2013 3rd Quarter

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PERFORMANCE WEIGHTED ASSET ALLOCATION REPORT

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ADVISOR'S THOUGHTS

At the start of the 4th Quarter of 2013 there seems to be a lot of confusion and questions, particularly about the **debt ceiling**, the **government shutdown** and the sideshow going on in Washington. And there doesn't seem to be clear answers for a long term solution. However, the underlying question that we are always concerned with is **how will this impact your investments?** As you review your 3rd quarter statements take a look at the One-Year Returns. We think you will be as pleased as we were that despite the partisan bickering and political brinksmanship going on in Washington, **your accounts have experienced a substantial increase** over the past year.

The Index Performance Table reflects the strong performance of stocks and weaker returns for bonds. During the past twelve months stocks have done well, gaining 16.72% as measured by the S&P 500, while both the Barclays Long Bond and Intermediate Treasury Bond Indices declined at 10.05% and 1.88% respectfully.

In preparing your performance reports and reviewing index returns, we are reminded that many **investors compare their investment portfolio returns vs. what they could earn depositing (loaning) their money to the bank.** This quarter we called Bank of America and asked what their current yields were on One-Year, Two-Year and Five -Year CDs. If you are a Platinum depositor with the bank and invest at least $10,000 in a One-Year CD, Bank of America is currently paying 0.14%. For a Two-Year CD the rate moves up to 0.15% and for a Five-Year CD you can get 0.30%. It is one thing to notice **that those yields are extremely low**, but it is

TOTAL RETURN THROUGH 9/30/2013

	3 Mo.	6 Mo.	12 Mo.
DJIA	1.48%	3.78%	12.60%
S&P 500	4.69%	7.16%	16.72%
Nasdaq	10.82%	15.42%	21.00%
MSCI EAFE	10.94%	8.60%	20.35%
MSCI Emerging Markets	5.01%	-4.58%	-1.52%
Barclays Inter-term Bond	0.34%	-1.81%	-1.88%
Barclays Long-term Bond	-1.98%	-7.42%	-10.05%

Source: Wall Street Journal
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.

NASDAQ Composite: Market value weighted index of approximately 2,082 companies.

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.

probably more revealing when you **compare it in dollars**. So we took a return that we were sure **everyone's portfolio would exceed in the last 12 months (6%)**. We assumed an investment of $100,000 at that same 6%. At the end of five years the investment would have grown to $133,822. We also know that right now inflation is low at 1.5% for the past twelve months. **We believe inflation will increase going forward.** If we assume an inflation rate of 2.5%, just to keep up with inflation at the end of five years you would need $113,140. If instead we put the money in a Five-Year CD earning 0.3%, at the end of five years we would end up with $101,509. Sadly, that is over $12,000 short of just breaking even with inflation and over $32,000 less than the hypothetical investment at 6%. It is easy to see that **there is a significant difference** between getting these unbelievably **low yields on CDs** and the **returns you have been receiving** in your own portfolio. It is important to remember that an investment and CDs have substantial differences. An investment may lose money, is not insured or guaranteed by FDIC or any other governmental agency and is subject to additional risks. Additional risks include market risk, issuer risk, credit risk, regulatory risk, investment style risk and liquidity risk. Our accounts can and do go up and down in value as most of you have experienced. (Please see full disclosure at the end of this newsletter) Yet despite all of the negative and often scary news that is reported daily, **the investment side has been doing quite well** the past few years.

Under the barrage of negative news that we are constantly hearing, **why have we been making money?** Is it a fluke or are there fundamental reasons investments are doing well? Exactly what is going on? In this report, we are going to look at the recent government shutdown and discuss how it is, or is not, affecting the overall economy. We will also **review what really drives the stock market, corporate profits** and how dividend changes are closely linked. We will also come back and take a current look at bonds, which we have reviewed in our last few reports, and then we will discuss the market outlook. Of course no one can predict or know for sure what the future holds, but if we look at **what has caused the growth** in the past, we might understand **how that could affect our investments in the future**.

GOVERNMENT SHUTDOWNS

There are two issues here, one is the government shutting down some of their spending and the other is the push to raise the debt limit so the US is able to continue to borrow to meet all of its spending commitments. **If partisan bickering in Washington is prolonged**, one of the big risks is it could have a **negative psychological effect on consumer confidence**, reduce personal consumption and **business confidence could drop** causing the postponement of hiring new employees. A second risk would be a complete political paralysis that could lead to a sovereign credit downgrade by one or more of the credit agencies. **In our opinion, an actual default** on US debt as a result of not raising the debt limit **appears unlikely** as there is plenty of government revenue to make interest and principal payments on debt when they come due. However, there would be forced cuts in spending on other budget items. The market held up well during the October shutdown and debate on the debt limit and it appears **investors were not too concerned with the sideshow in Washington**. Unfortunately, we look for this to resume again soon as the recent debt limit and budget resolutions were temporary extensions to early 2014.

From an investment standpoint, what has been the impact of these kinds of debates in the past? There have been **twelve instances** since 1976 when the **Government had a shutdown.**[1] On average the **S&P 500 has risen 11% in the following 12 months** after those twelve shutdowns. The last time there was a big speculation about a shutdown was in August 2011, and that was when Standard & Poor's stripped the US of its AAA Credit rating. The S&P 500 had a fairly violent 11% drop in three days, however in the **following 12 months it was up 25%** through August 2012. After the shutdown that occurred in December 1995, the S&P rallied 21% in the following year and in the 1982 shutdown the S&P index was up 36% in the following 12 months. The **history of government shutdowns** is that they have **not lead to financial Armageddon** and once they are resolved, when other key drivers of the market are in place, **the stock market has been able to move forward**.

THE ECONOMY

How has the economy been doing through all of this Washington gridlock? At the end of the third quarter the US economy was in good shape.

Unemployment has been reduced, the **housing market has improved** significantly over the last couple of years and economic growth along with **corporate earnings continues to be solidly positive**. The private sector is continuing on a healthy path of economic recovery and many companies are displaying robust fundamentals. **The US economy** is definitely **showing signs of slow but steady improvement**.

The US has $16.6 trillion nominal gross domestic product and with an economy this large and diverse it is not prone to sudden or sharp changes in direction or momentum. This suggests that short-term interruptions of the federal government operations should not have a prolonged impact on the private sector consumption or the US based economy. Much of the concern would be reflected in consumer spending. We've seen that **retail sales have been**, and continue to be, **very strong** since the start of the recovery in 2009. **Retail sales just set a new all-time record high** of $426.6 billion in August of 2013.[2] A closer look at the data shows an interesting trend in retail sales is occurring. For the last several quarters there has been a **significant increase of e-commerce spending vs. brick and mortar spending**. In other words more of us are buying things over the internet. The commerce department reports for the 2nd quarter 2013, **e-commerce sales increased 18.4%** over a year earlier while the **total retail sales increased 4.5%**. So although the volume of dollars is not near as large in e-commerce as it is in the brick and mortar side, you can see that it is really picking up - and that of course is helping retail sales.

In addition to consumer spending and overall US economic output we continue to follow producer and consumer prices. **The risk of inflation**, or deflation, is seen to be **relatively minor**. Over the past year inflation, as measured by the Consumer Price Index, has increased at 1.5% which is still below the Federal Reserve's target rate of 2% inflation. Due to the subpar economic expansion with little risk of inflation, the **Federal Reserve remains extraordinarily accommodative.** Their **quantitative easing program is currently spending about $1 trillion a year in buying treasury bonds** and **mortgage-backed securities** to try to get more growth into the economy along with a little more inflation. Their near zero interest rate policy has made **bank savings accounts unattractive encouraging capital to flow to stocks and real estate** and has encouraged further economic activity. There will always be volatility in the markets but investors appear to be focusing more on economic numbers and earnings than what is happening around Washington DC.

CORPORATE PROFITS

Overall, analysts have been forecasting a slower growth rate in earnings for the third quarter, but they are forecasting earnings will increase at a faster pace next year. While some analysts are anticipating earnings will increase at the fastest pace of the last two years during this fourth quarter, others are saying that earnings will start to slow down. Currently we look at earnings compared to the S&P 500's valuation and it is around 16.1 times reported operating earnings. That is just below a three-year high that was at 16.5 and is an increase of about 14% last year. **Profits have been climbing for the last four years** and **analysts are forecasting** that this **growth will continue into 2014 and 2015** when they predict the profits will rise by more than 10%. The corresponding earnings per share for the S&P 500 Index are estimated to be $26.92, which if the earnings season ends with this figure would tie the highest earnings per share figure ever.[3] **So in our view, earnings and not the government determine stock values** in the long run and the government can only influence things on a short-term basis. Long term the value of equities is based on corporate profits and as long as corporate profits are continuing to increase this **should bode well for the stock market**.

DIVIDENDS [3]

When you have increased earnings, the most logical question is, are the companies confident enough about their future prospects to commit to paying those earnings out to their shareholders in the form of dividends? Of the approximately 10,000 US traded issues year to date through September 30th, **there were 2,010 positive dividend events** and **only 287 negative events**, defined as either a decrease or suspension of dividends. This compares favorably with the 1,600 positive dividend actions in the first nine months of 2012. The S&P Dow Jones Indices announced that net dividend increases rose $11.9 billion for US domestic common stocks during the third quarter 2013 compared to an $8.8 billion increase in the third quarter 2012. The percentage of

issues paying dividends in the large cap S&P 500 Index reached 83.7% or 419 companies and that level has not been seen since November 1998 when 420 of the 500 issues were paying dividends. **All 30 stocks in the Dow Jones Industrial Average pay a dividend.** On a weighted average, the **dividend yield those issues were paying was 2.6%.** That was down from 2.65% at the end of the second quarter. Almost that entire decline is attributed to stock price increases. One of the few **income generating alternatives for investors has been stock dividends.** Actual cash payments to investors are set to reach new record highs posting double-digit gains over 2013, with 2014 already on track to set another record. So it is no mystery why your portfolios are up. Many of the stocks the managers are investing in are making higher profits and an increasing amount of those earnings are being distributed to shareholders in the form of dividends. In an incredibly low interest rate environment, receiving dividend is a place that many investors want to be. Thus the market values continue to climb.

BONDS

We have talked about bonds in our last few reports because bonds have reached a point were **further price appreciation** is very unlikely from these historically low interest rate levels. Investors have been moving to shorter dated securities or in the high yield area with the 10-year treasury yield currently at 2.6%. There has been a little reprieve in interest rate rising because the Federal Reserve decided not to start cutting back, or as it is called taper, its quantitative easing program. Prior to that realization the 10-Year treasury had climbed to near 3%. Janet Yellen, the **newly appointed Federal Reserve chairman**, is reportedly more of a mindset to **continue their bond buying program** for some time. There probably won't be a real quick jump in interest rates due to Federal Reserve policies and the modest recovery. However, as the economy continues to expand and with companies doing well, it is obvious to us that it is **just a matter of time** until the **Federal Reserve will stop holding interest rates** down through their policies, and interest rates will start up to more typical levels. **Rising rates will have a major impact on bonds.** From our standpoint, **you will see less and less emphasis in our portfolios on holding bonds.**

MARKET OUTLOOK

The market continues to climb a wall of worry with every concern that is raised. Today many market experts believe **the stock market is right around fair value.**

At the end of the day you ask what all of this fighting and disruption from Washington has accomplished, and what kind of harm is it doing to the market? In our view it has accomplished very little and it doesn't seem to be causing any long-term harm on the economic picture as you can see above with corporate profits. So although there is some volatility in the market, we are not seeing that what is going on in Washington will have any true long term affect. Finally, looking ahead, the Federal Reserve is going to be reducing their $85 billion in monthly bond purchases but that might not start until next year. If for some reason all the happenings in Washington get bad enough to stall the economy, the quantitative easing program might continue longer and even increase above current levels. **For the Federal Reserve to start reducing their bond purchases** sometime late this year or early next year, this **would mean that they are seeing an improving economy.**

The bottom line is the **equity market remains fundamentally attractive.** Profits have picked up substantially in recent years with earnings, in some cases at record highs, and the dividends paid out to shareholders have been on a continual increase. So although we know there are problems ahead, and we realize there can be changes, at this point in time the **equity markets are one of the best places we see to be investing** in and the US economy although growing modestly, is doing well.

[1] "Government Shutdown May Be Another Reason For US Investing", *Bloomberg News*, October 1, 2013

[2] US Census Bureau News, US Department of Commerce, Advanced Monthly Sales for Retail and Food Services August 2013, September 13, 2013

[3] "Lookout Report from Global Markets Intelligence" *Division of S&P Capital IQ*, October 4, 2013)