

The 70% Solution

Shifting the risk-reward ratio
in your favor

Managed Sector Fund Investing

Dec 2008/
Jan 2009

One for the Record Books

Like most forecasters, I expected the economy to muddle through most of 2008, but was in the minority who expected the equity markets to end significantly lower. A few persistently bearish forecasters who have predicted financial Armageddon for years finally got it right, but I wasn't prepared for how quickly it deteriorated into the worst market plunge since the 1930s.

Far from muddling through, we saw the demise of former giants Bear Stearns & Lehman Bros. Numerous others like GM, Chrysler, Countrywide, AIG and Merrill Lynch narrowly escaped bankruptcy with shotgun weddings and government bailouts. Credit markets seized up, while home and stock prices plunged. If that wasn't enough, we capped the year off with the revelation of the multi-decade, multi-billion dollar Madoff scheme. The verdict is in for 2008. Wall Street as we knew it, no longer exists.

My pessimistic observation a year ago that the S&P 500 could fall 30% (from the October 2007 highs) turned out to be wildly optimistic. Despite preliminary indications that our 2008 results were better than almost 95% of equity mutual funds, our managed account performance was embarrassing. The rapid expansion of debt that fueled bubbles in stocks, real estate, and commodities is over. The banking system is broken.

Our only road map going forward comes from lessons learned in the Great Depression. Since September, the Bernanke Fed has moved aggressively to expand liquidity. These actions are much more aggressive than the Fed actions that ended four years of deflation in 1933. In 1933 stocks rallied 66%. In 1934 inflation returned, and economic growth resumed. TBonds, the optimum investment from 1929-1932 (as well as in 2008), were big losers from 1934 through 1937. Chairman Bernanke knows this history well. The pace of the economic decline should slow by spring even we won't reach the bottom of the recession until fall. Stock prices won't wait for that clarity. We will still experience days and weeks of both hope and despair, but by year end, stock prices should record solid gains.

Equities and equity mutual funds are volatile investments. It is not advisable to adopt any stock market strategy for a period of less than 3 years.

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LONG TERM SECTOR RANKING

12/31/2008

Extremely Undervalued

Home Finance
Automotive
Communications Equipment
Banking
Electronics
Financial Services

Undervalued Relative to S&P 500

Paper & Forest
Telecommunications
Computers
Technology
Japan

Valued Similar to S&P 500

Consumer Discretionary
Multimedia
Pacific Basin
Retailing
Emerging Markets
Insurance
Environmental
Healthcare
Industrial Equipment
Utilities
Real Estate
Brokerage & Investment
Utilities Growth
Europe
Construction & Housing
China Region
Leisure & Entertainment
Energy Services
Natural Gas
Chemicals
Air Transportation
Software & Computer Services
Industrial Materials
Southeast Asia
Medical Delivery

Overvalued Relative to S&P 500

Energy
Transportation
Biotechnology
Consumer Staples
Defense & Aerospace
Natural Resources
Extremely Overvalued
Latin America
Pharmaceuticals
Gold
Target 2015 (Zero Coupon Bonds)
Target 2020 (Zero Coupon Bonds)

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Highlights of last year's forecast in italics.

US Economy & Inflation 2008 - *“Headline inflation will moderate from last year's...record of 4.1% but is likely to remain...at 2.7% in 2008...the recession is being postponed until 2009...Look for 2008 real GDP around 1%-1.5%.”* Inflation soared in the first three quarters, then plunged in the final last three months. When December's numbers are posted in a couple of weeks, our forecast is likely to be almost spot on. Real GDP is a different story entirely. I parted company with the majority of economic forecasters in late July who then thought a recession would be avoided. I stated in our June/July edition: *“The economy is probably entering recession right now, even though the headlines won't support that idea until the numbers are revised after the election.”* A few weeks ago the NBER declared that we have been in recession since December 2007.

Currencies & Commodities 2008 - *“It's time to take profits on the Euro and (especially) the Pound. We should also see currencies...that rely on...commodity exports like Canada and Australia correct in response to the global economic slowdown. Upward adjustment in the Chinese Renminbi Yuan and the Japanese Yen will continue.”* It's a shame I don't actively trade currencies instead of stocks. I nailed this part of the forecast. The Yuan and Yen rose sharply, the Pound as well as the Canadian and Australian dollars plummeted. Only the Euro was a marginal call. At the moment, it is a little lower, but was up a lot in spring and down a lot in early fall. *“Someday oil may reach \$200/bbl and gold may trade for \$2000 per ounce, but not this year. The combination of extremely high prices and a slowing economy means prices of these commodities are due for a significant correction.”* It only took a couple of months for Gold to top out and correct, but oil was a different story. I really looked stupid this summer when oil was visiting \$150 per bbl, but the *significant correction* eventually came.

Housing 2008 - *“It will be several years before the current housing surplus is absorbed. Although nominal home prices will eventually bottom, inflation is likely to outpace home prices for decades to come...Prices will fall until the after-tax cost of a 100% financed home is less than rent.”* What can I say, with house prices plummeting and mortgage rates hovering around 5%, the after-tax cost of a home is very close to rent already. Prices will fall further, but for the first time in several years it makes financial sense to buy rather than rent.

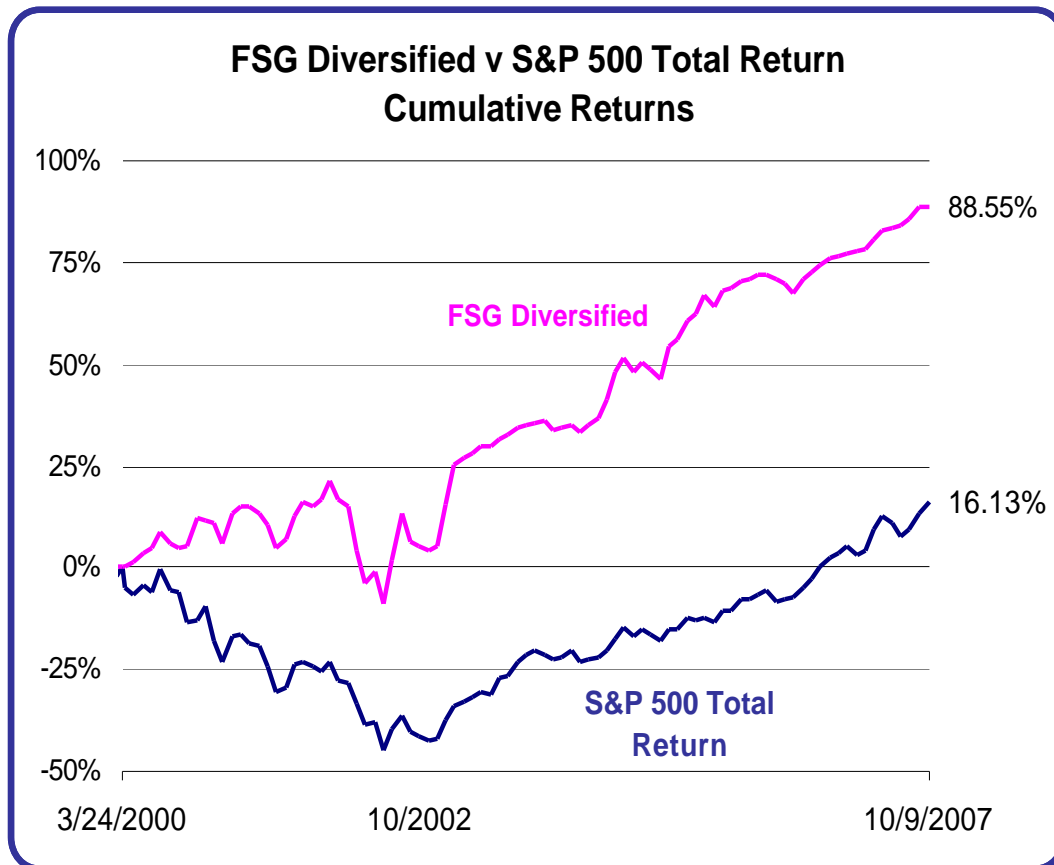
Interest Rates 2008 - *“The Fed will do whatever it takes to postpone the recession at least through September, including further rate cuts. Falling short term rates won't translate into lower long term rates. Yields on 10yr TBonds bottomed in January at 3.3% and have no where to go but up. Rates on conventional mortgages will follow. 10 yr TBond yields will be back above 5% by year end and conventional mortgage rates will be above 6.25%.”* I felt pretty good about this forecast until I saw the second quarter GDP numbers and realized we were already in recession. By June, 10 yr TBonds were back up to 4.25% but the entire financial sector started to fall apart. The panic that followed the collapse of Lehman Bros in September completely disconnected yields on TBonds from all other interest rates. TBond yields stabilized in the 3.75% to 4% range while mortgage rates soared to 7%. The corporate bond and interbank lending markets completely ceased to function. Things changed in November only after the Fed announced they would do whatever it took to get those rates down. TBonds ended the year close to 2% and mortgages fell to 5%.

The 2008 Stock Market - *“The first few weeks...have defined the trading range in US stocks for months...it [is] improbable that...stock prices will get above...S&P 1460...election year stimulus should keep the market above...S&P 1270...through mid year. Later in the year there is some risk of...S&P 1100 when...recession [is] likely. I don't share the optimistic consensus of analysts predicting 25% to 50% earnings growth,...but earnings should remain 25% above the peaks achieved eight years ago despite...recession. When the market begins to recognize the inevitability of a recession,...stock prices will suffer. I expect stocks to end the year in the lower half of the trading range (S&P 1270 -1350).”* As predicted, the market held the 1270 level through mid year and didn't break the 1100 bottom I suggested until October when the credit markets completely froze up. Today it's hard to believe that those words marked me as pessimist a year ago, but only four months earlier the S&P had traded at 1565. I only expected a 30% decline, not the worst market plunge since 1931.

The 70% Solution

Managed Sector Fund Investing

As of the market highs October 9, 2007, we have completed a full peak-to-peak market cycle*. If you have been reading our recent newsletters, you probably noticed that a key element to our investment strategy is avoiding the majority of losses in a bear market. A just and comprehensive analysis of any investment strategy MUST include both the bull and bear markets to accurately demonstrate the efficacy of the strategy. What follows are the results of the FSG LLC Diversified Portfolio (Net to clients after all fees) v. the S&P 500 Total Return Index (incl. dividends). Though our performance lagged the market during the latter bull phase, our strict risk management over the entire market cycle enabled our clients to beat the market by 5 ½ to 1.



*Using the S&P 500 Total Return Index as our market benchmark

Many Stock Brokers, Financial Planners, and Accountants are also registered as Investment Advisors. Our Programs are often misperceived as competitors to their business. Financial Solutions Group LLC and Clyde Kendzierski maintain strategic partnerships with other advisors and are willing to include additional qualified advisors in our programs to expand their business and enhance their clients' long term returns.

The 70% Solution

Managed Sector Fund Investing

The results shown on the previous page for the S&P 500 index represents total return including dividends and excludes commissions. The Total Return index is calculated using data provided by Standard and Poor's and prorating dividends. The results for the Diversified Strategy are net after deducting all charges including commissions, advisory fees, and fund management fees and redemption charges if any. Diversified strategy returns were calculated from the actual results in a specific account including reinvestment of all dividends and capital gains distributions. The results are self audited. Arrangements are currently being made with an independent accountant to verify our calculations.

Client portfolios over \$100,000 are usually invested based on some mixture of three primary strategies: aggressive, diversified, and fixed income. Most clients utilize the Diversified Strategy for at least a portion of their portfolio. Alternate strategies may be utilized for smaller accounts or for accounts domiciled outside of Fidelity Investments. Individual client strategy mix is determined by discussion with client to reflect the client's goals, tolerance for short term risk, and other assets. Increased risk offers the potential, but not the guarantee of higher returns. Conservative portfolios tend to be more stable but potential return is limited. The primary investment vehicles are no load mutual funds sponsored by Fidelity Investments with heavy emphasis on the Select (sector) Funds. Actual client returns will reflect the portfolio mix selected for the client. No two accounts will necessarily achieve the same returns, as there are factors that are unique to each account. Whenever possible, transactions in client accounts are executed simultaneously with those in the model portfolios, at the same NAV with the same fees (if any).

1. The addition or withdrawal of client funds is the primary reason that client returns may differ significantly from the return in the model portfolios (this is especially true for new accounts during the first ninety days) after an account is opened. Portfolios are not adjusted instantaneously to correspond with the model. Investments are phased in or out, as opportunities occur during subsequent weeks in an attempt to optimize the benefit to the client.

2. Client returns will differ from the model portfolio returns as a result of the mix of model portfolios in their particular account compounding at substantially different rates of return. Portfolios are rebalanced periodically on an individual basis back to the target portfolio ratios. This has a smoothing effect similar to dollar cost averaging. If however, one of the models in the client's mix has a large subsequent change in value the results will be different (smaller gain or loss) than if the sub portfolios (i.e. 75% diversified, 25% aggressive) were held separately.

3. Client returns may be affected by a variety of other factors. The effects of these factors are usually minor. For example: waiver of fees by the advisor, different fee schedules based on asset size, and/or technical trading errors or restrictions on fund switching (which is usually triggered by the addition or withdrawal of funds). It is our intention to minimize any negative effect on clients. Our success in that effort is always subject to unanticipated market conditions.

4. Client returns may differ from the return in the model portfolios depending on whether funds are held in a taxable or non-taxable account. Clients who have requested that their money market fund be maintained in tax free funds will usually have a slightly lower pre-tax return.

5. In most case, clients should achieve returns similar to the mix of portfolios selected (after adjustment for fees) in accounts over \$250,000 that have been established for over 90 days with no additions or withdrawals of funds during period being measured. For example, take a client with a mix of 75% Diversified and 25% Aggressive; in a year when the Diversified model produces 10% (gross) and the Aggressive model produces 15% (gross), this client is likely to have a gross return between 10.5% and 12% before advisory fees. Because advisory fees are charged quarterly, the difference between the gross return and the net return to the client will vary depending upon the point in the year when the returns are generated by each strategy. Results shown are net of fees of 1.5% annually.

6. Past performance is a poor indicator of specific future returns. It is however very useful in determining how a particular manager performs in different market environments. When evaluating the performance of a particular manager, it is important to include periods when the benchmark index was declining as well as periods when the index was rising. Investors have the ability to achieve results similar to the S&P 500 Total Return by investing in an S&P 500 Index Fund or ETF.

Past Performance does not Guarantee Future Returns

Jan 2009

I'm much more optimistic about returns on stocks and bonds this year than last. The economy is likely to bottom later in the year, while the prices of stocks and houses are likely to find at least a temporary bottom sooner, if they haven't done so already. Deflation will continue for a while, but year end will bring a drop in the trade weighted value of the dollar pushing commodity and import prices higher. Last year TBonds were the best performer. They will be crushed in 2009, but corporate bonds should perform very well. For much of my 09 forecast, I am less confident than my usual 65-75% probability of being right. Cut it to 50-60% this year. There is an outside chance that stocks could have a stellar year or post new lows before the bull market is established. As always with forecasts; the devil is in the details.

The 2009 US Economy – We will see continued shrinkage as we enter 2009 and some residual deflation will carry over into the New Year. The massive government stimulus and the Fed's unprecedented flood of liquidity since September have already ended the credit crisis. Revived credit markets combined with lower energy prices will end the recession by fall. While the economy will shrink in the first half, economic growth and inflation should resume as we end 2009. However, don't break out the party favors just yet. This will not be a V-shaped recovery although the cheerleaders on CNBC will probably be hyperventilating when the numbers turn positive. All of the negative factors like high unemployment, state budget deficits, overwhelming debt levels, relatively tight credit conditions, a global recession, and a rising savings rate will be formidable headwinds. Later in the year, when things are looking up, mortgage rates will creep back up over 6% ending the housing rebound.

History suggests that unemployment will continue to rise to at least 8 1/2%. In the unlikely event the Fed backs off or the stimulus package is delayed, it could rise to 10%. Unfortunately the stimulus package doesn't actually fix anything. Instead it reduces the severity of the recession in exchange for a reduction in potential future economic growth. Beyond 2009 we are likely to face an economy that oscillates between a series of modest recoveries and mild recessions for a decade. Normally inflation rises as we enter recession (it did) and falls in the first year of recovery. This time will be different simply because our basis of comparison is the deflation we are currently experiencing. Such rapid increase in peacetime government spending is unprecedented. Keynesian spending is a great tool to cushion a decline, but an obstruction to long term non-inflationary growth.

Even without the decline in productivity that comes with larger government, increased savings will impede economic growth. Instead of providing a stimulus to investment, increased savings will be needed to finance the huge deficits. From 1950 through 1985, Americans generally saved 9% of their income. After 1985, the savings rate ratcheted lower. Since 2005, the savings rate has been close to zero. To put this in perspective, increasing the savings rate back to 9% in 2009 would reduce US consumption by over 750 billion dollars, completely offsetting the proposed fiscal stimulus package. If Americans start saving just 3-5% of their income (as they have in the last few months) the impact of the stimulus package will be cut in half.

The economy will deteriorate significantly through the first quarter of the year. Come Q2, financial, housing, and auto manufacturing layoffs are likely to slow. Unfortunately layoffs in retail as well as state & local government positions will accelerate, restricting the pace of recovery. Only a year ago conventional wisdom argued that continued economic growth in China would decouple from the US, limiting the subprime related slowdown in the US. As I warned, decoupling turned out to be a fantasy. Globalization did however cushion the blow in an unexpected way. While significant numbers of manufacturing jobs shifted to China during the boom, many of the layoffs also shifted to the emerging economies in the bust.

Just as rising oil prices created the statistical illusion of economic growth in the 2nd qtr of 2008, falling oil prices will make economic growth in the 4th qtr appear statistically as the worst of the recession. In reality, the impact of layoffs and store closings on Main Street in the 1st qtr of 2009 will make this period the most painful even though the data will only show a 3-4% drop in GDP. The pace of decline will diminish after that but the economy is likely to shrink through the summer. The challenge of funding over \$6.4 trillion of maturing and new treasury debt over the next year will shape both the economy and economic policy as we enter 2010. Long term interest rates will rise, while persistent unemployment will prevent the Fed from raising short term rates. This sets the stage for a weaker dollar and renewed inflation at year end and beyond.

Inflation 2009 – Despite my forecast of declining energy prices in 2008, I never expected prices to soar to \$145/bbl in summer or plummet to \$35 at year end. Those 2008 swings will be a major statistical determinant of annual inflation rates this year. Consumer prices may show year over year declines through summer and big jumps at year end. The global recession is triggering fire sales and deep discounting in virtually all categories of goods. The deflation Alan Greenspan feared seven years ago is now a reality. This is a bit more than the “*break in the multi-year inflationary spiral*” that I forecast. Though it will take a while to work its way through the economy, the hordes of Fed-created money will raise the inflation rate in 2010 and beyond. In the meantime, supply of everything from autos to restaurants is being reduced. When the excess is worked off, prices will rise again. In light of current conditions it is hard to envision 2009 inflation as measured by the CPI above 2%, but that will seem high after 7 or 8 months of falling prices. Inflation during the last decade mostly took the form of rising asset prices. Federal Reserve money creation generated easy credit, inflating the prices of housing, stocks, bonds, and commodities. That era has ended. I will say it again. The financial system is broken. For the next few years, money creation will translate directly into a weaker dollar and higher consumer prices. Asset appreciation will lag in the absence of easy credit so don’t expect any mega bull markets in stock or home prices for many, many years.

Commodities - Inflationary pressure will be concentrated in the necessities of life. The big drop in energy prices will increase the profitability of mining operations leading to increased output and lower prices. For this reason, gold mining companies are likely to be better bets than gold prices in 2009. Although oil prices will remain low compared with early 2008 they should rebound back to the \$60/bbl area. Gold ended the year at \$865/oz. Now that the panic has passed, gold is likely to see \$765 sooner than \$965. The long term the story is different. Gold prices should double in the next few years in response to the aggressive debasing of paper currencies by the world’s central bankers.

Housing 2009 - Home prices were already plummeting a year ago when I forecast, “*For the past eight years, most stock investors (our clients excluded) would have been a lot better off in TBills and CDs. From the peak in 2005, real estate investors should expect the same [situation]...Prices will fall until the after-tax cost of a 100% financed home is less than rent.*” A year later, home prices in many areas have penetrated that threshold. Housing is again affordable for anyone with a decent down payment, enough income, and good credit. Statistically the median price in most areas will continue to fall, but the causes of that continued depreciation are changing. Until recently, home prices were driven by foreclosures which were concentrated in lower priced homes. Going forward the primary driver will be the traditional factors of layoffs, business failures, and loan qualifications. These factors affect all price levels. The previously immune upper end which is still overpriced will feel the most downward pressure. The best buys in some affordable areas may be right now. The Fed is flooding the mortgage market with money, pushing monthly payments down 20%-25% beyond the reductions created by the price cuts. Offsetting this is the general contraction of bank credit which shuts out most investors as well as homebuyers with less than perfect credit. Not only is the availability of credit limited, but unemployment will trend higher throughout the year. This housing collapse was unique in that it was triggered solely by the collapse of the credit markets rather than by rising joblessness. Employment is the single most important determinant of home prices and sales. Home prices may be approaching the current after-tax cost of rental housing, but there is substantial downward pressure on rents as unemployment rises and many foreclosed properties enter the rental market. It remains to be seen whether lower mortgage rates are sufficient to stem the receding tide. At best, prices may stabilize as new home construction effectively grinds to a halt. It will take years to absorb the existing vacancies and projects still under construction. The prices are likely to reach a temporary bottom in the first few months of the year then stabilize through summer. The surprise will come next winter when mortgage rates inch higher and prices adjust down again. Put it all together and the combination of tax benefits, reasonable prices, and cheap mortgage money make it a great time for first time homebuyers who can qualify to take the plunge. The same cannot be said for real estate investors. The numbers just don’t compare with stocks or corporate bonds until rents rise significantly or prices fall further.

Interest Rates and the Fed 2009 - A year ago I expected the Fed to keep the economy afloat with easy credit until at least September. The economy didn't fully implode until fall, but the recession began much earlier. The leaks in the debt bubble were just too big. Early last year, the Fed could not expand credit fast enough to compensate without completely destroying the value of the dollar and setting the stage for hyperinflation. A lot has been written about how allowing Lehman Bros to go bankrupt set off the credit crisis. Certainly it was the straw that broke the camel's back, but if it hadn't been Lehman it would have been General Motors or the Madoff scandal. By 2006, the credit crisis was an accident waiting to happen. It could not be prevented. It could only be postponed. The inability of the Fed to ease sufficiently, rather than a need to tighten inflation triggered the crisis.

Over the last decade, total US debt had expanded to an unsustainable 350% of GDP. The Fed's attempt to slow the expansion gently in 2006 and 2007 with gradual interest rate hikes failed. Like a snowball bounding around and over obstacles down a steep hill, debt kept expanding despite the rate hikes. Eventually the snowball gets so big and is moving so fast any obstacle big enough to slow the trajectory will also cause the snowball to disintegrate. The debt bubble started leaking at the beginning of the year. Despite rate cuts and a patchwork of bailouts, the bubble was too big to deflate without disaster. The global credit market seized up and the only borrower who could successfully issue bonds was the US Treasury. When private sector lending did occur, it did so because banks were obligated to honor previously committed lines of credit. Unprecedented actions by the Fed ended the crisis in record time, but those months seemed like an eternity. Libor rates have come down, the commercial paper market has reopened and rates on conforming mortgages have plummeted. The markets are no longer frozen, but only the most creditworthy of borrowers can borrow. The debt bubble load has not been significantly reduced, only shifted to the balance sheet of the federal government. With short term TBill rates at zero, the cost of servicing that debt has plummeted, but that won't last.

The banking system is under pressure to increase capital ratios. This is almost impossible in a world where consumer and corporate defaults are still rising. Lines of credit will be available, but in aggregate, lending is unlikely to expand. Most non-financial public companies have strong balance sheets so the economy can stabilize without credit expansion, but bond defaults will rise. The additional yield premium over TBonds compensates for that risk, providing above normal returns. The decision as to which credits will pay off is best left to the specialized professionals running corporate fixed income funds. 2008 left that playing field littered with corpses. Very few fixed income managers came close to matching our model portfolios in 2008, but don't let one year of negative bond returns keep you out. Although equities have a shot at being the top performing asset class in 2009, lower rated corporate bonds are likely to have higher risk adjusted returns. The sweet spot of investors is BB corporate bonds. Just slightly below investment grade these bonds yield between 11 & 13%.

10 yr TBond yields bottomed at 2.04% in December and ended the year at 2.36% (as a reminder, bond prices and yields move inversely with each other). A year from now, 10 yr TBond yields will be back above 4%. This will derive from four separate factors. First: risk aversion will moderate. Investors will move from the safety of TBonds to equities and corporate bonds. Second: inflation will bottom in 2009 and begin rising by year end; reducing the real return on bonds and sparking sales. Third: foreign investors who enjoyed big gains on TBonds in 2008 will suffer losses in 2009 and begin reducing their holdings and purchases. Finally: supply will be overwhelming. The Treasury needs to issue \$6.4 trillion dollars in new debt in the next year to cover the deficit and refinance maturing issues. This will become a vicious circle pushing prices lower and yields higher. Inflation Protected Treasuries (TIPs) are the only bright spot for treasury investors, but even TIPS could be overwhelmed by massive new supply.

Mortgage rates may fall further early in the year as the Fed buys mortgage backed securities. Those rates are likely to move higher late in the year when treasury issuance crowds out other borrowers. Municipal credit downgrades will continue in fiscal disaster areas like California. We mitigated that risk in 2008 for our fixed income clients by shifting out of double tax free California bond funds into Federal tax free national bond funds that have the ability to select higher quality issuers. Given the policy actions of the last few months a federal bailout seems almost certain so at some point it will make sense to move back into the lower rated bonds. The bottom line is that high yield bonds they are likely to be the best performers. TBonds will get decimated. AAA mortgage backed bonds, high grade corporates, and municipals should offer solid if not stellar returns while TBond investors are likely to lose money in 2009.

The Stock Market 2009 - This is the most difficult part of the forecast. Fortunately, some of my uncertainty lies with the chance that things could turn out better. As Mark Twain famously observed, "history doesn't repeat but it does rhyme". Stock market rallies of 30-90% from previous bear market plunges in the 1930s and 1970s were the norm rather than the exception. The economic environments in those periods were just as challenging as the headwinds we face today, so it is reasonable to expect some very good days and weeks in the near future. Unfortunately, the market suffered major setbacks following those rallies before it was clear that the bear markets were over. It is likely the bottom is behind us, but the future remains challenging.

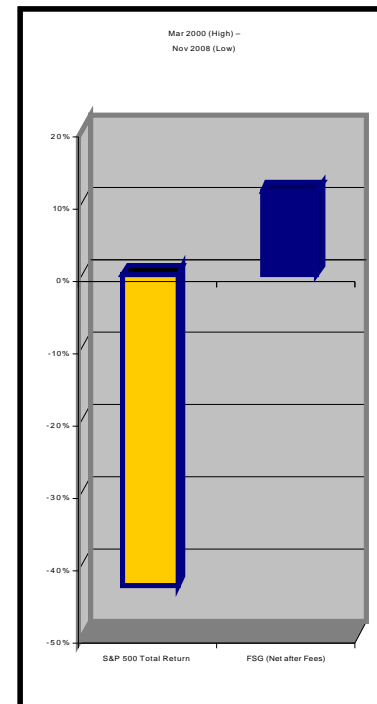
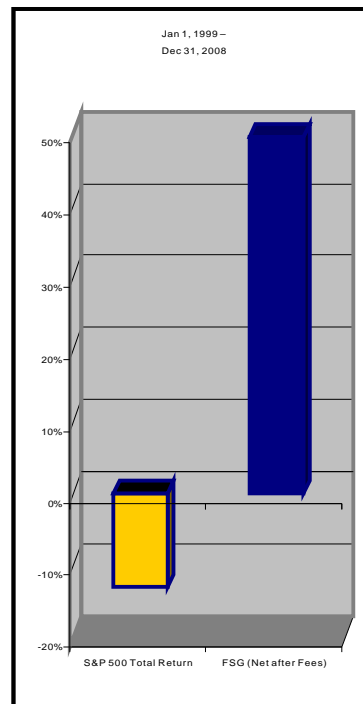
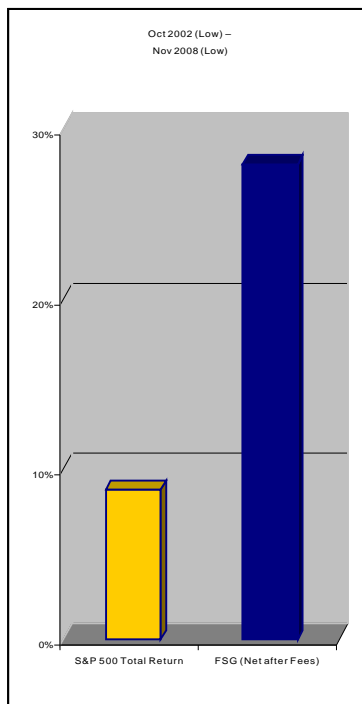
Last year I opined that the market could drop 30% to S&P 1100. That sounded scary but proved to be optimistic. This year the market could rally to S&P 1100, a 25% gain from year end and a 46% gain from the November lows. Whether that level will hold through year end is a much tougher call, but I will argue closing the year above 1000 on the S&P is likely. Combined with a 3% dividend yield, even that result would represent a double digit gain for the year. A rally of that magnitude increases what is now a minor risk of a major correction. That correction could retest or even breach last November lows, opening the possibility of a drop in the index to S&P 650. Even in that scenario, stocks are likely to produce excellent returns over the next five to seven years from current levels.

It may seem hard to reconcile my dismal view on the economy, housing, and the job market with my relatively optimistic outlook on stocks. Just as stocks turned down long before it was clear that the economy was entering a recession, stocks typically bottom long before the economy recovers. Although I am convinced that stock returns are likely to be above normal over the next few years, I disagree with those that argue investor sentiment is currently so negative it can only get better, putting us on the verge of a great bull market. I see investor sentiment as bifurcated. A large portion of former stock investors have truly capitulated and have retreated to money market funds and CDs. Unfortunately rather than representing money that will some day return to the market pushing it to new heights, these twice burned investors are unlikely to ever leave the safety of FDIC insured CDs and return to the volatility of the equity markets. Those who are still open the idea of equity investments are much more optimistic. They may be nervous but they are still cultivating the hope for the ultimate, if not imminent, recovery of stock prices. History strongly supports the idea of slightly above normal stock market returns from current levels. The mix of near term caution and medium term optimism may prove to be contrary indicators. Stocks are sufficiently depressed that a short lived rally could come at any time. Unfortunately full recovery to the 2007 highs may prove to be painfully slow. Corporate profit margins peaked in 2007 and will shrink in future years. Labor is going to get a bigger share of national income while taxes and regulation will increase over time, limiting profit growth. While I am optimistic about stock returns in 2009 (and possibly 2010), the evidence that we have seen the lows is not completely convincing. A primary source of my optimism is that volatile assets like stocks are incredibly cheap relative to so called risk free assets like TBills and TBonds. The biggest risk is not that the gap between stocks and treasury yield will fail to shrink. The biggest risk is that money will shift out of both TBonds and stocks into corporate bonds. The case for intermediate grade corporate bonds is compelling. A secondary risk is that TBond yields rise so rapidly they threaten all asset classes. This seems unlikely for several months but is a potentially serious risk at year end and into 2010. More likely is a healthy return between six and fifteen percent from stocks in 2009.

Managed Accounts and Model Portfolios in 2008

Diversified Portfolio – While the S&P 500 suffered its worst performance in over 70 years, our Diversified strategy had mixed results. In absolute terms, the strategy suffered the biggest loss we have ever recorded. In relative terms, we not only outperformed our benchmark (and Buffet's Berkshire Hathaway), but also outperformed almost 95% of US equity mutual funds. Our relative performance from the highs in October 2007 was even better. We may have outperformed most money managers, but our Diversified strategy was actually our worst performing strategy in 2008. A few years ago Fidelity imposed new trading restrictions on the sector mutual funds we have successfully used for decades. We adapted to these restrictions by substituting the sale of unrestricted sectors for the sale of sectors that our systems indicated should be liquidated. That process was ill suited for unprecedented trading volatility of 2008 and increased our losses by at least 3%. We have addressed this problem by reallocating a significant portion of the portfolio out of Fidelity Mutual Funds and into Exchange Traded Funds (ETFs). EFT transactions do incur nominal commissions but trade intraday like stocks and are free of the restrictions that hurt our performance in 2008. Here's how we've stacked up over various critical time periods.

	S&P 500 Total Return	Net to FSG after all fees
Calendar 2008	-37.00%	-27.36%
Oct 2007 (High) – Nov 2008 (Low)	-50.71%	-28.78%
Oct 2002 (Low) – Nov 2008 (Low)	+8.78%	+27.91%
Mar 2000 (High) – Nov 2008 (Low)	-42.76%	+11.47%
Jan 1, 1999 – Dec 31, 2008 (10 yrs)	-13.00%	+49.60%



What is The 70% Solution?

This newsletter was named after a diversified investment program for managed accounts. That program seeks to capture 70% of the gains of a rising stock market and avoid 70% of the losses when the market declines. It is intended for clients who desire long term investment returns similar to the S&P 500 Index, with reduced volatility. The program was originally designed for qualified plans such as retirement accounts and certain trusts (some taxable accounts may be unsuitable). We invest in industry specific, sector mutual funds. We never purchase individual stocks although on rare occurrences we will invest in industry specific Exchange Traded Funds. The diversified portfolio only invests in sectors that meet our proprietary criteria for being relatively undervalued at time of purchase. Most of the funds are part of the Fidelity Select family. Although this program is designed to reduce short-term volatility, we advise against investing in this or any other equity program for less than three years. Unlike market timing programs, this diversified investment program is rarely 100% invested or 100% in money market funds. We also offer an aggressive program for investors comfortable with very volatile investments as well as a fixed income program for more conservative investors. As with any investment program, past performance does not guarantee similar future results.

Investment opinions expressed in the newsletter are based on the analysis of Clyde E. Kendzierski, a Managing Director and Chief Investment Officer of Financial Solutions Group, LLC. Financial Solutions Group, LLC is an Investment Advisor registered with the Securities and Exchange Commission. Mr. Kendzierski is also a registered investment advisor and holds a Masters Degree in Economics. Since the mid-1970's he has been employed by major California banks as a money manager and bond trader, managing accounts as large as 1.7 billion dollars. Following the largest municipal bankruptcy in history (Orange County, California), he was appointed to the Treasury Oversight Committee to establish investment policies to prevent similar debacles in the future. He created the 70% Solution investment program in the early 1980's for management of his personal retirement funds.

Managed accounts generally reflect the results of the model portfolios published in the newsletter. Individual results reflect the client's unique mix between the diversified, aggressive and fixed income strategies (adjusted for fees, which vary with account size). The program is offered through NASD registered broker-dealers. Clients' funds are held in custody at a subsidiary of Fidelity Brokerage. The Advisor is given limited trading authority, but never takes possession of client funds.

*Financial Solutions Group, LLC publishes *The 70% Solution* newsletter, plus special Investor Alerts.

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