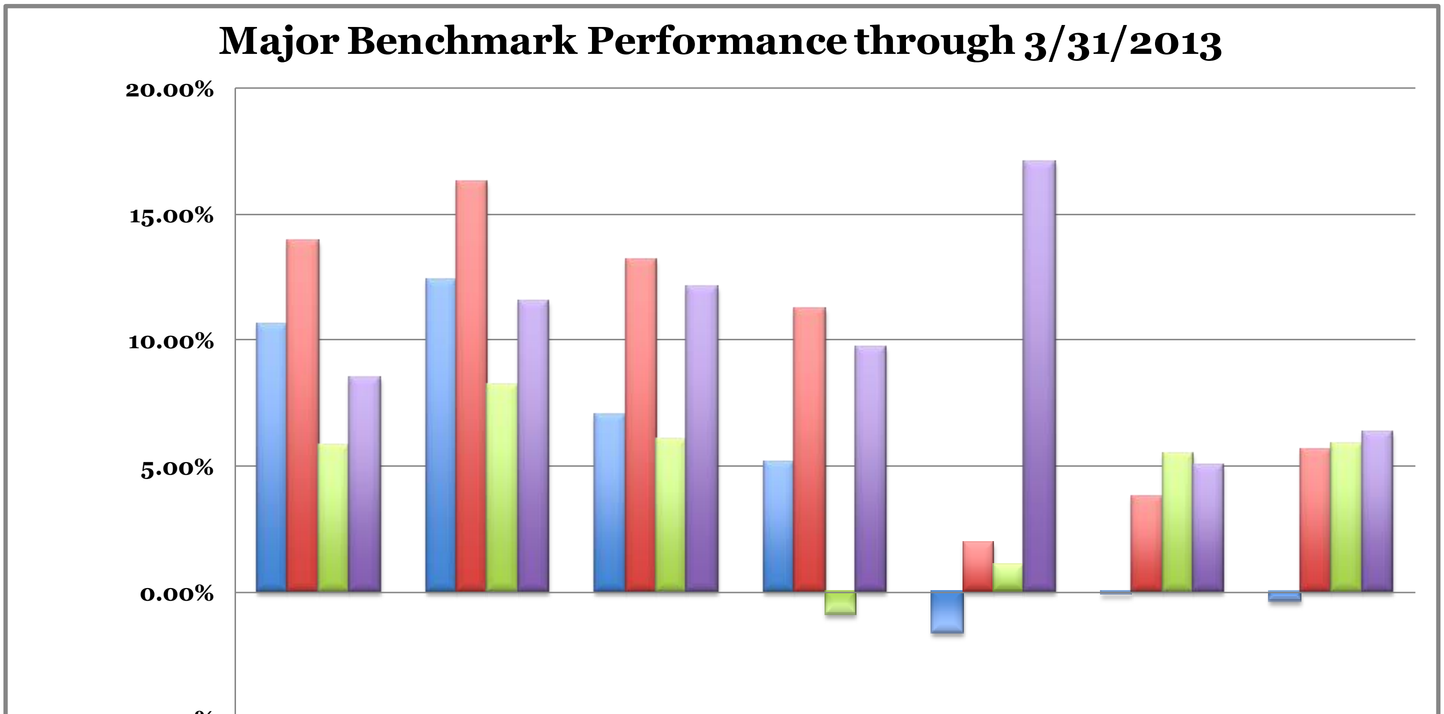
Market Summary and Outlook 1st Quarter 2013

With the income tax deadline now behind you, we thought this would be a good time to review the most recent market performance and the factors affecting future performance.

After a very strong 2012, we began this quarter with the following concerns:

- Potential showdown over the fiscal cliff which included spending cuts, tax increases, or a combination of the two
- Continued concerns over Europe
- Low interest rates and the Federal Reserve eventually paring back its policy of easy money
- The viability of our economic recovery

Investors shrugged off these concerns and piled into US and developed market equities. Fixed income was flat. The major benchmarks are shown in the table below.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
YTD	10.61%	12.39%	7.04%	5.13%	-1.62%	-0.12%	-0.36%
12 Months	13.96%	16.30%	13.19%	11.25%	1.96%	3.78%	5.68%
5 Year (ann.)	5.81%	8.24%	6.07%	-0.89%	1.09%	5.47%	5.89%
10 Year (ann.)	8.53%	11.52%	12.10%	9.69%	17.05%	5.03%	6.32%

The term "fiscal cliff" dominated the airwaves between the November elections and the January 1 deadline for Congress and the President to agree on how to address our deficit. In January, a partial resolution was reached that increased taxes for couples with taxable income exceeding $450K. The Social Security payroll tax increased 2% back to its original 6.2% on income under $113,700. The middle class was largely spared on capital gains tax increases.

The term "fiscal cliff" was replaced by the end of February with "sequestration" which referenced an agreement reached between Congress and the President in August 2011 during the debt ceiling crisis that would result in automatic spending cuts if they could not reach their own agreement. It was believed sequestration was so unattractive to all parties that Congress and the President would reach a better agreement before the deadline. The March 1 (originally January 1 but pushed back) deadline came and went, and the spending cuts did go into effect to everyone's surprise.

The markets remained on an upward trajectory until about mid-March when two events in Europe spooked investors. In Italy, the general election in March resulted in a loss for Prime Minister Mario Monti that was interpreted as an anti-austerity vote. In Cyprus, the banking system imploded quickly and spectacularly. Even though Cyprus is a small country (and not in any of our preferred international stock or bond funds), the bailout is significant because for the first time it affected depositors. Despite these setbacks, the equity markets, including Europe, still ended on a positive note for the quarter.

Going forward

The question is whether the rise in the market during the first quarter is the start of something longer lasting, despite threats from a potential U.S. debt downgrade, the possibility of a European collapse, and a sluggish U.S. economy. In other words, will investors continue to direct money into the equity markets?

Based on the more recent appreciation in stocks and the feeling that cautious investors are missing out, we are witnessing a historical pattern: when the market begins to rally, investors sitting on the sidelines (many since 2008) begin to invest, driving up prices further.

We remain concerned by the Fed's easy money policy and its effect on both stock and bond markets although not enough to try and anticipate when the payments will slow down and how the market would react at that time. There have been too many instances when very smart investors have tried to time the markets based on valid concerns such as this one. However, their timing has been wrong and they ended up worse off than if they had just maintained a long term outlook and a diversified portfolio.

Because interest rates are at historical lows and the economy is still improving, the likelihood of interest rates rising in the next few years is high. What we do not know is when and by how much. When interest rates rise, bond values go down. This was a concern in early 2011 and the press covered the topic aggressively. The downgrade of US debt later that year resulted in a return to the safety of Treasury bonds and bond prices were spared. The concerns have re-emerged and the media is again widely reporting on potentially dire scenarios for bonds.

Although the odds are against a major bond market collapse, we foresee that the most likely scenario for the bond market is one of low yields, higher volatility, and minimal price appreciation, especially if the equity markets continue to appreciate.

Based on the attention fixed income is receiving, we believe now is a good time to review the very important role it plays in a diversified portfolio. Below we discuss the broad categories we use, our rationale, and the risks associated with each category (as there is risk with every asset category, including cash).

A Primer on Fixed Income

As a result of the Fed's easy money policies to stimulate the economy interest rates are at historical lows. Many of you have taken advantage of this by refinancing your mortgages. As much as borrowers (who can navigate the much more stringent requirements for documentation and proof of income) have benefitted, savers in fixed instruments such as bonds are being penalized. With rates so low on high quality bonds, investors have shifted to lower quality bonds (junk or high yield) for a better yield. The problem with that strategy is investors are not being compensated adequately for the increased risk they are taking.

In general, bonds lose value when there is inflation. They also move inversely to the direction of interest rates. Rates have been falling for the past 30 years which has created a strong bull market for bonds. With rates at historical lows, the risk is bonds will lose value when rates go back up. This is a valid concern but the argument is not so simple. Part of a bond's return is its yield which will still be paid as rates go up. Also, in mutual funds (the investment vehicle we usually prefer), as bonds mature, the manager is buying cheaper bonds in an increasing rate environment.

US High Quality

This includes Treasury bonds, corporate and agencies (Fannie Mae, Freddie Mac mortgages). These bonds do not adjust with inflation. The quality is high and the maturity is relatively short term. This is to address the two most significant risks with bonds: that the bond payer will default or that interest rates will rise. Diversification helps address the first concern and avoiding long maturity bonds will help prevent a significant loss in value if interest rates rise rapidly.

While we do not expect US high quality bonds to provide the bulk of a portfolio's long term growth, we do expect this category to hold up the portfolio when the equity markets are down. A good example is the Vanguard Total Bond Index Fund: in 2008 it returned about 5% (mainly from Treasury bonds). That same year, the S&P 500 was down 37% and international equity benchmarks were down by even more. The statistical term is correlation – we like this category because its correlation remains low with stocks.

For clients in high tax brackets, high quality municipal bond funds are another good source of diversification. The risk is whether the municipalities will be able to meet their financial obligations, for example their pensions. This is called headline risk. To counter this risk, we choose low cost diversified funds with established managers that have strong credit research departments.

TIPS (Treasury Inflation Protected Securities)
This is a relatively new category, introduced in 1997. TIPS are treasury bonds whose prices adjust with changes in inflation. TIPS benefit especially when there is an unexpected inflation surprise. Since we are in a very low inflation environment currently, investors forget how insidious high inflation can be to purchasing power. The TIPS category is intended to address the possibility of higher than expected inflation.

International – both developed and emerging markets
International categories, in both stocks and bonds, are important to include in a diversified portfolio. We include funds of developed and emerging market countries whose economies are affected by different factors than the US. Another component to consider is whether the currency is hedged (locked in relative to the US dollar) or unhedged (floating). We include both since currency trends are even more difficult to predict than equity market trends.

As with the US categories, we choose foreign bond funds that invest in mainly high quality and low maturity bonds. After the financial crisis, it became apparent that emerging market countries survived with much stronger balance sheets. Their expected GDP growth rates continue to be higher than developed markets which have older populations, bloated bureaucracies, and high deficits. The reason we do not have a significant overweight to emerging markets is because of political risk, less transparent accounting and disclosure systems, and repatriation of capital risk.

Across all these categories, we keep the quality high and the maturities low to stay consistent with fixed income's role of offsetting volatility in the equity markets. Our preferred bond managers are Vanguard and PIMCO. These comments on fixed income have been simplified in the interests of brevity. We encourage you to contact us if you want to discuss fixed income in more detail.

Maintain a Long Term Outlook
Given how much US equity markets have risen in the past several months, we do not believe the markets are undervalued. We also, however, do not believe the markets are so overvalued that we would recommend selling equity positions. International markets, especially emerging markets, seem like attractive buys since their performance has been more modest.

What is remarkable is how much equities have rallied since the financial crisis. It is only recently that 5 year annualized equity benchmark performance is better than 5 year annualized fixed income benchmark performance. To us, this just reinforces our philosophy of maintaining a diversified portfolio including fixed income and not trying to determine which category will outperform.

As always, we encourage you to call or email anytime. We thank you sincerely for your confidence in us.

Janet & Barry