SARGENT BICKHAM LAGUDIS
CELEBRATING 25 YEARS 1988-2013

October 2013

SUMMARY:

Most equity markets have continued to rally and now appear fairly valued. They remain, however, more attractive than bonds and cash.

Gold, bonds, and emerging markets are all down this year.

Don't forget about year-end financial planning…qualified charitable distributions are a great example.

Thank you for helping us celebrate our 25th anniversary!

In This Letter

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"To do nothing at all is the most difficult thing in the world, the most difficult and the most intellectual." - Oscar Wilde

Dear Clients and Friends,

It had been a little bit too easy. The U.S. stock market is up 20% or more this year, and it hasn't had a 10% correction since 2011. That's a pretty long stretch. Not that it has always been easy to stay the course. That is often the most difficult part of making money in the stock market. Staying in. There is a long list of reasons to be worried about the market. Among them is the budget and debt ceiling fight in Washington; a national election in Germany that could have resulted in Angela Merkel losing her majority and upsetting the German backing of the Euro; there remains the possibility we will get entangled in another conflict in the Middle East; oil prices have remained above $110 per barrel for months; the economy is sputtering along at only 1% to 2% growth; unemployment remains stubbornly high at 7.5%; Europe has had one quarter of positive economic growth, but will still contract for the full year; China's growth has slowed to only 7.5% and many analysts worry their financial system is over leveraged; and the Federal Reserve's on again, off again tapering of bond purchases has confused the markets and led to massive capital flows out of emerging markets, creating havoc with exchange rates and foreign interest rates.

How can the market do so well in the face of these obstacles?

There are several explanations. Some would blame, or credit, it all on the Federal Reserve's policy of keeping interest rates so low. This has pushed investors and savers out of money markets and bonds and into higher returning (and riskier) assets like stocks. There is definitely truth in this theory. A more sinister take on the same facts goes even further and sees this as the Fed propping up stock prices artificially. We would not go that far. We believe the primary driving force behind stock prices is earnings, and earnings will grow this year by about 10% according to consensus estimates. So, since earnings are up only 10% and stocks are up 20% we have had an increase in market valuations. This has not yet reached a point of over-valuation, but we have left the period of under-valuation behind.

Returns as of Sept 30, 2013	YTD 2013	Last 3 Yrs. Cumulative	Last 10 Yrs. Cumulative
Large Cap U.S. Stocks	19.8	57.2	107.3
Mid Cap U.S. Stocks	23.0	62.0	180.0
Small Cap U.S. Stocks	27.7	65.5	151.0
Nasdaq 100	20.9	60.0	132.2
Foreign Stocks - Developed	16.1	27.6	116.0
Foreign Stocks - Emerging	-4.4	0.0	244.3
U.S. Bonds – Taxable	-1.9	8.9	56.7
U.S. Bonds – Tax-Free Municipals	-2.9	10.0	53.8
REITs	3.2	41.6	149.3
High Yield Bonds	3.7	30.2	133.7
Commodities	-8.5	-9.2	23.6
Hedge Fund Index	5.4	6.3	37.5
Gold	-20.9	1.5	241.8
60/40 Balanced Index	10.7	36.6	90.5

When we read or hear pundits claiming the Fed is propping up the market artificially, we think they must never study actual companies. We directly research about 150 to 200 companies every year.

Most of these (probably 100) we have followed for several years, and we review them at least 4 times each year – after they report quarterly earnings. At the end of each quarter companies report on their sales and earnings for the prior quarter. This information is what drives the price of the stock. The Fed's actions are only indirectly related to their businesses. A company like Caterpillar has suffered a decline in revenues due to a reduction in mining activity. Coach is having declining sales because Michael Kors is a tough new competitor. Based on our following of these companies, we would say there is very little influence on businesses from the Fed. If anything, lower interest rates have helped them due to refinancing their debt at lower rates.

The Fed's lowering of rates over the past few years has helped the real estate market, but it has shown some signs of slowing due to the more recent increase. Mortgage rates have increased by about 1% this year, but they remain at a historically low rate of 4.5%. That should not deter too many people from borrowing. In fact, if more people could qualify we would probably see an even more robust real estate market. We are still only building 600,000 homes per year versus over two million back in 2007.

As far as growth and unemployment go, you have to decide whether to look at the glass as half empty or half full. The pessimist looks at the situation and sees high unemployment, slow growth, and low job creation. The optimist sees a steady trend in job growth that began four years ago. Growth is slow, but steady. Inflation is low and there are few inflationary pressures. Interest rates are low, and for good businesses loans are easy to come by. We hear that the competition between banks is fierce for good loans. Most businesses are deciding not to borrow. Corporations and individual's balance sheets are stronger than they have been in decades. They have paid down debt, and with interest rates so low debt service as a percentage of incomes is very low. So the potential for growth to accelerate is there.

In the near term, it is the buffoons in Washington who are most likely to scuttle the markets rally. In our last letter we wrote it was improbable they would go through the same debacle as before, but now it has come to pass. The House of Representatives passed a bill they knew the Senate wouldn't pass and the President wouldn't sign. The government shut down. It didn't last long, but it was a drag on the economy. Worse, there was the willingness by a small number of congressmen to flirt with a default on Treasury bonds in order to get their way on other issues. This has the potential to create a crisis, and while it may be brief there will be longer term consequences. Any doubt about the United States credit quality could raise our borrowing costs for a very long time. Already, our interest rates are higher than most European countries. Can you believe France has a lower borrowing cost that the U.S.? Hopefully, a lesson was learned, but it is hard to be optimistic about Washington.

Finally, the Federal Reserve did an about face recently and decided not to begin tapering their purchases of bonds (yet). This surprised the market, and in our view was a mistake. The Fed needs to begin normalizing interest rates, and while the economy is not strong investors had adjusted to the expectation that the Fed was going to change policy. Now, there is more confusion than before. Much of the Fed's influence comes from communicating its intent to the market, which then adjusts the level of interest rates. Chairman Bernanke has been more forthcoming than his predecessors in communication, but now there is a gap in credibility. His term ends at the end of this year, and his successor is going to have to set her own communication style and market expectations.

Janet Yellen has been named the new Chairman. Larry Summers, the former Treasury Secretary and Economic Advisor to the President, withdrew his name from contention because several key Senators said they would vote against him. Mr. Summers was widely considered to be a brilliant economist, but also abrasive and arrogant. Ms. Yellen is considered to be more of a consensus builder. The Fed Chairman is often criticized, but extremely important. We believe all three of the leaders during the last 30 years have done a good job (most of the time). Chairman Volker ended the inflationary cycle; and on the whole, the Greenspan era was very prosperous. He miscalculated the real estate bubble, but handled the Fed well prior to that. Mr. Bernanke has been exactly what we've needed through this most recent financial crisis, but years and years of low interest rates and easy money have distorted basic economics. We need to normalize interest rates, but it will be a delicate task and we should not be surprised with volatility in both the markets and economy as it unfolds.

Strategy & Analysis

As 2013 started, we felt good about the prospects for the stock market, and we expected bonds to outperform cash. The Federal Reserve was keeping interest rates low, the economy and corporate profits were growing, and valuations were reasonable. As stocks have moved higher, and bonds lower, we have stayed with the asset allocation strategy we have had in place for a couple of years. We have had no cash target, have been equal weight to our equity targets, underweighted bonds, and allocated about 10% of balanced portfolios to our alternative strategies group. As the stock market has climbed, this has meant periodic rebalancing of portfolios to capture the equity gains and re-invest the proceeds in bonds and bond alternatives. At times, this has felt like a fool's errand. Nearly all fixed income investments have been flat or slight losers this year. Nevertheless, we have stuck with our allocation targets and still do.

Our allocation targets for a typical equity tilted balanced portfolio is 60% equities, 30% bonds, 10% alternative strategies. Throughout the year, we have sold longer term bond holdings, including TIPS, and shortened average maturities. We have shifted funds into non-traditional bond strategies such as adjustable rate loans and mutual funds that can hedge against interest rate risk. And, in September, we made a decision to hold cash equivalents in some portfolios as part of our fixed income allocation.

Through September 30th, equities in the U.S. are up 20% or more. Developed international equities are up 15%, and Emerging Markets are down 4%. Bonds have lost about 2%, and gold is the biggest asset class loser, down 20%. Globally balanced portfolios are generally up between 5% and 10%, depending on how much is allocated to equities.

ONE BOULDER PLAZA • 1801 THIRTEENTH STREET, SUITE 208 • BOULDER, CO 80302 • T: 303.443.2433, F: 303.443.0254 • WWW.SARGENTBICKHAM.COM

Financial Planning

By Gary Powell

Charitable Giving Through Your IRA

Qualified Charitable Distributions (QCD) are set to expire after 2013. The QCD allows clients to reduce their taxable income, achieve charitable giving goals and satisfy their required minimum distribution (RMD) – all in one transaction.

Who qualifies? Clients over 70½ can donate up to $100,000 from an IRA directly to a qualified charity without triggering any federal income taxes. The QCD counts toward your annual RMD requirement.

What are the steps that you should take? Request a distribution from your IRA made payable to the qualifying charity of your choice. Married spouses who are both 70½ or older can each contribute up to $100,000 annually. However the QCDs must come from their separate IRAs.

What are the income tax benefits? Income tax on the distribution is avoided – even if you do not itemize deductions and even if your gifts exceed the percentage of income limits for charitable deductions. Second, the distribution does not increase your adjusted gross income for purposes of reducing itemized deductions, nor does it limit the amount of deductible medical expenses or miscellaneous itemized deductions or increase the taxation of your Social Security benefits. And third, in Colorado, the state determines taxable income based on federal taxable income with adjustments. The QCD would not be taxable in Colorado. (Note: Because the transfer is tax-free, you may not take the charitable deduction on your tax return.)

What are the requirements? 1) The QCD must come from an IRA. SEP and SIMPLE IRAs do not qualify. 2) You must be 70½ by the date of the distribution. 3) The distribution must be paid directly from the IRA to a qualified charity. 4) The receiving charity can be any qualified charity other than a donor-advised fund, supporting organization or certain private foundations. 5) The contribution must be one that would normally be 100% deductible as a charitable contribution.

Summary If you do not otherwise need your IRA distribution, this can be a significant tax mitigation strategy.

What's Going on with Long-Term Care Insurance?

Over the past few years there have been many changes to the long-term care industry. Among the more significant changes are 1) a low interest rate environment where the insurance bond portfolios cannot earn enough to pay for the long-term claims; 2) an increase in the volume and amount of claims; and, consequently, 3) fewer insurers selling long-term care insurance and less price competition.

But the realities still exist. At least 70% of people over 65 will need long-term care services at some point in their lives. On a national average, nursing home care costs more than $83,950 annually. Long-term care insurance can help a family protect themselves from potential physical, emotional and financial consequences of a long-term issue.

Expect more change in the future. These include 1) underwriting changes that no longer rely on an applicant's prior medical history, but require medical exams, including blood tests; 2) women will have to pay more for long-term care coverage than men - the girls just live longer; 3) preferred health discounts will no longer be available; 4) couples discounts are being reduced.

The Affordable Care Act – What to do?

A lot of noise surrounds the Affordable Care Act (ACA) these days. If you happen to find yourself in the market for individual health insurance, our health insurance consultants tell us to allow a few months for things to settle down. If you have an existing health insurance policy, hang on to it until the dust settles.

Company News

By Patty Meneley, COO

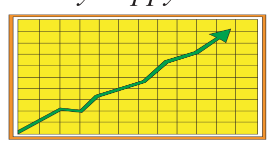
In company news, the SBL team enjoyed a fun trip to a Rockies game in August. Most of the crew ventured down to Denver to enjoy an evening at Coors Field. Brad and Steve caught not one, but two foul balls!

Our offices were very fortunate to not be directly affected by last month's flooding in spite of our proximity to Boulder Creek and considerable damage all around the downtown area. A few members of our team were dealing with wet crawl spaces and basements in their homes, and our offices were for the most part closed for two days while emergency crews worked to restore services and deal with the damage done by the flooding. We encourage you to support local relief efforts by making donations to the many funds that have been set up to help our neighbors to restore their communities. There is much recovery work still to be done.

On a brighter note, many of you joined us recently for our celebration of 25 years in business. A good time was had by all as we enjoyed cocktails and nibbles at Bitter Bar on October 3rd. Thanks to all who came to help us mark this milestone. We are forever grateful for your continued support and loyalty and we hope you had a great time!

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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