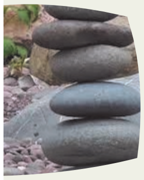

ISSUE 6 VOLUME 1 | DECEMBER 2012

Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Market Outlook - Part 2

We're in the home stretch of a genuinely interesting year and the market has performed pretty well - up approximately 10%. There's no question that we've had a number of headline events that had the potential to drive stocks lower on the year, but stocks have proven resilient. Our feeling is that over the next few months we'll see above average volatility with the potential for a rather good sized correction if the fiscal cliff isn't handled with care. Once a deal is made, we feel there's a good chance that markets will continue to grind upward into next year due in large part to loose monetary policy of central banks around the world, but we do see risks on the horizon that make us very cautious.

Short Term/Medium Term

For now, let's define short term as the next 3 months and the medium term as the next year. Based on high levels of uncertainty around the fiscal cliff issue – the onset of tax increases and deep spending cuts on January 1 – daily market swings will likely be large as markets hang on the tone of every word spoken by the parties involved. The outcome is unknown, so we won't attempt to predict where the market will be at the end of the year. However, there's a good chance that we could be either significantly higher or lower than where we are now based on the direction of the outcome.

We've written in past letters that markets at times can behave as though they're disconnected from the current economic realities and that seems to be happening now. In most cases, this can be the result of markets playing catch-up after declining heavily during the prior economic downturn. It can also be the result of forward looking sentiment regarding the state of the economy, corporate profits, and general investment landscape months from now. And finally, there may be times when stocks are simply the "least bad" place to put money regardless of what else may be happening in the world now or months from now – barring an outright depression being right around the corner. In considering this short list of potential explanations, we feel the "least bad" rationale has the greatest likelihood of explaining the relative buoyancy in the markets this year (especially when loose monetary policy puts money in our hands that may need to be directed somewhere – we'll get to that in a bit).

With bond yields so low, and dividend yields on stocks fairly high, there seems to be a yield-driven bias toward equities. Why not invest in something that pays good income and also has the ability to grow over time? In addition, the ability for corporations to borrow cheaply by issuing bonds and use these funds to either buy back shares or issue additional dividends down the road also looks appealing to the average dividend investor. They may get a dividend boost down the road or find themselves with more valuable shares. Fewer shares available after companies buy them back means each share is worth more. Assuming that stocks aren't too expensive (as measured by their share price relative to earnings or cash flow), which we don't feel they are, these are good arguments for maintaining exposure to equities over the coming months. Add the element of risk-seeking that central bank money-printing can provide and we see the potential for a slow, albeit choppy plod upward over the next year.

Long Term

We believe there are some risks on the horizon that are likely to affect markets negatively at some point, and although timing is anybody's guess, the more days that pass without resolve, the greater the risk. Here are a few of the risks that we feel have the potential to deal stocks a blow over the longer term. Since there's always the possibility that they materialize sooner, we need to remain balanced in our approach over the next few months.

Europe - We'll keep this one short since we've spent a bit of time on it recently. Although under some semblance of control currently, Europe's problems are far from solved. Dealing with high debt levels and stimulating the economy will prove to be very difficult. Ultimately, either defaults need to take place to wipe the slate clean or there will need to be a long slow effort to regain fiscal health – neither are very good for economic growth or markets over the long term.

Easy Money from the Fed - Quantitative easing, or "money-printing", can also have long term consequences. The idea here is to flood the financial system with money that can be used to fuel economic growth. The assumption when employing this type of policy is that people or corporations actually have a need for the money possibly because there isn't enough of it floating around. If this isn't the case – maybe because there are high debt levels that need to be paid down first – making more money available may not have the desired effect. It may instead end up sitting on bank balance sheets or being put to use for purely speculative purposes rather than productive investment oriented ones. The longer interest rates are held at abnormally low levels, the more vulnerable we become to market bubbles and ultimately crashes.

Low rates also enable individuals, corporations, and governments to accumulate debt easily since the cost to service the debt is relatively low. However, when rates eventually rise and those debts have to be rolled over at much higher rates, the amount of money that has to go toward interest payments on that debt can rise dramatically, potentially at a time when funds for other very important budget items may be in short supply. We know this could certainly be the case for the U.S. government. So bottom line, long-term accommodative policy – or easy money - can have negative effects on the health of the economic system over time. We've seen the effect of this with the tech bubble, then the real estate bubble, and we run the risk of seeing it once more.

China - There are also some interesting developments in China that give us pause. Although economic growth is still larger than that of any developed countries, it's on course for its slowest year since 1999 at about 7.5% GDP growth. On the surface, this appears exceptionally positive, but given China's demographic makeup, high growth rates are necessary to see any increase in the standard of living of its people. So this is actually a much lower number than it appears on the surface. When we look at the health of the average company in China, operating income has been falling while debt has been increasing. According to Thomson Reuters, Chinese corporations are expected to have debt levels 122% of GDP by the end of 2012. This is up from 108% at the end of 2011. Banks have continued to finance corporations even in situations where they are unlikely to return to profitability and repay the loans in the long run. Concurrent to this reckless lending, there are signs of credit contracting within certain pockets of the economy that are making it increasingly difficult for some smaller companies in China to secure financing. This looks on the surface to be a classic case of overcapacity and funds not being used productively. The Shanghai Composite – a market whose main participants are individual investors in China – is down roughly 10% this year. If this is the average citizen's message as to what is really happening in China, we may want to listen.

When investing feels simple, there's a good chance something may be about to go wrong. The last time it did in the stock market was the late 90's and most investors recall how that ended. Real estate also saw a period leading up to 2005 where it was so easy to make money, that it became a dinner table discussion. It's okay that getting returns from the markets don't feel like a sure bet – that's how opportunities are created. With the ability for information to speed around the globe in milliseconds and investors able to respond to that information faster than ever before, the ability for emotion and knee-jerk reaction to play a role in markets has never been greater. Negative news can create down markets, while down markets can create the need to explain them with negative news. This phenomenon is likely here to stay and we should expect it.

So as we bring this interesting year to a close, we expect to see a continuation of the headlines and volatility as we move into 2013. It would not surprise us if the net result of these swings was in the upward direction, and there will continue to be risks on the horizon that need to be monitored carefully.

<u>Portfolio Positioning</u>

A careful mix of traditional asset allocation along with a more active uncorrelated element may well be the best way to manage the challenges we face moving into 2013.

As a follow-up to last month's letter, here are our recommendations for the asset allocation portion of the portfolio. At Cadence, we refer to this component as Core Diversified. (Clients will receive a separate attachment with specific investment selections. Please make sure to take a look and let us know if you have any questions.)

Year-End Tactical Rebalance

Qualified Accounts Neutral Core Diversified Strategy

We tend to make more changes within our retirement account portfolios when we rebalance as there are no tax consequences for making those changes.

Equity Positioning

Our neutral global equity allocation target is 60% US Stock and 40% foreign stock. This allocation does achieve that global mix. There was a slight increase in developed foreign stocks relative to the last rebalance. Within our US stock exposure, we increased our small company stock exposure, with most of that increase coming at the expense of the medium company stock exposure.

Fixed Income Positioning

Our neutral global fixed income allocation target is 70% US bonds and 30% foreign bonds. This allocation is slightly overweight toward foreign bonds by about 2%.

Within the domestic bond allocation, there was an increase in our lower credit quality, higher yielding corporate bonds, and a decrease in our exposure toward US Treasury notes and bonds, high quality corporate bonds, and mortgage bonds. Within the foreign allocation, there was a slight decrease in emerging country debt and an increase in developed country debt.

After these changes, the fixed income position is still defensive relative to interest rate increases and somewhat defensive relative to stock market declines. 90% of the fixed income investments are in flexible mutual funds that can change their allocations to reduce loss exposure or increase yield and growth potential.

The target yield of the bonds is slightly over 5%.

Opportunistic Positioning

We frequently allocate a portion of what would normally go into the equity (stock) part of the allocation instead into areas where we see the potential for shorter term gain for a variety of reasons. As explained in the last newsletter, we currently see an opportunity in the stocks of gold miners, and have taken 5% out of the stock allocation and invested it into a Gold Miners Stock Index fund.

Volatility Reducing Positioning

In order to reduce the amount of sudden ups and downs that investment portfolios can frequently have, we allocate a portion toward investments that are specifically managed to reduce portfolio volatility. These investments are managed to also earn a positive return over time, and are positioned flexibly enough to play defense as well as offense. For this allocation, we have 11% in volatility reducing positions, which is an increase of 3% over the last rebalance.

Qualified Accounts Neutral Core Diversified Strategy Asset Class Distribution

Cash	2%

Equity Breakdown

Large Cap Stock	13%
Mid Cap Stock	5%
Small Cap Stock	6%
International Stock	11%
Emerging Markets Stock	5%
	41%

Bond / Fixed Breakdown

Treasury Notes & Bonds	3%
Agency Bonds	1%
TIPS	0%
High Grade Corporate Bnds	6%
Non-Agency Mortgage Bnds	7%
High Yield Corporate Bonds	5%
Floating Rate Notes	1%
International Developed Bnd	5%
International Emerging Bnd	5%
Short-Term Muni Bonds	0%
Intermediate Muni Bonds	0%
High Yield Municipal Bonds	0%
Other	5%
Cash	1%
	41%

Alternatives

Commodities	5%
Real Estate	0%
Sector	0%
Hedge	11%
	16%

Non-Qualified Accounts Neutral Core Diversified Strategy

We tend to make fewer changes within our non-retirement account portfolios when we rebalance as there can be tax consequences for making changes.

Equity Positioning

Our neutral global equity allocation target is 60% US Stock and 40% foreign stock. This allocation is slightly overweight foreign stocks. There was an increase in developed foreign stocks relative to the last rebalance, a slight decrease in emerging country stocks, with the net effect being around a 2.5% increase in foreign stock. Within our US stock exposure, we increased our small company stock exposure, with most of that increase coming at the expense of the large company stock exposure.

Fixed Income Positioning

Our neutral global fixed income allocation target is 70% US bonds and 30% foreign bonds. This allocation is overweight toward US bonds by about 6%.

Within the domestic bond allocation, there was a slight increase in our lower credit quality, higher yielding corporate bonds, high quality corporate bonds, municipal bonds, and mortgage bonds. There was a decrease in our exposure toward US Treasury notes and bonds. Within the foreign allocation, there was a slight decrease in both emerging country debt and developed country debt.

After these changes, the fixed income position is still defensive relative to interest rate increases and somewhat defensive relative to stock market declines. 70% of the fixed income investments are in flexible mutual funds that can change their allocations to reduce loss exposure or increase yield and growth potential.

The target yield of the bonds is slightly over 5%.

Volatility Reducing Positioning

In order to reduce the amount of sudden ups and downs that investment portfolios can frequently have, we allocate a portion toward investments that are specifically managed to reduce portfolio volatility. These investments are managed to also earn a positive return over time, and are positioned flexibly enough to play defense as well as offense. For this allocation, we have 14% in volatility reducing positions, which is an increase of 6% over the last rebalance.

Non-Qualified Accounts Neutral Core Diversified Strategy Asset Class Distribution

Cash	2%

Equity Breakdown

Large Cap Stock	12%
Mid Cap Stock	7%
Small Cap Stock	6%
International Stock	13%
Emerging Markets Stock	5%
	42%

Bond / Fixed Breakdown

Treasury Notes & Bonds	1%
Agency Bonds	4%
TIPS	0%
High Grade Corporate Bnds	6%
Non-Agency Mortgage Bnds	6%
High Yield Corporate Bonds	4%
Floating Rate Notes	1%
International Developed Bnd	3%
International Emerging Bnd	5%
Short-Term Muni Bonds	0%
Intermediate Muni Bonds	8%
High Yield Municipal Bonds	0%
Other	4%
Cash	0%
	42%

Alternatives

Commodities	0%
Real Estate	0%
Sector	0%
Hedge	14%
	14%

Have a wonderful holiday season!

Regards,
Cadence Investment Team

CADENCE
WEALTH MANAGEMENT

Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

CADENCE
WEALTH MANAGEMENT