2013 Third Quarter ReView of the Markets

Index	3rd Qtr Return	2013 YTD Return
Consumer Price Index	**0.3%***	**1.0%***
Barclay's Bond Index	**0.6%**	**-1.9%**
MSCI All World Stock	**8.0%**	**14.9%**
S&P 500 Stock	**5.2%**	**19.8%**

Third Quarter Investment Commentary

Fixed income investors began the third quarter of 2013 with the gloomy prospect of the Federal Reserve decreasing the amount of U.S. Treasuries it would buy (an action commonly referred to as "tapering"). Rising interest rates pushed bond values down as much as 1.5% during the quarter. However, as speculation developed that the Fed would postpone tapering until economic data improved to a greater extent, interest rates fell and bond values correspondingly increased. When the minutes from the Federal Open Market Committee were released in September, in which the Fed stated it would not taper pending further economic improvement, bonds quickly moved higher and finished September with a slight gain for the quarter, although still down for the year.

Although the Fed postponed tapering due to slow economic growth, the domestic and international equity markets reacted positively to the news. The equity markets viewed the delay of tapering to be a sign that the Fed would do whatever necessary to stimulate the economy. But, greater gains in equity markets were tempered by political gridlock in Washington that made the prospect of a government shutdown on October 1 appear likely. Despite the pressure in September, positive economic data and increased corporate profits throughout the quarter was enough to keep equities near record highs. The MSCI All Country World Index and the S&P 500 moved up 8.0% and 5.2%, respectively.

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Economic Outlook

Last quarter, we mentioned that the relative outperformance of the U.S. equity market was indicative of better underlying economic conditions and faith in the Fed's ability to navigate today's economic landscape. We feel the economic data throughout the third quarter continues to support this notion, as household spending increased, business fixed investment advanced, and home values increased (despite higher mortgage rates making home ownership relatively less affordable). We maintain our forecast of U.S. GDP growth of 1.5 to 2% for the next several years, with inflation in the 1 to 2% range.

Outside the U.S. the developed countries in Europe appear to be coming out of the deep recession they fell into several years ago. Industrial production has turned positive in nearly all the developed European economies and severe austerity measures have been cut back. However, political risks remain due to high levels of youth unemployment and general discontent that fiscal austerity has caused in many nations. While we believe in the long term growth of many emerging markets we do not view these markets as a panacea. Consumption is growing in the emerging world but most economies remain dependent on exporting raw materials or finished products to other nations. These export-driven economies depend on economic growth which, although improving, remains weak. Growth in industrial production in China and many of the other export driven economies remains anemic despite the apparent rebound in the developed world.

Investment Strategy

As with any investment environment, we must look through the short-term headlines and base our decisions on the basic fundamentals and long-term outlook. By focusing on the important underlying fundamentals, we can lessen the impact of short term emotions that buffet investment markets daily. There is always a multitude of positives and negatives that impact the capital markets – the most recent being the government shutdown and potential U.S. Treasury default. In the past, government shutdowns have not had a negative impact on stocks, but the thought of a government default is much more foreboding – so much so that we have consistently said that it would not happen. As we write this letter, Congress has voted to raise the debt limit and resume funding the government on a temporary basis. We find this hopeful because although it is a temporary funding, we believe it much less likely either party will have the political will to engage in another protracted budget battle after the recent pounding they have taken in public opinion polls.

As we look at fundamental market indicators, we continue to see a slow and steady improvement in the U.S. economy. Compared to alternatives such as fixed income, equities provide the best risk/reward of the major asset classes and thus we have a full weighting of stocks for each of our risk categories. As you know, we dramatically reduced our foreign positions in 2008 and started intentionally investing overseas again about a year ago. This appears to have been the right strategy. Europe now appears to be bottoming out and, in general, European equities carry lower relative valuations than U.S. equities. With this in mind, we might well continue to increase our foreign exposure. Fixed income continues to be a challenging segment of the market. We expect very low returns as interest rates slowly but steadily increase over the foreseeable future from near record lows. Thus, we remain very defensive as seen in our short duration positioning.

*Inflation numbers are through 8/31/2013. Due to the government shutdown on 10/1/2013, the U.S. Bureau of Labor Statistics, which is responsible for inflation data, was not operating. Inflation data for the previous month is generally released on or about the 15th of each month. September's inflation data was unavailable at the time of this report.

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