



Markets Mood Swings

U.S. MARKETS WITHSTOOD

AUGUST TUMULT and managed to halt a two-month losing streak. An uncommonly volatile August ended with the Nasdaq ahead nearly 2%, while the Dow gained 1.1% and the S&P 1.3%.

It's been a wild ride from mid-July highs for the S&P to a swift 12% drop by mid-August and then half-way back again. Since hitting an all-time high July 19th, the S&P 500 has been up or down at least 1% on the majority of trading days.

On steep down days, the news was full of concerns about the credit market swoon triggering a recession. Up days brought speculation that Fed interest rate cuts will contain the fallout, along with reports that robust global growth will continue to prop up the U.S. economy.

We suggest it's far more productive to ignore daily, weekly, and even monthly volatility, and instead focus on the longer term. Many investors choose to forget that "corrections" – defined as a loss of 10% or more, but less than the 20% bear market – are part and parcel of normal market action. The S&P 500 has experienced a 10% correction 87 times since 1928. That works out to slightly more than one a year for the past 79 years, according to Ned Davis Research.

Investors have been lulled into thinking that corrections are rare since there haven't been any in the last few years. Before this year's decline, the previous 10% correction for the S&P 500 occurred more than four years ago in March 2003.

As to what happens next, the pendulum seems to be swinging back to more emphasis on fundamental investing. Investors are going for solid profits, favoring larger companies with strong balance sheets and moving toward growth companies with strong earnings.

So far this year the growth portion of all major indices is far ahead of the value components. As a group, growth funds outperformed value again last month in all size categories. Technology funds again led last month and are one of the strongest domestic categories for the past 12 months, following only telecom and natural resources.

Surprisingly, the recently hardest hit sector, real estate, bounced in August. And beaten down financials, characterized by one analyst as "priced for disaster," led on several up market days.

Despite the fact that the recent upheaval was triggered by events in the U.S. markets (the sub-prime lending fiasco), domestic funds have actually held up better than their international counterparts.

Overseas markets generally lagged our own in August, with only China region funds bringing in stronger gains. China's benchmark Shanghai Index topped 5000 for the first time and holds an 88% gain so far this year, making it the world's best performing index. The iShrs Xinhua China 25 (FXI) gained a whopping 25% since August 16, more than making up for its 16% loss over the previous weeks.

Funds concentrated in Asia held up better than those focused in Europe, possibly because Asian corporations generally have limited debt and Asian nations sit on huge piles of currency reserves. U.S. bond market woes have far greater influence on European companies.

Diversified emerging markets funds weathered the storm relatively well, contrary to expectations based on previous global sell-offs. Emerging markets came of age in the 1990s and they also came to signify volatility and vulnerability for investors around the world. Their recent resilience points to positive fundamentals of their maturing economies and the strong global expansion underpinning the emerging markets uptrend.

International funds continue to dominate and represent the majority of our growth portfolios. Currently some funds remain highly ranked because their 12-month performance is higher than that of their

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peers. European stock funds have returned roughly twice as much as their American counterparts in the last three years. But we are seeing a resurgence of U.S. markets and as a result, many diversified domestic funds are again climbing our performance-based ranks.

In Upgrading, we stay fully invested because our returns are better when we continue to follow the system in a disciplined manner, rather than reacting emotionally to market swings. Investors who get frightened into making changes in the way they invest end up with subpar investment results by jumping in after a run-up and bailing after they've suffered losses.

We understand that it's particularly for new investors who may be starting off with losses – but the discipline to follow the system is necessary if you expect to participate in Upgrading's strong longterm performance.

It surprises some that our best long-standing performance comes from staying fully invested and Upgrading with the core of our portfolios in Class 3 funds – not from jumping in and out of the market. That's not to say that Class 3 funds never suffer losses. In our 35-year history, there were times we gained more than the market and times we lost more, but the ability to move independently is essential to the success of the system and leads to overall gains relative to the market.

Upgrading is a relative ranking strategy. The FundX Score has a built in lag because it includes the trailing 12-month returns. This lag is purposeful. We want to react to confirmed market trends, not blips in the market. It is tempting to try to capture short term moves, but remember that Upgrading's 35 year success stems from investing based on the FundX Score rather than gambling on potentially short-lived changes.



Again, I want to thank you for your business and the opportunity to be of service.

Thank you for your business...

P. Michael Valley II

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