summer series by taking a closer look at the whys and wherefores of rebalancing.

At Northwestern Mutual we talk a lot about account rebalancing – and for one very good reason: over the short term, stock markets and global economies keep us guessing. Indeed, as much as we'd like the various asset classes to move in predictable patterns, it's not going to happen as there are simply too many variables in play. And over the last few years it seems like we've seen them all: the collapse of financial giants, a worldwide recession, government stimulus spending on an unprecedented scale, massive policy intervention, new laws governing financial markets, sovereign debt crises, an unexpected market rebound – and then a correction. As a result, asset classes and carefully constructed asset allocation strategies have been disrupted, to put it mildly. Taken together, all of those changes need to be met with updated and rebalanced accounts and, as a result, revised asset allocation plans.

The effectiveness of any rebalancing hinges on such factors as the market environment, cost, the relative size of an asset class and frequency. When we reviewed those factors, we determined that because of varying market conditions, the impact of rebalancing in terms of returns can vary over the short term but is usually more effective if implemented in a consistent manner over the long run. Furthermore, rebalancing helps provide tighter risk control in terms of keeping an investor's asset allocation closer to his or her original targets to lead to less volatility, regardless of the near-term market environment.

To determine the best time for rebalancing – the one that offers the preferred balance between cost and benefit – we identified the point at which an investor's assets veer enough from their target that they produce unintended risks. (Here, if an investor has most of their assets invested in mutual funds rather than general securities, the cost of rebalancing is typically modest.) We concluded that asset classes that typically make up a larger percentage of a client's overall portfolio, such as Large Cap Equity or International Developed Markets Equity, could have an appropriate drift threshold of 5% either way while smaller, more volatile asset classes such as Small Cap Equity, Emerging Markets Equity and Commodities could have a lower drift threshold of plus or minus 3%. By way of example, if the weighting for an asset class is 20% and the tolerance threshold is plus or minus 5%, then the tolerance boundary is 15% on the low side and 25% on the high end.

As for frequency, we recommend a combination of time-based and threshold-based approaches. Specifically, we suggest rebalancing at the end of a quarter if an asset class has drifted to, or beyond, the thresholds noted above. That said, should they drift to twice or beyond their threshold between quarterly rebalancing, action should take place sooner as opposed to waiting until the quarter ends.

With that said, we know many investors prefer to rebalance at specific intervals such as semiannual or annual. These approaches work fine too. And, while we may have a preferred approach, it's far more important to select a methodology and stick with it. In any case, we know from long experience that having a repeatable process keeps emotion out of the equation for an investor and allows for successfully executing a rebalancing strategy.

Above all, it's important to convey that rebalancing is an essential element of investing – an opportunity to buy asset classes when they are low and sell ones when they are high – helping to keep your financial plan on track.

As always, we suggest you work with your financial advisor to determine the



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Please remember that all investments carry some level of risk, including the potential loss of principal invested. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Diversification and strategic asset allocation do not assure profit or protect against loss. Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market. The securities of small capitalization companies are subject to higher volatility than larger, more established companies and may be less liquid. Bond investors should carefully consider risks such as interest rate risk, credit risk, securities lending, repurchase and reverse repurchase transaction risk. Greater risk is inherent in investing primarily in high yield bonds. They are subject to additional risks, such as limited liquidity and increased volatility. There is an inverse relationship between interest rates and bond prices. Investing in foreign securities is subject to certain risks not associated with domestic investing such as currency fluctuations and changes in political and economic conditions.

All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics, and news.

The Dow Jones Industrial Average Index[®] is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Standard and Poor's 500 Index[®] (S&P 500[®]) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Standard & Poor's offers sector indices on the S&P 500 based upon the Global Industry Classification Standard (GICS[®]). This standard is jointly maintained by Standard & Poor's and MSCI. Each stock is classified into one of 10 sectors, 24 industry groups, 67 industries and 147 sub-

appropriate rebalancing strategy that will help meet your financial security needs.

A look ahead

Reports on the health of manufacturing, personal income, consumption and the continuation of second quarter earnings releases will keep analysts busy this week. Even so, all of that will serve as a mere warm-up to the big story of the week – and the one most likely to move the markets over the remainder of the summer – the Labor Department's report on the change in nonfarm payrolls and the unemployment rate for July.

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industries according to their largest source of revenue. Standard & Poor's and MSCI jointly determine all classifications. The 10 sectors are Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services and Utilities.

The NASDAQ Composite Index[®] Stocks traded on the NASDAQ stock market are usually the smaller, more volatile corporations and include many start-up companies.

NASDAQ - National Association of Security Dealers Automated Quotations. The NASDAQ is a computer-operated system owned by the NASD that provides dealers with price quotations for over the counter stocks.

Bear market calculations and interpretations are derived from data supplied by Ned Davis Research, Inc.

The S&P/Case-Shiller Home Price Indices are designed to be a reliable and consistent benchmark of housing prices in the United States. Their purpose is to measure the average change in home prices in a particular geographic market. They are calculated monthly and cover 20 major metropolitan areas (Metropolitan Statistical Areas or MSAs), which are also aggregated to form two composites – one comprising 10 of the metro areas, the other comprising all 20.

The ABC News Consumer Comfort Index, is a weekly index of U.S. consumer confidence. The index represents a rolling four-week average based on telephone interviews with approximately 1,000 adults nationwide. Results are calculated as the difference in percent of positive and negative numbers.

The Federal Reserve Beige Book is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its District through reports from Bank and Branch directors and interviews with key business contacts, economists, market experts and other sources. The Beige Book summarizes this information by District and sector. An overall summary of the twelve district reports is prepared by a designated Federal Reserve Bank on a rotating basis.

Edward Bellamy (March 1850 – May 1898) was an American author and socialist, most famous for his utopian novel, *Looking Backward*, set in the year 2000 and first published in 1888.