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# We Love Him, We Love Him Not

**Third Quarter Market Review From Your Portfolio Management Team—October 9, 2012**

Every four years, we go through a type of courtship ritual where every incumbent President makes a pitch (or plea) for us to keep him in office for another four years. He and his administration spend a great deal of effort and money to convince us that things are good and will get better, or that things will get worse if we elect his opponent. It's quite a spectacle and as we enter the month of October, we are in the final lap of this ritual.

The contest this year is pretty close so far, as a sluggish economy has given the challenger an avenue to make inroads with voters. History suggests that the advantage is with the incumbent, as people will typically stay with a known entity over the risk of an unknown entity.

Since the stock market is considered 'forward-looking,' meaning that it is trying to take into account how conditions will be in the future, can we get any clues about the eventual winner from the market's behavior this year? First of all, as we have said a number of times in these updates over the years, election years are historically positive for the stock market. Those in power coming into an election try to do whatever they can to keep conditions positive so that voters will return them to office.

The analysts at Ned Davis Research took a look at past election years and made the following observations: the stock market is usually positive in election years. If it turns negative, then it suggests the incumbent is at risk. So, the strong returns in 2012 would suggest that Obama will retain the White House. A final market indicator to watch would be any correction that begins around this time and runs through October. That would be a negative sign for the incumbent. The peak for the S&P 500 is on September 14, at a level of 1466, with the level at month-end at 1441. At this point, the correction is mild and does not suggest a change at the White House. The month of October will be interesting to see if there are any changes.

The third quarter proved to be a strong quarter for all risk assets, as domestic stocks, foreign stocks, bonds, and even commodities posted positive returns.

| *Index* | *Q3* | *YTD* |
|---|---|---|
| Dow Jones 30 | 4.3% | 10.0% |
| EAFE | 4.7% | 9.1% |
| Barclays Bond | 1.6% | 4.0% |
| 90-Day T-bills | 0.0% | 0.1% |

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 – 9/30/12.

## 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: 3%**

With a heavy allocation to bonds, Conservative Growth accounts have continued to move higher. Bonds continue to dominate the money flows and help insulate the portfolios from volatility in the stock market. We did bump up the equity allocation to 20% in stocks, to go along with the 20% allocation to high yield bonds, so these portfolios definitely benefit from rising stock prices. For the past quarter these accounts were up over 3%, on average, and are up over 6% for the year.

### Core Equity

*Current Money Market Allocation: 9%**

With stocks in an uptrend, we continue to move these accounts more fully invested in stock funds. The holdings include more defensive areas, such as health care, utilities, and real estate, as well as, some more aggressive areas, such as retail, and basic materials. We sold the precious metals fund during the quarter when it hit our FSA Safety Net®. For the quarter, Core Equity accounts were up over 2%, and are up just under 6% for the year.

### Tactical Growth

*Current Money Market Allocation: 17%**

Tactical Growth is our most actively traded strategy. We continue to look for opportunities anywhere we find them. During the quarter, we added an emerging markets fund, while selling our currency fund, as well as our inverse silver position, natural gas fund, and Treasury fund. Late in the quarter, we added an inverse Treasury fund that will rise in price if yields go higher. For the quarter, these accounts rose almost 4%, and are up over 7% for the year.

### Income & Growth

*Current Money Market Allocation: 4%**

With bonds continuing to deliver consistent returns, we have left the Income & Growth portfolios heavily invested in that asset class. As a result, they are spared from the volatility that is inherent in the stock market. These accounts do hold 10% in equity income funds, and also have 10% - 20% in high yield bond funds, which allow these portfolios the opportunity to participate in the stock market rally. For the quarter, these accounts were up over 2% and are up about 5% for the year.

### Income

*Current Money Market Allocation: 3%**

Even though this strategy does not own stocks, it managed to post a nice gain for the quarter as bonds fared well. We made no changes to the Income portfolio during the quarter, and have been comfortable with each of the positions. Even if interest rates begin to rise soon, several of the funds in the portfolio are designed to fare well in that environment. For the quarter, these accounts rose over 2% and are up over 5% for the year.

*These allocations represent the money market levels of our various strategies, including trades through September 30, 2012. Performance numbers for FSA portfolios represent composite results and include the annual fee of roughly 1.2%. A complete Performance History of all FSA strategies is available upon request.

## A Look Ahead

Regardless of who gets elected next month, the President will face a number of challenges in 2013. The global economy is slowing, and even though conditions in the U.S. are better than in most areas around the world, the economic numbers in the U.S. continue to slow. Overall growth of the economy in the second quarter came in at a sluggish 1.3%, and recently we have seen durable goods, as well as the Leading Economic Indicators index stall, which suggests that the economy is struggling to remain on a growth track.

Not helping matters is the so-called Fiscal Cliff which represents the dual whammy of automatic tax increases on everyone, coupled with government spending cuts that are slated to take effect after January 1. Many observers believe this one-two punch could knock the already weak economy back into recession unless Congress takes action before year-end or right after the new year. The rally in the stock market this year suggests that investors believe rational heads will prevail and Congress will do the right thing, but we don't believe investors should be so complacent.

In addition, there is some concern that company earnings have seen their peaks, and we could be in for a period of declining earnings. A number of companies have already warned of challenging times ahead (such as FedEx and Caterpillar). Some analysts are projecting earnings to fall around 2% this quarter, which would be the lowest quarter since 2009. With earnings season kicking off next week, investors may quickly turn from complacent to nervous.

While the election of our President (and Congressional representatives) is important, it does not affect the day-to-day management of your FSA portfolios. We will manage the portfolios with the same eye towards keeping them protected from too much market turbulence, while also providing some participation in the gains from the stock and bond markets. In recent years, it has been quite a challenge for all investors, but we remain flexible and willing to adapt to any new environments.