FINANCIAL SERVICES ADVISORY
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Staying Focused

January Market Review From Your Portfolio Management Team—February 10, 2011

During the peak of the financial crisis, the U.S. stock market dug itself a pretty big hole, falling 50% from peak (in October 2007) to trough (in March 2009). Since that time, and in spite of the continuing overhang of problems, stocks have staged a solid, if not impressive, recovery. Although the S&P 500 index still remains about 15% below its peak in 2007, it continues to close that gap. In January, this index rose another 2%, to get the new year off to a good start.

The journey back from the investment abyss has certainly been interesting. Back in 2009, observers were concerned about the survival of the capitalist system. Since that time, we have had to deal with bankruptcies, high unemployment, credit crises overseas in Greece and Ireland, high frequency trading, and the unexplained "Flash Crash" that spooked professional and retail investors alike. In spite of these issues, the stock market has managed to climb over 60% in 2009 (from its March low through year end), and then tack on another 15% last year. The Federal Reserve's actions of keeping short-term interest rates close to zero is basically forcing investors to take some type of risk—by moving money to stocks, commodities, or bonds. This has the effect of providing a great deal of money to fuel ongoing rallies in the stock, bond, and commodity markets.

This year, investors are having to deal with the turmoil in Egypt, as its citizens have decided they have had enough of the current regime. In addition, there is the nagging issue of our exploding debt and its impact on future inflation and interest rates. Longer term interest rates have already moved higher over the past few months, with the yield on the 10-year Treasury bond rising from 2.4% (in October) to 3.6% currently.

It is important to keep in mind that the market is forward looking. The news today is only important if it means that things may change in the future. As an example, the turmoil in Egypt has not affected our stock markets, so far, because observers are not seeing any direct impact to the U.S. economy. At this point, observers are not anticipating any spillover to the oil producing neighboring countries. As a result, we have not seen oil prices spike upward. To be sure, stocks on the Egyptian stock market exchange (yes, there is one) dropped 20% as the protests gained strength in mid-January, but they have already recouped nearly half of the drop over the past week or so. The U.S. stock and bond markets are generally very efficient, and it is very difficult to find information that others don't already know about that will have an impact on a security.

That is a main reason why we spend the majority of our time using technical analysis, which focuses attention primarily on the prices of securities. Technical analysis assumes that the current price of a security (both stocks and bonds) contains the most current information, and it is highly unlikely that any one investor is going to have a piece of information that will affect its price. As a result, it is better to remain focused on the current price rather than the news. Now, human emotions play a big role in the movement of stock prices, so there are times when prices of stocks and bonds go too far in one direction. This creates opportunity for strong returns for the investor who recognizes the opportunity and takes advantage of it.

The investment process at FSA has these basic components:

1. Stay on top of the overall market trend
    a. Generally rising trends are usually bullish and we will tend to have lower money market allocations and/or more aggressive funds in the portfolios;
    b. Generally falling trends are bearish and we will tend to have high money market allocations;
    c. Choppy markets are the most challenging to decipher, and we will look for areas of the market that may be trending well even in a flat market;
2. Follow market sentiment
    a. A complacent or over-optimistic market is susceptible to sharp corrections;
    b. Sentiment that pushes too far (either too bullish or too bearish) creates opportunities for strong returns;
3. Identify areas that are attracting strong money flows
    a. We tend to look for the most consistent trends with the least risk;
    b. Within the various strategies, we look to diversify the portfolios among the funds that meet our criteria;
4. Execute the FSA Safety Net™ on funds that have reversed direction and broken their upward trend.

So, from the investment research and portfolio management side of the business, the list above is how we spend the majority of our days—following overall market trends, following the behavior of our current positions, and constantly looking for new opportunities.

We try to avoid getting caught up with the media stories of the day because in most cases that information is already factored into the current stock prices. From the perspective of the list above, what are we seeing?

a.	Overall stock market trend is up:	Bullish
b.	Trend for emerging market stocks is flat:	Neutral
c.	Overall trend for government bonds is down:	Bearish
d.	Overall trend for corporate bonds is flat:	Neutral
e.	Sentiment towards stocks is complacent:	Warrants some caution

How these various signals are playing out in your portfolios can be summarized as follows: we are reducing our allocations to bonds (except for high yield bond funds that tend to move with stocks), and we are selectively increasing our allocation to stock funds. Given the strong rally we have already seen, as well as the relatively high complacency (that is, investors are becoming too optimistic about stocks), we are being careful not to jump in with both feet. In many portfolios, we are using more conservative stock funds (like convertible funds and equity income funds) that should hold up fairly well if the market stalls out in the coming weeks. One of our favorite areas within the stock market is technology, and many accounts include funds with heavy weightings in that area.

In our more income-oriented accounts we are using some inverse funds that rise in value as interest rates rise. This has allowed us to hold on to some of our high grade bond funds while we wait to see if they can resume their uptrends or if they hit our safety nets. Additionally, we have identified a few funds that can weather a rising interest rate environment fairly well, and those have made it into many portfolios, as well.

The new year always brings much hope and optimism for good things, and that sentiment certainly seems to be reflected in the current market environment. We will try to avoid being swayed by public sentiment and maintain our focus on the underlying trends and health of the markets to gauge market risk and invest your portfolios for long-term prudent growth.

Please let us know if there is anything we can add to these reports that will help you understand what is going on in your portfolios.