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

Fed Action Helps Markets Finish in Positive Territory

Third Quarter Market Review From Your Portfolio Management Team—October 3, 2007

The stock markets took investors on a roller coaster ride in the third quarter. In spite of the positive results posted by many indices, a look at the activity during the quarter shows a strong rally early in the quarter, followed by a sharp decline towards the end of July through the middle of August, with another rally to close the quarter.

Of course, the culprit behind all this volatility was the worsening housing data and the impact of sub-prime loans on institutional investors and hedge funds. The Federal Reserve Board surprised many observers in September by cutting the Fed Funds interest rate by one half of one percent (50 basis points). This cut in interest rates (the first in over 4 years) was seen as a signal that the Fed will do whatever it can to keep the proper amount of liquidity flowing through the markets to prevent a recession. On the day of the Fed action (September 17), the markets rose almost 3%, more than the gain for the entire quarter. Without this 1-day spike, most indices would have finished the quarter in negative territory. (See table below).

Index	*Q3 Return*
S&P 500	2.0%
EAFE	-2.5%
Lehman Bond	1.5%
Money Market	1.1%

Source: Principia
Note: EAFE represents the MSCI index of foreign stocks; Lehman Bond represents the Lehman Aggregate Bond Index. Money Market represents the average return for taxable money markets, as tracked by Morningstar.

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

Conservative Growth
These portfolios weathered the volatility pretty well in the third quarter, falling about half the loss of the S&P 500 from the market high in July. By the middle of August we had built up a sizable money market position (over 50%), and had reduced or eliminated such funds as Rydex Large-Cap Value, Mutual Shares, and Schwab Hedged Equity. During the choppy market that followed, we maintained a conservative allocation, and have only begun to reinvest in equity funds as the market environment began to look healthier—from a technical standpoint.

Throughout the third quarter volatility, we maintained a 10% allocation to bond funds, as this area provided a nice shelter from the equity storm.

Core Equity

The volatility in the third quarter made for a challenging environment for our more aggressive equity strategy. During the summer market swoon, we systematically reduced our exposure to stocks, taking our net allocation to stocks from roughly 70% to 30% at the market low in mid-August. As the market has rebounded we have brought that net stock position up to 50%. During the quarter, we exited Rydex Large-Cap Value and Schwab Hedged Equity, and we reduced Schwab Premier Equity. The industrial sector fund performed well for *Core Equity* clients in the third quarter. As the quarter drew to a close we added a large-cap growth fund and a technology sector fund to capitalize on the flow of money in that direction.

In addition to moving money from stock funds to money market funds, we also purchased so-called short funds—funds that are designed to go up when the market is falling. By adding a modest allocation to these types of funds, we can remain invested in funds that are performing relatively well in a down market and continue to protect the portfolio since the rising short funds will help offset losses from the regular stock funds being held in the portfolio. Our approach is to be 'long' in those areas we believe have the best potential, and to be 'short' in those areas with the worst prospects. The areas in which we purchased these short funds included small-cap stocks, high yield bonds and emerging market stocks. We have exited the short emerging markets and high yield funds, as those markets have recovered. We continue to maintain the short small-cap position, as small-cap stocks continue to lag the large multinational names.

Tactical Growth

Tactical Growth fared pretty well during the volatile third quarter, essentially matching or exceeding the return of the broad market (S&P 500 index). To accomplish this, the *Tactical Growth* portfolio owned stock funds, some short funds, and even owned an aggressive bond fund. The 20% allocated to technology areas provided the biggest lift for the quarter, as did the leveraged bond fund, as investors sought the safety of bonds during the market sell-off. In addition we owned a fund that moves in the opposite direction as real estate securities (we sold this fund just before the end of the quarter), and this fund helped the portfolios, as well.

At quarter end, these portfolios are roughly 45% invested in stock funds. We will increase this level if the market can break above its prior high (from July). We added a small energy position in mid-August, and we will look to increase this position at an appropriate time.

Income & Growth

Income & Growth portfolios continue to fare pretty well despite the volatility of the past 2 years. With a balance of stock funds and bond funds, they seem to offer a great sleep-at-night risk profile—a particularly nice feature for clients making regular and sizable withdrawals from their portfolios.

During the quarter, we exited any large-cap value positions, as well as the high yield bond positions. With the market improving through the end of the quarter, we will look to add modestly to these portfolios, so they can finish the year in line with our expectations.

Income

It has been a challenging environment for bond investors this year, with investment-grade bond funds struggling early this year and high yield bonds struggling more recently. During the quarter we exited our high yield bond funds as they tripped our safety nets, but have already taken a new position there as high yield bonds have started to rebound.

As we enter the final quarter of the year, we will continue to look for relatively stable income funds that can offer an alternative to CD rates.

The Future

Years such as 2007 are typically very challenging for active risk managers, such as FSA. The broad stock market was up 8% in July, then promptly sold off and was actually in negative territory as of the middle of August, only to rally over the past 6 weeks back to an 8% gain. During the 10% decline which began in July, we reduced our equity allocation to prevent more serious losses if the decline continued. Unfortunately, the market recovered pretty quickly, while we remained in a more conservative allocation (that is, we held a large amount in money markets). As a result, of course, we only participated modestly in the rebound at the end of the quarter.

Since we have been in business for 25 years, we have seen these types of markets in the past. The late nineties were another period marked by increasing volatility, and stock markets that only experienced a series of short, sharp corrections that were quickly reversed. Eventually, that environment gave way to the 2001 – 2002 bear market. The point we want to make is that our approach of protecting money during short corrections can be challenging when the market rebounds quickly, but works to our benefit when the correction develops into a bear market. With market risk rising, we believe that our approach to managing risk is as critical today as any time in the past 8 years. We caution all investors not to let short-term performance concerns lead to a poor long-term decision.

The fourth quarter is historically a positive quarter for stock investors and we have no reason to doubt that this quarter could also finish in positive territory. We have been shifting the portfolios to areas we believe have potential for the rest of this year and into 2008. This would include areas such as technology, health care, and large multinational companies. We will continue to scour the landscape to determine where the long-term flow of money is going, and to manage risk to keep your portfolios on a smoother ride.

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.