TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

July 2013

Quarterly Insights

EXECUTIVE SUMMARY

U.S. Stocks Rise And Bonds Fall In The Second Quarter

In the Second Quarter, the domestic S&P 500 Index rose 2.91% and is up 13.82% year to date. Europe (+2.33%) and Japan (+4.42%) had similar performance. Emerging Markets (-7.95%) was a disaster. Over the last two years, practically every investment alternative has considerably lagged the S&P 500 Index. Our portfolio continues to benefit from a 90% domestic exposure. The Barclay's Aggregate Bond Index fell 2.50% in the Second Quarter and is down 2.60% year to date. Higher risk bonds fared much worse. This is the biggest loss for bond holders in years.

Good News: Rates Are Rising

Speculation of tapered Fed quantitative easing in May and comments by Fed Chairman Ben Bernanke in June rattled the bond market and caused a bond sell-off. This drove up interest rates, which in turn hurts bonds (when bond yields rise, bond prices fall).

We believe higher interest rates is good news for investors. Bonds now offer a positive real rate of return. Higher rates also allow for better portfolio positioning regarding disciplined asset allocation, risk control, and meeting income needs.

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Second Quarter 2013

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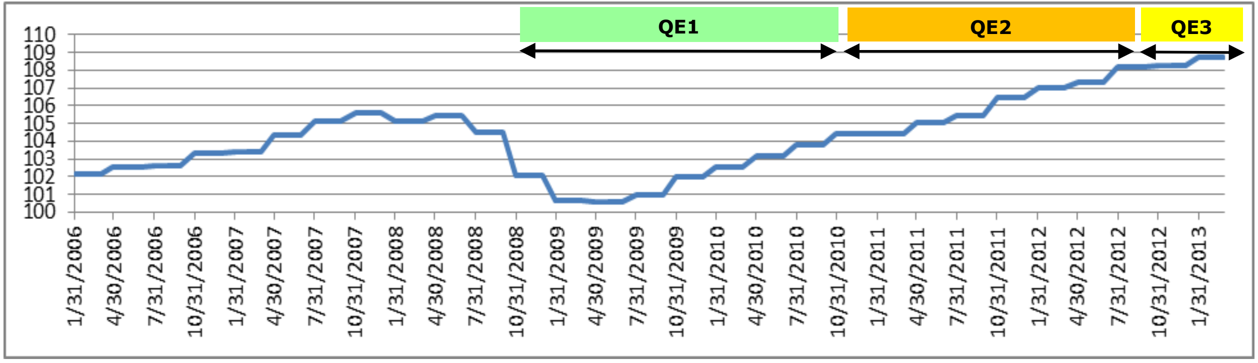
Good News: Rates Are Rising

The Fed Is Doing Exactly What It Said It Would Do

Since late 2008, the Federal Reserve (the Fed) has been stimulating the economy by keeping its Target Rate at zero and buying a variety of bonds (a program known as Quantitative Easing, or QE). There have been three rounds of quantitative easing: QE1 (November 2008 through November 2010), QE2 (November 2010 through September 2012) and QE3 (September 2012 to present). Open-ended bond purchases have helped keep interest rates low, a condition the Fed felt was necessary to help the housing market (which was shattered in 2008) and the economic recovery. The evidence shows that it has.

Home prices have risen 14 straight months, jumping a record 12.1% in June (source: Case-Shiller), which in turn pushed the Consumer Confidence Index to a five-year high of 81.4 (source: Conference Board). Consumer spending is more than 70% of the US economy and consumer confidence provides clues as to how consumers may spend in the future. The economy has recovered nicely from its 2009 bottom. First Quarter GDP growth, while tepid at 1.8% (source: Bureau of Economic Analysis), has easily surpassed its pre-recession levels (even with sequestration) and is poised to improve with increased consumer spending.

US Gross Domestic Product (source: Bureau Of Economic Analysis)



Recent Fed Comments Have Pushed Interest Rates Higher

The Fed has stated for a long time that it will keep its Target Rate at zero until the unemployment rate falls to 6.5% (currently 7.6%) or the inflation rate surpasses 2.5% (currently 1.4%). We stated in our April 2013 Quarterly Insights (“Don’t Fight The Fed”, page 2) that, based on their stance, “we expect the Fed will continue to be accommodative for the next year or two”. Many others likely shared our view.

Speculation of a policy change began in May. On June 19, Ben Bernanke said that, contingent on continued positive economic data, the Fed may taper its monthly bond purchases to $65 billion in September. He also suggested the bond-buying program could wrap up by mid-2014. Since there has been negligible movement with unemployment and inflation (the Fed yardsticks), his comments rattled the stock and bond markets. Stocks fell 4.3% over the next three days but recovered quickly. The threat of tapered bond purchases caused a bond sell-off, which in turn drove up interest rates (when bond prices fall, bond yields rise).

Bond Yield Increases Over The Last Two Months Of The Second Quarter (source: US Treasury)

	2 Year Treasury	5 Year Treasury	10 Year Treasury	30 Year Treasury
June 28, 2013	0.36%	1.41%	2.52%	3.52%
May 1, 2013	0.20%	0.65%	1.66%	2.83%
Difference	**0.16%**	**0.76%**	**0.86%**	**0.69%**

We View Higher Interest Rates As Good News For Investors

Both the stock and bond markets had a negative reaction to the prospect of tapered bond purchases. We think both markets over-reacted and view higher interest rates as good news for investors. Higher rates allow for better portfolio positioning regarding disciplined asset allocation, risk control, and meeting income needs.

The massive and unprecedented five-year (and counting) Fed stimulus has helped the economy but has also handicapped investors who require retirement income. Interest rates, even with the recent spike, remain far below historical levels. For example, the 10 Year Treasury yield is now 2.52% (June 30), but is far below its 51-year average of 6.65%. In our capacity as your portfolio manager, the current low-yield environment has presented unusual challenges. We seek safe and adequate income-producing assets that, for the moment, are very tough to find. Our challenges (and our clients' challenges) are best illustrated with a sample scenario.

CASE STUDY

Imagine a retired couple where the husband is 69 years old and his wife is 65 years old. They have after-tax income needs of $80,000 per year. Let's allow for 3% annual inflation. Their effective (average) tax rate is 20%. Social security payments are $40,000 per year and IRA assets available for income distribution are $1,000,000. They need $100,000 of pre-tax income to generate $80,000 of after-tax income ($100,000 * (1 - 0.20)), which means that they must withdraw $60,000 a year from their IRAs to meet their income needs. Put another way, their IRA assets must generate a 6% rate of return ($60,000 / $1,000,000 = 6%) to maintain principal value.

We use our proprietary model (TriVant Retirement Optimizer) to quantify the probability of a "successful retirement" (not running out of money). A minimum standard of 90% probability is the number we advocate for a successful retirement. Here is the couple's current model output for a $60,000 annual withdrawal:

Stocks	Bonds	Probability Of Success
100%	0%	92.0%
90%	10%	91.9%
80%	20%	91.5%
70%	30%	90.8%
60%	**40%**	**90.0%**
50%	50%	88.7%
40%	60%	87.1%
30%	70%	85.1%
20%	80%	82.7%
10%	90%	80.1%
0%	100%	77.1%

A 90% Probability Of Success can be met with a minimum 60% stock weighting and 40% bond weighting. Our model assumes long-term average returns for stocks (10%) and bonds (6%). Since the investment time horizon for this couple is long-term (25+ years), the model return assumptions are consistent with historical averages. Our problem right now is that bond returns are unusually low. With negligible returns for safe bonds (assume 0%), the stock component of the portfolio must generate 10% to reach an overall 6% return:

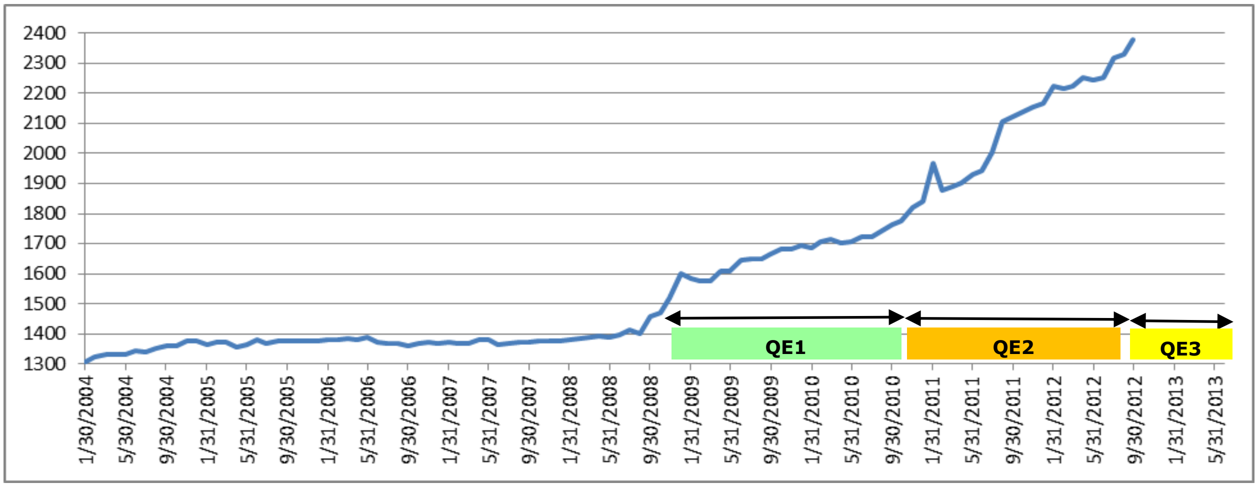
Stocks Bear Full Brunt Of Pressure: Stock Return (0.60*10%) + Bond Return (0.40*0%) = 6% Overall Return

Stocks have fortunately performed very well the last 21 months, but stocks will not return double digits every year. Higher bond interest rates will take pressure off the stock returns needed to maintain a safe retirement.

We Do Not Believe The Fed Stimulus Presents An Inflation Risk

Another effect of the massive and unprecedented Fed stimulus has been the dramatic growth of the money supply. Since the beginning of QE1, the M1 money supply has expanded by 60%. Economic growth over this time frame, while encouraging, is far less pronounced. The academic view is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth. Are we in trouble?

Growth Of M1 Money Supply (source: Federal Reserve)



The Fed has quadrupled its balance sheet assets (securities held outright) from $869 billion (August 8, 2007) to $3.47 trillion (June 30, 2013) through its quantitative easing. This number scares many people. A common fear about the Fed's strategy is the increased risk of future inflation - surely the amount of money the Fed is pumping into the economy will have dire consequences (have you seen pictures of the wheelbarrows of money pushed by people in Germany after World War I?). We believe the inflation fear is unfounded. From our standpoint, the Fed actions have had, and will continue to have, little if any inflation impact.

The duration of the Fed's securities portfolio is 5.91 years (source: Morgan Stanley). This tells us that $587 billion of bonds will mature each year and come off the Fed balance sheet ($3.47 trillion / 5.91). Stated on a monthly basis, $49 billion of bonds will mature. Economic growth is roughly 2%. If the current balance sheet grows at the rate of the economy ($3.47 trillion * 0.02), this would translate to roughly a $6 billion balance sheet growth per month. Therefore, the Fed can buy $55 billion of bonds ($49 billion + $6 billion) per month to maintain a balance sheet that grows at the pace of the US economy (let's call this the "maintenance level").

Calculation: The Fed Balance Sheet "Maintenance Level" For Monthly Bond Purchases

	Assets	Liabilities	Mismatch	Comments
Assets: Securities Held Outright	$3.47 T			
Liabilities: Notes In Circulation, Deposits		$3.47 T		
Duration (Years)	5.91	0	5.91	Deposits have no duration
Monthly Bond Maturities (Assets / Duration)	$49 B			Annual Level: $587B
Monthly Bond Purchase "Maintenance Level"	**$55 B**			Add 2% Growth ($6B)

The Fed is currently buying $85 billion of bonds per month, which is $30 billion a month ($360 billion a year) over its "maintenance level". This is not a level of stimulus that has had or will have significant inflation ramifications. If the Fed tapers its purchases to $65 billion per month, this will be only $10 billion per month ($120 billion a year) over its "maintenance level". This would have negligible inflation ramifications. Also bear in mind that the Fed has tremendous flexibility to quickly lower the size and duration of its balance sheet assets should it deem the move necessary. Don't worry about Fed stimulus inflation risk - we aren't.

Stock Market Spotlight

The U.S. Market Continued To Rise In The Second Quarter

In the Second Quarter, the domestic S&P 500 Index rose 2.91% and is up 13.82% year to date. The stock market was quite volatile given the Fed policy change speculation in May and its comments in June. The index rose 7.5% through its May 22 peak, subsequently fell 5.9% through June 24, and rose 1.7% through June 30. The European Monetary Union (+2.33%) and Japan (+4.42%) performed close to the S&P 500 Index. Emerging Markets (-7.95%) was a disaster.

Over The Last Two Years, The Grass Has Not Been Greener On The Other Side

Practically every investment alternative to the S&P 500 Index has lagged considerably over the last two years. Chasing better returns outside U.S. stocks during this time has proven to be a futile (and expensive) exercise.

Relative Out-Performance Of The S&P 500 Index Over The Last Two Years

Index	2 Year Return	Relative Out-Performance
S&P 500 (Domestic)	27.20%	-
Russell 2000 (does not include dividends)	18.13%	9.07%
Dow Jones Equity REIT	15.61%	11.59%
US Dollar	11.89%	15.31%
Barclays Aggregate Bond	7.11%	20.09%
MSCI EAFE (Foreign)	4.88%	22.32%
HFRX Global Hedge Fund Index (through May 2013)	4.54%	22.66%
US CPI (Inflation)	3.09%	24.11%
MSCI Emerging Markets (China, Brazil, India, others)	(12.95%)	40.15%
London Gold Spot	(20.82%)	48.02%
Dow Jones - UBS Commodity	(21.29%)	48.49%
London Silver Spot	(46.15%)	73.35%

There Is No Place Like Home - Most Investors Got It Wrong

U.S. stocks have not only led performance over the last two years, but have also led mutual fund outflows by a wide margin. The best place for investment has been our own backyard - most investors got it wrong.

Mutual Fund Flows For The Last Two Years ($ billions; Source: ICI)

Asset Class	Fund Inflow / (Outflow)	Breakdown
Stocks	$(239) B	Foreign: $49 B Domestic: $(288) B
Bonds	$406 B	

We Maintain Our Stock Emphasis Towards Higher Earnings Quality U.S. Companies

We did not change your stock positions in the Second Quarter. For now, we continue to emphasize large cap higher earnings quality companies. These are the companies that have financial strength, a well-established market niche, and an ability to weather tepid economic growth. We maintain a strong weighting (roughly 90%) to U.S. stocks, but may soon raise foreign exposure as their stock valuations are now more compelling.

Bond Market Spotlight

Bond Prices Fall In The Second Quarter

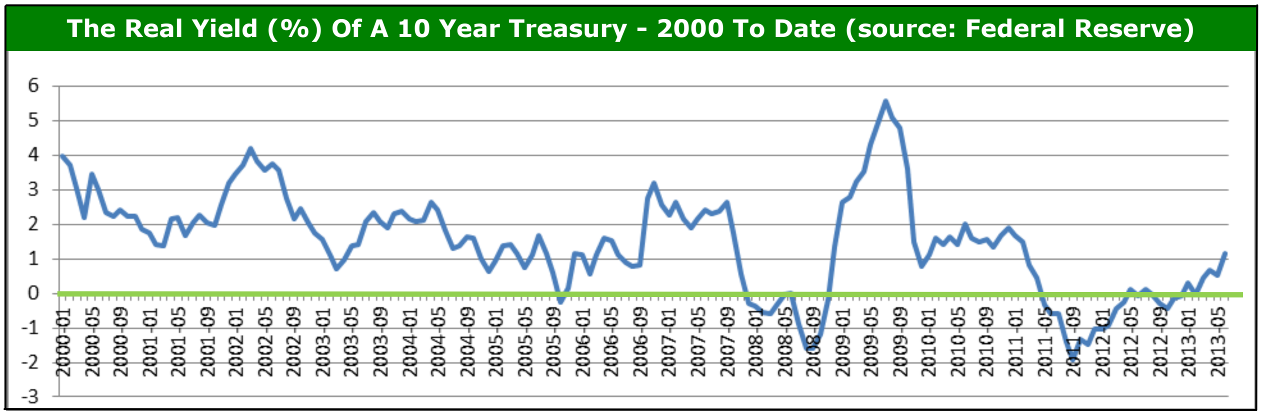
The Barclay’s Aggregate Bond Index, a broad-based representation of fixed income performance, fell 2.50% in the Second Quarter and is down 2.60% year to date. This is the biggest loss for bond holders in years as low yields could not cushion declining prices. In fact, many higher risk bonds fell in the range of 8% to 10%. Fortunately our bond exposure was much more conservatively positioned.

Good News: Bonds Now Offer A Positive Real Rate Of Return

We anticipate many investors (including our own clients) will be somewhat shocked to open their Second Quarter statements and see that bonds are down and stocks are up. After all, aren’t bonds supposed to be the lower risk asset class and not go down in value? Aren’t bonds supposed to smooth out the stock component performance, and not vice-versa? Over longer investment time horizons (20+ years), this is the case. However, bonds are not always the lower risk asset class in much shorter time frames. So far in 2013, portfolio principal value protection has come from stocks, not bonds. Surprising? Yes. Unheard of? No.

Numerous investors panicked before receiving their statements. An unprecedented $80 billion was pulled from bond funds in June (source: TrimTabs). This was an abrupt change as compared to 2009-2012, where investors added $1.21 trillion to bonds as they fled stocks (an error of epic proportions!) More bond outflows will likely follow. While investors may be lamenting their portfolio bond component, there is good news regarding the bond price drop and bond yield rise: bond yields now offer a real rate of return. Over the longer term, we believe this is critically important for investors who require portfolio income. The real yield is calculated by looking at the 10 Year Treasury yield and subtracting last year’s inflation rate. Much of the last two years have had a negative real yield (inflation has been greater than the 10 Year Treasury yield). Bond investors have been losing purchasing power. Bonds are always at risk for negative real yield as they don't have the inflation protection that stocks have. For now, this risk is gone.

The Real Yield (%) Of A 10 Year Treasury - 2000 To Date (source: Federal Reserve)



We Stress Safety Versus Yield Through Corporates And Inflation Protected Bonds

Rising rates and a return to positive real yields is good news. We want bonds as buffer protection in the event of a stock correction and still assign a very high probability that bonds will be up or down less than 5% in 2013 (see Quarterly Insights, April 2013, pages 5-6). Consequently we still hold relatively safer corporates and inflation-protected securities.

Your Portfolio

Through the first half of 2013, the S&P 500 Index is up 13.82% and the Barclay's Aggregate Bond Index is down 2.60%. Stock performance has surprised us to the upside - we predicted 6%-9% for 2013 (Quarterly Insights, January 2013). Bond performance has not surprised us. In the January report, we stated "our concern is that an inevitable rise in interest rates will send bond prices down and bond investors running for the hills. We know it will happen, just not when." The "when" turned out to be June.

We did not adjust your stock or bond positions in the Second Quarter because we saw no reason to do it. Our stock emphasis remains towards higher earnings quality U.S. companies, which has proven to be the right decision year to date and over the last two years. Our bond emphasis still prioritizes safety versus yield, which helped to minimize Second Quarter losses in the bond component of your portfolio. Looking ahead the next six months, we believe stocks still have reasonable upside potential and bond prices will likely stabilize.

Sometimes taking no portfolio action is the best action we can take. It does not mean that we are not watching your portfolio - far from it! It means that we insist on a deliberate purpose and rationale whenever we adjust your portfolio. We do not undertake transactions for the mere appearance of activity. It is costly and usually ineffective.

Having said that, the market is never static and we are an active (versus passive) manager.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

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Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.