

## **July 2013 Stay the Course**

The volatility of the past 45 days in the market has not been seen or felt since the financial crisis of 2008. Our job is to try to understand what is moving the markets, and do our best to select investments that will help our clients fulfill their long term financial goals. We are also here to reassure that we do not believe that the market's behavior (both good and bad) over the first six months of 2013 is sustainable.

Since the financial crisis of 2008, the markets have only known one mode for monetary policy direction which is printing money, known as quantitative easing (QE). This resulted in record low interest rates for an extended period and gold moving to record highs because of the real fears of the unknown effects of stopping QE. Equity investors were driven to buy stocks because of the artificial low returns of the bond market, and over the past seven months embraced the "Don't fight the Fed" mantra pushing the S&P 500 to an all-time high. This rally is not based on fundamentals.

On May 22, 2013, Ben Bernanke made a speech announcing that the Federal Reserve may consider "tapering" back on its bond purchase program in September. This means that the Fed sees the economy improving, albeit very slowly, and that it is just thinking about reducing the amount of monthly bond purchases of \$85B (i.e. printing money). The markets overreacted causing a mass selloff in both equities and fixed income in June.

An economy that relies on a central bank purchasing over a trillion dollars' worth of fixed income assets, while pushing interest rates artificially lower, is not one that is sustainable for the long run. We have known this over the past 5 years and have taken great care to select investments based on sound company fundamentals, income paying securities, shorter maturities, and short durations. All of these components should help to reduce volatility and principal loss when rates do finally rise. In short, we have prepared the portfolio for rising rates. However, no one could foresee 10 year Treasuries moving from 1.63% to 2.62% in just 30 days, nor 30 year fixed rate mortgages moving from 3.25% to 4.5%. Remember, when rates go up, bond prices go down. To give color to this point, the Barclay's Global Aggregate bond index is down (4.83%) for the year, the 10y US Treasury is down (4.17%) and Treasury Inflation Protected bonds are down (7.39%) year to date. The price reaction, we feel, is only temporary.

While this has caused price declines in our fixed income investments, the fundamentals of each of our investments are still strong and, most importantly, the income they produce has not changed.

Investors and markets must now adjust to a new paradigm where the Fed, while not totally going away, is easing off the accelerator. In short, the markets need to adjust to a long, slow, but inevitable return to a more normal monetary policy environment. The end of financial repression (negative real rates) and a return to more market-oriented conditions is a good thing, but the journey will definitely bring bouts of volatility and likely more "taper" tantrums. This reinforces our belief that we need to have a long-term, diversified plan in mind and discipline to stay on the plan.

As for the performance of your portfolios, let's address each asset class individually:

Stocks/Equities: Our annual growth expectations for the economy over the past several years have been in the 2-4% range, with a focus on healthcare, technology, and energy. The individual stock ETF's that we own have enjoyed double digit returns in line with the markets. Over the past six months, we added regional banks and US large-cap dividend players, and sold our position in Brazil. If our portfolios had been 100% in stocks, we would have also hit all-time highs. However, we have maintained and will continue to maintain a smaller allocation to this asset class due to fears of potential losses due to US fiscal budget deficits, the impact of sequester spending cuts, a slowing global economy, weakening corporate sales and margins, and a recession/depression in Europe.

Fixed Income: Our fixed income investments have included safe, AAA government and municipal securities for principle preservation, single issue corporate bonds for income and principle preservation, and preferred equities/ funds seeking higher yields and dependable income streams. This asset class has suffered from the recent volatility in rates, but remains fundamentally strong and well positioned due to our shorter maturities and shorter durations. We quickly sold our most volatile fixed income holding, REM, immediately after the Fed announcement in May. We also lightened up on our longer TIPS.

Precious Metals: Since the Fed's intervention in 2008, we have been fearful of the effects of the non-stop dollar printing press and its potential for rapid, high inflation and therefore have held up to a 7% allocation in some portfolios as an insurance policy. We started buying gold at \$800 and did ride it up to \$1700. The major cause of the overall declines in our portfolio is due to the declines in gold which is back down to \$1250. We still believe in the ultimate need to hold hard assets, especially precious metals, because when QE is finally reduced, the dollar will weaken and metals will be the currency of safety. We did reduce our target overall allocation to metals to 5% going forward because gold does have more volatility now than we anticipated due to the trading activity of hedge funds.

In conclusion, the Fed's "experiment" in artificially trying to financially engineer a US recovery has become a huge obstacle to traditional investing. The Fed's QE1 program's goal was to fix the breakdown in the mortgage market, and it worked. All the other QE's were aimed at bolstering economic growth through a wealth effect on spending, but this has not worked. The evidence suggests that this is the worst economic recovery ever. Bank lending has been anemic, low mortgage rates did not encourage first time buyers, and the Fed successfully created a 140% stock market rally but did not improve the fundamentals of the economy. We must remain focused on fundamentals and navigate through the rough patches of today's markets.

We all know that the investors most likely to reach their long term goals are those who remain invested through periods of volatility, and avoid short-term decisions that may take them off course. We remain dedicated to our total return investment approach and disciplined asset allocations. History has shown that this approach holds up to even the most significant market crisis such as the March 2009 meltdown, from which we have completely recovered. We are confident that this approach will also see us successfully through this period of volatility.

As always, we remain dedicated to you and your investments. We invite you to call, write, or stop by anytime with any questions or comments you may have.

Michelle & Jim