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Autumn Begins With a Fall

Third Quarter Market Review From Your Portfolio Management Team—October 11, 2011

Stocks finished the third quarter on a decidedly negative note, falling over 2% on the last day of the quarter, and sending the general stock market to its worst quarterly return (-14%) since the dark days of the financial crisis back in 2008. Investors seem to be gripped with two main issues: 1) concern that our economy is losing momentum and could slip back into recession; 2) concern that Europe has not resolved the ongoing debt troubles in Greece, and fears of a domino effect if Greece defaults or is booted from the Euro zone.

From its peak on 04/30/11, the S&P 500 index is down 17% through the end of September. It may seem hard to believe, but we are basically at the same level on the S&P 500 index as we were in September 2008. On 9/30/08 the S&P index closed at 1165, and we closed September this year at 1131.

Index	*Q3 Return*	*YTD*
S&P 500	-13.9%	- 8.7%
Dow Jones	-12.1%	- 5.7%
EAFE	-15.7%	-15.6%
Barclays Bond	3.8%	6.6%
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 06/30/11 – 09/30/11. YTD covers the period from 12/31/10 – 9/30/11.

As you would expect, our portfolios have fared much better. We have been leaning towards bond funds rather than stock funds all year. A good portion of our bond allocation has been in so-called high yield bonds, which do behave in line with stocks, but they have only fallen about half. And as we discussed last month, we have been hitting our safety nets across all our stock and high yield funds, so we have either sold the funds outright, or we have hedged the positions by purchasing inverse funds to offset some or all of any future declines. At this point, most of our portfolios carry a slightly negative beta, which means they may go up slightly on down days and go down slightly on up days. The main point here is that we are very defensive right now, and will remain that way until the overall stock market can regain some forward momentum.

Portfolio Review

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: 45%**

These accounts carry no stock funds currently, as what little stock funds we held were sold out in August. We have also dropped any high yield bond funds as concern over our slowing economy has put these funds under pressure. In fact, we are carrying an inverse high yield fund, which benefits as high yield bond prices fall. In addition, we continue to hold the higher quality corporate bond funds, which have held up just fine through this volatile quarter. On average, these accounts were down about 3% for the quarter, and are down about 1% for the year.

Core Equity

*Current Money Market Allocation: 65%**

Our more aggressive, equity-oriented strategy has shed almost all of its stock funds, except for a modest position. We also cut back the high yield bond funds in the portfolios, and continue to hold an inverse high yield fund. In addition, late in the quarter, we added a inverse real estate fund, which should benefit if REIT prices continue to be weak (and would also benefit if the overall stock market continued to slip). Overall, these portfolios are carrying a slightly negative beta. On average, the Core Equity accounts fell about 5% for the quarter, and are down about 3.5% for the year.

Tactical Growth

*Current Money Market Allocation: 40%**

In this strategy, we have been willing to invest pretty heavily in the inverse funds—with 24% of the portfolio currently invested in such funds. We continue to maintain a modest stock fund allocation, as well as a small allocation to high yield bond funds, even though those positions are hedged with inverse funds. As with Conservative Growth and Core Equity, Tactical Growth accounts carry a slightly negative beta, so they are very defensive right now. On average, the Tactical Growth portfolios fell almost 6% for the quarter, and are down about 3% for the year.

Income & Growth

*Current Money Market Allocation: 45%**

These portfolios currently carry no stock-oriented funds, as recent weakness in gold prices forced us to sell The Permanent Portfolio (PRPFX). We continue to maintain our allocation to high quality bond funds. On average, the Income & Growth accounts fell less than 2% for the quarter, and are essentially flat for the year.

Income

*Current Money Market Allocation: 50%**

Once again, this strategy has avoided the turmoil going on in the stock market. During the quarter, we did trim back a few positions that were designed to protect against rising interest rates. Since interest rates went the other way (even lower), we exited those funds. For the quarter, these portfolios fell about 1%, and are up slightly for the year.

*These allocations represent the money market levels of our various strategies, including trades through September 30, 2011.
Performance numbers for FSA portfolios represent composite results and are inclusive of the annual fee of roughly 1.2%.
A complete Performance History of all FSA strategies is available upon request.

A Look Ahead

What can we expect from the markets as we enter the fourth quarter? From a seasonal standpoint, we are entering the strongest months of the year (November – January), so history suggests that we should be on the lookout for a market turnaround. In addition, with stocks down 15% - 20% from their highs back in the spring, it is reasonable to expect a positive close to the year.

Nevertheless, from a technical standpoint, stocks remain in a downtrend, so we will keep the portfolios in a defensive position until that trend turns in a more favorable direction.

We will begin to get the reports on how companies fared in the third quarter beginning this week, which should give us a reading as to how they are navigating the struggling economy. In addition, we will get our first estimate of GDP growth at the end of this month, so these two data points should set the stage for the mood of the market through the end of the year. And of course, any news that paints a positive or negative picture of the situation in Greece will probably be a curve ball for the market to consider.

Since our portfolios weathered the recent storm in decent shape, we now have assets available (in money market) to take advantage of whatever opportunities we find in the weeks and months ahead.