"**Riches don't make a man rich, they only make him busier**" Christopher Columbus

"**Standing in the middle of the road is very dangerous; you get knocked down by the *traffic* from both sides**." - Margaret Thatcher

I love that quote because I think many people feel right now that they 'shouldn't buy stocks and they shouldn't buy bonds'. But I think they know that they can't stand in the middle of the road…

"**What lies behind us and what lies before us are tiny matters compared to what lies within us**." – William Morrow

I hope that you and your family and friends are enjoying your pre-Fall weather (it's still hot in Atlanta (86 degrees yesterday, but sunny and very beautiful)), and that you are not too worried about the economy, the markets, and global politics.

More volatility and current correction

"**The good thing about volatility is that it breeds opportunity – this is exactly when active money management earns its stripes**." Economist David Rosenberg – October 6'th, 2014

In July, I wrote that the end of Q.E., would bring more volatility and a return to more frequent corrections. We are in the middle of a correction right now. They're never fun, but they're incredibly healthy for markets to periodically correct rather than go up in a straight line (keep in mind, we've not had a healthy 10% equity correction in 3 years (third year anniversary>Oct., 3'rd)). On average, we have 20%+ corrections every three years, so we may only correct 5-10%, but we *may* only be about halfway through with this current one…

As a reminder, I believe that the right way to be invested is a very personal thing and the right asset allocation for you and your family is also a very personal thing and if you'd like to discuss that, let's schedule a time to do so.

Since last quarter

This information does not represent all of the activity in every account, it's simply intended to highlight some of the broader, tactical moves.

We sold our Astrazeneca shares with an approx.., 74% increase from 2011. The shares then were cheap on a Price/Sales , PEG ratio and PE basis. They are no longer cheap. We sold our KLA Tencor shares (similar reasons), with an approx.., 37% long term gain. We also sold our Teekay Corp., bonds at a gain for risk management reasons; we trimmed our duration in our Safeway grocery stores bonds by trading the 2031 bonds for the 2027 bonds and in the process we picked up a higher coupon (same yield, 7.5%). We sold our Supervalu bonds at a handsome gain. We trimmed our iShares Select Dividend symbol: DVY iShare position (almost a double in most accounts), and invested the proceeds in iShares Select Dividend Emerging Markets symbol: DVYE. We've added to our position in the JP Morgan Research Long/Short Institutional Fund. We are overweighting our MFS Large Cap Value Institutional Fund. And with the selloff to small caps, we're gradually adding to our position in the Earnest Partners Small Cap Value portfolio. We added (for some accounts), a 1% position in Senior Secured Corporate Bonds with Titan International symbol: TWI, now yielding 8% per year for 6 years. Titan manufactures tires and wheels for John Deere, Kubota, Case New Holland, AGCO, and also for ATVs. No tractor concentration, just two…we also purchased Case New Holland tractor bonds yielding 4% per year for three years. We added to our General Electric position, and invested a half-position in the Baron Emerging Markets Institutional Fund. Lastly for unconstrained municipal bond clients, we added a New Jersey Water and Sewer municipal bond that was

mispriced in my mind (and that of the bond traders and credit analysts I work with), yielding 4% per year for 5.5 years.

The traffic lights

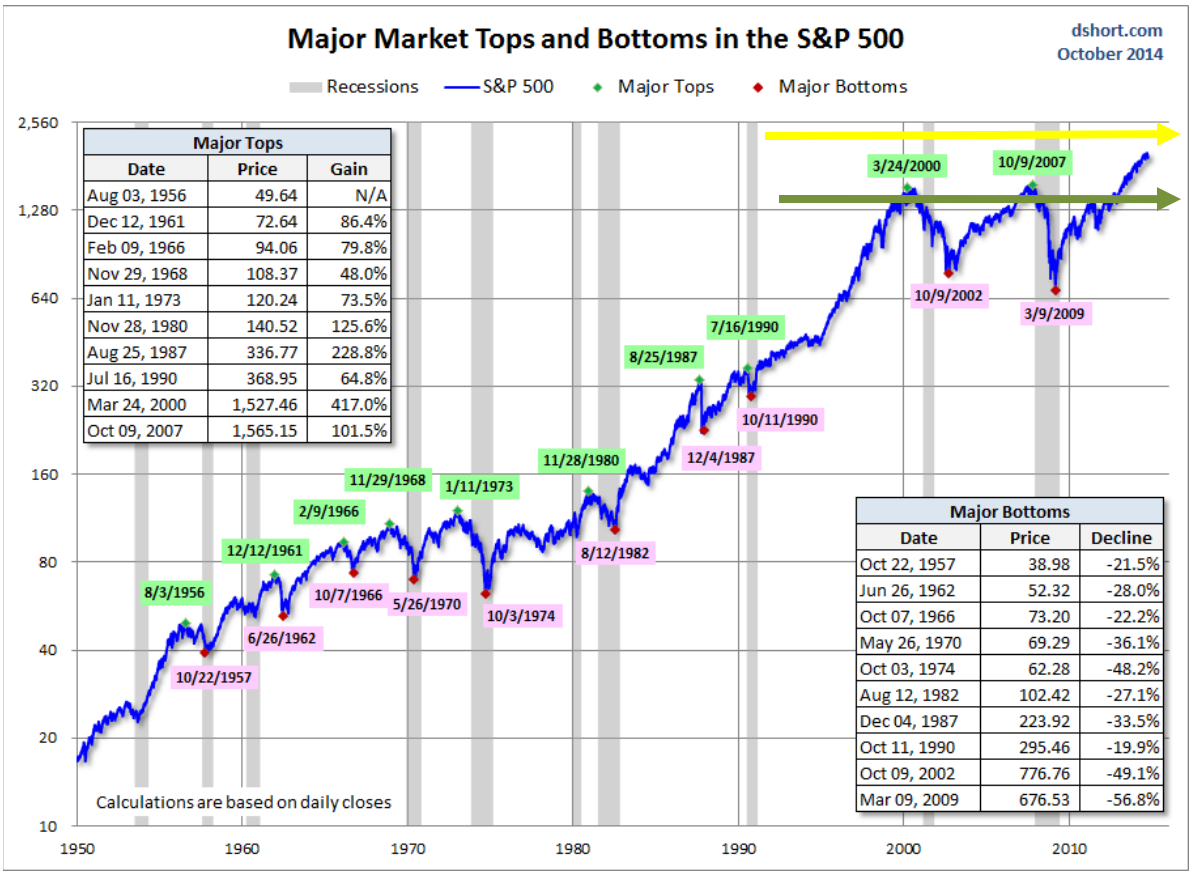
You know, when I started this company, I wanted to build an inexpensive (for clients), service structure with people and tools that would help clients sleep better at night and have access to me and their world class investments that provide dependable, budget-able streams of income along with growth so that people could afford to retire. Sounds obvious, but if you've got an income stream, you can afford to retire, but if you don't, you can't. Smart income is very important – and with all of the monetary policy groups on the planet singing from the same hymnal (mash down rates), it makes things challenging to say the least.

Since that time, what I'm finding is that my industry is turning more Hollywood than craftsman, and it is becoming harder and harder to use simple analogies and simple teaching tools to explain complex strategies.

So…to that end, I thought I'd use a traffic light. That's simple, right? Green means go. Yellow means be careful, go slowly. Red means stop. Got it?

So, I've made **a US equity traffic light** and **a US corporate bond traffic light**. These simple illustrations obviously don't provide insight into every single nuance of your family's particular global asset allocation and individual positions, but hopefully it helps. Humor me (please).

U.S. equity traffic light



Major Tops		
Date	Price	Gain
Aug 03, 1956	49.64	N/A
Dec 12, 1961	72.64	86.4%
Feb 09, 1966	94.06	79.8%
Nov 29, 1968	108.37	48.0%
Jan 11, 1973	120.24	73.5%
Nov 28, 1980	140.52	125.6%
Aug 25, 1987	336.77	228.8%
Jul 16, 1990	368.95	64.8%
Mar 24, 2000	1,527.46	417.0%
Oct 09, 2007	1,565.15	101.5%

Major Bottoms		
Date	Price	Decline
Oct 22, 1957	38.98	-21.5%
Jun 26, 1962	52.32	-28.0%
Oct 07, 1966	73.20	-22.2%
May 26, 1970	69.29	-36.1%
Oct 03, 1974	62.28	-48.2%
Aug 12, 1982	102.42	-27.1%
Dec 04, 1987	223.92	-33.5%
Oct 11, 1990	295.46	-19.9%
Oct 09, 2002	776.76	-49.1%
Mar 09, 2009	676.53	-56.8%

Buy certain EQUITIES (funds, ETFs), TODAY

Please note that I borrowed the above chart from Doug Short and I added the yellow line and the green line. You'll notice that there is NO red line on the chart. We will be approaching the red line in terms of adding money in full earnest to stocks (if valuations at that time are excessive), between 2% and 4% on the Fed Funds rate. We are a few years away from that based on my research. That will likely, in my estimation, be around the time to start thinking seriously about the next recession. Now, if I'm wrong, and the yield curve inverts before that time (which I don't think it will before), then that recession call is hastened. The U.S., economy (not the stock market), is firing on a lot of cylinders, though, and a recession in the U.S., unless we see a **serious** bolt out of the blue, seems very unlikely.

"**This is not 2006 or 2007 when there were only downside risks for residential real estate; at today's depressed housing start levels, there is only upside; the question is just how much**." Economist David Rosenberg – October 10, 2014

What about $2.75 per gallon for gas? It's most likely on its way by early 2015. That's the equivalent to a $50B tax cut to consumers before the busiest retail spending time of the year.

Remember, a stock market correction and an economic recession are two separate things.

"**Worry endeavors to destroy your joy**." – John MacArthur

It seems to me that there is little to fear in the U.S., Economy (of course, the economy and the market are separate); but to restate, globally, Euroland could double dip, the Chinese banking situation could get ugly, but there's nothing to worry about with the 2 year process of the Fed Funds rate going from 0.25%-2%. People (that are not our clients), should be more afraid of the types of investments they own, the way they own them, and the covenants and liquidity provisions of those investments.

U.S. corporate bond (graph shows BB rated), traffic light

Intermediate term Corporate Bond BUY traffic light: Red, Yellow, and Green (based on yield (assuming <3% CPI))

So, the chart above shows that I don't think it's wise to invest in full earnest (maybe only a half position waiting for an increase in yield to round out the position), in these types of bonds if your yields are below the yellow line. Conversely, I think it is wise to invest in full earnest (very selectively and carefully), above the yellow line.

These types of corp., bond prices are 72% correlated with stock prices and -28% correlated to Treasury bond yields. So, as treasury yields rise, the economy is doing well (call it improving), and therefore, generally speaking, the corp., bond prices do well (this applies only to the types of higher than market coupons we desire; **the folks that have bought newer issue low coupon stuff on bond IPOs will feel like they're looking in the sun**)...

There's a lot of nerdy thought processes that dictate how and why we do what we do (that these simple charts won't tell you), but hopefully these *traffic lights* are helpful.

Low default rates for now…

We have seen historically low default rates during ZIRP (Zero Interest Rate Policy), but that will change. The debt has been piled on in such a hefty manner, that many of these corporations will not be able to pay and we'll have several notable name defaults that really surprise people.

In 1986, a colleague concluded her master's thesis paper, which she based on corporate bond defaults (MIT Sloan College of Mgmt), "Most defaults took place after the worst of the economic crisis was over, i.e., defaults tended to come during the recovery."

"…Corporate bond spreads, as well as indicators of expected volatility in some asset markets, have fallen to low levels, suggesting that **some investors may underappreciate the potential for losses and volatility going forward**. In addition, **terms and conditions in the leveraged-loan market, which provides credit to lower-rated companies, have eased significantly, reportedly as a result of a "reach for yield"** in the face of persistently low interest rates. The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation issued guidance regarding leveraged lending practices in early 2013 and followed up on this guidance late last year. To date, we do not see a systemic threat from leveraged lending, since broad measures of credit outstanding do not suggest that nonfinancial borrowers, in the aggregate, are taking on excessive debt and the improved capital and liquidity positions at lending institutions should ensure resilience against potential losses due to their exposures. But we are mindful of the possibility that credit provision could accelerate, **borrower losses could rise unexpectedly sharply**, and that leverage and liquidity in the financial system could deteriorate." - **Fed Chair Janet Yellen** – July 2, 2014 (At the 2014 Michel Camdessus Central Banking Lecture, IMF, Wash., DC)

Why own bonds at all?

I'm going to let my lovely wife answer that. She is so much clearer, less garrulous, and more succinct anyways…

"**Bonds are like the insulation in your house. They're not attractive. But they're really important**." Kathleen Parsons – former municipal bond trader – Donaldson, Lufkin, & Jenrette – currently wife, mother, and domestic engineer.

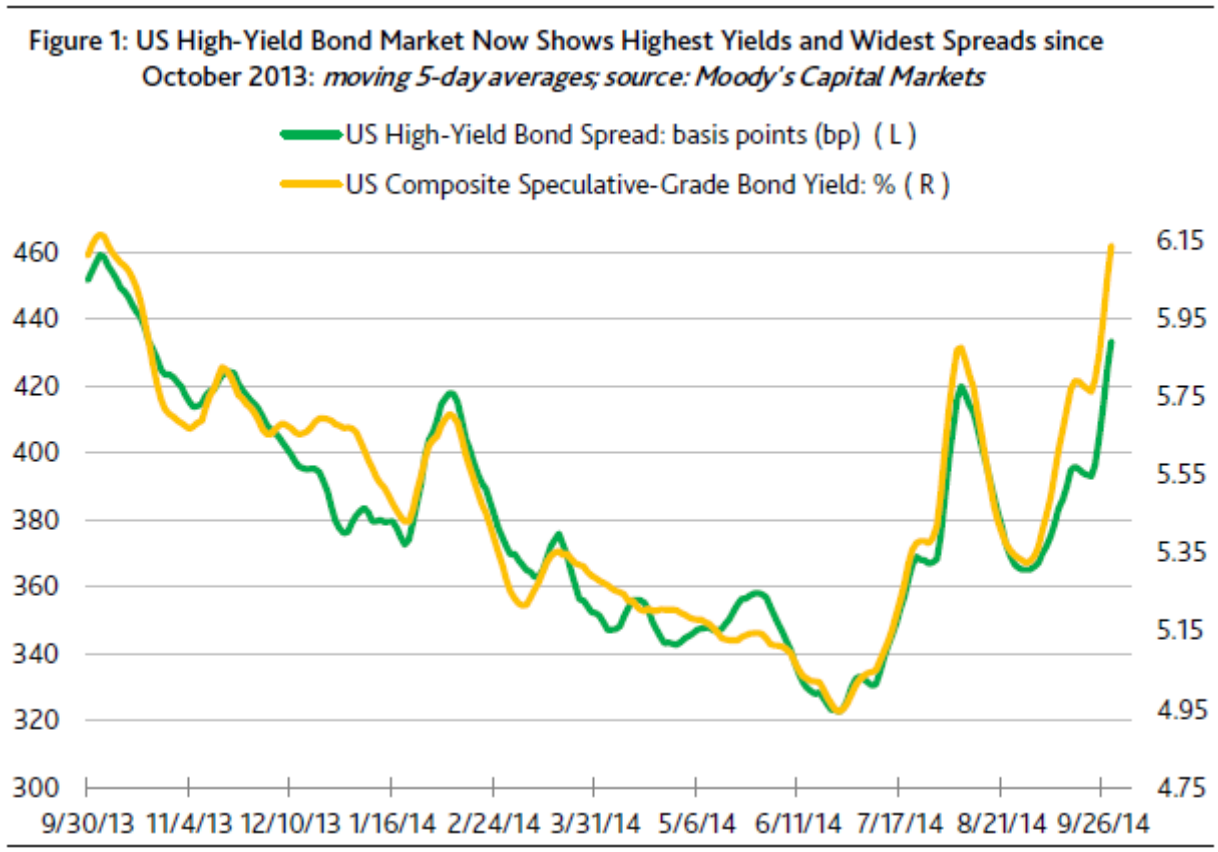
Buy certain BONDS TODAY

New money in bonds? Yes. Why? Because the math is more attractive now, but also because NO ONE wants bonds. Even with the Fed moving up to 2% on the Fed Funds rate, you're going to be fine. "Don't worry. Be happy." That's the time to buy things is when no one wants them. Ever notice that when things are so, so popular, the next ten years of ownership of that particular investment, tend to experience a lagging performance?

Several expensive parts of the stock and bond markets are going to be that way. But not with "reasonably" priced stocks and bonds.

I put together a sample portfolio for a client this morning illustrating an average BB rating, with average duration of 2.77, average maturity of 4 years and average yield to worst of 4.1% and average coupon of 6.154%. That is MUCH more reasonable than we've seen in some time. **Come on Q.E. movie, end! It's distorting things terribly**.

Yippee! See what I mean when I say more volatility brings opportunity? We've seen BB rated corp., bond spreads widen considerably. That means we're getting paid more yield with new money



Where are rates headed?

In the September 2014 edition of *Insights* by Gary Shilling, he wrote, "The **primary determinant of all interest rates is inflation**. Historically speaking, **a 1% rise in the Fed-controlled federal funds rate pushes up the 10 year yield by only 0.35 percentage points.** The influence of fed funds on the 30 year T bond yield was even weaker, with a 0.23 percentage point rise in the long bond yield."

So what happens when everyone freaks out and sells their bonds due to price volatility and lots of selling pressure when the Fed Funds rate approaches 2% and yet, the 10 year Treasury settles in at a non-lofty 4% and therefore **obtaining corp., and muni., yields at an attractive yield is very, very hard even then**? Because without all of the intervention by the Fed, the ECB, the Japanese, and every other country that has a monetary policy group, our 10 year U.S. Treasury would be around 3.25% (based on my research: this also assumes higher rates around the globe – the spread between the German 10 year Bund and the US 10 year is actually quite wide at present by historic

standards). So with the rest of the world slowing down, that'll keep a lid on rates as the "normalization" process begins in the U.S. Stop worrying, if you are, that you can't make money in stocks and bonds when rates rise. You can.

Random thoughts

Why are economists confused right now and scratching their heads about GDP growth?
So we are such a consumption nation (consumption makes up so much of our total GDP), but folks in general don't have nearly enough money saved to fund a comfortable retirement and so overall, the discretionary spending rate is experiencing a downward, secular trend, as the savings rate is experiencing the opposite. Meanwhile, however, manufacturing is coming back really, really, strong in the U.S. For a long, long time manufacturing has not been a very large contributor to GDP. This is changing - the slice won't be huge compared to consumption, but it'll grab a larger piece of the pie in the near term future than in the past - which is very positive. These are two positive developments longer term. But **this savings comes at the expense of current consumption and so economists are "freaking out" and thinking that the Fed will be on hold for longer - not true**. Whether they're a dove or a hawk, each Fed person knows that if they wait around until inflation is high, they've really created a mess.

Comment on bill gross leaving…
I truly do not mean this in a dishonoring way, it's just that, can I pose a question? **What is a bond fund**? Do you think it as anything to do with being a pool of funds that buys bonds and receives the interest and passes that interest along to investors or reinvests it? Well, PTTAX (Pimco Total Return Bond Fund), ceased being that several years ago. You see the turnover rate for that fund in some years was 500%. That means that if you started on January 1'st with 100 positions in the fund, by the next time January 1'st rolls around, those 100 positions have changed 5 different times. Is that bond investing or hyper, super-thin trading (is that a word?), fees generation?

If you want durable yield

On a conference call last week, Rick Rieder, the head of fixed income at Blackrock, said, "The world is going in reverse. **You're going to have to be flexible in your approach to duration and yield curve risk**." I agree.

"Having a flexible approach is going to be one of the only ways to really produce **durable**, consistent, stable, lower volatility **yield**s in fixed income in the next couple of decades. The next 2-3 years are going to be harder than ever before."

Positive stock sector screens (today):
Tech, Energy, Financials, select Healthcare, Industrials, and certain Consumer Discretionary. Ho-hum (not terribly exciting): Utilities, Telecom, and Staples.

Private Pensions

Ever seen the "I hate annuities", deal on google finance with Gary Fisher's face. He hates them…?…OK… with the advanced features of some of these structures (they're like private pensions in many ways), in recent years, the math looks awesome in some of them. He can hate them, but the truth is…Ben Bernanke has two of them for his family and…

You *may* need a fixed index annuity. It *may* be the right thing for a portion of your investment savings. A guaranteed, insured, low cost, lifetime income stream no matter what happens. They are not all created alike and many are sold and sometimes not properly evaluated and then recommended for clients – so no matter whether you love 'em or hate 'em, or don't care, let's talk.

Summary on the Fed and "the market" (in one paragraph)

As a summary of what I think, I think the Fed ends QE Oct./Nov., and will raise by 50 bps before the end of 2015 and will raise for two straight years to a terminus point of around 3.25-3.75% on the Fed Funds rate and I think that terminus data point (whatever it turns out to be), will be around 2017-2018. The markets have Yellen wrong - she is not a perma-dove. It is unfortunate that she is not preparing the markets for what's coming. If you look at her record, she raises rates. It seems like that because based on my research, they should raise the Fed Funds rate to 200 bps in December (just to get us within a reasonable range based on all of the current, economic weather variables), but they most likely will not (and in addition, they may not raise rates at all in 2015 – because, again, **this is more a political process at this point than scientific**). The voting membership changes in 2015 to a more 50/50 status. They may go on up to around 4% (as a final terminal point on Fed Funds), but I think the US Govt debt situation will keep them from going that high. The US econ., is improving monthly and **risks are:** China banking crisis, Euro area double dip, and a deeper than I expect stock market correction in US. But make no mistake about it, **the consumer**, though, not fully believing the resiliency of this expansion, will believe it after they get several more paychecks that are more than in the past. **2015** ought to have 4% GDP and 5.5% unemployment (which by the way would be really, really tight (*essentially full employment*)). We should see continued improvements in capex, consumer spending, and **increases in wages and actual inflation**. **Once we get the correction behind us, the market will make new highs**.

A reminder about why I do what I do

I visited with a client family last month and had such a good time with the husband, the wife and one of the two adult children. The three of us were in a facility where the mother was there recovering from a recent episode related to her Parkinson's. It was nice to be able to connect with her at a time when she was feeling much better – I imagine that what she had to endure to get to that state was not fun. I felt honored to be able to interact with her - smiling and telling jokes and laughing with her husband and daughter.

Joy

My hope for you and your loved ones is that you enjoy the remainder of 2014 playing a board game with a loved one or taking a hike with a family member or friend. The pace of life is such that things like that are often crowded out due to the demands of our modern society.

Thank you so much for your trust and for your business. I have a great job and people like **you** make it possible.

Yours,

Jack

Jack Parsons CTFA, AEP

Chief Investment Officer

Vickery Creek

October 10, 2014