APRIL 2014

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"Yesterday is not ours to recover, but tomorrow is ours to win or lose."
- Lyndon B. Johnson

SUMMARY:

The US economy continues to improve at a slow and steady pace.

We take a closer look at portfolio classifications and benchmarks.

Charitable giving rules have changed for 2014.

SBL's Boulder office is moving to 4840 Pearl East Circle, Suite 300E

Welcome Zach Cole and Christiana Glenn as the newest members of the SBL team.

Brad Bickham was named to Barron's "2014 Top Advisor Rankings" and was one of only two independent advisors in the state.

In This Letter

Dear Clients and Friends,

The following are returns for the last one, three, and ten years.

Returns as of March 31, 2014	1st Qtr 2014	Last 12 Months	Last 3 Yrs. Cumulative	Last 10 Yrs Cumulative
World Stock Index (ACWI)	0.9	17.0	28.4	102.8
Large Cap U.S. Stocks	1.7	21.8	50.7	104.4
Mid Cap U.S. Stocks	2.9	20.9	44.4	155.0
Small Cap U.S. Stocks	0.9	26.9	54.5	126.9
Nasdaq 100	0.3	29.1	58.4	163.5
Foreign Stocks - Developed	0.2	17.2	22.8	84.8
Foreign Stocks - Emerging	-1.9	-2.0	-10.6	148.2
U.S. Bonds – Taxable	1.8	-0.3	11.5	54.8
U.S. Bonds – Tax-Free Municipals	3.7	0.1	18.0	49.3
REITs	7.3	-1.7	24.1	119.1
High Yield Bonds	2.9	6.7	24.7	97.8
Commodities	9.7	0.1	-20.0	4.4
Hedge Fund Index	-0.1	7.0	8.2	37.1
Gold	6.5	-20.0	-11.6	204.9
60/40 Balanced World Index	1.3	11.5	26.8	88.9
60/40 Balanced U.S. Index	1.6	12.5	34.3	87.5

The first quarter was pretty flat for most stocks around the globe, but that does not mean they sat still all quarter. Equity markets were generally weak in January, strong in February, and flat in March. In the first two weeks of April we saw renewed weakness.

Bonds have done well, as has gold and some commodities. And, there has been strong performance from REITs and municipal bonds. What can we glean from these changing trends?

Unfortunately, we don't think there is much information in these returns. We believe these are most likely technical factors. Investors are repositioning

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portfolios, taking gains from areas that performed extraordinarily well in 2013, and investing in areas that have been underperforming.

Whenever there is a correction in the markets, investors begin to re-examine their assumptions and where their fundamental view may be wrong. But rather than a deteriorating condition, the recent news continues to point toward a moderately improving economy, low inflation, an accommodative monetary policy, improving sentiment, and a better employment market.

Consider the most recent news. The March manufacturing ISM index ticked up with a strong gain in production and a small gain in new orders. The March unemployment report was solid with a gain of 192,000 non-farm payrolls and weekly jobless claims hit their lowest level since May of 2007. The Michigan sentiment survey for April rose and is just shy of its post-recession highs seen last summer.

The Fed is unlikely to raise rates – quite possibly not until 2016. Yields on the 10 year Treasury bond have actually fallen slightly this year. Inflation is not a problem. If anything, deflation is a greater concern, but a broad based decline in prices seems like a remote possibility to us. Instead, this appears to be a goldilocks economy – not too hot, not too cold.

How about corporate earnings? What kind of reports are we likely to see? Investors expect mediocre results for the 1st quarter due to poor weather conditions. Consensus estimates imply 2% earnings growth and 5% revenue growth. This lowered expectation level explains part of the market's malaise. But with these lowered expectations largely priced in, investors will key in on any comments from management regarding improving business conditions.

As just one example of conditions, Polaris, one of our portfolio companies, announced they had released two new ATV models, a new snowmobile platform, a newly reintroduced Indian line of motorcycles, and a soon to be released roadster. They expect this to be the best new product portfolio ever and anticipate earnings growth of 20% a year over the next two years. If this isn't a sign of a healthy consumer, then we don't know what is. What can be more discretionary than ATVs, snowmobiles, motorcycles, and roadsters?

As we move through the year, we will be faced with another election. It is too early to make accurate predictions, except for a lot of hot air and irritating commercials on television, but most analysts expect Republicans to hold the House and possibly win enough seats to take the majority in the Senate. If that happens, while it would still be a divided government, the Republicans would likely be more aggressive in trying to make changes to the Affordable Care Act and might consider tax legislation or entitlement reforms. Our only expectation is that Washington will be more disruptive in the coming months.

Similarly, while Ukraine and Russia are not significant economically, the uncertainty created by the problems there will weigh on the markets. A new cold war is unlikely. The U.S. is the dominant world power, but there is no appetite for another war, so this issue along with lingering problems in Iran and the Middle East will periodically flare up and spook the markets. Unfortunately, the chances of a worldwide break out of peace and happiness seem remote.

Strategies

Our strategies did not change significantly in the first quarter. At least, we did not alter our broad asset allocation targets. We refined several of our portfolio categories, however, in order to make them more consistent and understandable. For example, we have long had two moderate growth allocation strategies: 65% equity / 35% bonds, and also 60% equity / 40% bonds. Going forward we will combine these into one allocation strategy we call "Moderate Growth". For comparison purposes, we will use a 60% equity / 40% bond benchmark because that is the most common industry benchmark; but we will allow the equity allocation to vary within a range of 60% to 65% during most environments. During extreme periods we may target an allocation further away from these levels, but in no circumstances would we deviate from a 40% to 70% range. The other allocation strategies have similar ranges. The idea is not to have rigid targets, but to match portfolios to clients' objectives and to have some flexibility to move with changing markets.

The new categories are as follows:

Name	Normal Target Equity/Bond	Typical Equity Range
Preservation	20 / 80	10 – 25
Conservative	35 / 65	20 – 40
Balanced	50 / 50	30 – 60
Moderate Growth	60 / 40	40 – 70
Aggressive Growth	75/ 25	50 – 80
Global Growth	100% Equity (U.S. & Int'l)	60 – 100
Core U.S. Equity	100% Equity (U.S. Large Cap)	60 - 100

Another refinement in our process this last quarter was to consolidate international equity into just one asset class from two. Emerging markets will be used as a tactical investment rather than be seen as a separate asset class. This simplifies the allocation analysis. A portfolio structure looks like this:

Safe & Stable
- Cash
- Fixed Income – Core
- Fixed Income – Tactical

Growth
- Core U.S. Equity (Large Cap)
- Small & Mid Cap U.S. Equity
- International Equity

Alternative Strategies
- Diversified Income
- Low Correlation
- Low Volatility

In addition to emerging markets, we have added small cap international to our toolbox for international equities. One can argue whether emerging markets and small cap should be broken out as different asset classes. We decided a more simplified approach suited our purposes partly due to the allocation to international. With only a 15% allocation to international in most diversified portfolios, breaking out emerging markets and/or small cap results in targets that are too small. We will compare the performance of our international asset class against the MSCI All Country World ex-U.S. Index. That index has a roughly 20% weighting to emerging markets.

International small caps have not garnered the same attention as in the U.S., but the argument is the same. Smaller companies typically grow faster and offer more opportunity for investors. They also tend to be more volatile. There are not nearly as many mutual funds dedicated to small caps internationally as there are in the U.S., but there are a handful with long histories. We identified the top two or three and interviewed them. The Oberweis fund stood out as the best in our opinion. Our analysis found the following:

- #1 International small cap fund over a 3 and 5 year period
- Highest Sharpe and Information Ratio
- Average market cap is $2bil. 13% large-mid, 56% mid, the rest small cap
- Fund has about $700mil in AUM, which allows them to be nimble and invest in smaller companies
- Fund was launched in 2007 - Oberweis recruited Ralf Scherschmidt, CFA as the lead PM - he is German and a Harvard grad.
- Employee owned firm. Total firm assets is about $1.5bil.
- Fundamental/bottoms up stock picking. Country selection is not a huge factor.
- Disciplined 16 step process to find companies.
- Sell discipline based on valuation and when the market fully recognizes their thesis.
- Because they are valuation and risk sensitive, they have high turnover.

Core U.S. Equity

Core Equity tracked the market closely in January and February, but underperformed in March and trailed 0.3% vs. 1.8% at the end of the quarter. The biggest losers were last year's biggest winners, and we find no fundamental reason for the declines. For example, Amazon was down 15%, Ralph Lauren was down 8%, and Nike was down 7%. There was a slowdown in consumer spending, but the longer term prospects for these companies have not changed. Especially in Amazon's case, we think this was just profit taking.
We made two changes to long term holdings last quarter.

Procter & Gamble was sold and the proceeds invested in Perrigo; and Chevron was sold and we re-invested in Enbridge. In both cases, we had held these stocks for over 5 years and performance had been reasonable, but we believe the two new companies can perform better. PG is one of the world's largest consumer staples companies. The problem is that it is so big, it is difficult for them to do anything to make earnings accelerate in a meaningful way. Perrigo is a smaller, but still substantial company ($20 billion) that produces store brand products in consumer health, nutritionals, and generics. When you buy Safeway brand Ibuprofen or vitamins, for example. We anticipate their earnings can grow close to 20% per year for the next few years.

Similarly, Chevron is a solid energy company, but has had a hard time producing growth. Enbridge is a company focused in energy transportation and distribution. They are investing billions of dollars ($36 billion through 2016) in new pipelines and distribution centers. They have long term contracts that should support double digit earnings growth and a rising dividend through the end of the decade.

Asset Class Roundup

The biggest surprise in the first quarter was probably the strength of the bond market. To some degree it can be explained by the weakness in the equity markets, but it is a head scratcher to us. We continue to believe the economy is strengthening, and while the Fed is probably a year or more away from raising rates, they have already started exiting their bond buying program. We continue to expect rates to rise over the next few years, and are underweighted bonds and short in duration.

In the last few weeks we have seen a rebound in some emerging markets related assets. This could carry on in the near term if global growth improves as we expect. However, it is early in this performance move and we are going to move cautiously.

Some analysts believe Chinese growth will accelerate, but we are skeptical about these predections. Growth was weak in the first quarter there, but is expected to rebound in the current quarter as policy measures and the rest of the world increases demand. Over the intermediate term, they are trying to support a more balanced economy that is less dependent on capital spending and more on consumption.

Europe is gradually improving, but it will continue to be slow. Several of the smaller economies that were in deep trouble have stabilized such as Greece, Italy, and Spain. Greece was able to come back to the market and issue bonds, which was unthinkable a couple of years ago. They have many problems but no longer look like they will fall into the abyss.

Japan is trying the second leg of their economic experiment. The first leg was massive money printing. They are trying to increase inflation, force companies to raise prices and wages, and inflate the stock market. They have been largely successful. The second leg is an increase in taxes to tame their growing budget deficit and debt. This has just begun and investors are cautious. A rise in taxes usually results in a slowdown in economic activity. We can only watch and wait.

Commodities and gold had big moves up in the first quarter. We view these assets as a zero sum game over the longer term, and we do not see fundamental reasons for their recent moves. Gold may be moving due to a fall in real interest rates, but this is likely temporary. Commodities do not appear poised for a longer term or dramatic move based on supply and demand, so it is likely technical factors driving them.

A note on relative performance & benchmarking

Like everyone in this industry, we compare our performance to benchmarks. We have had a solid performance over the long term, and having a clear set of goals in mind helps focus decision making. However, it should be noted that beating the benchmark is not the 'goal'. The goal is to achieve a client's objectives.

Recently, we noted two articles that made us think about benchmarks. The first was about Warren Buffet, perhaps the best investor that has ever lived. It turns out Mr. Buffett has underperformed the S&P 500 consistently for the last 5 years. Some people might say the asset base he manages has gotten too large, and others might say he has lost his touch now that he is in his eighties. But another reason might be found in another article we read. According to Leuthold Weeden, a quantitative research outfit, the best performing investment style over the last 5 years has been momentum stocks. Whether this is due to computer trading, hedge funds, or something else we don't know. But investors with a value bias, like Warren Buffet, and like Sargent Bickham Lagudis, have generally not outperformed this momentum style over this period.

Keep an eye on our blog because we intend to post an article on benchmarking there soon.

Analyst's Corner

By Jordan Kunz, CFA, CFP®

The following are some of the projects our investment team has been working on this quarter:

- Denis Nock – Over 110 qualitative company reports in Q1 alone.
- Dick Stebbins & Interns – New intrinsic valuation models, a major database conversion, and additional economic data points added to our research toolkit.
- Mutual Fund Committee evaluated a number of international small cap managers and selected a finalist.
- Income Committee continued to track the latest language and positioning from the Fed. We believe short-term rates will stay anchored near zero well into 2016.
- On the technology side, we are working hard to implement new portfolio management and trading capabilities, as well as a powerful web conferencing tool for client meetings. Look for these to roll out next quarter.

Financial Planning

by Gary Powell

Personal Internet Security

Today's headlines seem to have a recurring theme of internet security for critical personal financial information. Now that you have filed your tax return for 2013, it's a good time to do some spring cleaning on your computer, tablet, smartphone, and other electronic devices.

First, back up all of your financial data (and personal photos, music, etc.). You can store data on an external hard drive or use free storage in the "cloud." Microsoft, Apple, and other vendors offer several gigabytes of free space.

Second, uninstall any applications or software that you won't miss. Third, transfer old financial files, such as tax returns and account statements to your external hard drive or to cloud storage.

And lastly, create new passwords for important accounts, such as e-mail, bank and investment accounts. This is even more important due to the recent Heartbleed security flaw.

For those families who have experienced the loss of a loved one, don't forget to cancel e-mail, bank and investment accounts, as well as Facebook and other social media accounts to avoid them being used by unintended parties.

Charitable Giving in 2014

Many of you know the benefits of using appreciated securities when making gifts to charities. The current value of the security is a charitable deduction, and you avoid paying the capital-gains tax on the profits. Also, donor-advised funds allow you to deduct the value of the contributions when donated; but you can decide at a later time which charities to support.

A change in 2014 is scheduled for those of you who are older than 70 ½ and used to taking advantage of transferring up to $100,000 tax free from a traditional IRA to your favorite charities. The distribution to the charity was tax-free to you because the income was not reported on your tax return. This opportunity expired in 2013, and we will have to wait and see if Congress revives this method of giving. Don't expect any change until after the election in November.

Company News

By Patty Meneley, COO

Of course the big company news for this newsletter is our Boulder office's move to Pearl East Circle! That move will be taking place on April 24th and April 25th and we expect to be fully functional and moved in on Monday, April 28th. We hope you will come see us soon at 4840 Pearl East Circle, Suite 300E. We will all miss the constant activity of downtown Boulder but, after 10 years, we've squeezed every square inch out of our suite at One Boulder Plaza and we're looking forward to stretching out a bit in our sunny 7,000 square foot third floor space on East Pearl. The ample free parking and gorgeous views from every window are nice too! We'll be having an open house event early this summer so look for more information on that soon.

In the press, Brad Bickham was named to Barron's "2014 Top Advisor Rankings" and was one of only two independent advisors in Colorado.

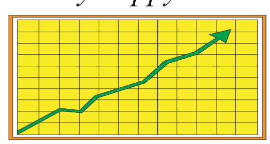
Meagan D'Angelo and family welcomed Lucca Marcelo D'Angelo to their family on March 11th. Meagan is home enjoying her now larger family, but will be back from family leave in June.

Also, we have some new faces here at Sargent Bickham Lagudis that you may have met already. Zach Cole joined us in January as our trading specialist and Christiana Glenn became a part of the team in March to assist Brad, Meagan, and Bill with client service management. Christiana is a graduate of Denison University with a B.A. in Communication and joins us from Greenhouse Scholars, where she was the Operations Director for their fundraising events in Colorado and Chicago. Welcome Zach and Christiana! They are helping us to ever improve our services.

Speaking of service, it is one of the differentiating factors for our firm and we thank you for your continued trust and partnership. All of our growth from the past 26 years has come from the referrals of clients and other professional advisors.

If you know of someone who could benefit from the same high level of service, please have them give us a call at 303-443-2433 or visit us online at www.sblfinancial.com.

Many happy returns,



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