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HELPING OUR CLIENTS BUILD AND MAINTAIN WEALTH WITH AN UNWAVERING FOCUS ON CLIENT SERVICE AND COMMUNICATION.

Market Outlook - Part 1

Our Take

If there's ever a time for a crystal ball, this would be it. The big question being, where can we deploy capital where we have a reasonable chance for return with an acceptable level of risk? Further, we have to attempt to answer this question against the backdrop of a presidential election, weak global economy, and looming "fiscal cliff" that is scheduled to kick in on January 1, 2013.

The Congressional Budget Office communicated that if consensus isn't reached around a deal in Congress to avert the "fiscal cliff" before year end, we are likely facing a significant hit to economic growth next year that would lead to recession. Although this isn't a good scenario by any standard, the real question is how financial markets could be impacted as a result. It's our opinion that if the hit to growth is limited, then equities would likely remain an attractive asset class in 2013. However, if corporate profits are affected more dramatically as a result of sun-setting tax laws (higher rates) and the onset of pre-programmed spending cuts (as a condition of increasing the federal debt ceiling in 2011), the stocks could have a more difficult time next year. Our bias is toward some sort of deal being worked out to minimize the immediate impact of the cliff which should allow more time for a reasonable debt reduction and economic growth plan to emerge over time. So given this outcome, how should we deploy capital in seeking the best risk reward relationship? Read on.

Portfolio Considerations

Over the next 6 to 12 months, we feel it prudent to maintain exposure to equities as part of a tactical asset allocation strategy. There are times when it's a bit clearer as to when to increase or decrease stock market exposure by a good margin, but in our opinion this isn't one of those times. Examples of market conditions that could make it clearer would be a large stock market decline or steep run-up in stock prices that aren't easily justified. So given that neither of these things has taken place, we find it most prudent to avoid one of those lopsided stances at the moment. Although equities on their own are priced at bargain basement levels, they also aren't overly expensive ei-

ther. When we add the fact that investors at the moment don't have too many alternatives to equities that provide the potential for return for a moderate level of risk, we begin to realize that they really do deserve a spot in the portfolio. We do see the possibility of some fairly dramatic short-term market swings as Congress negotiates a path through the aforementioned tax and spending labyrinth, but those are best managed with strategies designed to be more active and technical in nature. Given that our tactical asset allocation model is looking ahead six to twelve months, any short term volatility is a necessary part of the process for this approach. If one is less able to tolerate high levels of volatility, then their overall exposure to equity should be reduced accordingly within the portfolio. That said, we recommend a fairly even split between the broad stock and bond categories. Our "neutral" portfolio, which aims to seek the ideal balance between risk and return, will target this mix while carving out an allocation to alternative investments as well. (Keep in mind that our technically managed strategies may currently be adopting different allocations based on their specific investment timeframes and allocation criteria).

Although the overall allocation to stocks and bonds we're recommending is not changing much from our present allocation, there are some meaningful shifts within each of those broad categories that we feel can better insulate the portfolio against volatility while providing some opportunity for return through appreciation and yield. We will send a follow-up to this newsletter in the next couple of weeks with the details of which funds/holdings we're recommending in the portfolio for the next six months, but for now we'll comment on a high level regarding some of these recommendations.

Equity

Large Cap stocks have had a very nice run on a year-to-date basis. With the S&P 500 up 12.3%, without dividend re-investment it has outperformed the small cap Russell 2000 index by a bit over 2% over the same period, and the international FTSE index by about 2.5%. In fact, over a ten year time frame, U.S. large cap outperformance of these two indexes is near historical highs approaching a two deviation level. (What this means is that this level of outperformance doesn't happen very often). What this suggests is that it may be time to back away from large cap stocks and redirect our equity capital in the small cap and international space. This run-up in large caps has certainly been supported by the fact that investors in equities over the last couple of years have by and large sought out large stable companies that pay dividends as protection against economic weakness and the low interest rates of bonds and cash. As a result, many of these companies' stock prices are now trading at higher levels relative to their earnings than the average of the companies that make up the broad market. This could present a bit more risk to large dividend paying stocks than one would like.

Gold

For years people have been considering gold to be an attractive holding as a hedge against both inflation and market turmoil. For us to introduce gold into portfolios we would have to believe there to be a high likelihood of at least one of those conditions over the next six months. Although governments around the world have been printing money since the financial crisis, which many fear will bring about early 1980's style inflation, the massive debt problems and focus on paying down these debts in both the private and public sectors are keeping demand for goods low and wage growth in check. This limits upward pressure on prices. As a result, we believe inflation will remain tame over at least the next six months.

In addition, we feel a typical diversified portfolio with exposure to alternative investments will be able to limit the impact of market turmoil on portfolio returns over time. Although gold is perceived to be a "safe haven", this doesn't mean that it won't be susceptible to waves of selling and steep declines in the future. It's worth noting that between March 17, 2008 and November 13, 2008, in the heart of the financial crisis, gold lost over 31% of its value. This is in the same ball park as the S&P 500's 36.4% decline. Treasury bonds, which are more traditionally looked at as a safe haven, lost 3.2% of their value over the same period. So we don't

necessarily buy in to the idea that gold will hold its value in the event of a financial or market crisis.

Valuing gold can also be quite challenging. Ultimately the price at which gold changes hands is what people perceive it to be worth. Although perceived value does play a role in every investment, we would prefer to base investment decisions on real value instead. In other words, gold doesn't earn anything. There's no yield, no revenue from it, and no profit to pass along to its investors – only the hope that others will find it more valuable than they do when they sell it. On the other hand, a business with real earnings that get passed along to the shareholder, or a bond paying interest, has real economic value.

Although we may not agree with all of the arguments supporting substantially higher gold prices, that doesn't mean they won't hold their own or appreciate over the coming months. We feel there is another way to benefit from stable or rising gold prices. Those companies around the world that mine for gold actually present an interesting opportunity at this time. They have not been able to benefit from the run-up in gold prices as much as one would think because of the mechanism they use to manage the prices at which they sell their product. Many of these hedges which prevented them from selling their gold at current market prices are set to expire, and they will become more profitable as a result, potentially even if gold prices drop from here. That's not to say gold miner's shares aren't without risk, but with the ratio of gold bullion relative to the stock prices of the companies that produce that bullion near historic highs, we believe buying the stock of gold producing companies provides a growth opportunity that buying the metal itself may not.

Fixed Income

In the fixed income space, we're seeking to balance two objectives – reasonable "real" yield (net of inflation), and safety of principal in the event of market turmoil and/or rising interest rates. In looking to meet the first objective of "real" yield, we focus our attention to global bonds, high yield bonds, and mortgage or agency bonds. (Agency bonds are those backed by government agencies such as Freddie Mac and Fannie Mae). All of these asset classes offer very reasonable yields over both treasuries and inflation. The issue however is that the first two of these asset classes would likely be vulnerable to loss in the event of a market downturn while mortgage and agency bonds would be more exposed to rising rates. In an effort to balance these risks, we feel it best to keep the duration of the bond/fixed income investments on the lower side in order to minimize the risk of principal loss when and if interest rates rise (this means buying bonds that are maturing sooner than later and are therefore effected less when interest rates rise). We also feel that active and flexible management is important across some of the bond classes that pay higher yields, but would be more susceptible to a market downturn, in order to best manage this balance between risk and return. The bond classes that we're not particularly comfortable with at this point, and are therefore underweighting, are longer dated treasury bonds and floating rate notes. Longer dated treasuries just don't offer enough yield given the potential for loss while floating rate investments offer a decent yield and are protected against rising rates (due to their extremely short term nature), but aren't as likely to hold up in the event of market turmoil. Again, these two just don't seem to strike an acceptable risk/reward balance in our opinion. This will most likely change in the future.

Alternative Investments

Any investment asset class that doesn't fit into the standard stock or bond category or strategy that isn't managed in the same fundamental-based, long-only manner could be deemed as an alternative investment. The advantage of alternatives is that they tend to march to the beat of their own drum, and can move independently of both stocks and bonds over the short to medium-term. This concept has particular appeal in today's low-interest, slow growth environment since it's a bit more difficult to envision the payoff of a traditional buy and hold approach with stocks or bonds over time. Given that there is a reasonable chance of stocks and bonds moving in the same direction at times in the near future, alternatives could play a very important role within the portfolio in helping to minimize investment

correlation and ultimately risk and magnitude of loss. Alternatives aren't always flashy or exciting and have a tendency to underperform when markets are strong (depending on the alternative investment), but it's when things aren't going so well that they often show their merit in holding up total portfolio performance. We are recommending a weighting of 16% to alternatives within the portfolio. This would effectively bring the 50/50 stock to bond mix down to 42/42, as alternatives really don't fit within either category.

Bottom Line

In summary, we expect the road to be rocky over the coming months. There are significant risks on the horizon that may or may not rear their ugly heads. We have to respect these risks without running in the opposite direction, as we cannot forget that it's oftentimes in the face of these types of fears that markets have a knack for surprising. All the while, equities look like the most attractive medium to long-term asset class at the moment – bonds just aren't that appealing given low interest rates and carry their own risks as well. That said, we feel a reasonable exposure to equity is warranted, while focusing on minimizing volatility along the way through a careful selection of bonds/fixed income and alternative investments. (You may have accounts outside of this Core Diversified account that are managed more actively and according to a different set of criteria. This does not change our opinion around how a longer-term tactical asset allocation approach such as Core Diversified should be allocated at this time).

Please stay tuned for our specific Core Diversified portfolio changes in the coming weeks (Market Outlook – Part 2). We'd ask that you review the changes and respond to us accordingly to implement them within your account(s).

Have a great November!

The Cadence Investment Team

MAYFLOWER

The Mayflower was appraised at 128 pounds in 1624 when it was sold for scrap.

Using 3% inflation over the next 388 years – it would now be worth 12,247,661 pounds or $19,783,646.73 today!

MayflowerHistory.com

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