SARGENT BICKHAM LAGUDIS
CELEBRATING 25 YEARS 1988-2013

July 2013

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"Lately it occurs to me, what a long, strange trip it's been."
The Grateful Dead

SUMMARY:

The Fed has told us they will eventually raise interest rates. The market threw a tantrum.

Most Investment Pillars remain favorable.

Gold, bonds, commodities, and emerging markets are all down this year. The U.S. stock market has been the star.

It's possible to simplify your estate plan now that tax law is "permanent."

Trace got married and got his CFA!

In This Letter

Dear Clients and Friends,

For several years the United States has been operating under a monetary policy experiment. Interest rates have been at zero for five years now, and the Federal Reserve has been pursuing other aggressive policies designed to stimulate the economy. I believe, as do most economists, that these policies are the only thing that kept the Great Recession from getting much worse. 10% unemployment might have been 15% or 20% unemployment. You only have to look at Europe to see how a different policy fared. Unemployment there is over 12%, with some countries higher than 25%. Our unemployment rate now stands at 7.6% and we have been creating private sector jobs steadily for several years.

But this cycle of easy monetary policy will have to end someday. The most basic law of economics is that of supply and demand. Prices move up and down as either supply outstrips demand (causing prices to fall), or demand is greater than supply (causing prices to rise). Money is really just a medium of exchange. It shouldn't have an effect on prices, but we have learned over time that it can. If there is "too much" money, it can cause prices to rise and "too little" money can cause them to fall. How much is enough? There is a group of economists called Monetarists that believe the money supply should grow at about the same rate as the economy… 3% or so.

Milton Friedman, a Nobel Prize winning economist and professor at the University of Chicago was the leader of the Monetarist school of thought for several decades beginning in the 1960s. He is famous for saying, "Inflation is always and everywhere a monetary phenomenon." Milton Friedman and like-minded economists would be hard pressed to explain the current environment. In fact, they are still warning of the dangers of inflation in the *Wall Street Journal*, in Congress, and other academic and political circles. In this age of polarization, monetary policy has taken on its own politics. Those in favor of monetary stimulus are called "doves" and those opposed are called "hawks." It reminds me a little of the name calling in grade school.

Ben Bernanke, the Federal Reserve Chairman, has remained above the fray in this regard and has stood his ground, and maintained extraordinary monetary policies including buying U.S. Treasury bonds and mortgage-backed bonds. He patiently deals with uninformed Congressmen who attempt to score political points. The headlines from a recent article read, “Heading into today’s testimony before the Joint Economic Committee of Congress, Ben Bernanke was expected to get grilled on the danger presented by the Fed’s $85 billion-a-month bond-buying program, its plans to wind down that “quantitative easing” and the broader challenges facing an economy that’s growing only moderately.”

Returns as of June 30, 2013	YTD 2013	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative
Large Cap U.S. Stocks	13.7	65.5	100.7
Mid Cap U.S. Stocks	13.8	68.1	168.8
Small Cap U.S. Stocks	16.2	60.4	118.0
Nasdaq 100	10.0	72.1	153.2
Foreign Stocks - Developed	2.8	35.4	106.7
Foreign Stocks - Emerging	-12.1	9.4	239.8
U.S. Bonds – Taxable	-2.5	9.8	53.8
U.S. Bonds – Tax-Free Municipals	-4.0	11.1	46.5
REITs	4.6	57.6	138.4
High Yield Bonds	-0.5	33.3	96.0
Commodities	-10.5	3.5	114.0
Hedge Fund Index	7.2	9.2	40.2
Gold	-26.5	-2.1	244.5
60/40 Balanced Index	7.2	42.6	94.2

The beginning of the end is upon us though. Mr. Bernanke signaled in May that the Fed would begin “tapering” its bond purchases possibly as early as this fall. This sent the bond market into convulsions. The 10 year Treasury bond yielded 1.6% before this statement, and now two months later yields 1% more at 2.6%. That means the price of those bonds fell by around 10%, and all interest rate related investments had similar drops: foreign government bonds, REITs, high dividend stocks, corporate bonds, municipal bonds, etc.

Why did Mr. Bernanke choose to make this announcement now? I think there are three viable reasons, maybe all true to some extent. First, ultra-low interest rates for an extended period of time leads to unintended consequences. Bubbles form. In some areas of the economy and the investment markets, we have seen valuations and returns move beyond their fundamentals. Phoenix real estate, for example, is up over 25% in the last 12 months. Big pharmaceutical companies’ stocks were up over 20% in the first 3 months of the year. Sometimes a statement from the Fed Chairman can throw a little fear into the markets to prick these bubbles (at least temporarily).

Another reason is that Mr. Bernanke’s term ends January 31st. It is generally believed he will not seek another term. He may have wanted to begin preparing the markets for the removal of stimulus before his successor comes into office.

The final reason, and hopefully the real reason, is that he believes the economy is beginning to be strong enough to stand on its own. Remember, the steps they are taking are small and will be gradual. The first step is to buy less than $85 billion a month in bonds (tapering), then sometime next year they will stop buying bonds altogether, then sometime after that they will start raising interest rates. So we’re probably late into 2014 and maybe 2015 before we see any meaningful rise in rates.

Does this mean the markets have overreacted? Probably.

The markets are a discounting mechanism. Participants attempt to see into the future and make adjustments to valuations based on the changes in the view of the future. Interest rates are the most fundamental part of the valuation process. A rise in rates lowers the present value of most assets. It's math. A bond discounted at 1% is worth $99; discounted at 10% it's worth $90. The markets are looking into the future and predicting where rates will go. We know they will go higher. We just don't know how fast.

A look at the past can help us. The environment we are in, at least in terms of low rates, is similar to the period after the Great Depression. In the 1930s and 1940s, interest rates were near zero just as they are today. They began rising in the 1950s. The worst stretch of bond returns was 1955 through 1959. During that period, Treasury bills rose from 1% to 3% - a pretty good analogy for what we are likely to see. The total returns on intermediate term government bonds was as follows:

1955	-0.7%
1956	-0.4%
1957	+7.8%
1958	-1.3%
1959	-0.4%

It just wasn't the bloodbath that people expect, and my guess is that the last two months is a move too far too fast.

As always, I will finish with a summary of our Investment Pillars. These guide our decision making regarding asset allocation.

The Economy continues to grow modestly. According the IMF, global growth will be 3.1% this year. This is slower than their earlier forecast of 3.3% in April, and the slowdown is coming primarily from emerging economies. Europe remains at stall speed, and Japan is doing better. Chinese growth has slowed but is still in the 7% to 8% range.

Earnings growth is likely to be 5% to 10% this year. There is nothing wrong with this growth rate, but analysts are probably still too optimistic about this year's earnings.

Interest Rates have already risen as discussed earlier. If this continues unabated it is undoubtedly a negative, but things don't move in one direction forever. At a minimum, I would expect rates to pause for a while before moving higher, and I wouldn't be surprised to see them about here or lower at the end of the year. Inflation remains quiescent.

Valuation is ok. The S&P 500 trades at 1,650 and earnings will be around $105 this year. That makes the PE ratio 15.7x on 2013 estimated earnings, just below the long term average of 16x. As I have said before, this acts like a speed limit on the market. Right now we are neither too expensive nor too cheap, so the market will move in fits and starts as earnings and economic news develops.

Financial Stress has risen a little recently but is not near problem levels.

Politics could get dicey in a few months as we approach the debt ceiling. I doubt the Congress and President have the stomach for another major showdown, however. For anyone interested in a good story on this subject, I recommend reading Bob Woodward's book *The Price of Politics*. It is about the fiasco that happened in 2010 regarding raising the debt limit. Since most of the players are the same, and they have made some progress on deficits I'd bet there are no fireworks this time, but there will also be no grand bargain. The two sides are too entrenched in their positions.

Strategy & Analysis

By Kreighton Bieger, CFA

Often in the process of long-term investing, we make analogies to gardening. We do a lot of work and planning upfront, we set portfolio decisions in motion, and then we watch, wait and study. While many investments flourish, some never sprout, and others don't work as planned and have to be weeded out. But over time we expect that a well balanced portfolio that is diversified across asset classes will bear fruit for our investors in the form of income and growth of principal. But occasionally a storm tears through our garden, and while it may have been in the forecast, it nonetheless wreaks some havoc. This was the brief period from early May until around June 24th, during the second quarter.

Despite what you might hear, the Fed had been subtly warning markets and investors for nearly five months that their intention was to "taper asset purchases" beginning in the fourth quarter of 2013. This is why we have been shortening interest rate exposure in the form of duration; adding unconstrained bond managers and floating rate bond exposure. We underweighted bonds for alternative assets as well, staying well diversified across asset classes. Despite these efforts, we were surprised by the reaction of markets when the Fed reiterated its intent to taper asset purchases – as Brad said, there were convulsions.

We saw equities around the world decline between 6% and 16%; bond indexes declined by 1% to 8%, and commodities and metals fell 8% to 12%. High yield and emerging markets bonds declined 5% to 20%. There were few shelters in this storm, but as with most storms, it was short lived and we have come through it intact. Since the markets bottomed around June 24th, we have seen a rebound in prices for most assets.

To follow up on Brad's comments, I'd like to address whether or not what we saw was a collapse of certain "bubbles." I do not agree that any true speculative or price bubbles existed before the recent market correction, nor do they necessarily exist now. A bubble is defined when the price of an asset departs meaningfully from its intrinsic value and when expectations for future growth are exaggerated. I am not sure any of those things have happened. As Brad noted, the prices of assets are determined by interest rates because purchases today always reflect an expectation of some outcome in the future, be it a price or a cash flow estimate. Whether those prices or cash flows are known (as with bonds) or estimated (as with stocks, commodities, metals and real estate), it is nonetheless inescapable that higher interest rates, without a correspondingly higher expectation of future prices and cash flows, will lead to lower prices.

As the Fed has kept interest rates low, the prices of all assets has been driven higher, not due to any sort of maniacal exaggeration of future price expectations, but rather due to the simple mathematics of low interest rates. Thus, when the market fully digested the notion that the Fed was really planning to taper its purchases, i.e. begin to let interest rates find their natural level, the market adjusted immediately. The Fed could have just as easily said, "stocks are worth about 10% less now." The great value investor Benjamin Graham once said "in the short run the market is a voting machine, but in the long run it is a weighing machine." What he meant was that in the near term the market is a popularity contest, but eventually fundamental values overwhelm sentiment. I think what we just saw was a very rapid "weighing machine" action. The market nearly instantaneously adjusted asset prices to reflect its best estimate of asset prices in a higher interest rate environment.

So we know that the Federal Reserve has been manipulating interest rates in hopes of pushing investors into riskier assets, driving those assets higher (which was achieved simply through lowering interest rates), in turn spurring a wealth effect. Did it work? One can only speculate, but I believe it worked far better than most realize.

Now, for a review of asset classes.

Fixed Income: Are we worn out on this topic yet?

Boring old bonds have been a place to burn a lot of mental kerosene of late, but here are some thoughts on how we view the bond portions of our portfolios.

Year to date the aggregate bond market has returned about -2.4%, and in Q2 returned -2.3%.

TIPS have had a terrible year (-7.4% to date) because both the overall level of inflation and the market's expectations of future inflation are basically stuck. Inflation is running, by the Fed's preferred measure, around 1%. The market expects at most around 2.2%. As inflation expectations have not changed in nearly a year, the majority of the move we just saw in interest rates was an increase in the real interest rate. We have moved to the sidelines on our TIPS position in alternatives in favor of a global macro manager.

Municipal bonds declined more than Treasury bonds during the recent correction, and we think that is a little overdone. In general municipal coffers are improving, especially in Colorado, and the tax-adjusted yield on municipal bonds is quite attractive relative to corporate and Treasury bonds.

We continue to find interesting, if infrequent, mortgage backed and corporate bonds while we have largely avoided US government securities for the last several years.

In fixed income we have added to both floating rate and unconstrained bond managers. The floating rate exposure had a positive return as rates rose, as we would expect, and the unconstrained position, where the manager can invest both long and short bonds, also outperformed most sectors of fixed income during the back up in rates.

We expect that through the end of the year rates will be relatively muted unless there is a sustained change in the pace of economic growth or a change in tone from the Fed regarding the pace of tapering.

Equities:

It has been a year of tears and cheers in equities. To date, the S&P 500 has risen 13.7%, and 2.9% in Q2. Developed international is up 4.1% and fell -1% in the quarter. But emerging markets have declined -9.6% and were off -8% in the quarter.

The US markets have been variously referred to as the "tallest midget in the circus" and "the smartest kid in summer school", but I think those are (not my) unfair characterizations. The US also has a stabilized banking system, a deleveraging consumer base, an accommodative central bank, falling unemployment and an improving budget deficit situation. Contrast this with problems in Portuguese, French and German banks, Spanish unemployment and more, and we look pretty good. In the two largest emerging market economies, we have massive social unrest in Brazil and a rapidly destabilizing Chinese banking system where the central bank is tightening policy while banks suffer a liquidity squeeze.

Currently emerging markets represent some of the most attractive valuations in the world, and in the last 15 years, even relative to earnings expectations. But the problems and unrest in the largest nations gives us pause. European reforms have us more guardedly optimistic on Europe, but absent the performance of Japan, most developed markets have not yet started to perform.

With US valuations still at or slightly below their long term average, especially given current inflation expectations (lower inflation is associated with higher PE ratios), and modest earnings growth, we continue to favor US markets in equities.

Alternative Assets: Alternatives did not have a rosy quarter. As interest rates rose, so too did so-called "spreads" on various emerging market and high-yield bonds, meaning that the difference between those bonds' yields and Treasury bonds widened, leading to even deeper price declines. For the second time since 1969, both stocks and commodities fell by more than 5% while interest rates rose 0.25%. Our alternatives modestly underperformed bonds during the interest rate move, but are still outperforming bonds year to date.

We expect that as the markets normalize we will see a recovery in some of the asset classes in alternatives. As we look back over the firm's 12+ year history managing Alternative Assets, we have done well relative to other asset classes even in sustained and orderly periods of rising interest rates.

It was a rough quarter in many asset classes, but we can also breathe a partial sigh of relief that the market is at least acknowledging that the easy money policies of the Fed won't last forever. It is likely to be a bumpy ride, but we continue to work diligently to protect and grow your assets.

Financial Planning

By Gary Powell

Premium Increases for Long-Term Care Insurance

Over the past several months, we have seen long-term care insurance premiums increase by more than 50% for many of our clients. These increases are attributable to lower interest rates for insurance companies' portfolios, more people using their long-term care insurance because they are living longer, and health care costs exceeding actuarial assumptions. Keeping the insurance is generally advisable. One alternative is to adjust the terms of your insurance to absorb the premium increases. Please call us to discuss your alternatives if you have been notified of a premium increase. If you have not, expect to hear from your insurance carrier.

Supplemental Medicare Insurance

Selecting an appropriate plan and insurance carrier for your situation for your supplemental Medicare insurance is very complex with hundreds of combinations in the market place. After a plan is selected, changing your plan to a different carrier may not be possible. Additionally, certain plans should be avoided with the upcoming potential changes from Obamacare. If you are approaching 65, please let us know if we can assist you with this important decision.

The Dilemma of Estate Planning – Moving to Simplicity vs. Asset Protection

There is momentum to make estate planning simpler. In 2013, we now have the inflation-adjusted $5.25 million ($10.5 million for a couple) gift, estate, and generation-skipping transfer (GST) tax exclusion and the portable gift and estate tax exclusion for the surviving spouse. It is estimated that only 8,700 estate tax returns will be filed for the 2.6 million deaths expected to occur in 2013 (a .33 % rate of filing). Who needs to worry about complex estate planning any more unless you are very wealthy?

Let's look into the other 99.67% who still have legacy estate planning documents. A choice can now be made between simplicity or asset protection. For example, many estate planning documents have traditional marital trust and bypass trust (A and B trust combination). If the goal is administrative convenience, freedom from oversight and simplicity, the A and B trust combination would be avoided. The alternative to the A and B trust combination is a marital trust with the flexibility to disclaim to a bypass trust which is going to become more common in estates of less than $10 million.

Mandatory allocations to marital and bypass trust were the norm for most estate plans created more than two years ago, but they are confusing to the surviving spouse, and lead to squabbles with other beneficiaries, and may be overly complex where there is no estate tax.

Bypass trusts (often referred to as Family Trusts) have the disadvantages of requiring an annual income tax return (Form 1041) and the loss of stepped-up basis on the second death, but they offer many advantages. The bypass trust is an irrevocable trust established by a third party. If an independent trustee has the discretion to limit distributions from the trust, a bypass trust can provide protection for the decedents' and survivors' assets from creditors.

Many blended families will continue to rely on bypass trusts because the first spouse to die can control where his or her assets go after the second spouse dies. If the second spouse remarries, the first spouse can prevent the assets from passing to the new spouse. Access to the assets in the bypass trust by the surviving spouse is possible through the use of "health, education, maintenance, and support" (HEMS) language.

We generally come down on the side of simplicity in estate planning matters. Many existing estate plans were drafted before the new estate rules and would force complexity when it is not needed. However, there are situations where asset protection, and therefore more complexity, should prevail.

Company News

By Patty Meneley, COO

Lots of company news to impart this quarter!

This year marks our 25th anniversary and we're celebrating with a party on the evening of October 2nd. Save the date and stay tuned!

Speaking of anniversaries, Meagan D'Angelo has now been with SBL for ten years.

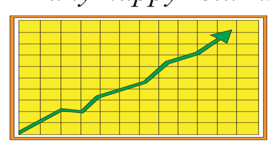
Trace Welch, our trader and security analyst not only got married in Alabama in April, but recently completed all requirements for the Chartered Financial Analyst designation. This brings our number of CFA charterholders to 5 along with 5 CFPs (with some overlap). We are so fortunate to have so much brainpower at work for our clients!

Wedding bells will once again be ringing at SBL as Lindsay Markin, one of our Client Service Managers, recently became engaged.

And, finally, you may have seen in a recent press release that Kreighton Bieger has been promoted to our Director of Research and will be taking on more responsibility with our investment team and managing the research process.

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, remind the rest of you that if you know of anyone who might be interested in our services, please have them give us a call or check us out at www.sblfinancial.com.

Many happy returns,



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