Fagan Financial Report

Registered Investment Advisors

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DIVERSIFICATION

Given the fact that the equity markets have rebounded from the latest Washington induced pullback to at or near all-time highs, it is easy to ignore the benefits of diversification in one's portfolio. However, we believe that investors do so at their own risk.

We believe in diversification. Too much is made in the investment world of the "BIG CALL". Investment gurus celebrate the hedge fund managers who made killings shorting the mortgage market in 2008 or those nailing the "dot.com" bubble of the late 1990s. When those same managers miss markets and moves, oftentimes it is ignored. The triumphs and follies have little to do with the average investor planning for retirement or saving for a vacation house or child's education.

At the present time, we believe that bonds will provide lackluster returns over the coming two to three years. Yes, the bull market in bonds that started during the early 1980's when then Fed Chairman Paul Volcker began to choke off inflation, is over. That said, we nonetheless still think that bonds should maintain a place in many investors' portfolios. Why? Because the second quarter surge in rates, when the yield on the 10-Year U.S. Treasury Note rose from 1.60% to 2.95% is temporarily taking a breather. Furthermore, over the next year or two, we foresee a **gradual** rise in interest rates and not another surge or spike upward.

With our negative outlook on bonds relative to stocks (however, we do believe that bonds will outperform cash over the coming 2-3 years) why would we own ANY bonds? Our answer is twofold.

One, bonds seem to be the perfect offset here to stocks. It is our belief that only with an improving economy will interest rates rise measurably. This rate rise and improved economic conditions would most likely herald continued solid performance in the stock market. So, accept bond underperformance as your hedge to the equity market.

Two, it is possible, remotely surely (tongue firmly implanted in cheek) that we are wrong. We subscribe to the theory that an investment adviser should never be too sure he/she is right and that it is the quickest way to lose both money and clients. If the bond market does advance this would most likely mean a weak economy and weak stock market. In that case, we will welcome this diversification.

In short, diversification makes sense. It made sense in 2001, 2008 and during the Summer of 2011 when stock investors flocked to lower risk bonds and those bonds made the downside in the market easier for our investors to survive. It makes sense now too and we'll work hard to make certain that your portfolios reflect this.

KEEP IN MIND

"Many of the winners during the last bull market will not outperform during this bull market." As with other aspects of their lives, when making a choice as to what to invest in, one of the primary considerations of an individual is familiarity. In the past we have heard that stocks like General Electric or Citigroup or Dell Computer are "safe" stocks, seemingly insulated from the volatility of the market. We also hear that should these stocks decline it would be wise for an investor to just "hang on and be patient" and they will come back. However, studies have shown that winners during a previous bull market are most likely not the most opportunistic place to invest during the subsequent one.

For example, the all-time high of General Electric stock is above $60/share. However, it now trades around $24/share. Citigroup currently trades around $51/share. Not too shabby until you consider there was a recent 1:10 reverse split putting its all-time closing high north of $500/share. Finally, Dell Computer, once a tech darling, conducting its business in the former secular growth sector of personal computer sales, now trades around $13/share, less than one-half of its all-time high. This is not to say that one or all of these are or are not sound investments at these prices. However, it does attest to the fact that the stock prices of seemingly good companies, household names, can decline precipitously and remain at depressed levels for years, even decades. Because many overpaid for these stocks looking for comfort and safety, they neglected the fact that they were overpriced and in industries that were in either a cyclical or secular decline.

Despite the paragraph immediately above, we can't emphasize enough that properly constructed portfolios should include household names and indeed, many do outperform the overall indices. That said, a) there is no guarantee and b) that during every bear market the stock price of many household names decline and never recover. However, out of the ashes of any bear market, new names emerge. Consider the fact that Facebook, Amazon, Linked-In, Panera Bread, Zillow and Travelocity were barely household names a decade ago, if they even existed as public traded entities. However, some have gone on to reward investors with returns that are many multiples of their original investments while some of the more safe, staid companies have languished.

First and foremost, prior to making any investment, we recommend that individuals do their homework and invest approximately 85% of their equity allocation in large-cap, recognizable companies, but look to invest the balance into companies that are just beginning to make a mark in their respective industries. In our opinion, this approach should help enhance returns and yet provide the appropriate level of predictability and correlation to the overall stock market necessary for long-term success.

"Emotions are the enemy of a sound investment strategy." Like a boat without a rudder many investors lack a specific plan of response should an investment soar upward or plummet downward. We believe that all investors have financial personalities and that if left unchecked, those personalities exhibit traits that are detrimental to long-term success in investing. A study by Henrik Cronqvist and Stephan Siegel first published on September 19, 2011 entitled "Why Do Individuals Exhibit Investment Biases?" identifies those traits from previous whitepapers. They are as follows. "They *lack diversification* and have a *preference for familiar investments* (French and Poterba (1991) and Huberman (2001)), trade too much (Odean, 1999)), *are reluctant to realize their losses* (Odean (1998) and Dhar and Zhu (2006)), *extrapolate recent superior returns* (Benartzi (2001)), and have a *preference for skewness and lottery-type investments* (Kumar 2009))." A specific plan of response or detailed set of disciplines helps investors overcome their biases and is an asset in helping one achieve success in investing.

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INVESTING IN THIS CONFUSING POLITICAL ENVIRONMENT

During a recent interview on CNBC this past Wednesday, when somebody yelled "fire" in a crowded room, President Obama chimed in with "yeah, and it's a big one." Obviously that is not the truth. However, it is not far from it as during this interview when reporter John Harwood noted that Wall Street was pretty calm despite the current shutdown of the federal government President Obama responded that "I think this time is different. I think they should be concerned." Despite the rhetoric and scare tactics coming from both sides of the political aisle, it never pays to disengage from managing your investment portfolio. The question is what to do.

Today, when the media wants you to believe that every tick of the market is critical to your financial well-being, it is beneficial to become grounded in some sound investment principles. It is also prudent to review your long term investment objectives and determine whether your portfolio is constructed appropriately to achieve these objectives.

Our first recommendation to the readers is to *become an investor rather than a trader.* Don't concern yourself with what will occur in the stock market over the next week, month or even quarter, but rather what do you believe will be the direction of stock prices over the next one to three years. Keep in mind that the media wants you to be a trader so that you will stay abreast of the markets on a daily basis. Become an investor. Tune out the "halftime report" of each trading day. Tune off "market wrap." Tune out news teasers like "you can't afford to miss these earnings releases."

Assuming that you agree and are an investor rather than a trader (trading may have worked during the last bull market, but is counter productive to long term growth of capital), make certain that *your stock holdings are diversified across four to six different industries.* You, therefore, are able to weather any unexpected downturns in a particular sector.

A third recommendation that may help you invest more profitably over time is to *realize that you will not be right all of the time. However, the important factor is to be right over time.* Once again, don't appraise your portfolio on a daily basis. It becomes not unlike weighing yourself every day. Given the heightened level of volatility of the stock market recently and the potential for a continuation of these conditions, recognize that short-term gyrations and perhaps losses come with the territory. If you focus too much on the short term, you will most likely never be satisfied, eventually become exasperated and give up. Measure your performance versus appropriate indices over time and recognize that you will make errors.

Using history as somewhat of a guide during these periods of political wrangling in Washington, it is quite possible for stocks to correct between five and ten percent. However, we believe that the size of the rebound will be approximately two times the decline. If this is correct and we experience continued short-term consolidation, it is important that investors *exit with the right portfolio.* Do you own the companies with earnings growth potential? Do you own the companies that are increasing their share of the market? Do you own the companies with a proprietary product or service?

Continue to invest on a systematic basis through your company sponsored pension plan *such as 401(k) or 403(b).* Assuming that you are allocated appropriately between stocks and bonds to meet your long-term objectives, it is imperative that you do not make major changes to your investment patterns during a downturn. Avoid the urge to make your investments more conservative. Contrarily, use any "sale on stock prices" to dollar cost average. Each dollar invested will now go a bit further in purchasing shares based upon their low net asset value.

Finally, during times like these it pays to upgrade your portfolio to industry leaders. Do not accept the marginal investments that you currently own. If they will not come out of a downturn as industry leaders, trade up to ones that will.

RISK ASSETS REMAIN IN FAVOR

Several months ago we penned an article entitled "Tepper – Taper – Bernanke" which quoted David Tepper, the influential President and Founder of Appaloosa Management during an appearance on CNBC. Mr. Tepper stated that "there better be a true taper, or else you're back to the second half of 1999," a period in which the stock market moved in a parabolic fashion only to come crashing down during 2000-2001.

Within the same article noted above we agreed with Mr. Tepper with some qualifications by stating that we believed that a "true taper will result in more sustainable economic growth as well as a more sustainable and longer-lasting upward trajectory to stocks."

For the purposes of this column tapering refers to the reduction in the amount of U.S. Treasuries and mortgage-backed securities (MBS) that the U.S. Treasury is purchasing in order to stimulate economic growth. At the current time this totals $85 billion per month, $45 billion in U.S. Treasuries and $40 billion of MBS.

Leading up to a recent meeting of the Open Market Committee of the Federal Reserve (FOMC), the body that determines monetary policy, investors believed that the tapering of these bond purchases to the tune of some $20 billion of the $85 billion per month was imminent and would most likely be announced via a press release immediately following this meeting. However, the Fed threw the markets a curve ball noting that "the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases. Accordingly, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month." Translating this to English, no change. No tapering.

Contained within Federal Reserve Chairman Ben Bernanke's Opening Remarks of his Press Conference following the FOMC Meeting were concerns regarding the rates of long-term unemployment and under-employment in the United States, the ongoing declines in the labor force participation rate as well as the restraint on growth resulting from the current fiscal policy in Washington. It is for these reasons that the Fed is keeping its respective foot firmly on the accelerator.

Among others, what is David Tepper saying now? "The Feds non-taper and forward guidance should give a clear message of what the Fed wants. They are not worried about inflation in the next few years and want growth first, growth second, and growth third. With the stabilization of Europe, the apparent pickup in China (note higher dry bulk index) and a U.S. economy still on reasonable footing, despite a slight slowdown in housing the Feds apparent heavy leaning to a growth policy should lead to a pretty favorable environment for the markets."

Other notable investors, namely active investor Carl Icahn of Icahn Investors believes that stocks are fully valued as does Warren Buffett who observes that stocks have "moved a long way" over the past five years, going from "ridiculously cheap to more or less fairly priced now." He further states that "we don't find bargains around but we don't think things are way overvalued either. We're having a hard time finding things to buy."

What do we think? We agree with Tepper, Icahn and Buffet, making special note of Tepper's concern over a parabolic move in stock prices. We also believe that stocks are fairly valued given the current of economic growth. However, at this time we believe that the path of least resistance remains upward as the Fed's easy monetary policy should promote a bullish stock market environment and that dips in the market should be bought. That said, be wary. Stay alert. We are getting late in the game.

Common Stock & Equity ETF Portfolio Holdings** Ranked by Market Value as of September 30th, 2013.					
Percent of Common Stock	Company Name	Symbol	As of Sept 30, 2013	As of Aug 31, 2013	As of July 30, 2013
5.70%	SPDR Dividend ETF	SDY	1	1	1
4.67%	Celgene Corp.	CELG	2	3	3
4.38%	General Electric	GE	3	2	2
4.25%	Conoco Phillips	COP	4	4	4
3.70%	Gilead Sciences, Inc.	GILD	5	5	5
3.66%	MasterCard, Inc.	MA	6	7	6
3.63%	Nike, Inc.	NKE	7	8	8
3.42%	Apple Computer	AAPL	8	6	9
3.37%	Visa, Inc.	V	9	9	7
2.68%	Google, Inc.	GOOG	10	10	11
2.59%	JP Morgan Chase	JPM	11	11	10
2.48%	Altria Group, Inc.	MO	12	12	12
2.24%	Hartford Financial Services	HIG	13	13	13
2.12%	Ford Motor Company	F	14	15	16
1.85%	Bank Of America	BAC	15	16	18
1.79%	Harley Davidson	HOG	16	18	26
1.77%	Direct TV	DTV	17	14	14
1.76%	Exxon Mobil	XOM	18	17	17
1.71%	Starbucks Corp.	SBUX	19	24	25
1.65%	McDonald's Corporation	MCD	20	19	19
1.62%	Lowes Companies	LOW	21	20	22
1.59%	Express Scripts, Inc.	ESRX	22	22	24
1.51%	Hertz Global Holdings	HTZ	23	21	20
1.51%	Verizon Communications	VZ	24	23	15
1.42%	YUM! Brands	YUM	25	26	23
1.39%	The Gap, Inc.	GPS	26	25	21

Portfolio Concentration: Top 25 holdings represent 67.05% of the Common Stock portfolio, as of September 30th, 2013.

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

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• "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.

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