SARGENT BICKHAM LAGUDIS

JULY 2014

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"Real courage is being scared to death and saddling up anyway."
- James Owen, Cowboy Ethics

SUMMARY:

Reasonably good returns for most asset classes through mid-year.

Interest rates and valuation are worthy of extra focus right now.

Fixed income markets might be less liquid than they appear.

Inherited IRA bankruptcy rules are changing for beneficiaries courtesy of the Supreme Court.

Thank you to those of you who joined us for our Open House at our new office.

SBL was featured in the *Wall Street Journal* and *Financial Times*.

Dear Clients and Friends,

Following are returns for the last one, three, and ten years ended June 30, 2014.

Returns as of March 31, 2014	2nd Qtr 2014	Last 12 Months	Last 3 Yrs. Cumulative	Last 10 Yrs Cumulative
World Stock Index (ACWI)	5.0	24.4	33.8	112.0
Large Cap U.S. Stocks	5.2	23.2	57.9	111.5
Mid Cap U.S. Stocks	4.3	25.5	52.0	171.5
Small Cap U.S. Stocks	2.1	24.1	57.4	130.3
Nasdaq 100	7.4	33.8	71.0	168.8
Foreign Stocks - Developed	4.1	23.3	25.5	95.5
Foreign Stocks - Emerging	6.6	14.2	-3.8	186.3
U.S. Bonds – Taxable	2.0	4.4	11.0	61.9
U.S. Bonds – Tax-Free Municipals	2.6	6.6	14.8	54.2
REITs	7.0	8.1	28.5	104.3
High Yield Bonds	2.4	12.1	27.3	137.8
Commodities	-0.9	8.3	-16.6	104.8
Hedge Fund Index	1.7	6.6	9.2	38.8
Gold	3.6	7.5	-12.3	232.2
60/40 Balanced World Index	3.8	16.3	30.0	96.9
60/40 Balanced U.S. Index	3.7	14.2	35.4	95.4

The second quarter turned out to be reasonably good for most asset classes, and for the first six months equities are up 6% to 7%, bonds 3% to 4%, and a few other asset classes even more. After last year's outsized results, most pundits predicted meager returns this year, but the market has a way of making fools out of the most people possible. Hubris is definitely the enemy of sound investment decision making. It is a little like golf. Never utter the words, "I think I have it figured out now" unless you are prepared to begin a long slump.

The results for the quarter and year belie the changing and whipsaw trends we saw. During the months of February, March, and April, we saw a sharp

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correction in growth oriented stocks and mutual funds. For example, Amazon (a growth stock if there ever was one) fell 29%, while a broad based value oriented index fund rose 2% over the the same period. Also, emerging markets started to look like they might be ready to perform in line with the developed world's equity markets. It is too early to conclude it will be lasting, but over the last four months the emerging markets index is up 12% versus 7% for the S&P 500. You can see on the table above that emerging markets have woefully underperformed over the last several years.

We have written for years that we follow six principal pillars in guiding our basic decision about asset allocation – to be defensive, neutral, or aggressive. Those six are:

1. The economy
2. Earnings growth
3. Inflation & interest rates
4. Valuation
5. Financial market stress
6. Politics
   (to the extent that it affects the prior five)

Despite the swoon in the first quarter, we believe the economy and earnings are solid right now. There are some who would quibble, but the numbers speak for themselves. GDP will be 3% or 4% in the second quarter and earnings are now predicted to grow by about 10% this year after a similar growth rate last year.

Financial stress, at least according to the markets, is very low, as is inflation. Politics is only a distraction. There are no meaningful laws being considered at all, and there is very little chance there will be for the next few years.

So the only two items for debate currently are interest rates and valuation. These offer interesting opportunities for different reasons.

Beginning with interest rates, it has long been my opinion that interest rates ultimately follow inflation. The Federal Reserve may have the ability to control short term rates, but they do so to control inflation. So if inflation rises, the Fed will raise rates. Longer term rates are controlled by the market (although the Fed is influencing these rates too with bond purchases); and the market is trying to anticipate changes in future inflation.

Historically, short term rates (we use the following interchangeably: Fed Funds, money markets, T-bills, cash, LIBOR) have yielded about one half of a percent more than inflation. We have stated over and over that we don't consider inflation a problem. By that statement, we mean it is below 2% and does not appear to be gaining momentum. The funny thing is inflation is not zero, but short term rates are! This has been a trend for a few years.

The Fed is essentially engineering a massive theft on the American saver. They have created negative "real" interest rates. The "real" rate refers to the rate after inflation. Since short term rates are 0% and inflation is about 1.5% or 2%, anyone with a savings account is losing 1%-2% in real terms per annum. Ostensibly, they are trying to stimulate the economy. After all, if someone is losing money in a savings account and is rational, they are likely to take it out and do something more productive with it.

Interest rates, therefore, are not following script. Short term rates should be 2.0% to 2.5% according to historical relationships. When will these rates rise? The Fed is encouraging us to believe it is still a year or more away, but they have begun hinting in various ways that it could be sooner.

Perhaps a more interesting question to ponder is… how will the rates rise? Will it be an orderly increase of 0.25% every couple of months? What will longer term rates do? How high could they go? How fast? Last year we had a taste of what might happen, and it led to a volatile few months. The Fed ultimately calmed the markets by convincing them they weren't really raising rates yet, but what happens when they really do?

Our questions are not merely rhetorical. We have to make decisions about what to do with the "safe" part of our portfolios. We have been wrong more than right the last few years as we have protected against rising rates. We do not think the economy is strong enough,

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nor inflation worrisome enough, that we have to worry about significantly higher rates. But it does seem S-T rates should be 2% or more. When the Fed embarks on that move, there is going to be additional volatility. We cannot see it now, but we are watching.

The other debatable investment pillar today is valuation. There are a number of approaches to valuation. Some analysts look at trailing earnings while others look at expected earnings. There are cash flow models and yield models. A very well-known professor from Yale, Robert Shiller, came up with a method of averaging the last 10 years of earnings in order to smooth out the business cycle, and others use the last 5 years.

The debate about methodology is nothing new. I noticed this when researching markets early in my career in the late 1980s. Rather than get swayed by each new method, I created my own model that used several different models and then calculated a weighted average based on regressing actual performance against different weights. Interestingly, I have found the most important variable was the change in interest rates.

When one creates models, it is important to understand the real drivers of the answer, even more so than the answer itself. I saw Peter Bernstein, one of the smartest financial analysts ever, speak at a conference once; and what struck me was his comment that all our financial data is suspect. What happened in the 1930s was due to what happened in 1920s. What happened in the 2000s was because of the 1990s. None of those periods will ever happen exactly the same again.

My observation that interest rates were the primary driver was due to the outsized influence of inflation during the 1960s and 1970s, and the subsequent decline during the following 30 years. If we spend the next 50 years with low inflation and interest rates, then we can be sure that there will be new primary drivers of returns.

Similarly, I am skeptical of models that use the last 10 years of earnings due to the extreme collapse in earnings in 2008 – 2009. The flip side of my skepticism is that the earnings destruction post-2008 was an adjustment for some earnings that for several years prior were artificially high. In any case, the Shiller model shows the market to be at a high valuation relative to its history. The reason this is an important debate is that the Shiller model implies long term returns (next 10 years) will be near zero. A look at valuation based on the last year of earnings, or the next year's expected earnings gives a different picture. From this perspective, the market is at an average level of valuation. I lean toward the more recent and expected earnings numbers, and think the market is at fair value. However, I respect the research of others and it gives me some heartburn. At a minimum, there is no longer a discount to fair value in the market generally. Like the cowboy who has to saddle up despite being scared, we are faced with a number of uncertainties every day, but we do not let them freeze us into inaction. We work to understand the risks, watch to see if they rise to significance, and then adjust our strategies.

Strategies

The new categories and our current targets are as follows:

Name	Normal Target Equity/Bond	Typical Equity Range	Current Equity/Bond/ Alternatives Target
Preservation	20 / 80	10 – 25	20/70/10
Conservative	35 / 65	20 – 40	35/50/15
Balanced	50 / 50	30 – 60	50/38/12
Moderate Growth	60 / 40	40 – 70	60/30/10
Aggressive Growth	75/ 25	50 – 80	75/19/6
Global Growth	100% Equity (U.S. & Int'l)	60 – 100	100/0/0
Core U.S. Equity	100% Equity (U.S. Large Cap)	60 - 100	100/0/0

Core U.S. Equity

Core Equity dug a hole in March and April and has not found a way out yet. Through February we were slightly ahead of the S&P 500 (1.11% vs. 0.95%), but then we lagged for the next two months. Since April 30th we have performed roughly in line but remain behind 3.7% vs. 7.1%.

As I wrote in the opening paragraph, it was partly due to

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a correction in some of our high growth stocks, notably Amazon and Polaris; but was also due to company specific news. Core Labs, Perrigo, and Chicago Bridge & Iron all had earnings announcements that were below Wall Street's expectations. We have studied all these companies and re-affirmed our confidence in their longer term prospects.

On the positive side, our best performers have been in the energy sector with Devon, Schlumberger, Continental Resources, and Anadarko all up 30% to 40% this year.

Our only change last quarter was the addition of Priceline to the portfolio. PCLN is soon to become the world's largest online travel agent, yet it still has global market share of all travel bookings of only 4%. We believe it can grow to a much larger penetration due to its strong network and position in the U.S. and internationally.

Misery loves company…

Craig Lazzara of S&P Dow Jones Indices writes, "In late 2013 and early 2014, we heard considerable chatter about how 2014 would favor stock selection strategies, it was said, because intra-market correlation was falling as macro-economic risks receded." A recent Wall Street Journal article reports that the contrary view — that low levels of stock market dispersion would make 2014 an especially difficult year for active managers — has been vindicated. "So far in 2014, more actively managed mutual funds are trailing market benchmarks than in any full year since 2011…" Hedge fund performance is said to be equally disappointing. The critical variable in understanding why active performance has been disappointing is the continuing low level of equity market dispersion. Computationally, dispersion is a (weighted) standard deviation of cross-sectional returns. Conceptually, it helps us gauge by how much more the "better" performing stocks beat the "worse" performing stocks. Economically, dispersion tells us how much over- or under-performance we are likely to experience. When dispersion is low, there is less opportunity either to succeed or to fail.

Our batting average isn't perfect, but we have a good long term record of outperforming the S&P 500. We have not changed our process or philosophy, so we are confident with continued hard work we will find a way to beat the index again.

Fixed Income Markets – Liquidity

Since the 2008 financial crisis there have been a number of developments in financial markets, such as new regulations, changes in market structure, technological advancements, and investor behavior. Taken together, these have the potential to cause significant problems in the fixed income markets. This isn't a prediction, but if investors decided to run for the exits in the fixed income markets, there could be a liquidity problem.

Liquidity is about more than volume. Volume can be high when markets are stable, but liquidity tends to disappear during times of panic. Liquidity means you can sell something when you want to – immediately and without affecting the price. New regulations have created constraints likely to curtail liquidity when it is needed. These have raised capital requirements and created multiple other restrictions. Large banks must now reflect changes in market values in capital accounting.

The result has been a reduction in dealer inventories. In the meantime, mutual fund and ETF assets have mushroomed by almost a trillion dollars. Dealer inventories are at the same level they were 20 years ago. Retail mutual fund investors are notoriously fickle. What happens when rates rise by 1% or 2% and they see their values fall by 5%, 10%, or more? If they all rush to sell, there will be no buyers.

Similarly, Bloomberg reported "Bond Anxiety in $1.6 Trillion Repo Market as Failures Soar." Superlative headline notwithstanding, the article goes on to explain that dealers have pared inventories of Treasury bonds used as collateral in order to meet more stringent capital requirements mandated by Dodd-Frank, the Volcker Rule, and Basel III. Repos are used by banks and other financial institutions to cover cash needs by using Treasury bonds as collateral to lend money back and forth. If a borrower cannot obtain the collateral they "fail" on the trade and have to pay a penalty of

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3%. Such failures have averaged $65 billion a week this year and reached as much as $197 billion one week in June. That compares to an average of $52 billion in 2013 and $29 billion in 2012.

This is a technicality in the plumbing of the financial system. What is important to understand is that if you have faulty plumbing, you can have some serious problems in your house. My concern about liquidity within the fixed income markets is that rising interest rates are really a question of when, not if. I worry that it could be unnecessarily disruptive if the system's "plumbing" is not corrected ahead of time.

Financial Planning

by Gary Powell

Inherited IRAs Not Protected in Bankruptcy
In a landmark, unanimous 9-0 decision handed down on June 12, 2014, the U S Supreme Court held that inherited IRAs are not "retirement funds" within the meaning of federal bankruptcy law. This means they are now available to satisfy creditors' claims. The plan to address an ongoing future financial need of a relative or friend with an inherited IRA may be compromised if that person declares bankruptcy.

The Court's decision differentiated an inherited IRA from an IRA based on 1) the beneficiary of an inherited IRA cannot make additional contributions to the account, while an owner can; 2) holders of inherited IRAs must withdraw money from the account regardless of how far they are from retirement, while an owner can defer distributions at least until age 70½; 3) the inheritor can withdraw money from the IRA – including the entire balance – at any time and use for any purpose, while the owner must generally wait until 59½ to take penalty-free distributions.

These factors characterize an inherited IRA as money that was set aside for the original owner's retirement and not for the designated beneficiary's retirement. This simple analysis has sent shock waves through the estate planning and financial advisory worlds because its logic may also be applicable to all inherited defined contribution retirement plan accounts, so inherited 401(k) and 403(b) accounts may also be affected. In the coming months and years, the legal minds and legislators will be weighing in on the scope and legislative corrections needed if the noise level becomes intolerable.

The legal pundits have initially come out advocating a "Standalone Retirement Trust" to protect the inherited IRA from each beneficiary's creditors, as well as predators and lawsuits. The downsides to an IRA inside these trusts are compressed tax brackets (income greater than $12,150 is taxed at 39.6% in 2014), ongoing accounting and trustee fees, and the sheer complexity of administering the trust year after year. Additionally, the trust agreement must be carefully drafted as a "See Through Trust" that allows for the Required Minimum Distributions (RMDs) to either remain inside the trust or be paid out over the oldest trust beneficiary's life expectancy.

Stay tuned for more developments as they unfold. In the meantime, taking extra care when designating beneficiaries for retirement plans would be prudent.

Company Update

By Patty Meneley, COO

Meagan returned from maternity leave recently and we're happy to be back fully staffed again. Summer is typically a quiet time at SBL while many of our clients are vacationing, but we're here ready to assist you with any service requests you may have.

Fraudulent activity has been a very hot topic in our industry and SBL has seen a few (unsuccessful) attempts to wire funds from client accounts to unauthorized parties. It is our policy to verify all wire requests with a verbal confirmation from the client anytime we receive a request via email. We appreciate your patience with this process. The fraudsters are getting more and more sophisticated so, for your protection, we will need to talk to you directly anytime a request is made to wire funds from your account to a third party. When you talk to your advisor and/or your client service manager please make sure that we have current mobile phone numbers for you. We have safeguards in place, and

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so do our custodian partners (Charles Schwab in most cases) to protect you from this exposure, but beware that other people are trying to get to your money by accessing your email.

Lindsay and I recently returned from a Schwab Solutions meeting in Phoenix where we participated in sessions covering various operational and procedural topics. One of the most interesting sessions we went to was an overview of Schwab's new electronic signature and disbursement verification tools. If you are enrolled in Schwab Alliance, Schwab's technology platform for clients of RIAs, you now have the capability to sign documents electronically and to verify wires either on your computer or, even better, on your mobile device. This provides an extra layer of security on your account, but also significantly speeds up operational procedures since you can approve them anytime, wherever you are. If you'd like to learn more about this, call us and we can help set it up for you.

The Last Word

By Rick Lawrence, CEO

We moved into our new offices at the beginning of this quarter. This was well communicated, but I am sure still resulted in some inconvenience to our clients. We appreciate everyone's patience and flexibility accommodating the move.

We held an open house last month, and more than 100 people attended. This was a great opportunity for us to show folks where we are, and create a venue for our clients and professional partners to enjoy being with one another for a relaxing evening. By the way, special thanks to the College of Music at the University for providing us with a great jazz quartet!

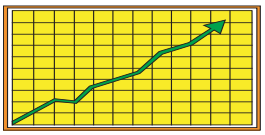
We sent a note out about this last week, but it is certainly worthy of a repeat here. The company was selected as one of the top 300 Registered Investment Advisors by the *Financial Times*; and Brad Bickham was featured in *The Wall Street Journal* on July 7th. The article included comments about small cap stock valuations and a recommendation for a mutual fund based portfolio which is very suitable for smaller accounts. Brad's Market Commentary above includes a more extensive discussion. Ask to read a copy of article the next time you are in the office.

From an operations standpoint, one important area we are giving significant attention to relates to fraud and identity theft. In Patty's Company Update section, she explains what we are seeing and some of our controls. It is worth a careful read. When you hear from us attempting to confirm the transaction or to execute other security precautions, please do be patient and recognize that we are trying to do our part to protect your assets. Also, if you are suspicious about any activity or communications involving SBL, do not hesitate to contact us. Effective communication is great protection from this risk.

I have been with SBL for six months now, as an employee. My accounts have been here for over seven years. A friend asked me the other day, "How do you feel about having your money managed there now that you have had a chance to 'see the sausage made'?" My answer, "I have never been more pleased with my portfolio and confident in the investment analyses and choices."

We hope you feel the same way, and thank you for giving us the chance to manage your money.

Many happy returns,



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