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June Slump Sinks Stocks to New Lows for the Year

Second Quarter Market Review From Your Portfolio Management Team—July 15, 2008

What a way to close a quarter. After putting together two solid positive months in April and May, the market abruptly turned tail and finished the month of June with its worst loss in over 40 years. The drop in June was so severe that it wiped out the gains from April and May. For the quarter, most stock indices finished in negative territory. For the year, most stock indices are staring at double-digit losses. The table below shows some of the damages among the more popular indices.

Index	*Q2 Return*	*YTD*
S&P 500	-2.7%	-11.9%
Dow Jones	-7.4%	-14.4%
EAFE	-0.9%	-15.7%
Lehman Bond	-1.0%	1.1%
90-Day T-bills	0.4%	1.0%

Source: Ned Davis Research
Note: EAFE represents the MSCI index of foreign stocks; Lehman Bond represents the Lehman Aggregate Bond Index. Q2 Returns cover the period from 3/31/08 – 6/30/08. YTD Returns cover the period from 12/31/07 – 6/30/08.

Of course, we had concerns that we might see exactly this type of reversal. It is the reason we did not get very invested as the market rallied in April and May. It was not comfortable seeing the market recoup much of its loss from the first quarter, while we remained mostly in money market (and in some cases some high yield bond funds). Our investment discipline, which has been developed and refined over the past 25 years, is designed to minimize our getting heavily invested during these so-called 'fake-out' rallies when the market stages a pretty impressive rally after a prior down move, leading many investors to believe that the worst is over. As a result, FSA accounts are down, on average, less than 2% (including fees) for the year, while most stock indices are down over 10%.

No one really knows what the market is going to do next, although many will offer their opinions about the market's next move. We have our opinions too (e.g., we think there are further drops to come until oil prices stabilize and reverse course); however, our discipline is to remain liquid (which means to hold high levels of money markets) until the trend of the market has turned upward. As a result, you can be comfortable knowing that we will keep the portfolios very defensive until we see strong evidence that the environment has turned more positive. That approach has served our clients well over the past 25 years, as we have avoided much of the market's biggest calamities, including the crash of 1987, bear market of 1990, and the bear market of 2000 – 2002. Events such as these can have a profound impact on your nest egg, and these are the types of market turmoil we try to mitigate.

Below we review the five broad strategies that FSA manages. Keep in mind that your specific portfolio may differ to some degree from the averages, as our portfolios are individually managed.

Conservative Growth

*Current Money Market Allocation: 90% - 95%**

With the nice rebound in high yield bond funds early in the quarter we began to add some of these bond funds into the portfolios, getting about 30% of the portfolio in high yield bond funds by mid-May. As the stock market rolled over in June, the high yield funds also began to retreat, so we have systematically cut back our position to 15% as of the end of the quarter. On average, the Conservative Growth accounts were down only a fraction of 1% for the quarter.

Core Equity

*Current Money Market Allocation: 100%**

Core Equity accounts maintained a high money market allocation throughout the second quarter; although, we did add a 10% position in a technology fund, as that area looked strong as the second quarter got underway. We held that technology position through the end of the quarter (although we did sell the position in early July). For the quarter, the Core Equity accounts performed quite well, falling just a fraction of 1% on average.

Tactical Growth

*Current Money Market Allocation: 45%**

Tactical Growth accounts fared quite well for the quarter, actually rising in value. These accounts include a mix of equity funds (biotechnology, wireless communications), commodity funds (agriculture, silver), and inverse funds (that typically rise when stocks fall). This eclectic combination managed to make money even during the treacherous month of June. The flexibility of the Tactical Growth strategy makes it particularly suitable for this volatile and shifting market.

Income & Growth

*Current Money Market Allocation: 90%**

This more conservative strategy fared well for the quarter and finished essentially flat, an admirable result considering the losses suffered by most stock indices. At one point we had these portfolios 50% invested in high yield bond funds, which tend to offer some characteristics of both bonds and stocks. As of the end of the quarter however, we had reduced our allocation to these funds down to 20% (By early July we had reduced that allocation even more, down to 10% in high yield funds).

Income

*Current Money Market Allocation: 90%**

Our most conservative strategy avoids stock funds entirely, so naturally the Income portfolios have missed most of the recent turmoil. For the quarter, these portfolios were down less than 1%. At one point during the quarter, we had built up a high yield bond allocation of 60%, in an attempt to take advantage of the rebound in that asset class. With those funds retreating in June, we have cut that position back to 20% as of quarter end (and in early July we cut the position even further—back to 10%).

*These allocations represent the money market levels of our various models, including trades through July 10.

The Future
As difficult as it is to manage money during these types of turbulent environments, conservatively oriented firms such as FSA actually welcome these types of markets as they help restore the markets into proper balance. During long bull markets investors tend to get complacent and expect the markets to only go up. Then we see stock prices get far ahead of the underlying values of the companies. Bear markets help get prices back in alignment with the value of the companies. We are much more comfortable getting heavily invested after a bear market than we are after 3 or 4 years of a bull market. You can rest assured that once the excesses of the prior bull market are washed away, we will have an exciting opportunity for market gains. We could be looking at an opportunity not unlike 1991, 1995, or 2003, all which saw gains in excess of 25% - 30%.

One of the advantages of having your money managed by professionals is that you can leave the stress and worry to someone else, especially during challenging times like these. And it has been an agonizing time for the investment team at FSA. In addition to all the clients around the country who have entrusted their life savings with us, we also have our own money invested in many of these strategies, plus we have family members and personal friends invested with us. So you can be sure that have every motivation in the world to be diligent and focused in managing your portfolios to achieve your medium- and long-term goals.

At this time we believe an excellent wealth creating environment is coming towards us, and we will be able to use our high money market position to good use. Until that time we will continue to remain liquid and keep you in calm waters.

Please let us know if there is anything we can add to these monthly reports that would help you better understand what is happening in your accounts. In addition, we are considering hosting a conference call to discuss the recent market turmoil, plus our outlook for the rest of 2008 and even some thoughts for 2009. If you would be interested in participating in such a call, please respond to this email or call our office and let Stephanie know of your interest.