DIVERSIFICATION STILL MATTERS

DIVERSIFICATION IS NOT WORKING RIGHT NOW

Being a diligent portfolio manager and investing in a multi asset class portfolio resulted in little gains so far this year. In fact, except for US Stocks, few other asset classes added to portfolio returns in any positive fashion. If you only, and I stress <u>only</u>, owned US Stocks you would have been quite happy with gains well into the double digits at the half way point of this year.

At the time of this writing the S&P 500 was up some 13% and the S&P small cap was up in excess of 17%. All Russell Indices of small, mid or large-cap US Stocks have double digit returns so far, year to date. Stocks outside the US were lackluster at best, offering little to no growth and in some cases negative returns. The MSCI-EAFE International index was barely up 2%. Latin American funds, as tracked by Morningstar, were down in excess of 17%. The BRIC (Brazil, Russia, India, China) countries equally showed double digit losses. If you owned US Treasuries, especially the benchmark 10 year US Treasury bond, you saw interest rates rise by some 100 basis points or 1% prior to July 4th. This translates into declines in a 7-10 year US Treasury portfolio (measured by the US Treasury aggregate) of nearly 10%. Additionally, Corporate Bonds, TIPS (Treasury Inflation Protected Securities), Emerging Market Bonds, Municipals and High Yield bonds all recorded declines, some only fractionally, but nonetheless declines. Bond managers have seen outflows of nearly $62 Billion in bond mutual funds alone.

To speak of diversification, or the lack thereof, reminds us of the days of Apple, when you only had to own the one technology company to make money. I obviously jest when I say, "who needed diversification, as everyone owns an Apple product; stores are packed, and everywhere you travel you see Apple products. Sell Microsoft; buy Apple... to the Moon!" Only nine short months later, with reality as well as emotions reigned in, Apple sits some 40% lower from its high. Year to date, Apple is down in excess of 20%. Interestingly, it's one of the few large-cap US Stocks registering declines for 2013. (Note: Microsoft is up nearly 30% year to date)

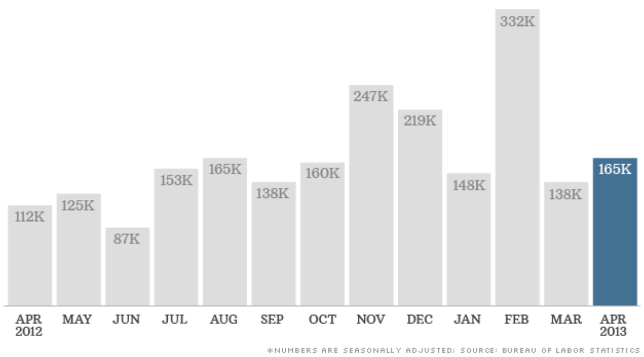
THE INGREDIENTS: JOBS & HOUSING

<u>JOBS</u>

Leading up to this past quarter we have seen improvements in many facets of the economy. Specifically, we have seen real improvement in the jobs picture, as more Americans are finding employment. We have said numerous times in our commentary that it's "all about jobs". Americans gaining employment injects real dollars into the US economy. Wages leads to spending and ultimately higher consumption leads to the potential for the economy to move out of a stagnant stage.

In April, the US economy added 165,000 jobs, in March 138,000; and in February 332,000 jobs were added. In addition, there have been positive revisions in the last several labor reports showing significantly stronger job growth. The strongest areas of job growth in April were from restaurants and bars with 38,000 jobs added; temporary services added 31,000 and retailers added 29,000 jobs.

JOBS REPORT: APRIL 2012 - APRIL 2013



The job growth is encouraging even when government data revealed that Federal, State, and local governments cut 11,000 jobs. By no means is the US Economy out of the woods though. When it comes to American workers, the bigger picture shows nearly 12 million people, or 7.5% of the population, remains unemployed. The unemployment rate does not include people who have not looked for work in the prior four weeks (known as the participation rate). We are not without continued problems in the US Economy as the labor participation rate fell to a 34 year low. The picture is especially troubling for people aged 20-24 looking for work as unemployment is at 13% for these young workers.

Compared to historical levels, the overall unemployment figures are quite high. Prior to the Great Recession, unemployment averaged approximately 4%. Nonetheless, the Federal Reserve sees that there is some degree of growth and stabilization in these figures as the overall unemployment rate is dropping.

The Fed has sent a clear message linking their interest rate outlook (and how they will adjust short term rates) to economic thresholds. Bernanke has said, interest rates will stay low at least as long as unemployment remains above 6.5% and if the Fed projects inflation of no more than 2.5% one or two years in the future. Officials at the Fed don't see joblessness falling near that goal until 2015.

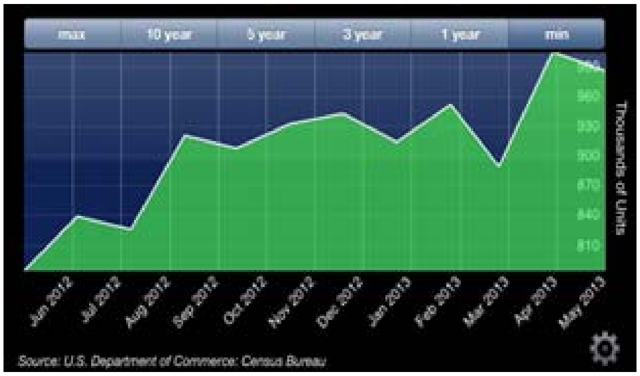
It is important to understand what Bernanke's Federal Reserve is trying to do here. The markets, and multiple asset classes at large, have responded to one of the most powerful tools the Fed has as a resource, "FED-SPEAK." Nothing more than the action of saying "we may look to taper the amount of stimulus we are injecting into the US Economy" has jolted both the bond and stock markets. This comes at a fragile inflection point in the recovery when we are seeing some improvement in data on the US economy. The Fed needs to tread lightly here so they do not choke off the recovery we have made thus far. We believe the Federal Reserve will maintain their commentary and track in letting the markets know they will remain "accommodative" until they consistently see strong US economic growth.

HOUSING

Another important ingredient in measuring the pulse of the US Economy is the housing market. The housing market represents a critical part of a healthy economy. When banks lend, the housing market and US economy is propelled. Jobs are created in businesses such as lumber, concrete, electrical, roofing, steel, bricks, appliances, furniture, and flooring. When housing declined, tens of thousands of jobs were lost and businesses closed that were interconnected to the housing industry. This important additive to the economy is staging a comeback.

In July 2010, sales of single family homes were 276,000 vs. 454,000 today. In the same time period the median sales price of a home was $204,000 vs. $271,000 today. In addition, the economic measurement of looking at housing inventory has come down from 9.1 months to approximately 4 months. New private housing permits to build homes are also up, as shown below:

NEW PRIVATE HOUSING UNITS AUTHORIZED BY BUILDING PERMIT



THE VIEW

When Ben Bernanke was a Princeton University professor, he presented an economic paper titled "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" In this paper, he criticized central banker's unwillingness "to try anything that isn't absolutely guaranteed to work." He went on to say that in slumps, policy makers need "Rooseveltian" resolve, which he described as a "willingness to be aggressive and to experiment, in short, to do whatever was necessary to get the country moving again."

Bernanke believes in the element of creative thinking coupled with unprecedented economic events. As the global credit crisis unfolded, more than $2 Trillion in aid, along with six loan programs, currency swaps with other world central banks and rescues of financial companies, tripled the balance sheet of our Federal Reserve Bank.

The intention of this entire stimulus was to bring down longer term borrowing costs and stimulate purchases of assets like homes and cars. The hope was also to stimulate businesses to finance growth and hire additional workers, ultimately driving consumption in a declining economy. To date, the Federal Reserve has made no action to increase or tighten interest rates. They have merely "Fed-Spoken" on the potential of "reducing" stimuli.

Much has been said in the media about Bernanke sending mixed and confusing messages. We don't believe this is the case. He has made it clear that the continuation of the economic stimulus is dependent on the data. Investors, however, only needed to hear a "hint" that a taper may be coming and they quickly exited.

THE TAPERING OF THE TAPER

Four years ago, interest rates were reduced to zero in order to divert a much wider spread economic depression. There are many unintended consequences of keeping interest rates too low for too long, which will ultimately be felt if The Fed does not begin to reduce the economic stimulus. The more the Fed allows itself to borrow and inject into the economy, the more it will have to pay back later.

Short-term interest rates will likely be kept low for a significant amount of time as The Fed looks to slowly reduce stimulus. The higher interest rates move, the more costly it will be for the US Government to pay back the debts it incurred to help save the US Economy. To the Federal Reserve, housing and jobs are two of the ingredients used to determine the needs of the US Economy, or in this case how much of the punch bowl can be taken away. This tapering is likely to take place over an extended period of time, to create minimal market disruptions as possible.

DIVERSIFIED PORTFOLIOS ARE STILL THE WAY TO GO

An integral building block of portfolio management is diversification. Having all your eggs in one basket (or “asset class”) would have led to zero returns for investors in the S&P 500 from 2000-2009. During this “lost decade”, adding international markets and bonds to the portfolio would have led to more positive returns in varying degrees, depending on the level of diversification.

Likewise, only owning US Stocks in portfolios for the last 6 months would have felt good in the short-term because of the substantially positive returns they provided; however, it would have violated the tried and true rules of portfolio management. Markets do not go straight up or straight down. At times, they can become full of frenzy and emotion. We have taken the opportunities provided by the bond and stock markets pull backs in the last six weeks to position portfolios for the long-term economic recovery we see unfolding, while being careful not to take on too much risk.

The portfolio management rules we continue to employ are as follows:

- Diversification reduces risk
- Diversification spread among other asset classes lowers volatility and risk
- Diversification takes advantage of exposure to multiple markets which perform differently over time.

We believe diversification represents the hallmark of long term wealth accumulation and preservation. We will continue to follow the rules of diversification, not letting emotion cloud our judgment, while making prudent portfolio allocation decisions.

We are always interested to hear your comments and answer any questions you may have on any part of your financial life. Stay cool, and enjoy the warm summer months.

Sincerely,

JJ