2014 3rd Quarter

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PERFORMANCE WEIGHTED ASSET ALLOCATION REPORT

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ADVISORS' THOUGHTS

In the **third quarter of 2014 stock markets** around the world **saw a heightened level of volatility** as investors became more concerned over a number of economic and geopolitical issues. **Within your accounts** the emphasis on large cap US equities over small cap, as well as US equities over foreign, helped minimize any losses. In addition, **equity allocations were lowered in the third quarter**. For most of you this occurred through the sale of one mutual fund that was under performing its peers.

The **strongest area of stock market** performance in the third quarter came **from larger US companies** as indicated by the Dow Jones Industrial Average and **S&P 500 gaining** 1.29% and **0.62%** respectively. This outperformance by larger US companies masked the overall negative tone to most segments of the global equity market.

Outside the US most measures of stock market performance **were negative**. Within the more **developed economies stock prices declined 6.39%**, as represented by the **MSCI EAFE**. Emerging market stocks saw similar losses with the MSCI Emerging Markets Index down 4.33%. Even within the US, many segments of the stock market experienced losses. For example, small capitalization US stocks, as represented by the Russell 2000, declined 7.65%.

In the past couple of months concerns have grown over a variety of issues that are impacting investors; geopolitical concerns from the Middle East and Russia/Ukraine, economic concerns from a slowdown in Europe and other global economies, and Ebola. Central to all of these from an investor's standpoint is how they will impact the US economy and its financial

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TOTAL RETURN THROUGH 09/30/14

	3 Mo.	6 Mo.	12 Mo.
DJIA	1.29%	3.56%	12.65%
S&P 500	0.62%	5.34%	17.29%
Russell 2000	-7.65%	-6.08%	2.60%
MSCI EAFE	-6.39%	-3.63%	1.53%
MSCI Emerging Markets	-4.33%	1.07%	1.81%
Barclays Inter-term Bond	-0.04%	0.92%	0.58%
Barclays Long-term Bond	2.53%	6.94%	10.77

Source: Wall Street Journal and Morningstar Principia
Does not include reinvestment of dividends

DJIA: A price weighted average of 30 stocks.

S & P 500: A market value weighted index of 500 stocks.

Russell 2000: A market value weighted index of 2000 stocks.

MSCI EAFE: A stock market index designed to measure the equity market performance of developed markets outside US and Canada.

MSCI Emerging Markets: A stock market which captures large and mid cap representation across 21 Emerging Market countries..

Barclays Capital Treasury Intermediate-Term Bond Index: An index comprised of US Treasury securities with maturities between 2 and 10 years.

Barclays Capital Treasury Long-Term Bond Index: An index comprised of US Treasury securities with maturities of 10 years or longer.

In **early October** most of you received a confirmation (and prospectus) that in your managed account **a new investment** was made in **SPDR® S&P 500® ETF Trust**. This exchange traded fund **(ETF)** is **similar to a traditional mutual fund**, however there are **some important differences** so we thought it might be helpful to provide an overview of what is an ETF.

POOLED INVESTMENT WITH DIVERSIFICATION

In many ways an ETF functions like a mutual fund. **In a mutual fund investors pool their money together** and hire a mutual fund manager **who selects what securities to buy** based on the funds objective. In a typical actively-managed equity mutual fund the manager may own 50-100 stocks or more. For most people it would be cost prohibitive to purchase a portfolio of 100 different stocks. Through a **mutual fund** the investor achieves a **greater level of diversification than they would be able to achieve on their own**, along with professional expertise as to which stocks to own.

An **ETF** is also an investment that allows **individual investors to pool their money together** to provide **greater diversification** than they would be able to achieve on their own. Although there are a growing number of actively managed ETFs, the typical **ETF seeks to mimic the performance of a specific benchmark.** For example, the SPDR® S&P 500® ETF Trust seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the S&P 500 Index. By purchasing this ETF the investor receives their pro rata share of all 500 stocks owned in the S&P 500.

INTERNAL MANAGEMENT FEES

In **comparing "index" ETFs** with traditional **"actively managed" mutual funds, internal operating expenses will generally be lower with the ETF**. This is often times how I have seen mutual funds compared to ETFs. However, this **differential of internal charges is primarily due to the investment objective** (actively managed vs. index tracking) **being different and not the structure of the investment product** (ETF vs. mutual fund) itself.

In the case of an actively managed mutual fund the management team will need to spend money on research and human capital for which securities to buy and sell. In the case of the index ETF no resources are spent to identify which securities should be bought and sold. With the index ETF the manager merely needs to match the index performance, and that can generally be done at a much lower cost. The reason for this is the securities represented in an index do not change very often. Typically an index will update its components only one time per year and generally few changes are made. Simply put, there is less work (cost) for the manager regarding the buy/sell decisions.

When comparing actively managed ETFs with actively managed mutual funds, or index ETFs with index mutual funds, the difference in cost mostly disappears.

PURCHASING SHARES

One key distinction between a mutual fund and an ETF is how shares are purchased. **In a mutual fund the value** of the mutual fund is **calculated at the end of each day** and divided by the number of shares outstanding **to determine the Net Asset Value (NAV) or share price**. This is the price that one would receive if they sold their shares at any point during that trading day, and the price that one would pay (before any sales load if applicable) to purchase shares in the mutual fund. **All purchases and sales occur at the end of the trading day and directly reflect that days NAV**.

An **ETF functions like a stock** traded on an exchange. **ETF shares may be bought and sold throughout the day** and the price that those shares are traded at will fluctuate. Like a stock there is a **bid/ask spread between what shares may be bought or sold for** at any given moment in time. With an individual stock of a large company that is widely held and trades often throughout the day, the bid/ask spread will be relatively low. On the other hand, a very thinly held and infrequently traded small company stock will have a relatively high bid/ask spread.

ETFs function in much the same way, with those ETFs that trade the most frequently, tending to have lower bid/ask spreads and those trading less frequently tending to have a higher bid/ask spread. The spread will change over time depending on variety of factors including market conditions. For example, during periods of high market volatility the spread may widen. Investors need to be cognizant of this spread when they evaluate which ETFs are appropriate.

Like a mutual fund, **ETF pricing** is also **closely tied to the NAV** of the underlying securities held in the ETF, **however unlike a mutual fund the ETF may trade at a premium or discount** to the securities held in the ETF. The size of the premium or discount is determined in part by the underlying securities being held in the ETF. If it holds stocks that are widely traded, such as those stocks in the S&P 500 index, the premium/discount to the NAV will tend to be small. If one is purchasing an ETF of small cap, foreign stocks the premium/discount to NAV will tend to be larger. Furthermore, this **NAV is calculated throughout the day** and not just at the end of the day like a mutual fund. It is referred to as the Indicative Net Asset Value or iNAV and is calculated on a real time basis every 15 seconds by the listing exchange. The **continual updating of the iNAV helps keep the market price of the ETF close to the value of its underlying holdings** and to minimize premium or discount.

TAXATION

ETFs are taxed in the same way as a mutual fund, although they tend **to be more tax efficient**. For example, if a mutual fund or ETF holds a security that has appreciated in value and then sells that security it will create a taxable, either short or long term, capital gain depending on how long it was held. In both a mutual fund and ETF any net realized short and long term **capital gain must be distributed at least annually to the shareholders** and is subject to income tax.

One major reason why ETFs tend to be less taxed than a typical actively managed mutual fund is because the investment objectives are different. In the case of an actively managed mutual fund the manager seeks to buy and sell securities in order to make a profit. This process of buying and selling securities is called "turnover". The more often a manager buys and sells securities the higher the turnover. The higher the turnover the more likely capital gains will occur and need to be distributed to shareholders. In an ETF that has an objective to replicate an index the turnover will tend to be much lower. Lower turnover means fewer securities are being sold and therefore fewer capital gains will need to be distributed and taxed.

The **tendency to having lower capital gains** distributions can be particularly important near the end of the year, as that is when most mutual funds distribute any capital gains. After nearly five years of strong market performance we are anticipating that capital gain distributions will be greater in 2014 than in recent years. For the few funds that have provided preliminary estimates, the tendency towards a larger capital gain distribution is in place. This was an **important consideration** for those of you in taxable accounts **for the recent purchase of the SPDR® S&P 500® ETF Trust**.

STOP THE PROPSECTUSES!

Last month in many of your accounts a new Exchange Traded Fund (ETF) was purchased and, as is required, Pershing mailed a prospectus. If you have more than one account, you received more than one prospectus.

You may choose to not receive prospectuses in the mail and instead receive an email notification that one is available.

With **Online Access and Electronic Delivery** you can choose **which communications you want** to receive in the mail and which ones you would like **an electronic notification** when they are available. This would include **fund prospectuses, annual reports, purchase and sales confirmations** and/or even **account statements.**

If you would like **to learn more** about this, or set up Online Access and Electronic Delivery, **give Sandi a call**.

markets. Thus far economic signals remain positive in the US.

One way to follow overall economic activity in the US is to monitor The Conference Board's tracking of the US economy. Each month they calculate three indices that are designed to measure turning points in the US economy. The **Conference Board Leading Economic Index®** (LEI) for the US is probably more **closely watched from an investment standpoint** because when its trend turns negative it has historically indicated that a recession may be coming.

During **September the LEI for the US increased 0.8%.** For the month, nine of the ten indicators that make up the LEI for the US showed improvement. In addition, the **strength among its components has remained widespread, with all advancing over the past six months.** In the press release from the Conference Board on October 23, 2014 Ataman Ozyildirim, Economist at the Conference Board stated, "The outlook for improving employment and further income growth are expected to support the moderate expansion in the U.S. economy for the remainder of the year."

The **employment picture continues to improve.** The Labor Department reported October 3rd that employers added 248,000 jobs in September. For the **first nine months of the year payrolls have expanded** an average of 227,000 a month, **putting 2014 on pace to be the strongest year of job growth since the late 1990s.**

Improvement in hiring along with post recession lows in weekly job layoffs have led to a continuing decline in unemployment. The **US unemployment rate dropped below 6% for the first time since the recession.** This upbeat news is somewhat tempered by the stubbornly high level of underemployment that remains in the economy.

A broad measure of underemployment stood at 11.8% in September. It measures not only the unemployed, but also includes part-time workers seeking full-time employment and those too discouraged to apply for work.

This slow improvement is actually encouraging from an investment standpoint because it means the economy may still be a long way from peaking and this should be good for corporate earnings.

As of October 16, 70 of the S&P 500 companies had reported third quarter earnings with 49 having beat consensus expectations, 13 having missed and 8 matching their expected quarterly earnings-per-share numbers according to S&P Capital IQ consensus data. Based on these first companies to report, the resulting 70% beat-rate is just above the historic tendency where 64% of companies exceed expectations once all 500 have reported.

Earnings gains are no longer being driven solely by cutting costs, but modest revenue gains are contributing to corporate profits. S&P 500 companies are expected to generate revenue growth of 3.8% in the third quarter with similar gains anticipated for next year. Solid profitability supported by revenue growth has provided confidence among company boards to increase their dividend.

According to S&P Capital IQ there were **563 dividend increases** (or initiations, resumptions, or extras) in the **US common stock universe in the third quarter, up 18.5% from a year ago.** During the third quarter only 65 companies decreased or suspended their dividend. Year to date through September there were 2,337 dividend increases, up 16.3% from the same period last year.

Furthermore, support for continued dividend improvements appear in place. Payout rates (dividends as a percentage of earnings) remain low and continue to decline. This means there is a higher level of earnings for each dollar in dividends that are paid out. **S&P Capital IQ anticipates actual cash dividend payments for 2014 will post a double-digit increase from 2013** which was the previous record.

Fundamentals of publicly traded US companies appear to be in a sound position as we enter the 4th quarter. In addition, the US economy continues to grow at a moderate pace. While there will always be **periods of volatility** in financial markets these should **prove to be temporary as long as the economy and corporate fundamentals are doing well.**