

ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
July 8, 2014

Dear Clients:

We write this letter on the anniversary of our first report to you following the formation of our firm in April, 2013. We find the investment landscape quite similar to that of a year ago, with bond and money market yields providing inadequate compensation for inflation and duration risks. Geo-political tensions across the global landscape remain high -- so high and threatening that a rational person might expect to see bear market declines in prices of most, in not all, investment classes. To the contrary, prices for stocks, bonds, real estate, and commodities all are higher than one year ago, with asset prices in the US leading the way. Despite record fiscal and monetary imbalances in the US, American "exceptionalism" seemingly continues to attract sufficient capital to sustain historically high equity price multiples and low coupon rates for all fixed income maturities. We all should be grateful for this good fortune, but mindful of the need to remain diligent about complacency and that human tendency to attach permanence to current conditions.

Investment Market Returns as of June 30, 2014

Equity market returns were positive across the globe as investors continued to bid up the price of risky assets to compensate for the very low returns available from fixed income assets. The S&P 500 Index produced total returns of 5.2% and 7.1%, respectively, for the second quarter and first six months of 2014. The Russell 2000 Index for US small cap stocks had the weakest returns year-to-date, at 3.2% (2.0% for the second quarter). Returns on international equities were also strong in 2014, aided by a falling USD exchange rate versus the major developed country currencies.

Fixed income markets also rallied through June 30, reversing the negative returns experienced in 2013. The Barclay's US Aggregate Bond Index generated a total return of 3.9% year to date, while the total return on US tax-exempt bonds and foreign bonds both reached 6%. These rather stellar returns were generated primarily by rising prices as annual yields remained only slightly above 2%. With the US CPI averaging about 2% per year, the average coupon bond is providing almost no real return and no purchasing power protection should future inflation rise to or exceed historical norms.

Returns from the Alternatives Investment space were also positive as the broad commodity index, the US REIT index, and the marketable hedge funds our firm uses produced year to date returns of 7.1%, 18.2%, and just under 6%, respectively. The return for the US REIT index was particularly strong and more than offset the negative return of -3.7% for the last half of 2013. The annualized yield on the US REIT index is now 3.8%, only slightly above that of the 30 year UST bond.

This near universal price euphoria and historically low yields gives us pause and brings to mind the Herbert Stein quote – "If something cannot go on forever, it will stop". Waiting for a stop point remains an exercise in patience and reminds us of the words of John Maynard Keynes – "Markets can remain irrational longer than you can remain solvent". Do not expect any out-sized contrarian bets in your portfolios at our firm.

Our View Looking Forward

As we try to make sense of current price levels for both stocks (aka equities) and bonds (aka fixed income), we continue to rely on the straight forward logic of the building block components of capital market returns. Those building blocks are an annualized cash return (primarily expected inflation), a fixed income duration yield premium, a fixed income credit risk yield premium, and an equity risk return premium. Using Ibbotson SBBI data (now a subsidiary of Morningstar), we believe the 88 year annual compounded average for these components to be 3.5%, 2.0%, 0.5%, and 4.1% (based on the S&P 500 Index), respectively. Today, we estimate these components as follows: 0.10% (at best a negative 2% in real terms); 3.2%; 1.1%; ????. We address the difficult-to-quantify equity return risk premiums (???) below.

Our best gauge for current annual inflation is the price quotes for longer term US TIPS bonds, which suggest a 2.3% annual CPI. We believe bond yields are at least 200 basis points below equilibrium; as a result, prices for intermediate and longer term coupon bonds seem to be 10% to 20% too high. Accordingly, we plan to maintain shorter than benchmark durations and strong credit quality for fixed income positions.

We think the S&P 500 Index is at least 10% above a normal equilibrium. Our view reflects the following assumptions used in the traditional dividend discount pricing model applied to the separate streams of dividends paid to shareholders and the retained earnings reinvested into the companies:

1. The long term UST bond yield of 3.32% represents a reasonable proxy for future earnings growth in the economy.
2. The long term A rated corporate bond yield is now about 4.43%.
3. The equity return risk premium for the dividend portion of corporate earnings is assumed to be about 2.5%.
4. For the year ended June 30, 2014, the current index equivalent dividend and reinvested earnings of the S&P 500 Index are 37.38 and 66.30, respectively, as obtained from Standard & Poor's Corporation.

At a current value of the S&P 500 Index of 1960, this pricing model suggests an incremental equity return risk premium from reinvested earnings of only about 6% which seems too low for this component. A 1760 Index level would imply such an incremental return risk premium of 8%, an expected return we think more in line with the uncertainty of this component. Many commentators today are calling for a 2100+ Index level that, in our view, represents an equity return risk premium of only 5%. Investors should not be surprised to see a 1500 Index level if bond yields rise by 200 basis points, in line with more traditional averages, but we will stay with our January 2014 view that long term investors should be happy with a 1760 level in December 2014.

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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