ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
October 7, 2014

Dear Clients:

The third quarter of 2014 came to an end with heightened global tensions from conflicts in Eastern Europe and the Middle East, contradictory worries about inflation from excess money creation and deflation from excess global labor supply, and a generalized decline of confidence in the effectiveness of government. In the US, a vigorous debate continues over domestic priorities and global obligations, with the upcoming mid-term election possibly leading to a significant change in direction for the country. US investment markets were mixed as high quality stocks and bonds experienced modestly positive returns for the quarter, but more worrisome cracks in the market's armor were seen in materially negative returns for smaller US stocks and high yield bonds. This quality divergence is noteworthy and may be setting the stage for a material re-pricing of securities markets.

Investment Market Returns as of September 30, 2014

The S&P 500 Index had a total return of 1.1% for the most recent calendar quarter, resulting in a year to date return of 8.3% and a trailing 12 month return of 19.7%. Returns for these stocks benefitted from continued growth in reported earnings, offset partially in the current quarter by a modestly lower earnings multiple. By contrast, returns on US small cap stocks as reflected by the Russell 2000 Index were a negative -7.4% for the 3rd quarter, a negative -4.4% for year to date, and only up 3.9% for the trailing 12 months. Returns for small US stocks seemingly reflected a contraction in earnings multiples due to a rising risk premium. International stocks generated modestly positive "local currency" returns over the last 12 months, but due to a very strong US dollar, generated negative returns to US investors for the 9 months ended September 30, 2014.

Returns on US fixed income assets have been generally positive for most of 2014; however, returns on the US investment grade taxable bonds was a negative -0.7% for the month of September, and returns on US investment grade tax exempt bonds was only 0.1% for the month. With indicated annualized yields on these bonds at or below 2.2%, the recent fall in prices may be signaling the long awaited inflection point for interest rates returning to more normal levels. Returns on foreign currency bonds declined dramatically over the last 3 months, reflecting the strong US dollar and concerns about rising credit risk in developed Europe and many of the emerging markets. The Barclays US Ba-B High Yield Bond Index experienced a negative -2.0% return during September alone, possibly signaling a trend reversal for this popular asset category.

Commodity prices turned decidedly negative in the current quarter, reflecting slack demand for industrial materials, energy, and precious metals. This trend suggests global economic activity is slowing down materially which may limit the upward trend in interest rates. Returns on REITs tracked that of stocks over the last 12 months but turned sharply negative in the 3rd quarter, perhaps signaling a rise in future interest rates. Accordingly, we may have to await confirmation whether the weakness in REIT prices in the third quarter reflects an economic slowdown or portends a rise in interest rates.

Our View Looking Forward

Sometime over the next 12 months, we believe the odds favor a decline in global stock prices of at least 10%. A 10% decline in the S&P 500 Index from today's level would take the index to 1750+/- from 1935 and to a more normal earnings multiple of around 16. A more significant decline would result from a severe reduction in global economic activity and/or a destabilizing event(s) most likely involving transnational security. A stable to modestly higher index level would be supported by continued strong corporate earnings and a continued benign interest rate market. The index

level with the least odds of realization is another double digit rise brought about by the confluence of strong corporate earnings, benign interest rates, and most importantly, a tidal wave of foreign capital into US investment markets.

Our view regarding interest rates continues to rest on our belief in the power of mean reversion and the historical building blocks of bond returns. Annual inflation is now around 2%, which combined with normal premiums for duration risk and credit risk, suggest a normal intermediate term bond yield of 4 – 4.5%. A rapid return to historically normal interest yields would subject current intermediate term bond portfolios to price declines approaching 10%.

Bottom line: we believe under-weighted allocations to stocks and longer duration bonds remains in our clients' best interest for the next couple of quarters or until material changes in valuation metrics are realized.

Sustainable Withdrawal Rates

One of the more important decisions many of our clients must make each year is the amount of cash to withdraw from their portfolio for annual spending/gifting. For permanent endowments and foundations as well as individuals with the goal of maintaining the current purchasing power of their portfolios for heirs or charities, the "normal" annual withdrawal rate has been 5% for many decades. This "spending rule" has been predicated on a continuation of long term annual stock returns of 10 – 10.5%, annual bond returns of 5 – 5.5%, and annual inflation of 3%. Using stock/bond allocations of between 50/50 and 60/40, the expected nominal portfolio return would be about 8%, and the real return would be about 5%. Thus, 5% of the trailing 5 year average of the portfolio market value could be spent each year, on average, without reducing the purchasing power of the portfolio. Not coincidentally, required minimum distributions for qualified retirement plans start at about 4% at age 70 and rise to over 5% at age 80 and 9% at age 90. Although over the last 5 years, many portfolio owners/fiduciaries have adopted a 4% spending rule given very low bond yields and volatile stock markets.

Some individuals have the goal of spending/gifting the large proportion of their portfolios during their lifetimes. For these individuals, the decision is complicated by having to choose a "safe" distribution period so that sufficient funds are available during the remaining lifetime. Using the same return assumptions above, a person willing to exhaust her portfolio over a twenty year period would be able to withdraw nearly 10% per year. Using a more modest investment return of 5% suggests an annual withdrawal of 8%. Not surprisingly, estimated annual withdrawal rates to exhaust a portfolio over 35 years into the future are between 5% – 6% or only slightly more than the spending rule for perpetual portfolios. The "longevity" risk of this approach can be mitigated partially by adopting a percentage distribution rate rather than a fixed dollar amount. However, the decision to consume one's portfolio within a specific time period injects a significantly higher risk of sustainability failure and should not be taken lightly.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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