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Markets Post Strong Returns for Second Quarter

Second Quarter Market Review From Your Portfolio Management Team—July 18, 2007

During the second quarter, stock markets around the world seemed to shrug off the concerns from the first quarter, and most went on to post solid returns. In the U.S., both the Dow Jones Industrial Average (DJIA) and the S&P 500 index (S&P) posted new all-time highs (for the S&P it was the high set way back in 2000, right before the technology bubble burst). It was a more difficult quarter for bond investors as high quality bonds posted negative returns with rising interest rates leading to falling bond prices (See table below).

Index	*Q2 Return*
DJIA	9.1%
S&P 500	6.3%
Lehman Bond	-0.5%
Money Market	1.2%

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.

We are seeing signs that this rally is beginning to weaken (from a technical standpoint); therefore, we have not been willing to aggressively position these portfolios to participate. In addition, there are some fundamental issues that could weigh on this market (such as rising interest rates, slowing economy, high investor complacency); although, these issues are only having a minor effect at this point.

We are not bearish, by any means, but we do believe that we should maintain some degree of caution because if the market hits a rough patch, the market could react quickly and violently. It is our opinion that the temperature gauge on this market is beginning to climb. It is not in the red zone, at this point, but it is clearly in the warning (i.e. yellow) zone. As a result, we will maintain a moderate level of risk in our various strategies, but we will not chase the market given the current environment. As the old saying goes, “Bulls make money, and bears make money, but the pigs get slaughtered.”

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

Conservative Growth
As you might expect, these portfolios had a rather consistent quarter, posting returns that are between the returns from a money market account, and the returns of the S&P 500. Over time, that is exactly where we like to see our flagship strategy. Funds such as Mutual Qualified and Mutual Shares posted returns right along with the broad market, while some of the more conservative funds within this objective (Merger, Gateway, Schwab Hedged Equity, etc.) posted solidly positive returns even though they could not keep up with the market. The money market allocations are fairly low (generally no higher than 30%), but the funds we own are generally more conservative than just buying an S&P 500 index fund.

Most *Conservative Growth* portfolios have a 10% allocation to intermediate-term bond funds. As mentioned above, bonds did not have a strong quarter, but we believe these funds could provide some help to *Conservative Growth* portfolios in the second half of the year, if inflation concerns cool.

Core Equity
Many of our *Core Equity* portfolios lagged our expectations in the second quarter even though they also reached all-time highs during the quarter. As mentioned above, we are not willing to chase this market higher because we believe the risk in this market is getting higher and higher. We did lower the money market level in most portfolios from 50% to roughly 30% during the quarter. In addition, we added an industrials sector fund to capture a movement towards large companies that manufacture goods to be shipped around the world.

Tactical Growth
We consider *Tactical Growth* to be our most aggressive strategy, and will use any asset class and even securities that move opposite the market. Unfortunately, in the second quarter, the flexibility did not work to the advantage of *Tactical Growth* portfolios. Even though the portfolios moved higher, in line with other FSA strategies, these portfolios could not keep up with the broad stock market indices. As with other FSA strategies, we have been unwilling to throw caution to the wind and chase the market higher; although, we consistently moved the portfolios to a more fully invested position as the quarter wore on.

We finally exited the Biotechnology sector during the quarter. We believe this area holds promise, but so far Biotechnology has been one of the lagging sectors of the market. The sector that currently is showing the greatest potential is Technology, where we own about 20% in *Tactical Growth*. In spite of the difficult first half of the year, we believe this strategy is well-positioned to fare well in the second half of the year.

Income & Growth
Income & Growth portfolios posted a good result in the second quarter. With roughly half of the assets in stock funds, and the other half in bond funds (mostly high yield funds), these portfolios continued to consistently move forward. During the quarter, we began to notice some weakness from our high yield funds, and we took the opportunity to trim back these positions a bit. We are now closely watching these funds to see if we will need to exit them completely, or if they might rebound. We are optimistic that they will rebound in July, but are prepared to sell them from the portfolios if necessary.

Income
Since most bond funds posted negative returns in the second quarter, we should expect the Income strategy to have a difficult time making money. Fortunately, the high yield funds that we tend to use in this strategy did manage to eke out a slight gain, so this strategy remains on pace for another good year.

As mentioned above, we have recently noticed some weakness in these high yield funds, and began to trim back some of these positions a bit. We also added an intermediate-term bond fund to these portfolios to diversify from the high yield funds, and to hopefully take advantage of stable to slightly falling interest rates in the second half of the year.

The Future

It is always a relief when the stock markets post good returns. Over the long-term, that is how investors can build wealth and stay ahead of inflation. Of course, we are always looking to the horizon and scanning for future problems. That perspective keeps us from getting too caught up in the emotion of the moment, so that we can focus on what might happen down the road.

Currently, that perspective leaves us with some concern regarding the housing market, U.S interest rates that have drifted higher, a modest technical breakdown among some of our indicators, and relatively high complacency among investors. When combined with the positive aspects of this market—including solid worldwide economic growth and ample liquidity to fuel further market gains—it leaves us in a mildly bullish (or high neutral) invested position.

For some of you—especially those who have only been with us for a few years—it can seem frustrating that we are not capturing more of the gains from the market. Hopefully, in time you will come to appreciate that we do not want to put your hard-earned money at risk, unless we feel the reward is worth the risk. At this time, while we have not retreated to a defensive posture, we do believe it is prudent to keep some powder dry in order to fight the next battle.

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.