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Throw the Rascals Out

Third Quarter Market Review From Your Portfolio Management Team—October 7, 2010

Mid-term elections are usually pretty quiet affairs. They don't carry the drama or excitement of the elections that occur in sync with the election of a president. Participation by voters is typically down considerably from those years that include a presidential election. And the outcomes usually don't mean as much to Wall Street either.

Well, in 2010, that does not seem to be the case. Ever since the financial crisis began in 2007, there has been a growing discontent on the part of the electorate with our elected officials. Voters of all political views are increasingly concerned that their representatives are not voting in the best interests of the country. In addition, the country is facing some serious issues, and there is a growing consensus among voters that we need problem solvers in office, not self-serving politicians who prefer to fan the flames of partisan politics.

The Tea Party movement (named after the Boston Tea Party in 1773 to protest the British Tea Act) has gained a good deal of traction (primarily within the Republican Party) in part to bring more fiscal responsibility to Congress. With a tax increase looming in 2011 unless Congress votes to extend the so-called 'Bush tax-cuts,' there is a great deal of interest in the outcomes of these elections. At this point there is no doubt that the Democrats will lose House and Senate seats to the Republicans (this typically happens during the mid-term elections—the party of the President loses seats to the opposition party). The question that analysts are trying to answer is whether the Democrats will hold on to their majorities in either the House or the Senate. Wall Street usually prefers a divided leadership among the legislature and the President because it helps ensure that no radical legislation is passed.

More than is usually the case, we believe these elections will have an influence in the stock and bond markets for the month of October, and any surprises could have implications that carry through year end and even beyond.

Even though September is traditionally the weakest month of the year for stocks, in 2010 stocks posted their best one-month return since April 2009. This strong result more than recouped the losses from August which left stocks with a solid return for the third quarter—historically the weakest quarter of the year. We believe investors are beginning to anticipate an extension of the tax cuts for 2011, as well as better balance among the political parties within Congress.

The table below shows the returns for a few of the most popular investment indices. In spite of the strong results for stocks in the third quarter, notice that bonds continue to maintain an advantage year-to date, and of course, that return advantage comes with less volatility as well.

Index	*Q3 Return*	*YTD Return*
S&P 500	11.3%	3.9%
Dow Jones	10.4%	3.5%
EAFE	7.1%	-0.8%
Barclays Bond	2.5%	7.9%
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. Q3 Return covers the period from 6/30/10 – 9/30/10. YTD Return covers the period from 12/31/09 – 9/30/10.

<u>Portfolio Review</u>

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%**

After the negative effects of the May 'Flash Crash' began to fade early in the third quarter, we began to redeploy the cash we had built up in the second quarter. Rather than investing very much in lower quality bonds, we put most of that money to work in diversified, higher quality bond funds. Some accounts will notice we have added some exchange-traded bond funds to the overall mix, as well. For taxable clients, we continue to like municipal bond funds, and we have as much as 30% - 40% of the portfolio in these tax-free income funds. On average, these accounts were up about 2% for the quarter, and are up roughly 4% for the year.

Core Equity

*Current Money Market Allocation: 15%**

We continue to go light on our equity positions in this strategy, as well, with most accounts only maintaining a 10% - 20% allocation to fairly conservative stock funds. We have also maintained positions in high yield bond funds, which will tend to move in the same direction as stocks. During the quarter, we reduced the money market position by adding some diversified bond funds, as well as slightly increasing our equity allocation. On average, the Core Equity accounts increased about 2% for the quarter, and are up between 1% - 2% for the year.

Tactical Growth

*Current Money Market Allocation: 23%**

Our most aggressive strategy continues to concentrate in bond funds, with over 60% of the portfolio invested in some type of bond fund—high yield, emerging market, long-term government, or municipal. During the correction we added the inverse real estate fund, but closed it out recently, as stocks rallied. On average, the Tactical Growth portfolios rose about 3% for the quarter, and are up about 3% for the year.

Income & Growth

*Current Money Market Allocation: 19%**

These conservatively oriented portfolios continue to be the beneficiaries of heavy allocation to diversified investment-grade bond funds, as well as a conservative, eclectic fund which owns (among other securities) gold bullion and silver. As with our other strategies, we have reduced the money market position during the quarter by adding some lower risk bond funds. On average, the Income & Growth accounts increased over 2% for the quarter, and are up about 4% for the year.

Income

*Current Money Market Allocation: 23%**

The past two years have been favorable for this strategy, as bonds have performed very well. We manage this strategy for investors who are looking for an alternative to CDs and money markets, but are willing to assume a modest amount of risk. For the quarter, these portfolios rose about 2% and are up roughly 5% for the year.

*These allocations represent the money market levels of our various strategies, including trades through September 30, 2010.

Looking Ahead

While bonds continue in a low-volatility uptrend, stocks peaked in April of this year, and have been bouncing up and down since that time. The strong return in September pushed stocks out of their recent trading range, which suggests there may be potential for further rallying through year end. To be clear, the health of this recovery is anemic, and stocks are a little extended in the short run, but we can't ignore the trends if they continue to persist.

Certainly, within the more aggressive strategies, such as Core Equity and Tactical Growth, we may add some equity positions within the coming days or weeks if the recent uptrend in stocks can continue. Areas that look attractive to us currently include technology oriented investments, as well as overseas investments.

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.