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The End of Trends?

Second Quarter Market Review From Your Portfolio Management Team—July 24, 2012

The year started with such promise. Coming on the heels of a strong 4th quarter, stocks continued their winning ways in the first quarter, giving hope to some observers that stocks could be breaking into a sustained uptrend. Shades of the late nineties began to dance across the imaginations of investors. Maybe the historical tendencies of election years would hold true in 2012. (Election years are typically good years for stocks, with 2008 being a notable exception.)

Well, no sooner had stocks begun to build up some momentum in March, did things take a decided turn for the worse in the second quarter. The worst damage was in May, with stocks slipping 6%. June actually managed a gain of 4%. For the quarter as a whole, stocks finished down 3%; although they were down nearly 10% at one point. The combination of growing evidence of slowing conditions in the U.S., coupled with the ongoing morass in Europe has investors around the globe on edge.

As you can see from the table below, it was a better period for bond investors as bonds managed to post positive returns, and the performance for the year is much closer among all the indices than we saw in the first quarter.

Index	*Q2*	*YTD*
S&P 500	-2.8%	9.5%
Dow Jones 30	-2.5%	5.4%
EAFE	-5.4%	4.2%
Barclays Bond	2.1%	2.4%
90-Day T-bills	0.1%	0.2%

Source: Ned Davis Research
Note: EAFE represents the MSCI index of foreign stocks; Dow Jones 30 represents the Dow Jones Industrial Average; Barclays Bond represents the Barclays Capital Aggregate Bond Index. YTD covers the period from 12/31/11 – 6/30/12.

It seems as though the stock market is incapable of breaking into a sustained uptrend as we had been accustomed to seeing back in 2003 – 2006 or 1995 – 1999, or even 1991 – 1993. The market is stuck in a frustrating cycle of sharp rallies followed by steep sell-offs. It has been a challenging environment for both strategic investors, who tend to buy-and-hold, as well as active managers, who move assets around to capture the prevailing trends.

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: 8%**

With stocks coming under some weakness in the second quarter, we were content to leave the Conservative Growth accounts alone. With over 50% invested in high quality bond funds, these portfolios managed to post a modest gain for the quarter because, for the most part, the bond funds moved steadily higher. During the quarter we added another bond fund to most accounts and held the modest equity positions in spite of the difficulties in the stock market. Coming into the second half of the year, these accounts continue to have 15% in conservative stock funds, as well as 20% in high yield bonds (which tend to move with stocks).

Core Equity

*Current Money Market Allocation: 13%**

With a heavier allocation to stocks (about 54%) and another 20% in high yield bond funds, the Core Equity accounts were more affected by the stock market weakness in the second quarter than the more conservative strategies. We sold our holdings in transportation and gold bullion, and trimmed back positions in REITs and retail. In addition, we added an inverse high yield fund as further protection if the decline continued. On the other side, we added a utility fund as well as a gold fund (mining companies, rather than the bullion). For the quarter, Core Equity accounts were down less than 1%.

Tactical Growth

*Current Money Market Allocation: 22%**

Our most aggressive strategy continues to be an eclectic mix of positions that can fare well in down markets, as well as positions that perform well in rising markets. As stocks began to struggle in the second quarter, we dropped our foreign positions and reduced the small-cap stock fund. In addition, we added a U.S. Treasury fund, and added to our Consumer Staples fund. Late in the quarter we added a fund that is concentrated in the Mobile Telecommunications sector. If stocks continue to rebound as we enter July, we may look for opportunities to bring down the money market position. For the quarter, these accounts were down less than 1%.

Income & Growth

*Current Money Market Allocation: 4%**

With 80% of the portfolio invested in bond funds, and only 10% invested in equities, we had no need to take any action during the quarter. With money flows continuing into the bond funds, we are content to leave these portfolios as they are. If we see a significant change in the direction of interest rates which puts these bond funds under pressure, we will begin to lower our allocation to these funds and look for a better alternative. For the quarter, these accounts were up slightly.

Income

*Current Money Market Allocation: 3%**

Our all-bond strategy fared quite nicely in the second quarter, with every position rising in value. As a result, clients in the Income strategy were spared the turmoil that rocked the stock market over the past few months. We made no changes to the portfolio in the quarter, but remain diligent to take action if interest rates begin to rise and thus put these bond funds under some pressure. For the quarter, these accounts rose slightly.

*These allocations represent the money market levels of our various strategies, including trades through June 30, 2012. Performance numbers for FSA portfolios represent composite results and include the semi-annual fee of roughly 0.6%, which was deducted in February. A complete Performance History of all FSA strategies is available upon request.

A Look Ahead

Why has it been so difficult for stocks to maintain a more consistent trend? There are a number of reasons. To start with, uncertainty and anxiousness is prevalent in the market today. Investors are not sure how the ongoing financial crisis in Europe will get resolved and what the impact may mean to U.S. investors. Plus, we are in the midst of a Presidential election, and the numbers at this point suggest a very close election. In addition, we have a large tax increase taking effect at the end of the year (called the fiscal cliff) unless Congress votes to do otherwise. Not to mention the regulatory environment (including health care) which has business leaders unsure of what to expect next year. Throw in signs of a slowing economy and it is no wonder stocks have had a tough time moving forward (or backwards) with any conviction. We call this environment of the past several years a 'Trader's market' rather than an investor's market because the opportunities to make money come in short windows that are measured in days or weeks versus months or years.

On top of that, with the challenging stock market of the past six years, many investment professionals are beginning to explore alternative ways to manage their clients' assets. Throughout the eighties and nineties, investment professionals were counseled to invest strategically (i.e. buy-and-hold) because the markets were basically very efficient, and it was nearly impossible to make changes to portfolios that would add any value. Given all the difficulties over these recent years, many are exploring more active strategies. With more and more investors beginning to follow our approach, it has made the environment more difficult for our active style.

So, how can we generate returns for our clients and yet still provide a mechanism to help protect them from these sharp declines? Well, for one thing, most of the 'johnny-come-latelys' will look for another solution quickly if their recent foray into active management doesn't bring results. At that point, we would expect the environment to be more conducive to our style again. With 30 years of experience in all types of market environments, we have been through these types of challenges before. Our approach has been successful over the long run because we are not quick to abandon it even though there may be short-term challenges.

At the same time, we do have access to more tools, which should enable us to manage our way through these types of environments. We have been using inverse funds more frequently as a way to hold good funds during these short-term sell-offs. If the market rebounds after only a minor sell-off, we can quickly drop the inverse funds, and continue holding the funds that are moving with the overall market.

We have taken other tactics depending on the strategy. In the more conservative strategies, such as Income, Income & Growth, and Conservative Growth, we have focused those portfolios only in the areas of most consistent money flows. That means these portfolios are primarily invested in bond funds. As a result, they may not keep up with stocks when stocks are making a push higher, but on the other hand, they exhibit great downside characteristics since they have so little tied to the stock market.

In Tactical Growth, we have, in some cases, traded more frequently in an effort to hold more of the gains. For example, we have traded in and out of silver and an inverse silver position several times over the past year.

While we continually look for ways to improve returns during this trendless market environment, we remain true to our overriding philosophy of protecting the portfolios from serious downdrafts. It has been a tough task over the past few years, but we have been through tough environments in the past, and we spend every day following the markets and your investments in order to help you reach your goals in a prudent fashion.