Prepared Comments from 7/15/2014 Conference Call

Stocks have done quite well over the past three months—is it time to worry or celebrate?

In the second calendar quarter, US stocks rose a little under 5%, while foreign stocks rose a little under 4%. Bonds rose about 2%. There were substantial variance amongst the types of stocks and bonds, but those are broad averages.

The P/E ratio, the price of a stock or index divided by its earnings, is the most common measure of whether a stock/index is cheap or expensive. PE levels have risen over the past year, and are generally at, or a little above long-term average levels. However, these are hardly average times.

The Federal Reserve Bank (the Fed) has kept rates at all-time lows for over five years. As such, another stock valuation method, known as the Earnings-Yield (EY) Spread, shows stocks as substantially cheaper than normal. There is a saying that "In the land of the blind, the one-eyed man is king." In the land of zero short-term interest rates, stocks with earnings yields of more than 6% are cheap.

Economics also supports current stock levels. Companies can borrow money at very low interest rates, and thus can operate with lower costs than normal. This enables them to be more profitable, and grow their profits faster. Core inflation has been about 2% or less since the crisis, and it is much easier to operate a company well when inflation is sustainably low.

These external environmental factors, short-term interest rates and inflation, are expected to move towards normal over time, however this should occur gradually, and thus there are no clear paths that would lead to a sharp stock market price pullback.

While the US economy stumbled in the 1st quarter, that is considered an artificial drop due primarily to a historically abysmal winter coupled with some technical matters related to companies' inventory levels, and the rest of the year is expected to bring economic growth levels above those from the past few years. Auto sales and Housing sales are increasing, and both should have an extended period of pent-up demand which should provide a steady tailwind for our economy for many quarters to come.

Companies are rebuilding their inventories, are making substantial capital goods orders, and we are beginning to see an increase in merger & acquisition activity. All of this indicates that the corporate sector and its confidence is at a good point and the future looks promising.

Consumers have been benefitting for years from the low interest rates, and with unemployment falling to almost-normal levels, consumers are better able to qualify for loans using those low rates. This has led to a rebound in consumer confidence, which can often build on itself, in a self-sustaining upward spiral.

There are significant challenges ahead of us, and there are many analysts who point to signs that the stock market is ready for a fall. Perhaps. However there are ALWAYS people who see such signs, and I feel that there are at least as many signs that the economy's slow and steady recovery is far from over, and that today's companies are well-positioned to handle a valuation-driven stock market decline, with minimal disruption.

I will next review Mallard's current allocation strategy and reasons.

We continue to overweight stocks slightly, to 102% of long-term levels. Thus a client with a 60% long-term stock target level will currently have about 61.2% in stocks.

We continue to use a 58/42 US/foreign stock balance. We have not changed this for several years. This remains less US-centric than most US stock investors, but remains more US-centric than the world stock markets. As such, it feels to be a good middle-ground. Foreign economies and markets continue to provide not only diversification to a US-only stock portfolio, but also access to many areas with higher growth than the US, and also areas with lower stock market levels than those in the US.

Within specific stock sectors, we are mindful of not getting out of balance unintentionally. Technology has had its highs and lows. We still like it but are paring it back if it is above normal levels due to 2014 gains. Utilities appear pretty pricey, and so we are often paring them back, and healthcare has been red-hot this year and so we are often cutting it back, too.

Our inflation hedge areas—real estate and energy—are two other sectors where we are particular with allocations. We currently aim for 4% of a client's stocks to be in energy stocks/funds, and 5% for real estate. 25% of real estate we like to have in foreign real estate. When a client has external investment real estate, we will run their US real estate levels within the portfolio much lower, if not to zero. We have not changed these figures for a bit.

For foreign stocks, we have not changed our top-level balances since April—57% in large companies/developed markets, 12% in smaller companies in developed markets, and 31% in emerging markets. We have adjusted the subcategories in the past quarter. We have shifted an eighth of the emerging markets slice from Pacific-focused to frontier emerging markets (the really small countries/markets). For the large-cap, we continue to prefer that half is invested through global stock funds, and that 10% is done via Europe only stocks/funds. We have cut from 15% to 10% the level focused on global infrastructure stocks.

With bonds, we are continuing with 67% quality and 33% opportunity. We have left the four quality sleeves alone, at 5% long-term, 17% intermediate-term, 35% short-term, and 10% inflation-focused.

We have four outer sleeves for opportunity (one more than in April), with 15% in high yield, 10% in multisector (down from 13%), 3% in bank loan/floating rate bonds (down from 5%), and 5% in emerging markets (new since April). For the 15% in high yield, we have shifted the four sub-sleeves, with 2% in regular, 3% in tax-free, 5% in high quality, and 5% in short-term. The changes since April reflect our view that high-yield is approaching the end of its above average returns with below normal risk. For that reason we are cutting the risk of our overall high yield bond holdings.

There are always challenges and worries for investors. We feel fairly comfortable at this time, due partially to fairly normal prices for stocks, a fairly steadily growing US economy, and no incredibly worrisome global problems. For this reason we are adopting a 'steady as she goes' approach, which involves a few shifts here and there, some normal pruning, but nothing dramatic.

The year has brought solid returns for both stocks and bonds. As is almost always the case, this is a good time for rebalancing your portfolio. What questions do you have?