

# Fagan Financial Report

VOLUME 11 ISSUE 2

SECOND QUARTER 2008

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## Fagan Associates, Inc. Registered Investment Adviser

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*Individually managed portfolios*

*No outsourcing to institutional money managers*

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## *To Our Clients*

On the cover page of our 2008 Quarterly Newsletter, the *Fagan Financial Report*, we provided to all of our clients our "2008 Outlook" detailing how we thought the current year would unfold. We stated, "*the problems with housing referenced several times above resulted in a twenty-percent decline in financial service companies. This will most likely linger into the first half of 2008.*"

Well, with the first half of 2008 having come and gone, not only did the stress in the financial services industry have a negative impact on the stock market, the forty percent rise in the cost of a barrel of oil and subsequently the price of a gallon of gasoline also weighed heavy on the economy and thus stocks.

As investors closed their books on the second quarter, a quarter

that was marked by the worst June since 1930 and the third consecutive quarter of negative returns for stocks, the Dow Jones Industrial Average had fallen 14.44% year-to-date. The four other major indices that we follow did not fare much differently with the S&P 500, the NASDAQ Com-

*We constantly remind ourselves that excessive optimism does not yield stock prices at attractive levels, excessive pessimism does. Where along this continuum do you think we are at this moment?*

posite, the Dow Jones Wilshire 5000, and the Russell 2000 falling 12.83%, 13.55%, 11.78% and 9.97%, respectively. With all of

negative news regarding the economy, the global geopolitical situation, and therefore the stock market, we thought it would be appropriate to outline some of the principles to which we adhere.

First and foremost, it is of the utmost importance that during difficult times in the investment world you remember that, together, we have developed a lifetime plan that factors in bad times. That said, despite the fact that the media wants you to stay tuned to every tick of a stock price, it pays to review your long term investment objectives and determine whether your current portfolio is constructed appropriately to achieve those objectives. (We welcome calls to meet and discuss these issues.)

Continued on page 2

Secondly, it is important to *be an investor rather than a trader*. We don't fret over what will occur in the stock market over the next week, month or even quarter, but rather what we believe will be the direction of stock prices over the next one to three years. We tend to tune out the "halftime reports," the "market wraps," and the "you can't afford to miss this" teasers in order to focus on what really drives stock prices, revenue and earnings guidance.

Having worked in the financial services industry for more than twenty-five years, we recognize that *we will not be right all of the time, but that the important factor is to be right over time*. Should you think that you are infallible and that you will always be right, you will ultimately be driven crazy by a market similar to the one we've faced over the past couple of years. We benchmark performance periodically, over several time frames and versus several indices, recognizing that time smoothes short-term volatility.

What matters during periods of consolidation such as the one we are currently experiencing is that our clients *emerge* with the right investment portfolio. We try to be flexible and take money off the table when appropriate. We also recognize that diversification is the key to long-term investment success and maintain strict disciplines

in response to changing market conditions.

Our third point addresses strategies regarding the cash in our clients' portfolios. We are continuously looking for opportunities to dollar cost average (a disciplined, systematic approach to asset accumulation that exploits the opportunities presented by a soft market). Patience will ultimately serve our investors well and give them the best chance of meeting long-term objectives. We strongly recommend that you

*We look for investments that will be the next winners and, at every available opportunity, look to upgrade our managed portfolios to these leaders.*

direct your employer sponsored pension plans, 401(k)s or 403(b)s, be managed in the same fashion.

Furthermore, assuming that your portfolio is 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 this downturn. Use the "sale on stock prices" to continue to dollar cost average into your mutual funds. Each dollar invested will now go a bit further in purchasing shares based upon their low net asset value.

In addition to the above macro

items that we are addressing during these tumultuous times, we draw an analogy to football. For some of our more conservative clients we are adhering to a *defense wins championships* theme adding to high-grade bond funds, government bond funds, inflation protected securities, balanced funds, and consumer non-discretionary companies such as Pepsi or Baxter International. Or, in conjunction with the defensive theme, we integrate *the best defense is a good offense* strategy, identifying mutual funds that will rebound strongly with the stock market and sectors that are experiencing long-term, secular growth periods including infrastructure, oil & natural gas, and agricultural stocks as well as companies with strong export demand. For many of our clients we have substantially raised cash levels in their portfolios assuming a posture of *preventive defense* acquiring ultra-conservative investments such as Certificates of Deposit, short-term bond funds, and inflation-protected securities.

Given the uncertainty surrounding the energy markets, the geopolitical scene, and the upcoming presidential election this fall, we continue to remain cautious and will invest our clients' money according to what we, after several meetings with each of our clients, believe will ultimately enhance long-term financial security.

## Protect Your Future

At Fagan Associates, our goal is to preserve capital in bear markets and grow capital at a faster pace than the market during bull markets. Equity holdings are selected for client portfolios following an analysis of company fundamentals in relation to industry data, money flows, economic data, and geo-political events. At the time of purchase, the portfolio managers at Fagan Associates assign exit strategies for all purchases. Portfolio holdings are also reviewed regularly for opportunities to trade laggard stocks for those with more potential to be market leaders

**The Record**

Read the Fagan Financial Report every week in *The Sunday Record*.

## BALANCE IS ONE OF THE KEYS TO A HEALTHY LIFE

The old saying “all work and no play makes Jack a dull boy,” is a time-tested adage that we recommend investors keep in mind when considering their portfolios. For every grilled hot dog we eat, it makes sense to offset that with a nice green salad, without the dressing!

For example, investors are tempted to run headfirst to companies and assets that benefit from higher gas and food prices. While these companies and sector specific mutual funds certainly have a place in nearly all equity portfolios; note the presence of Loews Corporation, ExxonMobil, Total SA, Bunge Limited, Syngenta and the XLE Energy ETF in many client portfolios, we must retain balance.

A similar scenario took place during the late 1990s bull market when nearly all investors were drawn to technology. Like moths to a campfire, investors overloaded their portfolios with technology and paid the price when the tech bubble burst. While we don't believe this is what to expect from resource stocks, caution is advised. Solid companies like PepsiCo, Hewlett Packard, and Emerson Electric, all more than ten percent from their fifty-two week trading highs, make long-term

sense and have a place in a balanced portfolio.

Balanced mutual funds also offer stability to investors, generally fluctuating less than the stock market due to their weighting in bonds and cash allocations. Two funds that we like and that are in some of our client portfolios are the American Funds Capital Income builder (CIBFX) and the Buffalo Balanced Fund (BUFBX). While both currently carry nearly sixty-percent in stocks, the fact that they have roughly 30% in bonds and an international weighting keeps them less subject to the movement in the U.S. equity markets.

It is our belief that the price of a barrel of oil will recede in the coming months/years. After the Chinese Olympics and as Americans realize that a Honda Accord that gets thirty-five miles per gallon of gasoline can get them to work as quickly as that GMC Tahoe, demand will slack. But (and this is a big but) any **major** move lower in the price that we pay at the pump or to heat our homes, will not be coming anytime soon. The global demand for natural resources is expanding. We recommend that clients stay the course with those energy and material names.

## WEEK ENDING JUNE 27, 2008

Stocks retreated below their mid-March lows on news that “teflon-coated” brokerage firm Goldman Sachs downgraded Boeing, Citigroup and General Motors, all to sells. Despite the fact that the Dow has sold off 7.8% over the past two weeks, the CBOE Volatility Index does not indicate that we are at a bottom. Although we concur somewhat with this indicator, we do believe that we are close enough to a tradeable low to nibble at stocks.

Regardless, with oil above \$130/bbl, we fear that this recent sharp move upward in gasoline prices has negated the tax rebate check and sent consumer sentiment spiraling downward, potentially fueling an even stiffer headwind to stocks later this year.

The bottom line is that, after becoming accustomed to \$100/bbl oil, investors are once again responding inversely to movements in oil prices and gasoline prices. As long as oil maintains its recent level of volatility it is hard not to be cautious. However, on the more optimistic side, a sharp, sustained pull-back in energy prices, like the one we witnessed three weeks ago, would place us squarely in the bullish camp. The strength of this economic recovery rests with the price of energy.

### The radio show ...



#### **Fagan Financial Report at a new time, Sundays, 10:00 a.m. - 11:00 a.m.**

following the Joe Gallagher Weekend Morning Show

And, don't miss Dennis and Chris' weekly visits  
with Joe Gallagher

Sundays, 8:30 a.m. - 9:00 a.m.

and with

Don Weeks, Fridays at 8:17 a.m.

*We take your calls at 1-800-TALK-WGY or \*WGY*

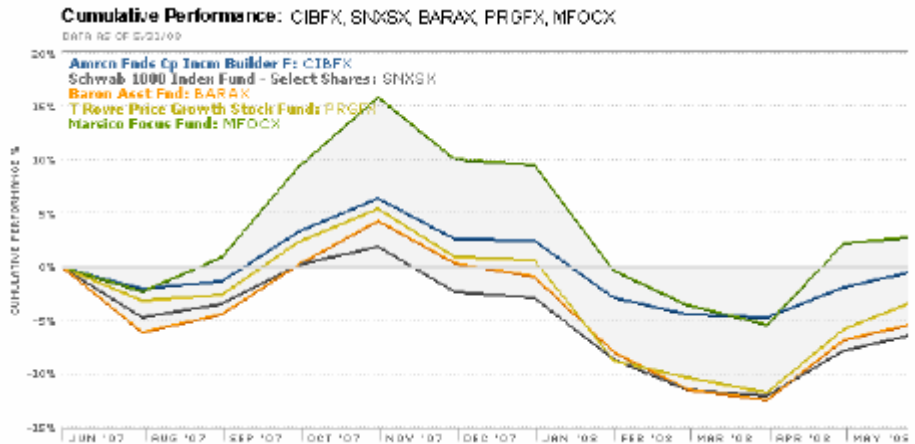
- A Recap of the financial markets, including company specific and economic news.
- “The Record Review” – an outline of our column that appears in the Troy Record every Sunday.
- “Widely Helds” – a look at the price action and news releases from the most widely held stocks.
- A spotlight on one or some of our **mutual fund holdings or ETF 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 and attorneys.
- Periodic interviews with local men and women making news that affects our lives.

PURE NO-LOAD MUTUAL FUNDS  
 NO SALES LOADS IN  
 NO DEFERRED SALES LOADS OUT  
 MANY WITH LOW INTERNAL EXPENSE RATIOS

Fagan Associates, Inc. Largest Mutual Fund Holdings as of June 30, 2008.

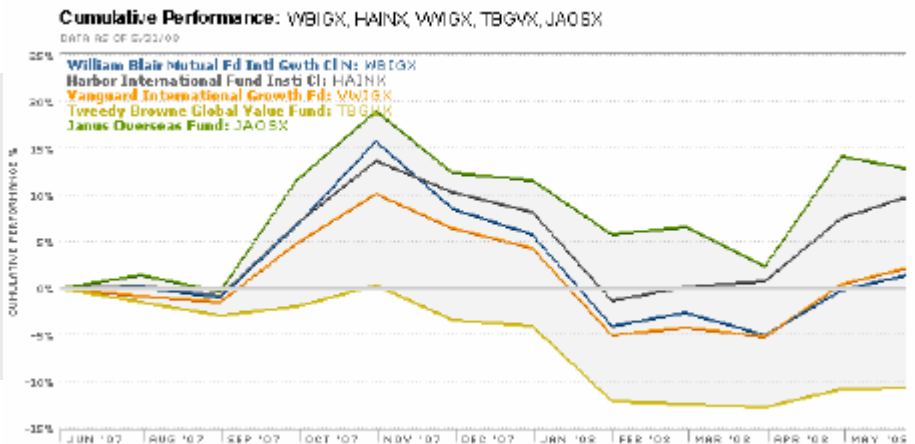
**Domestic Equity Funds**

- AF Capital Income Builder
- Schwab 1000 Select Fund
- Baron Asset Fund
- TR Price Growth Stock Fund
- Marsico Focused Equity Fund



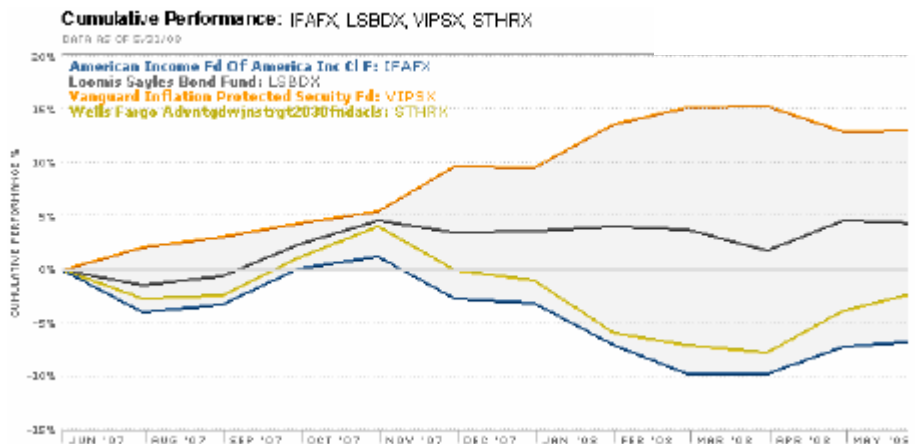
**International Equity Funds**

- William Blair International Growth
- Harbor International Fund
- Vanguard International Growth
- Twedy Browne Global Value
- Janus Overseas



**Hybrid/Fixed Income Funds**

- Income Fund of America
- Loomis Sayles Bond Fund
- Vanguard Inflation Protected Securities
- WF Short-Term High Yield



**Common Stock Portfolio Holdings\*\***  
**Ranked by Market Value as of June 30<sup>th</sup>, 2008.**

<i>Percent of Common Stock</i>	<i>Company Name</i>	<i>As of June 30, 2008</i>	<i>As of May 31, 2008</i>	<i>As of April 30, 2008</i>
6.32%	Exxon Mobil	1	1	2
5.68%	Hewlett Packard	2	2	3
4.58%	Loews Corporation	3	4	4
4.28%	General Electric	4	3	1
4.02%	Apple Computer	5	5	5
3.30%	Schlumberger, Ltd.	6	6	7
2.53%	McDonald's Corporation	7	8	9
2.29%	JP Morgan Chase	8	7	6
2.23%	Johnson & Johnson	9	10	12
2.23%	Oceaneering International	10	12	13
1.97%	American Express Company	11	9	11
1.83%	NYSE Euronext	12	12	10
1.78%	Emerson Electric Co.	13	14	15
1.73%	Joy Global, Inc.	14	16	17
1.73%	Research In Motion	15	13	21
1.68%	Gilead Sciences, Inc.	16	19	19
1.64%	Sasol, Ltd. ADR	17	20	20
1.57%	Manitowoc Co., Inc.	18	15	14
1.52%	Vimpel Communications	19	17	23
1.42%	Cisco Systems, Inc.	20	18	16
1.38%	Baxter International	21	25	27
1.35%	DuPont	22	24	31
1.25%	Intel Corp.	23	23	29
1.25%	Halliburton Co.	24	31	38
1.14%	Corning, Inc.	25	22	22
1.09%	MasterCard, Inc.	26	26	18
0.85%	Citigroup	33	27	25
0.69%	Bank of America	43	21	8
0.07%	ICICI Bank	123	28	24

**Common Stock Portfolio Holdings\*\***  
**Ranked by Share Balance as of June 30<sup>th</sup>, 2008.**

<i>Notes &amp; Stock Splits; Avg. Cost Per Share</i>	<i>Company Name</i>	<i>As of June 30<sup>th</sup>, 2008</i>	<i>As of May 31<sup>st</sup>, 2008</i>	<i>As of April 30<sup>th</sup>, 2008</i>
\$31.66	General Electric	79,678	88,688	116,010
\$43.10	Hewlett Packard Co.	63,756	63,126	61,811
\$41.03	Loews Corporation	48,431	49,811	50,216
\$40.63	Exxon Mobil	35,613	36,112	36,707
\$40.86	JP Morgan Chase	33,105	34,255	34,394
\$26.07	Cisco Systems	30,383	32,931	32,931
\$25.89	Intel Corporation	28,815	29,115	28,665
\$46.40	American Express Co.	25,912	27,562	24,997
\$32.87	Vimpel-Communications	25,370	25,260	22,875
\$37.48	Citigroup	25,097	27,297	26,303
\$26.13	Corning, Inc.	24,550	26,050	26,050
\$43.88	Manitowoc Co., Inc.	23,965	24,995	24,675
\$36.60	McDonalds Corp.	22,342	21,792	21,365
\$81.56	NYSE Euronext	17,920	18,150	18,210
\$45.50	Emerson Electric	17,835	17,110	16,905
\$8.08	First Niagara Financial	17,801	18,301	18,296
\$9.38	TrustCo	17,719	17,719	18,248
\$26.10	ABB, Ltd.	17,550	16,985	16,710
\$56.26	Johnson & Johnson	17,189	17,589	17,539
\$32.62	Gilead Sciences	15,710	15,710	15,710
\$48.12	DuPont	15,607	14,017	11,407
\$94.05	Schlumberger, Ltd.	15,246	15,546	15,546
\$26.79	Microsoft Corp.	14,500	14,899	14,729
\$67.31	Oceaneering International	14,345	14,345	14,120
\$35.10	Bank of America	14,271	23,814	37,722
\$27.10	Vodafone, PLC	6,024	15,770	15,720
\$37.28	ICICI Bank	1,275	15,300	15,095

## SECTOR WEIGHTINGS MATTER IN A DIVERSIFIED PORTFOLIO

A week or so ago a potential client came in the front door, sat down, and began lamenting over the fact that she thought she had done everything right. She had developed a portfolio of investments by first looking at her objectives, tolerance to risk, family situation, health, employer-sponsored plans, other sources of income, and debt. After doing so, she then constructed a well-diversified portfolio of different stocks and mutual funds across a broad number of industries. Even with all of this due diligence, her portfolio was not performing well. She wanted to understand why.

Of the ten industries that comprise the Dow Jones U.S. Total Market Industry Groups, only two, Basic Materials and Oil & Gas, are in positive territory, having risen 13.71% and 7.74%, respectively. Some of the sectors that make-up the Basic Materials Industry group include Coal, Steel, Chemical, Fertilizer, and Aluminum companies. Contained within the Oil & Gas Group are the Exploration & Production, Integrated, Equipment, Service and Pipeline companies. These are the very companies that have been supplying the rest of the world with the commodities it needs to fuel the Oil & Gas and Agriculture bull markets. After reading this list, it becomes apparent why these groups have been leading the market.

In fact, year-to-date, other than the Basic Materials and Oil & Gas, the next best performing group is Consumer Service Companies, down 3.77%. Not surprising, the worst performing industry group is Financials, followed by Health Care and Telecommunications companies, down 17.81%, 10.43% and 10.24%, respectively.

When we stretch this scenario back even further, the trailing year, with the Dow Jones Industrial Average down 5.13%, we see more of the same. Once again, leading the market higher are the Basic Material and Oil & Gas Groups, up 21.53% and 21.14%, respectively. Furthermore, once again lagging the market are the Financials, Consumer Services, Telecom and Health Care stocks, having fallen 35.50%, 16.99%, 16.55% and by 11.90%.

It was now that this individual began to recognize that her “diversified” portfolio was actually leading to underperformance because, unless a vast majority of her stock holdings were in either Basic Materials or Oil & Gas, she was losing money. To avoid this conundrum, we recommend a cautious and selective overweighting in sectors of the stock market that are showing strength. Keep in mind however that applying this strategy to Basic Materials and Oil & Gas during 2008 would not have prevented a loss. To avoid this trap, integrate strict sell disciplines that will cushion a portfolio against sudden declines in a specific sectors such as the collapse of the technology sector during 2000-2002.

The bottom line is that investors should maintain proper diversification while at the same time slightly overweighting the areas of the market that are showing signs of strength. By maintaining strict sell disciplines, this overweighting may lead to greater returns or at least a reduction of losses during periods of market volatility. However, keep in mind that your beta, or level of risk, will be increased relative to the overall stock market.

Fagan Associates, Inc., Sector Weighting, Master Portfolio Group, Combined Account Statement  
June 30, 2008

Common Stock	Total Cost	Market Value	Percent of Assets	S&P 1500 Composition	Weighting Relative to S&P 1500
Energy	\$ 6,858,552	\$ 9,343,590	18.85%	15.61%	120.74%
Basic Materials	\$ 3,086,772	\$ 3,526,406	7.11%	4.15%	171.40%
Industrials	\$ 7,644,425	\$ 7,507,260	15.14%	11.80%	128.33%
Consumer Discretionary	\$ 1,685,474	\$ 2,031,247	4.10%	8.54%	47.98%
Consumer Staples	\$ 1,136,953	\$ 1,658,109	3.34%	9.88%	33.85%
Health Care	\$ 2,600,619	\$ 3,728,721	7.52%	11.80%	63.74%
Financials	\$ 8,772,293	\$ 7,456,345	15.04%	14.36%	104.74%
Technology	\$ 9,605,891	\$ 9,916,783	20.00%	16.28%	122.87%
Telecommunications	\$ 2,247,426	\$ 1,983,564	4.00%	2.93%	136.56%
Utilities	\$ 750,031	\$ 815,732	1.65%	4.39%	37.48%
Index Investments	\$ 1,710,472	\$ 1,607,370	3.24%		
Common Stock	\$ 46,098,908	\$ 49,575,129	100.00%		

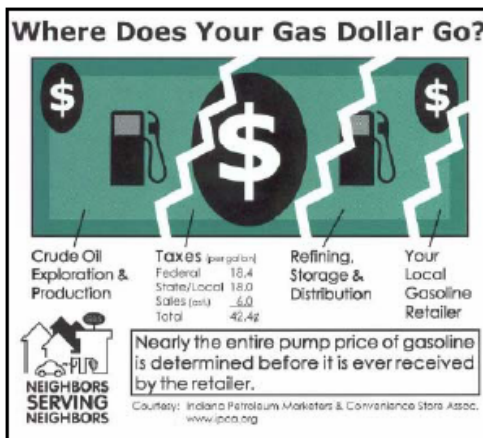
**\$4.29**

Even as recent as one year ago, who would have thought that drivers would be paying \$4.29 for a gallon of gas?

Americans are irritated and at the mercy of the ever increasing price of gas. We drive everywhere and almost never take mass transit. Furthermore, seventy percent of us drive to work alone. Americans may not have always been aware of the cost of a gallon of milk but almost ALL of us know exactly what we paying to fill our cars these days.

We are constantly being asked, "how high can gas/oil go" and "how can we profit from these high energy costs?" To the former we respond, over time much higher and to the latter, we offer an Exchange Traded Fund (ETF) that invests in the oil patch, the S&P Energy Select Sector SPDR (symbol XLE) which offers a diversified strategy in which to benefit from higher stock prices in the energy sector. As of midday July 7<sup>th</sup>, XLE was trading at \$83.72. It has a 52-week range of \$62.73 – \$91.42.

The beauty of an exchange traded fund is that it instantly provides diversification within the sector in which it invests. The energy ETF makes investments in the oil, natural gas, energy equipment and energy



services businesses. This allows investors to be diversified within the energy sector without assuming company specific risk. This diversification will most likely cushion the blow of a significant move lower in energy costs and energy companies.

As of the end of May, some of the largest holdings in the XLE included integrated multinational oil companies ExxonMobil and Chevron. These are the fund's two

largest holdings and the cornerstone of many energy portfolios. Oil industry service providers Schlumberger and Halliburton as well Apache Corp and Devon Energy are also in the funds top 10 holdings.

Unlike a mutual fund, one of the major advantages of Exchange Traded Funds is the ability to buy and sell during the trading day. This can be especially important in the volatile energy sector. While we are not market timers by nature, drops in oil prices can afford solid entry points in this ETF. Another advantage of an ETF over a mutual fund can be the management fee. The XLE has an annual management fee of just 0.23% and a turnover ratio of only 7.00%.

It is our belief that higher energy prices, as a rule, are here to stay. We are going to see pullbacks as economies wane but for the most part energy is going to be in ever increasing demand as world economies continue to expand, consume, and industrialize. We believe that XLE provides a diversified strategy in which to exploit the global expansion and demand for energy.

ENERGY SELECT SECTOR SPDR FUND  
as of 8-Jul-2008





**Top 10 States for Highest Gas Prices**

1. Hawaii
2. Alaska
3. California
4. Nevada
5. New York
6. Oregon
7. Montana
8. Washington
9. Connecticut
10. Idaho



**Fagan Associates, Inc.**  
Underwrites  
**Locally Produced WMHT Business Series**  
Monday evenings at 7:30 p.m.  
Rebroadcast Sunday at 1:30 p.m.

## AMERICANS HAVE BECOME A SOCIETY THAT MOVES

Moves on, moves up, moves out, moves constantly.

More of our children are living half-way across the country or in some cases, halfway across the world. Twenty years ago, Americans found a job in which they spent an entire career. After landing the initial job, they married, bought a home, raised kids, and retired from that same company. The pension offered was a Defined Benefit Plan from which the retiree received a lifetime of fixed monthly income. Once in the pension plan, many Americans eventually retired feeling happy and secure.

That was then, this is now.

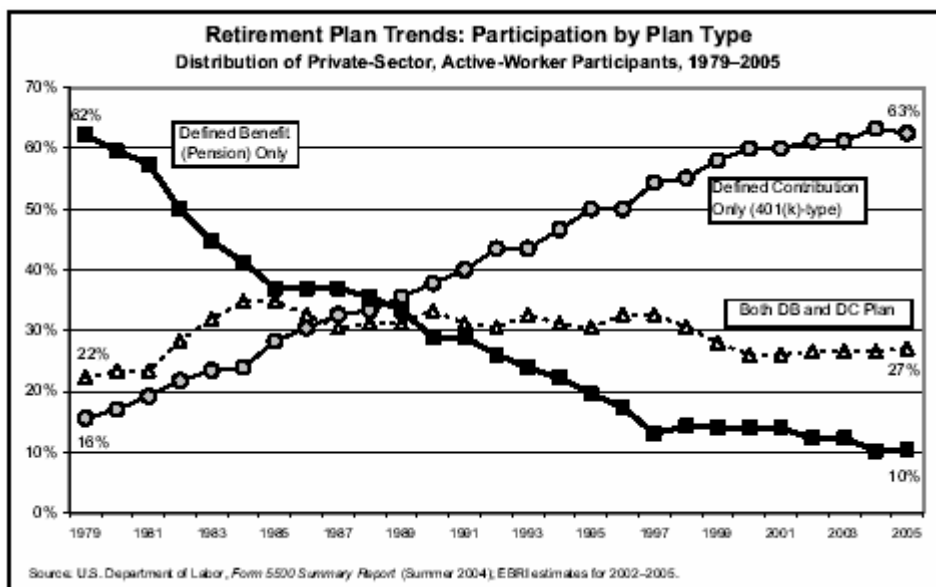
These days, fewer companies offer that same type of job security and upward job mobility. Furthermore, even if they did, would we want this security? On average, Americans now change jobs four times during the course of a business career. Guaranteed monthly income for life after retirement is quickly going the way of

the dinosaur. These so-called defined benefit plans are now being replaced by employer-sponsored defined contribution plans such as the 401(k) and 403(b). Unlike the plans of yesterday, 401(k)s and 403(b)s offer a multitude of investment choices and require contributions and thus attention from employees. Now, the standard of living in retirement is predicated upon choices made during working years. There is no free ride.

With the American worker on the move, an often neglected part of that turnover is the 401(k) and 403(b). Quite often, after changing jobs, an employee leaves these plans with the former employer. These plans sit without active management

and pose a risk to a retiree's security and lifestyle.

After changing jobs, an employee has the right to roll over an existing 401(k) or 403(b) into an IRA. We are convinced that it makes financial sense to consider taking this action due to the unlimited investment options (no-load funds, stocks, bonds even CD's) offered by an IRA, especially when compared to an employer-sponsored plan. It also makes sense to consolidate old 401(k)s or 403(b)s so that you can more easily track the results and growth of your retirement dollars. Getting four separate 401(k) statements can be flattering but it is both too time consuming and confusing for most investors to manage effectively.



Our advice is quite simple, take a minute or two to look the plan statements from former employers and make a concerted effort to consolidate into an IRA. This will prove to be time well spent and could make the difference in how you spend your retirement.

Fagan Associates, Inc. offers a wide variety of assets to meet all or your investment needs. We are an independent, fee only firm. We don't sell you a product to generate a commission. Dennis and Chris structure your portfolio to help you achieve your financial goals, without using any proprietary products.

When you call Fagan Associates, Inc., you will speak with your investment manager, not a salesperson.

If you have questions about ETFs or any other investment asset or strategy, please give Dennis or Chris a call at

518-279-1044 or 800-273-6026

Stocks, Mutual Funds, ETFs, Bonds and Fixed Income

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