CLIENT NEWSLETTER Q2 2013

AMM

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THE BIG PICTURE

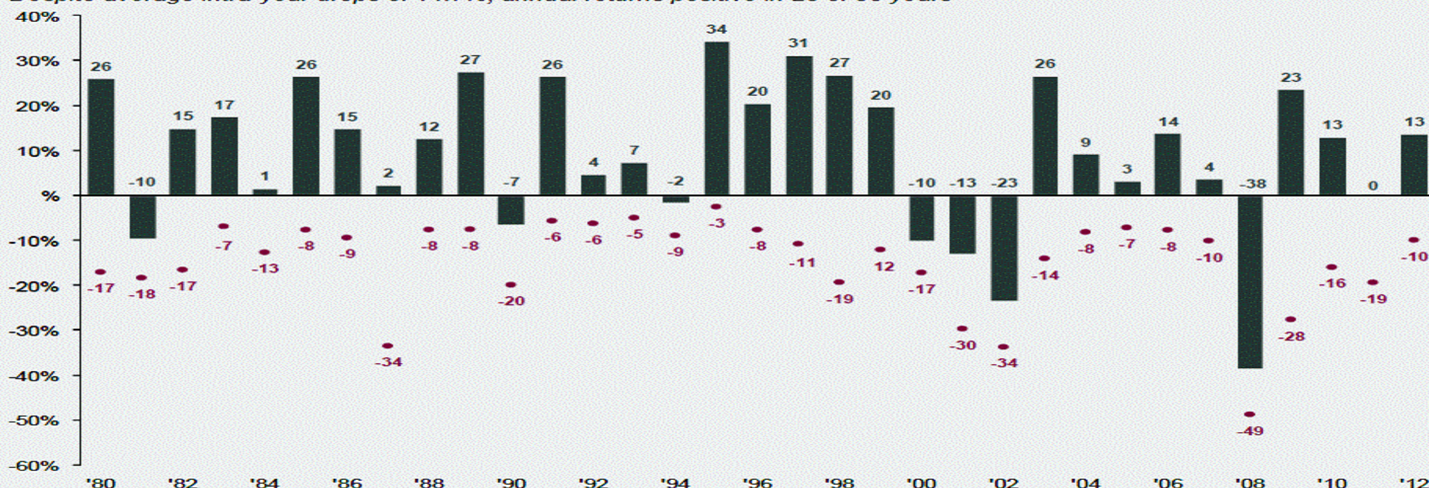
U.S. Stocks got off to a fast start in the first quarter of 2013 returning 10.6% (S&P 500) while International (EAFE) Stocks lagged returning +5.2%. The worst performing asset classes in the first quarter were Bonds (BarCap US Aggregate Index) down -.1%, Commodities (Dow Jones UBS Commodity Index) down -1.8%, Emerging Market Stocks (EME) down -1.9% and Gold down -4%. Broadly diversified asset allocation portfolios generally put up nice returns in the first quarter; however, depending on clients' exposure to international stocks, fixed income, and commodity holdings, these portfolios produced more muted returns than a pure domestic stock portfolio.

Over this period, we have heard expressions of bewilderment about *why* markets should be doing well in such a *weak* economic environment. After all, we are struggling with an unemployment rate more than 25% higher than the 50 year average; economic growth, although positive, has been quite tepid relative to prior recoveries; and, there are a host of macro-economic issues to worry about including the ongoing European debt crisis, the U.S. budget sequestration, North Korean bluster, the re-emergence of Bird Flu in China, etc. Nevertheless, there are some important positives that are helping to support market returns:

1. Consumer Finances Strong: Household net worth is estimated to be at an all time high due, in part, to the recovery in the stock market and housing. Meanwhile, household debt service ratios (debt payments as a % of disposable personal income) are at 30 year lows.
2. Fed in Easy Mode: The Federal Reserve has been explicit in their intention to maintain easy monetary policy (low rates + asset purchases) for the foreseeable future. This has artificially depressed bond yields and made the relative attractiveness of stocks that much greater. (See *Where we are Investing Capital Now* for greater detail.)
3. Pent Up Demand: Everything from consumer items, like automobiles and housing, to corporate capital goods spending took a severe hit during the great recession; and there is still significant pent up demand for these items.
4. Great Rotation: There are signs that investors have begun to rotate a larger share of their assets into stock oriented funds. Annual net flows into domestic stock mutual funds have been negative since 2005; however, in the first quarter of 2013, flows into stock funds turned positive to the tune of $17 Billion. One data point does not make a trend, but it is not surprising to see investor interest towards stocks begin to brighten given the miserable returns available from most high quality bonds.

None of this is to suggest that the market will not correct from these levels. In fact, it would surprise the great majority of professional investors if there was not some kind of correction in the 2nd or 3rd quarter of this year after such a strong start. Whether this correction materializes and is of the 5-10% variety or something scarier is anyone's guess. ***The ability to predict the timing and magnitude of the next market correction is impossible to do with any consistency and should not be a major driver of your long-term portfolio strategy.*** Chart A shows U.S. calendar year stock returns (S&P 500 - grey bar) and maximum intra-year declines (in pink) since 1980. Despite average intra-year drops of -14.7%, markets were up approximately 75% of the time. Long-term stock market *investing* is widely stacked in the investors favor as long as they are invested.

(OVER)



Source: Standard & Poor's FactSet, J.P. Morgan Asset Management. Data as of 3/31/13. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. **Chart A**

Where We Are Investing Capital Now*

Despite the long-term odds of stock investing being stacked in an investors favor, we still view a blind buy and hold at any price strategy as sub-optimal. Most of the portfolios we manage are of the asset allocation variety. How much should be invested in stocks, bonds and other diversifying assets (commodities, gold, real-estate, etc.) in light of your financial condition and in view of your investment time horizon and goals? In deeply overpriced markets, we would expect to be underweight stocks. Alternatively, in today's environment where we have historically low interest rates on bonds, we are generally underweight traditional fixed income (bond) instruments. Below, we highlight where we are investing capital now across the three primary asset classes that make up our asset allocation portfolios.

Stocks—US Stocks: We continue to tilt domestic stock exposure towards large cap dividend paying holdings and smaller growth oriented funds, where applicable. The majority of our clients hold some position in the S&P dividend aristocrats exchange traded fund (SDY) which invests in a basket of companies with a history of raising dividends for at least 25 years. For investors interested in holding *individual dividend paying stocks*, we also offer the AMM Dividend Strategy. The goal is to build a diversified portfolio (20-30 stocks) of companies with the ability to grow their dividend payouts over time. For clients invested in this strategy, we are seeking to build an enduring income stream in future years while also seeking capital appreciation. Regardless of whether you own individual dividend paying stocks or funds that hold them, dividends provide:

- Income to Owners: Investors in common stocks *own* a pro-rata share of the companies in their portfolio and, thus, should think like owners. Many of our clients are business owners themselves, and once all expenses have been paid and necessary funds have been retained for future growth, they typically pay a bonus or dividend to themselves. Large publicly traded companies effectively work the same way; they just have many more owners. While businesses may need to reinvest a portion of these profits for future growth initiatives, the remaining profits are available to pay out to shareholders in the form of dividends. While we do not think companies should sacrifice growth just to pay a dividend, we do favor companies that have the ability to do both.
- Total Return*: From 1926 through the end of 2012, stocks in the S&P 500 have annualized returns of 9.7% per year with 4.1% coming from dividends and 5.6% coming from capital appreciation. This ratio has varied over the years. In the 1940's, when stocks returned 9% per year, dividends accounted for wholly 2/3 of this return. In the lost decade of the 2000s, stocks in the S&P 500 annualized at *negative* .9% per year; however, without the positive return of 1.8% provided by dividends, stocks would have lost -2.7% per year in the last decade. ***In all decades since 1926 dividends have provided an important component to a stock investors' total return.***

**Data points in this section provided by: Standard & Poor's, Ibbotson & J.P. Morgan Asset Management.*

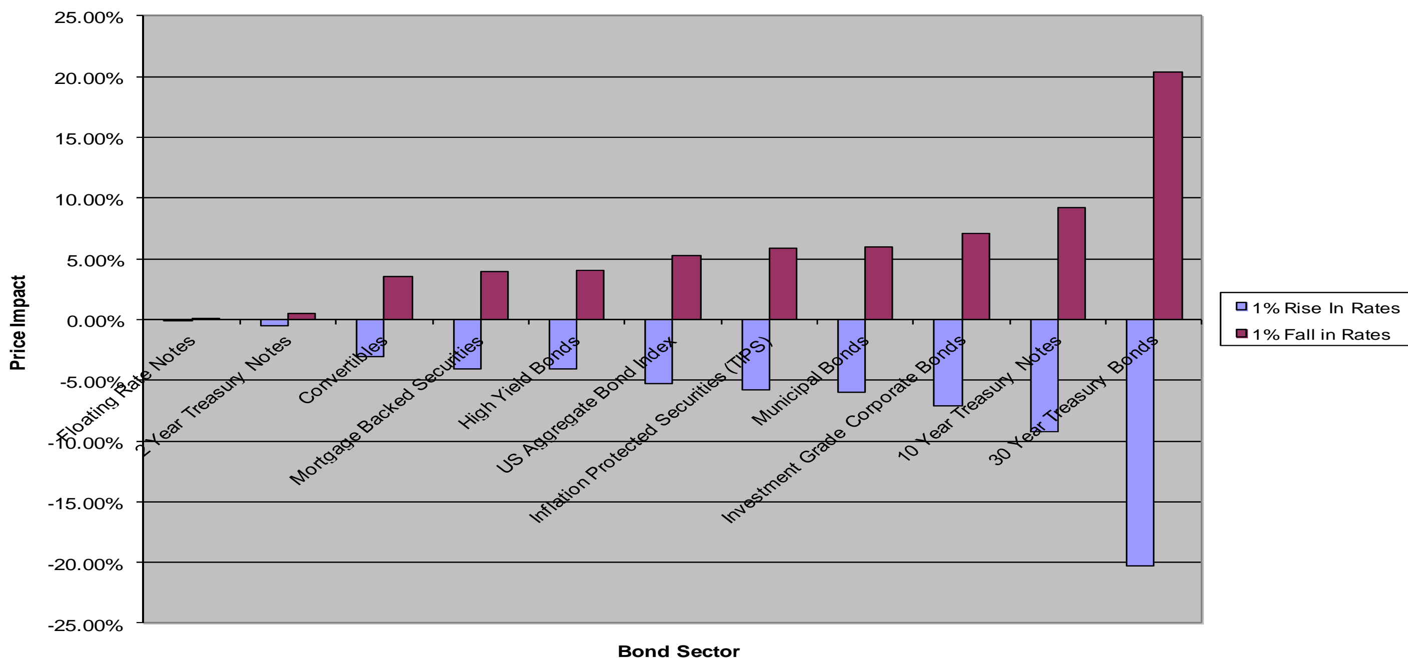
(Where We Are Investing Now cont.)

Not only do we like the long-term prospects of dividend paying companies, but we think the current environment is uniquely positioned to benefit companies with rising dividend prospects. Research from Pew suggests that approximately 10,000 baby boomers are retiring every day. With interest rates on high quality investment grade bonds at generationally low levels, retirees and those investing for retirement are looking for ways to increase their income. Blue chip dividend paying stocks that offer both income and growth potential appear well suited for this challenge.

Stocks—International Stocks: Internationally, we have focused the majority of our stock exposure in Emerging and Frontier markets which have better overall growth prospects than their developed market peers. Unlike U.S. markets, emerging and developed international markets have not yet reached new all time highs. In fact, international developed markets (MSCI EAFE Index) would need to rise around 46% to reach their 2007 highs, while emerging markets (MSCI EME Index) would need to rise more than 20% to hit their 2007 peak. Still, given the heavy weighting to problematic European economies in the EAFE index, we continue to favor emerging markets over developed.

Diversifying Assets: We continue to hold an allocation to Gold and commodities as both an inflation hedge and portfolio diversifier. In the first quarter, we eliminated our position in the Closed-End Fund of Canada (CEF) for the majority of client portfolios custodied at Schwab. CEF invested in a blend of gold and silver bullion; however, Schwab recently added a commission free gold exchange traded fund called the Swiss Gold Fund (SGOL) which we felt would provide us with a better and lower cost way to invest in Gold within client accounts held at Schwab. For the majority of accounts custodied at TD Ameritrade, we have continued to hold CEF as they do not yet provide a commission free precious metals fund.

Fixed Income (Bonds): The challenge in fixed income investing is to provide a fair (above inflation) rate of return without taking significant interest rate risk. This challenge is most pronounced for the "conservative" investor who has a shorter time horizon and/or cannot tolerate the volatility inherent in a stock heavy portfolio. Chart B below shows the price impact on various fixed income instruments of a 1% rise or fall in interest rates. The biggest impact is on long-dated treasuries (30 year) where a 1% rise in interest rates would result in a 20% price decline on these securities. The investor in this bond is taking enormous risk relative to the low 3% rate of return he/she is able to earn on the bond. Over the last year, we have continued to move our clients fixed income exposure to less interest rate sensitive issues.



Source: U.S. Treasury, Barclays Capital, FactSet, J.P. Morgan Asset Management, AMM.

Chart B

(Where We Are Investing Now cont.)

Where fixed income is a component of a client's investment mandate, we continue to invest in a mix of investment grade bond funds with relatively low average durations (< 5 years) so as to minimize the impact of an unexpected rise in interest rates. Additionally, we continue to invest in strategic income positions like floating rate bonds, absolute return bond strategies and foreign bonds which we feel offer much better risk/reward prospects relative to other sectors of the fixed income markets.

**Individual accounts will vary based on the client's stated objectives, risk tolerance, and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities listed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy in greater detail.*

Housekeeping

In March, we filed the annual amendment of our firm's ADV brochure dated March 31, 2013 with the Securities and Exchange Commission. Pursuant to regulatory requirements, we have included a document that itemizes material changes to the last annual amendment filed in March of 2012. If you would like to request a full copy of the ADV filing, please do not hesitate to contact our office at (858) 755-0909.

As always, it is a great privilege to be entrusted with the stewardship of your retirement and investment assets.

Your Portfolio Management Team

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