



FINANCIAL SERVICES ADVISORY

I N C O R P O R A T E D

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Fed Takes Action to Calm Markets—Will it Work?

August Market Review From Your Portfolio Management Team—September 7, 2007

The credit concerns that began to grip the market in the second half of July took the market by a choke-hold in the first half of August, sending the broad market averages down by 10% or more from their respective peaks. At this point, the Federal Reserve Board stepped in to break up the fight by lowering the discount rate and injecting money into the financial system. In the short run, this action has seemed to work, as the markets have established a bit of calm since mid-August. The so-called VIX index is a measure of market sentiment and has traded less than 15 for most of the year. During this recent turmoil it spiked over 30, but has recently fallen back below 25 as investors try to decide if the worst of the credit fears are past.

As you would expect from FSA, we began reducing the equity exposure in our portfolios as this decline continued to gain momentum. By mid-August, we had very little pure stock funds in our portfolios. In our more aggressive strategies, we even had purchased some funds which move opposite the direction of the broad market. This allows us to hold good stock funds that we like, while still protecting the portfolios, as these so-called short funds offset some of the declines from our favorite long funds. For taxable accounts, this approach also allows us to delay or reduce realized gains.

Let's review the top holdings at FSA as of the end of August:

- **Schwab U. S. Treasury Money Market**

We currently have over 50% 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.

You have probably noticed that most of our money market assets are held in a treasury money market fund rather than the higher yielding Premier money market fund. We moved the money market assets in August, as detailed in the letter we sent you. As we said in the letter, we do not expect any issues from the Premier money market as a spillover from the problems in the sub-prime market, but we took this extra precaution just in case conditions in that market deteriorated more than we expect. We believe the small reduction in yield by holding the treasury money market (less than one half of 1 percent over a year) is worth the peace of mind achieved by holding the highest credit-worthy money market.

- **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.

We have reduced these positions in many portfolios where we own them, but we continue to believe these funds are good holdings in this volatile environment. 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.

- **Merger Fund (Conservative Growth)**

After an uncharacteristic drop from this fund in late July, it made a strong recovery in late August and now trades near its all-time high. 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 one that we can hold through all but the worst market conditions.

- **Schwab Hedged Equity (Conservative Growth, Income & Growth)**

This eclectic fund struggled as the market declined in late July, but has attempted to recover in late August. We eliminated the position in most Core Equity accounts, and have reduced the position in Conservative Growth and Income & Growth portfolios.

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.

- **iShares NYSE Composite (Core Equity)**

We sold this broad-based exchange-traded fund (ETF) in the Tactical Growth objective, but continue to own it in some of the Core Equity portfolios. This portfolio 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.

- **Intermediate-Term Bond Funds (Conservative Growth, Income & Growth, Income)**

This area has been one of the few bright spots in the mutual fund world, as investors have flocked to the relative safety of bond funds during the turbulent July and August time period. Conservative Growth and Income & Growth portfolios have a 10% allocation to bond funds, while the Income portfolios have 20% in this area.

The Federal Reserve Board meets again later this month, and many observers are literally begging for them to lower the Fed Funds interest rate, hoping that a lower Fed Funds rate will provide a boost to the credit markets and to stocks. We don't believe it is the mission of the Federal Reserve to bail out investors who made bad investments, but if the Fed believes that the financial system is in some danger due to these sub-prime loans, they may reduce the Fed Funds rate to help maintain some calm.

We will remain pretty defensive until we have sufficient evidence that the worst is behind us, at least for this most recent episode. Frankly, we like down markets because they act like a rain storm to wash out the excesses, and clear the way for new leaders. We are looking for those new leaders and plan to add them to the portfolios at an appropriate time.

Please contact us if you would like to discuss recent market behavior or if you have changes to your personal situation that might require a change to your risk profile.