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Darn the Torpedoes…Full Speed Ahead

Third Quarter Market Review From Your Portfolio Management Team—October 6, 2009

With apologies to the Civil War naval officer David Farragut who made a similar quote, investors continued to push stocks and bonds higher in the third quarter, seemingly blind to the realities of the global economy in the aftermath of last year's turmoil. After posting returns over 15% in the second quarter, we saw nearly a replay in the third quarter—a quarter that over the past ten years has provided anemic returns at best. In fact, you have to go back to 1989 to find returns that are anywhere close to the returns we witnessed this year.

Once again, the rally was broad, with most stocks participating. It was also a good quarter for corporate and municipal bonds, as these areas benefited from investors seeking higher returns than money markets, but with less volatility than stock funds. According to the mutual fund trade association (ICI), bond funds have seen net inflows that are roughly 10 times the inflows for stock funds so far in 2009. Since the approach at FSA is to "follow the money," you can see why we have put so much emphasis on bonds this year.

The table below shows the results for the quarter and year-to-date for a number of stock and bond market indices.

Index	*Q3 Return*	*YTD Return*
S&P 500	15.6%	19.3%
Dow Jones	15.0%	10.7%
EAFE	14.8%	20.7%
Barclays Bond	3.7%	5.7%
90-Day T-bills	0.0%	0.1%

Source: Ned Davis Research
Note: EAFE represents the MSCI index of foreign stocks; Barclays Bond represents the Barclays Capital Aggregate Bond Index (this index used to be called Lehman Aggregate Bond Index). Q3 Return covers the period from 6/30/09 – 9/30/09. YTD Return covers the period from 12/31/08 – 9/30/09.

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: 25%**

Conservative Growth accounts posted solid results in the third quarter, thanks to the strong returns from our various bond funds. During the quarter, we added a global balanced fund, to go along with the collection of corporate bond funds and municipal bond funds we have owned for a good part of the year. Most accounts have 20% - 30% in money markets, which we will tap if the stock market can maintain its upward trend in the fourth quarter. On average, these accounts were up over 6% for the quarter, and are up close to 10% for the year.

Core Equity

*Current Money Market Allocation: 22%**

This strategy posted a decent return for the quarter, as we have increased the equity allocation since the market trend finally turned positive in late July. Given the strength of the rebound in such a short period of time, we are being careful in adding stock funds to these portfolios, but if the stock market can maintain its momentum in the fourth quarter, we will look to invest the rest of the money market position before year end. The corporate and municipal bond funds we added to Core Equity accounts this year have also made a nice contribution to returns. In some cases these bond funds have outperformed many stock funds. On average, the Core Equity accounts were up about 5% for the quarter, and are up about 6% for the year.

Tactical Growth

*Current Money Market Allocation: 15%**

There was not much activity in the Tactical Growth accounts during the third quarter. We sold the inverse Treasury fund we had bought earlier in the year, as well as the inverse real estate fund. In addition, we purchased an energy sector fund as we see this as an area with good long-term potential. In addition to the rather modest equity allocation, we also maintain a heavy bond weighting, at nearly 60%. On average, the Tactical Growth portfolios rose about 7% for the quarter, and are up roughly 17% for the year.

Income & Growth

*Current Money Market Allocation: 12%**

Even though Income & Growth is a rather conservative strategy, these accounts continue to post excellent results. Typically, we don't see bond returns matching stock returns, especially when stocks are doing so well. Nevertheless, this strategy performs well with its mix of conservative growth & income oriented stock funds, as well as its corporate and municipal bond funds. On average, the Income & Growth accounts were up roughly 8% for the quarter, and are up nearly 11% for the year.

Income

*Current Money Market Allocation: 13%**

With the amazing rebound in the bond markets this year, the Income accounts have made an equally amazing rebound, as well. The returns for many of the bond funds in our portfolios, including the high yield funds, the multi-sector funds, as well as the municipal funds were above 10%. This performance from the bond market has enabled our more conservative strategies to keep pace (and even outpace) some of our more aggressive strategies. For the quarter, these portfolios rose over 7% and are up almost 13% for the year.

*These allocations represent the money market levels of our various strategies, including trades through September 30, 2009.

The Future
Well, the stock and bond markets have come a long way since the fear and panic of six short months ago. Back then investors were concerned about a replay of the Great Depression that took stocks down over 80% and brought unemployment to 25%. Some of the talking heads on television were painting a dismal picture of the economy in a vicious spiral of falling economic growth and rising unemployment. Well, the reality, as usual, was less dire than the media portrayed, just as things were not as rosy as the media would have had us believe back a few years ago, when it was common knowledge that houses only go up in value and oil was on its way to $200 a barrel.

One of the biggest lessons from the past three years for investors to learn is that things are usually not as rosy as they sometimes appear, nor are they as dark as they sometimes appear. In order to be successful as investors, we have to learn not to follow the common emotional highs and lows of the day. As Warren Buffet has said, “Be fearful when others are greedy, and be greedy when others are fearful.”

We are pleased that the stock and bond markets have rallied and that our accounts have participated to some degree in that rally. As we noted in an earlier Commentary, most clients should have reached all-time highs in their accounts with this recent rally (unless, of course you are taking money out of your accounts). Most Core Equity accounts remain a little below their highs (about 5%), while the other four strategies recouped their losses back in June.

We remain skeptical that the economy and the stock market are on a fast track to full recovery. The underlying problems that led to the meltdown have not been resolved. As we see it, we spend too much money on current consumption, and do not save enough. So what has been the government’s response to the crisis? Spend a huge amount of money and try to coax the consumer to buy more things. The massive government stimulus has helped give the appearance that things are getting back to normal, but we are not convinced that once the stimulus runs its course, the U.S. consumer will be ready and willing to carry the load going forward. That suggests to us a sluggish and tepid recovery, which will make us reluctant to get too aggressively invested.

We are grateful for the gains thus far, but we are constantly scanning the horizon for new torpedoes.

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.