JANUARY 2014

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"The trouble with managing money is that everyone once made a successful investment." - Unknown

SUMMARY:

2013 was an excellent year for investors in most equity markets.

It was not so good for gold, bonds, and emerging markets, which were all down.

We do not expect 2014 to be as dramatic, but we still favor stocks over bonds and other asset classes.

We are bound to have more volatility and a correction this year.

Thank you for helping us celebrate our 25th anniversary!

We are excited to announce Rick Lawrence is joining SBL as President & CEO. Several other changes are also taking place at SBL in 2014.

In This Letter

Dear Clients and Friends,

2013 will go down as one of the best years ever for the U.S. stock market. The S&P 500 returned 32% and some of the small cap indexes were up even more. I can't remember anyone predicting that kind of year. Following are returns for the last one, three, and ten years.

Returns as of Dec 31, 2013	YTD 2013	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative
World Stock Index (ACWI)	23.6%	31.7%	108%
Large Cap U.S. Stocks	32.4%	54.9%	104%
Mid Cap U.S. Stocks	33.1%	53.4%	157%
Small Cap U.S. Stocks	40.5%	64.7%	110%
Nasdaq 100	35.0%	66.8%	159%
Foreign Stocks - Developed	22.8%	26.6%	91%
Foreign Stocks - Emerging	-2.6%	-6.9%	165%
U.S. Bonds – Taxable	-2.0%	9.5%	53%
U.S. Bonds – Tax-Free Municipals	-2.6%	14.1%	46%
REITs	2.5%	23.8%	99%
High Yield Bonds	7.4%	28.1%	94%
Commodities	-10.9%	-22.0%	99%
Hedge Fund Index	7.7%	4.3%	n/a
Gold	-28.3%	-16.3%	182%
60/40 Balanced World Index	14.6%	28.4%	90%
60/40 Balanced U.S. Index	16.9%	35.5%	94%

While the U.S. stock market got the headlines, it is worth noting it was not a year where every asset class gained. You could have easily lost money in bonds, commodities, and especially in gold. Investors who were overly cautious could have lost money last year if they held too much of these assets. Even in the equity market, there was tremendous disparity between U.S. returns and foreign market returns – emerging markets in particular.

SBL had a pretty good year navigating these waters. We sold commodities and gold early in the year, and we reduced emerging markets to bare minimum holdings. By diversifying our fixed income into more flexible mutual funds and bonds, and by reducing the average maturity (duration) of our holdings, we managed to produce a small positive return from our fixed income allocation compared to the bond index, which was down 2%. And our Model Equity portfolio managed to beat the S&P 500 by a small margin with a 33.3% return.

Why did no one predict this stellar result, what caused it, and what should we expect for 2014?

I'm not sure anyone ever predicts a monster year like this. Forecasters generally take the current situation and project it forward. At the beginning of 2013, if you will think back, the Congress and President signed a new tax law at the very last minute. Here are some of the other 2013 headlines:

- The health care law, the Affordable Care Act, became official on October 1st.
- The Boston Marathon bombing in April.
- Snowden's disclosures about NSA spying.
- A new Pope was elected in March.
- There was a tentative nuclear pact made with Iran.
- The federal government was shut down when Congress couldn't agree on a budget.
- Obama threatens, then pulls back from military action against Syria.
- Supreme Court hands gay Americans a victory by striking down DOMA.
- JP Morgan pays $15 billion in fines.
- Fed decides to dial back bond buying. Obama nominates Janet Yellen as next Fed Chair.
- Philippine typhoon kills thousands.
- Turmoil in Egypt after Morsi ousted.

There aren't many of those events we could have predicted a year ago. The exception being Congress' inability to agree on a budget.

Have you ever noticed that pessimists seem smarter? There are always things to worry about, and there is always someone who can very eloquently explain to us how bad things are. What those people miss is the adaptability of humans. We are constantly learning, innovating, and changing the way we do things. There are young people who are willing to try new things, and while it is not always pretty to watch, governments and social policies change.

In short, I would posit the reason the market went up so much is that people are getting more optimistic. The U.S. economy has now grown five consecutive years despite all the headwinds we faced. Things are better. The level of the stock market reflects the value of businesses and people's perception, or confidence in the growth of those businesses.

Despite the rise, it is not overvalued. We have gone from cheap to fair value. So as we look into 2014 we must grapple with an environment a little more dicey than last year. First, the market is no longer cheap. A year ago, the S&P 500 was at 1426 and earnings are now estimated to be $107 for 2013, making the forward P/E 13.3. Today, the S&P is at 1831 and we would predict earnings will grow $115 or $118, so the forward P/E today is 15.5x to 16x.

Second, we are now more certain that interest rates will rise. Higher rates create a number of problems for investors including lower valuations for stocks and bonds, a slower economy, and reducing the appeal of stocks versus bonds.

On the other hand, the Fed has told us not to expect short term rates to rise for at least a year, and maybe two. So, the rising interest rate problem might be further out. As said earlier, while the stock market isn't as cheap as it was, a P/E of 15.5x or 16x is not high. It's equal to the long term average. An optimistic view, which I think is plausible, is that confidence grows even further this year as the economy gathers momentum and the P/E expands a little more. If this happens, it would mean the return on stocks would once again exceed earnings growth, leading to a double digit gain.

SEVEN PILLARS

The Economy: It is stronger than most people believe. The U.S. economy grew at a 4.1% annual rate in the 3rd quarter, the strongest quarterly gain since 2011. Housing and manufacturing are improving, employment is gradually getting better, personal consumption is growing, and consumer confidence is getting better. Government spending has been a drag on economic growth for two years, and despite this the economy has continued to grow faster than 2% per year. Most economists expect growth to pick up in 2014 in the U.S. and abroad. We do not expect robust growth, but we see no recession on the horizon and surprises are likely to be on the positive side.

Two facts worth noting… First, are you aware of the size of the U.S. economy relative to the rest of the world? Here is a table showing the world's leading economies ranked by GDP (in trillions of $):

1.	United States	$15.8
2.	China	3.5
3.	Germany	3.0
4.	United Kingdom	1.8
5.	France	1.5
6.	Japan	1.3

This is worth keeping in mind when you read about China, or Japan, or Europe having slow growth. It matters, but not nearly as much as what happens here.

Second, is the energy boom taking place in the U.S. This has the potential to dramatically alter the economic landscape. U.S. manufacturers will have a significant advantage in energy cost that offsets the differential in labor cost compared to other countries. U.S. consumers are likely to enjoy lower energy costs and gasoline, which gives them more discretionary spending power. Many people have strong feelings about the environmental risks of fracking. We accept there are risks, but we are unqualified to comment. If those risks are greater than regulators currently believe, or if the quantity of oil and gas is not as great as currently believed, then the economic benefits will be less pronounced. But, at the current time, the U.S. economy appears poised to benefit from this energy boom for quite some time.

Corporate Earnings: Still growing.

Year	Operating EPS	Change
2010	$84	+46%
2011	$96	+14%
2012	$97	+1%
2013 *Est.*	$107	+10%
2014 *Est.*	$115-$122*	+7% - +14%

** Estimated by Standard & Poor's. Initial estimates are usually too high.*

Interest rates and inflation: Inflation is benign, but interest rates have risen. We still do not see inflation on the horizon. It may return, but not in 2014. It has been 2% or below for several years and is likely to remain there for a while longer. Ultimately, interest rates follow inflation, but the Fed has been holding rates artificially low. As a rule of thumb, intermediate term rates (use the 10 year Treasury as a proxy) have averaged 2% over inflation. If inflation is running 1.5% to 2%, then the yield on the 10 Year Treasury should be 3.5% to 4%. In 2013, the yield got as low as 1.7% before the Fed surprised the markets in May by telling us they would not keep rates low forever. Since then, the yield has risen to 3%, so by our math most of the adjustment has taken place. The direction of rates is still higher, but the pace is likely to be slower. Or, at least the degree of change is less. A move from 1.7% to 3% is a 76% change. A move from 3% to 4% would be only 33%.

Valuation: Fair. As we said above, the current P/E is 15.5x to 16x forward earnings. A year ago, the forward P/E was 13.3; but for the last few years we argued the market deserved a discount due to the significant risks to the economy and the financial system. Today, while there are still risks, they seem more subdued. If the economy continues to grow as we have predicted, the P/E could expand even further.

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Financial Stress: This risk has gone to sleep for the time being. We will continue to watch, but there are no warning signs at the present.

Politics: We think the political theatre is likely to be quieter over the next few months, but there is an election in November so it will increase in the summer and fall. It will probably be another year of noise, but no action. By most accounts, 2013 was the least effective Congress ever. The good news is that they want to repair their images before the election, so budget impasses and government shutdowns are unlikely. The bad news is that there will probably be no movement on immigration reform, tax reform, or entitlement reform. Depressing, but not likely to be market moving.

Performance, Strategy, & Analysis

We maintained our allocation targets during the entire year of 2013, making only minor changes. For a typical equity tilted balanced portfolio we allocate 60% to equities, 30% to bonds, and 10% to alternative strategies. Throughout the year, we sold longer term bond holdings, including Treasury Inflation Bonds (TIPS), and shortened average maturities. We shifted into non-traditional bond strategies such as adjustable rate loans and mutual funds that can hedge against interest rate risk. Early in the year we sold our gold and commodities. In September, we made a decision to hold cash equivalents in some portfolios as part of our fixed income allocation. This paid off as rates rose causing many bonds to lose value. In July, we re-allocated our Liquid Alternatives strategy slightly to de-emphasize global bonds and increase the low-volatility group. While none of these changes were perfect in their timing, all of them contributed to performance.

The biggest challenge was outperforming indexes, which is often the case in very strong markets. As mentioned, the Model Equity portfolio returned 33% last year, outperforming the S&P for the 9th year out the last 11. Over that period the cumulative gain is 184%, which is 54% better than the S&P 500 gain of 130%. Some of the individual company returns were extraordinary. Core Labs was up 94%, American Express 62%, and VF Corp. (maker of jeans and shoes) was up 65%. We had a few losers last year too, but we were diligent in weeding them out. Last year's underperformers were Edwards Lifesciences, Toronto Dominion, Telus, and Caterpillar. All of these companies were sold during the year.

The mutual funds we used in the large cap U.S. allocation had similar performance to our model equity, returning about 30%. The small cap mutual funds fared even better, returning over 36% on average. These returns were all in line with the indexes. I have often commented that when indexes provide returns like 30%, I am happy to equal them. It is when returns are lower that active management has more opportunity to outperform.

International returns were quite varied. In local currency, Japan was up 47% and China was down 5%. Argentina was up 90% and Brazil was down 18%. More broadly, Europe was up 10% and the emerging markets were down 6%. We sold about 90% of our emerging markets exposure during the year, which helped, and we concentrated much of our international investments in the indexes themselves, which was also beneficial. The active mutual funds had a difficult time outperforming in this treacherous environment. All told, our international developed investments averaged about 17% vs. the EAFE index return of 22% and the ACWI ex-U.S. return of 15%.

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Financial Planning

by Gary Powell

Financial Planning by the Numbers in 2014

In our digital age, it often seems that many facets of our lives have a number (or numbers) associated with our every move. And as expected, the 2014 annual limits relating to financial planning are no exception. A few selected key numbers with comparison to 2013 follow:

Retirement Plans For 401(k), 403(b) and most 457 plans	2014	2013
Maximum elective deferral by employee	$17,500	$17,500
Catch-up contribution *(age 50 or older)*	$5,000	$5,000
Defined contribution - maximum contribution *(employee and employer combined)*	$52,000	$51,000
SIMPLE plans	$12,000	$12,000
Catch-up contribution	$ 2,500	$ 2,500
SEP participation limit	$ 550	$ 550
Maximum compensation limit	$260,000	$255,000
IRA or ROTH IRA contribution limit	$ 5,500	$ 5,500
Catch-up contribution (age 50 or older)	$ 1,000	$ 1,000
ROTH IRA deduction phase-out		
Single	$114,000 to 129,000	$112,000 to $127,000
Married filing jointly	$181,000 to $191,000	$178,000 to $188,000
Social Security		
Social security base	$117,000	$113,700
FICA tax rate – employee	7.65%	7.65%
SECA tax rate – self-employed	15.3%	15.3%
Cost-of-living adjustment	1.5%	1.7%
Maximum monthly benefit; retiring; retiring at Full Retirement Age (FRA)	$ 2,643	$ 2,533
Estate and Gift Tax		
Annual gift tax exclusion	$14,000	$14,000
Estate tax exclusion	$5,340,000	$5,250,000
Gift tax basic exclusion	$5,340,000	$ 5,250,000
Maximum estate tax rate	40%	40%

Company News
By Patty Meneley, COO

We are very excited to announce that Rick Lawrence has joined SBL as President & CEO. Brad Bickham has been the company President since the retirement of Mike Sargent in 1999. Brad will remain as Chairman, and will focus his energies on portfolio management and investment research. Clients will not see any changes. If anything, he will be more involved in their portfolio management than before. As he said in an earlier letter to clients, “This is something I have wanted to do for a long time”.

Rick was most recently the President and CEO of the University of Colorado Foundation, and before that was their Chief Operating Officer. Prior to working at the Foundation, he spent 30 years in banking with Vectra Bank and Bank One, where he held a number of management positions in Finance, Operations, and retail bank management. This experience will be invaluable in helping our company to continue to grow as we have in the past.

These changes come at the same time that Kreighton Bieger has decided to pursue another opportunity. We will miss Kreighton, but we are also exploring opportunities to collaborate together in the future.

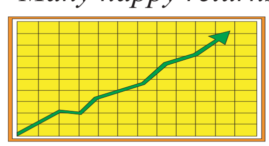
And last, but not least, Zach Cole will be joining our team as a trader and financial analyst. Zach was most recently at Deloitte Touche where he was an Advisory Consultant on financial controls and technology to several large corporations such as Great West Financial and Charles Schwab. He is a graduate of C.U. Boulder with a joint major in Economics and Finance, and a minor in Mathematics.

Wedding bells are ringing as Lindsay Markin enters into newlywed bliss this month with her fiancée, Patrick, and then the happy couple will leave behind the Colorado snow for a warm Caribbean honeymoon. Best wishes!

Finally, we will be moving our offices to 4840 East Pearl Parkway in April. We have outgrown our current space. We are sad to be moving away from the Pearl Street Mall, but we are excited to have more offices, more conference rooms, free parking, etc. We will send you more information as the time gets closer.

As we say in every letter, all of our growth over the past 25 years has come from referrals from clients and other professionals. We thank those of you who have referred your friends and colleagues. If you know of anyone who might be interested in our services, please have them give us a call at 303-443-2433 or check us out at www.sblfinancial.com.

Many happy returns,



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