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WEALTH MANAGEMENT

2013 FIRST QUARTER MARKET COMMENTARY

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EXECUTIVE SUMMARY

The U.S. equity markets and the RDM Capital model portfolio had strong performances in the first quarter of 2013. The S&P 500 and Dow Jones Industrial Average were up 10.02% and 11.24%, respectively, and the RDM Capital model portfolio was up 12.62%, outperforming both indices. The S&P 500 and Dow are now at all-time highs, not factoring in an inflation discount.

We are bullish over the long term despite the recent highs for several reasons, which we discuss in more detail below. Briefly, U.S. equities remain the only game in town, with returns surpassing most other types of investments. The U.S. dollar also has risen in tandem with U.S. equities, a bullish sign not seen since the late 90's. U.S. companies continue to expand their earnings and are flush with cash, much of which is being returned to shareholders in the form of dividends and share buybacks. The financial sector is well-capitalized and looks ready to outperform for the foreseeable future, despite the desire of some to demonize the industry. Unemployment is down, the housing market is up, and the Fed continues to stoke the market with its easy money policies. In short, there were many long term bullish signs in the first quarter of 2013.

Nevertheless, we are moderately cautious heading into the second quarter and have been positioning our clients' accounts accordingly. The haggling in D.C. continues unabated and threatens to temporarily derail the economy. U.S. companies also have given negative earnings guidance for the first quarter of 2013. Europe was quiet for most of the quarter, but still has the potential to roil markets as demonstrated by recent news from Cyprus. And, even in a bull market, some temporary pullback is inevitable. Considering these factors, we would not be surprised to see a pullback in the second quarter.

Ultimately, we believe the 30 year bond bull market is nearing its end, and a great rotation into U.S. equities is in process. This rotation will have significant implications for investors over the next decade and, as a result, we continue to recommend an equity-weighted portfolio for most of our clients' accounts.

Within the equity market, we continue to favor those sectors that stand to benefit from an expanding economy, such as the financial, industrial, and energy sectors. As the U.S. economy continues its sluggish expansion out of the financial crisis, these sectors will likely out-perform the more defensive sectors in the market. One exception to this rule is the healthcare sector, which we also favor due to the demographics of an aging baby boomer generation and the expansion of healthcare coverage to millions of Americans through Obamacare. These factors will lead to increased demand for pharmaceuticals, other medical products and related healthcare services.

I. The Dow And S&P 500 Set New All-Time Highs In The First Quarter Of 2013

The bull market that began nearly four years ago continued in the first quarter of 2013. The S&P 500 and Dow Jones Industrial Average were up about 10% and 11%, respectively, setting all-time highs along the way. While the recent run up has been impressive, it is important to keep this performance in perspective. Even in a flat, neutral economy, we would expect to see the market averages rise on the basis of inflation alone. After adjusting for inflation, the Dow is still below both the all-time inflation adjusted high set in January 2000 and the October 2007 level prior to the recent financial crisis (See Figure 1). And, all-time highs have been set dozens of times in prior bull markets. For example, during the 1990s, the Dow set over 80 new all-time highs.

Figure 1. Inflation Adjusted Dow Jones Industrial Average, 1913 - Present
Source: Dow Jones, Yahoo

Nevertheless, there is little doubt that we are in a bull market for U.S. equities that began in 2009. The more important question for investors is where we're going now: are we in a *cyclical* bull market in the middle of a long term bear market that began in 2000 or are we in the early stages of a long term, *secular* bull market that began in 2009? In a *secular* bull market, there are repeated all-time highs over the course of a decade or more (e.g., 1982-2000), while a *cyclical* bull market is a short lived reprieve from a long term bear market (e.g., 1972).

We believe we are in a secular bull market that will last at least the next two or three years. We focus the remainder of this letter on the factors that got us to this point and will drive the markets for the remainder of 2013 and going forward.

II. We Are Bullish On U.S. Equities Over The Long Term Despite The Recent Market Gains

There were several strong bullish indicators in the first quarter of 2013 that drive our conclusion that we are in the beginning of a long lasting bull market:

- ***U.S. equities remain the only game in town*** – As we've noted in prior market commentary letters, returns on U.S. equities continue to surpass bonds, treasuries, gold and other investments. U.S. equities are simply the best place to put your money now and in the foreseeable future.

- ***The U.S. dollar and U.S. equity markets are rising in tandem*** – Despite the Fed's easy money policies and record low interest rates, the U.S. dollar has been rising in value against other currencies. For over a decade, the U.S dollar has been a safe haven asset, rising in times of equity market turmoil and declining in times of equity market strength. However, foreign investors are increasingly turning to the U.S. dollar and equity market in the face of uncertainty at home, while U.S. demand for foreign assets has declined. The result is that the U.S. dollar index and the S&P 500 are rising together with a correlation of roughly 0.5 – a bullish correlation not seen since the late 1990's.

- ***Earnings and cash reserves of U.S. companies are increasing*** – Fourth quarter 2012 earnings reported this year were up about 6% versus the same period last year. Cash and cash equivalents held by U.S. corporations rose another 10% in the fourth quarter to $1.79 trillion. These

significant cash reserves suggest there is still room for companies to spend the resources needed to grow earnings. In the meantime, many U.S. companies are sharing this cash with shareholders by increasing dividend rates and share buy-backs.

- ***The U.S. real estate market continues to improve*** – There is now little doubt that the U.S. housing market is bouncing off the bottom set last year. This is a bullish indicator because of, among other things, the so-called "wealth effect" – as home owners see the market value of their homes rise, they feel wealthier and spend more, helping to fuel the economy further. Indeed, consumer spending was up in the first quarter, despite the end of the payroll tax holiday and higher gas prices, due in large part to the housing market recovery and the rise in the stock market.

- ***The unemployment rate ticks down*** – The most recent unemployment rate was 7.7% – above the optimal rate but off the lows of the financial crisis. The labor force participation rate declined only slightly to 63.5%, suggesting that the unemployment rate is dropping increasingly because of job creation and not primarily due to a declining labor force as we feared. A declining unemployment rate is a boost for consumer spending which will further fuel the economy.

- ***U.S. banks are well-capitalized*** – 17 of the 18 largest U.S. banks passed the Fed's recent "stress test," which tests the banks' capital cushions in the event of a catastrophic financial shock. (Ally Financial was the only bank to fail.) That is, for these 17 banks, the Tier 1 common ratio – a measure of high quality capital as a percentage of risk-weighted assets – was over the Fed's minimum 5% capital ratio. Further, 14 of the 18 banks received Fed approval to return capital to shareholders; only Ally and BB&T had their plans unconditionally rejected. We believe a strong financial sector is necessary for the U.S. economy to continue to grow, as bank lending is a major driving force for the economy. Despite the continued push by some government leaders to demonize big banks, the financial sector continues to outperform and we see further upside ahead.

- ***U.S. companies are beginning to benefit from cheap natural gas*** – The U.S. appears to be on the verge of an energy revolution driven by cheap natural gas and new drilling techniques that could lead to U.S. energy independence in the next few decades. The long term impact of the U.S. evolving from a net energy consumer to a net energy producer is still unclear, but in the short term, U.S. companies that rely heavily on U.S. natural gas, such as chemical companies and manufacturers, and those that produce equipment used in natural gas production are benefitting. If this trend continues, many U.S. companies could enjoy a cost advantage over their foreign counterparts.

- ***The Fed continues to grease the wheels*** – We have discussed in prior market commentary letters the significant impact that the Fed's bond buying program and easy money policies have had on the stock market. The Fed repeatedly has said it will continue to keep interest rates low as long as unemployment is above 6.50% and inflation is below 2.50%. As a result, economists predict that the Fed will not begin to slow its monthly bond purchases until November 2013 and will continue buying at least some bonds until May 2014. Short term interest rates will not begin to rise until June 2015 under this scenario. We believe the Fed will eventually decide to retain its bond holdings to maturity rather than sell at a loss, and fears that the Fed will be forced to sell bonds at a discount at the end of the program are overblown. In short, unless there is a drastic improvement or decline in the economy, the Fed will continue its current program for at least another year before slowly letting its bond holdings mature.

While we are generally bullish over the long term, there are warning signs for a possible short term pullback in the second quarter of 2013.

- ***The federal government impasse continues*** – The dysfunction in D.C. continued for yet another quarter. In March, $1.2 trillion in mandatory government spending cuts (known as the "sequester") kicked in. Ironically, these spending cuts were agreed upon as part of the 2011 debt ceiling compromise to force Democrats and Republicans to reach a deal on less drastic spending measures, but even the threat of across the board spending cuts failed to bring the two sides together. Democrats and Republicans also continue to fight over a budget, with both sides showing little interest in moving their positions on raising additional revenues and lowering spending. While markets have largely ignored the federal government bickering, we view the dysfunction as a long term negative for the U.S. economy and equity markets in general, which will impede although not altogether prevent future growth.

- ***Earnings are growing faster than revenue*** – As noted above, U.S. company earnings reports were largely positive in the first quarter. However, digging a little deeper, there are some signs of weakness. Most importantly, earnings are growing at a faster rate than revenues, suggesting that much of the recent earnings growth is the result of cost-cutting and increased profit margins. Companies can cut for only so long before earnings suffer. Companies also are cautious on earnings for the first quarter of 2013: the ratio of negative guidance to positive guidance was unusually high at 4 to 1. Based on these warnings, analysts predict earnings growth for the first quarter of 2013 at only 1.4% year over year.

- ***Negative news from Europe still can rattle the market*** – After several years of seemingly constant news about Europe's financial difficulties, Europe largely receded from the market spotlight in the first quarter of 2013. However, Cyprus (a country about the size of Rhode Island) caused a brief uproar in March when it proposed unilaterally taxing all bank deposits in exchange for a bailout from the EU and the International Monetary Fund. While Cyprus' financial system is relatively small, some feared that other EU countries would propose similar solutions to their financial troubles and cause a panic among bank depositors throughout the region. Cyprus' government ultimately settled on a bank restructuring which included a forced haircut on only those accounts with more than €100,000. The Cyprus situation served as a reminder that the Euro Zone still has the potential to rattle US markets.

- ***A short term pullback is unavoidable*** – The point here is simple: the market cannot continue to rise in a straight-line. Some pull back is inevitable, even if it's only a few percentage points. The market has had few pullbacks since November 2012 and is due for some correction. A 5% to 10% correction would not surprise us.

The upshot is that the U.S. economy is gaining strength as reflected in the stock market gains, but the ground has been laid for a short term pull back in the market. As a result, we have positioned our clients' accounts for a short term decline by ensuring that there is sufficient cash to take advantage of buying opportunities in the second quarter. While we have reduced some exposure, we do not advocate exiting the market more aggressively. Ultimately, we are proponents of the view that time in the market is more important than timing the market. If you bought into the market at any of the 80-some high points in the 1990s, your portfolio would likely be impressive today. Even if you bought all of the Dow components at the height of the market in October 2007, and then rode out the financial crisis, you still would have more than a 6% inflation-adjust return, including dividends.

In short, any short term pull back is a buying opportunity, and we have ensured that our clients' accounts have flexibility to take advantage of such an opportunity.

III. We May Be In The Beginning Of A Historic Rotation From Bonds To Stocks

As bullish indicators increase in the U.S. equity market, there are increasing warning signs that the bond bull market is coming to an end. The past 30 years have been good ones for bond investors. Due to a combination of falling interest rates, low inflation, and the Fed's easy money policies, bonds have enjoyed a historic run since the late '70s. The interest rate on the 10 year treasury note has moved from a high of over 15% in the early '80s to about 1.6% in early 2013, reflecting a steep rise in bond prices (see Figure 2).

Figure 2. U.S. 10 Year Treasury Note Yield, 1980 - Present
Source: Yahoo

However, some of the factors that are driving the U.S. equity markets as discussed above could be significant headwinds for the bond market. Treasury rates recently have ticked up to over 2% as the economy, housing market and employment all show signs of improvement. When the Fed slows and then discontinues its bond buying program, bonds will suffer. And, in the meantime, the money that the Fed is pumping into banks' balance sheets will eventually find its way into the economy, potentially stoking inflation. Combine these factors with the bull stock market, and some are suggesting that the bull bond market may be over.

We believe that the great rotation has begun but, like most massive, secular changes, it will not happen overnight. Interest rates have crept up many times during the descent down to the 1.6% level, only to decline again. Indeed, investors continue to put more money into bond funds than stock funds. When the rotation actually does take place, it will be painful for fixed income investors. Many investors view bonds as a safe haven from the perceived volatility of the stock market. To some extent that is true – bond investors should receive a return of principal when the bond matures, barring the complete failure of the bond issuer. But, bonds can still decline in value just like any other asset. An investor holding a long term bond may be in the unenviable position of holding the bond for years, if not decades, or selling the bonds at a loss. Investors may be surprised when they see the value of their bond portfolios decline, which will further ignite a bond bear market.

While there is a place for fixed income in some of our clients' portfolios, we prefer high dividend-paying equities and MLPs for our clients who need income. The average yield on the equity portion of the RDM Capital Composite Portfolio is about 2.7%, which is 25% higher than the 10 year U.S. treasury note, and many of our clients with income needs have equity portfolios yielding even more. We recommend that investors interested in fixed income consider dividend payers, rather than bonds, for their income portion of their portfolio.

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We would like to take this opportunity to remind our clients of two additional services that we provide.

First, we now have the capacity to open 529 Plan accounts for our clients through our custodian, Pershing Advisor Solutions. Briefly, a 529 Plan is a state-run savings plan designed to save and grow money to pay college expenses. These state-run plans typically offer a variety of mutual funds ranging from age-based funds to single-strategy funds. You may open a 529 Plan account in the name of a child, grandchild, niece, nephew or anyone else who will be attending college in the future. We can help you

set up a 529 Plan account, select appropriate investments, and monitor these investments as the account beneficiary approaches college age. If you are interested in opening a 529 Plan account, or know someone who is, please reach out to us.

Second, we are available to help you structure a withdrawal strategy to fund your retirement years. As an individual moves from the asset accumulation stage to the retirement stage, he or she should put into place a strategy for safely withdrawing assets at a rate that is likely to last the remainder of the individual's life. If you are at or nearing retirement, we recommend that you begin to quantify your nondiscretionary expenses and consider whether you can meet these expenses through a combination of social security income and a safe level of withdrawals from your investment and retirement accounts. Many retirees also use fixed annuities to supplement their retirement income. Please contact us if you would like to discuss setting up a retirement withdrawal plan.

As usual, all comments are welcome.

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