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THE FSAG ADVISOR

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Contact us:

Scott J. Munkvold, CFP, CTFA
(773) 714-1541
sjm@fsadvisorygroup.com

Scot A. Jurczyk, CFA
(773) 714-1543
saj@fsadvisorygroup.com

Mark C. Soehn
(773) 714-1542
mcs@fsadvisorygroup.com

Brian H. Wilson
(773) 714-0012
bhw@fsadvisorygroup.com

Market Update

No matter what your income level, it is no fun pulling into the gas station anymore. Not that it was fun to begin with, but paying more than $50 to fill a 17 gallon gas tank is becoming painful. Speaking of pain, going to the doctor has not been a pleasure either. While the doctor itself may not be expensive, it is the insurance companies who are making policy holders pick up a larger percentage of the bill that is agonizing. Meanwhile, we see the price of steel, corn, movies, and bottled water going up.

Sure, the prices of many products and services are rising, yet many are declining, too. Talk to anyone lately who paid more to replace a comparable computer, television, or camera? Who would have ever thought you could buy a laptop computer for less than $500! What about a car? Auto prices have been flat for the past ten years. If it is timed correctly, most auto buyers can use a rebate or some type of dealer incentive to purchase a new car at the same price as their last new car. In fact, when replacing a similar model, new cars have even more "standard" options included in the price, which means the buyer is actually paying less. In addition, prices of clothes, meat, brokerage commissions and homes are falling.

Balance all these price movements and the overall result is slowly rising prices. This is no surprise, it is just inflation. Inflation is the grease on the wheels of our economy. With the unemployment rate at 4.6%, that means 95.4% of the people that want to work have a job. Most of those employed are working hard to get a raise. When workers receive increasing amounts of income, they normally buy more goods and services, demand increases and usually higher prices follow. Higher prices bring more revenue to firms allowing them to expand and hire more people. This continuous cycle is how our economy has worked for centuries.

The key, however, is keeping inflation under control. Recently, that has been the Federal Reserve's (the Fed) job. The Fed has been raising interest rates for two years now. Higher rates make it more expensive for borrowers to spend in order to buy more goods. Without the demand to buy more, sales slow, cooling the economy. The big debate going on in the stock and bond markets now is whether interest rates have risen enough to slow the economy or have they already been lifted too high, which will put us in a recession. For the most part, how high is not the issue, the fact is rates are higher, and those effects will work through the system and slow the economy. If the economy slows to the point where we fall into a recession, the Fed will just lower rates.

Doomsayers in the media say they "fear" inflation. But should the markets be afraid? No, not now. The Fed agrees inflation is a concern and is addressing the issue. Is there a trend to watch that may signal inflation may become worrisome? Yes, we need to make sure consumers do not stockpile goods. If shoppers feel that prices are rising so fast that they would rather, for example, purchase 20 bars of soap now, instead of the 5 they usually buy, so they do not have to obtain them at higher prices later, that will be troublesome. A hoarding mentality is a behavior that is hard to change once it starts. The economy can get into a real bind as demand for items surge, then shortages occur as consumers panic. While the late 1970s were not that long ago, we do not foresee this occurring in the near future.

2006 YTD Returns

Index	Return
DOW	*5.21%*
S&P 500	*2.71%*
NASDAQ	*-1.51%*
Russell 2000	*8.21%*
Mid Cap 400	*4.24%*
MSCI EAFE	*8.50%*
Lehman US Agg.	*-0.73%*
Lehman Muni.	*0.28%*
10 Year Treasury Yield	*5.14%*

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Asset Selection and Allocation - Keys to Investment Success

"Studies have shown that the choice of asset classes and asset allocation are critical elements of portfolio performance."

No matter what your financial goals are, setting an appropriate investment policy and choosing your investments wisely can help increase your chances of success.

Asset allocation drives portfolio returns...
Investment returns are a key factor impacting a portfolio's future value, especially for long-term investment horizons, due to the power of compounding returns. For example, the difference in future values for a $300,000 portfolio, over a 20-year period, between a 6% rate of return and an 8% rate of return amounts to $436,147.

Studies have shown that the choice of asset classes (e.g., cash, bonds, stocks, real estate, international investments, hedge funds, private equity) and asset allocation (the mix of different types of investments) are critical elements of portfolio performance. (Another potentially important factor is the investment strategy implemented for selecting specific investments, depending on whether an active or indexed approach is used.) Thus, care needs to be taken in establishing which asset classes to hold, and in what proportions, as well as in choosing specific investments. However, keep in mind that asset allocation does not ensure a profit or guarantee against a loss.

... And helps manage risk
The importance of asset selection and allocation isn't limited to portfolio returns. Asset allocation may also help manage portfolio risk. Not all asset classes move the same way at the same time. By investing in assets that are imperfectly correlated, you may reduce the volatility of your portfolio returns.

Correlation is a statistical measure of the relationship between different investments or asset classes. Investments in the same asset class (e.g., different bonds) tend to have a higher positive correlation than investments in different asset classes (e.g., stocks versus bonds). Similarly, all else being equal, investments in the same geographic region or industry tend to have higher positive correlation than those that are unrelated by geography or industry. By diversifying your portfolio with investments that aren't highly correlated, you may reduce the volatility of your portfolio returns, as losses or low performance during a given time period in one asset class may be offset by higher performance in another.

Do you have the right asset allocation?
An efficient asset allocation strategy will lead to the creation of a diversified portfolio that minimizes risk for a given level of expected return or maximizes expected return for a given level of risk. A financial professional can help you organize and analyze the relevant data, select asset classes for investment, build an asset allocation plan appropriate for your personal situation, and implement a specific investment strategy. Over time your original asset allocation will change as markets fluctuate, so it should be re-examined periodically to see if it is still appropriate or whether it needs to be modified.

Investor Confusion Exists Over the Differences Between RIAs & Brokers

In the 2006 U.S. Investor Perception Study conducted by TD Ameritrade, most investors indicated they don't know the difference between Registered Investment Advisors (RIAs) and brokers. In fact:

- 54% of investors believed both stockbrokers and independent RIAs have a responsibility to act in their best interest.
- 74% of investors were not aware that only Independent RIAs have a fiduciary responsibility.
- 79% said they would rather work with an investment advisor if they knew advisors provided greater investor protection than stockbrokers.

In summary, RIAs are held to a higher standard than stockbrokers when it comes to putting investors' interests first and doing the right thing for their clients' investments.

Ask the Expert: What is Monte Carlo Analysis?

In the context of financial planning, Monte Carlo Analysis helps clients better understand the probability of being able to achieve their goals.

Monte Carlo Analysis expands the traditional financial planning model by adding uncertainty into the plan. This analysis takes into consideration the difficulty of accurately predicting annual return rate expectations. While return rate expectations over the long-term can be reasonably predicted, the actual pattern over the short term is difficult to predict and may often appear random. Monte Carlo Analysis evaluates a financial plan by randomizing the return rates within the normal expected range each year and performs this analysis multiple times to simulate a number of possible financial outcomes.

For example, an account with a projected average return rate of 8% is subject to variations due to future uncertainties of various investment markets. Monte Carlo Analysis allows us to randomly project an account's returns, assuming that in some years the account will return rates lower than the average, say 4%, and in other years the account will return a rate higher than the average, say 12%, for an overall average of 8%. Allowing for this variability in returns does have an impact on the overall plan and the probability for success.

Another element that may be taken into consideration is the uncertainty of your life expectancy. What if you die tomorrow or live to be 110? Monte Carlo Analysis can also add this parameter to the analysis by simulating a different possible life expectancy for each projection.

From a financial planning perspective, it is important for your plan to withstand the expected changes in the value of your investments and be able to meet your income needs throughout your lifetime. The greater the risk in your investments, the greater the cushion of assets you will need to withstand the ups and the downs of the market.

Monte Carlo Analysis is a critical part of the financial planning process. We have seen financial plans that illustrate a client meeting his/her goals when returns were assumed to be "average" each year. When Monte Carlo Analysis was added, and the returns varied each year, the overall probably of success was below 60% - far below what we would consider a "successful plan." Excluding Monte Carlo Analysis from a financial plan could cause clients to incorrectly believe they are on track to meeting their goals.

Scot Munkvold, CFP, CTFA is a Principal and Managing Director of FSAG.

"Monte Carlo Analysis expands the traditional financial planning model by adding uncertainty into the plan."

Investing in Real Estate

Real estate investing includes either direct or indirect investments in buildings and/or land.

Real estate investing has numerous benefits including, diversification, potential for significant gains, income and it can allow you to take advantage of certain tax credits. Over the last few years, it was not uncommon to hear comments like "Invest in real estate, it never goes down." As with any investment, we caution our clients that real estate, like every investment, has risks too. These include some of the following:

- Lack of liquidity
- High initial costs
- Market risks
- Environmental risks e.g. soil contamination, earthquakes, flooding, hurricanes, etc….
- Local rent control laws
- Pests and insects
- Eminent domain
- Code violations
- Neighborhood changes
- Security issues
- Tenant-related losses

To determine whether investing in real estate is right for you, decide whether you have (1) the financial resources to invest in real estate, (2) the temperament to accept the associated risks, and (3) the knowledge and experience to make sound real estate investments on your own. If not, consult additional resources and seek the advice of a trusted advisor.

Annualized Returns
12/31/85 - 12/31/05

S&P 500	
Gross Return	*11.9%*
Real Return	*8.9%*
Residential Real Estate	
Gross Return	*5.5%*
Real Return	*2.5%*
Inflation	*3%*

Source: Standard & Poor's, Bureau of Economic Analysis

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Please contact us if you would like to receive this publication by e-mail.

8700 W. Bryn Mawr Ave.
Suite 710-N
Chicago, Illinois 60631
(773) 714-1540 *Main*
(773) 714-1550 *Facsimile*
fs@fsadvisorygroup.com
www.fsadvisorygroup.com

Stocks in the News: Morgan Stanley (MS)

The Glass Steagall Act of 1933 forced banks in the U.S. to become either an investment bank or a commercial bank. This law was created after the depression by the Roosevelt administration as a way to put confidence back in the banking system. J.P. Morgan was the largest and most powerful bank at that time. Since the firm elected to become a commercial bank, Henry S. Morgan and Harold Stanley left J.P. Morgan to form the investment bank Morgan Stanley in 1935.

Since then, Morgan Stanley has become known as one of the premier investment banks in the world. Almost 60% of the firm's revenue is derived from the institutional securities business. Its global reputation comes from Morgan's forward thinking. They like placing offices in the major city of a country that is embracing the idea of tapping markets to raise capital. When laws change or, a country creates a formal exchange, Morgan Stanley is there to help.

As our domestic markets continue to change, Morgan Stanley adapts. Bringing new companies to market in an Initial Public Offering has been a staple for the investment banking business. As the 1980s progressed, Morgan was there (and still is) to earn a fee helping companies get together during "merger mania." Today, Morgan generates revenue when those same companies decide to break themselves apart in the form of a spin-off.

In 1997, Morgan Stanley had a merger of its own, buying Dean Witter Discover. The Dean Witter brokerage firm merged into the existing Morgan Stanley infrastructure and the Discover Card was kept as a separate business. Years later, with the Dean Witter CEO running the company, it was apparent that the Dean Witter side of the business was holding more sway than the Morgan Stanley group. Disgruntled Morgan Stanley employees left, weakening the company. After much dispute among Board members, they brought back the old Morgan Stanley CEO, John Mack, to run the company. Since that time, the company has slowly regained its old stature on the street.

The brokerage side of the business earned $1.4 billion last quarter, or about 16% of the total revenue. Catering mostly to high-net-worth individuals, revenue has been stable. Its other two divisions, asset management, which runs their mutual funds, and the Discover card have been experiencing stagnant revenues. John Mack is spending much effort to get these divisions growing again.

Key Statistics: MS	
Price	*$61.00*
EPS	*$4.81*
Estimated EPS	*$6.00*
P/E Ratio	*10.5x*
PEG Ratio	*0.80x*
Dividend	*$1.08*
Market Cap	*$65B*
52 Week High	*$65.60*
52 Week Low	*$51.50*
Beta	*1.40*
Expected Annual Growth Rate	*13.0%*
ROE	*24.0%*

Financially, Morgan Stanley is in solid shape. Standard & Poor's rate their debt A+, giving it the best ranking among its peers. The dividend has grown 6% annually the last 5 years and a $3 billion share buy back is in place. A price earnings ratio (P/E) on last years earning of 10.5 is cheap to the market P/E of 17 and its historical average of 15. John Mack's presence at the helm should continue to help bring this company around.

Umbrella Insurance

A personal umbrella liability policy is a broad form of liability coverage that protects you against large losses, or losses not covered by basic personal liability insurance. Issued with higher liability limits than basic liability coverage (a $1 million limit is common), an umbrella policy can be purchased as a stand-alone policy or can be added using a rider to an existing homeowners or automobile insurance policy. If the insured is found legally responsible for injuring someone or for damaging property, then the umbrella policy will pay either that part of the claim in excess of the liability limits of the insured's basic liability coverage or for certain losses not covered by basic personal liability insurance, up to the limits of the umbrella liability policy. If any of the following apply to your situation, you may want to consider an umbrella policy.

- Own multiple, high value homes
- Plan to remodel or expand an existing home
- Own aircraft, large boats horses or highly valued collectibles
- Have domestic help
- Have a high visibility career/lifestyle
- Serve on boards of other organizations

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