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# A Look at the Major Themes in the Portfolios

**August Market Review From Your Portfolio Management Team—September 12, 2012**

Stocks and bonds continued to grind higher during the hazy lazy days of August. Traders frequently take their vacations in August, which lowers the volume of activity in the stock and bond markets. As a result, it is difficult to decipher how meaningful any moves in the markets might be, with many players away for the month. So, even though stocks posted nice gains this summer, we remain cautious that the environment could quickly change when all the players return to their jobs.

Let's review the major themes at work in our strategies:

*Money Flows Continue to Dominate the Bond Markets*

We are in the fifth year of this wave, as investors continue to seek consistent returns and avoid the volatility in the stock market, even if it means sacrificing some gains. From the end of 2008 – June 2012, stocks have returned over 60%, with bonds returning less than 40%, but bonds have provided a much smoother ride.

**High Quality Bond Funds:** These funds are prominent in the Income, Income & Growth, and Conservative Growth Strategies, but at times you will find these funds even in Core Equity and/or Tactical Growth. As mentioned earlier, this is where the major money flows have gone since the end of the financial crisis, including government bonds, as well as corporate bonds and municipal bonds. In spite of the multiple warnings of their coming demise, this area remains strong.

**High Yield Bonds:** Every strategy at FSA includes one or two funds in this area. This is a more aggressive area of the bond market and provides some correlation to the stock market. So, high yield bonds provide a less risky way to capture some of the returns from the stock markets.

*Stocks defy pundits and make a strong move in 2012*

It has been a challenging environment for active managers trying to capture and keep returns from the stock market over the past three years. In 2012, however, stocks appear like they are breaking out of their trading range even though we are in a tight election race in the U.S., and the so-called Fiscal Cliff looms large in the coming months. (The Fiscal Cliff refers to the potential economic hit that the U.S. economy could suffer if the Bush era tax cuts are reversed and a series of automatic spending cuts take effect next year.) And let's not forget all the angst and turmoil coming from the Euro zone countries as they struggle with too much debt and too little discipline.

**Equity Income:** You will find these types of funds in Income & Growth and Conservative Growth accounts. They give us exposure to the stock market but with less volatility. While these types of funds will not usually keep up with the general stock market on the good days, they provide a bit more cushion on the down days.

**Sector Funds:** In the more aggressive strategies, we have made use of so-called sector funds to give us a targeted allocation to strong areas of the stock market. In Core Equity, such funds include Real Estate, Utilities, Retail and Leisure stocks, and even Health Care. For our Tactical Growth accounts we have Biotechnology, Consumer Staples, and Telecommunications funds.

This table shows the overall allocation to various asset classes among our five strategies. What becomes immediately apparent from the table is that our money market position is very low across the board, with the exception of Tactical Growth which is higher due to a few recent sales. We would expect that cash position to drop in the near future if stocks continue to maintain their uptrend.

| Strategy | Stock Funds | HY Bonds | Quality Bonds | Money Markets |
|---|---|---|---|---|
| Tactical Growth | 45% | 22% | 10% | 23% |
| Core Equity | 62% | 22% | 10% | 6% |
| Conservative Growth | 20% | 20% | 55% | 5% |
| Income & Growth | 10% | 15% | 70% | 5% |
| Income | -- | 15% | 80% | 5% |

Note: Allocation percentages are as of August 31, 2012 and are an average of all accounts within the strategy. Individual account allocations may differ from these averages.

Different areas of the stock and bond market perform well in different economic conditions. With economic growth so sluggish (second quarter GDP grew at 1.7% and most economists would like to see growth above 2.5%) and inflation subdued (also below 2%), that has traditionally suggested that more defensive stocks or more consistent growers tend to do well. This might lead an investor to health care stocks, consumer staples stocks, utilities, or REITs (Real Estate Investment Trusts). These areas can often do well even if the overall economy is sluggish, since we need these products regardless of the economic condition or because they tend to generate income, which is attractive for investors during these times. In addition, this type of economic environment also favors government bonds and high quality corporate bonds since investors often seek safety in this type of environment.

Interestingly, during the month of August, investors seemed to prefer more aggressive sectors of the market (such as small-cap stocks, technology, and consumer discretionary). Government bonds actually lost money, as did utilities, with REITs lagging. Are investors sensing a better economy on the way, or are they being fooled by the promise of future Federal Reserve stimulus? Time will tell. Until we get a clearer picture, we are holding positions in both themes, with investments in the areas that were strong earlier this year that should be favored in this type of slow growth environment (Health Care, Utilities, REITs, Consumer Staples), but we have also made forays into areas that are currently strong (Technology, small-cap stocks, Retail and Leisure stocks).

Depending on what happens in the weeks ahead, we will no doubt find ourselves favoring one theme versus the other. We expect that by the next Market Update, we will have a better sense of the themes that will play out through year-end. That's one of the advantages of our active style. We can shift fairly quickly to changes in the environment, so that our portfolios reflect what is happening in the market.