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Bulls Fight Back…Can They Hold On?

October Market Review From Your Portfolio Management Team—November 16, 2011

Following the markets these days is like watching a spy movie—you have to pay close attention because if you miss one detail, you can easily get lost and not follow the plot of the movie. After suffering through a brutal third quarter that brought stocks down close to 10% for the year, investors found enough good nuggets in the economic data to propel stocks up over 10% in October, the best return for the S&P 500 since December 1991. Stocks are now back to where they started the year. It has been an awful lot of turbulence and stress to just be flat for the year.

Frankly, we're not sure what got stock investors so excited. Sure, the recent economic growth number (GDP) came in at 2.5%, which clearly shows we're not falling into recession, but growth at this level is not going to do much to improve the lagging unemployment numbers. Also, there have been repeated hints at some type of resolution on the default problems in Greece, but nothing concrete yet. So, it's hard to get a handle on whether this turn was the beginning of a new uptrend, or if it is merely the latest false rally that will fizzle out in the near future.

As the stock market rebounded in October and broke above resistance (above 1220 on the S&P 500 index), we closed out any remaining hedges in the portfolios (funds designed to go up when stocks are falling). In our more aggressive strategies (Tactical Growth and Core Equity), we have begun to modestly put some cash to work—either in high yield bond funds or some type of sector equity fund. If stocks can continue to make upward progress as we move to the end of the year, we will continue to selectively reduce our money market position.

From the table below, you can see that the portfolios remain quite defensive, in spite of our recent moves. Across all strategies, we have roughly 50% of the assets in money market funds. Outside of money market funds, our highest weighting of assets is in high quality bond funds, with roughly 40% of our assets across the firm.

Strategy	Stock Funds	HY Bonds	Inverse Treasury	Quality Bonds	Money Markets
Tactical Growth	15%	25%	7%	7%	46%
Core Equity	10%	20%		10%	60%
Conservative Growth	0%	10%	5%	45%	40%
Income & Growth	0%	0%	5%	60%	35%
Income	--	0%	5%	45%	50%

Note: Allocation percentages are as of October 31, 2011 and are an average of all accounts within the objective. Individual account allocations may differ from these averages.

As stocks rallied in October, bond prices retreated (thereby sending yields higher). As a defensive measure to offset that weakness, we added a small position (about 5%) to an inverse Treasury fund, which goes up in value when interest rates are rising. Thus, these types of funds tend to make money on the days when our high quality bond funds are losing money. Fortunately, most of our bond funds recovered somewhat later in the month, so we don't have any bond funds that are in danger of tripping their safety nets. If our bond funds break to new highs, we will drop the inverse funds.

The inverse funds are a good way to protect the portfolios during these short-term volatile periods until the traditional funds either trip their safety nets or rebound. Volatility has increased so much in both the stock and bond markets over the past several years that these inverse funds are a good way to manage the ups and downs, until a new trend unfolds. Right now, there is a great deal of choppiness, and the trend is very unclear.

Prospects For Year End

As we mentioned last month, this time of year has historically been a good time to invest in stocks. The results for the month of October would certainly validate that notion. However, this year the traditional drivers of market returns, such as earnings and the economy, have taken a back seat to various political events:

A) The ongoing tumult in Greece and now Italy;
B) The ongoing debt issue in the U.S.;
C) Result of budget Super Committee
D) 2012 Election campaign

As a result, it is a particularly challenging and volatile environment for making prudent investment decisions. Investors are focused on much more than corporate earnings results—which, incidentally, have continued to be better than expected. Offsetting the rather positive earnings results, we have the ongoing impasse of the budget Super Committee which is supposed to present its recommendations by the end of the month, in addition to the ongoing events in Europe which continue to sway the market. These events have resulted in high market volatility, coupled with stock and bond markets without clear direction, so we are content to keep defenses high.

Finally, as we approach the end of another year (how fast it seems to go by), we want to thank you for your business, your loyalty, and your continued trust in our firm. It is a pleasure and an honor to serve you and work with you during this season of your life.