FINANCIAL SERVICES ADVISORY
INCORPORATED

Rockville, MD 20850   800.235.4567   www.fsainvest.com

Autumn Rebound Continues

October Market Review From Your Portfolio Management Team—November 11, 2010

Stock and bond investors continued to bid up prices in October, in anticipation of renewed gridlock in Congress (assuming Republicans would make serious gains in the mid-term elections), as well as another round of quantitative easing (i.e., stimulus) from the Federal Reserve. Building on the strong showing in September, stocks added another 3% in October, while bond returns varied from flat to 2% depending on the type of bond. And investors got what they were looking for during the first week of November, as the election ushered in a new majority party for the House of Representatives and the Federal Reserve announced a new aggressive effort to jumpstart the economy. Will this be enough good news to keep stocks and bonds higher through the end of the year? I guess we'll learn the answer to that question in the weeks to come.

While FSA accounts maintain their emphasis on bond funds, given their consistent trends and steady returns, we are beginning to nibble in the equity markets, especially in the more aggressive accounts (namely Core Equity and Tactical Growth). Both of these strategies now have roughly 30% of their assets in some type of equity-oriented investment, which have participated nicely in this fall rally. While we remain wary of a correction now that the election is over, with most equity indices breaking to new highs for the year, we continue to look for opportunities to add equities selectively between now and the end of the year.

Below, we highlight some of the areas that are getting focus in our portfolios:

- **Investment-Grade Bond Funds (Core Equity, Conservative Growth, Income & Growth, Income)**
  Across all of our accounts, we maintain about 30% in these funds which invest in high quality corporate and government bonds. We increased our allocation to these types of funds this summer in the aftermath of the so-called May Flash Crash. While riskier assets have performed better recently, we like the stabilizing influence of these more conservative bond funds. If interest rates or inflation begins to perk up down the road, these funds would probably be among the first to get sold as they are the most sensitive to rising interest rates. In our taxable accounts (non-retirement accounts), we are making use of tax-free municipal bond funds to help soften the taxable impact of the monthly dividends.

  Examples: Bond Fund of America, Dodge & Cox Income, PIMCO Total Return

- **High Yield Bonds (Tactical Growth, Core Equity, Conservative Growth, Income & Growth)**
  These funds are more volatile than the investment-grade funds discussed above, but so far in 2010, they have delivered better returns. We reduced our allocation to high yield bond funds earlier this summer as the stock market weakened, but they rebounded and continue to perform well. These funds tend to move with the stock market, so they have done well as stocks have rallied.

  Examples: BlackRock High Yield, Pioneer High Yield, DWS High Yield

- **Multi-Sector Bond Funds (Core Equity, Conservative Growth, Income & Growth, Income)**
  As the name implies, these funds tend to own a variety of bond types—including high yield bonds, high quality bonds, and even foreign bonds. With these types of funds, we let the portfolio manager vary the mix among a variety of bond types, depending on where they are finding opportunities.

  Examples: Federated Strategic Income, Loomis Sayles Bond, Managers Bond

- **Foreign Bond Funds (Tactical Growth, Core Equity, Conservative Growth, Income)**
  These funds invest in bonds issued by foreign governments, as well as foreign corporations. A weakening dollar will usually give these types of funds a boost.

  Examples: Eaton Vance Global Absolute Return, DWS Emerging Markets Fixed Income, PIMCO Foreign Bond

- **Equity Funds (Tactical Growth, Core Equity, Income & Growth)**
  As the stock market has firmed up over the past 6 weeks, we have begun to increase our weightings within our more aggressive strategies. Both Tactical Growth and Core Equity have roughly 30% in these types of funds. For the most part we are using a combination of more conservative funds along with a few aggressive funds, including those within the technology area. Tactical Growth clients have also recently added an ETF that invests in China. If stocks can maintain their recent upward path, we will look to increase our equity position in Conservative Growth and Income & Growth, as well.

  Examples: Rydex Technology, iShares MSCI China, Permanent Portfolio

- **Schwab U.S. Treasury Money Market**
  Across all five strategies, we have pulled down the money market position to around 10%, on average. In the days and weeks ahead, we will look to reduce the money market position below 5%, either by adding equity or fixed income, depending on the strategy. Money market funds play a critical role in the investment discipline of FSA, primarily by helping protect the portfolios from significant drawdowns, but with yields at zero, there is little incentive to park money there unless conditions in both the bond and equity markets appear weak, which is definitely not the case currently.

Future

With the election and the Federal Reserve meeting and most of the earnings season behind us, we struggle to find the impetus for further market surprises to the upside. It could be economic releases that show a slowly improving economy. Or it could be news that our political leaders are willing to work together to address the issues that weigh on the economy and the markets. Maybe there is enough momentum behind stocks right now that they could continue to grind higher through the end of the year. At the end of the day, we will focus on the price trends and buy those areas getting the most investor interest (being sensitive to how much volatility we may have to endure).

Unless there is a serious reversal in the next week or so, we will be looking for a good opportunity to add to our equity positions between now and yearend. With our low money market positions, there is not much we can buy unless we sell some of the bond funds we already own. And we are not in any hurry to do that as long as our bond funds continue to perform well.