FINANCIAL SERVICES ADVISORY
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Last Minute Spike Pushes Stocks

Fourth Quarter Market Review From Your Portfolio Management Team—January 11, 2011

After bouncing around for much of the year, stocks finished with a nice pop, as the S&P 500 added almost 7% in December, one of the strongest Decembers in 20 years. For the full quarter, stocks rose over 10%, while bonds slipped a bit. The surprising finish pushed most stock indexes out of their six month trading ranges, leaving many investors feeling rather bullish as we enter the new year.

And there are a number of reasons to feel bullish, including the Fed's willingness to keep the stimulus faucet turned on, the extension of the Bush era tax cuts for 2 more years, a short-term reduction in payroll taxes, plus growing evidence that the economic recovery—while more subdued than average—remains intact. As a result, if the earnings releases that begin this week are relatively positive, we could see stock prices continue to move forward over the coming months.

The fourth quarter rally had a distinctively American color to it, as most foreign markets did not participate to the same degree. In addition, with the exception of high yield bonds, which managed some modest gains, most bond funds finished the fourth quarter flat or even in negative territory. Within the realm of U.S. stocks, the winners were among the more aggressive sectors, including energy, basic materials, and stocks that benefitted from consumer spending. The more stable areas like health care, consumer staples, and utilities lagged considerably.

As a result, it was a quarter that rewarded risk taking.

At the beginning of the quarter the FSA portfolios continued to be tilted towards the bond funds. For the more aggressive strategies, such as Core Equity and Tactical Growth, we began to increase the weightings to equities, but maintained a heavy bond allocation. While the portfolios managed some modest gains, they were unable to keep pace with the broader stock indexes.

The good news for FSA clients is that our portfolios continue to hit all-time new highs in account values, while the broader stock market (such as the S&P 500) remains almost 20% from the highs it hit in late 2007, and only slightly higher than the levels from early 2000. Said another way, the S&P 500 index is just now back to the levels it first reached back in early 1999.

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: 25%**

Since these portfolios entered the quarter without any equity funds, it should come as no surprise that this strategy finished the quarter slightly down. During the quarter, the municipal bond funds (in the taxable accounts) hit their safety nets and were sold. The investment-grade corporate bond funds were trimmed back, but they did not fall enough to hit their safety nets. To protect the portfolios from further increases in interest rates (rising interest rates leads to falling bond prices and vice versa), we added a fund which is designed to rise in value when interest rates are rising. This fund allows us to hold on to some of the excellent bond funds we have (and continue to collect their dividend income), while protecting them from rising interest rates. In addition, with the equity market beginning to break out above its trading range, we added some equity funds to these portfolios. At year end most portfolios held 15% - 20% in equity funds. On average, these accounts were up over 3% for the year.

Core Equity

*Current Money Market Allocation: 22%**

With a higher allocation to equities than the more conservative strategies, Core Equity accounts managed a modest gain for the quarter. Taxable accounts felt the impact of falling municipal bond prices and we sold those positions during the quarter. The high yield bond positions provided a lift for the quarter as these funds maintained their solid up trends. During the quarter, we added a technology fund, as well as an emerging market fund to most portfolios. Currently, most accounts have 40% - 50% in equity funds, with another 20% - 30% in high yield bond funds. On average, the Core Equity accounts rose about 4% for the year.

Tactical Growth

*Current Money Market Allocation: 29%**

Tactical Growth accounts managed a slight gain for the quarter as gains from the equity positions were largely offset by losses from the municipal bond and emerging market bond positions. We exited the municipal bond position and trimmed back the emerging market bond position, while increasing our allocation to equities. On average, the Tactical Growth portfolios rose over 3% for the year.

Income & Growth

*Current Money Market Allocation: 32%**

These accounts managed to eke out a slight gain for the quarter even though the bond positions faced considerable headwinds. As in the other strategies we eliminated our municipal bond positions in the taxable accounts and reduced some of the taxable positions. We also added an ‘inverse’ treasury fund to these accounts. This fund allows us to maintain some of our bond positions, while we wait to see if interest rates can stabilize around these levels. On average, the Income & Growth accounts increased over 4% for the year.

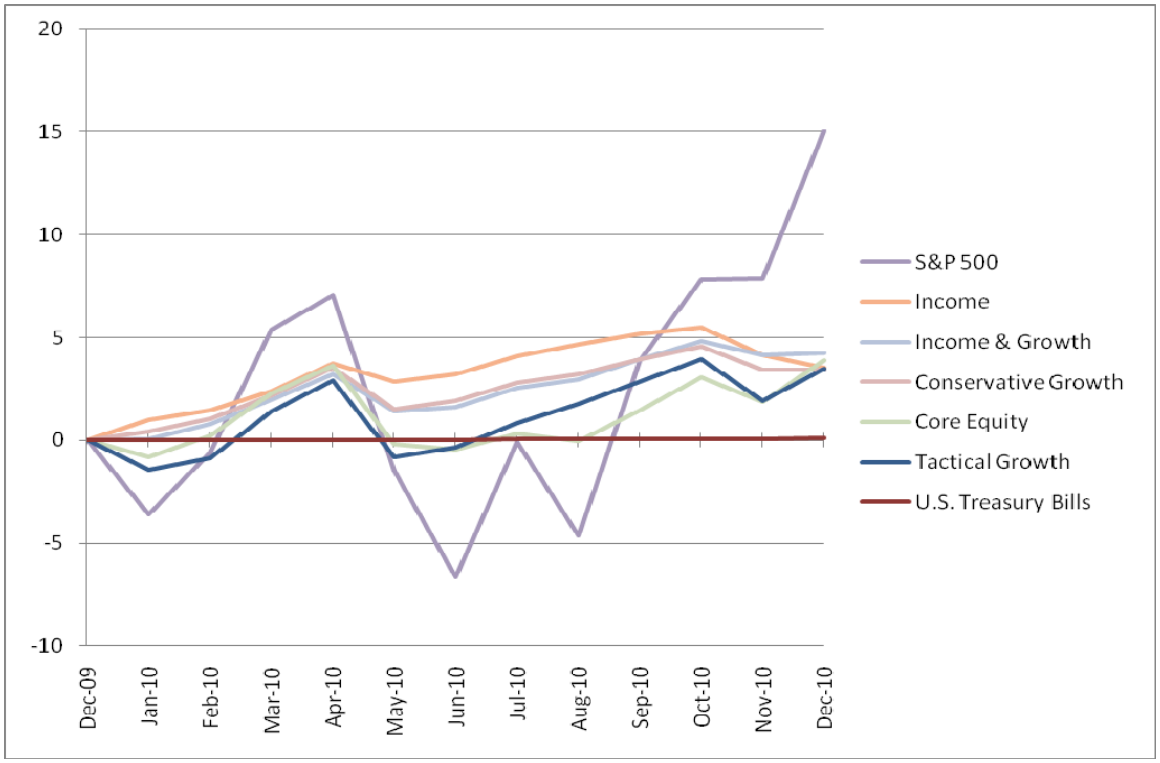
Income

*Current Money Market Allocation: 21%**

With bonds struggling in the fourth quarter it should come as no surprise that this strategy fell modestly for the quarter. Fortunately, most of the funds in this portfolio are short- to intermediate-term in maturity, so they weren’t hurt too badly in the fourth quarter. For taxable clients, we did sell all of our municipal bond fund positions. We also added an inverse treasury fund to this strategy, to help insulate the portfolios from further losses due to rising interest rates, while we wait to see if interest rates will settle down in the weeks ahead. For the year, these portfolios rose over 3% for the year.

*These allocations represent the money market levels of our various strategies, including trades through December 31, 2010. Performance numbers for FSA portfolios represent composite results and are net of all fees. A complete Performance History of all FSA strategies is available upon request.

The chart below shows the returns for the five FSA strategies for the year versus the S&P 500 and treasury bills. As you can see from the chart, the strong jump in stock prices in December, coupled with the retreat in bond prices created the gap in performance of the FSA portfolios versus the major stock indexes.



Looking Ahead

There is no doubt that 2011 will be as interesting a year as the last few years have been. We are in the third year of the Presidential election cycle, which is historically the strongest of the four year cycle, as the incumbents do what they can to keep the economy humming in order to ensure their re-election. On the other hand, it is also the third year of the current cyclical bull market which began in March 2009. Historically speaking, the environment for stocks gets more difficult and selective, so it will be more important to be in the 'right' areas of the market this year.

From a flow of money perspective, we continue to see money coming out of the municipal bond area, so we are content to avoid that area for now. Given the relatively sharp decline in those bonds, we may be presented with a compelling re-entry point some point this year, so we will keep an eye out for that possibility for our taxable clients. Foreign funds (emerging markets, in particular) have been getting investor dollars over the past several months, and this is an area that we have added to our more aggressive strategies, namely Core Equity and Tactical Growth. We may look to do more in the weeks ahead, although we will be sensitive to the generally high volatility in this area.

We have also added technology oriented funds across most accounts. In Core Equity, we own one pure technology sector fund, while in Conservative Growth, we added a large-cap growth fund, which maintains a fairly high weighting to technology—but more diversified and thus less volatile. These funds have clearly broken through to new highs for the year, but we have to be diligent in maintaining our safety nets, as these funds are also pretty volatile.

The theme of our portfolios over the past two years has been “Bonds.” For 2011 the theme may turn out to be “Balance,” as we may see a more equal mix between bond funds and stock funds. With the exception of the municipal bond funds, the trends for most bond funds remain in an upward direction; however, with interest rates at these low levels, and with an economic recovery continuing to move forward, bonds will face more headwinds in 2011. As a result, we may find the money flows this year moving back towards equities, an area that has not attracted much investor interest over the past three years. As always, we will continue to “follow the money” wherever it leads us this year.

Please let us know if there is anything we can add to these monthly reports that would help you better understand what is happening in your accounts.