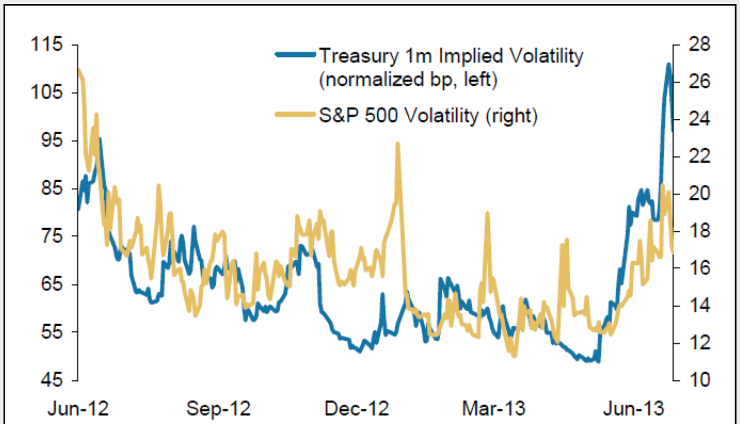
second quarter 2013

INVESTMENT. perspective

While the Standard and Poor’s 500 Index returned 2.9% for the second quarter and the Index has posted an impressive 13.8% return mid-way through 2013, the Federal Reserve has embarked upon what may be an extended phase of reduced monetary accommodation, which will likely heighten market volatility and impact equity and fixed income valuations over the short term.

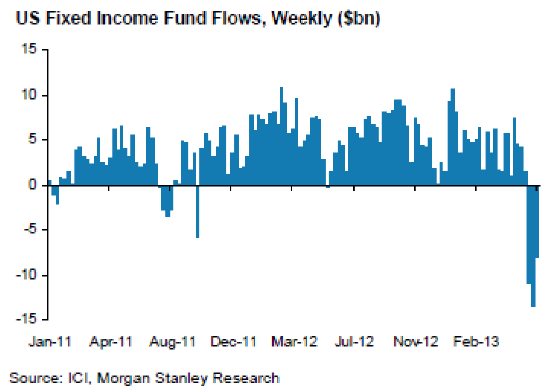
The rhetoric of Federal Reserve Governors has been mixed but it is clear that the bias is for the Fed to begin its tapering process, and markets have responded accordingly. When central banks print money (Quantitative Easing, “QE”) while there is insufficient demand for new loans (as is the case now), money flows into asset prices rather than loans and economic activity. Therefore, as the Fed begins to reduce QE we expect the reduced monetary stimulus to impact asset prices more than real economic activity. Recent market volatility reflects market participants reducing leveraged positions and preparing for less monetary support in the future.

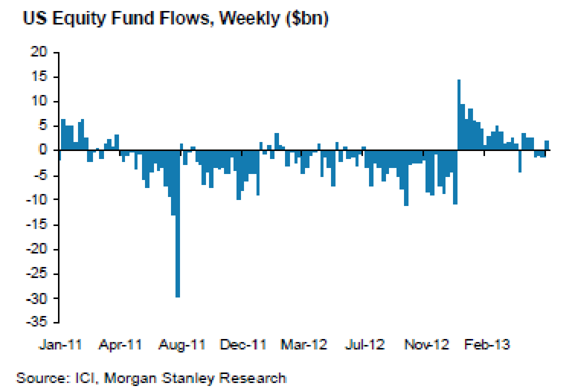


Source: BofA Merrill Lynch, Bloomberg, Morgan Stanley Research

The Fed anticipates reducing QE over multiple quarters allowing the market to adjust to lower levels of monetary stimulus without creating unnecessary dislocations in the marketplace. While the Fed would like to end QE during 2014, such a timeline is data dependent and should additional stimulus be required the Fed will not hesitate to provide monetary support.

As the Fed winds down QE market participants appear ready to provide liquidity to risk assets. Pension funds are reducing return expectations and inflation/commodity price expectations. Over the medium to long term this will result in increased pension contributions and reallocations that will support equity and credit markets. Institutional investors have been holding back on adding to their fixed income portfolios awaiting higher yields/better prices. As such, once volatility eases expect inflows to credit markets to increase capping the increase in interest rates and ultimately leading to stock purchases via share buy backs, recapitalizations, and acquisitions, all of which should assist further gains in the equity markets.



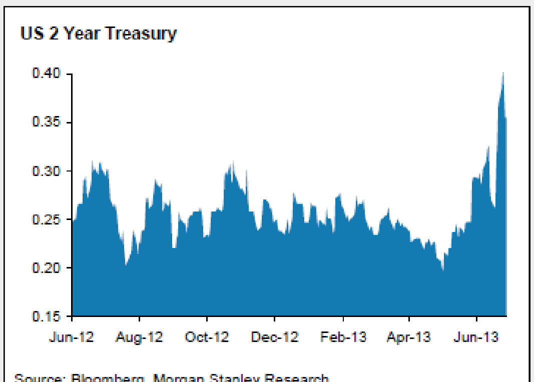


As institutional investors begin replacing the Fed as the dominant marginal buyer of assets, stock price appreciation will be driven primarily by earnings growth rather than further multiple expansion. We do not see the current level of interest rates as an impediment to economic growth. However, the rate of change in interest rates could have a temporary impact on asset prices and economic activity. Also, the winding down of QE will entice the significant idle capital on the sidelines to be invested. Businesses and institutional investors want to see where credit costs and asset prices settle once the Fed has stopped buying. Once we have greater price transparency, capital will go to work via acquisitions and capital expenditures.

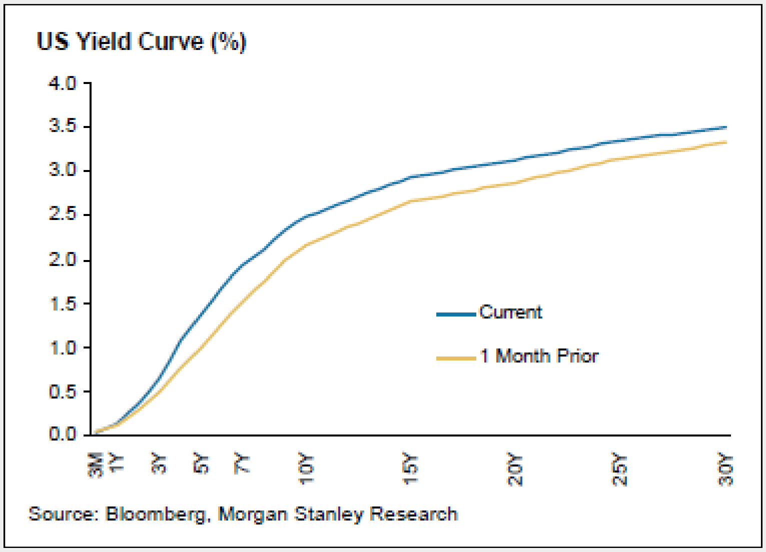
For equity markets in general the broad recovery in the equity indices should slow, with index investors likely to experience low to mid single digit total returns from the broad market over the next three to five years. However, there are still individual stocks that will perform extraordinarily well despite the lowered return expectations for the general market. This positive outlook is stock-specific, not reflective of opportunities in specific industries or regions of the world. The indices will become a less attractive option and investors need active managers focused on absolute returns and not relative sector weights going forward.

The initial move higher in interest rates will cause the greatest volatility in the fixed income markets and fixed income proxies such as high dividend yielding stocks. These areas will continue to struggle during the rate adjustment period. If such valuations reach oversold levels, we may look to acquire such names, as the global economy is not yet strong enough for a sustained and consistent increase in rates to occur.

Within our clients' fixed income portfolios we continue to be positioned with a shorter duration, which was a benefit during the quarter. In taxable portfolios we have been overweight corporate bonds and, aside from the most recent quarter, such positioning has benefited portfolios for an extended time and we intend to maintain a bias for Corporate, Mortgage-Backed and Agency securities over Treasuries. The spike in interest rates caused by the prospect of the Fed tapering its QE3 program has forced those with leveraged positions to at least partially liquidate long-held trades.



The combination of forced sellers, a less liquid secondary market due to quarter-end broker/dealer capital constraints and crowded investments in higher yielding assets all contributed to a more volatile and rapid adjustment process, which disproportionally hurt corporate bonds. This adjustment is largely behind us and we expect a gradual rise in rates from current levels. Such a scenario will benefit fixed income investors longer term as this sets the portfolios up for less reinvestment risk and higher returns in the future. In non-taxable fixed income portfolios we continue to like intermediate term municipal bonds, especially on a taxable equivalent basis. While municipal bonds also experienced a pull back during the quarter, the higher rate environment positions the portfolios for better reinvestment opportunities with more attractive yields in the future.



Taxable Equivalent Yields as of 6/30/13

	AA G.O. Municipals	Taxable Equivalent 43.4%	Taxable Equivalent 35.0%	Treasuries	A Industrial Corporates
1 YR	0.40	0.71	0.62	0.13	0.42
2 YR	0.75	1.33	1.15	0.37	0.79
3 YR	1.17	2.07	1.80	0.69	1.20
4 Y5	1.46	2.58	2.25	1.09	1.70
5 YR	1.74	3.07	2.68	1.42	2.14
7 YR	2.28	4.03	3.51	1.99	2.87
10 YR	3.18	5.62	4.89	2.59	3.50
15 YR	4.15	7.33	6.38	3.17	4.15
20 YR	4.44	7.84	6.83	3.23	4.53

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