ASCENTIAL
WEALTH ADVISORS

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Focus:

- ✓ Shift a portion of emerging market bonds to high yield municipals
- ✓ Reduce US large cap equities
- ✓ Increase foreign developed equities

Improving Economies - Good for Stocks…Bad for Bonds

Index:	2013	2012	2011	2010	2009
S&P 500	+32.4	+16.0	+2.1	+15.1	+26.5
DJIA	+29.6	+10.2	+8.4	+14.1	+22.7
EAFE (Int'l)	+22.8	+17.3	-12.1	+7.8	+31.8
BC Ttl Bond	-1.9	+4.4	+7.7	+6.5	+5.9

Dow Jones Relative Risk Benchmarks					
Conservative	+1.4	+5.4	+5.3	+8.5	+10.8
Moderate	+14.5	+11.2	+0.3	+14.0	+23.8
Aggressive	+27.0	+16.8	-5.1	+19.4	+39.0

In 2013, US unemployment fell from 7.9% to 7.0%, housing prices rebounded 13.6% in major metro markets, and the economy grew nearly 2%. With growth expectations accelerating to 3% for 2014, US equity markets fueled by optimism, cheered these improvements and rallied to new all-time highs.

On the other hand, US bonds pressured by rising interest rates, suffered their worst annual result in nearly 20 years.

With Europe's economic recovery trailing that of the US, performance in their equity markets lagged slightly. In emerging markets, financial fears and slow growth, combined with a stronger US dollar, led to poor performance.

The wide disparity in these results led to a greater gap between the performances for risk managed accounts and equity markets than we would normally expect, as bonds and emerging markets weighed heavily on overall performance.

Focus

We continue to focus on efficient risk management. Our challenge is to hedge portfolios against an equity sell-off while avoiding the risks of falling fixed income prices should interest rates continue to rise.

We remain convicted to managing risk with non-traditional bonds and alternative investments. Our recommended fixed income strategy remains largely unchanged, with a mix of hedged US corporate bonds, variable rate notes, and international sovereign debt. The one change we recommend is adding high yield municipal bonds, as we feel bond investors have overreacted to headline news, driving down prices.

Overall, our allocation remains overweight US equities, but we are recommending a reduction in favor of more international stocks. We see European economic conditions stabilizing, and deep value opportunities in their equity markets. Specifically, we recommend small and mid-size European companies where earnings are most levered to the anticipated improved conditions.

Fixed Income

"We believe widespread default fears are overblown and have created opportunities within municipal bonds."

Although no actions were taken by the Federal Reserve to taper quantitative easing or raise the fed funds rate, interest rates in the US moved higher simply in anticipation of those events. The 10 year US Treasury yield opened 2013 at 1.8% and closed the year at 3.0%.

The rising rate environment hurt bond prices, evidenced by the Barclays Municipal index closing the year at -2.6%.

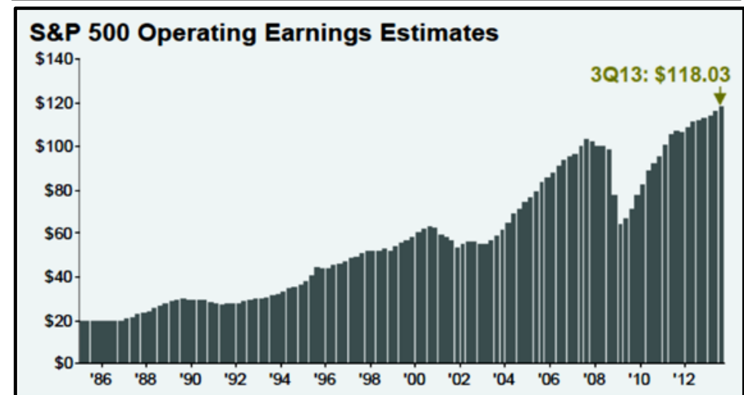
Selling pressure in the municipal market was exacerbated by headline bankruptcies like Detroit. We believe widespread default fears are overblown and have created opportunities within municipal bonds. In fact the default rate has fallen steadily over the past three years for both credit and high yield municipals. As a result, we recommend shifting a portion of emerging market debt to high yield municipals, where current yields are compelling. Given the outlook for higher interest rates, we continue to recommend holding bonds that are generally less sensitive to rising rates, such as floating rate and short to intermediate durations through funds that are also incorporating interest rate hedges into their strategies.

US Equities

"Despite high index levels…From a P/E perspective, we view US stocks as fairly priced."

US equities registered their 5th consecutive annual increase following the severe bear market of 2008. Corporate profits surpassed previous all-time highs from 2007 which helped to push stock prices into record territory. Despite high index levels, prices relative to earnings are reasonably close to historical averages. From a P/E perspective, we view US stocks as fairly priced.

All is not roses, and we are also mindful of the uncertainty and risk associated with all equity markets. Among other potential concerns, maintaining record profit levels could be challenging for US companies. This, combined with improving economic conditions abroad, prompts us to modestly reduce our overweight position in large cap US stocks in favor of increased developed international exposure.

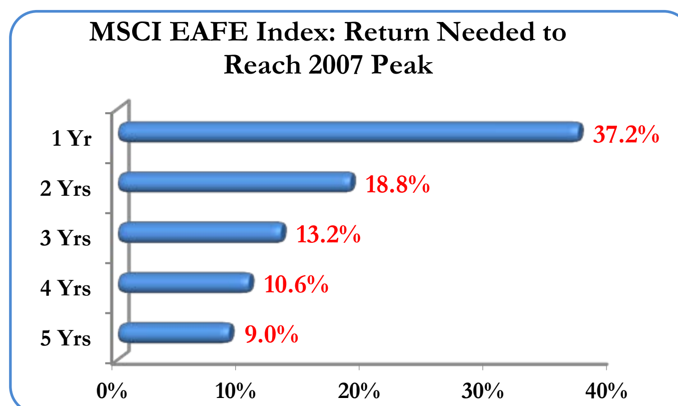


Source: JP Morgan "Guide to Markets" Sept 2013

Within our US equity allocation we continue to favor growth over value stocks, with an emphasis on technology; while on the value side, we maintain a preference for financial services companies. Our recommended allocations to small and mid-sized US companies and MLPs also remain unchanged.

International Equities

Despite lagging the US equity market, developed international equities posted strong returns in 2013. Europe's economic recovery is still in its infancy, with several EU countries barely emerging from recession. Looking ahead, we expect the European economy to gradually improve as we have seen in the US, and that similar to US markets, the return to risk assets will take hold. As the chart to the right indicates, developed international markets remain well below their previous peak, and as we have witnessed in the US, these markets will advance as economic conditions improve.



Source: JP Morgan "Guide to Markets" Sept 2013

Though we recommend maintaining an overweight position in US Equities, we suggest increasing our international exposure by moving a portion of our US allocation to small and mid-sized European companies.

Based on current valuations, small to mid-sized companies appear to carry the most opportunity for a rebound, as they typically gain favor when an economic recovery matures. After being underweight international equities for the past few years, this will bring our international allocation closer to normal historical levels.

Emerging markets had a tough year closing down 2.6%, though they bounced back significantly after a 9.6% drop in the first half of 2013 (MSCI Emerging Markets). Slower growth in developed economies has weighed on emerging markets due to their dependence on exports and capital investments from abroad. The global economic recovery should benefit emerging economies, and we maintain our belief that these markets hold a tremendous amount of opportunity for patient investors, and recommend maintaining current allocations.

"We expect the European economy to gradually improve as we have seen in the US, and that similar to US markets, the return to risk assets will take hold."

Other (Real Estate, Commodities, and Alternatives)

Over the past 3 years, we have recommended greater alternatives in place of US traditional fixed income as prices have ballooned. We remain convicted in this strategy and believe that traditional fixed income will return less than in the past 10 years and continue to weigh down portfolio performance. As a result, we continue to employ alternatives in our allocation to help manage risk. Publicly traded real estate investments (REITS) underperformed the broader equity markets, with the Wilshire REIT index advancing only 1.2%. While REIT valuations are becoming more attractive we prefer to hold our underweight status for the time being.

For the most part, commodities performed poorly in 2013, with gold producing one of the most notable losses. After a long stretch of rising prices, intensified by fear in 2008, gold was hit hard, losing 28%. We are not overly optimistic about the outlook for commodities and are not currently recommending additions to this asset class.

"We believe that traditional fixed income will return less than in the past 10 years and continue to weigh down portfolio performance… we continue to employ alternatives in our allocation to help manage risk"

Heads Up:

- **2013 tax document mailing dates (tentative):**
  February 14 - Original 1099s
  February 28 - Amended 1099s, and those delayed due to reporting for certain securities
  March 14 – Final mailing for original and amended 1099s
- **K-1s** are not available until the **first week of March**. Please contact Gayle or Lori if you need assistance.
- **Forgot to make your 2013 IRA contribution?** 2013 IRA and ROTH IRA contributions can be made up until April 15th, 2014 as prior year contributions.

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Diversification: You do not need it- until you need it

In bull markets like 2013, we expect diversified, risk managed portfolios to fall short of the returns delivered by the equity indices. While it is tempting to chase the returns of the best performing assets, we don't have to look too far back in the history books to see that this can be dangerous. Just as those invested aggressively in equities this year had a positive experience, investors who had their assets largely in fixed income likely had a negative experience. The opposite was true in 2008. Nobody cares about diversification when everything goes up; everyone cares on the way down.

Our risk management strategy includes diversification and asset allocation. While we make tactical adjustments to our investment mix over time to take advantage of opportunity and mitigate risk, we try not to get caught up in the trends of the day. Maintaining our core strategy is crucial to being prepared for the unknowns financial markets could hand us tomorrow. As always our goal is to help clients make decisions away from the emotions of fear and greed that can drive investors, and strike an acceptable balance between risk and return. We are optimistic about 2014, but because there is never certainty in what lies ahead for the next month, year, or decade, we remain dedicated to a diversified risk management strategy.

Disclosures

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