Equity Market Update

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The 3rd quarter continued to experience volatility that first surfaced in the previous quarter on Ben Bernanke's comments that the Federal Reserve was considering reducing its monthly mortgage purchases. The market see-sawed on every Fed governor speech and economic data release; however, the overall direction for stocks in the United States was higher. The S&P 500, along with mid-cap and small-cap companies, was trading at record highs before pulling back slightly to end the quarter up 22% year-to-date.

The market was captivated by the Federal Reserve in the dog-days of Summer and early-Fall. Business news channels frequently had guests giving their prediction on the amount and pace of tapering the FOMC would take, along with who they thought would replace Ben Bernanke as Chairman of the Federal Reserve once his term ends in January 2014. By the close of the quarter, both matters were resolved by surprising outcomes.

First, Larry Summers, the perceived front-runner to replace Mr. Bernanke, had to withdraw his name from consideration after many senators objected to his close ties to the financial-services industry. This left Janet Yellen, currently the Vice Chairman of the Fed, as the only viable candidate. Markets rallied on the news since Ms. Yellen is not expected to make any radical changes to the current Fed policy.

Next, the FOMC threw the market a curve ball at its September meeting by announcing they were taking no action to their current quantitative easing (QE) program. Once again, stocks rallied as the market was caught off-guard given their belief that the QE program would be reduced. Bernanke cited mixed economic data, along with uncertainty about the political willingness to reopen the government or raise the debt ceiling, as reasons for taking no action.

All of the focus on the Fed caused interest rates to gyrate in a wild manner. The 10-year US Treasury started the quarter at 2.5%, rose to almost 3%, and then fell back down to 2.6% by end the quarter. Interest rate sensitive stocks--REITs, telecom, utilities, and staples--were especially volatile during the quarter and underperformed the overall market. We used the volatility in these dividend-rich areas to increase and/or establish positions in our Equity Income portfolio.

Despite all the attention given to the Fed and Washington politics, the US economy continued its slow and steady improvement in the 3rd quarter. Manufacturing strengthened mainly on auto sales, and consumer spending remained firm on increased access to credit. The only blemish was housing, which weakened somewhat on higher mortgage rates. Economic data, as a whole, seems to indicate the US is in the latter stages of a mid-cycle expansion. This can also be seen by the outperformance of Financials, Consumer Discretionary, and Industrials over the other sectors. These indicators of growth are positive for our Core and Strategic Growth portfolios.

Our Core portfolios were also aided by our allocations to international and emerging markets. Economic data out of Europe seems to indicate the worst of the recession has passed, and they are beginning to enter the primary stages of

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an early-cycle recovery. Despite Europe's progress, their underlying uncompetitiveness on wages and labor, along with their sovereign debt issues, have remained largely unsolved. Emerging markets, on the other hand, remain much more volatile than developed economies due to China's disappointing economic growth and the prospects for higher interest rates in the US. Both developed international and emerging markets trade at a steep discount to US stocks. Morningstar believes Europe is the cheapest region to invest, and emerging markets' PE is five points less than the PE of developed markets, the largest disparity on record. This makes investing in these regions prudent despite their underperformance YTD.

Finally, the end of the 3rd quarter marked the five-year anniversary of the financial crisis. We have come a long way since those scary days in September 2008. To be more precise, the S&P 500 is 140% above the March 2009 lows. With the market once again making all-time highs, investors are feeling comfortable with equities. TrimTabs states US stocks have experienced positive inflows every month this year as investors increase their equity allocations. While this behavior could last for quite some time given the low interest rates, we believe it is prudent to reevaluate expected forward returns.

At nearly 16x 2013 estimated earnings, the S&P 500 is trading in-line with its average historical PE value going back to 1926. According to data provided to us by Fidelity, when the market trades at this valuation, the average return over the next five years is 6%, far less than what we just witnessed in the previous five years as stocks were coming off extremely low PE values.

The only way to replicate those returns is through robust earnings growth; however, growth in earnings has been decelerating in the past few quarters on slowing revenue and productivity gains. For example, look at the upcoming quarterly earnings season. Wall Street analysts were initially forecasting 6% growth for the 3rd quarter, but they have now cut the forecast to 2%, with much of that growth coming from stock buybacks. With all the media attention on politics and monetary policy, we believe this issue needs to be given more spotlight because valuations ultimately decide returns in the long-run.

With that being said, we continue to focus on owning growing companies with strong competitive advantages trading at reasonable prices. With the market trading near fair-value, in our opinion, our basket of ideas is not as large as the past few years; however, we continue to use market ups-and-downs to reposition the portfolios of all our equity styles among high quality companies with the most attractive valuations.

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