

Fagan Financial Report

Registered Investment Advisors

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FOURTH QUARTER 2010

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TO OUR CLIENTS

The third quarter turned out to be somewhat of a mirror image of the prior quarter with the broader stock market averages rising above historical trends, nearly offsetting the more than double digit losses stock investors experienced during the second quarter. Indeed as this newsletter goes to print, the S&P 500 has moved into positive territory year-to-date, albeit by low single digits. This positive action came despite the fact that most economists expect below-trend economic growth in the United States. Fixed income investors during the third quarter also witnessed solid returns that, if annualized, would approach double-digits as bond yields fell, and as they work in an inverse manner, caused bond prices to rise, thereby adding capital appreciation to interest payments.

The first two months of the quarter were somewhat of a tug-of-war between those that felt that the recent slowdown in economic growth was the start of another recession, a double-dip, and those that felt that the slowdown was an historically normal event after the rapid growth resulting from a restocking of inventories as we exited the recession. We noted within the Cover Letter of our last newsletter that “the economic and corporate data released during the third quarter should continue to point to an economy that remains in a pattern of slow growth. Notice we said ‘slow growth.’ Unlike some others, we do not expect to dip back into recession.” The month of September has proven us accurate as the economic and corporate data of the past

few weeks has pointed to sluggish economic growth and not another recessionary environment.

Some of the more notable events that occurred during the third quarter did so within the past month that in one form or another helped push the stock market higher. The first occurred towards the end of Summer as stocks were finishing one of their worst Augusts in quite some time. According to the American Association of Individual Investors, the number of individual investors that were bullish fell to their lowest level since March 2009 which was recorded right around the time the S&P 500 was making its 12-year low. Our thoughts were echoed by John Melloy (Executive Producer, Fast Money) who noted that “so, effectively, individual investors feel as good about stocks as they did at the very depths of the credit crisis, even though the S&P500 is still more than 50 percent higher than that low.”

Another tailwind helping stocks was contained within the Press Release from the Open Market Committee of the Federal Reserve (FOMC). The FOMC observed that “measures of underlying inflation are currently at levels somewhat below those that the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability.” Translating this into layman’s terms, “the Fed will do all it takes to promote economic growth and combat the potential for deflation. Inflation is not a concern at this time.”

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A third aid to stocks came in the form of three dividend hikes by Microsoft, Lockheed Martin and McDonalds in rapid succession to current yields of 2.70%, 4.30% and 3.30%, signs that companies remain confident of the prospects for continued growth in their businesses, thereby easing investor concerns over the direction of the economy.

The final arrow into the bear (at least for the third quarter) came as a result of comments from famed hedge fund manager, David Tepper, Founder and President of Appaloosa Management who stated that "either the economy is going to get better by itself in the next three months and what assets are going to do well? You can guess the assets. Stocks are going to

do well. Bonds won't do so well. Gold won't do as well. Or the economy is not going to pick up in the next three months and the Fed is going to come in with QE (Quantitative Easing). Then what's going to do well? Everything, in the near term, everything."

As described and included as an addition to our Q2 2010 Fagan Financial Report, this Midterm Election Year is playing out eerily similar to prior cycles as the stock market has been choppy for the vast majority of the first three quarters prior to beginning an uptrend, one that at this time we believe perhaps after a brief pullback, will last at least into the first quarter of 2011.

THE WEATHER CHANNEL AND CNBC

Let's face it, the Weather Channel and CNBC are little more than glorified reality television. In fact, they are also very similar to each other. Both know that unless they can create a panic, an emergency, or a sense of urgency, not enough people to satisfy their advertisers care about either issue. Take The Weather Channel, regardless of the size of the storm or even if there exists a threat, they have to make the most of what they have available to them in order to get us to watch, scaring the wits out of everybody in the process. What storm, who really needs a storm? During the Summer months we get bombarded with shows and weeks about sharks, hurricanes and tornadoes while during the Winter we get pounded about the potential for NorEasters or recaps of The Blizzard of the year 18-whatever.

Meanwhile, over at CNBC, they also know that business is boring and that, absent any real news and due to the fact that they are a twenty-four hour a day, seven day a week business station, they realize that they need to create some news when business is slow. Hmm, let's see, do we really need to watch CNBC and have our lives interrupted daily by every data point? Is that helpful in helping us reach our financial objectives? Absent any meaningful news, CNBC will still try to scare us to death, get us angry, make us react, make us watch. After all, why air American Greed or The Bernie Madoff Story? Do you really need to interview the self-described "Dr. Doom," Nouriel Roubini, after the stock market has declined for a few consecutive days? This is not unlike The Weather Channel that perches Jim Cantore or Stefanie Abrams atop some sand dune in their gortex suits describing the fact that it is rainy and windy. Oh, by the way, thank God the hurricane/tropical depression/sun shower "just" missed us.

Let's face it, how often do you watch The Weather Channel unless there is a storm coming? How often do you watch CNBC unless there is big news? The answer is not often enough to make advertisers happy. The solution for The Weather Channel is to make every storm a Hurricane Katrina and for CNBC to make every business event another Bear Stearns Collapse. Is this must see TV? I think not. Does it make investors react, more often than not adversely affecting this financial situation? I think so. As far as I'm concerned, I'll just grab my umbrella when I leave the house to be prepared and with regard to my investments, focus on the long-term where the true value lies.

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AMERICANS REPAIRING THEIR BALANCE SHEETS

According to a recent Economic Letter from the Federal Reserve Bank of San Francisco, “U.S. household leverage, as measured by the ratio of debt to personable disposable income, increased modestly from 55% in 1960 to 65% by the mid-1980s. Then, over the next two decades, leverage proceeded to more than double, reaching an all-time high of 133% in 2007. That dramatic rise in debt was accompanied by a steady decline in the personal savings rate. The combination of higher debt and lower saving enabled personal consumption expenditures to grow faster than disposable income, providing a significant boost to U.S. economic growth over the period.”

Furthermore, according to Haver Analytics, “annualized, credit growth averaged 8% during the fifteen years ended 2007. Over an even longer time period that increase does not loom particularly large. However, against an average 5% growth in disposable income during those years, it precipitated a rise in the ratio to disposable income to 24% from a longer term norm of 17%.”

Taking into consideration both of these statistics noted above, the meat of the issue and the main cause of our current economic predicament is illustrated by the next statement contained within the aforementioned Economic Letter. “In the long-run, however, consumption cannot grow faster than income because there is an upper limit to how much debt households can service, based on their incomes.”

This past month the Federal Reserve also released data that showed revolving (credit card) debt has fallen 9.0% over the past year while non-revolving (automobile and consumer durables) has risen only fractionally. This combination has helped push the U.S. Savings Rate above five percent, a multi-decade high. We consider this contraction of consumer debt, either voluntarily due to a lack of demand or involuntarily as a result of a lack of availability, to be a permanent change in the spending patterns of American consumers that will negatively impact the strength of the current economic recovery. We believe the recovery, unlike past economic rebounds, will not be led by the housing or the automobile industry, purchases that results in debt accumulation. Unfortunately, thus far it has been led by government spending that will, hopefully, eventually give way to the private sector. Specifically, we find attractive for investment those sectors that export their goods and services to the emerging economies of the world; those industries that provide materials and services for the infrastructure build-out both here and abroad; and finally, those industries that provide goods that consumers can purchase without breaking the bank as well as mid-range dining.

From its peak in 1989, Japanese Automakers are selling approximately fifty percent of that amount, locally. Automobile sales in the United States peaked at around seventeen million during 2007. We do not believe that U.S. automakers will suffer the same fate as those of their Japanese counterparts. However, we do not think it likely that we will see sales in the U.S. move back toward their old highs anytime soon. In addition to the sectors noted above, investors would be wise to look at companies such as Nike, McDonalds Corp, Pepsi and Apple as well as other companies that have a strong presence in the United States as well as growing sales abroad.

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Stocks, Mutual Funds, ETFs, Bonds and Fixed Income*

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FINANCIAL REFORM BILL SIGNED INTO LAW

This past quarter President Barack Obama signed into law sweeping changes meant to provide the framework believed required to regulate the financial services industry and prevent the potential for a systemic collapse of the economy, a collapse that we came precariously close to during the Autumn of 2008. In addition to the regulatory authority, several bodies have been created that will oversee the application of the law.

Recalling the causes for the near collapse, during the early 2000's, after the repeal of the Glass-Steagall Act, a bill signed into law during the Great Depression and meant to provide regulation and oversight to the financial industry, banks and other financial organizations began to securitize mortgages in an effort to collect fees, maximize profits and make home loans available to more Americans. Unfortunately, this process of securitization led to lax underwriting procedures for mortgages by regulated entities such as FannieMae, and FreddieMac and banks as well as unregulated entities including Bear Stearns, Lehman Brothers and AIG. A bubble and subsequent collapse occurred in the housing market. The rest is history.

Enter financial reform.

For consumers, the federal government has established the Consumer Financial Protection Bureau within the Federal Reserve that will oversee banks and credit unions with more than \$10 billion in assets as well as all mortgage related businesses. Furthermore, the law also permanently lifts Federal Deposit Insurance (FDIC) to \$250,000 and establishes minimum underwriting standards for mortgages. Regarding mortgages, the law now requires verification of income, job status and credit history.

The law also attempts to address the issue of "too big to fail," one which led the U.S. Treasury to bail-out AIG and Citigroup, but let Bear Stearns and Lehman Brothers go by providing authority to the Treasury, FDIC and the Federal Reserve to seize, regulate and perhaps even liquidate struggling companies, regardless of whether or not they can be defined as a

bank in the strictest terms or not, if their collapse would pose a systemic risk to the U.S. Economy. In order to provide adequate oversight, the government would assess charges on firms with more than \$50 billion in assets.

The assumption of excess risk, a contributor to the meltdown, is also intended to be regulated by the law through a limit on proprietary trading by financial firms. In addition, the law also raises capital requirements.

The securitization of mortgages noted above as well as the usage of derivatives, intended to maximize profits from the potential increase in market value of the underlying real estate also contributed to the deep recession when real estate prices tumbled.

Furthermore, given the fact that much of this risk was taken by unregulated firms, the Government was slow to respond. The Financial Reform Bill, officially known as the Wall Street and Consumer Protection Act, begins to regulate the over-the-counter derivatives market by requiring transactions to be completed over an exchange, thereby increasing transparency. Finally, the law also establishes a Financial Services Oversight Council, chaired by the Secretary of the U.S. Treasury, and charged with identifying potential issues or companies that pose systemic risk to the global economy.

No legislation is ever perfect. However, we believe that this is certainly a step in the right direction as it will hopefully provide early warning signs, thereby preventing a similar near-death economic collapse like the one we experienced during the latter stages of 2008 and early 2009 and from which we continue to recover.



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WHY NOT TO CONVERT TO A ROTH IRA

It is more often that you hear or read of reasons to convert from a Traditional IRA to a Roth IRA than you hear or read of reasons not to convert. Given the fact that this column pertains to the latter, we will only briefly note the reasons to convert. These include the potential for rising personal income tax rates, tax free withdrawals after five years from a Roth and no mandatory distributions. That said, there are several reasons why one should not convert from a Traditional to a Roth IRA.

First and foremost, a bird in the hand is worth two in the bush. When you convert from a Traditional to a Roth IRA, you must pay the tax on the conversion immediately. This has two negative consequences, the first being that you are paying those taxes from retirement savings thereby reducing those savings and secondly that the tax money is now in the pocket of the Internal Revenue Service rather than continuing to work for you.

One must also keep in mind that the dollar amount that is converted is added to your current income and taxed as ordinary income, which for most of us is at a federal rate of 28%. This added income may push you into a higher tax bracket or cause your Social Security Benefits to become taxable, if you are currently collecting.

Another reason not to convert is that for many of us, our tax bracket during retirement may be lower than our tax bracket while working. If you convert during your higher income earning years, you will most likely lose 28% to the IRS. However, there is a fair chance that in retirement you may be in a lower tax bracket, perhaps 15%. Therefore, why pay 28% now when you can pay 15% later?

Current law states that an individual may begin to withdraw from your Traditional IRA without penalty after you turn age 59½, but that you must begin to make withdrawals on or before April 15 following the year the individual turns 70½. For some of our clients, we are able to make calculated withdrawals between

these dates in such an amount that will keep the client in a low tax bracket. This is another reason not to convert while you are in a high income tax bracket.

We like to turn the tables on those that recommend conversion due to the fact that with Federal and State budget deficits at alarmingly high levels, higher personal income tax rates are a fait accompli. Although we do believe that marginal rates will rise, we do not consider it a done deal nor do we believe that they will rise substantially for the middle class.

With the tidal wave of baby boomers set to retire and thus set to begin to live on their savings, pensions and Social Security, we believe the Federal Government through the IRS will begin to explore different methods of taxation as a supplement to the personal income tax. These alternatives include a flat tax, a value added tax (VAT), consumption tax or a national sales tax. This may result in personal income tax rates remaining at or near where they are now with the added revenue coming one or more of these four sources noted immediately above.

Finally, although somewhat remote and given the wave of baby boomers nearing retirement, we would not be surprised should the government eventually tax distributions from Roth IRAs should the income or assets of the taxpayer exceed a certain level, a la Social Security. “Somewhat” remote, but not that unlikely. Think about it.

Think twice prior to converting from a Traditional to a Roth IRA. As noted above, a bird in the hand is worth two in the bush. Why pay taxes now when you can pay them later.

Abby Joseph Cohen (Goldman Sachs) describes the “paradox of prudence” as an environment in which “investors become too conservative at the wrong time in the market cycle.”

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WEIGH INVESTMENT RISKS VERSUS OPPORTUNITIES

Investors have a tendency to be unable to prioritize or “rank” issues or concerns that will have an impact on their portfolios. For example, given the fact that fear or self-preservation is a greater motivator than greed, investors tend to overweight the negative issues and underweight positive influences. A useful exercise that may help you avoid continuously being scared out of making the appropriate investment choices for your objectives is to assign each a percentage with the entire list adding up to one hundred percent. Then, periodically, update the list along with your rankings. Given the constant bombardment of bad news by the media, this will help you sort out what is news and what is only noise.

We have identified twenty-five different issues, fourteen negative and nine positive, that may have an impact on your portfolio. Please keep in mind that despite the fact that there are 14 negative issues and only 9 positive, this does not imply that we are bearish. Secondly, we have listed the issues in the order that we believe will impact your portfolio, from the most to the least.

“Given the fact that fear or self-preservation is a greater motivator than greed, investors tend to overweight the negative issues and underweight positive influences.”

First the negative influences. These would include the fact that in an effort to get the economy moving again, the Federal Government is spending too much, putting our credit rating at risk; the labor market remains weak and unemployment remains high most likely hampering consumer spending; higher taxes will cause all to reign-in spending; continued weakness in the economy could cause deflation; the private sector continues to retrench, shoring up their balance sheets and reducing their debt; the across-the-political-aisle fighting is resulting in the inability or the belief that the government is unable or unwilling to deal with the issues affecting America; the government is maintaining too big of a role in the economy when they need to get out of the way and let the private sector do its thing; the United States is turning into a welfare state, one in which ingenuity and creativity will wane; too much government spending and the accompanying deficit may result in a devaluation of the dollar and inflation; the “flash crash” of early May,

One which sent the Dow Jones Industrial Average down nearly 700 points in less than one-half hour has weakened investor confidence and caused the belief that the “playing field” is not level; energy prices have risen over the past few years placing U.S. dollars and therefore influence and power outside of our borders; gold is rising signaling destabilization; immigration is placing a strain on our system; the upcoming political season has heightened the rhetoric regarding class warfare; terrorism and finally that the bull market in bonds is over.

On the flip side, we have potential positive catalysts for investors. These include the easy monetary policy or the accommodative stance by the Federal Reserve in the forms of low interest rates and quantitative easing; interest rates will most likely remain low for an extended period of time making stocks more attractive; stocks have gone nowhere for a decade while corporate earnings have more than doubled resulting in an attractive valuation; housing affordability is at multi-decade highs; there exists strong global demand, especially in the emerging markets; excesses in the U.S. housing market are being reduced as time passes; consumer debt is being pared down and finally that there is a transition from defined benefit to defined contribution plans resulting in a continually flow of funds into the financial markets.

Keep in mind that very few investors consider the risk they are assuming when the stock market is rolling. Case in point would be calendar year 1999. Conversely, investors tend to not perceive opportunity amidst market turmoil, concentrating solely on the risk they are assuming. By periodically reviewing the risks you are assuming and weighing them against the potential rewards, investors are much more likely to make an objective, intelligent decision rather than a subjective, fear-driven, emotional one.

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*Largest Holdings Regardless of Asset Class
Ranked by Market Value as of September 30th, 2010.*

Percent of Total Assets Managed	Company Name	Symbol	As of Sept 30 th , 2010	As of Aug 31 st , 2010	As of July 31 st , 2010
11.56%	Cash & Equivalents		1	1	1
5.46%	Payden GNMA Fund	PYGNX	2	2	2
3.16%	Apple Computer	AAPL	3	3	3
2.30%	Loomis Sayles Bond Fund	LSBRX	4	4	4
2.15%	SPDR Dividend ETF	SDY	5	5	6
1.90%	Hewlett Packard	HPQ	6	7	5
1.80%	PIMCO Total Return	PTTDX	7	6	7
1.64%	McDonald's Corp.	MCD	8	8	10
1.56%	General Electric	GE	9	10	9
1.49%	JP Morgan Chase	JPM	10	9	8
1.42%	Conoco Phillips	COP	11	11	11
1.37%	Ridgeworth High Income	STHTX	12	13	14
1.33%	MasterCard, Inc.	MA	13	14	15
1.31%	Nike, Inc.	NKE	14	15	16
1.30%	iShares Lehman Bros TIPs	TIP	15	12	13
1.18%	Intel Corporation	INTC	16	17	12
1.18%	Schwab 1000 Fund	SNXFX	17	16	17
1.06%	MetWest Tot Ret Bond Fund	MWTRX	18	18	19
1.03%	Cisco Systems, Inc.	CSCO	19	20	18
1.01%	Baron Asset Fund	BARAX	20	22	20
0.98%	Exxon Mobil	XOM	21	21	22
0.97%	Pepsico, Inc.	PEP	22	19	21
0.96%	Johnson & Johnson	JNJ	23	23	23
0.84%	Emerson Electric	EMR	24	26	26
0.81%	Vanguard GNMA	VFIIX	25	24	24
0.81%	S&P 500 DR's	SPY	26	25	25

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- 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 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.

- * Periodic interviews with local men and woman making news that affects our lives.

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

Fagan Financial Report

THE NATIONAL FOOTBALL LEAGUE – AND YOUR INVESTMENTS

Every team in the National Football League either has “personality traits” or is looking to develop some. For example, the Green Bay Packers, Minnesota Vikings, Detroit Lions and Chicago Bears play in the “black and blue” division. Furthermore, the names of many of the teams also resemble different investment portfolios. Let us explain.

The New York J-E-T-S are high flyers. They like to talk loud and live fast. Rex Ryan, Mark Sanchez, Bart Scott, et. al. They are dangerous and alluring because they are good. However, are they as good as people say? After all, they have not proven anything yet. When we think of the New York Jets, we think of high-flying stocks like VMWare (cloud computing) or Netflix where expectations are large and investors are flocking to them like ants to a picnic. However, investors must be wary of these type stocks. Expectations are high as well as the potential for disappointment.

The Buffalo Bills. Now there is a team whose name resembles a lot of investors. Buffaloes, like investors travel in herds. Unfortunately, this herd mentality caused the near demise of the buffalo some one hundred years ago and can also do damage to your portfolio. Despite the nearly twenty-eight year bull market (pardon the pun), investors continue to pour money into government bonds, ignoring the risk of an adverse movement in interest rates, focusing only on the perceived, yet false sense of security. Conversely, should one wish to break out of the herd, consider stocks or bonds other than U.S. Treasury securities. With stocks, investors are ignoring the potential for return and focusing solely on risk much unlike 1999 when investors focused solely on return and ignored risk. Look what that brought them. Furthermore, some areas of the bond market still hold much appeal, namely mid-grade corporate, inflation protected securities, U.S. Government Agency and foreign bonds.



Now, our team, the New York Football Giants (just typing the name brings back beautiful memories of our victory over the New England Patriots). As it pertains to the stock market, think of giant, mega-cap stocks like JP Morgan Chase, Honeywell, McDonald’s, Apple Computer, Intel or Nike, companies that use size to their advantage to dominate their respective industries. Like the NY Giants, ignore these companies at your own peril. Think of the size, think of the dividends, think of the low valuations. Think of the opportunity.

Being Giant fans, last and not least consider the Dallas Cowboys, everybody’s Super Bowl pick during pre-season, a team who, despite their 1-2 record is “guaranteed” to make the playoffs. The Cowboys and the Minnesota Vikings are perennial playoff flops. Stocks like football teams can carry a lot of fanfare and positive plugs by analysts, but then underperform, unable to sustain momentum. A few companies who fit this bill (not Buffalo) would be Research in Motion, Motorola and Palm. The best cure for this is to maintain a disciplined approach to investing especially when it comes to selling.

If we have insulted the fans of any of the teams noted above, we apologize. That said, please don’t blame us. We suggest you perhaps place the blame on your Mom and Dad for not being fans of the New York Giants or the era in which you grew up (Miami Dolphins, Oakland Raiders, Dallas Cowboys). You fumbled the ball. Finally, this column is for your eyes only. Please don’t let it be intercepted.

