

Fagan Financial Report

Registered Investment Advisors

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THIRD QUARTER 2012

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TO OUR CLIENTS

THIRD QUARTER – THE CALM BEFORE THE STORM

At the close of our “To Our Clients” column contained on the cover of our previous newsletter we observed that “although we may be hitting something of an economic soft patch resulting in some profit-taking in the stock market, at this time we believe it will be relatively shallow and provide an attractive entry point for long-term investors.” To that end, after gains of 12.54%, 12.00% and 8.14% recorded during the first quarter by the U.S. Total Market Index, the Standard & Poor’s 500 and the Dow Jones Industrial Average (DJIA), respectively, those indices shed 3.69%, 3.29% and 2.51% during the second.

As we enter Q3, there are many issues that, if solved could propel stocks substantially higher, but if not will continue to provide headwinds. They include, the Upcoming U.S. Presidential Election which at this time appears to be a dead heat. Without taking sides, we will say that it is dangerous to let one’s political leanings influence their investment policy as our leaders from both sides of the aisle tend to take us to the brink of calamity before solving a problem. Regardless, although the rhetoric will heat up, the question of who will be our next President will not be answered until the fourth quarter.

At or about the time of the election, the United States will bump up against the debt ceiling, \$16.394 trillion, which is the aggregate amount of debt that the federal government can legally borrow. Recall that the last time this occurred, stocks retrenched. If pushed, there is no reason to believe this won’t happen again.

Domestically, in addition to the above, another Q4 issue that will be making market-moving headlines during the third quarter is the so-called “Fiscal Cliff”, a term to describe

the fact that the tax cuts enacted by President George W. Bush and extended this past year by President Obama coupled with mandatory spending cuts will expire in their entirety at the close of 2012, right at the peak of the lame duck session. This economy killing combination would result in tax increases with little federal help.

Finally, U.S. investors will continue to wrestle with domestic headline risk including the expiration of the 2% break on employee Social Security withholding and sifting through what the recently upheld Patient Protection and Affordable Care Act (aka Obamacare).

On the international front, European Debt Issues, including Portugal, Italy, Ireland, Greece and Spain (PIIGS) as well as the potential for a hard economic landing in China will also be alternating between the front and back burners.

Now for the good news and believe us, there is a lot, as investors, given their cynicism (a classic symptom of a long-term secular sideways moving market), will treat not-so-bad news as good news, neutral news as good news and good news as good news. For example, the housing and labor markets, although not robust, will no longer be an economic drag.

Furthermore, bull markets begin amidst uncertainty. There is an old adage on Wall Street, “markets climb a wall of worry” and this time is no different. On a short-term basis, historically the stock market bottoms in an election year during the second quarter and then begins a nearly four quarter period of positive returns.

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TO OUR CLIENTS THIRD QUARATER – THE CALM BEFORE THE STORM - continued

There are a slew of other reasons why we believe the upside outweighs the downside by a sizable margin. For example, the stock market has gone nowhere over the past few years while corporate earnings have doubled; politicians have at least begun to talk about our long term problems (Social Security, Medicare, Medicaid), the first step to a solution; Corporate balance sheets are stronger than ever; consumer confidence remains high; gas prices are headed lower; mortgage rates are at or near record lows and the bear market of 2008-early 2009 is becoming more of a distant memory. Finally, believe it or not, the United States is becoming a very competitive place for manufacturing and industry, potential ways out of this job malaise

For the third quarter, for reasons outlined above, we believe that the stock market will continue to be choppy, providing investors with an opportunity to get in rather than to get out.

Yes, stocks will go down when headline risk makes the front page and go up when there appears to be progress on macro-economic issues. We will experience more “muddling through.” However, we believe that by the end of calendar year 2012, stocks will be marginally higher than where they closed out Q2 as they are the only game in town when compared to cash, bonds and real estate. That said, everything in moderation.

ANOTHER SUMMER SLOWDOWN

Americans are becoming accustomed to summer economic slowdowns as well as pullbacks in their investment portfolios and, if past Summers are any indication, buckle up for more turbulence. Economic data across-the-board, both here and abroad has weakened considerably. Although still positive, Gross Domestic Product, the sum of all goods and services produced in the United States, has slowed to a crawl as both businesses and individuals alike have turned a wary eye to the upcoming Presidential Election in November, the approach of another bout with the debt ceiling, the end of the Bush era tax cuts in addition to the situation outside the United States, specifically the liquidity and potential solvency crisis within several European countries.

The Open Market Committee of the Federal Reserve, the body that determines monetary policy, after its meeting June 20, released a statement that contained the following cautionary notes. “Information received since the Federal Open Market Committee met in April suggests that the economy has been expanding moderately this year. However, growth in employment has slowed in recent months, and the unemployment rate remains elevated. . . . Household spending appears to be rising at a somewhat slower pace than earlier in the year. Despite some signs of improvement, the housing sector remains depressed.”

Recently the Federal Reserve released its updated projections for the economy in which its “central tendency” (removal of the three highest and lowest estimates) for annualized U.S. Gross Domestic Product this year now ranges from 1.9% to 2.4% as compared with 2.4% to 2.9% in April, ranges from 2.2% to 2.8% in 2013 as compared to 2.7% to 3.1% in April and between 3.0% to 3.5% during 2014. The Federal Reserve is also projecting the Unemployment Rate to gradually decline through 2014, but does not see it going below seven percent.

What’s the Fed to do? Despite the self-described limitations of the impact, solely of monetary policy, the Fed has extended Operation Twist, in which it is selling approximately \$270 billion of shorter-term U.S. government debt and buying the same amount of longer-dated maturities, hoping to reduce the cost of borrowing, thus spurring economic growth.

Despite these cautionary signals, the U.S. economy as well as stock market is nonetheless the “cleanest shirt in the laundry.” At some point in time investors will hold their respective noses and put money to work in the stock of publicly traded companies domiciled in the United States. That said, over the near term we remain cautious and expect this choppy trading environment to continue.

PLACES TO HIDE

As investors slog through the summer months there is much to worry about. Here in the United States the upcoming Presidential Election should bring with it heightened political rhetoric and, believe it or not, even less of an attempt from our politicians to fix the economy. In addition, the United States will most likely hit its debt ceiling again, the legal amount set by Congress that the Federal Government can borrow, by the end of 2012. The last time this occurred back in 2011 it rocked the financial markets and resulted in a first-ever downgrade of the debt rating of the United States. Domestically, last but not least, the Bush-era tax cuts, meant to spur economic growth, expire at the end of 2012 which, if not acted upon, will automatically result in tax increases for the vast majority of Americans.

The picture abroad looks much worse than here at home as Europe continues to wrestle with their debt problems. Unlike the United States, at the present time the European Union and the European Central Bank lack the legal authority to effectively deal with this mess, leaving them somewhat rudderless. Hopefully, with German leadership, this problem will be dealt with soon or at least the can will be kicked down the road. Either way, it is a headwind for the stock market.

All the above begs the question, “what’s an investor to do?” With this in mind, we’ve come up with several options, all of which entail the investor shouldering some risk but also provide an alternative to your zero percent bank account or ½% Certificate of Deposit. Managing risk played a greater role in determining which investments are noted below rather than the potential return. With this in mind, we researched investments that are managed by individuals with a lengthy track record; performed relatively well during the financial crisis of 2008; held bonds with relatively short average maturities thereby limiting the negative impact of a rising interest rate environment; and also whose portfolio of bonds were predominantly investment grade.



The first no-load mutual fund that fits the above criteria is the MetWest Total Return Bond fund (MWTRX), established in March of 1997 and managed since its inception by Tad Rivelle. This fund currently has over \$20 billion in assets, fell by only 1.74% during 2008 and holds bonds whose average maturity is only 7.50 years, 75% of which are rated A or better by Standard & Poor’s. Their historical return has also been very competitive, rising 5.25% year-to-date, by 7.78% over the past year and by an average annual 11.04%, 8.40% and 7.44% over the trailing three, five and ten years, respectively.

Another rather conservative choice for cautious investors is the PIMCO Total Return Fund (PTTRX), established in 1987 and managed since its inception by William Gross. This fund currently has over \$258 billion in assets, actually rose by 4.82% during 2008 and holds bonds whose average maturity is only 8.93 years, 80% of which are rated A or better by Standard & Poor’s. Their historical return has also been very impressive, rising 6.06% year-to-date, by 7.13% over the past year and by an average annual 8.62%, 9.28% and 7.00% over the trailing three, five and ten years, respectively.

A final conservative choice for ultra-cautious investors is the Payden GNMA Fund (PYGNX), established during 1998 and managed since its inception by Gary Greenberg. This fund has over \$1 billion in assets, rose by 7.69% during 2008 and holds bonds whose average maturity is less than six years, 95% of which are rated A or better by Standard & Poor’s. Their historical return has also been very impressive, rising 2.48% year-to-date, 7.09% over the past year and by an average annual 6.91%, 7.44% and 5.69% over the trailing three, five and ten years, respectively.

Keep in mind that even one step away from your bank account entails you assuming some risk. However, to a certain extent, this risk can be quantified. One risk, not noted above but certainly out there is the potential for a negative impact on these bond funds should interest rate begin to rise.

HEALTH CARE AND THE EUROPEAN UNION SUMMIT

It is very difficult to determine which is the bigger story, the fact that the Supreme Court upheld the patient Protection and Affordable Care Act or news from the summit of European Union Leaders in Brussels, Belgium? So, we'll briefly tackle both.

On Thursday, June 28, in a 5-4 split, citing the power of Congress to tax, the U.S. Supreme Court upheld "Obamacare" at least temporarily clearing the way for inclusion of approximately 32 million uninsured Americans into a quasi-nationalized health insurance program. That said, Chief Justice John G. Roberts, Jr., noted within the majority opinion that "the Framers created a federal government of limited powers, and assigned to this court the duty of enforcing those limits. The court does so today. But the court does not express any opinion on the wisdom of the Affordable Care Act. Under the Constitution, that judgment is reserved to the people."

Beginning in 2014, U.S. citizens along with legal residents will be required to maintain health insurance or pay a tax penalty based upon your income along with the number of members in your family. In addition, those tax penalties will increase each calendar year. Furthermore, employers with more than fifty but less than two hundred full-time employees will be required to offer coverage or pay a premium tax credit while employers with more than two hundred employees must automatically enroll employees into health insurance plans offered by the employer.

Without delving in too much depth to the other provisions, the Affordable Health Care Act also ensures coverage for individuals under age 26 who can get on their parent's health plan, coverage for individuals with pre-existing conditions and guaranteed coverage for those individuals who are sick.



The Act will hopefully improve the overall health of Americans as many that are currently uninsured and therefore not seeking preventive testing and nonemergency treatments due to the cost will no longer have to face that obstacle. It will also most likely benefit hospitals inasmuch that it will reduce the number of uninsured patients who obtain care at the expense of the hospital.

The big question is how will business be impacted? The Obama Administration predicts lower cost for business. However, most analysts see this as a pipedream and firmly believe that the Act will increase the cost of providing health care for their employees or as an alternative opting out and paying the penalty. Furthermore, should health care costs rise, small business will either have to absorb it or pass them along to their consumers.

Regarding the E.U. Summit in Brussels, leaders appear to be constructing a lasting framework for dealing with their debt burden. Up until now, given the fact that there has been no single body constitutionally capable of deciding policy, no cohesive plan has been enacted. However, there has been serious discussion regarding a European Banking Supervisor much similar to Federal Reserve Chairman Ben Bernanke, Direct Capitalization of European Banks from the European Central Bank, thereby eliminating pass-thru Sovereigns and the direct purchase of Sovereign Bonds, similar to the Quantitative Easing moves by the Fed in the United States.

There remain many unsolved issues both here in the United States and abroad, including the upcoming Presidential Election which will weigh heavily on the psyches of investors. We recommend dollar cost averaging into your investment portfolio and establishing a longer-term timeframe.

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Largest Holdings Regardless of Asset Class Ranked by *Market Value* as of June 30th, 2012.

<i>Percent of Total Assets Managed</i>	<i>Company Name</i>	<i>Symbol</i>	<i>As of June 30, 2012</i>	<i>As of May 31, 2012</i>	<i>As of Apr 30, 2012</i>
12.22%	Cash & Equivalents		1	1	1
5.43%	Payden GNMA Fund	PYGNX	2	2	2
3.87%	Apple Computer	AAPL	3	3	3
3.21%	SPDR Dividend ETF	SDY	4	4	4
2.75%	Loomis Sayles Bond Fund	LSBRX	5	5	5
2.23%	PIMCO Total Return	PTTDX	6	7	9
1.91%	DoubleLineTotal Return	DLTNX	7	8	11
1.89%	MetWest Tot Ret Bond Fund	MWTRX	8	9	10
1.76%	MasterCard, Inc.	MA	9	10	7
1.69%	General Electric	GE	10	12	13
1.66%	Nike, Inc.	NKE	11	6	6
1.60%	iShares Barclays TIP Bond	TIP	12	11	12
1.53%	Conoco Phillips	COP	13	13	8
1.46%	Altria Group, Inc.	MO	14	15	15
1.45%	Visa, Inc.	V	15	16	17
1.44%	Intel Corporation	INTC	16	14	14
1.30%	Ridgworth High Income	STHTX	17	17	25
1.20%	McDonald's Corp.	MCD	18	18	16
1.07%	Exxon Mobil	XOM	19	20	20
1.05%	Celgene Corporation	CELG	20	19	18
0.94%	Schwab 1000 Fund	SNXFX	21	22	24
0.94%	JP Morgan Chase	JPM	22	27	19
0.92%	EMC Corporation	EMC	23	26	22
0.90%	Google, Inc.	GOOG	24	23	28
0.88%	Permanent Portfolio	PRPFX	25	24	26
0.82%	Las Vegas Sands	LVS	29	25	21
0.81%	Ford Motor Company	F	30	22	23

Portfolio Concentration: Top 25 holdings represent 55.29% of the Assets Managed at Fagan Associates as of June 30th, 2012.

Largest Mutual Fund Holdings as of June 30th, 2012.

<i>Domestic Equity Funds</i>	<i>International Equity Funds</i>	<i>Hybrid/Fixed Income/ Muni Fund/ETF</i>
Schwab 1000 Fund	William Blair International Growth	Payden GNMA Fund
Baron Asset Fund	Tweedy Browne Global Value	Loomis Sayles Bond Fund
Parnassus Equity Income Fund	Harbor International Fund	PIMCO Total Return
Dow Jones Broad Market Index	Vanguard International Growth	Double Line Total Return Fund
Oakmark Fund	Harding Loevner Emerging Markets	MetWest Total Return Fund

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•A spotlight on one or some of our **mutual fund holdings or EFT holdings**.

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