Fagan Financial Report

Registered Investment Advisors

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TO OUR CLIENTS

As we watch the Dow trade above 15,480 and the S&P 500 above 1,680 we can't help but think back to the arduous last twelve years and the path the markets /economy have taken getting us here – 9/11, the subprime crisis and every type of "–flation" fear known to man (inflation, deflation, stagflation). Despite these events and through it all, we have attempted to remain focused, disciplined and invested according to the objectives of each specific client. At our offices we have often thought of old sayings such as "we have met the enemy and he is us" or "the only thing we have to fear is fear itself." With the stock market at or near record highs, you may think that now might be a good time to lean back with your beverage of choice and enjoy the patience that has led many investors to success.

Not so fast….Today we face a subtle challenge, but one which has mushroomed over the past six weeks and it comes in the form of higher interest rates. The ten-year U.S. Treasury ten year treasury has gone from a paltry 1.45% to 2.61% over that short period sending bond funds into free fall and with that the portfolios of many "conservative" investors. The tendency in the 2013 world of "shoot first and ask questions later" is to exit bonds in a lemming-like fashion. No doubt that for some investors this is the right choice but for most some pruning (another garden reference) is in order.

It appears that rates will continue higher (but at a slower pace). However, like life itself, there are no guarantees that this will occur. Many pundits that are now crowing about calling the recent decline in the bond market are the same folks who called it in 2010, 2011 and 2012. Remember when these talking heads were proclaiming that the NASDAQ was headed to 7,000 in the year 1999 or that gold was sure to hit 2,000 a couple of years ago. Everyone and their brother had the stock market dead and gone in mid-2008. Markets have a way of inflicting the most pain and most frustration on the most number of investors before heading in the other direction.

It is for these reasons and from thirty years of experience that we believe diversification and moderation are hallmarks of a well thought out investment plan. We ***think*** that rates are headed higher and bonds will underperform stocks but unless we get some guarantee (and that's not going to happen) we will remain diversified with your money. Another saying that we subscribe wholeheartedly to is "the biggest danger is being too sure you are right."

Throughout the dog days of summer we will continue to work hard to help make certain that you are well positioned to benefit from what the financial markets have to offer. Your objective and risk tolerance are key factors in determining your account composition . Keep in mind that the longer a bull market lasts the more investors let down their guard and discount portfolio risk. We will not let down our guards. Enjoy the remainder of your Summer.

TEPPER – TAPER - BERNANKE

Yields on Ten-Year U.S. Treasury notes have risen from 1.66% at the beginning of May to 2.62% as of this writing. The Federal Reserve has hinted that the tapering of Quantitative Easing (QE) may occur sooner rather than later. In addition to lowering short-term interest rates down to a record target of 0% to 0.25% on the Federal Funds rate (the rate at which banks charge each other for overnight loans necessary to meet reserve balances required by the Federal Reserve), some time ago the Fed embarked on a program of Quantitative Easing in which they purchase longer-dated U.S. Treasury Securities as well as agency mortgage-backed securities (MBS).

This artificial demand to the tune of $85 billion per month for Treasuries ($45 billion) and MBS ($40 billion) noted above has put downward pressure on interest rates, including mortgage rates so that any hint of a tapering of either of these programs will result in a gradual shift upward in treasury rates as well as mortgage rates.

Reading from text before the Joint Economic Committee of the U.S. Congress, Federal Reserve Chairman Ben Bernanke stated that at the most recent meeting of the Open Market Committee of the Federal Reserve, "the committee made it clear that it is prepared to increase or reduce the pace of its asset purchases to ensure that the stance of monetary policy remains appropriate as the outlook for the labor market or inflation changes." Obviously, with the economy improving, albeit at a moderate pace, the Fed is not going to increase the amount of purchases. Therefore, this is most likely a shot across the bow regarding the potential for a decrease.

Many fear that a backup in interest rates will result in the end of the current bull market, a run that has seen the broad indices more than double. We disagree and would compare a rising of interest rates as a result of the tapering of QE to a modest amount of rain after a long drought. Initially, we think it will be welcome as it will be a sign of an improving economy.

We would also point out that even if Quantitative Easing should come to an end, this was the second of the two policy tools that the Fed deployed before, during and after the 2008-09 recession, the first being a reduction in the Fed Funds Rate to between 0% and 0.25%, a rate that Bernanke notes "will be appropriate at least as long as the unemployment rate remains above 6½ percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's two percent longer-run goal, and longer-term inflation expectations continue to be well anchored. This guidance underscores the Committee's intention to maintain highly accommodative monetary policy as long as needed to support continued progress toward maximum employment and price stability." Currently, the Unemployment Rate nationally is 7.5%.

In fact, David Tepper, the influential President and Founder of Appaloosa Management, during an appearance on CNBC told Andrew Ross-Sorkin that "there better be a true taper, or else you're back to the second half of '99," a period in which the stock market moved in a parabolic fashion only to come crashing down during 2000-01. We wholeheartedly agree and think that a "true taper" will result in more sustainable economic growth as well as a more sustainable and longer-lasting upward trajectory to stocks.

EXCITING MILESTONES

This August fifteenth Fagan Associates will have completed twenty-four years in the business of providing Investment Advice and Portfolio Management on a fee-only basis. As one of the Capital District's pioneers in fee-only advice, we are proud to also note that we have surpassed another milestone. As this newsletter goes to print, client Assets Under Management is in excess of $200 million. Rest assured that we take this responsibility very seriously and will continue to work hard to retain your confidence and trust.

NO PLACE TO HIDE

This past quarter was one of the first in a very long time that was challenging for fixed income (bond) as interest rates moved higher. For example, after bottoming out near 1.46% early this year, the interest paid on a 10-Year U.S. Treasury Note now yields 2.61%, an increase of 80% over the 1.46%. This rise in interest rates is due in large part to an improving economy which will eventually force the Federal Reserve to reduce the $85 billion per month they are spending to purchase bonds ($45 billion U.S. Treasuries and $40 billion mortgage-backed securities). However, until recently the timeframe was somewhat vague.

At the conclusion of a recent two day meeting of the Open Market Committee of the Federal Reserve, as part of Fed Chairman Ben Bernanke's Opening Statement to his Press Conference, he noted that "going forward, the economic outcomes that the Committee sees as most likely involve continuing gains in labor markets, supported by moderate growth that picks up over the next several quarters as the near-term restraint from fiscal policy and other headwinds diminishes. We also see inflation moving back toward our two percent objective over time. If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year."

Following this statement a selloff ensued with most bonds and bond funds shedding approximately three percent of their value. What's an investor to do? First and foremost, all investors should a) have a plan for good times as well as bad and b) execute that plan without any emotion. As long-term investors, our fixed income (bond) plan lies in the belief that over the next twelve to thirty-six months interest rates will move higher as the economy continues to normalize and the Federal Reserve reduces and then eliminates the bond purchases referenced above. In addition, we believe that the opportunity for stock investors lie with companies whose primary objective is growth of revenue and earnings and those companies that pay out a dividend as a secondary objective.

The bottom line is that investments that were once fueled by Fed liquidity will now have to be fueled by a continuation of this economic recovery. Nonetheless, we maintain that over the next twelve to thirty six month stocks will outperform both bonds and cash.

FALSE TWEET

On Tuesday, April 23rd, at 1:07p the Associated Press posted a tweet, which read, "Breaking: Two Explosions in the White House and Barack Obama is injured." Just before the tweet, the Standard & Poor's 500 was up nearly one percent or 15 points, a gain that evaporated rapidly over the next three minutes and in the process temporarily destroyed $134 billion of wealth, as investors sold on the news. However, three minutes later, at 1:10p, the Associated Press then tweeted, "Please ignore AP Tweet on explosions, we've been hacked." By 1:13p, a mere six minutes after the initial, false tweet, stocks had regained levels prior to the tweet.

Many blame the sell off on computer programs that use complex algorithms to continually search the web, news releases, tweets and statuses, for specific words, phrases that contain specific words, or two or more of these specific words appearing within a certain range from one another. Once these algorithms spot what they're looking for, it triggers a reaction. For example, words that might have been contained with the algorithm(s) and subsequently triggered the computerized response to sell after this tweet could have been the combination of "explosion," "White House," "President Obama" and "injured" in the same sentence.

In an article in the Washington Post, reporters Dina ElBoghday and Craig Timberg write that this is all made possible by a "new generation of analytical software [that] sifts through hundreds of millions of tweets and other forms of social media for early warnings about news that may move markets, and, in some cases, the programs order trades automatically, without human involvement."

The accounts of our clients were not affected by this "Twitter Event" as we do not employ stop orders. At Fagan Associates we have found it beneficial to buy good companies that you trust will appreciate over the long-term and ignore the day-to-day fluctuations of the market as well as the accompanying noise that short-term traders respond to.

BOND BASICS

With bank rates having fallen dramatically over the past several years, conservative investors have looked to maintain their stream of income through the purchase of bonds. However, as they have become acutely aware lately, there are pitfalls to investing in these securities. With this in mind, given the recent rhetoric from the Federal Reserve regarding their economic outlook as well as their talk of tapering Quantitative Easing (QE), we thought that it would be appropriate to discuss the pros and cons of fixed income investing. Always keep in mind that, like stocks, investors can and do lose money in bonds!

The first fact that any investor in bonds should recognize is that the price of a bond responds inversely to interest rates. For example, let us assume that you purchased a ten year U.S. Treasury Notes (both principal and interest payments backed by the full faith and credit of the U.S. Government; widely accepted as the most secure fixed income investment in the world) for $10,000 and that note yields interest of 2.60% semi-annually. Therefore, you would receive $260 per year or $130 every six months with your principal guaranteed upon maturity in ten years. Now let us assume that after purchasing the note, interest rates on ten year U.S. Treasury Notes rise to 4.00%. Therefore, should you now purchase a 10-year note, you would receive interest payments of $400 per year or $200 every six months. However, in response to the rise in interest rates, what has happened to the interest rate and the value of the 2.60% bond that you purchased initially? Very succinctly, the interest payments of $130 semi-annually will remain the same for the balance of the life of the bond or until its maturity. However, should you wish to sell the note prior to its maturity, the principal value of the note would have declined! After all, who would give you $10,000 for a note yielding 2.60% when they can go out today and buy their own note that pays 4.00%? The answer, nobody in their right mind! You are stuck getting $260 per year until the note matures rather than the $400 that you would receive if you had waited until interest rates rose a bit. The loss to you is $140 per year until the note matures.

This inverse relationship between the direction of interest rates and the price of a bond can be measured by duration. Investopedia best defines duration as “a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.” For example, if the duration of your bond or bond fund is “four” the price of your bond or bond fund will fall or rise by a multiple of four relative to the move in interest rates. If interest rates rise by one percent, the price of your bond or bond fund will fall by four percent. Conversely, if interest rates fall by one percent, the price of your bond or bond fund will rise by four percent. Please note that, generally speaking, longer-term bonds have a higher duration than shorter-term bonds and therefore respond to changes in interest rates to a greater degree.

What conclusion should investors draw from the slew of examples outlined above? Your bond or bond fund can decline in price or net asset value! Once again (for the benefit of both of us) bond prices respond inversely to interest rates! As interest rates go up, the price of bonds go down and as interest rates go down, the price of bonds go up! As interest rates have turned up over the past quarter, the value of bonds has declined. However, alone, this rise in rates does not have any impact upon the interest payments!

What should you now do? Be patient. Historically, when a secular move in any investment ends, the turn can be rapid and violent. However, at the conclusion of this initial move, a prolonged period of sideways action usually occurs. It is quite possible that we are at the tail-end of this initial phase and are at the outset of this sideways to slightly upward move in interest rates. In addition, keep in mind that proper asset allocation, defined as the percentage of your total financial assets that you allocate to equity, fixed income and cash investments, works best over the long haul. Generally speaking, it is unwise to ignore any one of these asset classes.

We think it very important to contact us should this article column require any further clarification or should this article engender any questions.

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Common Stock & Equity ETF Portfolio Holdings** ***Ranked by Market Value as of June 30th, 2013.***					
Percent of Common Stock	***Company Name***	***Symbol***	***As of June 30, 2013***	***As of May 31, 2013***	***As of April 30, 2013***
6.23%	SPDR Dividend ETF	SDY	1	1	1
4.96%	General Electric	GE	2	2	2
4.10%	Conoco Phillips	COP	3	4	3
4.07%	Celgene Corp.	CELG	4	3	4
3.75%	Visa, Inc.	V	5	5	7
3.64%	MasterCard, Inc.	MA	6	7	8
3.61%	Nike, Inc.	NKE	7	8	6
3.25%	Gilead Sciences, Inc.	GILD	8	9	10
3.04%	Apple Computer	AAPL	9	10	9
2.94%	Altria Group, Inc.	MO	10	6	5
2.94%	JP Morgan Chase	JPM	11	11	11
2.87%	Google, Inc.	GOOG	12	12	13
2.38%	Verizon Communications	VZ	13	13	12
2.14%	Exxon Mobil	XOM	14	14	14
2.09%	Direct TV	DTV	15	15	17
2.04%	Ford Motor Company	F	16	16	19
1.93%	McDonald’s Corporation	MCD	17	18	15
1.90%	Pfizer, Inc.	PFE	18	19	16
1.87%	Hartford Financial Services	HIG	19	21	28
1.82%	Bank Of America	BAC	20	25	31
1.58%	YUM! Brands	YUM	21	23	22
1.50%	Starbucks Corp.	SBUX	22	28	26
1.47%	Lowes Companies	LOW	23	24	24
1.42%	Cheniere Enrgy, Inc.	LNG	24	20	21
1.36%	Hertz Global Holdings	HTZ	25	27	32
0.55%	iShares DJ Select Divd Index	DVY	47	26	23
0.53%	Ebay, Inc.	EBAY	49	22	20
0.45%	Medical Properties Trust	MPW	60	31	25
0.00%	Las Vegas Sands	LVS	N/A	17	18

Portfolio Concentration: Top 25 holdings represent 68.90% of the Common Stock portfolio, as of June 30th, 2013.

Largest Mutual Fund Holdings as of June 30th, 2013.		
Domestic Equity Funds	***International Equity Funds***	***Balance/Fixed Income/ Muni Fund/ETF***
Parnassus Equity Income Fund	Oakmark Global Select	PIMCO Diversified Income Fund
Schwab 1000 Fund	Harbor International Fund	Loomis Sayles Bond Fund
Dow Jones U.S. Broad Mkt Index	Tweedy Browne Global Value fund	Double Line Total Return Fund
Oakmark Fund	Vanguard International Growth	MetWest Total Return Fund
Scout MidCap Fund	Manning & Napier World Opportunities	PIMCO Total Return Fund

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Additional information including management fees and expenses is provided on our Form ADV Part 2. The actual return and value of an account fluctuate and, at any time, the account may be worth more or less than the amount invested. Bond Investments are affected by interest rate changes and the credit-worthiness of the issues held in the portfolio. A rise in interest rates will cause a decrease in the value of fixed income positions. **Past performance results are not indicative of future results.**

Presentation is prepared by: **Fagan Associates, Inc.**

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- "The Record Review" – an outline of our column that appears in the Troy Record every Sunday.
- "Widely Helds" – a look at the price action and news releases from the most widely held stocks.
- A spotlight on one or some of our **mutual fund holdings or EFT holdings.**
- A look at the upcoming week, including economic data and earnings reports.
- Monthly notable changes to our investment portfolios after the close of the prior month.

* Periodic interviews with other industry professionals, including mutual fund managers, insurance professionals, accountants & attorneys.

* Periodic interviews with local men and woman making news that affects our lives.

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