October 2013

Third Quarter Investment Commentary

The quarter ended with a surprising turn as the Federal Reserve's much-anticipated shift toward tapering its monthly bond buying failed to materialize at its September meeting. Shortly thereafter, monetary policy was upstaged by fiscal policy as Congress clashed over the budget and veered toward a government shutdown (which began just after the quarter ended). Despite these twists and turns, stocks posted another strong quarter. Large caps rose 5% and are now up 20% year to date. (See our benchmark returns table for complete performance details.) These gains have occurred even as the U.S. economic recovery remains only moderate and corporate earnings growth has slowed. Our portfolios are modestly underweight U.S. stocks based on our expectation of subpar returns in most scenarios. At the same time, many of our stock fund managers (both U.S. and international) have added value relative to indexes through their stock selections, which has helped our portfolio performance despite this underweight. We address our bearish stock market views at length in the commentary that follows.

September Benchmark Returns (Preliminary)

Large-Cap Benchmarks	**Sept**	**3Q**	**YTD**
Vanguard 500 Index	3.1%	5.2%	19.7%
iShares Russell 1000	3.6%	5.7%	20.6%
iShares Russell 1000 Growth	4.4%	8.3%	20.7%
iShares Russell 1000 Value	2.5%	4.0%	20.2%
Mid-Cap Benchmarks			
iShares Russell Midcap	4.6%	7.8%	24.2%
iShares Russell Midcap Growth	5.1%	9.5%	25.3%
iShares Russell Midcap Value	4.2%	6.1%	22.7%
Small-Cap Benchmarks			
iShares Russell 2000	6.5%	10.7%	27.7%
iShares Russell 2000 Growth	7.3%	13.3%	32.8%
iShares Russell 2000 Value	5.8%	7.7%	22.9%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	7.9%	11.6%	15.1%
MSCI World ex USA Index	7.1%	11.4%	15.1%
Vanguard FTSE Europe ETF	7.2%	13.7%	14.8%
Vanguard FTSE Emerging Mkts ETF	7.3%	4.3%	-7.7%
Vanguard REIT Index	3.3%	-3.0%	3.1%
Vanguard Total Bond Mkt Index	1.0%	0.5%	-2.0%
BofA Merrill Lynch U.S. High Yield Cash Pay	1.0%	2.3%	3.8%
Vanguard Int. Term Tax-Exempt Fund	2.0%	0.5%	-2.0%
S&P/LSTA Leveraged Loan Index	0.2%	1.2%	3.5%
Citigroup World Govt. Bond Index	2.0%	2.9%	-2.9%
JPMorgan GBI-EM Global Diversified Index	4.4%	-0.4%	-7.6%
DJ-UBSCI (Commodity Futures)	-2.6%	2.1%	-8.6%

International markets improved in the third quarter following a rocky start to the year, particularly for emerging markets. Positives for developed markets included indicators of an improving economic outlook in both Europe and Japan. Among emerging markets, China showed signs of stronger growth (albeit at a lower rate than in prior years) so this was an overall positive given the country's significance among emerging (and developed) market economies. Emerging markets as a group rose in the third quarter (despite losses for some countries) and developed international markets outperformed U.S. stocks. We have not made changes to our emerging-markets stock or bond allocations and review both in detail in the quarter's update.

Finally, core bonds in aggregate were modestly positive for the quarter thanks in large part to a rebound in September as both the Fed's decision to stand pat and investor risk-aversion in the face of an impending budget stalemate (and looming debt-ceiling standoff) were ultimately positive for bonds. The benchmark 10-Year Treasury yield ended the quarter at 2.64%, slightly higher than where it started, though down from its intraquarter high. Our underweight to core investment-grade bonds has benefited our portfolios considerably over this changing fixed-income environment as the more flexible bond funds we own instead have continued to outperform the benchmark.

Current Affairs

For all the Fed's good intentions about being transparent, it is ironic that it has managed to surprise market participants yet again. A mere mention of the possibility of tapering its bond purchases (i.e., quantitative easing) this summer led to a spike in bond yields not seen for nearly 20 years. More recently, when most investors expected the Fed to start tapering, the Fed decided to delay, bringing bond yields down sharply following the September 18, 2013, announcement. While we do not focus on such short-term market moves (or devote time trying to second-guess monetary-policy decisions), both the Fed's actions and the market's subsequent reactions raise several questions in our minds, which only serve to reinforce our view that an unusually broad range of outcomes remain very possible.

While the Fed can try to manage market expectations, it obviously does not control them. The bond market appears to have overreacted on tapering news this summer. Fed Chairman Ben Bernanke cited the sharp increase in long-term bond yields as one of the reasons behind the Fed's decision to delay tapering. In other words, bond yields went up more than the Fed expected or wanted. How can we be confident the Fed will be in control when it unwinds its massive balance sheet? How can we be sure that, down the road, this experimental monetary policy will not lead to high inflation?

Maybe the bond market *did* overreact, but how egregious could its overreaction be? After all, we are still well below normal interest-rate levels. What does it imply about the health of our economy if the Fed appears concerned that it cannot absorb interest rates that are slightly higher than it expected? It might suggest that our economy still faces significant deflationary pressures. If not, surely the Fed has risked its credibility for little gain since the amount of tapering in question was too small to matter relative to the size of our economy. If the Fed's credibility comes into question, how will it smoothly exit the ultraloose monetary policy we have today?

One beneficiary of the Fed's ultra-loose monetary policy has been housing. The rise in housing prices over the past nine to 12 months should go at least some way in fixing household balance sheets, lowering their need to deleverage. According to CoreLogic, an analytical services firm, about 15% of U.S. households have mortgages that are under water, i.e., their house is worth less than their mortgage, which is typically their biggest liability. This is a significant improvement from the 26% reported back in late 2009 and 22% about a year ago.

While housing is a positive development, the rapid rise in home prices is concerning and we question its sustainability. Another question is how housing prices will react to the recent sharp increase in mortgage rates, and to future increases in those rates as the Fed eventually normalizes its interest-rate policy. We plan to assess how the recent increase in housing prices impacts the progression of our deleveraging thesis. It is important to remember that the absolute level of debt within the economy has not declined in a material way. Some of it has merely shifted from the private sector to the public sector. Ultimately, this debt has to be paid back, i.e., public-sector deleveraging will have to take place at some point since the current path is mathematically unsustainable.

How We View Our Fiduciary Role When Managing Client Portfolios in This Uncertain Environment

The word "fiduciary" is defined as "relating to, or involving one that holds something in trust for another." Another word that goes hand in hand with being a fiduciary for our clients is "prudence," which is defined as "careful management." In our industry, these words—fiduciary and prudence—are used liberally. We want to share what these words mean to us and how they influence our day-to-day management of client portfolios.

Our typical client in a balanced portfolio expects us to maximize long-term return without losing more than 10% in any normal 12-month period. There's an inherent trade-off in this dual objective.

Managing to a downside risk threshold sometimes means we have to be willing to leave some return on the table. We have always said we do not manage our portfolios to one economic or asset-class scenario because we don't think we can know with confidence which scenario will play out. We hope optimistic scenarios play out, but do not build portfolios based on them unless we believe they are likely. Investing based on hope would not be in line with acting as a responsible fiduciary for our clients who have specifically entrusted us with the mandate to care about downside risk.

Managing portfolios to withstand various scenarios is as much art as science. In shielding our clients from one scenario, we expose them to others. The key is to strike a reasonable portfolio balance that allows us to meet our clients' risk and return objectives over the long term. As we noted above, both inflation and deflation risks exist, and both are bad for risk assets. Our economy is still fighting significant deflationary headwinds due to ongoing private- and public-sector deleveraging. At the same time, the experimental monetary policy of keeping short-term interest rates near zero over extended periods could easily stoke inflation, and we don't know if and when that would occur. In this inflationary scenario our clients would expect us to protect their purchasing power. It would be nice if we had a crystal ball to know which outcome will occur and when, so we can position our clients' portfolios accordingly. But part of being intellectually honest is acknowledging that we do not have a crystal ball and there are many unknowns, especially now, when we are going through a major deleveraging episode and the range of possible outcomes is unusually wide. Our job becomes harder in a period when most assets appear to be richly valued. So, how do we balance out two extreme risks—inflation and deflation—given each scenario warrants a vastly different portfolio positioning?

To protect our balanced portfolios from a recession or deflation outcome, we continue to have a decent allocation in investment-grade or core bonds. In such an environment, interest rates would likely fall, and core bonds would increase in value as most risky assets are declining. We cannot ignore this outcome because in this scenario our stated 12-month risk-threshold objective is *most* at risk. Given their very low yield levels, core bonds would not give as much protection as they did in the past, but would still do a much better job of protecting capital than most other asset classes in this scenario.

That said, we acknowledge that relative to history, core bonds carry a significant opportunity cost. Our expected returns from bonds are extremely low across all of our five-year scenarios; if we were to carry a full allocation, there is the significant risk that we could fail to meet our clients' return objectives. As a result, roughly half of our bond allocation has gone to absolute-return-oriented and flexible, or non-core, bond funds. Over 12 months, in a recession/deflation scenario, absolute-return-oriented and non-core bond funds are likely to lag core bond funds that have a longer duration and heavier emphasis on Treasury bonds. But over our five-year investment horizon, absolute-return-oriented and non-core bond funds are likely to generate significantly better returns. The value of these bond funds comes from their underlying managers' ability to add value by investing opportunistically across fixed-income sectors (without being constrained by the core benchmark) as well as from individual issue selection.

Some of our U.S. equity underweight has also gone to fund a few of the absolute-return-oriented and non-core bond fund investments, and here we see the latter's role differently. Over a 12-month period, we expect our absolute-return-oriented and non-core bond fund investments to have much less downside risk than stocks, and similar or better returns in all but our most optimistic five-year scenarios. That is not such a bad trade-off in and of itself. In the past several years, these funds have generally met our expectations. Through a strong period for stocks, they have provided a reasonable return with much less risk. In addition, by having a lower allocation to stocks, we worry a bit less about capital preservation in a deflation/recession scenario and can afford to have less protection in the form of core bonds, which, in addition to having poor return prospects over our five-year investment horizon, expose us to the risk of rising interest rates. Again, our goal is to

factor in multiple scenarios and strike an appropriate balance when constructing portfolios. If we were to worry only about recession/deflation risk and have more in core bonds, we may end up overexposing the portfolio to rising interest rates, which could result from an improving economy, inflation, and/or investors' concerns about the country's large debt and deficits.

Building a sensible portfolio in an uncertain environment is not just about having different pieces in place to ensure the portfolio can withstand different scenarios and outcomes. It is also about understanding the risk and reward of each asset, the role of each asset in the portfolio, and how assets interact with each other. This understanding helps us optimally position portfolios in our clients' favor, and offset, at least to some degree, the cost their portfolios bear to insure against the unknown (which, without that crystal ball, is an unavoidable cost).

To cite some examples, we have underweighted U.S. stocks for much of the period since the 2008–2009 recession. In the early part of the recovery, we found high-yield bonds offered us a better return at a lower risk level than U.S. stocks, so we chose to overweight the former (by a lot) at the expense of the latter. We also had a successful, albeit short, tactical overweight to emerging-markets stocks, also funded largely from U.S. stocks. Later, we chose to fund a good part of our large allocation to emerging-markets local-currency sovereign bonds from U.S. stocks. This position reduced the opportunity cost of underweighting stocks during this period, and with much lower risk. In addition, it served as a cheap, longer-term insurance hedge against the risk of a decline in the U.S. dollar, and the related inflation risk. It worked well enough such that in 2011 and 2012, we sold a good chunk of emerging-markets local-currency bonds to fund other assets (the sale reflected the bonds' lower return potential as well as broader portfolio-risk considerations), and we held on to some emerging-markets local-currency bonds because we view them as more of a strategic long-term position (we discuss why below). Last year, U.S. stocks clearly trounced the other assets we held in its place, but even then our overall performance was solid as other areas of our portfolio (such as our actively managed bond funds) performed well. As such, despite being underweighted to the best-performing asset class (U.S. stocks), our balanced portfolios have outperformed their benchmarks over the past five years.

Rational Reasons for a Bearish View on U.S. Stocks

We are maintaining our underweight to U.S. stocks in our balanced portfolios. (The underweight ranges from 9% to 11% depending on the portfolio.) Over the past two years or so, GAAP trailing 12-month earnings have gone nowhere, but the market has continued its ascent, especially over the past year (CHART 1). The S&P 500 now trades at 19x trailing 12-month earnings. In our base-case scenario, we assume a 15x multiple on our normalized earnings number five years out. This is an average historical multiple excluding the market's frothiest periods and a prudent multiple in our view given the deleveraging headwinds are still in place. If the S&P 500 were to trade at 15x current trailing 12-month earnings, it would imply a price of around 1,350 on the S&P 500 index, i.e., a decline of roughly 20% from present price levels. This would bring U.S. stocks within our fair-value range and roughly the level where we'd consider raising our exposure to U.S. stocks to our strategic level.

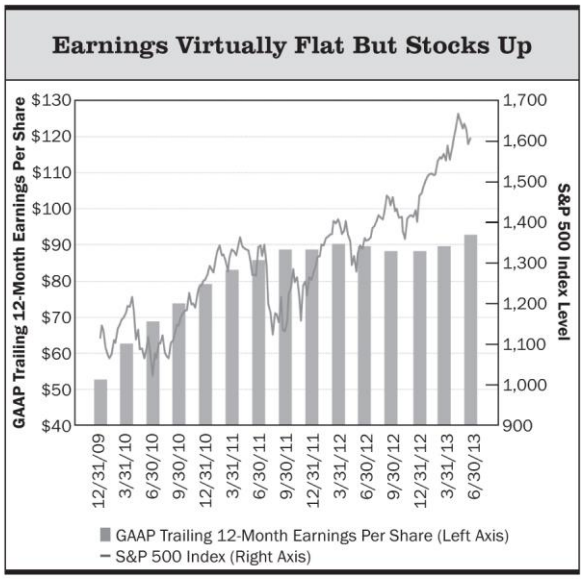
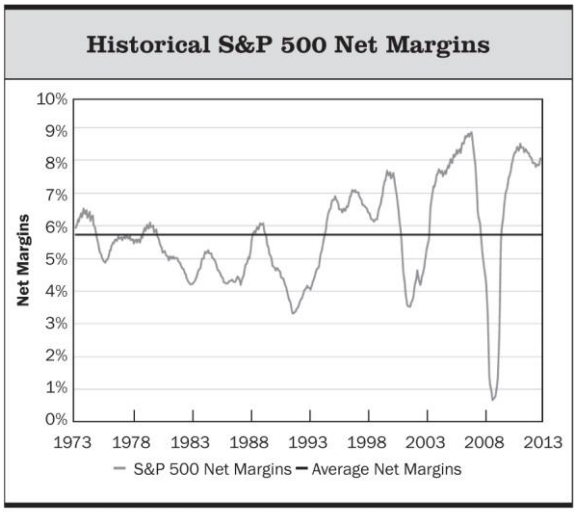


CHART 1 *Data as of 6/30/13 (estimated). Source: Standard & Poor's.*

On the other hand, given that most investors expect the Fed to keep short-term rates near zero until 2015 at least, P/E multiples of 18x–20x are quite conceivable in this environment, and quite normal to most investors who in their professional lives have only experienced the post-1980s investing world. Applying those P/E multiples to our normalized earnings five years out, then adding a dividend yield of slightly over 2%, we get returns in the 6%–8% range—not bad at all considering that the expected returns of other asset classes we can invest in are generally lower. This is one reason we are not *more* underweighted to U.S. stocks. On the other hand, if stocks continue to rise to the point where U.S. stocks start looking unattractive, even given these optimistic valuation multiples, we will lighten-up further.

While our normalized earnings and P/E framework remains our primary valuation tool, we consider other approaches, frameworks, and viewpoints, and ultimately make decisions based on what the weight of the evidence tells us. In the adjacent article, "Sales and Margin Analysis of U.S. Stocks," we discuss another framework for analyzing U.S. stocks based on a sales-margin analysis. This analysis also suggests we should remain underweighted to U.S. stocks. The key point to take away from this analysis is that in order to get any return from U.S. stocks we have to use aggressive or optimistic sales-growth and margin assumptions relative to history and what we'd consider prudent. We can't justify margins staying at these elevated levels over our investment horizon, so it means we need to remain patient before we are proven right.

Sales and Margin Analysis of U.S. Stocks



Data as of 6/30/13. Source: Ned Davis Research, Shiller, and Standard & Poor's.

In past commentaries, we have described in detail our normalized earnings and P/E framework looking out five years, so we will only briefly walk through our key assumptions. Our current estimate of the S&P 500's normalized earnings power is close to $80. If we add to this the benefit we expect U.S. companies get from doing increasing business with emerging markets, we get an earnings number in the mid-$80s, which is in line with the current trailing 12-month S&P 500 earnings of about $90 (again, based on GAAP accounting standards). Looking out five years, we expect S&P 500 normalized earnings power to be around $111. This earnings number assumes the U.S. economy will continue to delever and heal over the next five years, and by the end of it most of the deleveraging forces are behind us. To $111 earnings five years out we apply a P/E multiple of 15x (as noted earlier). When we add dividends, we get expected returns in the low single digits, annualized, over the next five years.

As we've noted in the past, we also think it's important to consider different approaches, frameworks, and viewpoints, and make decisions based on what the weight of the evidence tells us. One such framework is our sales-margin analysis we use to stress test the earnings-growth assumptions we describe above. This analysis, which we detail below, also suggests we should remain underweighted to U.S. stocks.

As of the end of the second quarter, the constituents of the S&P 500 companies, according to Ned Davis Research, were generating sales of $1,130 per share. At the time of this writing, based on the nearly 99% of the companies that have reported, the S&P 500 companies earned roughly $91 per share on a trailing 12-month basis ending June 30, 2013. This implies U.S. companies, as represented by the S&P 500 index, were operating on net margins of nearly 8%. Over the past 40 years, net margins, both average and median, have been in the 5.5%–6% range. Looking at the chart, we will make two observations. First, margins over the past 40 years have gone in cycles and indeed have shown a tendency to mean-revert. Second, post-1980s, they seem to be reaching higher highs before trending down. This makes sense in light of capital owners getting an increasing share of economy-wide profits at the expense of labor for the past couple of decades. Bottom line, S&P 500 profit margins are a lot higher than their historical average. In fact, current 8% net margins are more than one standard deviation away from the 40-year mean. From a statistical standpoint, it means the S&P 500 has spent only a very small fraction of the time hovering at margin levels as high as we see in the present day.

S&P 500 Earnings Per Share Five Years Out

		Five-Year Annualized Sales Growth			
	As of June 30, 2013	5.0%	6.0%	7.0%	8.0%
Margins	6.0%	86.5	90.7	95.0	99.5
	6.5%	93.7	98.2	102.9	107.8
	7.0%	**100.9**	**105.8**	**110.9**	116.1
	7.5%	**108.1**	**113.3**	**118.8**	124.4
	8.0%	115.3	120.9	126.7	132.7

Source: Litman Gregory Analytics

We evaluate what sales growth and margin assumptions we would have to make in order to realize our $111 normalized earnings estimate five years out. The table above shows a matrix of sales growth and margin assumptions. There can be many permutations, but one plausible outcome could be that the S&P 500 companies in aggregate grow sales at nearly 5% per annum, in nominal terms, and maintain net margins around current levels. Another realistic possibility could be that sales grow at 7% per annum, while margins come down to about 7%, which is still close to one standard deviation away from the mean and, by definition, a historically infrequent occurrence. Since March 2009, near the bottom of the great recession, S&P 500 sales have grown about 2%, annualized. In theory, sales should track nominal GDP growth more closely than earnings so, given the slow economic recovery, this anemic sales-growth number makes sense. (We also know the S&P 500 companies generate a good portion of their sales—nearly 50%—from outside the United States, and they benefited from faster-growing emerging markets. Europe we know did not grow faster than the United States.) We don't want to prognosticate about GDP growth because that's not something we can confidently analyze, so instead we view the data history another way. Historically, high single-digit annualized sales growth has been achieved when either the private sector had the balance sheet capacity to borrow and spend, or when we were going through a credit boom that ended with a financial crisis. It does not seem likely we will get another bout of levered growth … we hope we do not. The point we want to make is, in order to get any return from U.S. stocks we have to use aggressive or optimistic sales-growth and margin assumptions relative to both history, and to what we'd consider prudent based on our forward-looking assessment of the economic environment. Our sales and margin analysis supports the case to remain underweighted to stocks. We can't justify margins staying at these elevated levels over our investment horizon, so it means we need to remain patient before we are proven right.

Why Bother Investing Outside the United States?

This is a question we have been getting more frequently in recent times. We were getting similar questions back in the late 1990s after U.S. stocks experienced a great run of outperformance over international stocks. Developed international stocks subsequently went on to outperform U.S. stocks for six years, and emerging-markets stocks did even better.

It is important to revisit why we have investments outside the United States as part of our very long-term or "strategic" allocations. The strategic allocations are the starting point for our investment process. They are intended to be an appropriate, fixed-asset allocation for a long-term investor, as they reflect a weighted mix of asset classes we believe offer the best long-term-return potential for a given risk threshold, which we define as a maximum acceptable loss over a 12-month normal worst-case period. Our investment horizon in regard to strategic allocations is 10 years or longer. The most important reason for having a globally diversified strategic mix is that it should provide a much smoother ride than just being invested in U.S. stocks (CHART 2). The second reason to invest outside the United States is to tap into a broader investment opportunity set—much of which is not well-covered by Wall Street—allowing active managers to add significant value. This is especially true for emerging markets.

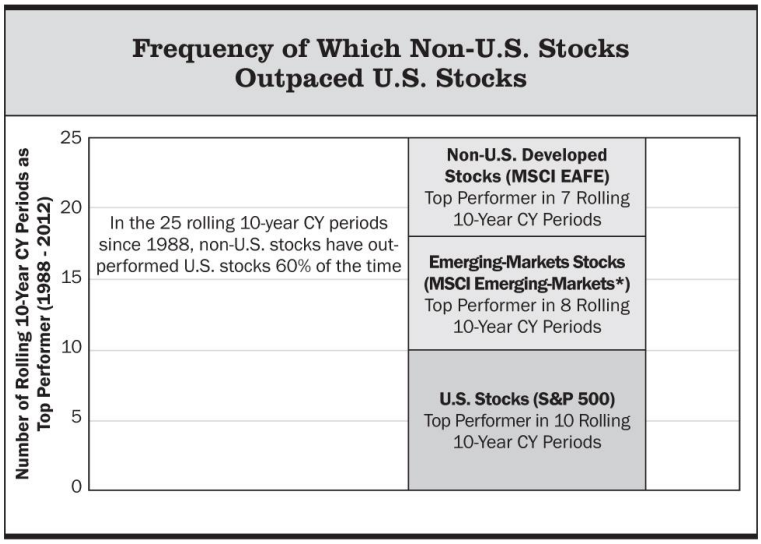


CHART 2 *MSCI Emerging-Markets Index's inception date is 12/31/87, first rolling 10-year period used in analysis is year-end 1997. Data: Rolling 10-Year CY Periods from 1988 to 2012. Source: Litman Gregory Analytics.

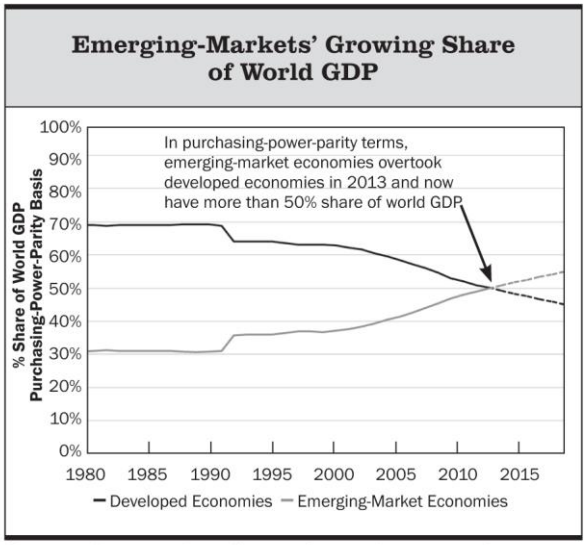


CHART 3 Data as of April 2013. Source: International Monetary Fund (estimates are also from IMF).

The case for having a dedicated long-term allocation to emerging markets is particularly compelling. On a purchasing-power-parity basis, emerging-markets' share of world GDP has grown from 37% in the late 1990s to nearly 50% as of 2012, and currently has a share of about 11% of world market-cap (in contrast, the United States has a 19% share of world GDP and 48% of world market-cap) (CHART 3). Emerging markets are home to a large proportion of the globe's young working-age population, and are benefiting from the transfer of knowledge from developed nations that is happening at a rate faster than any other time in human history. This process ultimately leads to higher productivity, per-capita incomes, and GDP. We know higher GDP and/or faster GDP growth does not necessarily lead to higher stock market capitalization in the shorter term, but over the long term, if profits are not squandered away via mismanagement or devalued via inflation, faster GDP growth does lead to faster profit growth and a deepening of capital markets (where we are already seeing significant progress). As this

happens, emerging-market countries will see the gap narrow between their shares of world GDP and market cap. We want our clients to benefit from this long-term opportunity. The problems we've seen this year in emerging markets is only a blip on what we expect to be a very long-term, upward path. In the next section, we discuss the risks in emerging markets over the shorter term, but even that does not negate the strategic case for owning emerging markets—stocks and bonds—in client portfolios.

Taking Stock of Emerging Markets

Emerging-markets stocks were hit especially hard this year after the Fed indicated its intent to taper QE, and over the last couple of years have underperformed U.S. stocks. During this time we have taken advantage of price weakness in emerging-markets stocks by moving toward our strategic weighting at a gradual, measured pace. As such we are only one percentage point overweighted to emerging-markets stocks in our typical balanced model (taking into account our look-through analysis of our international stock-fund holdings as well as our dedicated emerging-markets funds). As we've reiterated along the way, the primary reason we have not increased our weighting further is our longstanding concern related to China's credit and infrastructure bubble.

This summer it became clear to us that this China risk might well play out. The Chinese government's actions to rein in credit growth suggest they are concerned about past overinvestment and potential bad debts. China's actions, in turn, are slowing growth there as well as in the rest of the emerging markets. When we model in the China risk, returns from emerging-markets stocks could be as low as mid- to upper-single-digits (nominal) five years out, which, adjusted for their relatively high risks, puts them roughly in fair-value territory in relative terms, and not attractive in absolute terms. However, there is also a decent possibility that the infrastructure bubble is not as significant as we fear and/or China might be able to unwind this bubble in a relatively orderly fashion. Assuming these China-related headwinds end up not as material as we fear, we get low double-digit returns in our likely scenario, which are attractive in both absolute and relative terms (even after we discount these returns substantially because our emerging-markets modeling is based on a very short data history that lowers our confidence level). Hence, we are sticking with our current, very slight overweight position in emerging-markets stocks.

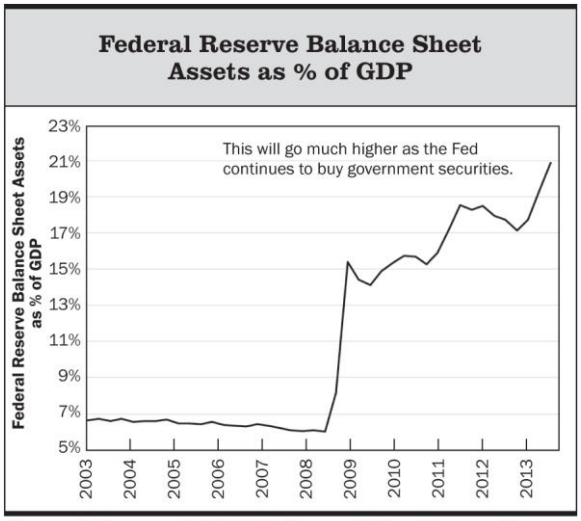


CHART 4 *Data as of 6/30/13. Source: Federal Reserve/Bureau of Economic Analysis.*

Coming to emerging-markets local-currency bonds, they too suffered this spring and summer as emerging-markets currencies declined versus the U.S. dollar. Before delving into our analysis of emerging-markets local-currency sovereign bonds, it is important to review how we think about this allocation, which we have through PIMCO's Emerging Local Bond fund. Our time horizon for this position has always been longer than the five years typical for our tactical positions. We see it as a good way to hedge a potential decline in the U.S. dollar/U.S. inflation. As covered earlier, insuring against this risk remains prudent in our view, given the Fed's unprecedented monetary policies in recent years that have bloated its balance sheet (CHART 4). In aggregate, long-term fundamentals—primarily balance sheets and growth prospects—for emerging markets are stronger than the United States. As such, in a normal scenario we believe we can get at least mid- to upper-single-digit returns over our investment horizon. These returns are better than what we expect from U.S. stocks in our likely subpar recovery scenario. Finally, to adequately factor in emerging-

markets currencies' equity-like risk, which we clearly experienced this summer, we fund them mostly from U.S. stocks. Overall, looking out five years and longer, given the role they are playing in the portfolio and taking into account the risk from our allocation to emerging-markets stocks, we have thus far been comfortable holding a four percentage-point allocation in emerging-markets local-currency sovereign bonds in our balanced models.

What's Behind the Recent Declines in Emerging-Markets Currencies?

We have been surprised by the magnitude of decline in emerging-markets currencies following talks of the Fed tapering its QE program (though they have recovered nicely from the bottom). We can't imagine anyone believing that QE is a permanent state of affairs. So it's hard to not conclude that many investors were playing a game of musical chairs and reaching for yield, without a proper appreciation of emerging-markets fundamentals. Moreover, even if the Fed tapers, which would likely be a gradual process, and despite the slowdown we have witnessed in some emerging-market countries, the differential in growth rates and real interest rates between U.S. and emerging markets would remain attractive, in our view. That said, this decline also raised a question in our minds as to whether we were missing something in our own assessment of emerging-markets fundamentals. So, the past few months we have been spending a lot of time re-evaluating our thesis and beliefs, verifying a lot of data, and, as we constantly do, asking ourselves what can go wrong. This effort is continuing but we can share some findings and conclusions, including outstanding questions and risks that require more analysis and continuous monitoring.

Our broad thesis on emerging markets rests on the belief that their macroeconomic fundamentals are much better than they used to be during their crisis-prone years. So, one key question we asked ourselves again recently is: are emerging markets fundamentally better than they were in the late 1990s, around the time of the Asian crisis that led to severe currency declines? Another question we are wrestling with is whether or not there is a risk of contagion in emerging markets, where even countries with decent fundamentals can see some sort of a run-on-the-bank, contaminating their fundamentals. We don't think we have all the answers we need yet, but here are our current thoughts and findings:

In the past, fixed-exchange rates resulted in overvalued emerging-markets currencies, which in turn resulted in large current-account deficits, making emerging-market countries vulnerable to capital outflows and currency crises. (If a country imports more than it exports, it runs a current-account deficit that it has to finance by attracting capital from abroad. The United States runs a current-account deficit and needs to do the same, for example.) So, as a first step, we verified whether or not emerging-market countries today are as vulnerable to capital outflows as they were back in the 1990s.

We looked at current-account deficits across different emerging markets with and without China. We wanted to evaluate current-account deficit without China because its large current-account surplus might hide vulnerabilities in the rest of the emerging-markets universe. While there are fewer emerging-market countries running current-account deficits today than in the late 1990s, some regions are clearly vulnerable (CHART 5). Emerging Europe and Africa are running relatively

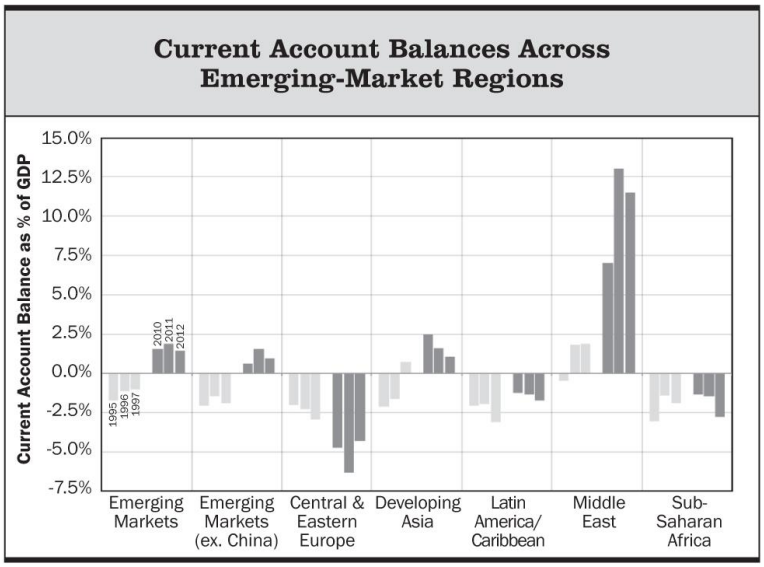


CHART 5 *Data as of April 2013. Source: International Monetary Fund and Litman Gregory Analytics.*

large current-account deficits; Latin America is not, though their current level is similar to what Asia's was before they experienced a currency crisis in the late 1990s. Asia's aggregate current-account deficit level doesn't look threatening, but hidden in those numbers is India, which could face a crisis if capital outflows continue. Moreover, in recent years the trend in Asia's current-account balances has been negative. Looking at current-account deficit in isolation, it seems that emerging markets are susceptible to a major crisis akin to the 1990s. However, in our view current-account deficit should not be looked at in isolation.

First, most emerging-market countries today have floating (rather than fixed) exchange rates. This allows currency moves to release pressure that might develop due to fundamental imbalances. For example, if a country's terms of trade are deteriorating, i.e., it is becoming less competitive, currency declines help correct that imbalance. Declines in currency also help fix the current-account deficit problem. In the past, most emerging-market countries had fixed-exchange rates, so there was no pressure-release valve, leading to larger imbalances in the economy and ultimately larger devaluation events.

Second, the true indicator of an economy's dependence on foreign capital is the sum of current-account deficit and external debt burden, especially debt denominated in a foreign currency (typically in U.S. dollars). Today, most emerging-market countries do not have as significant an amount of dollar-denominated debt (as a % of GDP) as they did back in the late 1990s (CHART 6). Their external liabilities are thus unlikely to shoot up astronomically when their currencies decline versus the U.S. dollar. This rapid rise in liabilities in the late 1990s forced emerging-market countries to spend their foreign-exchange reserves to stem the currency declines, which made them more vulnerable, compounding the vicious cycle. Also, it forced them to raise interest rates sharply (to attract investors via higher yields, and to counter inflation resulting from a weak currency) at a time when their economy was already slowing, leading to a much sharper economic downturn/recession (a worrying dynamic we are seeing played out in India at present). In the past decade, most emerging-market countries have started issuing local-currency debt (which is what we have been investing in for many years), lowering their need to issue dollar debt. So, the risk of currency declines contaminating emerging-markets balance sheets is much less today. This is a key fundamental difference between the two periods.

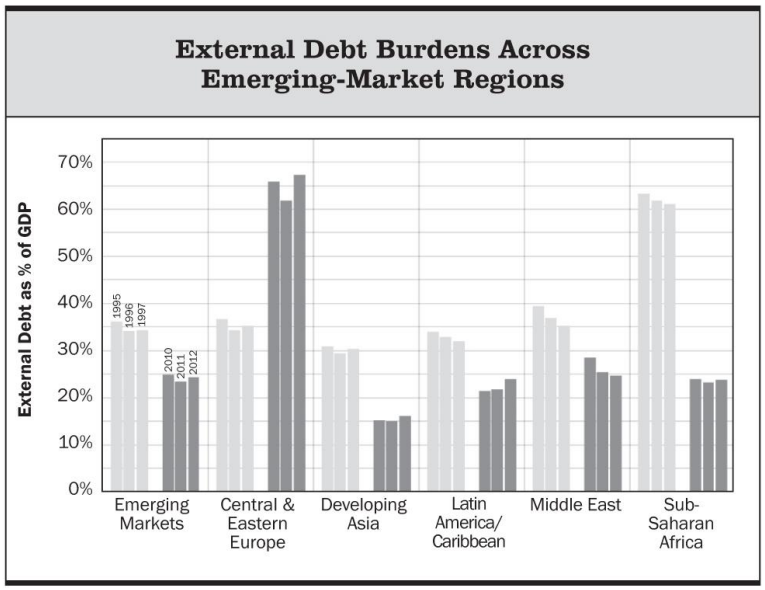


CHART 6 *External debt is debt owed to nonresidents by residents of an economy. Data as of April 2013. Source: International Monetary Fund.*

Finally, most emerging-market countries have relatively large foreign-exchange reserves. These reserves allow current-account deficit countries to pay for necessary imports when capital flow dries up (CHART 7). They also serve as a deterrent to speculators, as the central banks in question can expend these reserves to support their currencies. The fear of loss is a powerful deterrent to speculators, or else the United States would have had a crisis long ago.

Weighing the positives, while the current-account deficit situation across emerging-market countries makes us nervous, we think a broad-based emerging-markets contagion is unlikely. That said, contagion risk cannot be completely ruled out either. There are some key unknowns that we cannot analyze with a high level of confidence. These unknowns, which impact our thinking on both emerging-markets stocks and bonds, warrant close monitoring:

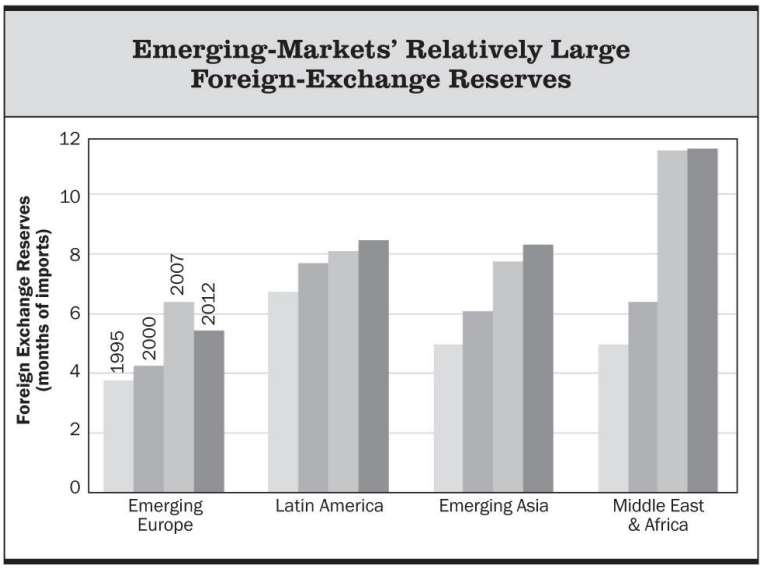


CHART 7 *Data as of 12/31/12. Source: Capital Economics.*

- If capital outflows from emerging markets continue, such that long-term-oriented investors also throw in the towel, there is a risk that technical factors (i.e., capital outflows) could contaminate fundamentals, i.e., the damage becomes sort of a feedback loop. Emerging-markets foreign-exchange reserves are healthier than they were in the past, but in absolute terms they are not large enough to ward off a sustained bout of capital outflows. If outflows continue, we may revisit the negative cycles the emerging markets went through in previous crises.

- If emerging-market countries start abandoning their relatively newfound inflation discipline due to political pressures and/or factors beyond their control that will impair our long-term thesis, especially for emerging-markets local-currency sovereign bonds and the role (discussed above) we see them playing in our portfolios.

- If China's credit and infrastructure bubble unwinds in a more destructive fashion than we currently envision, it would be a major drag on emerging-markets growth and a major negative for emerging-markets risk assets.

- If the commodity cycle goes in reverse in a major and sustained way, due to China's slowing demand and/or significant increases in supply of commodities, it will negatively impact macroeconomic fundamentals of some key emerging-market countries, such as Brazil and Russia, and could result in higher risk-aversion toward all emerging-markets assets.

- We have witnessed a relatively sharp increase in dollar-denominated debt among emerging-markets corporations. Based on our discussion with emerging-markets fund managers thus far, this does not appear to be a material risk; it's more a company-specific risk. But we are not confident that is the case, and will keep digging to assess this risk factor further.

In the case of emerging markets, the unknowns are too many for our liking. This means that the bar to add to emerging-markets stocks and/or emerging-markets bonds is much higher than normal (though our concerns have not yet led us to unwind our existing holdings because their risk/reward still looks relatively attractive in most scenarios). If any of the above-mentioned concerns begin to play out, we may change our current view on these asset classes quickly. It is also possible, if and when these risks play out, that prices will decline enough to make them attractive in our minds. The bottom line is that the downside associated with the above-mentioned risks and our mandate to

manage to specific 12-month-risk thresholds are key reasons why we want to see a greater margin of safety or lower prices before we allocate more to emerging-markets stocks and/or bonds.

Parting Thoughts

An important part of our investment discipline is to protect client portfolios against risk scenarios we believe are plausible and not already adequately factored into asset prices. Taking this precaution means we will likely underperform in the shorter term if these risk scenarios do not play out. The fear of underperforming our benchmarks over the short term is not good cause to deviate from the investment discipline that has served our clients well over the long term. We will continue to work hard to assess the environment around us and not shy away from deviating from our benchmarks and/or peers if we believe that is the prudent thing to do for our clients.

—Todd Balber, CFP and Gary T. Richards, CFP

B& R Financial, LLC

www.brfinancialgroup.com

[i]

[i] This letter is intended to be for informational purposes only and not an offer to buy and sell securities. The views expressed in the letter relate to a particular investment program offered by Todd Balber and Gary T. Richards, and do not reflect the views of World Equity Group. All investments carry some degree of risk that needs to be reviewed with your financial advisor. Todd Balber and Gary T. Richards are Registered Representatives and Investment Advisor Representatives offering securities and advisory services through World Equity Group member FINRA/SIPC.