FAI Advisors, Inc.

Monthly Investment Commentary

July / August 2009

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Stocks regained momentum in July after pausing in June, with large-cap U.S. stocks (as measured by Vanguard 500 Index Fund) gaining a robust 7.6%. Smaller-cap stocks did even better, with the small-cap iShares Russell 2000 ETF climbing 9.6%. The small-cap advantage was driven by the 11.5% gain from small-cap value stocks (based on the iShares Russell 2000 Value ETF) while small-cap growth performed roughly in line with the broader equity market. For the year to date, Vanguard 500 Index Fund is now up 11%, and growth has a sharp advantage in return over value across the spectrum of company size.

Updated Market Data

	July	YTD
Large Cap Benchmarks		
Vanguard SP 500	7.60%	11.00%
Russell 1000 Growth ishares	7.10%	19.30%
Russell 1000 Value ishares	8.20%	5.10%
Small Cap Benchmarks		
Russell 2000 Growth ishares	7.70%	20.00%
Russell 2000 Value ishares	11.50%	5.80%
Other Benchmarks		
Vanguard REIT Index	10.60%	-2.30%
Vanguard Total Intnl Stock Idx	10.00%	21.80%
Vanguard Total Bond Idx	1.40%	3.60%
Merrill Lynch High Yld bond Idx	6.00%	36.70%
Citigroup World Govt Bond Idx	1.80%	0.30%
DJ-AIGCI (Commodity Futures)	3.20%	8.00%

"A Year in Review"*

	08/17/09	08/17/08	% Chg
Consumer Rates			
6 Month CD	0.47%	3.07%	-84.69%
30 Yr Mortgage	5.38%	6.57%	-18.11%
Prime Rate	3.25%	5.00%	-35.00%
Commodities			
Gold	945.85	805.60	17.41%
Crude Oil	67.48	115.02	-41.33%
Gasoline	2.65	3.88	-31.70%

* Source: JP Morgan Weekly market recap

Looking overseas, foreign stocks did even better, with Vanguard Total International Stock Index tacking on 10% for the month to bring its year-to-date gain to almost 22%, while Vanguard Emerging Market Stock Index gained 11.6% in July and is up a whopping 50% so far in 2009. High-yield bonds saw gains a percent or two below those of U.S. large caps in July, but the 36.7% year-to-date return for the Merrill Lynch U.S. High Yield index is more than triple the return of U.S. stocks. Vanguard Total Bond Market Index Fund was up 1.4%, and it's worth noting that active bond managers continued to handily beat that index in July.

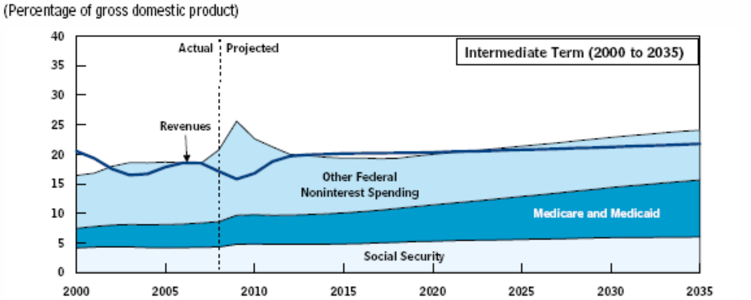
GOVERNMENT HAPPENINGS:
Stimulus, Deficits and the expanding Federal Debt

What about the stimulus? Even though little of the stimulus money has actually been put to work in areas that will help stimulate economic growth, many experts believe that the funds will work their way through the system and provide some lift to the economy, until the private sector catches up to provide recovery.

Figure 1-1.

Federal Revenues and Noninterest Spending, by Category, Under CBO's Extended-Baseline Scenario

(Percentage of gross domestic product)



This stimulus and bailout spending, combined with collapsing tax revenues, are causing record setting budget deficits and an expanding of the Federal debt. The deficit will set a post-WWII record in 2009 thanks to the economic crisis.

It is possible that a combination of economic growth and more-effective cost management will keep deficits at manageable levels. However, even after the economy begins to recover, this issue will not go away as we face more and more baby boomers entering their retirement years.

Factoring in the president's budget, the Congressional Budget Office projects that our national debt held by the public will double from the end of fiscal 2008 to fiscal 2018, when it will push 80% of GDP. Looking out a few more decades, the numbers are frightening (assuming current policies) with debt as a percent of GDP growing to almost 300% based on some projections. And these projections may well be based on optimistic assumptions regarding economic growth. In the shorter term, higher-than-expected economic growth or better management of government spending could mitigate the problem but realistically it is hard to be optimistic about either. Finally, if we are not successful in reining in the growth of the deficit and the resulting national debt, we will be faced with a challenge financing it. Interest rates will likely be driven higher as investors (lenders) demand a higher return to fund our huge borrowing need. Higher rates could partly be the result of fear that debt could reach levels that would force the government to resort to the printing press (to create currency) to help it pay its debts, potentially damaging the value of the dollar. It is a very complex issue, but there are some serious concerns.

HealthCare

There is no doubt the healthcare debate is capturing the news headlines right now. In 1968, Medicare, Medicaid, and Social Security were 17% of Federal spending. In 2008, their share had grown to 41%. These entitlements, along with other mandatory spending such as interest on the national debt, will continue to grow in absolute terms and as a percent of total spending. So, what does this mean to the markets? From our standpoint, we want to take note of what impact a government controlled or heavily influenced healthcare system can have on the investments in this sector. For example, the demand for services could skyrocket if millions of uninsured's are given "free" coverage all at once. On the other hand, certain segments could be completely driven out of business. It will be very interesting to see how this plays out.

Energy

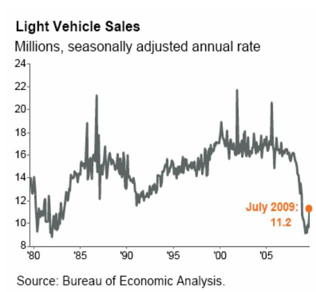
The other main area of government influence and change is the energy sector. There is no doubt the "green" economy is circulating as a recent catch phrase. Many stimulus dollars are committed to fund green government buildings using solar, wind, and other energy enhancements. There is both a business/ investment side of this issue, as well as the political side to this issue. We are much more interested in watching private sector involvement to see if investment dollars will continue to flow into the areas that the government has shown an interest.

Taxes

As we have discussed in previous commentary editions, and as discussed in this Deloitte article: http://www.financialarch.com/obamatax.html, taxes will almost have to increase on many households in the next few years. Despite the rhetoric coming from Washington and in the town hall meetings, the health care plan will likely add to the funding shortfall in federal budgets. www.cbo.gov Also, despite the Presidential campaign talk about raising taxes on households earning in excess of $250,000 per year, higher taxes on many more of the tax-paying population are almost certainly going to be part of the attempt to deal with the ongoing deficit. This can have serious economic consequences depending on the magnitude and the form of the tax increases. In addition, Americans closer to retirement may feel differently about continuing to defer income into in a 401k, feeling that it may be taken out in a higher tax bracket. This likely affects how we will be managing after tax portfolios. Potential changes in capital gains tax rates and ordinary income tax rates will require adjustments in strategy. Therefore, taking a flexible, independent approach to asset management will be quite valuable.

THE SIGNS OF RECOVERY

We have all heard the reports of good numbers in housing starts and auto sales, but we need to ask ourselves the following question, just as we would with any piece of economic data: What does this really mean? **Cash For Clunkers** has certainly stimulated auto sales as shown in the following chart. However, it will likely be the financial health of the American consumer and the availability of financing that will sustain this trend over time.



The same applies to Housing Starts, although it is excellent to see this trend turn around from the almost 4 year free fall. Once we have real economic recovery that will sustain this progress, inventories will again reach low enough levels to bring about a stabilization of prices. Eventually.

TREND LINES AND HISTORICAL MARKET MOVEMENTS

We have seen a nice short term rally in the stock market, good thing. Where does it go from here over the next 12 – 18 months? The chart below shows that during the depression in the 1930's, there were 6 substantial rallies during this depression era market cycle. Heavily weighting into stocks and trying to time the entry point was very difficult, and in fact since the overall trend was heading down it would have made sense to stay underweighted to stocks throughout that cycle. In fact, always buying at every "low point" would have produced a painful outcome.

Today, the Fed has taken measures to avoid the depression scenario for now, but we are still in a "deflationary" environment. Most economists agree that the economy is likely to experience a slow recovery process over the next few years due to the bursting of a massive credit bubble. Americans are resilient, but this has been a major adjustment to the previous status quo. This will almost certainly be a drag on consumer spending for quite some time. The likely result is a below-average economic recovery and subpar corporate-earnings growth over several years. We view a normal cyclical recovery as a best case to hope for but certainly not the most likely outcome (though we do not dismiss). If the anemic growth scenario plays out, stock prices on the broad U.S. indexes are now at a level that suggests a bumpy path to disappointing returns (ranging from slightly negative to about 5%, annualized) over the next few years.

OTHER ASSET CLASSES

High Yield Bonds and some of the other bond areas have been welcome additions to the accounts in calendar year 2009. In previous market cycles as in this cycle, these alternative areas of investment were used to manage risk. Taking a look back in history for some context, the last time our portfolio models contained High Yield Bonds was from late 1999 to late 2004. During this time, the US stock market was experiencing the Tech bubble and burst (2000 to 2002). The decision was made back then to use some of the portfolio that was held in stocks and instead used high yield bonds (+- 14% of the portfolio). According to the history of these funds, here are some historical cumulative annual return results using full calendar years (2000 - 2004).

History of Funds	*Cumulative Return*
	(2000-2004)
T. Rowe Price High Yield (PRHYX)	38.49%
SP 500 Index (Vanguard VFINX)	-3.99%

Why is this important? During this current market cycle, High Yield Bonds have been part of the portfolios for a small fraction of the time that it was held last time. The reason we would continue to hold them would be if the expected return from this asset class could produce more favorable risk adjusted returns than having the money in stocks, gold, or any other area. For now, since we are underweighted to stocks, the overweighting of these "alternative" areas will continue to play a substantial role in our allocations.

EMERGING MARKET BONDS

Emerging Market Bonds are the most recent addition to the portfolio models. This is considered to be another alternative asset class, added primarily because of the belief that longer term the US dollar will continue to decline. Reasons for this would include: the still large US trade deficit, the large debt the US has taken on to deal with this recession, and the likely anemic growth of the US economy over the next few years. Emerging markets are likely to grow faster than our domestic economy, and this is a non equity (not stocks) exposure to these markets. They appear to offer less downside risk with attractive yields.

NEWS – EVENTS COMING

For those of you that would like to experience some training in how to navigate your NetExchangeClient website for your Pershing account online access, we are planning to have a web demo/conference call. This will be run by our office, so you can ask questions and have some interactive involvement in navigating the website. We will be looking at some areas of the website that most people don't explore, as well as explaining some definitions of all the different numbers on the BALANCES page. If you have interest in attending something like this, we would like to hear from you. Please email Jan Winters with your comments at jan@financialarch.com.

FAI Advisors, Inc.
Investment Policy Committee July / August 2009

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