November 16, 2013

the X-factor Report

by Lance Roberts

Market Strategies, Economic Analysis, Risk Management

Yellen Commits – Stocks Surge

To start this week's missive I want to share with you an excerpt from Randall Forsythe's "Up and Down Wallstreet" column this weekend:

*"**IN A NEW STUDY**, McKinsey & Co. concluded the Fed had no role in boosting stock prices and hence there is no bubble. Truth to tell, the consultancy had slipped from my consciousness since it extolled Enron as "one of the world's most innovative companies," instead of a criminal enterprise. Of course, since then, former McKinsey managing director Rajat Gupta was convicted of insider trading. McKinsey advised AT&T there wasn't much future in mobile phones (which Bell Labs invented); advised General Electric, which lost $1 billion by following its advice; recommended that U.K. rail company Railtrack cut infrastructure spending, leading to fatal accidents and Railtrack's collapse, among other great calls.*

In particular, McKinsey asserts there has not been a large-scale shift to equities in search of higher returns. To be fair, the consultancy's paper preceded the report from colleague Brendan Conway on Barrons.com that inflows into equity mutual funds and exchange-traded funds are on track to top $450 billion in 2013 -- more than the previous four years combined. Anybody can overlook nearly a half-trillion bucks in concluding there's been no big shift to stocks.

*McKinsey based its conclusions on the observation that price/earnings ratios and price-to-book ratios aren't out of line. Yellen pointed out the equity-risk premium -- the expected extra return from stocks over risk-free government bonds -- adequately compensates investors. On the latter score, the equity-risk premium is flattered by the low level of Treasury yields -- QE's explicit goal. **As for P/Es being moderate, that's helped by the numerator being boosted by the reduction of interest expense -- some $319 billion since 2007,** according to ever-invaluable analysis from MacroMavens' Stephanie Pomboy.*

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Inside This Issue:

Not coincidentally, the Wall Street Journal reports ***investment-grade corporate-bond issuance is running at a $1 trillion annual rate as companies take advantage of historically low rates,*** *with which the Fed has had something to do. Moreover,* ***the release of banks' loan-loss reserves has added $112 billion to financial companies' profits*** *in the past two years, Pomboy says, which just might have something to do with higher house prices.*

At the same time, an analysis by a famous hedge fund (whose name I can't reveal or they'd kill me or I'd have to kill you) ***finds profits at nonfinancial companies have been flat since 2011.*** *Thus, the rise in their stock prices implies higher P/Es -- consistent with the effects of monetary stimulation.*

The assertion the Fed has had nothing to do with the stock-market rise is all the more curious, given that was the central bank's explicit goal. Bernanke wrote in the Washington Post in November 2010, on the occasion of the ***second round of QE, that 'higher equity prices will boost consumer wealth and help increase confidence, which can spur spending.'*** *On that score, Pomboy points to the divergence between stocks and spending, with the latter lagging the averages.*

The stock market is benefitting from excellent PR, better than the fundamentals."

That excellent analysis of the fundamentals in one thing, however, all Mackenzie had to do was simply look at the highly correlated relationship between the size of the Fed's balance sheet and the stock market.

What is probably most disturbing though is that Janet Yellen does NOT BELIEVE, despite mounting evidence to the contrary, that investment risk is rising:

- *Yellen Says Fed Doesn't See Buildup Of Financial Risks*
- *Yellen Sees Limited Evidence Of 'Reach For Yield'*
- *Yellen Says Fed Looks Out For Any Potential Asset Price Bubbles*
- *Yellen Doesn't See `Misalignments' In Asset Prices*

the X factor Report by Lance Roberts

JOIN THE CONVERSATION

FEEDBACK

CLICK TO SEND COMMENTS

Even with this detachment from reality, and fundamentals, the markets advanced higher this week as Janet Yellen promised MORE, and potentially MUCH MORE, accommodative policy in the future.

"Today's exuberance in stocks matched only by confirmation that Janet Yellen has gained her helicopter pilot's license and is ready to take over the reins of printer-in-chief from Bernanke.

Yellen Says Economy, Jobs `Performing Far Short' Of Potential
Yellen: Supporting Recovery Is Path Toward More Normal Policy

Key extracts, including Credit Suisse's take:

Support demand /lower for longer *-'supporting the recovery today is the surest path to returning to a more normal approach to monetary policy'*

No hurry to taper *- 'A strong recovery will ultimately enable the Fed to reduce ... reliance on unconventional policy tools such as asset purchases'*

More transparency (think consensus FOMC projections) *- 'have strongly supported this commitment to openness and transparency, and will continue to do so'*

Sup and Reg for bubbles not tighter policy - '*I am committed to using the Fed's supervisory and regulatory role to reduce the threat of another financial crisis'*

And of course, status quo continues - '*I believe the Federal Reserve has made significant progress toward its goals but has more work to do.'"*

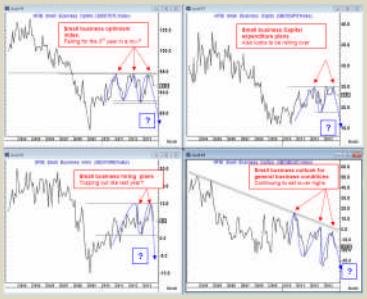
(By the way, Janet Yellen's confirmation hearing was a "love fest" by the Senate. The only thing they didn't do was bring her flowers.)

With the threat of a "taper" in monetary interventions removed the market pushed higher by 1.56% for the week. This move higher has now pushed the S&P 500 past 2-standard deviations above the long term average. As you can see, such extensions generally lead to some sort of corrective action in the near future.

RECOMMENDED READING

6 Things To Ponder: Market Bubble Edition

Is there a bubble in the financial markets? A variety of views to spark your thinking.

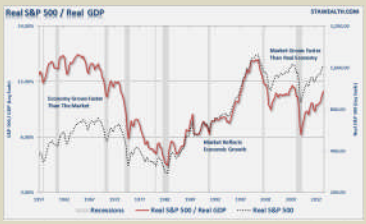


Yellen Promises More

Yellen promises more QE to boost economy. However, economic data says it doesn't work.

Too Much Bubble Talk

There is simply too much talk of a bubble for there to actually be a bubble.



This idea is confirmed by the analysis below.

The bottom part of the chart is a long term Moving Average Convergence Divergence indicator (MACD). Over time, as prices increase, the indicator moves higher as prices diverge from their underlying long term moving average. The vertical blue lines denote when prices have reached a historical maximum divergence from the underlying average.

While corrections are not an immediate consequence from such divergences – corrections occur nonetheless.

Year End Target Of 1800 Arrives Early

Back in August I wrote that the S&P 500 could likely rally to 1800 by year end. I specifically stated:

"The dotted red line shows the potential for a speculative push higher that ***would likely see the markets approaching 1800.*** *However, at this level, valuation, interest rate relationships and earnings arguments are going to become much more difficult to justify."*

The series of charts on the next page show some divergences between some key fundamental and economic metrics. These divergences suggest that foundation is laid for a major market reversion, however, what is currently lacking is the *"match"* to light the fire.

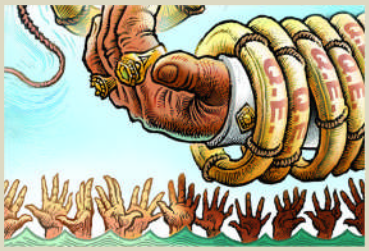
The first chart below is QE relative to the economy.

As you can see, QE 1 had the most impact on spurring growth following a complete economic blow out post the financial crisis. Importantly, fully three-quarters of the economic recovery in 2009 and 2010 can be directly attributed to inventory restocking rather than broad increases in organic growth.

RECOMMENDED READING

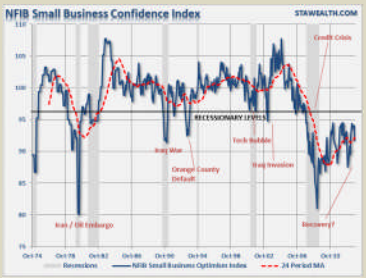
Confessions Of A QE Easer

A Must Read WSJ Op-Ed of a former Federal Reserve member who ran the mortgage bond buying desk.



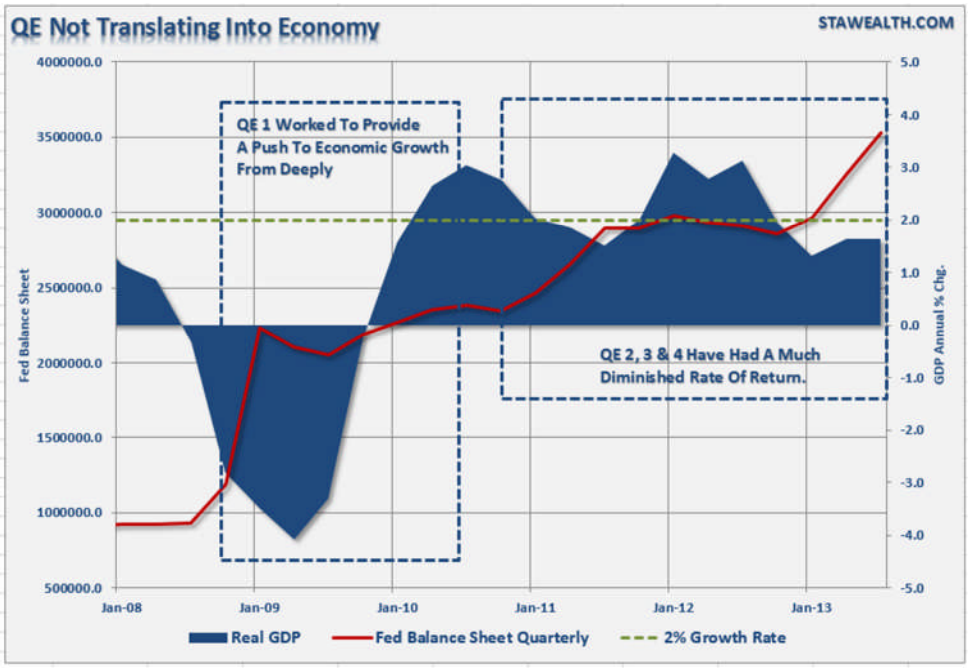
NFIB: Optimism Fades

Slowing economic data and government turmoil impacting small business optimism.

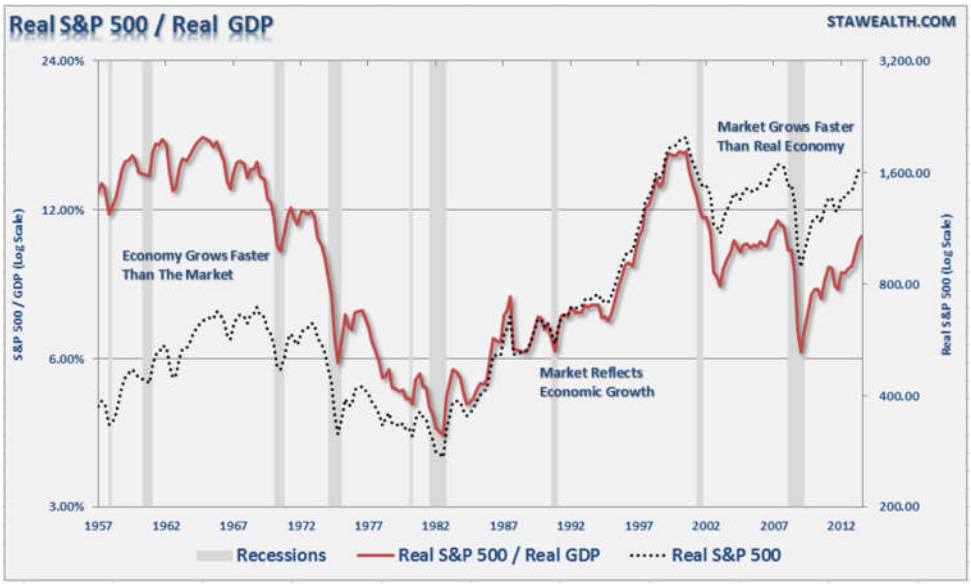


The Market In Pictures

After taking a look at the economy in pictures, it was that markets turn. Judge for yourself.



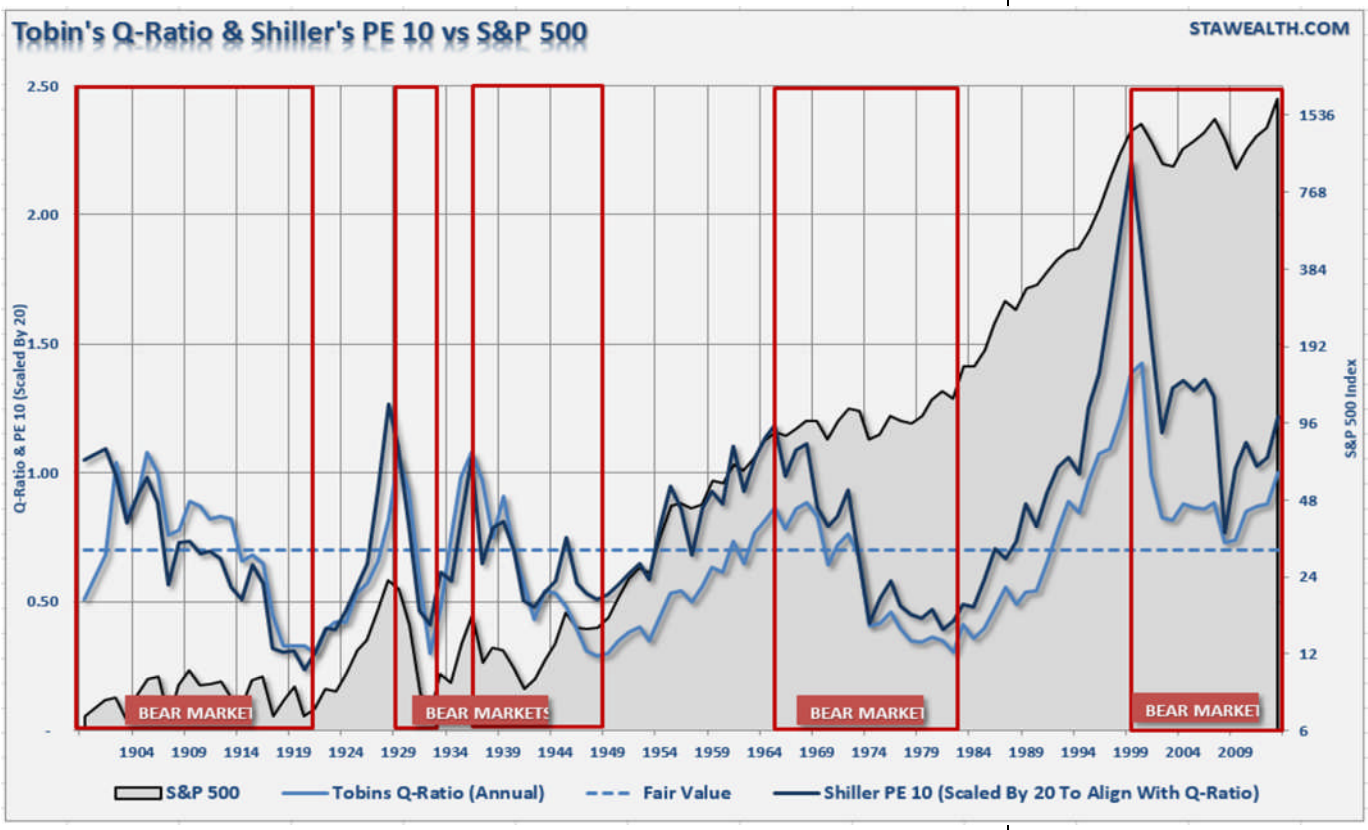
More importantly, the financial markets should be a reflection of the economy and not vice versa. The next chart shows the market as a ratio of the economy. Currently, stocks remain detached from the real economy do to a variety of ongoing liquidity driven events.



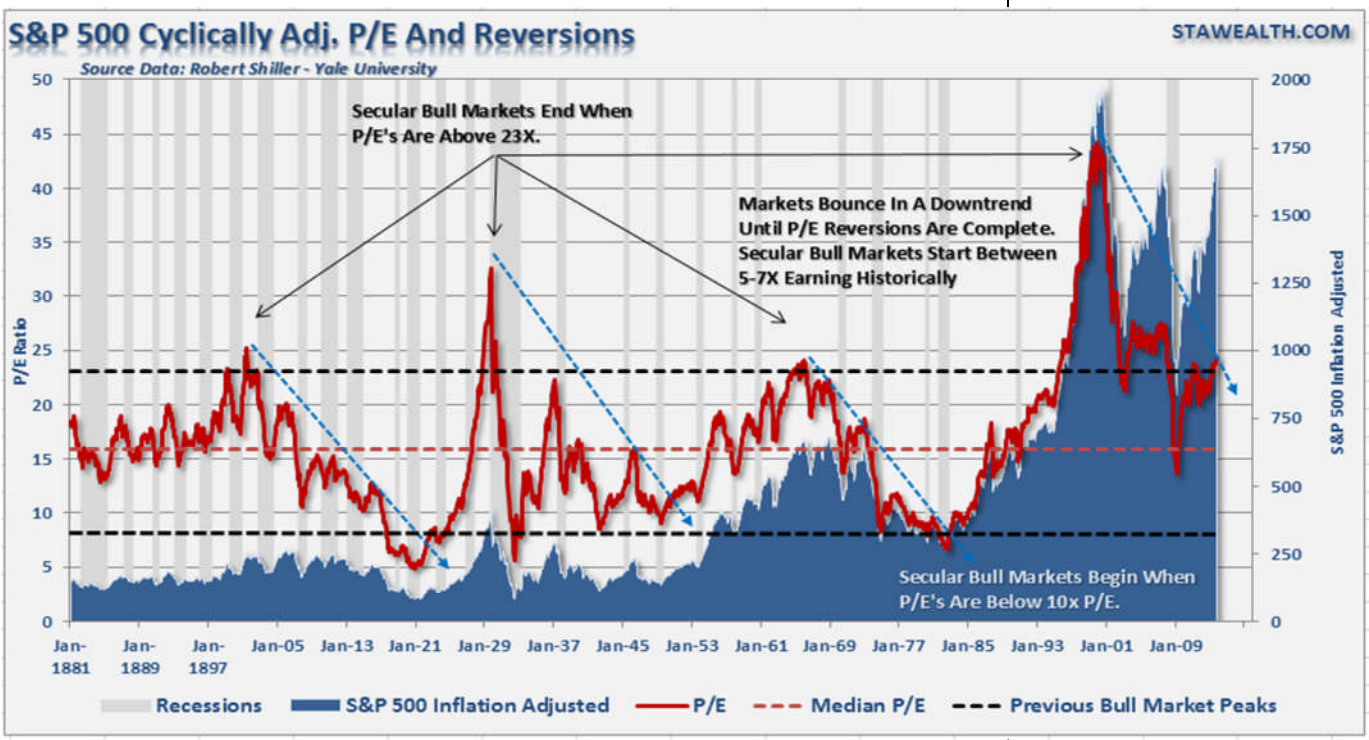
Valuations are also once again extended and are at levels that typically denote the end of secular bull markets rather than the beginnings of new ones.

The following chart shows Tobin's "*Q*" ratio and Robert Shillers "*Cyclically Adjusted P/E (CAPE)*" ratio versus the S&P 500. James Tobin of Yale University, Nobel laureate in economics, hypothesized that the combined market value of all the companies on the stock market should be about equal to their replacement costs. The Q ratio is calculated as the market value of a company divided by the replacement value of the firm's assets. Dr. Robert Shiller, also a Nobel Prize winning Yale professor, created CAPE to smooth

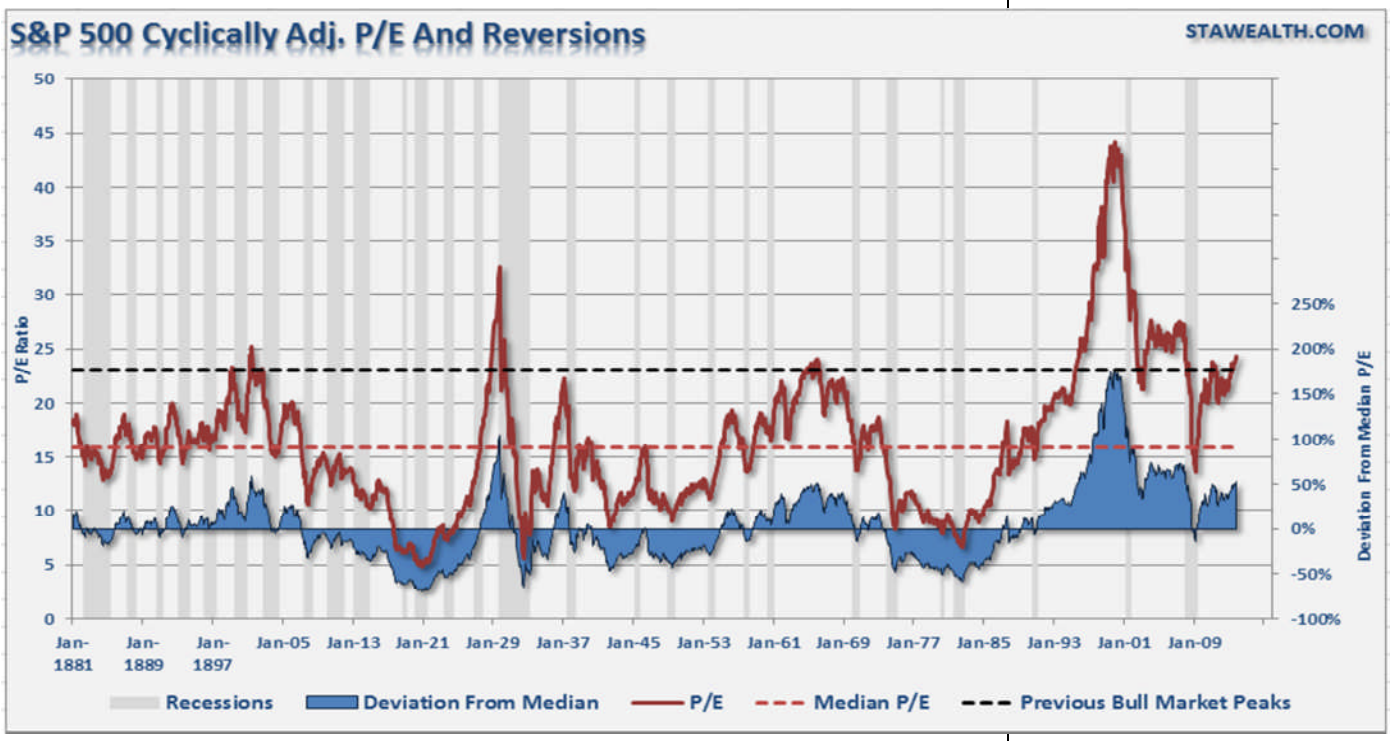
earnings variations and volatility over time. CAPE is calculated by taking the S&P 500 and dividing it by the average of ten years worth of earnings. If the ratio is above the long-term average of around 16x, the stock market is considered expensive. Currently, the CAPE is at 24.42x, and the Q-ratio is at 1.00.



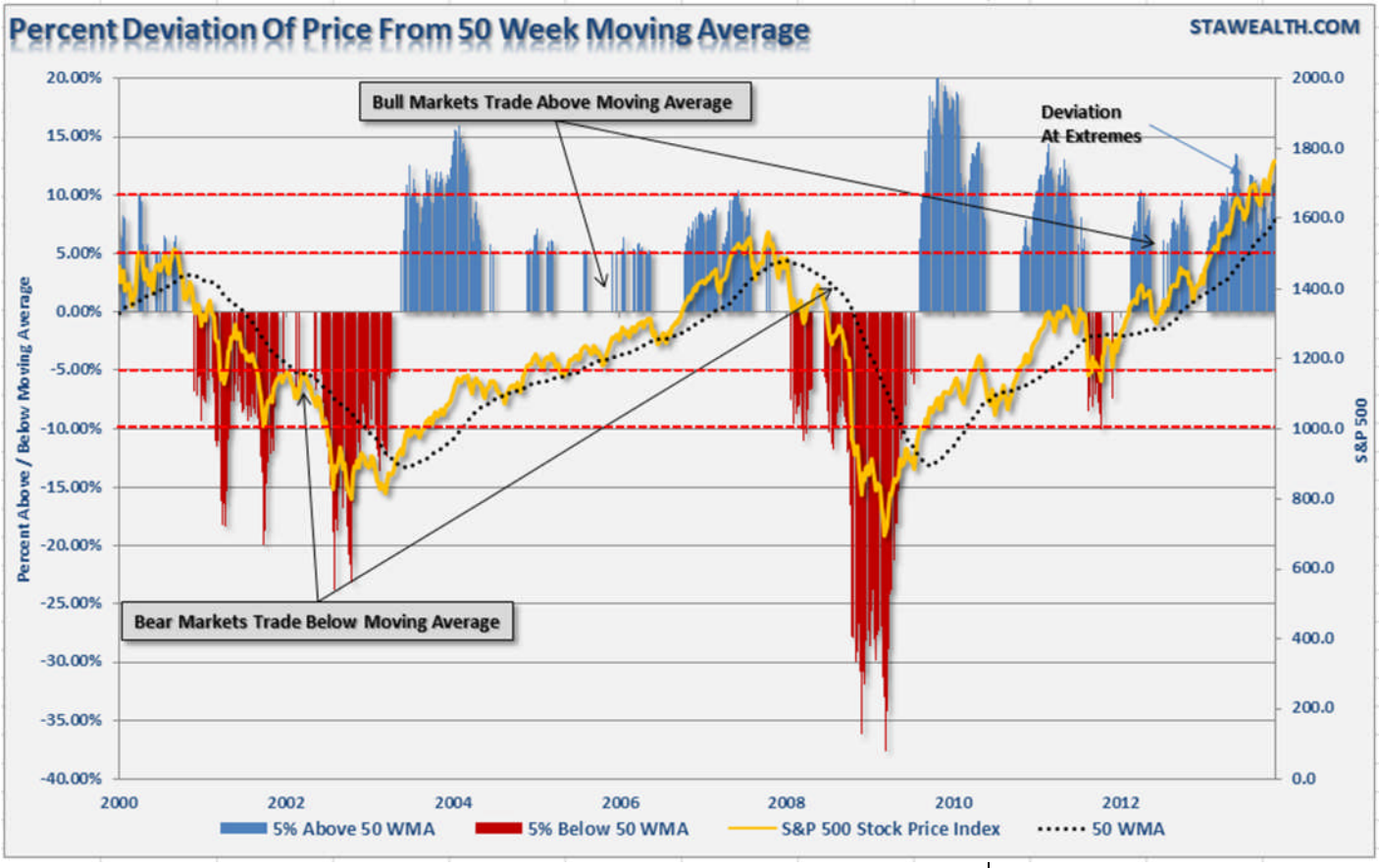
The next two charts are variants on Robert Shiller's CAPE. The first is just a pure analysis of CAPE as compared to the S&P 500.



The next chart shows the deviation of valuations from their long term average.



The next charts show the deviation of prices from their long term moving averages. Like a "rubber band" being stretched to its limits – such extensions must be reversed before they can be stretched again.



While Janet Yellen states that there are no signs of *"bubble-like conditions"* in the market; I am hard pressed to find where she might actually be looking, or rather, not looking.

However, we should not be surprised since Alan Greenspan never saw the bubble in 1999 and Ben Bernanke failed to see the bubble in 2008. Why should Janet Yellen be expected to be any different.

Nonetheless, with the Federal Reserve committed to their ongoing liquidity operations there is very little to stop the market from rising beyond our target of 1800 by the end of the year. Therefore, the question is what we, as investors, should be doing now.

Buy, Sell, Hold Or Short

So, with all of this in mind, what do you do now. The reality is that there is no set answer and how you approach the market from here depends much on variety of factors such as how long do you have until needing your money, how much can you afford to lose and how much growth do you really need.

Unfortunately, I cannot feasibly detail the multitude of various scenarios that exist around this one simple question. However, if I make some assumptions based on the demographics of those reading this weekly missive, I can provide an overview of actions that should be considered.

"I am currently primarily in cash"

Believe it, or not, this is one of the most common emails that I get on a daily basis. The problem with being primarily in cash is that chasing markets at these extremes have tended to work our poorly historically speaking.

However, as long as you are paying close attention to your portfolio AND, and this is crucially important, are **WILLING TO QUICKLY SELL AT A LOSS** if things do not go according to plan, then you can use dips in the market to add exposure. The chart below illustrates a reasonable expectation.

Since the beginning of 2013 the markets have entered into an accelerated "bull trend" which is indicative of a third phase of a bull market. These mania phases can last long, and accelerate faster, than logic would expect.

Therefore, adding to portfolios on dips to the accelerated bullish trend line is feasible.

However, as stated above, a break of that bullish trend could set the markets up for a deeper correction and recently added positions would need to be liquidated.

DO NOT BUY HERE – if you have ever uttered the words *"maybe if I hold it – it will come back."* This means you do not have the psychological makeup to sell at a loss. Holding losers is a sure way to be crushed by a market reversion.

"I am invested but underweight the model allocation"

This is the position that I am currently in. I am slightly underweight the model allocation and am awaiting a slight dip in the market to increase weightings back to target.

However, as with the scenario above, each position bought has a trailing stop-loss and I have no issue with selling positions if things go wrong.

This market is indeed ahead of itself and a correction is very likely in the weeks ahead. As long as that correction does not violate the accelerated bullish trend then portfolio positions can be added. However, as with the scenario above, if you do not have the mental capacity, and/or capability, to make quick changes to your portfolio then just HOLD current allocations for now.

"I am overweight equities"

This is the easiest position to be in at moment. While "holding" current positions are the easiest thing to do; you should consider some ongoing maintenance to protect the portfolio from a sudden market reversal.

- Stocks with huge gains should be reduced back to original investment levels.
- Stocks that have been declining or severely lagging the current rally should be sold in full.

This will begin to raise some cash and align the equity allocation of your portfolio to the model. However, it will provide some cash to add positions on market corrections that do not violate the current trend.

"Considering A Short? But Not Yet"

I have been getting asked more frequently about shorting the markets at these levels. I do not recommend it for most. The reason is that shorting the market takes a particular mentality of understanding what a hedge does to short term portfolio performance versus long term returns.

If you are the type of person that measures your performance against the S&P 500 from one month to the next – DO NOT TRY AND SHORT THE MARKET.

However, I am currently modeling out the addition of *"short market"* position for portfolios. However, importantly**, I have not instituted such a position just yet** as the right *"set up"* has not presented itself.

The idea is to begin to slowly add, through dollar cost averaging, a *"short market hedge"* to portfolios as the market rise continues. While such a position will hinder short term portfolio performance; such a position will offset a sharp market reversal allowing time to reduce the long equity positions that are currently in portfolios.

I am not so much interested in trying to make money when the market declines, which will be a side effect of the hedge, as much as giving me an opportunity to reduce the risk of the portfolio against a sudden and sharp loss of capital.

Again, this type of strategy is not for everyone and should only be done with highly tactical portfolios. If you are not the type that watches your portfolio very closely then just maintain an overweight position in cash which is also an excellent hedge against market risk.

Next Stop 1900 Or 1500?

I really don't have much sense of where this market goes from here. One thing I am sure of is that these advances don't last forever. However, while they are rising we must participate and with the Fed fully engaged, and possibly even increasing their efforts, the current extremes could become even more extreme.

However, looking back in history, the markets have not only ignored the early warnings of some very prominent people and institutions, but, even when faced with the reality of events, continued to operate in a state of denial.

The current market delusion is not about the dot-coms of 1999-2000 or the housing boom of 2006-2007, but about the blind faith in the ability of the Fed to hold up the market for an indefinite period in the face of a faltering U.S. economy, global weakness, decelerating earnings gains, significant overvaluation, overly bullish sentiment and the dysfunction in Washington.

Although the bulls, as usual, say "this time it's different", there is nothing new in the market's historical cycles between greed and fear. In the end, there is only the same old excess speculation in a brand new game.

See you next week.
Lance Roberts

STREETTALK ADVISORS

What makes us different?
It's really pretty simple. We believe that managing risk is the key to long term success. Conserve the principal and the rest will take care of itself.

Risk = Loss
Seems like a simple concept – yet most people take way too much risk in their portfolio which is fine as long as the market goes up. The problem comes when it doesn't.

Managed Risk = Returns
By applying varying levels of risk management to a portfolio of assets the potential for large drawdowns of capital is reduced thereby allowing the portfolio to accumulate returns over time.

Total Return Investing
We believe that portfolio should be designed for more than just capital appreciation. There are times when markets do not rise. During those periods we want income from dividends and interest to be supporting the portfolio.

If you are ready for something different then you are ready for common sense approach to investing.

Get Started Today!

Sector Analysis

Major Markets

S&P 500
Analysis: Hold

Not much change from last week except that the markets are now even more extended than they were previously. As discussed above, extensions beyond 2-std deviations above the long term moving average do not tend to last long. Look for a short term correction in the next couple of weeks.

International Markets
Analysis: Hold

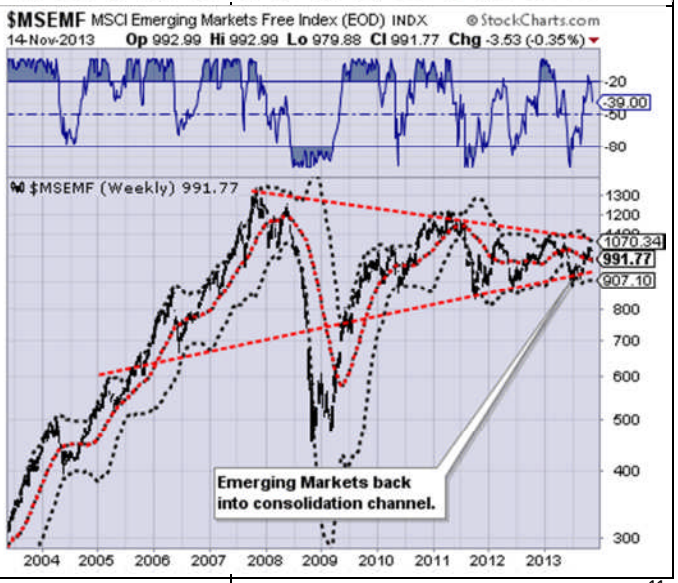
International markets are starting to underperform. This goes along with weakening economics that are starting to emerge as I discussed a couple of months ago regarding their restocking cycle.

However, a pullback to 1800 that holds and turns previous resistance into support will provide a better opportunity for entering into international markets.

Importantly, Domestic stocks are dominating performance over international and should be the focus of portfolios.

Emerging Markets
Analysis: Hold/Sell

Nothing much going on in emerging markets except a resurgence of weak economic and fundamental underpinnings. Use this rally to eliminate emerging market positions from portfolios.



S&P 500 Strong Sectors

(Sectors That Outperformed The S&P 500 Over The Last 10 Days)

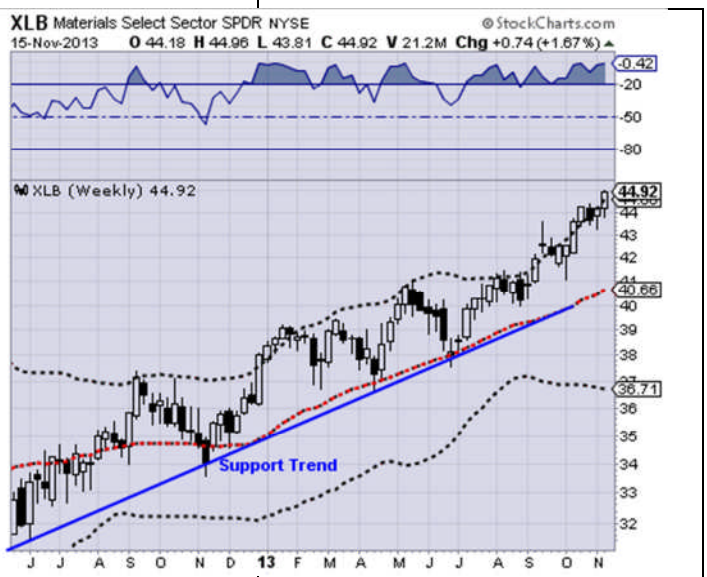
Basic Materials

Analysis: Hold/Take Profits

Basic materials continue their outperformance over the S&P 500. Such outperformance allows for an overweight position in portfolios.

However, that comes with an increased level of risk. Material stocks are VERY extended from their support trend line currently which has been a consistent reversion point since 2012.

It would certainly not be a bad idea to take a little profit at current levels.



Health Care

Analysis: Hold/Take Profits

Like Basic Materials the Healthcare sector continues to outperform the S&P 500. Also, extremely extended, this sector warrants some profit taking but can remain overweight relative to the portfolio allocation.

Financials

Analysis: Hold

Financials have been lagging the S&P 500 performance wise over the last couple of months. However, over the past 10 days financials have been getting a bid from the markets.

Hold current positions but do remain underweight financials in portfolios due to the longer term performance drag.

S&P 500 Weak Sectors

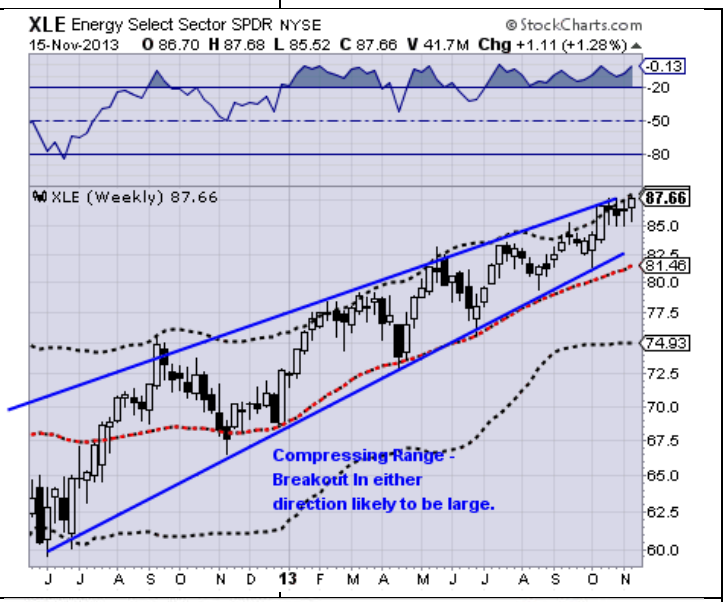
(Sectors That Underperformed The S&P 500 Over The Last 10 Days)

Energy

Analysis: Hold

Energy stocks continued to defy their underlying commodity trends. The surge by XOM on Friday because of Warren Buffett's stake announcement, propped energy stocks up.

Energy has underperformed the S&P 500 over the past several weeks and should remain underweight in portfolios.



Utilties

Analysis: Hold/Reduce

Utilities have reversed their selloff due to the spike in interest rates earlier this year as the "chase for yield" has resumed.

However, Utilities remain a net underperformer to the markets so it is time to reduce utilities to underweight relative to the underlying portfolio allocation.

Technology

Analysis: Hold

Technology, while still lagging the broad market, got a significant bit over the last couple of weeks. The breakout of the consolidation pattern has vaulted technology stocks higher – but still less than the broad market.

Hold current positions but remain underweight technology in portfolios in favor of stronger performing sectors.

Interest Rates

Analysis: Favorable For Bonds

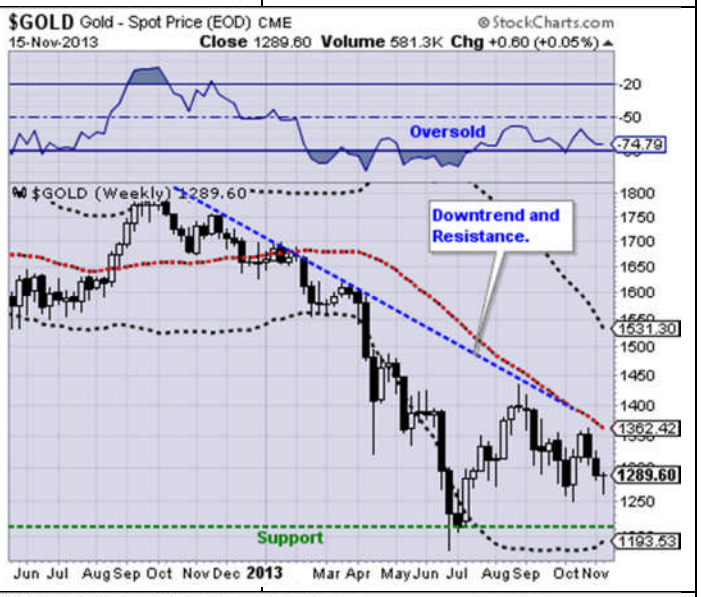
Interest Rates pushed up to resistance on anticipation that Yellen might "taper" current liquidity policies. However, much to the relief of stock market participants she not only quelled that fear but suggested that even more accommodation is yet to come.

Current target for rates remains 2.39%

Gold

Analysis: Sell

Still no reason to buy gold. With Yellen's commitment to more easing there is no reason to own gold at the current time.



Oil

Analysis: Holding Critical Support

It is make or break for oil prices. With oil sitting on long term support at 93.74 – a break below that trend will suggest energy prices into the mid-80's.

Oil should hold current levels but unless we start getting really cold weather – there is a decent probability that oil prices fall further.

THE ROAD TO RETIREMENT

Is It Time To Upgrade Your Annuity?

You have heard us discuss annuities on the radio quite frequently. Do you personally own a variable annuity? Have you considered surrendering it due to poor performance? Before you cash in your contract let's consider what that move could cost you.

Surrender Of Any Annuity Will Mean:

- *Ordinary income tax is due (up to 35% federal and state IF you experienced any gain in the contract)*
- *Surrender charges may apply – I've seen some up to 10% on your money*
- *Unless you are 59.5 years of age – the IRS will impose a 10% penalty also*

Result:

Surrender could cost you sixty cents on every dollar you put in that annuity contract.

There Is Hope:

The IRS has a bailout provision for you. This special clause in the tax code will permit you to get out of that variable annuity income-tax free. That's correct. Under Internal Revenue Code Section 1035 you can exchange one annuity for another. You can surrender the annuity and avoid tax as well as penalty. The catch is that you have to keep the owner and annuitant on the existing annuity the same as the owner and annuity on a new contract. This means that you can upgrade the high-cost annuity you currently have for one of the newer versions that just might "fit the need" greater as it relates to your family. By processing it under the grace of the IRS you are back in the driver seat to seeing greater results for your purchase.

What results would you like to see? Annuity companies are constantly changing and expanding the options now available on Texas products. You can swap out your outdated annuity contracts without limit for more efficient ones and continue to defer income taxes on the gains. Let's consider some optional benefits that may be desirable now that were not available when you originally purchased the annuity:

- *Some have no caps to limit the upside potential of earnings*
- *Lower expenses or some with no expenses if the market does not produce a gain*
- *Enhanced living benefit options that include a guaranteed income you cannot outlive*
- *Rather than a penalty when additional needs arise and you have to withdraw from your annuity, some provide "double income" when nursing home needs arise*

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It Is More Than Just Insurance…

Strategies For Your Financial Security.

- *Bonuses on deposits at the time of exchange can help restore or offset surrender charges*
- *Moving the annuity to a newer product that includes a death benefit and much larger amount of benefits should a long term care event arise*
- *Principal guarantees unavailable in the variable annuity contracts*

What Are The Risks?

You want to upgrade to the newer annuities with lower fees but moving would mean that you are beginning a new surrender penalty schedule again. If you have counted on these funds for retirement use a new surrender schedule may not be the best "fit" UNLESS you assuredly want to upgrade with an annuity that has a lifetime income payout guarantee.

Things You Will Want To Know:

- *Costs for making any exchange*
- *Features that would improve the gap between my family's needs and what my portfolio is pressured to provide*
- *Surrender period – how long will it last? What are all options for getting my money out of the annuity contract once I do an exchange*

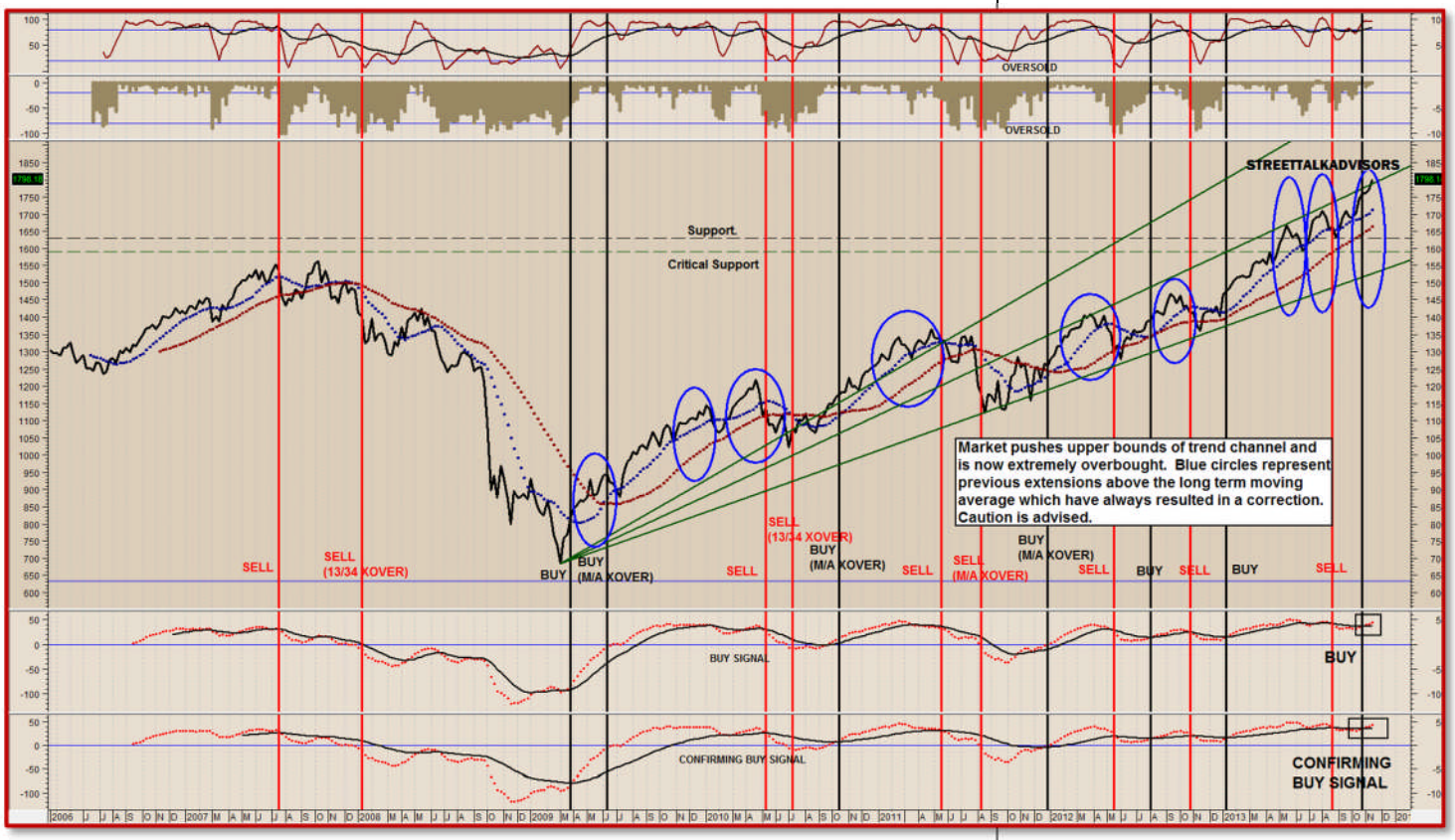
Moving Forward – What To Do?

Send me an email. Send me a copy of your current annuity contract statement. We can call the insurance company together to obtain pertinent information that reveals whether it is a good idea or better left alone. Annuities are long-term retirement investments set aside to age 59.5 at the minimum and up to 70.5 at the maximum for tax deferral. Today's annuity products are the newer and improved version, no doubt. But all of your questions as to whether an exchange is a good idea for you and your family can only be answered first with questions. Today is a good day to send us the information and let's call the insurer together. Two heads are better than one. I would love to earn your business once we define your goals.

Email me at: *Lynette@Streettalkinsurance.com*
Or call the office 281.822.8800.

Respectfully submitted,
Lynette A. Lalanne

401K Plan Manager



As earnings season now fades for the quarter it is down to the economic data and the Federal Reserve to support the markets. However, judging by recent releases of the economic data it is really down to just the Federal Reserve.

The markets are currently extremely extended above their long term moving averages. Such previous extensions (noted by blue circles) have always led to an eventual correction. The only real questions are 1) how big will the correction be; and 2) from where will it begin.

This is not a good opportunity on a risk/reward basis to be adding equity exposure. However, there is no reason to currently sell positions OTHER THAN to take some profits and rebalance positions accordingly.

As discussed in this week's missive; if you are heavily weighted in cash this is one of those time where it is best to wait for a better opportunity to add equity risk. If you are overweight equity; then this is a good opportunity to reduce position back to original weightings, take profits and sell laggards.

A correction is coming. Unfortunately, I just don't know when.

If you need help after reading the alert; don't hesitate to ***contact me***.

[Suggestions Wanted]

I am in the process of revamping the newsletter and the 401k plan manager for the new website. If there is anything that you would like to see added to the 401k plan manager please email me.

Common 401K Plan Holdings By Class

Cash

Stable Value
Money Market
Retirement Savings Trust
Fidelity MIP Fund
G-Fund
Short Term Bond

Fixed Income

Pimco Total Return
Pimco Real Return
Pimco Investment Grade Bond
Vanguard Intermediate Bond
Vanguard Total Bond Market
Babson Bond Fund
Lord Abbett Income
Fidelity Corporate Bond
Western Asset Mortgage Backed Bond
Blackrock Total Return
Blackrock Intermediate Bond
American Funds Bond Fund Of America
Dodge & Cox Income Fund
Doubleline Total Return
F-Fund

Equity

Large Cap

Vanguard Total Stock Market
Vanguard S&P 500 Index
Vanguard Capital Opportunities
Vanguard PrimeCap
Vanguard Growth Index
Fidelity Magellan
Fidelity Large Cap Growth
Fidelity Blue Chip
Fidelity Capital Appreciation
Dodge & Cox Stock
Hartford Capital Appreciation
American Funds AMCAP
American Funds Growth Fund Of America
Oakmark Growth Fund
C-Fund (Common Assets)
ALL TARGET DATE FUNDS 2020 or Later

Balanced Funds

Vanguard Balanced Index
Vanguard Wellington Fund
Vanguard Windsor Fund
Vanguard Asset Allocation
Fidelity Balanced Fund
Fidelity Equity Income
Fidelity Growth & Income
American Funds Balanced
American Funds Income Fund
ALL TARGET DATE FUNDS 2020 or Sooner

Small/Mid Cap

Vanguard Mid Cap Growth
Fidelity Mid Cap Growth
Artisan Mid Cap
Goldman Sachs Growth Opportunities
Harbor Mid Cap Growth
Goldman Sachs Small/Mid Cap Opp.
Fidelity Low Price Stock Fund
Columbia Acorn US
Federated Kaufman Small Cap
Invesco Small Cap

The above represents a selection of some of the most common funds found in 401k plans. *If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.* All funds perform relatively similarly within their respective fund classes.

I will modify this list over time as the asset allocation model changes to reflect international holdings, emerging markets, commodities, etc. as the model changes to reflect the addition of those holdings.

***Email me* if you need further assistance.**

Current 401k Allocation Model

5.00% **Cash + All Future Contributions**

Primary concern is the protection of investment capital

Examples: Stable Value, Money Market, Retirement Reserves

35.00% **Fixed Income (Bonds)**

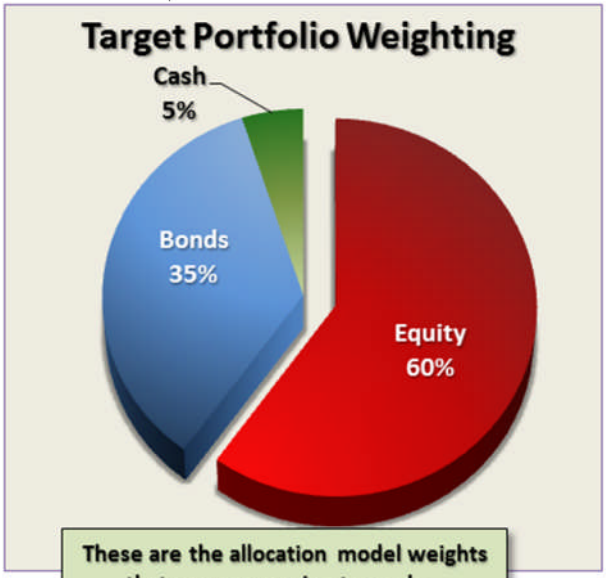
Bond Funds reflect the direction of interest rates

Examples: Short Duration, Total Return and Real Return Funds

60.00% **Equity (Stocks)**

The vast majority of stock funds track an index. Therefore, select on ONE fund from each category. Keep it Simple.

25% Equity Income, Balanced or Conservative Allocation
25% Large Cap Growth (S&P 500 Index)
10% Mid Cap Growth



These are the allocation model weights that you are moving towards.

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STREETTALK ADVISORS

Lance Roberts
Director of Fundamental & Economic Analysis

Michael Smith
Director of Alternative Investments

Luke Patterson
Chief Investment Officer

Hope Edick
Compliance Officer

Lynette Lalanne
General Partner – Streettalk Insurance

Office Location
One CityCentre
800 Town & Country Blvd.
Suite 410
Houston, TX 77024
Tel: 281-822-8800

Web Sites
www.streettalkadvisors.com

Email (For More Information)
Streettalk@streettalklive.com

FOR APPOINTMENTS

Brooke Sanders
fis@streettalkadvisors.com