Market Summary and Outlook

Executive Summary

The stock market continues to be volatile as reported by the media, which announces one day that the market has appreciated the highest percentage since (whenever) only to report that the market just dropped by the most significant percent since (whenever). To make the volatility and media reporting more aggravating, the explanations given for market appreciation one day seem to be the same explanations given for the declines the following day.

Despite the volatility and conflicting explanations in the media, here's what we know (today):

- ***The broad US market, as measured by the S&P 500, is still up year to date***
- ***The US economy continues to improve slowly and is predicted to continue to improve***
- ***The world economies are (currently) a drag on the stock markets***
- ***Uncertainty about the Federal Reserve's view on the market and potential changes in fed policy are significantly contributing to the (current) volatility of the stock market, especially US small cap***

Despite the volatility and conflicting explanations in the media, here's what we expect:

- ***Diversified portfolios are the best defense in a volatile market***
- ***The US economy will continue to improve***
- ***The world economies will continue to be a drag in the short-term, but will improve over the long-term***
- ***The Federal Reserve will eventually raise rates which is a posiive reflection on the US Economy***
- ***Markets will continue to be volatile at least in the short term***

Despite the volatility and conflicting explanations in the media, here's what we recommend:

- ***Stay the course and maintain a long term outlook…do not pull out of the stock or fixed income markets (and miss the upside)***
- ***Do not try to time the market (including sub-markets, i.e., U.S. vs. foreign markets, or individual mutual funds)***

Following is a summary of what has occurred year-to-date, this quarter and the last few days.

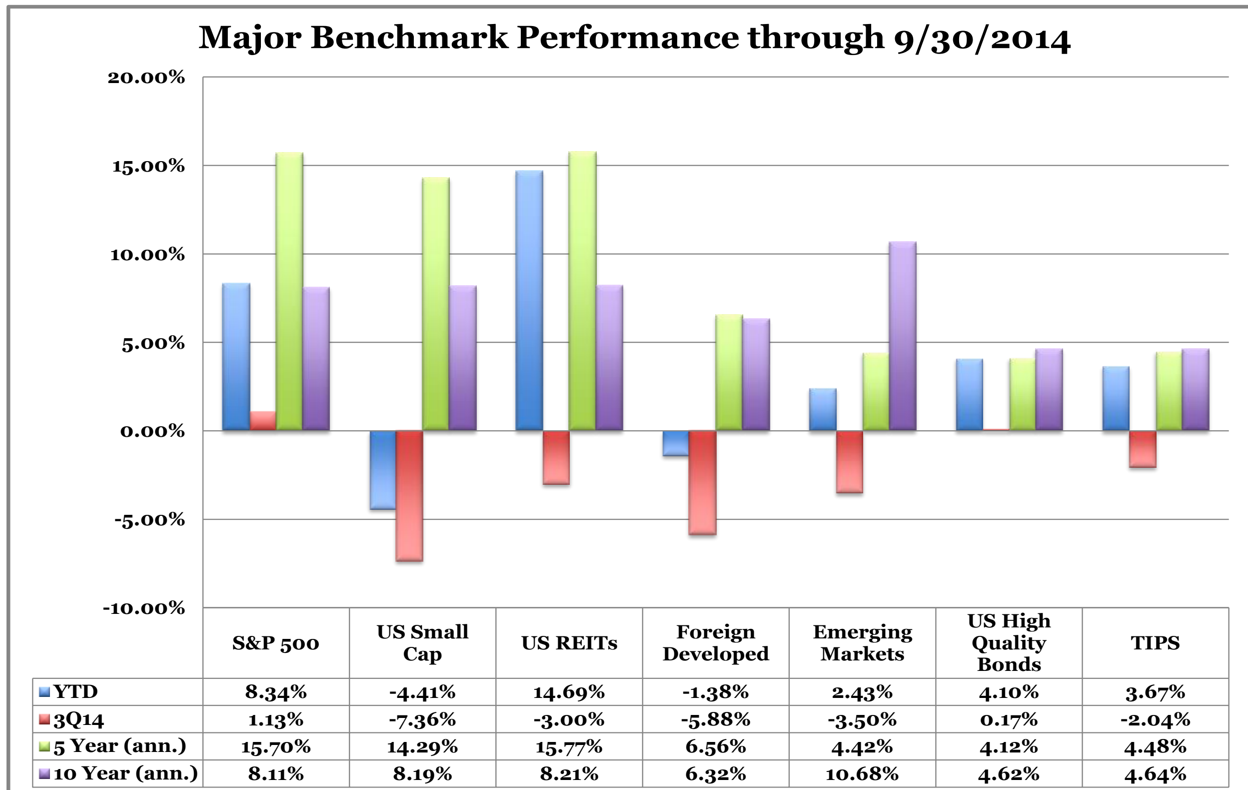
3rd Quarter 2014

The 3rd Quarter was one marked by uncertainty. The markets had a slight downturn in July, recovered in August, while September and early October brought volatility.

Markets have been especially volatile in early October; this is an unfortunate part of being in the market. In any given year, the equity markets can and do decline, sometimes markedly. However, in

most years, the equity markets end with positive numbers, and the long term trend for stocks is positive.

As is evident in the chart below, many asset classes were negative for the quarter, though the S&P 500 stock index and Barclays Aggregate bond index were up. The international equity drops were largely due to a strong US dollar. There were major geopolitical setbacks that overshadowed mostly positive economic data, which will be discussed below.



	S&P 500	US Small Cap	US REITs	Foreign Developed	Emerging Markets	US High Quality Bonds	TIPS
YTD	8.34%	-4.41%	14.69%	-1.38%	2.43%	4.10%	3.67%
3Q14	1.13%	-7.36%	-3.00%	-5.88%	-3.50%	0.17%	-2.04%
5 Year (ann.)	15.70%	14.29%	15.77%	6.56%	4.42%	4.12%	4.48%
10 Year (ann.)	8.11%	8.19%	8.21%	6.32%	10.68%	4.62%	4.64%

Source: DFA

Macroeconomic

Within the US, the economy continues to grow. The latest GDP number exceeded expectations at 4.6% annualized (beating the previous 2Q estimate of 4.2%). The GDP expectation for 2014 is in the 2 to 2.5% range. Economists are optimistic that we will have a good earnings season.

Late last week, the newest unemployment report indicated 248,000 jobs were created in September. Unemployment now stands at 5.9%, the lowest level since August 2008. The US is now below the 50 year average of 6.1%. The Federal Reserve considers 5.4% unemployment to be “full employment.”

Wage growth continues to be modest, which should temper inflation expectations. The market volatility within the US is being caused partly by investors trying to predict when the Fed will start to raise interest rates. An increase, should it occur, wouldn’t necessarily be without benefit, as consumers are sitting on $16T of short term investments such as CD’s that will benefit from a higher yield.

Corporations also continue to sit on a significant amount of cash. As of 2014, cash is about 30% of the assets of S&P 500 companies, up from 14% in 1999. On the bright side, pent up demand seems to be easing, as corporate capital expenditures are finally picking up and consumers are spending more on big ticket items such as cars and housing.

Despite the uncertainty in the rest of the world related to geopolitical issues, current growth and estimates for 2015 are for the most part positive, with albeit lowered forecasts from the IMF and Fed. A stronger dollar has pushed down performance of international equity markets.

While the S&P 500 is the best performing market so far in 2014, this has not always been the case. We thought this newsletter would be a good time to show one of our favorite charts. Here is the periodic table showing broad asset class returns going back to 1999. Broad asset classes represent different stock and bond categories and the chart shows how they perform each year. Please note there is no discernable pattern, which underscores our philosophy of maintaining a long term outlook and a diversified portfolio. Also, take note of the wide range of returns, especially in 2008.

The Randomness of Returns

Annual Return (%)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Highest Return	66.4	31.0	14.0	7.6	69.2	35.1	34.5	36.0	39.8	8.8	79.0	28.1	9.4	21.2	38.8
	33.0	22.8	12.3	5.1	66.8	33.2	24.1	33.0	8.2	6.6	48.6	26.9	3.4	18.6	34.5
	30.2	9.0	8.4	3.8	60.2	32.1	22.6	32.6	8.0	4.7	47.8	24.5	2.3	18.2	32.5
	21.5	8.3	7.3	3.6	56.3	30.6	15.1	27.5	6.3	-28.9	44.8	20.7	2.1	18.1	32.4
	21.3	7.3	6.4	3.4	47.3	26.0	13.8	26.3	6.3	-33.8	28.5	19.2	0.6	17.5	29.5
	21.0	7.0	2.5	-2.9	46.0	22.3	7.0	23.5	6.2	-36.8	27.2	19.2	0.4	17.1	25.8
	7.4	4.0	-2.4	-6.0	36.2	18.3	4.9	22.2	5.9	-37.0	26.5	15.5	-4.2	16.8	25.3
	4.0	-2.0	-5.6	-11.4	30.0	16.5	4.7	18.4	5.5	-39.2	20.6	15.1	-5.5	16.4	1.2
	3.6	-3.0	-6.5	-13.8	28.7	10.9	4.6	15.8	-0.2	-42.5	19.7	13.3	-15.1	16.0	0.6
	1.9	-9.1	-11.9	-15.5	2.0	2.7	3.1	4.3	-1.6	-45.1	2.3	3.7	-15.6	2.1	0.3
	-1.5	-12.3	-15.4	-20.5	1.9	1.3	2.4	4.1	-9.8	-47.1	0.8	2.0	-17.1	0.9	-0.1
Lowest Return	-2.6	-30.6	-16.7	-22.1	1.5	0.8	1.3	3.8	-17.6	-53.2	0.2	0.8	-18.2	0.2	-2.3

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
US Large Cap	21.0	-9.1	-11.9	-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	32.4
US Large Cap Value	7.4	7.0	-5.6	-15.5	30.0	16.5	7.0	22.2	-0.2	-36.8	19.7	15.5	0.4	17.5	32.5
US Small Cap	21.3	-3.0	2.5	-20.5	47.3	18.3	4.6	18.4	-1.6	-33.8	27.2	26.9	-4.2	16.4	38.8
US Small Cap Value	-1.5	22.8	14.0	-11.4	46.0	22.3	4.7	23.5	-9.8	-28.9	20.6	24.5	-5.5	18.1	34.5
US Real Estate	-2.6	31.0	12.3	3.6	36.2	33.2	13.8	36.0	-17.6	-39.2	28.5	28.1	9.4	17.1	1.2
Intl Large Cap Value	33.0	4.0	-15.4	-13.8	69.2	30.6	15.1	33.0	6.3	-45.1	48.6	13.3	-17.1	21.2	25.3
Intl Small Cap	30.2	-12.3	-16.7	-2.9	60.2	32.1	22.6	26.3	8.0	-47.1	44.8	20.7	-15.6	16.8	25.8
Intl Small Cap Value	21.5	-2.0	-6.5	3.8	66.8	35.1	24.1	27.5	6.2	-42.5	47.8	19.2	-15.1	18.2	29.5
Emerging Markets	66.4	-30.6	-2.4	-6.0	56.3	26.0	34.5	32.6	39.8	-53.2	79.0	19.2	-18.2	18.6	-2.3
One-Year US Fixed	4.0	7.3	7.3	3.4	1.5	0.8	2.4	4.3	5.9	4.7	0.8	0.8	0.6	0.2	0.3
Five-Year US Government Fixed	1.9	9.0	8.4	7.6	2.0	1.3	1.3	3.8	8.2	8.8	0.2	3.7	3.4	0.9	-0.1
Five-Year Global Fixed	3.6	8.3	6.4	5.1	1.9	2.7	3.1	4.1	6.3	6.6	2.3	2.0	2.3	2.1	0.6

In US dollars. US Large Cap is the S&P 500 Index, provided by Standard & Poor's Index Services Group. US Large Cap Value is the Russell 1000 Value Index. US Small Cap is the Russell 2000 Index. US Small Cap Value is the Russell 2000 Value Index. Russell data © Russell Investment Group 1997–2014, all rights reserved. US Real Estate is the Dow Jones US Select REIT Index, provided by Dow Jones Indexes. International Value data provided by Fama/French from Bloomberg and MSCI securities data. International Small Cap data compiled by Dimensional from Bloomberg, StyleResearch, London Business School, and Nomura Securities data. International Small Cap Value data compiled by Dimensional from Bloomberg and StyleResearch securities data. Emerging Markets is the MSCI Emerging Markets Index (gross dividends), © MSCI 2014, all rights reserved; see MSCI disclosure page for additional information. One-Year US Fixed is the BofA Merrill Lynch One-Year US Treasury Note Index, used with permission; © 2014 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Five-Year US Government Fixed is the Barclays Capital Treasury Bond Index 1–5 Years, formerly Lehman Brothers, provided by Barclays Bank PLC. Five-Year Global Fixed is the Citigroup World Government Bond Index 1–5 Years (hedged), © 2014 by Citigroup.

Indexes are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Market Outlook

Equities

The US equity markets continued to flirt with all-time highs during the third quarter, which makes some investors nervous. Fidelity Magellan fund manager Peter Lynch once said "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." We wholeheartedly agree with this sentiment regarding both the equity and fixed income markets. A Schwab study using Standard & Poor's data indicates that between 1994 and 2013, investors who missed the top 10 equity market days had an annualized return of 5.5% vs. 9.2% -- if they had remained invested.

The general consensus with institutions (Schwab, Morningstar and J.P. Morgan) is that the US equity markets are fair to slightly overvalued. JP Morgan has analyzed data from all bull markets after 1966. Their study indicates the market usually continues to appreciate after the market is considered fully valued.

The US small cap market is down this year, after a stellar 38% return in 2013. Year-to-date through September 30, the Russell 2000 benchmark is down -4.41%, after giving up over 7% in the 3rd quarter. Typically, times of uncertainty more adversely affect small cap companies that are less established. In this case, analysts believe investors, fearful of the Fed raising rates, are pulling out of small companies who have a harder time borrowing than a more established large cap company. After months of underperformance, we argue this may present a buying opportunity for those who can tolerate potential short term volatility but who have a long term outlook. Valuations definitely look more attractive now than they did earlier in the year, as they do with international equity markets, emerging markets in particular.

Fixed Income

With positive economic data being widely reported by the press, investors are increasingly worried about the Fed increasing rates sooner rather than later. Federal Reserve Chairwoman Janet Yellen, who thus far has not raised rates, has indicated that increases will not happen for the foreseeable future. We believe the Fed is very sensitive to the market's reaction to rate increases and will likely be very slow and deliberate in its timing.

We do not believe we are in a fixed income bubble. With the baby boomers moving into retirement, there remains solid demand for fixed income. To maintain fixed income and protect against a rise in rates, we continue to choose funds with mostly low maturity and high quality bonds. As with equities, we include several fixed income categories to maintain diversification, as we don't want all investments going up and down at exactly the same time. The broad theme with fixed income is that it provides long term stability to the portfolio. We prefer to take more risk on the equity side of the portfolio and therefore expect the bulk of the portfolio's long term growth to happen with the equity investments. On the flip side, we expect the fixed income to buoy the portfolio in adverse market conditions such as 2008 (please refer to the chart above, which clearly shows how fixed income buffered portfolios from catastrophic losses in 2008).

PIMCO updates

Any current discussion about fixed income should include updates about PIMCO. As reported in our most recent email (*PIMCO developments*), near the end of the quarter the biggest financial news was that Bill Gross, considered by many to be the "Bond King", abruptly left PIMCO amid much public speculation and a predictable media circus. As we stated in our related email to you on September 29th*, we felt the change warranted monitoring, but we did not recommend selling PIMCO funds*. We continue to watch developments at PIMCO very closely, and our position not to sell PIMCO funds has not

changed. While our position is not consistent with all investment advisors, we note that the departure of Mr. Gross does not appear to be having a negative impact on PIMCO funds, including PIMCO Total Return fund, considered their "flagship" fund that was managed by him. Despite his departure and net outflows, the fund has performed similar to the bond market, *up* about .4% (as of this writing) since Gross' September 26 departure announcement.

Conclusion

We wish every asset class increased every quarter, but that is unrealistic. This quarter's performance chart illustrates why we do not try to guess which asset classes will outperform. Further, for those with cash balances, we invest over time again because we do not know how the market will perform short term. As always, we maintain that maintaining a prudently diversified portfolio is the best course through market uncertainty.

We thank you for your confidence in us and encourage you to call us anytime.

Janet & Barry

Sources: DFA, JP Morgan, Morningstar, Wall Street Journal, PIMCO, Payden & Rygel, BlackRock, Schwab, Global Financial Data, Professor Kenneth French, Jeremy J. Siegel