January 24, 2014

The last month of 2013 looked much like the year overall: U.S. stocks were strongly positive, and international developed markets also gained. At the other end of the spectrum, bonds declined as yields rose and emerging-markets stocks and international bonds were generally negative. For the full year, the Vanguard 500 Index (our S&P 500 proxy) was up 32%—the index's best showing since 1997—and small caps soared even higher, gaining 39%. In the year-end commentary that follows, we review the big-picture themes underlying these results, including U.S. (and global) monetary policy and U.S. (and, in some cases, global) economic improvement.

December Benchmark Returns (Preliminary)

Large-Cap Benchmarks	Dec	4Q	YTD
Vanguard 500 Index	2.5%	10.5%	32.2%
iShares Russell 1000	2.7%	10.1%	32.8%
iShares Russell 1000 Growth	2.8%	10.3%	33.1%
iShares Russell 1000 Value	2.5%	9.9%	32.1%
Mid-Cap Benchmarks			
iShares Russell Midcap	2.9%	8.3%	34.5%
iShares Russell Midcap Growth	3.2%	8.1%	35.5%
iShares Russell Midcap Value	2.8%	8.5%	33.2%
Small-Cap Benchmarks			
iShares Russell 2000	2.0%	8.6%	38.7%
iShares Russell 2000 Growth	1.9%	7.9%	43.3%
iShares Russell 2000 Value	2.0%	9.3%	34.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	1.9%	5.9%	21.8%
MSCI World ex USA Index	1.5%	5.6%	21.6%
Vanguard FTSE Europe ETF	2.9%	8.3%	24.4%
Vanguard FTSE Emerging Mkts ETF	-0.3%	3.1%	-4.9%
Vanguard REIT Index	0.3%	-0.7%	2.3%
Vanguard Total Bond Mkt Index	-0.7%	-0.2%	-2.3%
BofA Merrill Lynch U.S. High Yield Cash Pay	0.6%	3.5%	7.4%
Vanguard Int. Term Tax-Exempt Fund	-0.2%	0.5%	-1.6%
S&P/LSTA Leveraged Loan Index	0.5%	1.7%	5.3%
Citigroup World Govt. Bond Index	-0.9%	-1.1%	-4.0%
JPMorgan GBI-EM Global Diversified Index	-0.5%	-1.5%	-9.0%
DJ-UBSCI (Commodity Futures)	1.2%	-1.1%	-9.5%

Several of the year's dominant macro trends were also front and center in December. Monetary policy—a major source of support for rising global stock markets in 2013—made news last month as the Federal Reserve announced its first actual reduction in its monthly bond buying. In contrast to May of 2013 when Fed Chairman Ben Bernanke began discussing a possible taper, investors took December's announcement largely in stride. Another key theme for the year overall was U.S. economic improvement. Here, too, December continued the trend with positive data releases in areas such as employment and consumer confidence.

Developed international markets gained nearly 2% in December and 22% for the year. Much as in the United States, supportive monetary policy (in Europe and Japan) was one factor that helped stocks. On the economic front, the picture is more mixed. While Europe exited recession, many countries continue to struggle with excessive debt and weak economies. Japan's stock market was the top performer in 2013. However, it remains to be seen whether Prime Minister Shinzō Abe's plan for dealing with deflation and sparking economic growth will deliver on its initial promise. Finally, amidst the positives, emerging markets were strikingly divergent as softer economic growth generated investor concerns and the potential Fed taper roiled markets further.

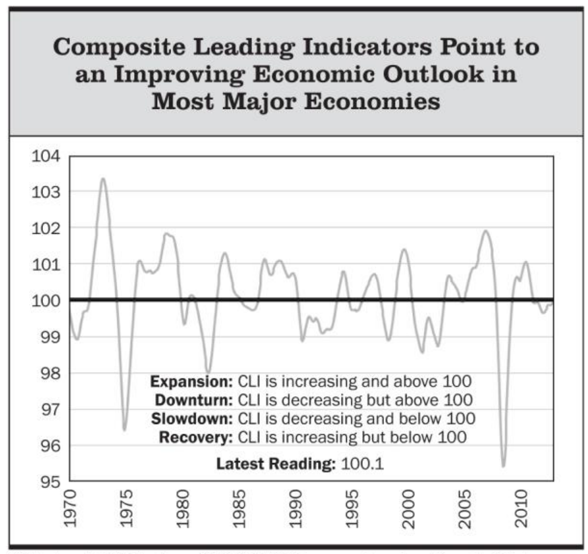
The investment-grade bond market suffered a rare calendar-year loss, falling 2%, its first decline since 1999. Results were driven by a general preference for risk assets as the economy recovers and investors seek higher returns, as well as concerns about a potential change in U.S. monetary policy. We review the performance of our portfolio positions in the commentary that follows.

The Improving Macro Picture

We find ourselves with a more sanguine big-picture view, at least over the nearer term, than we have had in some time. U.S. and global economic fundamentals gradually improved over the past year across a number of dimensions, and seem poised for continued improvement or at least stability in 2014. Unfortunately, the risks related to excessive global debt, subpar growth and unprecedented government policy that we have worried about since the aftermath of the 2008 financial crisis still remain largely unresolved. But before we revisit our concerns, let's quickly run through some of the key positives.

THE GLOBAL ECONOMY SLOWLY STRENGTHENS

At the broadest level, the **growth rate for the global economy** (which the International Monetary Fund estimates at 2.9% for 2013) improved in spots over the year and seems set to increase at least modestly next year. On a year-over-year basis, the U.S. economy grew at a real (i.e., inflation-adjusted) rate of around 2% in 2013 (through the third quarter), Europe finally emerged from recession, and the United Kingdom (2.6%) and Japan (2.1%) also generated modest but positive growth. Emerging-markets' growth was disappointing overall in 2013, but they should benefit from improved export demand in developed markets next year. As shown in the chart at right, the leading indicators index produced by the Organization for Economic Cooperation and Development recently rose above 100 and is increasing, which indicates an economic expansion is underway. The indicators are designed to provide early signals of turning points between the expansion and slowdown of economic activity, and are based on a wide variety of data collected by the OECD from its 33 developed country members and a handful of emerging countries.



Weighted CLI index of 33 OECD countries plus Brazil, China, India, Indonesia, Russia, and South Africa. Data as of 10/31/13. Source: Organization for Economic Cooperation and Development.

Manufacturing is a particularly bright spot with the J.P. Morgan Global Manufacturing Purchasing Managers' Index hitting its highest level since February 2011 and also signifying an accelerating economic expansion. The PMIs are based on monthly surveys that provide advance indication of what is happening in the economy by tracking changes in production, new orders, inventories, employment and prices.

HOUSING AND LABOR GAINS HELP BOOST THE U.S. ECONOMY

Specific to the U.S. economy, there are a number of positives extending a trend that was highlighted in commentary at the end of 2012:

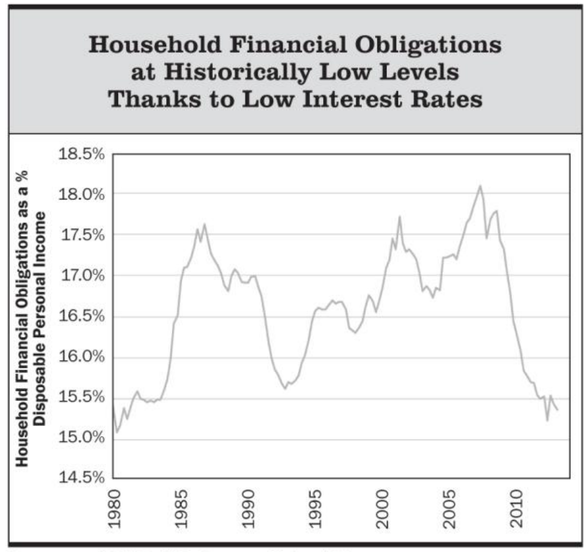
- The **housing market** continues to improve. For example, the widely followed S&P/Case-Shiller Home Price Index was up 11% from a year earlier, and CoreLogic reports the percentage of homeowners who owe more than their homes are worth fell to 13% (as of the third quarter) compared to 22% a year ago.

- Along with the surging U.S. stock market, the strengthening housing market boosted **household net worth** to new highs.

- The **labor market** continues to gradually improve. Nonfarm payrolls (the net new jobs created in the economy each month) averaged a solid rate of nearly 200,000 per month during 2013 (although that is still below the pace of job growth during a typical economic recovery), and the unemployment rate dropped to 7% in November. Of course, much of the decline in the unemployment rate has been driven by a drop in the labor participation rate to 30-year lows.

AN IMPROVED DEBT AND CREDIT PICTURE BODES WELL FOR CONSUMER SPENDING

Household deleveraging (i.e., debt reduction and repair of consumers' balance sheets) continued apace and household debt appears to be well along the path toward reaching more sustainable levels. The **household debt/income ratio**, a measure of the willingness and ability of consumers to increase their borrowing, has dropped 20% from its peak in 2007, and is now back where it was in 2003 and in line with its long-term historical trend.



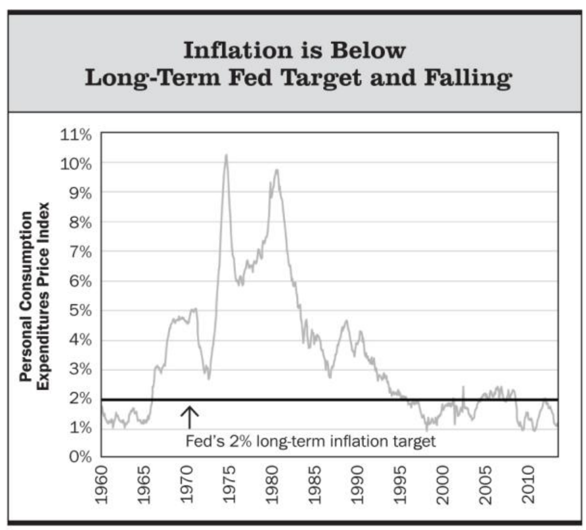
Data as of 9/30/13. Source: Federal Reserve.

Meanwhile, **household debt service and financial obligations ratios** remain at historically low levels thanks to extraordinarily low interest rates engineered by the Federal Reserve, along with modest income growth. Furthermore, **credit conditions** (i.e., credit availability and cost), as measured by a variety of indicators, also continue to improve and remain relatively loose.

These indicators bode well for an improvement in consumer spending, or at least limited further consumer retrenchment.

INFLATION IS LOW, MONETARY POLICY REMAINS SUPPORTIVE AND THE BUDGET DEFICIT HAS DECLINED

Inflation in the United States (and globally, with a few exceptions) is low and remains well-contained due to subpar growth and significant slack (excess capacity) in the economy. While prior commentaries have worried about the inflationary risks from overly accommodative Fed policy (and it remains a medium- to longer-term risk), there exists a more immediate risk of continued disinflation (a falling inflation rate). In 2013, the price index for personal consumption expenditures—the Fed's preferred measure of inflation—fell further below its target of 2%. As of November 30, 2013, the core PCE index (which excludes food and energy prices) stood at 1.1%, its lowest level since early 2011. The headline PCE inflation rate (which includes food and energy prices) was just 0.9%. On the other hand, if the economy gains some momentum and unemployment comes down further we will likely see increased wage pressures, which would put some upward pressure on inflation. (Rising wages would also pressure corporate profit margins, which remain at/near historical highs. This would have negative implications for earnings growth and stock market performance.)

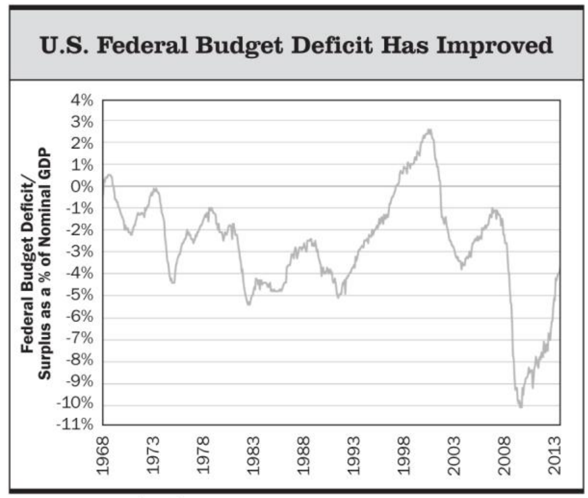


Data as of 11/30/13. Source: U.S. Bureau of Economic Analysis.

Also related to the inflation picture, **developed country central banks are likely to remain highly accommodative** at least over the next year or two in terms of holding short-term interest rates at extremely low levels, and in some cases also providing additional liquidity via quantitative easing bond purchases. Specific to the United States, at its December 18, 2013, meeting the Fed initiated tapering of QE bond purchases by $10 billion, to $75 billion per month. Fed chairman Ben Bernanke also stated that if the Fed sees continued improvement in labor market conditions along with stable inflation it "will likely reduce the pace of asset purchases in further measured steps at future meetings." If so, QE would likely be finished before year-end 2014 (there are eight Federal Open Market Committee meetings each year).

But importantly, the Fed also reinforced its intention (a.k.a. "forward guidance") to keep the federal funds policy rate at near zero for the foreseeable future, including "well past" the point when unemployment drops below 6.5%. Moreover, Bernanke was clear that the Fed remains concerned about inflation that is too low and anticipates keeping rates low at *least* until inflation clearly moves back toward its 2% objective.

The **U.S. federal budget deficit has come down sharply** over the past year, and, with the recent bipartisan two-year budget agreement, the drag on GDP growth from fiscal policy tightening will be reduced in 2014. This compares to 2013 when tax increases and "sequester" spending cuts shaved 1.5 percentage points off of GDP growth, according to Congressional Budget Office estimates. The two-year budget deal also greatly reduces the threat of another government shutdown during that span. However, another ugly political fight over the debt ceiling remains a possibility later in the first quarter of 2014. And the need for a credible medium- to longer-term plan for government deficit and debt reduction remains.



Data as of 11/30/13. Source: U.S. Treasury.

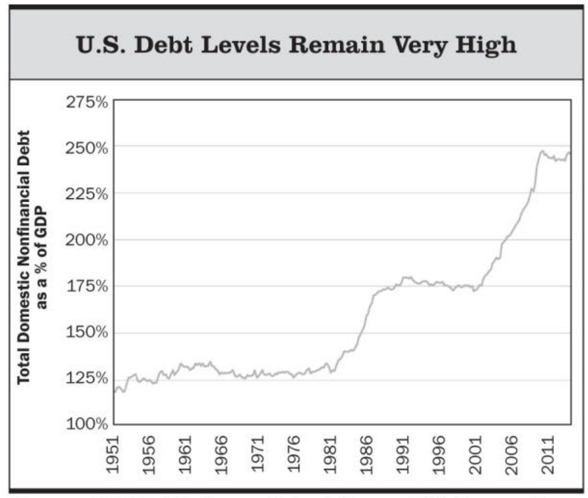
So, there are many macro positives that should not be ignored, but it is important to remember that just because economic fundamentals are improving doesn't necessarily imply a strong year for the stock market. Valuations, earnings growth, interest rates and overall investor sentiment/psychology (to name a few) are likely to be much more important drivers of market returns. The stock market is a discounting mechanism, so presumably it already incorporates positives like stronger economic fundamentals as this evidence comes out. This is reflected in what value oriented analysts see as unattractive/high valuations (even given a more sanguine macro outlook). So, don't be surprised to see a decent year for the global economy, but a weak year for U.S. stocks after the very strong rally in 2013. There also remain significant macro risks and uncertainties that continue to influence investment outlook and portfolio positioning as we look out over the next five years. We will discuss those next.

MACRO RISKS, NEGATIVE CONSIDERATIONS AND UNCERTAINTIES REMAIN

Wage growth and income growth in the United States remain subpar, although both have been increasing since late 2012. Weak income growth implies that consumer spending is likely to be subdued even as consumer deleveraging becomes less of a headwind. With consumption accounting for roughly 70% of U.S. GDP, this suggests continued sluggish economic growth absent a significant increase in consumer borrowing or reduced saving.

Overall U.S. debt levels remain very high and the projected growth in government debt and entitlement spending relative to GDP is still too high to be sustainable over the very long term. Resolving this without causing an economic contraction is likely to be challenging, even in a normal growth environment.

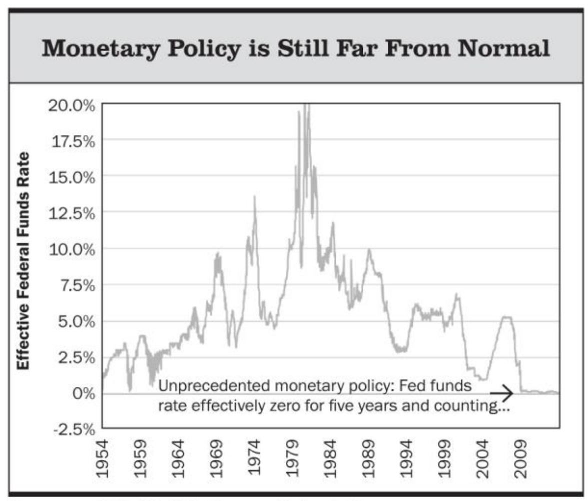
The chart to the right shows total household, government (federal, state, and local), and nonfinancial corporate debt as a percentage of GDP. It is still right near the all-time post–World War II high, due to continued growth in government and corporate debt.



Data as of 9/30/13. Source: Federal Reserve/U.S. Bureau of Economic Analysis.

Beyond the economics of deleveraging, the situation is made even more challenging due to the **U.S. political dysfunction**. The ability to forge compromise and progress on the country's longer-term debt/deficit situation remains highly uncertain, although there may be signs of light reflected in the recent bipartisan budget agreement. It's possible that the political dysfunction hit a low point with the government shutdown fiasco last fall. And public opinion of Congress is so low there is the potential for a positive surprise in this regard (though we shouldn't hold our breath.)

Fed monetary policy is still far from normal and, although the QE taper has begun, there remains a great deal of uncertainty as to how the Fed will exit from its zero fed-funds rate policy and unwind its huge balance sheet (currently at $4 trillion, or 22% of GDP, and still growing due to bond purchases) without causing an economic or market shock. I think it's more likely than not that the Fed will err on the side of tightening monetary policy (raising rates) too late rather than too early, and that inflation will become an issue for the financial markets, which would be a negative for both stocks and bonds. But as discussed above, that is not an immediate concern. Given the Fed's policy pronouncements as well as their unpleasant experience with the market's reaction to last summer's "taper talk," we should put a low probability on the Fed tapering or tightening too aggressively. But policy errors in either direction are certainly possible. (The change in Fed leadership from Bernanke to Janet Yellen is unlikely to lead to a significant change in policy.)



Data as of 12/18/13. Source: Federal Reserve.

THE BIG PICTURE IN SUMMARY

While there have been fundamental improvements in the macro environment over the past year, many big-picture risks remain as we look out over the next five years. I am not confident in predicting that any of these risks will actually play out, but I think many of them have a reasonable likelihood of happening (and many of these risks are interrelated, meaning if one happens others are more likely to occur as well). If so, the consequences for financial markets and asset prices would likely be severe. Although there don't *appear* to be any near-term catalysts, I believe it remains prudent to manage our balanced portfolios with these risks—and their potentially significant market impacts—firmly in mind. This is particularly so, given the assessment that current valuations for U.S. stocks (in aggregate) are not sufficiently pricing in the potential impact on the market if these risks actually do play out.

Investment View: Looking Back and Looking Ahead

With that macro backdrop, we'll move now to a discussion of our portfolios, looking at some of the key developments in the financial markets over the past year, their impact on performance and the investment outlook heading into 2014. Before doing so, I reiterate that we don't invest based on a one-year outlook or time horizon. Similarly, I don't judge the success of our investment decisions (or those of the fund managers with whom we invest) on a one-year basis. But, it is human nature at year's end to look back at what transpired over the past 12 months...

PORTFOLIO HEADWINDS

We had several headwinds to our relative performance in 2013. Let's look at each:

» Equities: *Underweight*
Our balanced portfolios were underweighted to stocks in 2013 and that hurt us in terms of returns. Over the course of the year, as the macro and valuation risks facing equities were weighed against the estimate of their longer-term (i.e., five-year) return opportunity, my conclusion was that having a moderately defensive portfolio positioning (reflected in a below-benchmark allocation to stocks) made sense. The fact that the major risks we considered did not play out over the past 12 months does not invalidate them.

Within our non-U.S. stock exposure, we were underweighted to developed international stocks relative to emerging-markets stocks. Within our U.S. stock exposure, we have been underweighted to small-cap stocks relative to large-cap stocks and underweighted growth relative to value stocks. All of these relative positions were headwinds to our performance in 2013. U.S. growth stocks were the top-performing asset class, with the S&P 500 up 32%, followed by developed international stocks (up 22%). Emerging-markets stocks declined 5%. Adding to the relative performance headwind, small-cap U.S. stocks outperformed U.S. large caps by roughly six percentage points.

I have presented analysis and rationale for our underweight to U.S. stocks in many previous commentaries, so I won't repeat all the details again here. But in summary, based on a scenario analysis (using a range of reasonable earnings-growth and valuation assumptions) and looking out over a five-year tactical time horizon, the reasonable estimate of the most likely annual return for U.S. stocks is in the low single digits. If true, stocks' current upside potential is not high enough to *fully* compensate us for their downside risks unless a more optimistic scenario than expected plays out. Put differently, I view U.S. stocks as broadly overvalued, but not egregiously so and therefore we have been moderately underweight.

» Small Cap U.S. Stocks: *Underweight*
From a top-down perspective, small-cap stocks look even more overvalued, both on an absolute basis and relative to large caps, which is the primary reason we are underweight small caps. For example, analysis by the Leuthold Group shows small caps selling at a 20% valuation premium relative to large caps. They note that this is the *fourth-highest* monthly observation in the past 30 years. In addition, from a bottom-up perspective, a number of small-cap and all-cap managers have been saying they are finding it increasingly challenging to find attractive investment ideas in the small-cap space as stock prices have shot higher. As a result, many of them are holding large cash positions or have shifted their all-cap portfolios heavily in favor of larger-cap names.

» Emerging-Markets Stocks and Commodities, including Precious Metals: *Overweight*
I devoted a good portion of prior reports to analysis of potential returns and risks for emerging-markets stocks and commodities. We also discussed the key drivers of the disappointing recent performance of these asset classes and our rationale for having a long-term (strategic) exposure to them in our portfolios. Moreover, on a tactical five-year basis, I continue to view emerging-markets stocks as likely to generate better returns than U.S. stocks across most scenarios—a function of their more attractive starting valuations (particularly after the huge disparity in performance in 2013) as well as what analysts expect to be stronger earnings growth over this time horizon. But I also continue to view the downside risk and volatility of emerging-markets stocks as higher than for U.S. stocks, and take this into account in our overall portfolio construction. Emerging markets represent 7% of our overall equity exposure.

Commodities, including precious metals (and especially mining stocks), were the worst performing asset class in our portfolios in 2013, declining 10%, 31% and 52%, respectively. Not only did they lose money, but we funded them from a mix of U.S. and international equities, so the relative return shortfall was about 40%. (Meaning about 40% of our portfolios' underperformance was due to this allocation.)

We are allocating 9% of our total equity exposure to precious metals because we expect them to generate mid- to high-single-digit returns over the next five years, and because they also provide some "insurance" against an unexpected decline in the U.S. dollar, which is one potential outcome of the Fed's aggressive monetary policy. This allocation represents about a 25% reduction in our metals exposure due to the current expectations for low inflation and the likelihood that significant inflation pressures are not yet on investors' radars. The reduction in metals exposure will allow us to fund a slight increase in exposure to mining stocks due to the "fat pitch" they currently represent.

Mining stocks are in the bargain bin after spending the past three years in a tough bear market. Junior mining stocks topped in February 2011 and fell for the rest of the year…then for all of 2012 and all of 2013. After falling more than 50% in 2013, gold stocks have never been cheaper compared with the price of gold. Now, large cap miners are starting to buy up dirt-cheap junior minors, setting the stage for the start of the next big bull market in junior mining stocks. Increasing our exposure to 3% of our equity exposure to this depressed sector should help our losses be reversed in the coming quarters.

While the weak performance of emerging-markets stocks and commodities in 2013 was certainly disappointing, it is important to remember that 1) we should view these as long-term investments; 2) their potential returns remain attractive on a longer-term basis; 3) by definition a diversified portfolio is going to have some investments that are performing more poorly than others over any given period, but that does not invalidate the longer-term portfolio benefits of owning a variety of asset classes with different risk and return drivers; 4) the magnitude of the relative outperformance of U.S. stocks vs. emerging-markets stocks and commodities in 2013 was unusual; and 5) I think it was largely an overreaction to shorter-term factors (e.g., disappointing emerging-markets growth, Fed tapering fears) and not justified by longer-term fundamentals or valuations.

» Income Oriented Equities: *Overweight*

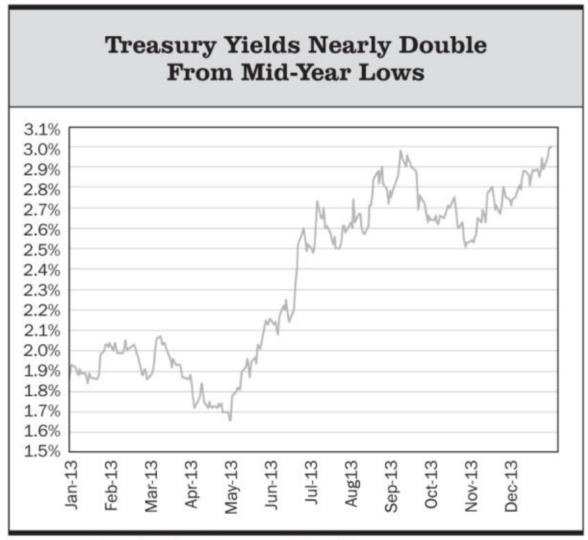
The third area in the portfolio that we funded from our tactical underweight to U.S. and international stocks was income oriented equities. These include lower-risk strategies with preferred stocks and convertible bonds, high income strategies with master limited partnerships and REITs and dividend reinvesting strategies with large value stocks that gush free cashflow and are backed by impeccable balance sheets (stocks I call globally dominant dividend growing stocks). Buying and reinvesting dividends in income oriented equities like Intel (3.6% yield), Sysco (3.1% yield), Cisco (3% yield), Microsoft (2.7% yield) and even Apple (2.1% yield), all of which are globally dominate in their industries and aggressively increasing their dividends, while continuing to grow earnings and revenues, are intended to generate long-term returns that are equivalent to the S&P 500 Index, but with much lower downside risk and volatility due to their industry dominance and our strict price limits when we add shares. Note that mutual funds and ETFs that invest in these stocks are used in place of individual stocks due to diversification issues in some portfolios.

Our income oriented equities met their strategic risk/return objectives for the most part in 2013, generating positive returns with low volatility, though the returns were below the S&P 500 Index and our longer-term expectations. In the few brief periods where stocks declined meaningfully in 2013 we saw the risk management benefits from owning income oriented equities. But for the year as a whole they were no match for stocks' 30%-plus returns. We continue to maintain a 30% weighting of our equity exposure to income oriented equities for their diversification benefits and expected contribution to overall portfolio risk-adjusted return.

» Core Fixed Income vs. Flexible and Absolute Return Oriented Fixed Income

Over the fourth quarter we have been rotating out of about 50% of our core investment-grade bond exposure into flexible and absolute return oriented fixed income. The expectation is that longer-term returns for core bonds will be very unattractive—a function of their very low starting yields and the likelihood that interest rates would rise over our five-year horizon, leading to price declines. As such, we replaced half of our core bond exposure with tactical positions in several "non-core" flexible and absolute-return-oriented fixed-income funds run by skilled managers. We also added positions in floating-rate loan funds in our bond-heavy portfolios, where the negative return impact from rising interest rates on the overall portfolio is greatest. In aggregate, these non-core fixed-income positions have been a positive for our balanced portfolios' performance over the final quarter of 2013, but our returns suffered significant damage from the traditional fixed income exposure when interest rates almost doubled starting in May of 2013.

As illustrated in the chart on the right, the 10-year Treasury yield started the year at 1.8% and ended it at 3.0%. This translated into a 2% loss for the Barclays Aggregate core bond index—its worst year since 1994, and second worst in the index's 37-year history. In aggregate, our non-core bond funds outperformed the core bond index. We are maintaining our underweight to core fixed income going into 2014.



Data as of 12/26/13. Source: Federal Reserve

Looking ahead, longer-term expected returns for core bonds remain unappealing. Unlike stocks, where the range of potential returns is very wide depending on the scenario, core bonds are likely to return somewhere in a narrow range of 1%–2.5% annualized over the next five years. Given this dreary return outlook, the sole purpose of core bonds in our balanced portfolios at present is as protection against a negative economic surprise or financial market shock that causes investors to flee stocks and riskier assets in favor of the safety of high-quality bonds.

I also continue to evaluate the trade-off between the opportunity cost of our core bond position (i.e., the likely higher returns we could earn from riskier investments, including more aggressive flexible bond funds) and the benefit it provides in terms of downside protection, particularly for our clients who are most risk averse. In a bull-market year like 2013, the opportunity cost of core bonds is evident. But should some of the deflationary risks and weaknesses that remain in the global economic system intensify, core bonds would benefit.

»Diversification…A dirty word when stock indexes soar

As we look back on our portfolios' performance in 2013, it is a year in which our investment discipline, manager selection, portfolio management and risk management processes were critical, as each of these played an important role in determining our portfolio allocations. While our biggest tactical positioning was away from the asset class that ended up having the strongest performance (U.S. stocks), we still maintained meaningful exposure there because of the potential for a more positive scenario for stock returns and, in all but the most pessimistic scenarios, stocks were still likely superior to core bonds. Our positioning reflected *both* the conviction that on a five-year forward basis U.S. stocks were unlikely to deliver satisfactory returns *and* the acknowledgement of the unusually high degree of uncertainty and, by implication, unusually wide range of potential outcomes.

Part of what I mean when I talk about being intellectually honest is that I don't pretend to have certainty or a high degree of confidence in a particular outcome if I don't believe such confidence is strongly justified by the facts, circumstances and analysis. To do so would be fooling our own selves. That is why *diversification*—owning a variety of asset classes, strategies and managers that should perform differently depending on the scenario and building a portfolio that should perform reasonably well across a wide range of possible scenarios—is an important part of the discipline *in addition* to our conviction-driven investment approach. Over the long term we should outperform, but it won't happen every year and we shouldn't take undue risks to try to achieve that objective.

Almost every client portfolio entrusted to us is large enough to fund a comfortable retirement. Slow and steady growth with reduced volatility, as opposed to excessive exposure to highly volatile asset classes, is the desired path. And we have been successful in reducing the volatility in our portfolios, as measured by the standard deviation shown on your performance reports. Large cap stocks have historical standard deviations over 15%, while small and international stocks have volatility north of 20%. Our portfolios' standard deviations are usually half of those numbers, sometimes only one-third, indicating we have been successful at reducing the size of the rollercoaster to which our finances are subject. Not withstanding that, I continue to evaluate additional strategies and asset classes that will add alpha (higher returns) in an effort to maximize our portfolios' return potential.

Concluding Comments

The renowned value investor Seth Klarman concisely summarized the current environment when he wrote the following in his year end shareholder report:

> Investing today may well be harder than it has been at any time in our three decades of existence, not because markets are falling but because they are rising; not because governments have failed to act but because they chronically overreact; not because we lack acumen or analytical tools, but because the range of possible outcomes remains enormously wide; and not because there are no opportunities, but because the underpinnings of our economy and financial system are so precarious that the unabating risks of collapse dwarf all other factors.

Patience and maintaining a long-term perspective, while always very important, are especially critical in this environment. Most asset classes are currently priced for just fair or subpar longer-term returns in my view and stock market sentiment in the United States is reaching optimistic extremes, suggesting a pullback may be close at hand. Investment "fat pitches" are few and far between and this is not the time for most investors to be at the plate swinging aggressively. (Yet that is what always seems to happen *after* markets have strongly rallied, and the very heavy recent inflows into stock mutual funds and ETFs suggest it is happening again.) However, with hugely accommodative monetary policies still in place against a backdrop of tame inflation and gradually improving global growth, I could make the case that the conditions for a major market decline also do not appear imminent. Stocks could continue to follow the path of least resistance higher over the months ahead.

Our asset allocation discipline is to assess potential asset class returns and risks across a range of scenarios, based on forward-looking analysis and judgment, and informed by experience and study of market history. I don't know the timing, but I am confident better investment opportunities will arise over the next few years—it's always been the case, driven by market cycles and the timeless human emotions of fear and greed. We should continue to apply our discipline in order to capitalize on compelling return opportunities when they arise, but always with a strong focus on the risks our portfolios may be exposed to, while understanding that not all such risks will ultimately come to pass.

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.