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Most Market Indices Make Little Progress in First Quarter

First Quarter Market Review From Your Portfolio Management Team—April 12, 2007

After a very encouraging beginning to the new year, stock markets around the globe stumbled briefly in late February, before settling down a bit at quarter's end. When the quarter was officially over, we find that stocks, bonds and money markets all finished in the same range. (See table below)

Index	*Q1 Return*
DJIA	-0.3%
S&P 500	0.6%
Lehman Bond	1.5%
Money Market	1.1%

Source: Principia
Note: DJIA represents the Dow Jones Industrial Average. Lehman Bond represents the Lehman Aggregate Bond Index. Money Market represents the average return for taxable money markets, as tracked by Morningstar.

Before that stumble, the markets had been almost eerily calm for quite some time. Investors seem to be quite willing to take on more and more risk in an effort to find returns. The market's behavior in late February reminds us that if we want more return, we have to be willing to take more risk—and that means potentially suffer greater losses.

As a firm that spends a great deal of time evaluating risk, we understand that some of the worst corrections can come seemingly from nowhere—just think about the Crash of 1987 or the correction in the summer of 1998. That is why we are often willing to give up some of the gains from the market, so that we can avoid some of the pain from the market.

Here is a brief review of the major FSA strategies during this first quarter:

Conservative Growth

These portfolios were already rather conservatively positioned, even though the money market level was fairly low; therefore, we did not need to sell much during the turbulent period in early March. With a mix of conservative core funds and long-term bond funds, *Conservative Growth* portfolios managed to hold up quite well during that time. We did exit our international positions as the foreign markets were hit harder than our own market and these funds hit our 'safety nets.'

More recently, we have exited the last of our long-term bond positions as ongoing concerns of rising inflation also caused these funds to drop in price. We plan to add a more conservative bond fund to these portfolios in the near future to act as a cushion from future stock market turbulence.

Funds such as Merger Fund, Gateway, and Schwab Hedged Equity all performed ahead of the broad U.S. market indices even though these are quite conservative—exactly the reason we like to have these types of funds in the *Conservative Growth* portfolios.

Core Equity

With their more aggressive objective, *Core Equity* portfolios captured more of the rally in January and early February, but gave up more on the downside in March. During the heat of the turmoil we exited the international position, as well as the most aggressive U.S. positions, including Rydex NOVA and DireXion OTC. This left most portfolios with only a 50% allocation in stock funds.

Most recently, we have added a fund which moves in the opposite direction as emerging market stocks. That is, they rise when emerging markets are falling and fall when emerging markets are rising. As a result, these portfolios are in good shape to hold up well if the market continues to slide in April. If the storm clouds clear, we will exit the short emerging markets fund and look to add additional stock funds in an effort to capture market returns.

Tactical Growth

Similar to Core Equity, our *Tactical Growth* portfolios were moving right with the broad market until the sharp sell-off in late February. We cut back our international position as well as some of the most aggressive U.S. stocks, including DireXion OTC. This left us with 50% invested in stocks. Since that time we have also added two funds which move opposite the direction of the market—a short real estate fund and a short emerging markets fund.

We continue to maintain exposure to some sector funds, believing these areas to offer good prospects in this market environment—Health Care, Internet, and Biotechnology. If the broad stock markets resume their slide in April, these portfolios are well positioned to hold up well. If the markets show signs of recovering and moving on to new highs, we will take steps to get these portfolios more fully invested.

Income & Growth

This conservative strategy fared quite well through the turmoil in late February. With only 40% of the assets invested in stocks, *Income & Growth* portfolios fell less than half of the drop in the broad market. High yield bond funds (which make up roughly 35% of assets) also held up quite well during the turmoil. Of course, if the market begins to move strongly higher, this strategy will fall behind because of the more conservative funds it holds.

This strategy makes sense for very conservative investors, as well as those who have begun to take rather sizable distributions from their portfolios. It is designed to offer consistent gains during favorable market environments, with minimal losses during market downturns.

Income

Since this strategy has an income objective, and in fact it does not own any stock funds, we would not expect it to be impacted very much by the stock market. And that is exactly what we witnessed from this strategy, as it suffered only minimal losses during the market drop.

Presently, this strategy is 90% invested in high yield bond funds, which have been a relative bright spot in the market this year. High yield bonds have had over four years of strong returns, so we are sensitive to the possibility that they could run out of steam, but for now, we are content to leave these funds alone.

The Future

Our job as risk managers is to constantly review the investment landscape for evidence that the market is in a high risk (or low risk) environment. With economic growth slowing, with oil prices consistently above $60 a barrel, and with inflation unwilling to lie down, we believe it is time to be on guard against further market gyrations.

In spite of our concerns, however, there are also reasons to feel optimistic about the balance of this year. With an election coming next year, politicians are usually encouraged to keep monetary and fiscal policy as stimulative as possible to help the parties in power to stay in power. Also, global growth seems quite healthy at this point, so the risk of a global recession remains quite low.

Overall, it seems that conditions are as they usually are—some positive factors and some negative factors—and our job is to maintain a constant watch over the markets and position the FSA strategies to take advantage of the prevailing trends. Our objective is to help you reach your financial goals, and to do so in a way that allows you to rest comfortably.

Please let us know if there is anything we can add to these monthly reports that would help you understand what is happening in your accounts.