TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

July 2014

Quarterly Insights

EXECUTIVE SUMMARY

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

In the Second Quarter, the domestic S&P 500 Index rose 5.23%, the foreign MSCI EAFE Index increased 4.09%, Japan recovered by 6.66%, and the MSCI Emerging Markets was up 6.60%. Year to date, the S&P 500 Index (+7.14%) is leading the way, albeit not by a large amount. Regional portfolio emphasis has not been a significant performance factor so far in 2014. The Barclay's Aggregate Bond Index rose 1.93% in the Second Quarter to follow its 2.05% rise in the First Quarter. As we stated at the beginning of the year, "there is room to make some money in bonds".

Anatomy Of An Acquisition Offer

Mergers and acquisitions (M&A) activity is finally returning. U.S.-based deals in the First Quarter increased over 50% from last year and over 25% from the previous quarter. What would you do if an acquisition offer suddenly elevates your stock by 20%? Would you sell or hold it? What would be the rationale? On June 16, we faced this exact dilemma with Covidien PLC (symbol: COV), a stock in our portfolio for over a year. Medtronic (symbol: MDT) offered 0.956 shares of MDT and $35.19 in cash for every share of COV. We discuss our decision process in concluding to sell COV.

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Second Quarter 2014

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Anatomy Of An Acquisition Offer

Merger And Acquisition Activity Is On The Rise

Merger and acquisition (M&A) activity is finally returning. U.S.-based deals in the First Quarter increased over 50% from last year and over 25% from the previous quarter. This is the most active start to the year since 2011 (source: Mergermarket). Record S&P 500 corporate cash levels and rock bottom interest rates, paired with an increasing willingness on the part of banks to make loans, is fueling this activity surge. We believe the M&A growth trend will continue. Confidence is back!

M&A Drivers: Q1 2014 Versus Q1 2013

Category	Trend	Source
Company Cash	+7%	FactSet
Prime Bank Rate	Unchanged*	The Fed
Commercial Bank Loans	+7%	The Fed

* Unchanged Since December 2008

M&A Increase: Q1 2014 Versus Q1 2013

Region	Trend	Source
USA	+56%	Mergermarket
Asia Pacific	+36%	Mergermarket
Europe	+19%	Mergermarket

What Would You Do If An Acquisition Offer Suddenly Elevates Your Stock By 20%?

Imagine you own shares of a stock and an offer is made to acquire it for a 20% premium over the current price. Would you sell the stock? Would you continue to hold it? What would be the rationale for your decision?

On June 16, we faced this exact dilemma as Covidien (symbol: COV), an Irish-based medical device maker our clients own, was acquired by Medtronic (symbol: MDT), a U.S. - domiciled medical device maker. The MDT offer was a combination of shares and cash that equated to a 20% premium over the COV stock price.

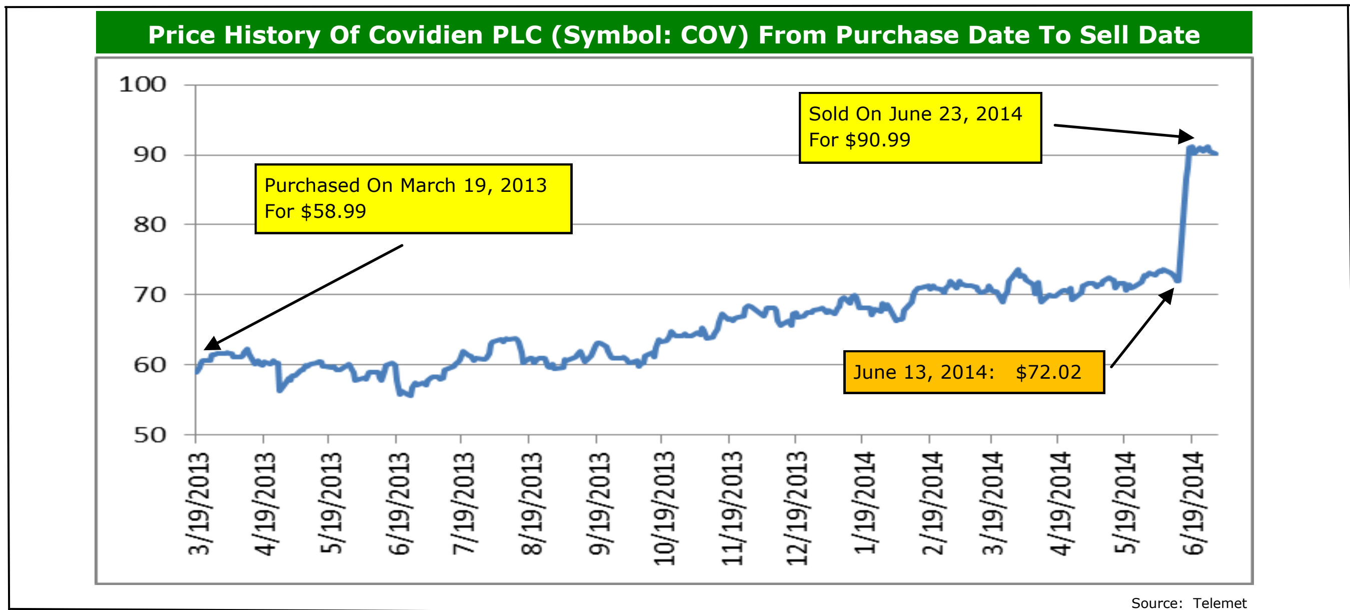
The Medtronic Offer To Purchase Covidien

For every share they own,
the COV shareholders would receive
0.956 shares of MDT and $35.19 in cash.

The deal is expected to close in
Q4 2014 or Q1 2015.

CASE STUDY: How We Evaluated The Covidien Acquisition Offer From Medtronic

We purchased Covidien on March 19, 2013 for $58.99 to gain portfolio diversification from both a sector and geographic standpoint. Covidien performed well even before the acquisition offer drove its price above $90.



Our ultimate decision to sell Covidien one week after the Medtronic acquisition offer was driven by math. For the sake of simplicity, let's assume for the moment that we expect the deal to close in the shortest time frame possible (six months) and that there is a 100% chance that the deal will close under the specified terms. On any given day, the total offer for the acquisition is the combination of the cash and Medtronic stock offers.

Should we decide to hold Covidien, the estimated six-month return is calculated as follows:

Six Month Return = **Total Offer* - COV stock price** / **COV stock price**   * (0.956 x Share Price Of MDT) + $35.19

A rough estimate of an annual holding return is double the six month return. If the estimated annual return exceeds 10% (the average long-term annual return of the stock market as a whole), we want to hold COV. If not, we want to sell it. Here are our calculations from the date of the offer to when we sold the stock (June 23).

BASE CASE: Deal Closes In Shortest Possible Time Frame (Six Months) And 100% Chance That Deal Closes

Date	Close Price: COV	Close Price: MDT	Cash Offer	Share Offer 0.956 MDT	Total Offer	Six Month Return	Annualized Return
June 13	$72.02	$60.70					Hold COV If > 10%
June 16 (Offer)	$86.75	$60.03	$35.19	$57.39	$92.58	6.72%	13.44%
June 17	$88.12	$61.58	$35.19	$58.87	$94.06	6.74%	13.48%
June 18	$91.01	$63.77	$35.19	$60.96	$96.14	5.64%	11.28%
June 19	$91.24	$64.67	$35.19	$61.82	$97.01	6.32%	12.64%
June 20	$90.11	$63.86	$35.19	$61.05	$96.24	6.80%	13.60%
June 23 (Sell)	$90.95	$64.14	$35.19	$61.32	$96.51	6.11%	12.22%

The prospect of a 13.5% annualized return (double the 6.7% six-month premium) would merit holding COV. However, remember that this is a "base case". We also have to consider the probabilities of an increased and rejected offer, as well as a longer than six month time frame to complete the deal. This changes things.

When We Factor In The Probability Of A Rejected Offer, It Leads To A "Sell" Decision

Out of the three probabilities we have to assess (increased offer, accepted offer, rejected offer), by far the one we are most concerned about is the rejected offer. A rejected offer would likely cause the price of Covidien to fall back by 20% to its pre-offer level.

There are five reasons why deals fail:

1. The bidder fails to secure adequate financing
2. The target does not want to be acquired and fights the bidder through hostile takeover defenses
3. Shareholders on either side reject the offer
4. Unexpected issues are uncovered through the due diligence of either side
5. A government and/or regulatory authority derails the deal (regulatory and/or anti-trust issues)

The first four reasons did not concern us regarding the Covidien acquisition offer. The last reason did.

Risk Assessment Of A Rejected Medtronic Offer For Covidien		
Potential Issue	**Our Thought**	**Rationale**
Financing	Not Concerned	The cash component of the deal will cost MDT roughly $16 billion. MDT now has $14 billion. They can borrow the difference.
Fight From COV	Not Concerned	COV has embraced the offer.
Shareholder Rejection	Not Concerned	We believe COV shareholders are very happy with the premium inherent in the offer.
Unexpected Issues (Internal)	Not Concerned	Both companies are well established and know each other very well.
Government / Regulatory	**CONCERNED**	The stated rationale for the offer was "synergies" but the more believable reason appears to be the opportunity to move MDT headquarters from the USA (35% tax rate) to Ireland (12.5% tax rate). We think there is a chance, albeit small, that the US government may fight re-domiciling of US corporations to lower tax countries in order to take a strong stand on tax avoidance.

The Weighted Return Of Holding Covidien Is Less Than The Long Term Market Return

We assign a probability and expected return to each of the three offer scenarios. The weighted average return drives our decision. Here is our calculation.

* Six Month Return	Offer Increased	Offer Accepted	Offer Rejected	Total
Expected Return *	15%	6.7%	(20%)	**Hold COV If > 5%**
Probability	12.5%	75%	12.5%	100%
Weighted Return *	1.88%	5.03%	(2.5%)	**4.4%**

Even with a small probability assumption (12.5%) of a rejected offer, the weighted return for six months is only 4.4%. On an annualized basis, this return is less than 10% (the long term market average). If the deal takes longer than six months to complete (which is likely), this return will be lower. An inadequate weighted return is why we decided to sell COV. We have no regrets. The stock appreciated 54% in a little over a year.

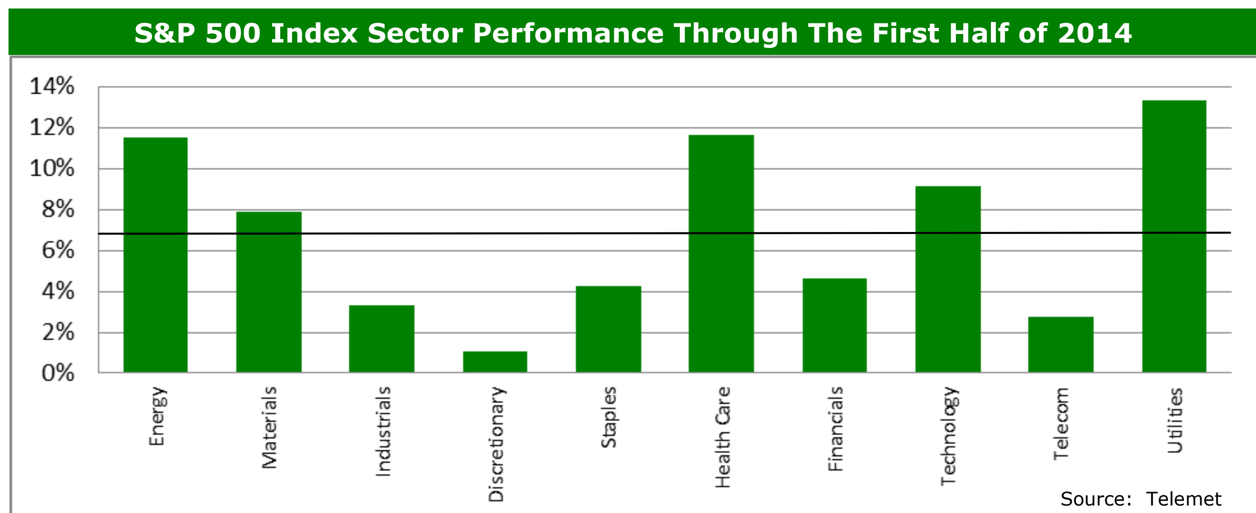
Stock Market Spotlight

The U.S. Market Kept Pace With Other Global Markets In The Second Quarter

In the Second Quarter, the domestic S&P 500 Index rose 5.23%, the foreign developed MSCI EAFE Index increased 4.09%, Japan recovered by 6.66%, and the MSCI Emerging Markets was up 6.60%. Year to date, the S&P 500 Index (+7.14%) is leading the way, albeit not by a large amount. Regional portfolio emphasis has not been a significant performance factor so far in 2014.

There Has Been Sector Performance Disparity Year-To-Date In The S&P 500 Index

So far in 2014, the big sector winners in the S&P 500 Index are Utilities, Energy and Health Care. The laggards include Consumer Discretionary, Telecom and Industrials.



Despite Under-Weight Positions To Utilities and Energy, Our Portfolio Held Up Fine

The Utilities Sector

Companies in the Utilities sector share two characteristics: they pay high dividends and tend to carry a lot of debt. Therefore Utilities act as bonds in having an inverse relationship with interest rates. As interest rates fall, Utilities stocks rise. And vice-versa. The Utilities sector comprises only 3% of the S&P 500 Index. At this time, we hold only one stock in this sector (Southern Company, symbol: SO) with a weighting just above 1%. This underweight is deliberate because we believe interest rates will rise (a negative for Utilities). With falling interest rates year to date, the decision has been wrong. However, we believe we will be right going forward.

The Energy Sector

We are underweight to Energy (a 5.7% weight versus the 11% S&P 500 Index sector weight) because we believe it is overly expensive to produce oil. Put another way, the oil business is becoming less attractive. We view the recent rise of the Energy sector as having more to do with (hopefully temporary) Middle East tensions than improving business fundamentals. Consequently we maintain our Energy underweight.

Our Portfolio Performance

Our stock portfolio has paced closely with the front-running S&P 500 Index year to date. Whatever we lost in sector weighting decisions, we gained in decent stock selection decisions. We will never get everything right in our portfolio strategy - no one can! Our goal is to consistently be more right than wrong in our strategic decisions. If this happens, the portfolio should continue to do well.

Bond Market Spotlight

Bond Prices Rise Again In The Second Quarter

The Barclay's Aggregate Bond Index, a broad-based representation of fixed income performance, rose 1.93% in the Second Quarter to follow its 2.05% rise in the First Quarter. As we stated in our Quarterly Insights January 2014 (page 6), "there is room to make some money in bonds". The 10-year Treasury bond yield fell from 2.73% to 2.53% during the Second Quarter. Despite the trend of a falling 10-year Treasury yield year to date (it started at 3.04%), we anticipate higher yields ahead.

News Flash: Right Now There Is "Something For Nothing" In The Bond Market

An anomaly has recently appeared in the bond market. In many instances, the yield on a bank certificate of deposit (CD) is higher than the yield on a lower-rated similar-maturity-date corporate bond. This should not happen. Lower-rated bonds should offer a higher yield because they have more risk than a FDIC-insured CD. The CD has no risk because it is guaranteed by the Federal government. When there is an opportunity to gain more return by taking less risk, we want to take advantage.

Example Of A Bond Market Anomaly: A CD Is Paying More Than Similar-Maturity Bonds

Standard & Poor's Rating	Issuer / Borrower	Yield To Maturity (%)
AAA Corporate Bond	Johnson & Johnson	0.957 (August, 2017)
AA Corporate Bond	Coca Cola	1.242 (August, 2017)
A Corporate Bond	JP Morgan Chase	1.468 (June, 2017)
Certificate Of Deposit (Guaranteed)	Discover Bank	1.266 (July, 2017)

Source: Charles Schwab

CASE STUDY - DISCOVER BANK CERTIFICATE OF DEPOSIT

Regarding the bond anomaly noted above, the Discover Bank CD should be yielding less than any of the other bonds because it carries no risk. But this is not the case. The CD is yielding more than both the AAA-rated Johnson & Johnson bond and the AA-rated Coca Cola bond. Why is this happening?

One possible reason is that Discover Bank believes it can earn an excellent rate of return by lending all the additional capital it can attract. Discover Bank is a leader in student loans, which is a booming and lucrative business. As long as there is sufficient demand for student loans, raising their CD rates above market price is worthwhile. There is still ample profit with the "spread" between borrowing and lending.

We Will Take Opportunities To Buy CDs That Yield More Than Similar-Maturity Bonds

Our bond strategy has not changed. We continue to hold short-term maturity bonds while we wait for higher interest rates. For quite a while, we have held roughly 70% short-term corporate bonds and 30% medium-term TIPS (Treasury Inflation Protected Securities). With this market anomaly, we can add CDs.

Cash accumulates in portfolios for many reasons. Dividend and bond coupon payments arrive. Cash remains as we re-balance portfolios or sell securities in order to send distributions. We invest cash and will take any opportunities to buy CDs that pay more and have less risk than similar-maturity bonds.

Your Portfolio

The stock market had a strong Second Quarter. Halfway through the year, the S&P 500 Index is up 7.14%. Our bullish 2014 prediction (the S&P 500 Index will rise 12% - 15%) is right on pace. We hope we are proven right! Another positive trend so far in 2014 is that there is money being made in bonds - not a lot of money, but certainly more than in 2013 (where the bond index was slightly negative).

During the quarter, we sold Covidien PLC (symbol: COV) for reasons already detailed in this report. We also purchased certificates of deposit (CDs) in some portfolios for reasons already discussed, and anticipate further CD purchases.

We do not make portfolio adjustments for the sake of appearance. There are numerous research studies that prove a negative correlation between high portfolio turnover and performance. Please do not interpret our low number of recent trades as a sign of complacency! Rather, we view disciplined strategy as a strength.

Mid-term elections are approaching and U.S. political turmoil often temporarily pressures markets. If our interest rate expectation proves accurate, we could also soon see rising interest rates. Higher interest rates would pressure bonds immediately and likely pressure stocks in the shorter term.

A pullback in the market over the next few months would not surprise us. It is not something we want to see and not something you want to see. But it would be completely normal if it happened. Don't panic if it does.

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,

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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.