FINANCIAL SERVICES ADVISORY
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Bubbles, Bubbles Everywhere

First Quarter Market Review From Your Portfolio Management Team—April 9, 2010

We hear a good deal of talk about 'bubbles' these days—much more than we ever had in the past. Back in the late nineties, a few analysts warned of a brewing bubble in internet stocks, but most investors ignored them. During the middle part of the last decade some analysts warned of a brewing bubble in the housing market, but again most observers ignored their calls. However, after the meltdown in 2008, suddenly analysts see bubbles everywhere—credit bubble, money bubble, emerging market bubble, information bubble, political bubble, etc. It's hard to open a financial publication these days without finding another reference to some new asset being in a bubble.

Well, if it's one thing we've learned after nearly 30 years following the markets, it's that if everyone is seeing bubbles under every tree, then we probably are not going to see one pop any time soon. If most investors are truly aware and concerned about an investment bubble popping, then clearly they are going to take steps to protect themselves. That collective activity will in essence let the air out of the bubble before it 'pops.' Investment bubbles pop when everyone is still in the investment and something comes along to spook everyone into leaving at the same time. With all the warning and concern over bubbles in the media these days, especially after the turmoil of 2008, investors will be too skittish to commit too much money to any area with even the hint of serious losses. That is not to say that we won't see another bubble and that it won't be devastating—as they always are—but just that they tend to happen when we are focused on other things. In addition, the general media will not see the bubble because they tend to write based on the prevailing mood of the day, so not only will they not see the bubble, they will tend to write in support of whatever the bubble asset is. Investing is a crazy business, isn't it?

Well, no one is talking about a bubble in stocks these days, but they continue to forge ahead. The table below shows the results for the first quarter for a number of market indices.

Index	*Q1 Return*
S&P 500	5.4%
Dow Jones	4.1%
EAFE	4.3%
Barclays Bond	1.8%
90-Day T-bills	0.0%

Source: Ned Davis Research
Note: EAFE represents the MSCI index of foreign stocks; Barclays Bond represents the Barclays Capital Aggregate Bond Index. Q1 Return covers the period from 12/31/09 – 3/31/10.

Clients of FSA realize that we have ridden the bond bandwagon for almost 1½ years. We began putting money to work in this area in late 2008 as we saw credit spreads at historic highs, coupled with a basing process from a number of corporate bond charts we follow. With money market yields close to zero, we moved to bonds to capture solid single digit returns and avoid the volatility of the stock market. Well, these corporate bond funds have been a great ride for FSA clients—providing solid returns at relatively low volatility. What else could an investor ask for?

Even though some observers are beginning to call for a bubble in bonds, given the strong money flows in their direction, as well as the solid price gains, bonds continued (at least through the first quarter) to provide a compelling investment choice. Given our continued apprehension concerning the stock market, we remain comfortable holding to these positions. Of course, we keep the FSA Safety Net™ in place with each position in case the environment changes considerably for the worse. In addition, if our comfort level with the stock market grows in the coming weeks or months, we can always use the proceeds from some of those bond positions to increase our stock fund allocation.

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: 15%**

Conservative Growth accounts continued to grind higher this quarter. With very little equity holdings, these accounts have had to rely on the various corporate and multi-sector bond funds to do most of the work. Once again, however, many of these bond funds posted returns that one might expect with stock funds, with returns ranging from 3% - 5% for most of these funds.

With the stock and bond markets firming up in February after a pullback in January, we moved to reduce our money market allocation by adding a foreign bond fund to many of the portfolios. At quarter end, we held roughly 15% in money market, on average. We will look to reduce that allocation even lower if the overall market trends can support such a move.

Core Equity

*Current Money Market Allocation: 15%**

These accounts have continued to perform well since they have the highest allocation to stocks at the moment. We reduced the money market position a bit by adding to our bond position. We remain a bit skeptical regarding stocks, but continue to look for an opportunity to add to our stock allocation. Small- and mid-cap stocks look promising currently.

Tactical Growth

*Current Money Market Allocation: 10%**

Our most aggressive strategy lagged a bit in the first quarter, relative to our other strategies. This was due primarily to weakness in our energy fund and natural gas fund. We reduced our energy fund position in February as it was approaching our stop loss. Fortunately, it rebounded, so we have maintained a 5% position. We sold the natural gas ETF as prices reversed course and turned lower, in spite of the generally improving economy. We believe there will be a good opportunity in this area, but we will need to wait for trends to improve again. The bond funds for the most part posted solid results for Tactical Growth clients, and we added a high yield fund to the portfolios in March.

Income & Growth
*Current Money Market Allocation: 6%**
These portfolios continue to chug along, thanks to steady results from its mix of stock and bond funds. During the quarter, we reduced the money market position slightly by adding to our bond position. For taxable accounts we increased our tax-free municipal bond position, while for the retirement accounts we added a defensive bond fund that should generate better returns than money markets but not face too much risk from rising interest rates. On average, the Income & Growth accounts were up roughly 2% for the quarter.

Income
*Current Money Market Allocation: 8%**
Our conservative Income accounts posted the best returns among our five strategies for the quarter. Solid results from nearly all holdings in the model allowed this all-bond strategy to keep pace (and even outperform) our more aggressive strategies. During the quarter, we reduced the money market position slightly by adding a low duration (or lower risk) bond fund.

*These allocations represent the money market levels of our various strategies, including trades through March 31, 2010.

Final Thought
According to Wikipedia, bubbles occur when market participants drive prices above some perceived notion of fair value. There have been these so-called bubbles as long as people have been speculating. In 1841, Charles Mackay wrote what has become an investing classic, called, *Extraordinary Delusions and the Madness of Crowds*. In this book, he describes a number of these episodes, including the Tulip Mania in the Netherlands in the 1600s. During that time the price for tulip bulbs rose to the stratosphere as people would take their entire life savings to trade these flower bulbs. As you might imagine, when the bulb prices collapsed many people were wiped out financially.

Then there were two notorious bubbles in the 1700s that involved trading in company shares that had trading arrangements in the New World—one a French company and the other a British company. Once again, people made good money in the early going, but those who were drawn in later were devastated.

Bubbles are a phenomenon of human behavior, and we will have bubbles as long as goods or services are exchanged among people—whether it is stocks, bonds, gold coins, or cabbage patch dolls. Investment bubbles typically begin as valid investment concepts, but they morph into irrational exuberance as valuations get more extreme. Investors get overwhelmed by greed and believe this investment offers a 'can't lose' proposition or even a guarantee of riches. At this point, the investment has moved into the realm of a bubble. Historically, bubbles can take 3 – 5 years to develop, and when they pop it may take a decade or more before interest returns to that area.

As investors, we need to be constantly on guard for those periods of time when the value of an item gets grossly separated from its real (or intrinsic) value. Obviously, that can be difficult to measure at times, but that is the challenge and thrill of investing. For clients of FSA, the FSA Safety Net™ is in place to help mitigate losses from any investment that changes course and begins to fall in value. The safety net, of course, cannot prevent losses, but it does provide us an exit strategy to help reduce losses. Rest assured that one of our most important jobs in managing your hard-earned money is to make sure we recognize the difference between a bull market and a bubble.

Let us know if there is anything we can add to these monthly reports that will help you better understand what is happening in your accounts.