Three Strikes and You're Out (or Take First Base)
Third Quarter Market Review From Your Portfolio Management Team—October 10, 2014

It's Fall season, which means cooler temperatures and late night playoff baseball games. For clients in the DC area and California, there's much to root for, with three California teams in the playoffs, as well as teams from Baltimore and Washington, DC among the initial eight playoff teams.

Over the past quarter, stocks markets were divided. Domestic large company and technology indexes managed to eke out modest gains, while smaller company stocks and foreign stocks have clearly turned down. The Russell 2000 index of small companies stocks was down over 7% for the quarter, while the MSCI EAFE index of predominantly European and Japanese companies finished down almost 6%. One source of weakness for foreign securities is the recent strength of the U.S. dollar, which rose over 7% in the third quarter. A rising dollar creates a headwind for foreign securities, as well as commodities such as gold and oil.

What's Ahead

As we head into the final quarter of the year, there are three factors we are watching that could make things difficult for the stock markets in the near term. First of all, history shows market advances (bull markets) typically last 4 - 6 years and this advance is now approaching six years, which suggests that we are certainly getting closer to the end of this bullish cycle.

Secondly, we have seen market breadth narrow this year. Market breadth refers to the number of stocks that are moving up as the various stock indexes rise in value. In a healthy market, most stocks are moving in the same direction (usually up), while in a more dangerous market, fewer and fewer stocks are going up, while the majority are stalling out or even falling. Back in 1999, before the internet bubble burst, the returns from S&P 500 and Nasdaq indexes were driven by just a handful of names. It was a warning sign that trouble was brewing. While breadth is not as narrow as back in the late nineties, current conditions suggest that caution is warranted.

Finally, we have noticed that volatility has increased. The VIX index (which reflects market volatility and risk) rose 40% in the third quarter. While that index reflects expectations for volatility in the near future, a rise in VIX usually goes along with a rise in market volatility. This pick-up in volatility does not guarantee a bad stock market, but it is another warning sign to be on our guard.

So, why is the market facing these three strikes against it right now? There are a number of factors at work.

- Federal Reserve ending its bond purchasing program
- Upcoming mid-term elections
- Concern over anemic global growth
- Political concerns regarding ISIS
- Concern over the potential spread of the Ebola virus

So, by the time we know who the winner of the World Series is for 2014, investors may get the clarity they need to feel confident about investing in stocks once again. For now, we are letting the trends drive our decisions, with the FSA Safety Nets® in place to keep small losses from turning into big losses.

Portfolio Review

Below we review the five broad strategies that FSA manages. Keep in mind that your specific portfolio may differ to some degree from the averages, as our portfolios are individually managed.

In most of the FSA strategies, we have been holding our positions since they have held above our FSA Safety Nets®. Generally speaking, we did take the recent weakness to exit most of our foreign positions, as well as any small-cap stock positions. Given the apparent strength in the U.S. economy, it is a bit surprising that small-cap stocks have struggled, but we let the trends do the talking for us, and when a fund breaks through its trend line, we exit first and ask questions later.

Income (Strategy #1)

Bonds have been consistent performers this year, with the exception of a modest hiccup in September. As volatility has picked up, the more aggressive areas of the bond market began to feel some of the pressure. As a result, we sold the emerging markets bond fund we purchased at the beginning of the year. The high yield municipal fund continues to perform well, and overall, the Income portfolios were down slightly for the quarter, performing a little better than we expected.

Income & Growth (Strategy #2)

This conservative strategy has a maximum potential allocation to stocks of 50%, but we have been content to leave the allocation at 40%, since bonds have remained so consistent this year. With market volatility picking up, we are comfortable erring on the safer side in this strategy. We made no changes to this strategy during the quarter.

Conservative Growth (Strategy #3)
We made no broad changes to these portfolios during the quarter. Currently, the portfolios are equally balanced between growth and income, a pretty good place to be until the equity markets can break into a new trend. For the quarter, the high yield bonds lagged, as did several of our equity income funds, while the high yield municipal bond funds continued to perform quite well.

Core Equity (Strategy #4)
It was a tug-of-war among the holdings in this strategy for the quarter, as a strong return from the health care holding was offset by weaker results from the high yield bond positions and the REIT fund. During the quarter, we sold the leisure sector fund we had first purchased back in 2012. We also exited the emerging markets position that we added in early April, as that area has rolled over (once again). These accounts were down slightly for the quarter, in line with what was impacting most areas of the stock market.

Tactical Growth (Strategy #5)
Our most aggressive strategy has continued to struggle this year, as participation has narrowed to include just large domestic stocks. The weakness in small-cap stocks and foreign stocks weighed on the results for this strategy, as did the energy holding. As a result, we sold our positions in small company and foreign stocks. We also reduced our energy position (and exited the position completely in early October). To help protect the portfolio as volatility picked up, we added two inverse positions as well as a VIX fund (which will tend to rise as volatility increases).

Please let us know if there are any changes to your personal situation that might suggest some changes to your investment objectives.

FSA Investment Team

One Church Street, Suite 901 | Rockville, MD 20850 | 301.949.7300 | 800.235.4567
5237 Summerlin Commons Blvd. | Fort Myers, FL 33907 | 239.489.3346
FSAinvest.com