FINANCIAL SERVICES ADVISORY
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All Eyes on Washington

Third Quarter Market Review From Your Portfolio Management Team—October 10, 2013

In theory, stock returns are driven by corporate earnings, implying things such as economic growth, the trend and direction of interest rates, and investor psychology will typically determine how well stocks do. Unfortunately, in recent years and particularly right now, these more typical measures are being usurped by what the politicians in Washington are doing or are not doing. While stocks managed to post a solid return for the third quarter (with the S&P 500 index up about 5%), stocks were heading up higher than that when they were derailed by Washington's inability to make any compromise at all.

At first, it was a looming government shutdown, as Congress is using government employees as pawns in a political chess game. And right on the heels of the shutdown, we have a new debate on the debt ceiling. If this sounds familiar, we were talking about this very same issue just over 2 years ago [link July 28, 2011 Market Update]. This debate could be as cantankerous as the last one, but at least the economy is on firmer ground this time around. The debate is an important one. The U.S. government has to learn to balance its expenses with its income, just like everyone else. Borrowing more and more to pay for current expenses will eventually get the government into trouble, just as it would a typical American family.

Index	*Q3*	*YTD*
Dow Jones 30	1.5%	15.5%
S&P 500 Index	5.2%	19.8%
EAFE	7.5%	19.3%
Barclays Bond	0.6%	-1.9%
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 12/31/12 – 9/30/13.

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

Conservative Growth accounts recouped their modest losses from the second quarter as the increased allocation to stock funds helped this strategy. During the quarter, we added a sector fund that invests in consumer staples companies (which includes such companies as Proctor & Gamble and Coca-Cola). We held our bond allocation at roughly 30% as they appeared to rebound late in the quarter. Taxable accounts got a municipal bond fund as these funds were making a turnaround, as well. Also, we sold the inverse treasury fund as it looked as though interest rates were beginning to slip. For the quarter, these accounts were up just over 1%, on average.

Core Equity

Core Equity accounts continued their winning ways, as they reached all-time highs in values. The various sector funds (including health care, leisure, and transportation) performed strongly. During the quarter, we added a small position in gold bullion. We also sold the inverse funds we had added when stocks sold off in June. For the quarter, Core Equity accounts were up around 4%.

Tactical Growth

These accounts managed to post a solid return in the third quarter, as the international positions (Japan and the Netherlands) provided the biggest boost. It was also a strong quarter for small-cap stocks. We decreased our hedges during the quarter as stocks rebounded, but continue to maintain a small hedge as the choppiness continues into October. For the quarter, these accounts were up around 2%.

Income & Growth

These balanced accounts recouped most of the modest losses from the second quarter, as we have increased the allocation to stocks, and as bond funds have managed to rebound a bit. In addition, we have added some bond funds that tend to hold up well as interest rates are rising (so-called Floating Rate funds). For the quarter, these accounts were up over 1%.

Income

As the quarter wore on, the bond market settled down and even began to rebound a bit. During the quarter, we added another floating rate fund (which holds up relatively well as interest rates rise), as well as a municipal bond fund (which appears to be rebounding from a very difficult second quarter). For the quarter, these accounts rose almost 1%.

*These allocations represent the money market levels of our various strategies, including trades through September 30, 2013. Performance numbers for FSA portfolios represent composite results. A complete Performance History of all FSA strategies is available upon request.

A Look Through Yearend

So far, stocks and bonds have held up pretty well in the face of the government shutdown and the looming debt ceiling debate. Unfortunately, the longer the impasse continues, the greater the risk of a more serious correction. In addition, earnings season is kicking off this week, and many analysts believe the results for corporate America will be modest, at best. All of this suggests that stocks will find the going tough in the final quarter of the year. In fact, stocks are already having a difficult time moving forward with most stocks no higher than they were in late May. Most observers believe the federal government will make some type of compromise soon which could prompt a relief rally in stocks and (possibly) bonds.

From a technical perspective, in spite of the nervousness resulting from Washington, stocks remain in a holding pattern within an uptrend, while bonds appear to be rebounding from a moderate sell-off which began this spring. Bond funds have certainly helped the portfolios recently.

Stock prices are ultimately driven by earnings, so we do not want to overreact to political posturing and miss what is happening in the economy; nevertheless, if stocks continue to weaken from these levels, we will continue to lighten our allocation to stocks until things calm down and the mood improves.

On the other hand, if rational heads prevail in Washington and we get a compromise that resonates with investors, we may just finish the year with a nice gift from the markets. And maybe we can turn our gaze from Washington to more important areas.

Ronald J Rough, CFA
Director of Portfolio Management