FINANCIAL SERVICES ADVISORY
INCORPORATED
Rockville, MD 20850 800.235.4567 www.fsainvest.com

# Where's The Beef?

**May Market Review From Your Portfolio Management Team—June 6, 2007**

The market continued its winning ways, posting another strong return for May. As of June 1, the return for the S&P 500 is roughly 8% for the year. We are on pace for a very respectable year for the U.S. equity markets.

Of course, we are getting a bit bothered by the market's apparent disregard for what we see are a number of trouble spots. For one thing, the government just released its revised estimate of economic growth for the first quarter, and it came in at less than 1% (0.6% to be exact). At this level, we are getting dangerously close to negative growth—that is, recession. Yet the market seems unfazed by this number. The reason seems to be that most observers believe this number will mark the low point in the current economic cycle, and we will see steadily improving numbers in the second half of this year and into next year. This sounds plausible but the margin of error is getting razor thin, especially considering the other issues still to be resolved.

One of those other issues includes the continued high prices being paid for commodities such as oil, copper, and agricultural goods. Even though the inflation numbers remain tame, the consumer will ultimately have to feel the impact of these higher resource prices. And of course, we have the ongoing dilemma of the slumping housing market. While most homeowners will fare just fine through this slowdown, the days of pulling equity out of houses to finance consumer spending has ended, and this could mean more difficult times ahead for U.S. economic growth.

The issues above have influenced our investments this year. Below we list the top ten holdings within the various FSA strategies:

- **Schwab Premier Money Market**
  We currently have roughly 20% in money markets across the entire firm at FSA. Obviously some portfolios will notice higher allocations to money markets, while some portfolios will carry lower money market weightings. As we discussed in last month's commentary we believe market risk is high enough to warrant a moderate allocation to the safety of money markets. Of course, we will continue to monitor market conditions and may lower these allocations if the market conditions improve. In the meantime, money market yields are close to 5%, so at least we are getting paid a decent yield while we wait for better market conditions.

- **Schwab Hedged Equity (Core Equity, Conservative Growth, Income & Growth)**
  This eclectic fund is held in most portfolios at FSA. It buys stocks according to Schwab's proprietary stock ranking system, and it will short stocks that rate the worst. Therefore, it tends to act like a more conservative stock fund that typically holds up well in bad markets, while offering nice participation in good markets. This is the type of fund we would typically hold in all but the worst market environments because it usually holds up pretty well when the overall market is doing poorly.

- **Mutual Series (Core Equity, Conservative Growth)**
  Mutual Series actually represents several funds that are run by the same management team. They include Mutual Shares, Mutual Qualified, Mutual Beacon, and Mutual Discovery. As you may know, we have used these funds for many years. They employ a value strategy of looking for undervalued companies and they are willing to look all over the world to find good values. In addition, they often tend to hold up pretty well in tough markets.

- **Rydex Large-Cap Value (Core Equity, Conservative Growth)**
  As the name implies, this fund focuses on big companies that they consider to be undervalued. As such, this fund will tend to own financial companies, utilities, and companies that make consumer goods. At some point, we will begin to lower our focus on these so-called value funds and begin to increase our allocation to their alter ego—growth funds—but for now, these funds continue to do well.

- **Schwab Premier Equity (Core Equity, Conservative Growth)**
  This fund concentrates on companies that are the highest rated within Schwab's ranking system. At some times it will tend to look like a growth fund, while at other times it could look more like a value fund. We like funds that have some flexibility to find the best opportunities. Even though it is a relatively new fund, it has impressed us with its consistent returns.

- **Merger Fund (Conservative Growth)**
  This is possibly the most unusual fund we own. The fund managers wait for a merger to be announced and then they buy the stock of the company being acquired and sell short (making money if the stock price drops) the company that is acquiring the other. This creates a fund that has very low market risk, and tends to generate consistent returns in the 8% to 10% range. It is a fund that we would probably not own if we felt the economy was slowing towards a recession since mergers tend to taper off in those environments (although merger activity remains very strong in the current economic cycle). Otherwise it is a fund that we can hold through all but the worst market conditions.

- **iShares NYSE Composite (Tactical Growth, Core Equity)**
  This broad-based exchange-traded fund (ETF) mimics the return of all stocks that trade on the New York Stock Exchange. As a result, it offers a good exposure to the broad stock market. Since it is an ETF, we can buy or sell throughout the day, which gives us greater flexibility during times of market stress.

- **Gateway Fund (Conservative Growth)**
  This is another eclectic fund that owns common stocks of large companies, but also sells index call options with part of the portfolio. Selling call options reduces the fund's volatility and provides income to the portfolio. This is another fund that can be held in all but the worst market environments.

- **Intermediate-Term Bond Funds (Conservative Growth, Income &Growth)**
  In April, we added a modest allocation towards diversified intermediate-term bond funds, both taxable funds and municipal funds (for taxable accounts). With interest rates remaining in a range, we felt these funds could help diversify the portfolios, as well as provide income.

- **High Yield Bond Funds (Income)**
  We have held these funds for some time in the Income objective. Even though we have some concerns that high yield bond returns are stretched—given their strong five year run—we will continue to hold them until they break their current trends.

At this point, many investors seem to be hoping for the best, and are willing to throw money at the market and hope the economy manages to muddle through. And in the end they could be right. At FSA, our role is to prudently invest your hard-earned money so that it can grow consistently over time and hopefully avoid the periodic disruptions that can occur. With this rally almost five years old, and with economic growth appearing to stall in the first quarter, we want to make sure there are good reasons to invest more aggressively. In the end, many investors may be left holding the bun with no beef.

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.