

# **SELECTOR<sup>®</sup> Money Management**

## **2010 Third Quarter Review**

**The third quarter of 2010 has proven to be the most constructive quarter of the year thus far.** After an overbought first quarter followed by an oversold second quarter, equity markets were in need of structure and direction. This meant defining a bottom (the end-of-June lows), rallying beyond the June highs (accomplished by early August), successfully testing that bottom (completed with the end-of-August sell-off), then rallying to higher prices (impressively, during the September rally). In doing so, equity markets achieved several other objectives, including topping important moving averages, establishing new leadership, and setting up the fourth quarter.

**As impressive as all of that sounds, true progress year-to-date remains in the single digits for most major market indexes.** The S&P 500 closed out the third quarter up +3.89% for the year. The Dow Jones Industrial Average finished up +4.17%, and the Russell 2000 gained +9.12% YTD. The S&P 400 Mid Cap Index added +11.98% by the end of the third quarter. On the international front, the S&P Europe 350 reclaimed a good deal of lost ground in the third quarter, finishing with a YTD gain of +0.17% after falling as much as -20.12% in May. Emerging markets equities also were stronger in the third quarter, with the MSCI Emerging Markets Index showing a YTD gain of +8.70%, rallying from a loss of -11.93% in May.

**Bond markets continued their strong rally into the third quarter.** But when equity markets made their big move in September, institutional investors were quick to take profits in the most overbought bond sectors, such as long-term government bonds. While all bond sectors are still showing good performance for the year, high yield bonds in particular benefitted from the strong equity performance in September. The Barclays Capital U.S. Aggregate Bond Index ended the third quarter with a respectable gain of +7.94% YTD. The Barclays Capital U.S. TIPS Index is up +7.03%, and the Barclays Capital High Yield Bond Index up +9.85% YTD.

**Every single domestic and international equity and bond index that we follow had gains in the third quarter.** However, there were some changes in leadership. Small cap equities had been one of the top-performing equity sectors going into the quarter. They were sold heavily during the July and August sell-offs before rallying with the herd in September, and lost their leadership position. Long-term treasuries had become very overbought, and experienced heavy selling in the September rally. Mid cap equities are now in the lead role for domestic equities. Additional leadership is being provided by real estate equities, emerging markets equities, and high yield bonds. There were very impressive recovery rallies from international equities and bonds in the third quarter.

**This sets the stage for the fourth quarter.** From a technical perspective, equity markets deserve a break after a very impressive September, and a mild pullback would be expected from current levels. Moving averages are turning upward, and could provide support for any sell-off. Most notably, in September, several major market indexes successfully completed a bullish breakout from a four-month sequence known as a inverse-head-and-shoulders pattern. The November elections may also throw some gas on the fire for market bulls who believe that the economy could benefit from a political shift in Congress. Certainly, there are no guarantees of fourth quarter progress, but historically the fourth quarter is the most productive of the year, especially in mid-term election years.

**The third quarter, while productive, was also quite volatile, and execution risks were very high.** Accordingly, we did not make any portfolio adjustments during the quarter. We are now making selected tactical adjustments in managed portfolios in response to the new leadership and the improved technical picture. Sectors of interest include mid cap equities, emerging markets equities, real estate equities, and high yield bonds. We are favoring growth over value. We continue to hold an added measure of bonds in all styles of management except Aggressive Growth. SELECTOR<sup>®</sup> Aggressive Growth models are 100% equities. SELECTOR<sup>®</sup> Growth models are 80% equities/20% bonds. SELECTOR<sup>®</sup> Conservative Growth models are 60% equities/40% bonds, SELECTOR<sup>®</sup> Balanced Growth models are 40% equities/60% bonds, and SELECTOR<sup>®</sup> Income & Growth models are 20% equities/80% bonds.

**Edward D. Foy**  
**Manager, SELECTOR<sup>®</sup> Money Management**  
**Chief Investment Officer, Foy Financial Services, Inc.**

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