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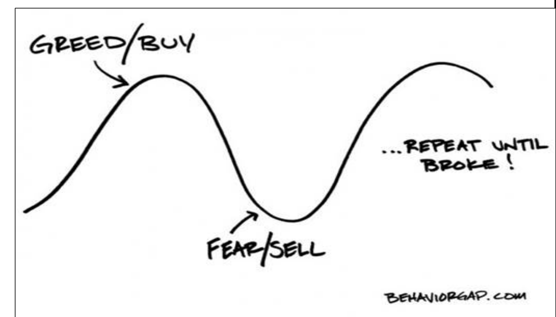
The Big Picture ~ New Year's "Investment" Resolutions

Now that the indulgences of the holiday season have worn off, our annual tradition of setting self-improvement resolutions begins. Interestingly, the origins of these New Year's resolutions have been traced as far back as the ancient Babylonians who made promises to their gods at the start of each year that they would return borrowed objects and pay their debts. In more recent times, it is estimated that some 40% of Americans set New Year's resolutions, many financial in nature. In addition to common financial resolutions like setting a budget, saving more and paying down debts, here are three of our favorite "Investment" resolutions for 2014:

1. Train your brain: Perhaps the greatest obstacle to successful investing is ourselves. While we all know the adage "buy low, sell high", it is frustratingly hard to put in to practice. When times are difficult, fear and trepidation rule the day, causing investors to shore up their finances or "de-risk" their portfolios by selling. Alternatively, periods of strong markets and economic strength tend to breed complacency and greed, pushing more money into the market, even at higher prices.



   We don't claim to have an easy, quick fix to this psychological dilemma. But, recognizing this inherent weakness in our collective investment psyches is a good start. Accepting that a long-term investment program should not be clouded by short-term decision making is a prudent next step. Real wealth comes from the compounding of investment returns over time, not from deftly buying and selling securities in an attempt to "time" the market over the short run. Finally, preparing for the inevitable market correction when times are good is an important final step. It can help us make better, less emotional decisions in the event of a sell off.

2. Focus on Dividends and Income, not Current Yield: In a low interest rate environment, investors looking for income naturally seek out the highest yielding investments in a particular asset category. For example, treasury and municipal bond investors may seek to buy a 30 year bond because it has the highest current yield. An investor who buys a 30 year treasury bond (yielding 4% as of 12/31/13) is taking significant interest rate risk as it would only take a 1% rise in rates to create an 18% drop in the price of the treasury. In stocks, there are many choices offering 10% yields; but, generally, these companies are paying out all of their earnings, and sometimes even more than they've earned. The volatility and financial risks associated with these investments is generally very high and not worth the risk to the investor's capital.

   Rather than focus on yield, investors should focus on their actual *need* for income. For those in the growth and accumulation phase of their investment portfolio with no need for current income, we recommend seeking dividend growth over time. It is much better to invest in a stock with a modest 2% dividend yield that has good prospects for dividend growth and capital appreciation than a "high yield" stock with more speculative prospects. For investors in the "distribution phase" (retirement) who want current income, we generally recommend a balanced approach including dividend growers as well as more conservative bond exposure. Our Dividend Income Strategy is uniquely positioned for both kinds of investors. Please call us if you want to learn more about this strategy.

3. When Cash Pays Nothing, Invest in Something: The post-2008 policy of the Federal Reserve has been to maintain extremely easy monetary policy in an attempt to help stimulate economic activity. Recent data suggests that they have been at least partly successful in this endeavor; however, the dark side of this policy is that savers and conservative income (bond) investors are being penalized with extremely low returns on their cash, CDs and money

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(The Big Picture cont.)

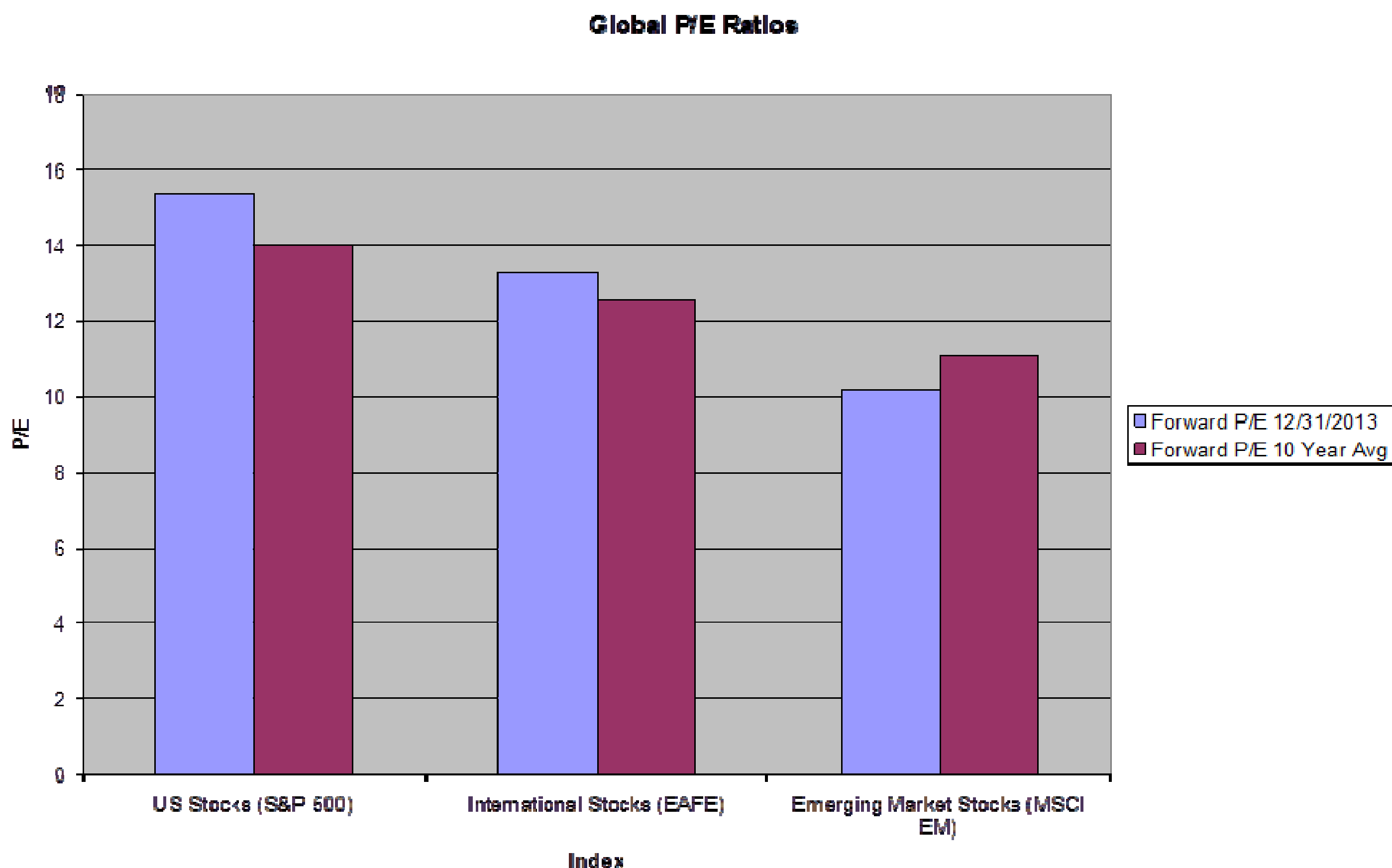
market funds. While we recommend most individuals have liquid reserves of at least 3-6 months' worth of living expenses, if you find yourself with a significant portion of your net worth invested in cash, chances are good that your purchasing power will continue to erode over time due to inflation.

The perceived "safety" of cash may be appealing; however, with inflation running 2% above the return on cash assets, these funds are essentially losing 2% in purchasing power every year, basically guaranteeing a loss. Of course, this view should not to be confused with our tactical use of cash in investment portfolios (i.e. we may hold a modest amount of cash as dry powder for use in the event of a market correction or hold a high percentage of cash as we get a new lump sum invested).

Where We Are Investing Capital Now*

Stocks: 2013 was a goldilocks year for US stocks with the S&P 500 gaining more than 25% for the 18th time since 1928 and only suffering one market correction of at least 5% (the least since 1995). While we remain cautiously optimistic on domestic stocks for 2013, last year's strong returns have lessened our expectations for returns over the next few years. An historical analysis of other 25% plus years shows that the average return in the following year was +6%. Additionally, following very strong years, the S&P 500 posted a positive return 2/3 of the time. While these statistics offer reasonably good odds, they should at least temper our expectations for domestic stock returns in 2014.

The good news is that tempered expectations and modest returns aren't always a bad thing. It is better for the stock market to rationally digest strong gains and grow at a more reasonable pace than to rapidly inflate and become another costly bubble. The chart below shows current and historical (10 year average) P/E ratios for three broad global stock indices. While valuations are slightly above their long term averages for US and international stocks, they are far from bubble level valuations. For example, at the peak of the technology bubble, US stocks traded at a P/E of 26 vs. today's P/E of 15.



(Where We Are Investing Capital Now cont.)*

As we enter 2014, we are focused on the performance gap between large US stocks and their international counterparts. While US markets have broken out to new all time highs, international stocks (EAFE) are still trading well below the pre-crash highs of 2007. We expect this gap to close as the global economy continues to heal. We recently swapped our position in Germany (EWG) for broader international exposure. EWG outperformed developed international stocks (EAFE) by more than 9% in 2013, so we decided to lock in these relative gains and move towards a more diversified international position.

Moreover, while developed international markets are trading slightly above their long-term averages, *emerging market stocks are currently trading below their long-run averages*. Three year annualized returns for these stocks are negative 2% vs. positive 16% for US stocks, which we feel provides an opportunity for this asset category to play "catch up" over the next few years. For most asset allocation oriented portfolios, we intend to increase our exposure to these markets in the first quarter of 2014.

Bonds: For some time, we have focused on positioning our clients' bond portfolios for an inevitable rise in interest rates. This four pronged strategy includes: 1) positioning the core of a client's fixed income allocation in high quality investment grade bonds with short and intermediate maturities (shorter maturities are less sensitive to interest rate moves); 2) diversifying more of the portfolio into strategic income funds, including floating rate notes and strategic funds with more flexibility to succeed in a rising rate environment; 3) generally underweighting bonds relative to a more normal interest rate environment; and 4) where applicable, allocating a portion of a client's bond allocation to "inverse" bond funds that should rise in price when longer term interest rates rise.

While clients with very long time horizons and/or a very healthy tolerance for risk may choose to avoid bonds altogether, we view a core allocation to bonds as providing a prudent level of diversification to most strategies. Of course, the weight of this allocation will depend on the client's individual circumstances.

Diversifying Assets: For multiple years now, we have included "diversifying asset" exposure as an inflation hedge. Commodities have suffered over this recent period as monetary inflation has remained subdued. It is important to segregate the concept of monetary inflation (i.e. the increase in the cost of goods and services) and asset price inflation. The last few years have brought significant asset price inflation. For example, stocks, real estate and most other asset categories have increased in value on the tailwinds of low interest rates and a steadily improving economy. Surprisingly, there has not been a corresponding increase in monetary inflation, perhaps because the economy is not yet running at full capacity. Once the economy hits full capacity, we feel the risk of an inflation acceleration will be high. While we made a reduction to our gold position in Q4, we continue to allocate a portion of most asset allocation strategies to both gold and commodities as a diversifier and a hedge against future inflation.

**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.*

2013 PERFORMANCE REVIEW

US stock markets cleared a major hurdle last year with the S&P 500 and Dow Jones breaking out to new all-time highs. For the year, domestic (S&P 500) and international stocks (EAFE) were up 32.4% and 22.8% respectively. Most other asset classes struggled throughout the year with bonds (Bar Cap Agg Index) down 2%, commodities (DJ-UBS Commodity Index) down 9.5%, and gold posting its worst return in 30 years losing 27.6%. As would be expected in such a strong market year, our Dividend Income Strategy and other pure stock oriented accounts were our best performing portfolios in 2013. More broadly diversified asset allocation portfolios (which include a varying blend of stocks, bonds, and diversifying assets), provided decent risk adjusted returns, but underperformed the stock market.

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Enclosed is a copy of our Privacy Notice. We can also provide you with a current copy of our SEC Form ADV Part II, at your request. Should you have any questions regarding your investment account(s) or, if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office.

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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