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Financial Market Commentary: 2nd Quarter 2014

Reacting to All-Time Highs

After the economy's sluggish start to 2014, the second quarter proved to be very positive for both the equity and bond markets. In fact, the S&P 500 has closed at record highs more than 20 times this year.[1] Looking across the entire investment universe, all major asset classes returned positive results during the second quarter and are now in the green for the year.

Investors looking for the "inevitable, next big pullback" to deploy cash have been undoubtedly disappointed by the market's resilience. This despite disruptions during the year including the ongoing unrest in Ukraine and the issues in Iraq which came to light during the second quarter. After brief periods of weakness in both January and June, the equity market was quick to continue its climb from its bottom in 2009.

Ultimately, lessons learned from the market can be punitive. By waiting for the perfect time to invest, investors are following the notion that one can effectively "time the market," and moreover "beat the market." However, historical data has shown that even the best money managers in the world have not been able to pull off this feat reliably over time. Despite this, individual investors continue to practice these destructive behaviors.

20 years Later

2014 also marks the 20th anniversary of DALABR's Quantitative Analysis of Investor Behavior. The report, which is intended to improve the performance of independent investors and financial advisors alike, measures the effects of investor decisions to buy, sell, and switch into and out of mutual funds over both short and long-term timeframes. The results have consistently shown that the average investor earns less, and in some cases much less, than the mutual fund performance reports suggest.[2]

Of course, poor investment results due to the effects of ill-timing have historically become evident while studying investor behavior during downturns. After significant losses, some investors have rushed to the perceived safety of cash, only to see the markets recover before redeploying the cash. This time around however, investors may be looking to exit the market before the next big meaningful correction.

Moving Forward

So what is an appropriate action to take based on the market's recent performance? The answer depends on your unique situation. For those that have been saving for a specific goal (e.g. to have enough money to purchase an annuity that will provide an acceptable level of income throughout retirement) and determine that the current balance will be enough to fund that goal, now may be an appropriate situation to sell. In other words, why continue to play the game if you've already won?

For the rest of us who are attempting to build wealth in an efficient manner consistent with our appetite for risk and unique financial situation, we should continue to pursue our goals through prudent investment strategies such as maintaining a diversified portfolio, rebalancing, and tax-loss harvesting. However, this does not include reallocating capital based on what you think is going to be the market's next move. The DALBAR study illustrates that investor decisions to buy and sell are overwhelming ineffective, and can lead to significant underperformance in the long-term.

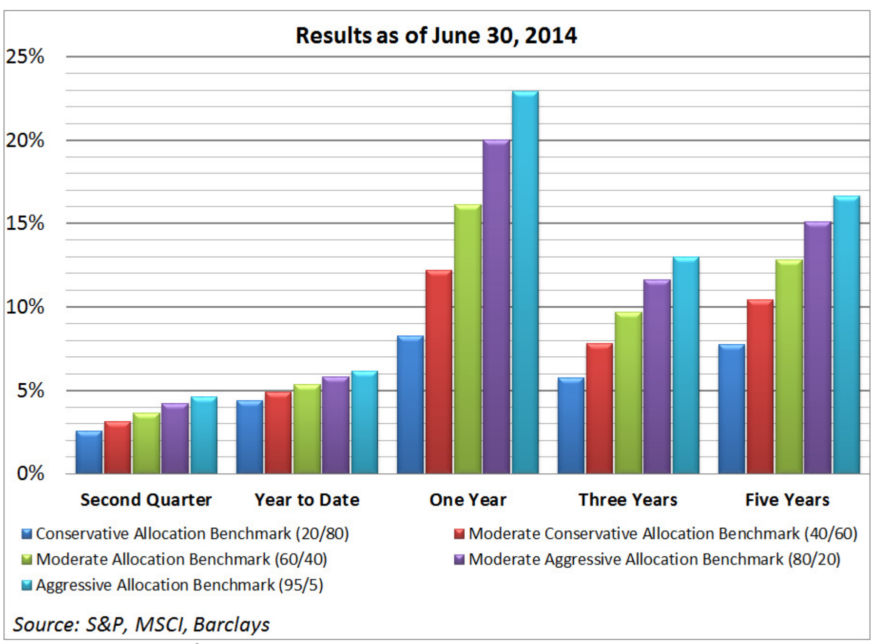
Bond Market Shows Relatively Strong Performance

A year ago, rates were moving up aggressively, as the rate on the 10-year Treasury Note rose over 1.25% over a relatively short 4-month time period. Market pundits warned of the prospect of rates rising even higher as the Fed wound down its quantitative easing efforts. Remember, as rates move up, the prices of bonds tend to go down. Fortunately, those dismal forecasts have not come to light. In fact, the trend of *decreasing* rates continued through the second quarter. The 10-Year Treasury Note rate stood at 2.51% at quarter-end, down from 2.72% it started the quarter at, and down from 3.03% it started the year at.[1]

Meanwhile, the Fed has continued to decrease it quantitative easing program as the economy has shown improvement. Namely the decrease in unemployment which stands at 6.1%[3] is below the Fed's 6.5% threshold for reconsideration of its zero interest rate policy. Much like equity markets, we take the stance that it is very hard to predict the next move in rates. However, relative to stocks, short to medium-term bonds have proved to be a suitable investment for conservative investors and as a store of value within a portfolio to reduce its overall volatility.

In Focus

The market has shown extraordinary resilience during the past five years. After the volatility throughout the great recession and in the years following including the "flash crash," it's understandable how one could make the assumption that the next big downturn is just around the corner. Rather than delaying your investment strategy by waiting for the perfect time to invest, employ an asset allocation strategy that has shown levels of volatility you are comfortable with *through all market cycles*, and let time take it from there.



[1] Yahoo Finance [2]DALBAR and Associates 2014 Report [3]ING U.S. Investment Management

Disclosure: Certain sections of this commentary may contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets.
The performance quoted represents past performance and does not guarantee future results. Investing involves risk including loss of principle. No investment strategy such as asset allocation or diversification can guarantee a profit or protect against loss in periods of declining values. Index returns are for illustrative purposes only and do not represent actual account performance. Indexes are unmanaged and one cannot invest directly in an index. Index performance returns do not reflect any management fees, transaction costs or expenses. The Internal Rate of Return (IRR) is used to calculate the true, money-weighted rate of return. Like the Modified Dietz calculation, the portfolio or asset is valued at the starting and ending points of the period. Cash flows are based on their timing. The IRR is related to the time-value of money or present value formula. It calculates the discount rate which will take the starting value and all cash flows to result in the ending market value. Performance returns for time periods longer than 365 days have been annualized.

Conservative Allocation Benchmark (20/80) is comprised of 10% S&P 500, 2% S&P MidCap 400, 1% S&P SmallCap 600, 6% MSCI Developed EAFE, 1% MSCI Emerging Markets, 80% Barclays Aggregate Bond.
Moderate Conservative Allocation Benchmark (40/60) is comprised of 21% S&P 500, 4% S&P MidCap 400, 2% S&P SmallCap 600, 11% MSCI Emerging Markets, 2% MSCI Emerging Markets, 60% Barclays Aggregate Bond
Moderate Allocation Benchmark (60/40) is comprised of 30% S&P 500, 7% S&P MidCap 400, 3% S&P SmallCap 600, 17% MSCI Developed EAFE, 3% MSCI Emerging Markets, 40% Barclays Aggregate Bond
Moderate Aggressive Allocation Benchmark (80/20) is comprised of 41% S&P 500, 9% S&P MidCap 400, 4% S&P SmallCap 600, 22% MSCI Developed EAFE, 4% MSCI Emerging Markets, 20% Barclays Aggregate Bond
Aggressive Allocation Benchmark (95/5) is comprised of 48% S&P 500, 11% S&P MidCap 400, 5% S&P SmallCap 600, 26% MSCI Developed EAFE, 5% MSCI Emerging Markets, 5% Barclays Aggregate Bond