Rochester Financial Services

Fee-Only Financial Management Services*

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
15,471	1,691	3,654	1,044	2.60%	6.82%	$1,285	$104.37

Investment Strategy Report

Stocks Recover From June Pull Back. Bonds Stabilize - For Now

I feel like I've been doing double duty these days, having to worry just as much about the bond market as I do the stock market. It used to be that the bond funds just did their thing, inching steadily higher with very little volatility while my main focus was in trying to properly position our stock funds. That has changed in the past 3 months, as a surge in interest rates has thrown the bond market into an unsettled position. Investors need to reassess the role of bond funds in their portfolios. Can bonds continue to be counted on to conservatively produce returns of 4-6% per year, or has their expected rate of return dropped while their risk profile become higher?

As mentioned in this letter's title, July was a good month for stocks as investors shrugged off concerns about a weaker bond market and instead focused more on stock related factors. From its low point of 1573 on June 24th, the S&P rose to an all time high of 1710 on Aug. 2nd, a respectable 8.7% gain, before pulling back the last 3 days to its current level of 1691. While it seems that stocks may want to consolidate for a while at these levels, there is no question that they have been in a solid uptrend this year.

Bonds also had a decent month in July. While not all bond funds gained, the large swings in share price that we saw in May and June ended and they returned to the low volatility environment we had seen previously. The 10 year Treasury yield which peaked at over 2.70% has now drifted down to 2.60%. Our bond fund strategy of balancing traditional with non-traditional bond funds is back to doing nicely and I feel comfortable that these funds will resume their role of contributing positively to our portfolios' performances while reducing overall risk.

In regards to this last statement, I do want to discuss my current strategy that I outlined in the email message I sent out earlier this month. I explained that I do expect the stabilization in the bond market to continue at least for the short term. However, longer term, it does seem inevitable that interest rates will have to rise and the returns on bonds to therefore be adversely affected. I therefore began repositioning our portfolios to increase our stock fund allocations to the higher end of our agreed upon ranges, thus reducing our bond fund exposure. This is something that I will continue to monitor. I urge all of you to determine your comfort level with these new allocations and to feel free to call me to discuss this.

The stock market on the other hand is having an excellent year and is in the midst of another formidable uptrend. This advance has been supported by mostly positive economic data. Manufacturing data is improving, applications for unemployment insurance have declined, cyclical companies like Ford and Honeywell have surged to 52 week highs, and the S&P Retail index (XRT) has also broken out to a 52 week high. If the consumer is doing well, the economy can't be doing that badly. Yale professor Robert Schiller (and creator of the S&P Case Shiller housing index) stated that the housing market is showing lots of momentum. And this is despite the recent rise in interest rates.

During the past month, we have seen significant inflows into stock funds, something that we haven't seen much of until now. If this trend continues, this flow of money can continue to push stock prices higher. Another positive development in the equity markets is that we are beginning to see a pick up in stock prices in Europe. Yes, Europe. It seems that for years I have been telling you that we should avoid investing in Europe because of their dire financial situation. However, values over there are very cheap and it seems like they have hit the trough of their recession and are beginning their recovery. This is good news because 1) a recovering Europe will increase their demand for US goods and 2) this may present us with a promising investment opportunity in the not too distant future. And while we're on the topic of international investing, emerging market stocks have dropped to very favorable valuations and may be another promising area for us. So while the market might be in the middle of a consolidation period right now, its future prospects look favorable. *Jeff Feldman*

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