October 22, 2013

The quarter ended with a surprising turn as the Federal Reserve's much-anticipated shift toward tapering its monthly bond buying failed to materialize at its September meeting. Shortly thereafter, monetary policy was upstaged by fiscal policy as Congress clashed over the budget and veered toward a government shutdown. Despite these twists and turns, stocks posted another strong quarter. Large caps rose 5% and are now up 20% year to date. (See the benchmark returns table for complete performance details.) These gains have occurred even as the U.S. economic recovery remains only moderate and corporate earnings growth has slowed. Our portfolios are modestly underweight U.S. stocks based on our expectation of subpar returns in most scenarios. At the same time, many of our stock fund managers (both U.S. and international) have added value relative to indexes through their stock selections, which has helped our portfolio performance despite this underweight.

September Benchmark Returns (Preliminary)

	Sept	3Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	3.1%	5.2%	19.7%
iShares Russell 1000	3.6%	5.7%	20.6%
iShares Russell 1000 Growth	4.4%	8.3%	20.7%
iShares Russell 1000 Value	2.5%	4.0%	20.2%
Mid-Cap Benchmarks			
iShares Russell Midcap	4.6%	7.8%	24.2%
iShares Russell Midcap Growth	5.1%	9.5%	25.3%
iShares Russell Midcap Value	4.2%	6.1%	22.7%
Small-Cap Benchmarks			
iShares Russell 2000	6.5%	10.7%	27.7%
iShares Russell 2000 Growth	7.3%	13.3%	32.8%
iShares Russell 2000 Value	5.8%	7.7%	22.9%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	7.9%	11.6%	15.1%
MSCI World ex USA Index	7.1%	11.4%	15.1%
Vanguard FTSE Europe ETF	7.2%	13.7%	14.8%
Vanguard FTSE Emerging Mkts ETF	7.3%	4.3%	-7.7%
Vanguard REIT Index	3.3%	-3.0%	3.1%
Vanguard Total Bond Mkt Index	1.0%	0.5%	-2.0%
BofA Merrill Lynch U.S. High Yield Cash Pay	1.0%	2.3%	3.8%
Vanguard Int. Term Tax-Exempt Fund	2.0%	0.5%	-2.0%
S&P/LSTA Leveraged Loan Index	0.2%	1.2%	3.5%
Citigroup World Govt. Bond Index	2.0%	2.9%	-2.9%
JPMorgan GBI-EM Global Diversified Index	4.4%	-0.4%	-7.6%
DJ-UBSCI (Commodity Futures)	-2.6%	2.1%	-8.6%

International markets improved in the third quarter following a rocky start to the year, particularly for emerging markets. Positives for developed markets included indicators of an improving economic outlook in both Europe and Japan. Among emerging markets, China showed signs of stronger growth (albeit at a lower rate than in prior years) so this was an overall positive given the country's significance among emerging (and developed) market economies. Emerging markets as a group rose in the third quarter and developed international markets outperformed U.S. stocks.

Core bonds in aggregate were modestly positive for the quarter thanks in large part to a rebound in September as both the Fed's decision to stand pat and investor risk-aversion in the face of an impending budget stalemate (and looming debt-ceiling standoff) were ultimately positive for bonds. The benchmark 10-Year Treasury yield ended the quarter at 2.64%, slightly higher than where it started, though down from its intra-quarter high.

Lastly, precious metals rebounded during the quarter, with gold gaining 5.8% and silver up 10.4%, but both remain down for the year (22% and 30%, respectively).

Third Quarter 2013 Investment Commentary

The word "fiduciary" is defined as "relating to, or involving one that holds something in trust for another." Another word that goes hand in hand with being a fiduciary for our clients is "prudence," which is defined as "careful management." In our industry, these words—fiduciary and prudence—are used liberally. I want to share what these words mean to us and how they influence the day-to-day management of client portfolios.

Our typical client in a conservatively balanced portfolio expects us to maximize long-term return without losing more than 15% in any normal 12-month period. There's an inherent trade-off in this dual objective. Managing to a downside risk threshold sometimes means we have to be willing to leave some return on the table. We have always said we do not manage our portfolios to one economic or asset-class scenario because we don't think we can know with confidence which scenario will play out. We hope optimistic scenarios play out, but do not build portfolios based on them unless we believe they are likely. Investing based on hope would not be in line with acting as a responsible fiduciary for our clients who have specifically entrusted us with the mandate to care about downside risk.

Managing portfolios to withstand various scenarios is as much art as science. In shielding our clients from one scenario, we expose them to others. The key is to strike a reasonable portfolio balance that allows us to meet our clients' risk and return objectives over the long term. Both inflation and deflation risks exist, and both are bad for risk assets. Our economy is still fighting significant deflationary headwinds due to ongoing private- and public-sector deleveraging. At the same time, the experimental monetary policy of keeping short-term interest rates near zero over extended periods could easily stoke inflation, and we don't know if and when that would occur. In this inflationary scenario our clients would expect us to protect their purchasing power. It would be nice if we had a crystal ball to know which outcome will occur and when, so we can position our clients' portfolios accordingly. But part of being intellectually honest is acknowledging that we do not have a crystal ball and there are many unknowns, especially now, when we are going through a major deleveraging episode and the range of possible outcomes is unusually wide. Our job becomes harder in a period when most assets appear to be richly valued. So, how do we balance out two extreme risks—inflation and deflation—given each scenario warrants a vastly different portfolio positioning?

To protect our balanced portfolios from a recession or deflation outcome, we continue to have a decent allocation in investment-grade bonds. In such an environment, interest rates would likely fall, and core bonds would increase in value as most risky assets are declining. We cannot ignore this outcome because in this scenario our stated 12-month risk-threshold objective is *most* at risk. Given their very low yield levels, core bonds would not give as much protection as they did in the past, but would still do a much better job of protecting capital than most other asset classes in this scenario.

That said, we acknowledge that relative to history, core bonds carry a significant opportunity cost. Despite a recent spike, interest rates remain very low by historical standards, which means that expected returns from core bonds are extremely low over the next five years. As a result, roughly half of our bond allocation has gone to absolute-return-oriented and flexible bond funds. Over 12 months, in a recession/deflation scenario, these bond funds are likely to lag core bond funds that have a longer duration and heavier emphasis on Treasury bonds. But over a five-year investment horizon, absolute-return-oriented and non-core bond funds are likely to generate significantly better returns. The value of these bond funds comes from their underlying managers' ability to add value by investing opportunistically across fixed-income sectors (without being constrained by the core benchmark) as well as from individual issue selection.

Some of our U.S. equity underweight has also gone to fund convertible bonds and preferred stocks, and here we see their role differently. Over a 12-month period, we expect our convertible bonds and preferred stock investments to have much less downside risk than stocks, and similar or better returns in all but the most optimistic scenarios over the next five years. Through a strong period for stocks, they have provided a reasonable return with much less risk. In addition, by having a lower allocation to stocks, we worry a bit less about capital preservation in a deflation/recession scenario and can afford to have less protection in the form of core bonds, which, in addition to having poor return prospects, expose us to the risk of rising interest rates.

Rational Reasons for a Modestly Bearish View on U.S. Stocks

We are maintaining our slight underweight to U.S. stocks in our balanced portfolios. Over the past two years or so, GAAP trailing 12-month earnings have gone nowhere but the market has continued its ascent, especially over the past year. The S&P 500 now trades at 19x trailing 12-month earnings. In a base-case scenario that assumes a 15x multiple on normalized earnings number five years out (an average historical multiple excluding the market's frothiest periods and a prudent multiple in our view given the deleveraging headwinds are still in place), it would imply a price of around 1,350 on the S&P 500 index, i.e., a *decline* of roughly 20% from present levels. This would bring U.S. stocks within a fair-value range and roughly the level where we'd consider raising our exposure to U.S. stocks.

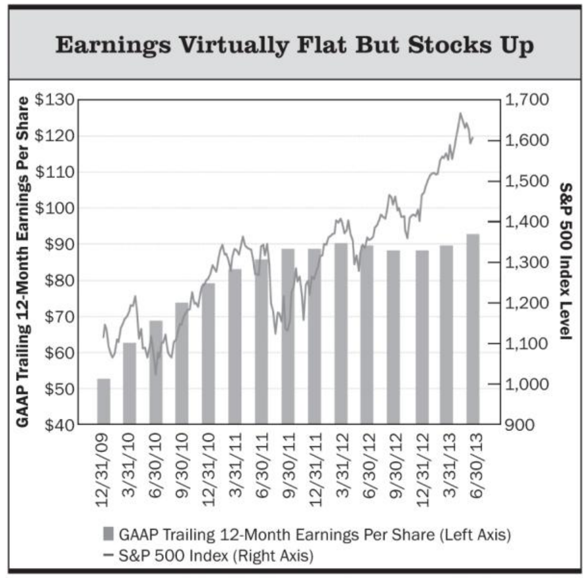

CHART 1 *Data as of 6/30/13 (estimated). Source: Standard & Poor's.*

On the other hand, given that most investors expect the Fed to keep short-term rates near zero until 2015 at least, P/E multiples of 18x–20x are quite conceivable in this environment, and quite normal to most investors who in their professional lives have only experienced the post-1980s investing world. Applying those P/E multiples to our normalized earnings five years out, then adding a dividend yield of slightly over 2%, we get returns in the 6%–8% range—not bad at all considering that the expected returns of other asset classes we can invest in are generally lower. This is one reason we are not *more* underweighted to U.S. stocks. On the other hand, if stocks continue to rise to the point where U.S. stocks start looking unattractive, even given these optimistic valuation multiples, we will lighten-up further.

Why Bother Investing Outside the United States?

This is a question we have been getting more frequently. We were getting similar questions back in the late 1990s after U.S. stocks experienced a great run of outperformance over international stocks. Developed international stocks subsequently went on to outperform U.S. stocks for six years, and emerging-markets stocks did even better. It is important to revisit why we have investments outside the United States as part of our very long-term or "strategic" allocations. The strategic allocations are the starting point for our investment process. They are intended to be an appropriate, fixed-asset allocation for a long-term investor, as they reflect a weighted mix of asset classes we believe offer the best long-term-return potential for a given risk threshold, which we define as a maximum acceptable loss over a 12-month normal worst-case period. Our investment horizon in regard to strategic allocations is 10 years or longer. The most important reason for having a globally diversified strategic mix is that it should provide a much smoother ride than just being invested in U.S. stocks.

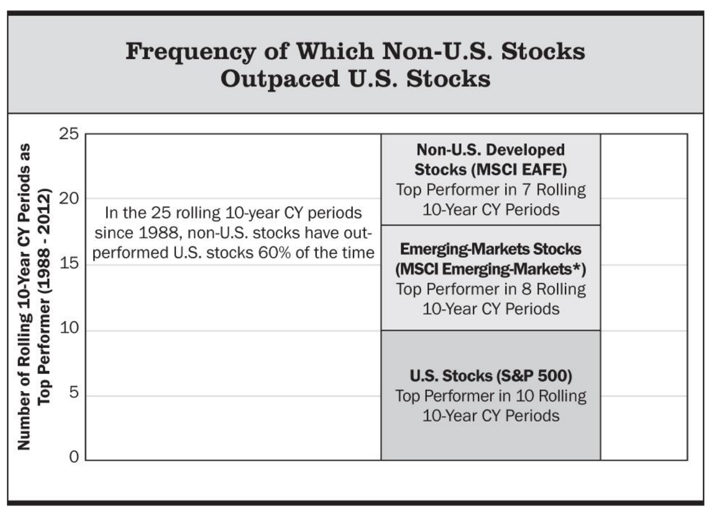

CHART 2 **MSCI Emerging-Markets Index's inception date is 12/31/87, first rolling 10-year period used in analysis is year-end 1997. Data: Rolling 10-Year CY Periods from 1988 to 2012. Source: Litman Gregory Analytics.*

The second reason to invest outside the United States is to tap into a broader investment opportunity set—much of which is not well-covered by Wall Street—allowing active managers to add significant value.

The case for having a dedicated long-term allocation to emerging markets is particularly compelling. On a purchasing-power-parity basis, emerging-markets' share of world GDP has grown from 37% in the late 1990s to nearly 50% as of 2012. Yet emerging markets still represent a much smaller share of global market value (on a market cap basis). The rapid pace of knowledge transfer from developing nations ultimately contributes to higher productivity, per-capita incomes, GDP, and profit growth in emerging economies. As this plays out emerging-market countries will see the gap narrow between their share of world GDP and market cap. We want our clients to participate in this long-term opportunity.

Taking Stock of Emerging Markets

Emerging-markets stocks were hit especially hard this year after the Fed indicated its intent to taper QE, and over the last couple of years have underperformed U.S. stocks. During this time we have taken advantage of price weakness in emerging-markets stocks by moving toward our strategic weighting at a gradual, measured pace. As such we are only one percentage point overweighed to emerging-markets stocks in our typical balanced model. We see it as a good way to hedge a potential decline in the U.S. dollar causing U.S. inflation. Insuring against this risk remains prudent in our view, given the Fed's unprecedented monetary policies in recent years that have bloated its balance sheet.

We believe the problems we've seen this year in emerging markets are only a blip on what we expect to be a very long-term, upward path. At the same time, we are cognizant of and continue to analyze risks to our emerging-markets investment thesis, but that does not negate the strategic case for owning emerging-markets stocks (and bonds) in client portfolios.

Parting Thoughts

An important part of our investment discipline is to protect client portfolios against downside risk scenarios we believe are plausible and not already adequately factored into asset prices. Taking this precaution means we will likely lag the broader stock market if a more optimistic scenario plays out. However, the fear of leaving some money on the table over short periods is not sufficient cause to deviate from the investment discipline that has served our clients well over the long term.

Enclosed are your investment reports for the quarter ended September 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.