QUARTERLY NEWSLETTER

July 19, 2013

Market Commentary:
Second quarter 2013 ended with global developed equity markets relatively flat overall, with the US once again outperforming foreign developed markets as a whole. The second quarter also saw investors showing a bit of fear that the Fed would halt its bond buying program. The result was a fairly dramatic decline in longer term bonds and emerging market equities, but more on that later.

Since June 30, 2013, however, investors seem to have become reassured that the Fed will be able to successfully phase out its monetary support program. As of the writing of this letter both stocks and bonds have generally regained upward momentum. Long term bonds and emerging market equities, though generally higher than the June 30 valuations, are still well off from where they began the year.

Developed market equities are now trading at relatively expensive levels so that either corporate profitability will improve to justify these prices or prices will revert. All indications suggest the former scenario is likely over the longer term, but whatever the case current valuations certainly aren't high enough to warrant a shift in strategy.

Below are the returns of major market indices as of June 30, 2013. Year-to-date returns are cumulative; 1, 3, and 5-year returns are annualized:

Benchmark	Year-to-date	1 Year	3 Year	5 Year
S&P 500 Index[1]	13.82%	20.60%	18.45%	7.01%
US Small Cap Value Index[1]	15.46%	26.25%	18.44%	10.12%
Foreign Developed Market Index[1]	4.13%	18.66%	10.50%	-0.63%
MSCI EAFE Small Cap Index[2]	5.84%	20.92%	12.25%	2.37%
MSCI US REIT Index[1]	6.36%	9.03%	18.28%	7.99%
Emerging Markets Index[1]	-1.28%	-1.52%	-0.27%	-0.38%
Barclays Capital US 3-7 Year Treasury Bond Index[2]	-1.88%	-1.08%	2.92%	4.54%
Barclays Capital US TIPS Index[2]	-7.42%	-4.86%	4.48%	4.26%
Barclays Capital U.S. MBS Index[2]	-2.17%	-1.44%	2.11%	4.47%
Barclays Capital U.S. 5-10 Year Corporate Index[1]	-0.05%	-0.15%	-0.80%	n/a

1 Source: Vanguard. Visit **www.vanguard.com** for a description of each index.

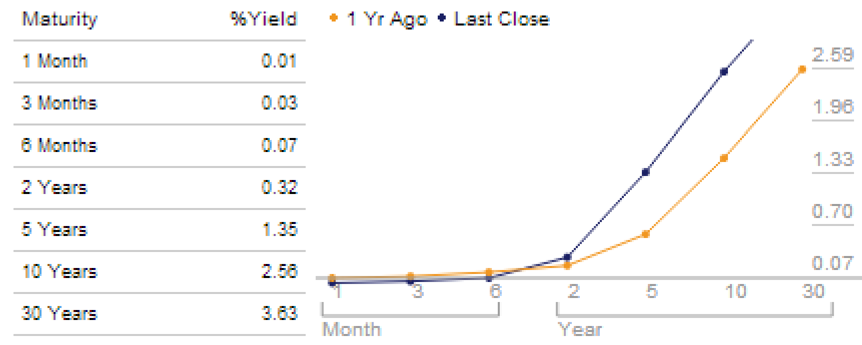
2 Source: BlackRock. Visit **us.ishares.com** for a description of each index.

Bonds and Emerging Markets

Bonds, especially longer term bonds, have had a rough go since the first of May. This resulted from increasing interest rates at the longer end of the yield curve. Below is a chart that compares the current yield curve with that which existed a year ago.

U.S. Treasury Benchmarks

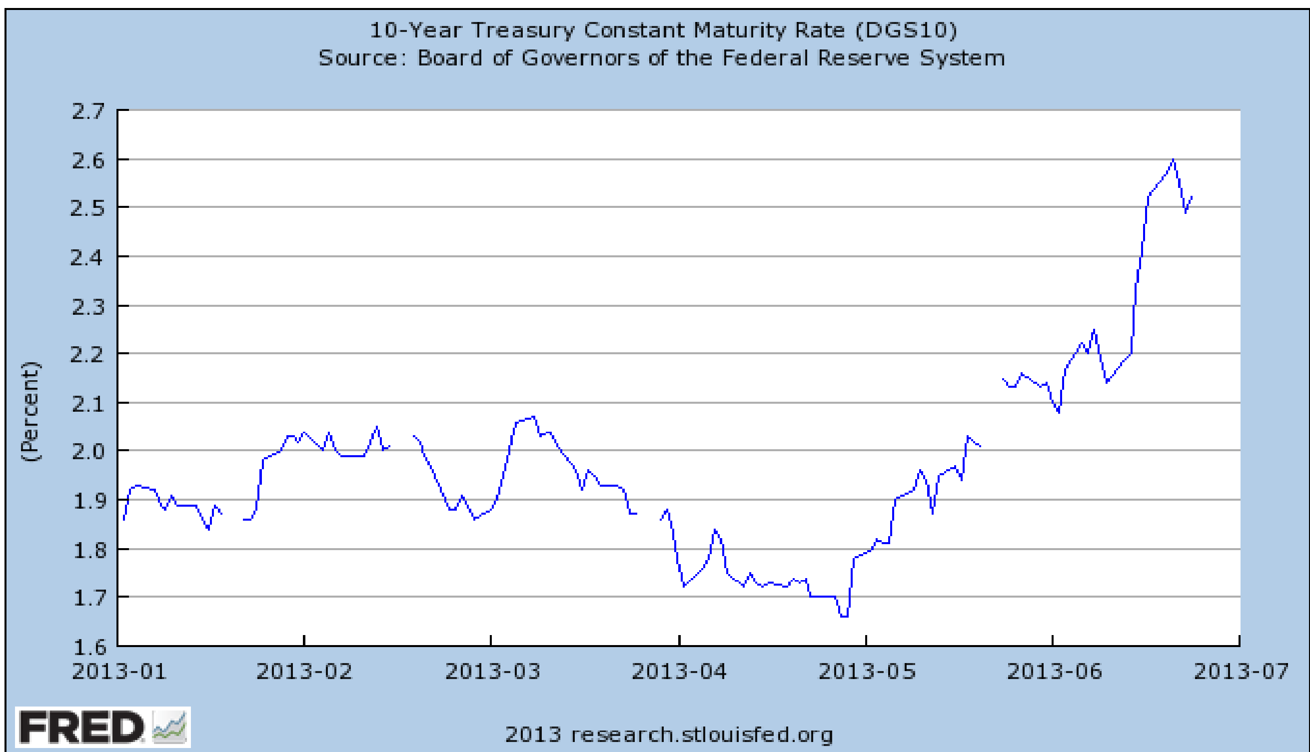
Treasury Yield



Maturity	%Yield
1 Month	0.01
3 Months	0.03
6 Months	0.07
2 Years	0.32
5 Years	1.35
10 Years	2.56
30 Years	3.63

Source: FINRA Market Date retrieved 7-19-2013

You will notice the current curve is much more steep than it was a year ago, and actually only recently shifted largely due to investor concerns about Fed policy. The chart below shows the spike in 10-year Treasury bond yields which began early May.



The chart below reflects the change in value of 7-10 year Treasuries (as measured by symbol IEF) alongside the change in value of 3-7 year Treasuries (as measured by symbol IEI). You will notice the peaks and valleys of the blue line correspond almost exactly opposite of the 10-year rate chart on the prior page. This is to be expected.

Source: Morningstar

As discussed in the 4Q2011 newsletter, you will recall that changes in prevailing interest rates magnify changes in bond valuations as duration increases. This valuation sensitivity to changes in prevailing interest rates is approximately reflected by the equation:

$$-(D - (I \times 100)) \times IC \approx \text{Loss}$$

Where: D=duration; I=interest rate; IC=interest rate change; and Loss=% loss in value

So let's do a rough work up to see how this formula prevailed from May 1 through the end of June:

$$-(10 - (.017 \times 100)) \times .8 = -6.64\% \approx \text{Predicted Loss}$$

Using IEF as a proxy for 10-year Treasuries (though its duration is actually 7.63 years):

4/30/13 close = \$108.83
6/28/13 close = \$102.50
Principal loss = \$6.33 = decrease of 5.82%

Though this exercise wasn't exactly 'apples-to-apples', it does show that the equation to approximate loss in the face of increasing interest rates does work fairly well. The real world decrease in bond principal value (especially as bond duration increased) from early May through the end of June showed us once again why it's important to keep bond duration in check, especially in low yield environments. This is why I have recommended shorter term bond durations over the past several years.

So how do bond yields affect what's currently going on with emerging market equities? The chart below reflects emerging markets as measured by symbol SCHE. You will notice that the shape and direction is much the inverse of the 10-year Treasury rate graph on page 2. The reasons for this are complex, but suffice it to say that emerging markets rely heavily on foreign investment and lending. With the dollar strengthening and US interest rates increasing, investors worry that money will flee out of emerging markets and back into the US thereby leaving emerging market economies with little to work with (for more on this see: *The Economist*, July 13, 2013).

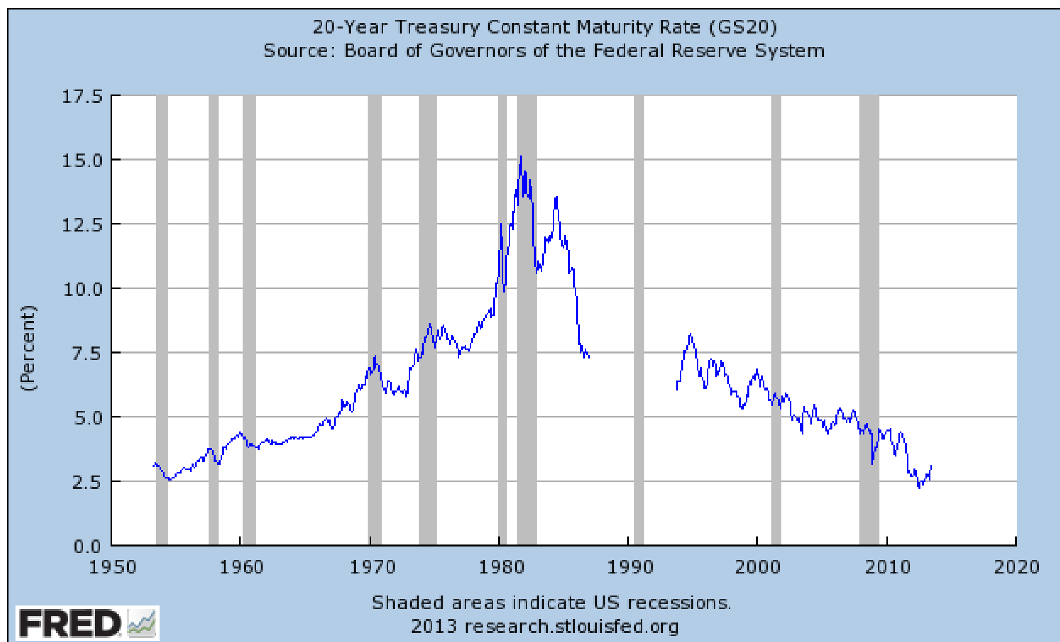
Source: Morningstar

This sounds like a reasonable theory to me, but on the other hand emerging markets are now trading at fairly attractive prices, and certainly more reasonable than those of developed countries. Now, like always, it's a much better plan to develop a process-oriented investment program and stay the course. That would likely mean buying more emerging market equities now that the relative price has dropped significantly.

A Note on Historical Interest Rates

The graph on the following page reflects the rate on 20-year Treasuries from 1952 through June 2013 (the gap represents a few years when the Treasury did not issue 20-year bonds). You will notice that since about 1982 there has been a general decline in interest rates. This caused bonds to basically be on a bull run for just over 30 years! Quite an exceptional market for bond investors, but do not be led into believing bonds are safe just because they have been over what is likely our entire investing memory.

"Those who cannot remember the past are condemned to repeat it."
George Santayana, *Life of Reason*, 1905



Look again at the graph and you will also notice that rates generally *increased* from 1952 through 1982. Bond investors during that time would have had a much different experience than the post-1982 bond investors. It certainly seems to me that the bond market over the next 30 years could easily look much like the 1952-1982 era. You should appropriately position your bond portfolio.

In Closing

On a fundamental basis, equities around the globe now appear fully priced, with the exception being emerging market equities. Given the still historically low interest rate environment, bonds continue to be fraught with interest rate risk so thinking of them as a panacea would be misled. Yes, even with the recent pullback there's still plenty of room for longer duration bonds to fall.

Remember: *Develop a financial plan according to your unique situation and manage your investment portfolio according to a well thought out and documented investment policy. Doing so will greatly increase the probability you will actually meet your financial goals.*

Troy

Troy Sapp, CFP®
Commencement Financial Planning LLC
www.commencefp.com

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