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Right Back Where We Started

Fourth Quarter Market Review From Your Portfolio Management Team—January 12, 2012

2011 would have been a good year to have spent on a deserted island, without following the week-by-week gyrations. The S&P 500 index ended 2010 at a level of 1257 and ended 2011 at the same level—1257. If you add back the dividends paid by the companies, the final result for the S&P index was a positive 2%. The average equity mutual fund was down 3%. Of course, in between those two dates was a great deal of turmoil. At one point in the year stocks were up over 9%, while five months later those same stocks were down 12% on a year-to-date basis. According to Ned Davis Research, during the year, there were 12 corrections of at least 5%, which is double the long-term average. So, while the final result for stocks was relatively flat and benign, the path for the year was treacherous.

Long-Term Treasury bonds had a strong year in 2011, surprising most of the experts who were expecting interest rates to rise. These concerns were premature, at the very least. Gold bullion also fared pretty well for the year, rising 10%, except that its drop of 10% in December probably left many investors with a bad taste in their mouths. Conversely, foreign stocks fell over 10%, with emerging markets equities down almost 13%.

Index	*Q4 Return*	*YTD*
S&P 500	11. 8%	2.1%
Russell 2000	15.5%	- 4.2%
EAFE	4.1%	-12.2%
Barclays Bond	1.1%	7.8%
90-Day T-bills	0.0%	0.1%

Source: Ned Davis Research
Note: EAFE represents the MSCI index of foreign stocks; Russell 2000 represents an index of small-cap stocks; Barclays Bond represents the Barclays Capital Aggregate Bond Index. Q4 Return covers the period from 09/30/11 – 12/31/11.YTD covers the period from 12/31/10 – 12/31/11.

The strong returns for the fourth quarter were generated in the month of October, with the bulk of the monthly gains generated in a 5-day stretch from October 3 – October 10, coming on the heels of a sharp drop in September. It was a year dominated by political issues, both in the U.S. (debt ceiling, Budget Super Committee, Election) and abroad (Euro crisis, Arab revolutions), which distracted investors from the typical concerns over corporate profits and economic growth prospects. All said, it was a good year to keep one's head low, not take much risk, and keep one's powder dry in order to take advantage of better times ahead.

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: 38%**

Conservative Growth accounts finished the year with no allocation to stock funds; although, we did add a high yield bond fund (which tends to move with stocks) to most accounts. As a result, these accounts were not buffeted by the market's gyrations, even though they did not participate in the sharp rebound in stocks back in October. With our corporate bond funds continuing to trend in a positive direction, we have been comfortable holding these positions. If stocks can begin the new year by breaking out to the upside, we will look for some suitable candidates for inclusion in the portfolios. Otherwise, we will be content to leave the portfolios invested in bond funds and money markets. On average, these accounts were down about 1% for the year.

Core Equity

*Current Money Market Allocation: 55%**

Given the downdraft in stocks during the third quarter, these portfolios were very conservatively positioned going into the fourth quarter. As a result, they did not capture much of the sharp rebound in October. As stocks attempted to break into an uptrend, we added modest equity-oriented exposure to the portfolios. If stocks can re-establish an uptrend in the first quarter, we will look to add to our positions. On average, the Core Equity accounts were down just over 4% for the year.

Tactical Growth

*Current Money Market Allocation: 54%**

This strategy has maintained an eclectic mix of sector funds (Biotechnology and Consumer Staples), mixed with high yield bonds, a currency fund (bullish on the dollar), and a few inverse funds. One of our inverse funds moves opposite the direction of silver prices. For taxable clients, we sold that position at a gain at year end to offset some losses in the portfolios. Retirement accounts held the fund through year end with the expectation that we would sell the fund in the first week of 2012 (which we did). On average, the Tactical Growth portfolios fell about 4% for the year.

Income & Growth

*Current Money Market Allocation: 35%**

We continue to hold no positions in stock-oriented funds in this strategy, with 60% - 65% of the portfolio invested in various high quality bond funds. With stocks oscillating around their long-term moving averages, and bonds seeming to have stalled near their highs, we are content to leave these portfolios alone until one of these asset classes can resume its uptrend. On average, the Income & Growth accounts were essentially flat for the year.

Income

*Current Money Market Allocation: 35%**

We did not need to make many changes to this conservative strategy as this collection of bond funds performed right in line with expectations. With bond funds maintaining their upward trends, we continue to hold our current positions, and even added a new fund in December. For the year, these portfolios finished up nearly 1%.

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

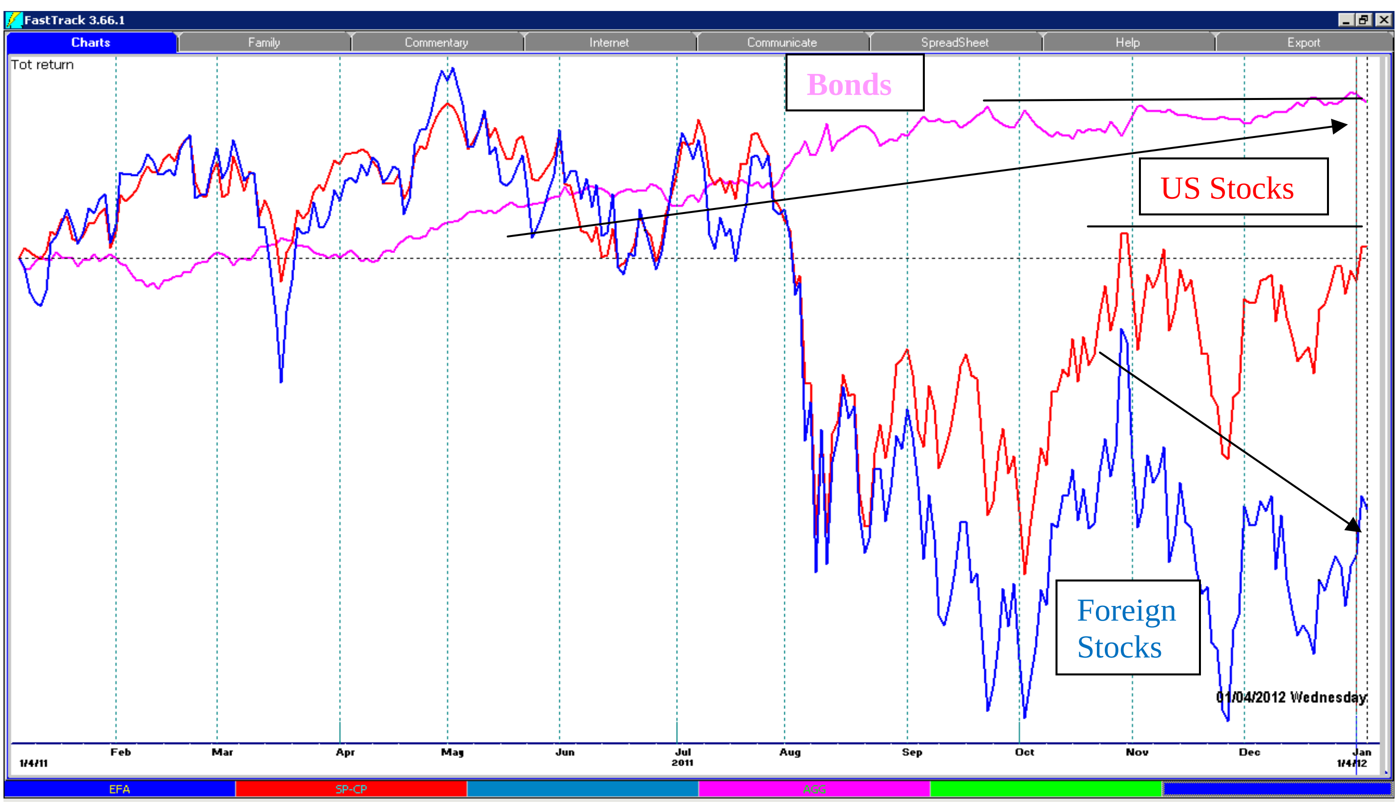
A Look Ahead

Times like these can be very frustrating for investors. Returns have been very hard to come by the past two years, with volatility on the rise and news from overseas dominating the markets here at home. Our approach is designed to capture returns from up-trending markets, while avoiding much of the losses from down-trending markets. Flat markets are difficult because the trend is unclear.

The good news, though, is that periods of flat, choppy markets are always followed by trending markets. For example, the stock market struggled from 1992 – 1994, with the S&P 500 index rising only 23% over that 3-year period. What followed was the mega-bull market of 1995 – 1999. From 2005 – 2007, the S&P 500 index only managed to rise 28% during that 3-year period. And, of course, what followed was the mega-bear market of 2008.

So, we fully expect to see a more favorable environment for our tactical investing style in the future. What we cannot say for sure is whether the trend will turn positive or negative. There are plenty of arguments for either side.

As we enter 2012, domestic stocks are generally in a flat trend (they are equally likely to rise from here as go down). That is why we have relatively little invested in stocks currently. Foreign stocks are generally in a downtrend, which is why we have no money in that asset. Bonds are generally in an uptrend, even though they have stalled out recently, so we continue to hold those positions (See chart below).



We will maintain our emphasis on bond funds (especially in the more conservative strategies—Conservative Growth, Income & Growth, Income) as long as the trends do not break down. In the more aggressive strategies (Core Equity and Tactical Growth), we will maintain the relatively modest equity positions until stocks can break out of the doldrums. What could spark a rally in stocks into a new uptrend? The economic data in the U.S. is actually pretty good. The unemployment rate has dipped a bit, retail sales were decent through the holidays, economic growth is reasonable. If it were not for our attention on Europe, it is possible that the U.S. market would be higher than it is today. So, U.S. investors are probably looking for some resolution to the European debt crisis before pushing stocks much higher. The concern is that a severe recession in Europe would drag down the U.S. (as well as nearly everyone else).

If Europe can avoid a recession, then we might see better times ahead for this year. Historically speaking, stock returns during election years are usually decent (2008 being a notable exception). And with returns finishing so anemic in 2011, there might be some dry powder to push stock prices higher if the global leadership can manage to make some progress in Europe.

This past decade has been hard for investors to comprehend, since stock returns were so strong in the eighties and nineties, while returns over the past ten years have been close to zero. To survive these so-called secular bear markets (or 'Red Markets' as we call them because of our 100-Year Chart, http://www.fsainvest.com/files/FSA_100YearChart.pdf, investors must be very patient. Preservation of capital is the primary objective in these environments, not participation. When we find periods of growth opportunities (2003, 2009), we want to take advantage of them, but most years, it pays to be wary. Being flexible and adapting to new market realities has been our hallmark since we started thirty years ago, and it will continue to serve us well through whatever challenges that lie ahead.