July 24, 2013

After a period of relative calm, volatility returned with a vengeance to global financial markets in May and June. Core investment-grade bonds lost 3.3% from May 1 through June 30—one of the worst two-month declines in the benchmark's 37-year history. Long-term Treasury bonds, as represented by the iShares Barclays 20+ Year Treasury Bond Fund, lost 9.8% in the last two months of the quarter. Emerging-market bonds dropped 10% from May 8 (their intra-quarter peak) through June 30, while emerging-markets stocks lost 11.4% and developed international stocks dropped 6.5% over the same time period.

Bucking the trend to a large extent were large-cap U.S. stocks, which fell only 0.8% over that same period. Gold, which is typically viewed as a safe haven during periods of market turmoil, was not spared—losing 15% from May 1 through June 30, and melting 26.5% for the year to date. Silver was down 30% for the quarter. See table at right for additional benchmark returns.

June Benchmark Returns (Preliminary)

Large-Cap Benchmarks	June	2Q	YTD
Vanguard 500 Index	-1.4%	2.9%	13.8%
iShares Russell 1000	-0.5%	3.1%	14.1%
iShares Russell 1000 Growth	-2.1%	1.9%	11.4%
iShares Russell 1000 Value	-1.0%	3.2%	15.6%
Mid-Cap Benchmarks			
iShares Russell Midcap	-1.4%	2.0%	15.2%
iShares Russell Midcap Growth	-1.4%	2.7%	14.5%
iShares Russell Midcap Value	-1.4%	1.6%	15.7%
Small-Cap Benchmarks			
iShares Russell 2000	-0.8%	2.7%	15.4%
iShares Russell 2000 Growth	-0.9%	3.6%	17.2%
iShares Russell 2000 Value	-0.5%	2.5%	14.2%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-2.8%	-0.7%	3.1%
MSCI World ex USA Index	-3.7%	-1.4%	3.4%
Vanguard FTSE Europe ETF	-4.3%	0.1%	1.1%
Vanguard FTSE Emerging Mkts ETF	-5.3%	-8.3%	-11.6%
Vanguard REIT Index	-2.0%	-1.6%	6.3%
Vanguard Total Bond Mkt Index	-1.7%	-2.4%	-2.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	-2.6%	-1.4%	1.5%
Vanguard Int. Term Tax-Exempt Fund	-2.6%	-2.9%	-2.5%
S&P/LSTA Leveraged Loan Index	-0.6%	0.2%	2.3%
Citigroup World Govt. Bond Index	-0.6%	-3.0%	-5.7%
JPMorgan GBI-EM Global Diversified Index	-4.1%	-7.0%	-7.2%
DJ-UBSCI (Commodity Futures)	-4.7%	-9.4%	-10.5%

This quarter's commentary focuses on two second-quarter market developments that are noteworthy at both a broad macro level and given our particular portfolio positioning. We'll look at what happened in the quarter, what the impact was on our portfolios, and, most importantly, how to view these developments in the context of our long-term fundamentally driven investment approach.

The two main developments we'll focus on are: 1) the spike in Treasury bond yields, and 2) the sharp decline in precious metals. Understanding these two developments is helped by first looking at the monetary policy backdrop.

The Backdrop: Monetary Policy and the Market's Short-Term Game

Interestingly, both of these developments had (to varying degrees) the same underlying driver: pronouncements from the Federal Reserve about the future course of monetary policy, and, specifically, the Fed's plans to begin "tapering" its QE (quantitative easing) bond-buying program. (More details about this below.)

This is a theme we've discussed a lot in recent years: the unusually heavy influence of monetary policy on the financial markets in the aftermath of the 2008 financial crisis, and the unusually strong sensitivity of markets to perceived changes to such policy. We know that Fed policy—by "repressing" interest rates to all-time lows, and aggressively purchasing government and mortgage-backed bonds via QE—actively encouraged (if not forced) investors to move out on the investment risk spectrum into higher-yielding and inflation hedging asset classes. This helped to boost the U.S. stock market to levels beyond what may be justified by the longer-term economic (earnings) fundamentals.

Also noted was that this behavior could certainly continue in a self-reinforcing cycle as long as the markets believed two things: 1) that the Fed would keep up their stimulative policies, and 2) that such policies were necessarily positive for stocks rather than, say, indicative of the severity of our economic problems. If so, as the markets moved higher, more and more short-term-oriented or performance-chasing investors would feel the urge to jump on the stock market bandwagon, propelling the market still higher and further divorcing it from its underlying longer-term economic fundamentals. In other words, the market could continue to overshoot to the upside, driven by short-term but ultimately unsustainable factors.

But that is a short-term, speculative "game" best left to traders, not investors. That approach is not part of any investment discipline, nor is it likely to yield consistent, sustainable success for most investors.

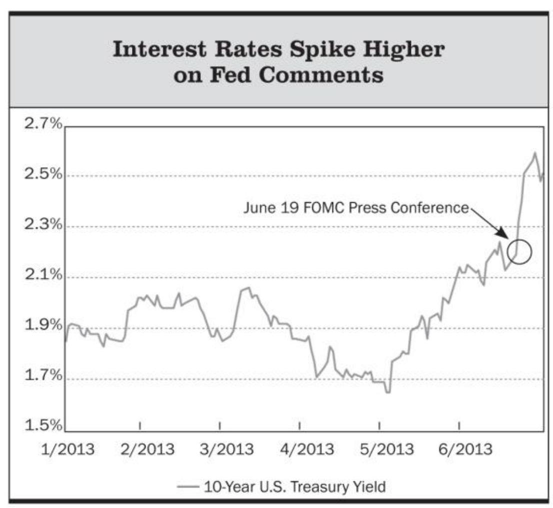
That does not mean that we should ignore what the Fed is doing, how their policies might change, or what the implications might be for the economy and financial markets. But maintaining an awareness of different possible monetary policy scenarios and outcomes is very different from making portfolio decisions based on the confidence that we know which particular scenario will play out over the short-term *and* that we can get the timing right. Trying to ride the market's short-term momentum requires consistently buying at the right time and also selling before the forward momentum unwinds, typically caused by an unexpected catalyst, which can result in a swift and sharp decline.

We need only look at what happened with the recent spike in rates as an excellent example of how rapidly things can change and what can happen if you are a short-term investor and don't get the timing right.

DEVELOPMENT #1:

Interest Rates Spike Higher

On May 2, 2013, the 10-year Treasury bond yield hit a low of 1.63% for the year. The yield then rose steadily through May, ending the month at a 12-month high of 2.16%. After meandering the first half of June, the yield spiked sharply higher, hitting 2.6% on June 24—its highest level since early August 2011. As noted in the introduction, the rise in rates resulted in significant capital losses for bond investors (rising bond yields mean falling bond prices), reaching into the high single digits for long-term Treasury and TIPS bond funds, and low single-digit losses for the core bond index.



While this looks like a pretty dramatic increase, if you put it in the context of rates of the past 50 years, it is apparent how depressed rates still are relative to history. Data as of 6/30/13. Source: Board of Governors of the Federal Reserve System.

The driver of the sharp rise in yields was comments from Federal Reserve policymakers—culminating with Chairman Ben Bernanke's June 19 press conference—indicating that the Fed might begin to slow ("taper") the pace of its monthly bond purchases sooner than had been expected, perhaps as early as this September. (As a reminder, under the current open-ended QE program, which was launched last fall, the Fed has been buying $85 billion of Treasury bonds and government agency mortgage-backed securities each month. The goal is to suppress borrowing costs, mortgage rates in particular and ultimately stimulate economic growth and employment. While most Fed watchers believe this most recent QE program has goosed stocks and other financial asset prices higher, its real economic benefit appears muted.)

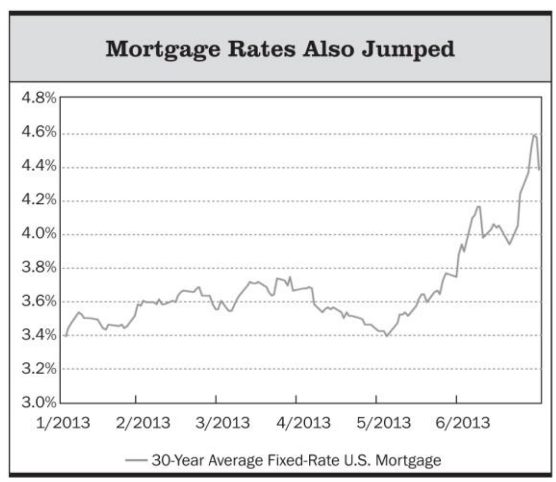
Specifically, Bernanke said:

> The committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year; and if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7%, with solid economic growth supporting further job gains.

Bernanke likened tapering to "letting up a bit on the gas pedal as the car [i.e., economy] picks up speed." He also tried to make it clear (again) that this tapering road map is not set in stone and would be contingent on incoming economic data. He specifically said that if the Fed's growth and employment forecasts turned out to be too optimistic (as they have consistently been since the financial crisis), the Fed could stop tapering and even increase its bond purchases again (step back on the accelerator). He also reiterated that even with a cessation of QE in mid-2014, monetary policy would remain stimulative for a considerable period because the Fed would not begin to increase short-term interest rates (i.e., step on the brakes) from their current near-zero percent level until unemployment fell to *at least* 6.5%, as long as inflation and inflation expectations remain low (in the 2%–2.5% range). The current consensus among the Federal Reserve Board members is that such a rate hike won't even be discussed at their meetings before 2015.

Despite Bernanke's best efforts to manage market expectations and communicate that the process of ending QE does not mean an actual tightening of monetary policy, investors saw it a different way, resulting in the bond market sell-off and a spike in interest rates. In a nutshell, investors' fears that rates would rise (and bond prices fall) as a result of a less-expansive Fed policy caused them to sell bonds, thereby causing rates to rise just as they feared. As TrimTabs Investment Research recently reported, bond mutual funds and exchange-traded funds had $72.8 billion in outflows from June 1 through June 25, smashing the previous record monthly outflow of $41.8 billion in October 2008, during the depths of the financial crisis. Prior to June, bond funds had registered net inflows for 21 consecutive months.

Thirty-year fixed mortgage rates, which are a specific target of QE, also jumped sharply from a low of 3.4% on May 1 to 4.6% on June 25. Thus, the Fed's optimism about economic growth/recovery, which led Fed policymakers to conclude they could begin ending QE, might in fact become a headwind to that growth. Rising borrowing costs and falling asset prices could ultimately short-circuit the economic recovery and, in turn, the tapering process. This is just part of the broader challenge the Fed faces as it tries to unwind its unprecedented post-crisis monetary policies without causing any major market or economic disruptions. At best, one may be confident in saying the "exit" will be a very bumpy road, with meaningful risks of policy errors and unintended consequences.



Data as of 6/30/13. Source: Bankrate.com.

DEVELOPMENT #2:

Precious Metals Sharply Declined

The second key development last quarter was the sharp sell-off in precious metals and their continued underperformance this year relative to U.S. stocks. From their intra-quarter high in early April through their low in late June, gold lost over 24% and silver 34%. In comparison, U.S. stocks appreciated over 2.5% during that period. Needless to say, this dramatic performance difference created a heavy anchor that prevented the market's rising tide from lifting our boats.

As always, there were numerous drivers of the performance of precious metals during the quarter, but clearly the rise in interest rates in the United States, and the Fed's tapering announcements were key factors. These developments, along with news that the Japanese central bank was not planning to further expand its own QE program, triggered a general unwinding of the "carry trade," in which investors (mostly short-term traders and hedge funds) borrow the currencies of countries with low-yielding debt and/or depreciating currencies (such as the Japanese yen) and invest in higher-yielding/appreciating investments, such as precious metals. As the carry trade unwound, metals depreciated against the dollar.

In addition to the markets' worries about reduced central bank liquidity, ongoing concerns about the dollar weighed on metals. In my opinion, a good part of the metals' decline is part of the process of establishing that there is no safe haven from the dollar. The Federal Reserve has to prevent metals from appreciating too rapidly to protect its quantitative easing policy.

How Did These Key Market Events Impact Our Portfolios in the Second Quarter?

These two market developments had opposite effects on our portfolios: we were helped by the first and hurt by the second.

HIGHER INTEREST RATES AND OUR BOND ALLOCATIONS

As discussed in commentaries for the past few years, part of the fixed-income portion of our balanced portfolios has been positioned for what we expect to be a longer-term trend of rising interest rates. We have been tactically underweight to core bond funds and have about one-third of our bond allocation to more flexible, unconstrained and/or absolute-return-oriented fixed-income funds.

As a result of this positioning, our fixed-income portfolios held up better than the bond benchmark through the sell-off in the core fixed-income markets. As an example, the average second quarter loss for the non-core bond funds that we use in our portfolios (PIMCO Unconstrained, PIMCO Unconstrained Tax Managed and Schroder Absolute Return EMD) was 1.0%. This compares to a 2.5% loss for the core bond index.

Although our portfolios are underweight to core bond funds due to an expectation for a long period of slowly rising rates, we have maintained exposure to core bonds in our balanced portfolios as a hedge against an economic downturn, deflation or some unforeseen event that would lead to increased risk aversion among investors and a flight to quality assets (as core U.S. bonds are traditionally perceived to be).

In summary, our overall domestic fixed-income positioning added value again for the quarter versus the benchmark. This has also been the case over the longer-term multi-year periods we've owned these funds, and this is the time horizon over which we are most focused for our investment decisions.

PRECIOUS METALS SELL-OFF

Turning to the developments in precious metals, our positioning was a negative for the quarter. As noted above, precious metals meaningfully underperformed stock markets in the second quarter. This was a major headwind to performance given the wide differential in returns in metals versus U.S. stocks during the quarter. While I do expect metals and stocks to generally move in opposite directions, I don't expect this level of negative correlation to persist.

These two opposing forces resulted in more muted short-term results overall for our portfolios. However, as we will discuss in the next section, we should view this short-term performance in the context of our longer-term views and objectives for our portfolios.

Time Arbitrage—Taking Advantage of the Market's Short-Term Focus

Having spent most of this commentary talking about what happened in the last quarter and how it impacted our short-term portfolio performance, we now turn to what is the much more important topic, which is to put these *short-term* developments in the context of our *long-term* investment discipline and portfolio management approach. Often the best approach is to not even discuss quarterly portfolio performance because such a short-term focus for many people is a major impediment to attaining long-term investment success. That is, by constantly reacting to every jump, dip, and wiggle in the markets and their own portfolio's performance, many investors lose sight of their long-term investment objectives. As such, they risk becoming part of the emotional investing herd—jumping into areas of the market that have already had a run of strong performance, or panicking and selling out of assets *after* they have had a sharp downturn, i.e., being "whipsawed" by the markets—also known as "buying high and selling low."

In an effort to inoculate ourselves against these natural behavioral tendencies, our investment approach evaluates investment opportunities over a multi-year time horizon. I think this is an important part of our investment edge. Other successful long-term, value-driven investors have referred to this as "time arbitrage"—meaning having a long enough investment time horizon to be able to take advantage of the market's short-sightedness and mispricing of assets due to transitory factors, greed and fear. This happens both on the upside when assets become overvalued due to irrational exuberance, and on the downside when an asset class may become a compelling long-term investment due to extreme short-term pessimism.

To benefit from time arbitrage, one must move away from the market herd (because by definition the short-term herd behavior is what is creating the long-term opportunity). And to do that successfully requires discipline, analytical ability to accurately assess the opportunity, confidence to act independently from the herd and patience and conviction to maintain one's positions—*as long as one's analysis suggests the long-term opportunity remains compelling*—during the inevitable periods of portfolio underperformance.

It also requires being intellectually honest about what one can and cannot know—when to have the conviction to act on analyses, but to not be overconfident given that the future is inherently uncertain. So we should consider a number of different potential scenarios or outcomes in our analysis, what the potential risks are (both in terms of probability and magnitude), and where our analysis could turn out to be wrong. If the facts and circumstances and our analysis do change, we have the intellectual flexibility to unwind a position and move on. In such circumstances it's important not to dig in one's heels and become contrarian for contrarian's sake—crossing the fine line from "discipline" into "stubbornness."

SHOULD OUR VIEWS OR PORTFOLIO POSITIONS CHANGE AS A RESULT OF THE SECOND QUARTER DEVELOPMENTS?

The events of the past quarter have not materially changed the longer-term asset class views or risk assessments. However, our tactical portfolio positioning has begun to see some minor fine tuning.

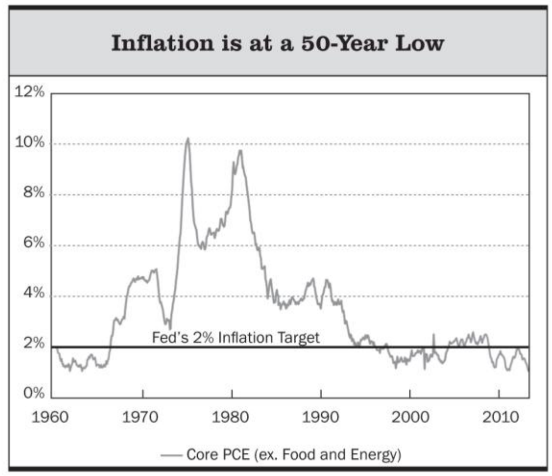
Fixed Income: While consistent with our longer-term expectation that rates will rise (but only gradually) and that returns to core bonds will be extremely low if not slightly negative over the next five years, the recent spike in interest rates was a warning of just how much damage can be done to even the most conservative core bond holdings, including municipal bonds. Accordingly, exposure to more flexible unconstrained bond funds and floating rate funds is being increased from one-third to one-half of our fixed income exposure to further reduce our portfolios' exposure to interest-rate risk.

I want to emphasize that while I continue to expect rates to be modestly higher five years from now, I do not try to precisely predict when or by how much rates will increase or what the trigger might be (e.g., an earlier than expected tightening of Fed monetary policy, stronger economic growth, higher than expected U.S. inflation, a weakening in investor perception of the creditworthiness of the U.S. government, some combination of the above or something else completely unexpected). Although predicting (i.e., guessing) where the 10-year Treasury yield will be at year end or month end might be a fun game (at least for some people!), No one can consistently get it right, and we can't base our investment decisions on such prognostications.

Also, within the context of a longer-term uptrend, don't be surprised if rates come back down somewhat from current levels in the near term as markets further digest the Fed's message and intentions. A key data point driving Fed policy is inflation, so it is worth highlighting that the Fed's preferred inflation measure—the PCE (personal consumption expenditure) price index—has dropped to a year-over-year rate of just 1.1%, which is the lowest inflation rate in its 50-plus year history and well below the Fed's 2% long-term target. There is still significant slack in the economy (U.S. GDP is well below its potential) and wages—a key driver of inflation—are stagnant. The recent strength of the U.S. dollar is another disinflationary factor.

Therefore, economists and market watchers don't see any strong drivers of government measured inflation rates in the near term; and much more importantly, neither does the Fed—they are currently projecting core inflation to be at or below 2% through at least 2015. As such, I do not expect rates to continue their sharp spike higher from here based on the economic fundamentals.

There is also the self-correcting mechanism of the markets as higher bond yields start to attract buyers back into the market creating upward pressure on prices (and downward on yields). In fact, several highly respected bond managers have said they view the recent market sell-off as overdone and creating some attractive bond-picking opportunities.



Data as of 5/31/13. Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Precious Metals: Just as interest rates might continue to spike higher driven by investor sentiment and market momentum, the negative impact on gold and silver could continue as well over the shorter term. But in this case, the markets are overreacting to short-term developments that don't take into account the longer-term, economic fundamentals and attractive return potential for this asset class.

Looking back over the last four decades, it's clear that when America's fiscal and monetary policies are prudent, fundamental strength bolsters the dollar; and when our fiscal and monetary policies are irresponsible, fundamental weakness undermines the dollar. And every time the dollar moves, gold moves in the opposite direction. So, what's the future of the U.S. dollar? Answer that and you know the future for gold prices.

We can attempt to answer that with one number: $123 trillion—the size of the U.S. Government's on- and off-balance sheet debts. It's a number too large to wrap your head around. So consider this comparison: World GDP is between $70 trillion and $80 trillion; therefore, our government carries a debt load 50% larger than the economic output of the entire world.

Congress and the Federal Reserve have no choice but to devalue the dollar quietly so that we can pay off as much of our debts as possible with cheap dollars; otherwise, our government risks default. As monetary policy purposely debases our currency, some other currency must, by necessity, rise. In a world littered with shoddy fiat currencies, history teaches us that the winner has always been gold.

Despite the metal's bear-market weakness at the moment, the long-term prospects for gold remain bullish simply because the long-term prospects for fiscal prudence in D.C. are so bearish.

Technical analyses of the metals had looked very bearish, until recently. After peaking in August 2011, gold has been in a severe bear market that seems to be following the path taken by gold in the 1970's, during its last bull market.

Gold corrected 44% lower over 1975-76 after multiplying over five times from its early 1970s low at $35. In 1976, the gold correction ended in August and the equity market began a deep correction in September (27% over 18 months). During that period, gold rallied by about 78% and over the 1976-1980 period it multiplied in value by a factor of eight from just over $100 to over $800. The final part of that rally saw gold rise from $470 to $850 within four week on the back of the USSR invasion of Afghanistan. Even without that move it still multiplied by about 4.5 times in just over three years.

While I continue to view metals as an attractive asset class on a relative risk and return basis over the next five years, the relentless price declines over the last two years created a very negative technical environment during the quarter for gold that suggested it could go as low as $900 per ounce and added significantly to the volatility measurements of our portfolios. Therefore, in an effort to avoid holding our full weighting of precious metals as they retraced much of our early gains while also dramatically increasing our portfolios' volatility, precious metals allocations were reduced during the May/June period to a target of 5-10% (5% for Retiree Portfolios and 10% for Equity Portfolios, with remaining portfolios falling in between).

Concluding Comments

While it can be uncomfortable to see short-term losses in one's portfolio and financial markets falling across the globe, we should welcome this recent market volatility as it has the potential to create more attractive, if not outright compelling, *long-term* investment opportunities if the investing herds overreact and cause markets to overshoot to the downside.

I remain confident, however, that by being aware of overall portfolio-level risk and setting allocations accordingly, taking tactical allocations only when highly compelling opportunities are presented to us and using managers believed to be highly skilled, we can continue to earn above-average long-term returns while keeping shorter-term downside risk within our loss thresholds.

Enclosed are your investment reports for the quarter ended June 30, 2013. Thank you for your continued trust and confidence.

Highest regards,
Stegent Equity Advisors, Inc.

Loyd J. Stegent
President

Enclosures

Past performance does not guarantee future results. Investors cannot invest directly in an index.