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THE TEMPO VANTAGE

October 2010

September Surprise

The markets have a way of doing the opposite of what most participants expect. That has certainly been true in 2010 for both the stock and bond markets.

After a choppy and negative second quarter for the stock market (S&P 500 down -11%) and with the weak economic recovery (continued high unemployment), many feared a double dip recession and the return of a bear market reminiscent of 2008. Happily, this is not how it turned out – at least not yet. The third quarter turned out to be terrific with most equity benchmarks gaining in excess of 10%.

Even more surprising is that most of the third quarter gain occurred in September. Historically September has been one of the worst months for stock market performance. Since 1926 the median return for the S&P 500 in September was 0%, and the average return was actually negative (-0.7%). Going against history, the return this September was the second highest return (+9.0%) of all Septembers over this 85 year period. The only September that was better was back in 1939 (+16.7%)!

Last January the prevailing wisdom was that bonds would be the next asset-class bubble (the last two bubbles being technology in 2000 and real estate in 2008). With rates so low and the government pumping so much liquidity into the economy surely inflation was just around the corner. This in turn would send bond prices falling. Even I surmised as much in the 4Q 2009 Tempo Vantage. It turns out that "around the corner" is a little further off than we all thought. Continued weakness in global economies has required governments to maintain low rates and to continue to encourage liquidity with whatever tools they have. As a result bonds have been a good investment thus far in 2010, returning from 6% to 14% depending on quality and duration.

While the bear market and bond bubble expectations were certainly confounded in the short run, what are the chances they will be true in the intermediate/long term? When it comes to the stock market, as sure as the sun will rise tomorrow (unless of course it rains) there will be other declines and other bear markets. That notwithstanding, I have already gone on record as saying that for this market cycle the worst of the decline has already occurred. That is not to say that I believe the market will continue at the September pace. The likely scenario is a continued slow recovery and a market that waffles back and forth a bit over the next year or two.

For bonds, however, the future will bring higher rates. Unlike the stock market, where cycles seem to last 5-7 years, interest rates cycles last for decades. From a long-term perspective the last time rates bottomed was 1946. For the better part of the next 35 years rates rose, peaking at 19% in 1981. Since 1981 rates have been falling. Due to the weak economy and the flight to safety (for better or worse the U.S. looks like the best of the weak economies) interest rates have remained very low for a long time. Although a rise in rates does not appear imminent, that won't be the case forever. Exactly when rates will start rising, how high they will rise, and how long the cycle will last is anybody's guess.

Here is what you can do to take advantage of the low rates now and protect yourself from the likely rate increases in the future:

- If you have not already refinanced your house consider doing so.
- If you have already refinanced and have a low rate, don't pay it off early. This is the cheapest money you may get in a long time.
- If you have any variable rate loans (home, home equity line, credit card) either be sure you have the wherewithal to pay the loans off should rates start rising, or consider converting the loans to fixed rate (ie pay these loans off when you refinance your house).
- Don't buy long term government bonds (the most vulnerable to declines in a rising rate environment).

Tempo Financial Advisors' 3rd Quarter Investment Performance

As you may know by now I have expectations for how much up-side capture we can expect from the Tempo Dynamic Strategies. (Capture is the percent return generated compared to a market benchmark. For example, if a strategy gains 5% and the benchmark gains 10%, the up-side capture ratio is 50%) Our returns usually trail in the strong bull markets because we don't take as much risk as the overall market does. That is the price we pay in these strategies to minimize the potential for devastating losses.

I am pleased to report that contrary to historical norms, both the Tempo Dynamic Growth and Tempo Dynamic Income Strategies did a tremendous job in the third quarter of capturing the lion's share of the up-side.

The Tempo Dynamic Growth Strategy gained close to 7% in the quarter, making this one of our most successful quarters from a number of perspectives. First, the return was better than 90% of past quarterly returns (both real time and hypothetical). Second is the up-side capture ratio of nearly 64%. This is well above the 50% capture ratio we have experienced other times the S&P 500 gained over 9% in a single quarter.

As happy as I am with the performance of the Dynamic Growth Strategy, I am ecstatic about the return in the **Tempo Dynamic Income Strategy**. The third quarter 2010 return of 8.5% represents the highest quarterly return compared to nearly 14 years of actual and hypothetical performance. According to my calculations that is the 100th percentile. And, the up-side capture ratio is off the charts. The average up-side capture ratio for the Tempo Dynamic Income Strategy when the S&P 500 gained over 9% in a quarter was 28%. The up-side capture ratio in the third quarter was 77%.

I have to stop now, I'm getting a little farklempt. This is like the feeling I get when my daughter scores a goal in soccer or my son a basket in basketball!

With all this gushing over the Dynamic Strategies I don't want to give short shrift to the **Tempo Lifestyle Strategy.** We expect the Lifestyle Strategy to turn in a terrific quarter when the S&P 500 gains more than 10%, and it delivered. Returns for the third quarter ranged from 7% for more conservative clients to 12% for more aggressive clients.

During the quarter we did make one significant change to accounts, selling a position in convertible securities we had owned since April 2009 in favor of a position in healthcare. We reduced exposure to healthcare in 2008 when we reasoned that the specter of healthcare reform would dampen returns. Now that healthcare reform has passed the dynamics have changed. At the end of the day the new law will do much to increase the demand for healthcare services while doing nothing to address supply. Basic economics 101 tells me that companies have pricing power when demand increases and supply does not. That, in turn, leads to profits.

Company News

Hopefully you read the notice I sent recently announcing that Tempo has moved to a new location. Even more significant was my offer to buy lunch for anyone willing to come by to see the new space. Much to my delight a few of you have already taken me up on this offer. The offer still stands, so please call to schedule your lunch now.

Daniel J. Traub