Prepared Comments from 4/15/2014 Conference Call

Happy tax day! I am hopeful that your returns are duly filed, or that you have your extension requests filed by now.

While I will spend a lot of time talking about stocks, and about bonds, the most important decision you make as an investor is what proportion to direct to stocks, and to bonds—the asset allocation balance. That is your job #1, and you should largely disregard economic forecasts and market analysis when setting this target balance. Once set, however, it is worthwhile to consider economics and valuations, as I do here.

After a very strong 2013 for the stock markets, 2014 began with two major themes, troubles between Russia and the Ukraine, and a very harsh winter in the US. While I may regret stating this, both themes appear minor.

The winter did slow economic growth in the past quarter, however some economic growth that is held back in a bad winter is not prevented, only delayed. The harsh winter, while directly causing an unremarkable 1st quarter, will likely lead to pleasant economic news for the rest of this year.

While the US economic recovery is getting long in duration, its very modest rate has enabled it to avoid any 'overheating,' and there is no strong reason for it not to continue for much longer. Typical symptoms of the 'warning track' on this recovery, symptoms such as rising inflation, high factory utilization, a tight labor market, are no where in sight.

In fact, on several fronts the economy is strengthening. The residential home market is recovering, with inventories of homes on the markets down to normal levels, while housing affordability remains well-cheaper than normal. Light vehicle sales continue to recover, remaining above normal levels, which should continue for a few years, to compensate for the long period of below-average levels during the downturn. Unemployment, after peaking at 10%, is down to 6.7% and is expected to drop further this year. Average hourly earnings are growing at 2.5%. As this is more than inflation, this can be an additional boost to our economy. Inflation is keeping under 2%.

The federal government's finances are steadily improving. After peaking at 10% of GDP, the federal budget deficit is coming in around 3% this year, which is close to average for the past 40 years. The Fed, the Federal Reserve Bank, is planning for removing the trillions of dollars of stimulus it has spread through the economy since 2008. There are many opinions as to how best to execute this—my takeaway is 1) they know their responsibilities, 2) they are planning for 'pulling the trigger', 3) they have a LOT of dials to adjust, an incredible amount of money and programs, and 4) they are waiting until the economy is ready to survive on its own, without any of this support. We appear to be getting closer and closer to that point.

After a fairly fine 1st quarter, stocks have fallen this month. Year-to-date, most US stocks are down a little, as are most foreign stocks. A global stock fund from Vanguard was up ½% through March 31st, but is now down a smidgeon. Many bond funds were up 2% or so in the first quarter, and have added ½% so far this month.

Some sectors have had big swings. Technology stocks were up 2½% through March 31st, and fell almost 5% this month. Healthcare stocks were up 6½% through March, and are now down 1%. While precious metals have fallen over 8% in the past month, they remain up over 16% year-to-date. Other sectors have been solid this year, as real estate gained 9% in the 1st quarter, and this month has held onto those gains.

So what are we comfortable with in portfolios at this time, and why?

Between stocks and bonds we are maintaining a slight (2%) preference for stocks, not due to considering them cheap, but rather due to considering bonds still expensive. Holding any large amount of cash is condemning it to a loss of 1½% annually to inflation.

Within bonds, we have been making several changes. We have set our quality/opportunity bond balance to 67/33. Of the two-thirds of bond money in quality bonds, we direct a large 35% in short-term bonds, given their greater safety. We direct 10% to inflation-linked bonds, although we don't expect these to 'pay off' for a few years, as we don't foresee troublesome inflation for at least that long. We have cut our intermediate-term bonds to 17% of bond money, due to concerns that this bond area may suffer the most pain from rising rates. That said, their price declines in the past year, while modest, should limit the amount of future price declines. We have introduced long-term bonds into our clients' bonds, with a 5%

starting level. For our quality bonds, we primarily use corporate bonds, and municipal bonds (municipals for our clients in higher tax brackets).

We have both simplified and complicated our clients' opportunity bonds. We now have only three categories—5% in floating rate, 13% in multisector, and 15% in high yield. That said, we have divided the high-yield bonds into four sections: regular high yield, tax-free high yield, higher quality high yield, and short term high yield. We believe that the best gains have already been earned from high yield bonds, and so we are being more precise in how we invest clients' high yield bonds. We have cut back on the floating rate bonds, as we feel that investors are expecting too much from these, and that this will lead, in the future, to disappointed investors and price declines.

Within stocks, we have not made any notable changes. We prefer a 57/43 balance between US and foreign stocks. We are using a 70/20/10 guideline for large/mid/small-cap stocks, and we prefer a slight growth lean at this time, due to attractive values, versus history.

Within sectors, we are using a 4% specific dedication to natural resources/energy and 5% to real estate (both US and foreign). We are mindful of avoiding the overexposure to the technology, healthcare, and utilities sectors. Let's not go overboard.

Despite the turmoil in Eastern Europe, we feel that most of Europe is on its path to recovery, and we have dedicated a 6% or so allocation to Europe-only stocks. We continue to like large foreign companies, both in foreign-only stock funds and in global stock funds. We generally include an allocation to funds specializing in foreign infrastructure companies.

We recognize that greater growth comes with greater risk, and we complete our overseas stock approach with three sectors—foreign small/mid blend (smaller companies in larger countries), general emerging market stock funds, and Pacific/Asia stock funds in particular.

We use a lot of buckets in our client portfolios, however we are very intentional about what buckets to include, what buckets to exclude, and what amount goes into each bucket.

All for me—what questions do you have?

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