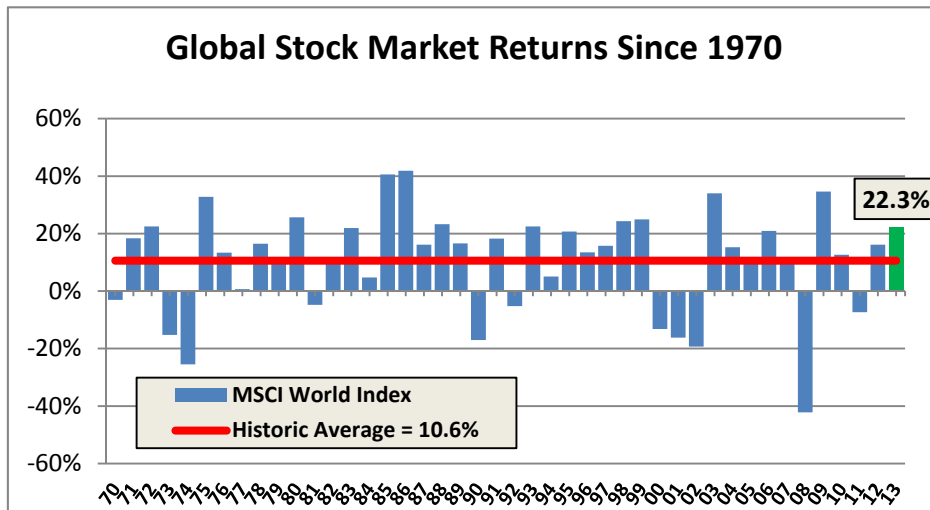


From: Warner A. Henderson, ChFC

Subject: Despite the Headwinds, a Surprisingly Strong 2013

For 2013, the MSCI World Stock Market Index posted its best annual gain since 2009 and the index is now in record territory. In looking back at global stock market returns since 1970, last year's gain of 23% was near the top of the performance chart and was more than double the average annual return of 10.6%. 2013 was an especially strong year for US stocks with the gains of between 32% and 45% for US Large Caps and Small Caps respectively. Developed foreign markets also posted robust returns with Pacific region stocks advancing by 18% and European stocks by 25%. Emerging Markets stocks, on the other hand, were left in the dust with a loss of close to 3%. The Frontier Markets offered excellent diversification benefits with a gain of more than 17%. All in all, 2013 was an exceptional year for stocks despite the gridlock in Washington and the various geopolitical headwinds.



Underpinning the stock market advance was an improving economic picture in the US and in most of the Developed Markets economies. The US economy picked up steam as the year progressed with the latest GDP figures indicating an annualized growth rate of 4.1% compared to 2.5% for the prior quarter. Many economists see continued progress in 2014 with the US economy expected to grow by 3%, or possibly higher. Europe's growth is also expected to accelerate; even the "PIGS" (the acronym for the economies of Portugal, Italy, Greece and Spain) are expected to post modest economic expansion in 2014 with all but Greece climbing out of recession. Likewise, Japan's economy should continue to benefit under the pro-growth policies of "Abenomics", i.e., the economic stimulus program introduced in 2012 by their Prime Minister Abe. For the Emerging Markets (EM), the picture is mixed with growth in the "BRIC" economies (Brazil, Russia, India and China) expected to bottom out and improve only modestly in 2014. Finally, economies in the diverse Frontier Markets (FM), comprising 22% of the world's population, are expected to expand at higher growth rates than both the Developed and Emerging Markets.

Given the generally favorable economic forecasts for the global economy in 2014, should investors expect another strong year for stocks? After all, momentum might well push stock prices higher as investors continue moving money from low yielding cash and bonds into the stock market. Or, should investors expect a pullback in stock prices given the extraordinary returns in 2013? Perhaps the stock market has already priced-in the positive economic outlook and performance in 2014 may prove disappointing. As with every New Year, the prognosticators have offered up their predictions for the economy and stock market. While there is a general consensus about the growing strength of the economy, predictions for the stock market are diverse, though most see higher prices by year end. Several strategists are predicting a 10% correction before stocks move modestly higher for the year while one of the more optimistic forecasts is for the Dow to reach 18,000 by year-end (18,000 is about 10% higher than the current level representing an *average* year for stocks).

Some Risks to the Outlook

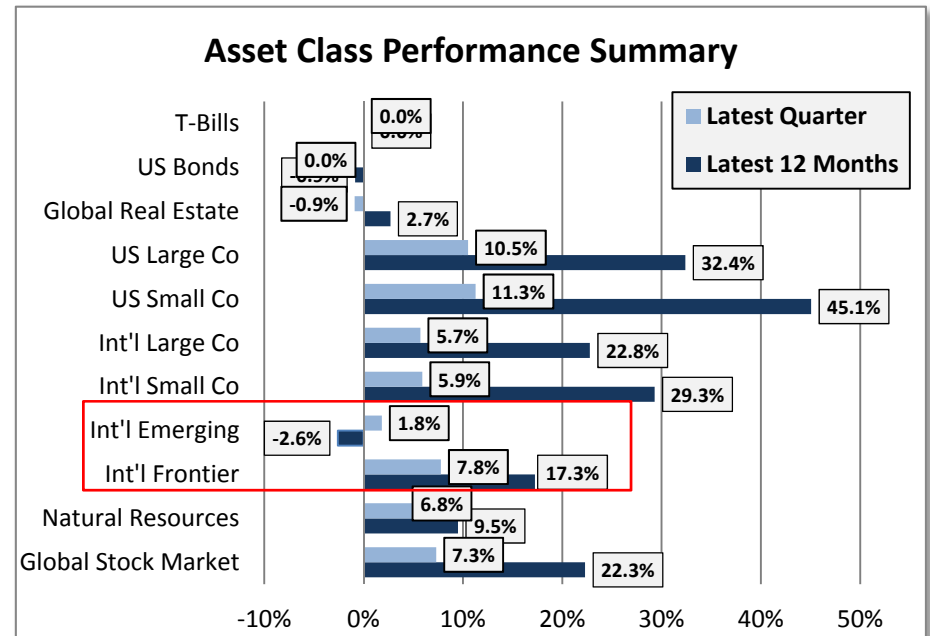
A significant risk to the outlook is the impact of the Federal Reserve's plan to gradually withdraw, or "taper", its monetary stimulus. Just the mere utterance

of the tapering plan by then Chairman Bernanke last June sent the market into a nosedive. Since then, against the backdrop of a strengthening economy, investors appear to have accepted the reality of the Fed's inevitable tapering actions; however, if the Fed unwinds its stimulus too quickly and economic growth stalls, corporate earnings would likely suffer causing stock prices to plummet. The other side of the argument is that if the Fed doesn't begin unwinding its stimulus soon enough, the economy may overheat and we'll be faced with much higher inflation. Fortunately, the new Fed Chairwoman, Janet Yellen, appears to have a firm grasp on the reins handed over to her by Ben Bernanke, but only time will tell whether or not she and the Fed will be successful in their attempt to unwind stimulus while maintaining a "Goldilocks Economy", i.e., an economy that's neither too hot nor too cold.

There are other threats to the outlook, of course, including geopolitical risks, terrorism and natural disasters; most of which, unfortunately, are inherent realities of the modern world. While such risks are highly unpredictable, we know from recent experience that one of the best ways to weather a variety of storms is to structure portfolios with an appropriate *balance* between safe assets and riskier long-term growth assets. Over the past fifteen years we've experienced wars in the Middle East, two stock market crashes, a major housing bubble, terrorist attacks and the worst economic recession in more than eighty years. By maintaining our *globally diversified balanced* portfolios, we've been able to not just weather the various storms, but we've been able to take advantage of the highs and lows of the stock market's volatile path. *Selling high and buying low is not just a catchphrase for wishful investors; it's a practical and profitable discipline that can be applied in all economic conditions through the process of regular portfolio rebalancing.*

Asset Class Performance Review

For the latest quarter, the Global Stock Market gained 7.3% as all of the stock asset classes posted positive returns with the exception of Global Real Estate. The top performers were US Small Co's (+11.3%) and US Large Co's (+10.5%); gains which reflected growing optimism about the US economy. The International stock asset classes were also positive, with the Frontier Markets leading the way (+7.8%), followed by Int'l Small (+5.9%), Int'l Large (+5.7%) and Emerging Markets (+1.8%) lagging behind. The mixed economic outlook for the Emerging Markets has soured some investors toward this asset class (a little too much so in our opinion). Natural Resources posted a bit of a rebound for the quarter as investors saw attractive valuations in energy stocks



following their lagging performance. Global Real Estate (-0.9%) paused for the quarter and now looks more attractive from a valuation perspective. US Bonds were flat and T-Bills didn't budge. Rates will likely rise over the next few years providing more attractive returns, but for now, we continue to recommend maintaining a short average maturity for our clients' bond allocations in order to reduce interest rate risk.

For the trailing twelve months, the returns were extraordinary for most of the stock asset classes led by US Small (+45.1%), US Large (+32.4%), Int'l Small (+29.3%), Int'l Large (+22.8%) and the Frontier Markets (+17.3%). Global Real Estate was disappointing (+2.7%), but the major laggard was Emerging Markets which posted a loss of 2.6%. Investor fund flow has been moving out of Emerging Markets (EM) toward the US, Europe and Japan as prospects for the Developed economies improve. As a result, EM stock prices are now at depressed levels relative to the Developed Markets and may represent an attractive *long-term* investment opportunity (more on this topic below). Importantly, the Frontier Markets (FM) delivered robust gains in 2014 (+17.3%) in stark contrast to the Emerging Markets; a differential of almost 20% and offers a clear reminder of the benefit of *regional* diversification. Natural Resource stocks gained a respectable 9.5% for the year with most of it coming in the fourth quarter. The Global Stock Market gained 22.3% which is

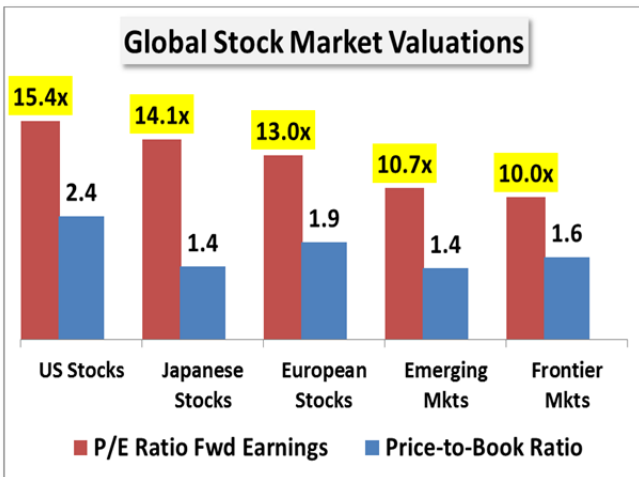
more than double its historic average annual return. T-Bills had a zero return and US Bonds, reflecting rising interest rates, posted a small loss of 0.9%.

Asset Class Valuations

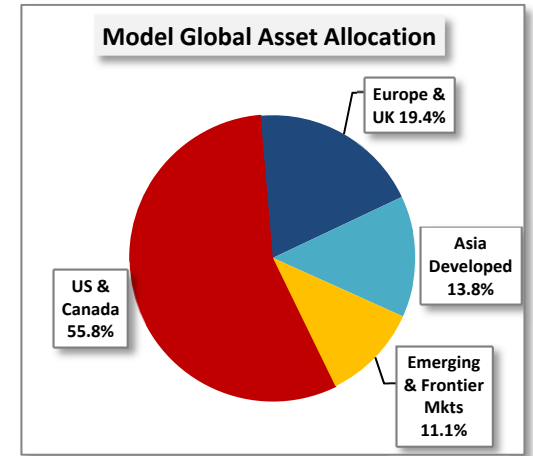
Paying close attention to stock valuations provides guidance in determining which asset classes to under-weight and which to over-weight. Extensive academic research has demonstrated that “value” stocks, i.e., stocks trading at lower prices relative to their earnings and book value, have over time outperformed stocks with higher price valuations (i.e., growth stocks). Eugene Fama, Professor of Finance at the University of Chicago Booth School of Business and member of the board of directors at Dimensional Fund Advisors (DFA), won a Nobel Prize in Economic Science last year as a result of his lifetime of stock market research. By looking at historic data, he found that *out of favor* value stocks tend to sell for “discounted” prices while growth stocks

tend to sell for “premium” prices (in other words, investors are willing to pay a higher price for stocks of companies that have been successful in the past). Fama also found that while value stocks are riskier than growth stocks, i.e., exhibiting greater price volatility, investors have been compensated for accepting the additional risk through superior *long-term* price appreciation.

Furthermore, by looking at the valuations of various asset class groupings of stocks, one can favor those asset classes which appear more attractively priced. Currently, among the major geographical regions, US stocks are the most expensive based upon Price to Forward Earnings Ratios (15 x Earnings) while the least expensive are stocks in the Emerging and Frontier Markets (trading for 10-11 x Earnings, or *one-third less expensive*). European stocks appear to be more attractively priced than both US stocks and Japanese stocks. As a result of these and other valuation measures, we have adjusted our model portfolio’s strategic asset allocation weights by reducing the target to US stocks to about



55% from 57% and raising the allocation to foreign stocks to 45% from 43%. The model’s Emerging and Frontier Markets weight is now just over 11% with Europe at 19.4% and Developed Asia close to 14% (these percentages relate to the stock allocation of our model portfolio and exclude bonds). One might ask if we shouldn’t be reducing the US weight even further given the apparent foreign stock *discount*. We agree with this logic; however, the latest move comes following a series of similar adjustments we’ve recommended over the past few years. Our approach has always been to advise *incremental* adjustments to the strategic asset allocation model to reduce timing risk, i.e., an approach similar to Dollar Cost Averaging. Furthermore, our investment committee meets monthly to review our asset allocation targets and we may recommend additional adjustments later in the year.



Final Prognostication

Stocks had a spectacular year in 2013 driven by improving global economic conditions in the US and abroad. Most economists see continued improvement as the global economy recovers from the Great Recession. While the strategists we follow see positive returns for stocks in 2014, we shouldn’t be surprised to see a 10% correction before stocks resume their upward path. Of course, wildcard events could derail the outlook which argues for a cautious approach balancing safety and capital preservation against the long-term quest capital appreciation. The globally balanced approach has worked very well in the past and we see no reason why it won’t be up to the task in the future (with appropriate adjustments along the way). Here’s to a healthy, prosperous and more peaceful year ahead!

