

Prepared Comments from 10/15/2013 Conference Call

Our country could go bankrupt this week, and yet US stocks are setting records. What gives?

While the crisis in DC is very significant, financially, economically, and personally, the markets (and by that I mean investors) are looking beyond the crisis, and are taking a longer-term view, concluding that we will find our way past this, as we have with so many past crises. This is appropriate, for investors should be looking at tomorrow, not today, when making decisions.

Let's stay here in today for a little. The crisis is an inability of our Congress and our President to pass a CR, a continuing resolution, which would permit the federal government to operate this fiscal year, which began on October 1st. The crisis also reflects the imminent deadline when Congress must raise the overall debt ceiling—if they fail to act, the government will be unable to pay its existing obligations. This month has been filled with 'last minute deals,' but no deal has yet been reached to at least kick the can down the road a few months.

During this partial shutdown many government offices are closed, and government employees have been furloughed. This isn't the first such partial shutdown, and it won't be the last. Investors recognize that there should be a fairly swift economic bounce back, and that most economic impact will be fleeting. Investors further recognize the very high likelihood of a deal on the debt ceiling before the country needs to default on a required payment.

Two weeks Dr David Kelly from JP Morgan suggested that one path out of this would be for the Treasury to cherry-pick which bills they pay for the next two weeks, and as the November Social Security payments approach, the public outcry will compel our Congress and President, with their collective backs up against the wall, to actually work together and solve this. While today's news appears promising, I hold out the very real possibility that Dr. Kelly will be proven right, and that the solution will take another week or two. Hang in there!

By putting walls around this month's Congress Crisis, we can move onto real economic news. The news this year has been positive. The country continues to grow, at a modest but steady rate, most recently a 2.5% annual real growth rate. Car sales are now (slightly) above their 20 year-trend level. Real capital goods orders are 5% higher than trend levels, and appear fairly steady at this positive level. Housing starts are not up to average levels, but they continue to

recover and maintain this momentum. Housing prices are well below highs from 2006-2007, but are also the highest that they have been since late 2008. Despite rising this year, mortgage rates remain low and owning a home remains notably less expensive than renting. Household debt service levels are the lowest they have been for over 30 years, at only 10.4% of disposable personal income. Household net worth has more than recovered from its 2007 highs, and now stands 10% higher than prior highs.

The federal budget deficit has fallen from about 10% of the country's economy (GDP) to the current level of under 4%. The sequester deserves some of the credit/blame, as are the expired payroll tax reduction and other expired tax provisions. As a result, the federal debt growth is expected to be slower than the overall economy for the coming decade. While we are not in a great spot, we are also not in a terrible spot.

Unemployment has fallen almost 3% from its 2009 highs, from 10% to near 7%. The rate is half that for those with a college education or higher. Hourly earnings growth has moved up this year, which indicates is very good for those with jobs—it indicates that employers are beginning to provide raises—remember them?

Inflation has been subdued for almost 10 years. With energy prices actually falling in the past year, both core and headline inflation over the past year are under 2%. The dreaded inflationary consequences of the Fed's historic stimulus remain at bay. The Fed is certainly putting a great amount of effort in determining how to slowly let the air out of the stimulus balloon, without the balloon bursting. This will likely take several years.

The multiple year path for interest rates is upward, however the slope is no longer as daunting. Corporate bond yields rising ½% a year for five years simply is not fear-inspiring. This year investors have begun shifting substantial dollars out of bonds, for the first time since 2007, but the rate has been measured. It would take several years at the current pace to make up for the massive bond buying we have witnessed over the past four years.

In the past quarter bonds were able to tread water, while US stocks did well, and foreign stocks did quite well. After the unstable June, with the Fed's threatened stimulus reduction, the past three months brought significant investor confidence, with new dollars preferring riskier areas—technology, small US stocks, and even small foreign stocks.

Investors are seeing areas of promise across the globe. Europe is emerging from its austerity-led recession, and even Greece has apparent light at the end of their tunnel, as their 10-year government bonds now yield less than 10%. China is showing stability after a government-crafted slowdown to head off spiking destabilizing inflation.

Most of all, investors appear to be recognizing that, while stocks are not cheap, they are reasonable, and reasonable is far preferable to the expensive nature of bonds. Global economic growth is improving in developed markets, and stable at an attractive level in emerging markets. Government deficits in Europe are shrinking.

With a glut of natural resources, especially natural gas, commodities appear to offer limited appeal. With cash paying near zero interest, bonds facing a protracted headwind, and commodities having downward pressure, stocks look pretty attractive.

In this environment, we are sticking to our fundamental principles, focusing on long-term stock allocation targets, and executing disciplined rebalancing. Rebalancing, by its nature, cuts the flowers and feeds the weeds. We are therefore cutting back a bit in smaller US stocks and in foreign stocks, especially smaller-cap foreign stocks. We continue to be cautious in individual stock selection, as many stocks are up 30% or more this year, and thus offer limited downside protection.

In bonds we continue to separate our quality bonds from our opportunity bonds, and in our quality bonds we continue to favor short-term bonds. If, however, sales of bond funds drive bond prices down and yields up enough, we could extend our quality bonds' maturities. We aren't there yet, though.

In our opportunity bonds, we are eliminating our foreign bonds, and redirecting these dollars into multi-sector, unconstrained bonds, where the manager is authorized to invest across the globe, in the sectors in which he/she finds the most promise.

We currently have a 3% preference of stocks over bonds, so we currently are investing 51.5% in stocks for a long-term 50% stock portfolio. We continue our 58/42% balance of US/foreign stocks. We are also continuing our 70/30% quality/opportunity bond balance. We feel that this multi-pronged approach is best prepared for the wide range of possible paths ahead of us. Betting the farm is a bad strategy if you need to be able to eat tomorrow.