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The Best Offense is a Good Defense

July Market Review From Your Portfolio Management Team—August 7, 2008

Former heavyweight champ Jack Dempsey is credited with saying that the "best defense is a good offense." Well, at FSA we turn that phrase on its head and argue that the best offense is a good defense. That is to say, the best way to build lasting long-term wealth is to protect those gains during bear markets. It is a philosophy that we have upheld for over 25 years. So far in 2008, it characterizes how we have positioned the portfolios for much of the year.

As of early August, most FSA accounts are sitting in the safety of 100% money market funds. And with the high money market allocations we have held for most of the year, we have escaped the wrath of the bear with only a few minor scratches. Nevertheless, in order to participate in the long-term gains from investing in stocks, we have to be willing to suffer some losses along the way. Our approach attempts to minimize those losses, so that when stocks rebound, we can recoup those losses and move on to new highs more quickly than just investing passively in the various stock market indices.

As we begin the month of August, the markets are oversold and due for some type of bounce. With the accounts heavily in money markets, we need to examine every rally to determine if we want to participate or not. That is, do we believe any rally has the potential to have legs, or is it likely to fail pretty quickly? Since no one knows the future, our approach is to nibble a bit if the rally begins to build, and then gradually add to those positions as momentum builds. If the rally fails, we have relatively little invested, so the portfolios are insulated from serious damage.

The Future

In mid-July, the decline in the S&P 500 index reached beyond 20% (starting from the high in October 2007) which characterizes this decline as a so-called 'bear market.' As such, it is the first bear market since the particularly painful one of 2000 – 2002. It also marks the 22nd bear market since 1929 (according to a report from Ned Davis Research). The average bear market lasts almost 12 months and takes down the popular stock indices about 30%. If this bear market follows the averages, it would last another 2 months and fall another 10% (which would bring the S&P 500 index down to 1100 before beginning its recovery). Of course, over the past 80 years, there has been a very wide dispersion in the lengths of these bear markets, with the shortest one lasting only 2 months, and the longest ones lasting over 2 years. So, the average duration of 12 months is just a guideline. Each bear market has its own unique signature, and investors have to react and adapt to each one.

The main factors driving the market today seem to be oil prices and the housing market. High oil prices, coupled with a weak housing market, have spurred concerns of a recession in the U.S., while these same high fuel and food prices have other people concerned with inflation. In addition, we have a presidential election underway with no incumbents running. This event is adding an additional layer of uncertainty to the markets. As a result, we see few, if any, trends—at least in a positive direction—that we could add to the portfolios at the moment. So, having a high money market position is actually a pretty good investment in this type of market. In addition, we have made use of 'inverse' funds in our Tactical Growth strategy. These are funds that can go up when the overall market is falling since they are designed to move opposite the general direction of the market. As a result, we see opportunity even in a falling market, as long as the trend is clearly definable.

For now, we are content to keep our gloves up and elbows in, while waiting for the opportunity to go on the attack again.

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.

Special Announcement
In response to interest from a number of our clients, we have scheduled a conference call/webinar to discuss:

a) The current market environment
b) How FSA portfolios are faring in this environment
c) Our thoughts on potential future market leaders once we enter the next up-cycle
d) Questions from our clients

To view our slides you will need a computer with internet capability, as well as a telephone to listen to the commentary. We have reserved two dates so that hopefully one of these times can be convenient for you:

Date:	Friday, August 15	Tuesday, August 19
Time (EDT):	2:00pm	11:00am
Duration:	45 minutes	45 minutes

If you would be interested in participating in such a call, please respond to this email or call our office and Stephanie will give you the conference number and password. If you sign up and then cannot participate, please let us know so that someone else can join. If you would like to participate, but neither of these times is convenient, please let us know that as well, because we plan to host conference calls in September if there is sufficient interest. Thank you.