

Newsletter – July 2013

MARKET TRENDS 06/30/2013

<u>US Stock Markets</u>	<u>Q2</u>	<u>YTD</u>
S&P 500 Index	3.4%	13.8%
S&P MidCap 400 Index	2.0%	14.6%
Russell 2000 Index	4.5%	15.9%

<u>Int'l Stock Markets</u>		
EAFE Index	-0.5%	4.1%
Emerging Mkts Index	-7.8%	-9.6%

<u>Fixed Income</u>		
Barclays Intermediate Gov't/Credit Bond Index	-1.8%	-1.5%
Barclays Capital Muni Bond 3 Year Index	-0.6%	-0.04%

<u>Commodities</u>		
SPDR Gold Shares (NAV)	-25.5%	-28.5%
Goldman Sachs Commodities	-5.7%	-5.4%

<u>Real Estate</u>		
Dow Jones US REIT Index	-1.6%	5.7%

<u>Yields</u>	<u>6/30/2013</u>	<u>12/31/2012</u>
T-Bills	0.03%	0.04%
10 Yr UST	2.49%	1.76%

Sources: Total Returns from WSJ Market Data Group, Standard & Poor's, Barclays

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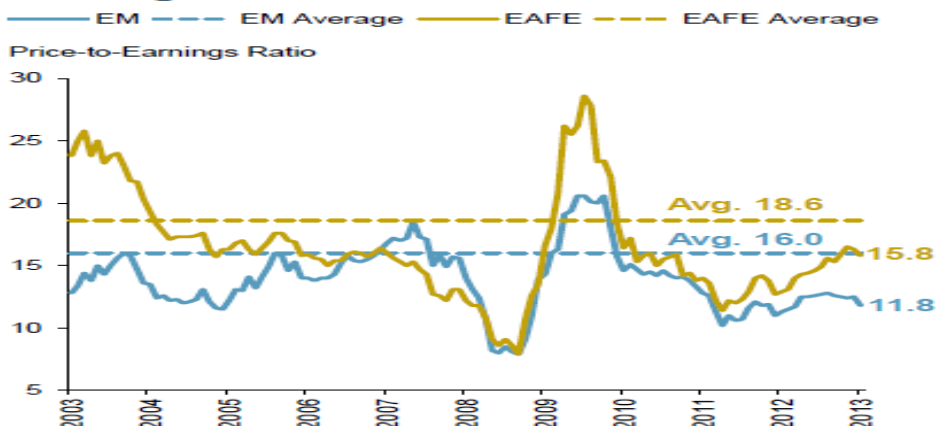
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Second Quarter 2013 Market Recap

As investor complacency increased throughout the second quarter, significant volatility returned by the end of the quarter to the equity, bond and commodity markets. **The sell-off was prompted by the Federal Reserve's release of their June minutes "hinting" at a possible pullback on its unprecedented low-rate policy.** Especially hard hit were bonds and dividend-paying stocks. Even with an equity correction of over 5% in the last five weeks of the quarter, most equity markets still managed to post positive returns with the major exception being emerging market equities. Domestic equity markets were led by small caps (Russell 2000 Index +4.5%) with large caps (S&P 500 Index +3.4%) and mid caps (S&P Mid Cap 400 Index +2%) close behind. International equity markets were weak in the quarter with developed markets down -0.5% and emerging markets down -7.8%.

So far this year, domestic small caps (+15.9%) have led the way as investors focus more on stocks that are less dependent on international economic growth. However, both mid caps and large caps have posted double-digit returns for the first half of the year while international developed markets are up only 4.1% and emerging markets down -9.6%. Emerging markets were negatively impacted by the Fed commentary, concerns about China's economy and political unrest in Brazil and Turkey. As we discussed in our last newsletter, our allocation to international equities, especially emerging markets, has been a drag on performance as U.S. equities have significantly outperformed. Although many concerns still persist, we continue to believe that allocations to international equities, particularly emerging markets, are appropriate and provide long-term growth opportunities.

Trailing 12-Month P/E Ratios

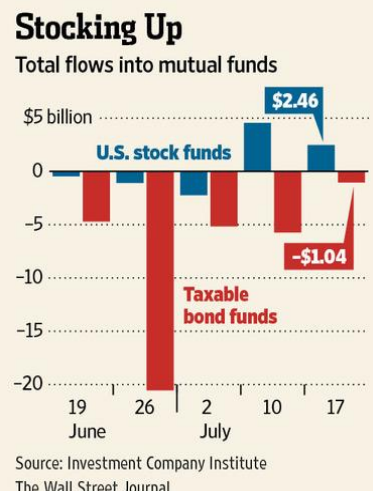


Long-term average P/E for emerging markets includes MSCI EM Index data for 1988–2013. Long-term average P/E for non-U.S. developed markets includes MSCI EAFE Index data for 1978–2013. Source: FactSet, Fidelity Investments (AART) as of 3/31/13.

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For the first time in years, bond investors experienced negative returns across various bond sectors during the second quarter. For example, intermediate governments returned -1.42%, intermediate municipals -3.2%, U.S. Inflation Protected Securities -7.2%, international -3.3% and emerging market debt -6.3%. The benchmark yield on 10-year U.S. Treasuries jumped to 2.6% from 1.6% in just two months before finishing near 2.5%. Investors withdrew \$43.8 billion from taxable-bond funds and \$16.4 billion from municipal bond funds, making June the worst month on record for bond funds in terms of total outflows, according to Morningstar.



However, this is only a small amount compared to the \$1.25 trillion that investors have poured into bond funds since 2007, while pulling \$388 billion from stock funds.

As investors experience negative bond returns, we might see an acceleration of bond fund redemptions and the question is how the money is reinvested: into money market funds with minimal yield and/or equities and/or alternatives? The irony is that rising bond yields from selling will make bonds more attractive!

With global economic growth concerns and the prospect of the Fed reducing its bond purchases in the near future, commodities (Dow Jones UBS Commodity Index) were down 8.7%. Gold prices fell 23% in the second quarter - the biggest quarterly decline since trading of U.S. gold futures began in 1974 and is down 32% since October 2012. The severe weakness in the gold markets may be indicating that significant speculation exists. Real estate also sold off, down -3.5% for the quarter while still up 3.1% for the first half of the year.

The Bernanke Taper

At the end of the second quarter, we experienced corrections in both the stock and the bond market. It was the first significant decline in the stock market since last September. As for bonds, the declines were far more dramatic. The drop in 10-year Treasury prices, raising yields from 1.85% to 2.49%, is historically significant for Treasuries, where volatility is typically much lower. The bond market sell-off elicited cries from pundits as full of hyperbole as one

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would expect. Commentators cautioned about the return of bond market vigilantes who would stop buying U.S. government debt. We also heard much conjecture and rumor on Bernanke’s state of mind in mentioning the potential tapering of the Fed’s monthly purchases of long term government bonds. Was he preparing the bond market for a change of policy in advance of his potential retirement from the Fed at the end of this year?

At Shorepoint, we try not to change our long-term investment thesis too hastily; and in this case, it has been our belief since 2009 that stocks would be more attractive than bonds and cash. Bernanke’s shot across the bow to the bond market would seem to support this view, though we were perhaps too early with it. We continue to believe stocks will revert to the mean in the years to come as will bonds; that implies that stocks, which have had a poor decade until recently, may do better than bonds, which have enjoyed a multi-decade bull market. We think the next move for the Fed will eventually be modest tapering and exiting the massive stimulus of the Bernanke era over many years, which will make fixed income investing trickier than in past cycles.

Over the past few years, we have been positioning the bond side of our portfolios carefully and somewhat unconventionally given the “bubble-like” state of Treasuries noted in our newsletters and at our client meetings. We have diversified fixed income away from U.S. Treasuries and into mortgage, floating rate, emerging markets, and bank loan bond funds. Though not a fixed income product, we have also employed MLPs (Master Limited Partnerships), which provide strong income (more than double the 10-year Treasury yield) and the opportunity for growth of distributions. Emerging market bonds have also come off of a terrible quarter as well, but we think the sell-off is overdone, especially for those with long-term time horizons and patience. The 4.8% yield of the J.P. Morgan Emerging Market Bond Index seems like fair compensation for the risk. Granted, all these bond sectors trade with more volatility than government bonds, but looking forward, which is our mandate, we would rather own positions in these sectors than U.S. Treasuries for now.

And as we have reiterated for four years, we still favor equities. We believe adding capital to stocks on weakness or correction makes sense for long-term investors. We continue to focus on companies that can grow their dividend distributions to shareholders over time and are trading at reasonable price to earnings ratios and compelling valuations. Granted, the search for cheap stocks is less fruitful than it was in 2009 and 2010.

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“Shorepoint see[s] the line of fair valuation on the horizon, but we aren’t there yet.”

“How we bear that uncertainty and risk may ultimately be the most significant factor in how well we do as long-term investors.”

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Howard Marks’ Pendulum, On Bearing Risk

Luis and I read a new book by Howard Marks that had many thoughtful ideas on how investors behave - the very core of how markets work. In The Most Important Thing, Marks compares the valuation of assets in the market as a pendulum rather than a set point of truth. For example, the pendulum and appetite for stocks in 2008 and 2009 swung to a deep undervaluation of the actual prospects for making money in equities by the market. People were scared – understandably so. How many people can add money to an investment knowing that the next statement will likely show that they have suffered a loss on the value of their contribution? The momentum was for stocks to go down, creating within that destructive process the seeds in pricing for recovery.

In 2013, we find the pendulum swinging back from undervaluation in stocks toward a midpoint, if you will, on the way perhaps to overvaluation, if history is a guide as it often is. Currently we at Shorepoint see the line of fair valuation on the horizon, but we aren’t there yet. Granted there will likely be a significant period of overvaluation and that is where as your advisors, we need to become contrary - slowly, incrementally and agonizingly methodical in our execution. And this will make us unpopular with you for a time as we begin selling stocks into strength (hopefully) to invest in bonds and cash that actually have yield. We will be more cautious as stocks go higher, driven by cabbies and hot tips and a new sense of hubris - well, not really new as history always rhymes with itself.

Howard Marks also points out an important yet simple concept. We need to remember that all of these investments that we make bear risk. As investors, we bear the potential loss of our money with the potential reward. How we bear that *uncertainty* and risk may ultimately be the most significant factor in how well we do as long term investors. Modern life doesn’t help us with investing, which, like life, is messy, unpredictable, beset by levels of pain and reward; it’s sloppy and organic - more like the tending of fields and crops than most CNBC viewers would believe. We take pills to ward off pain. We are enabled by technology with texts and emails which give us instant power to ward off discomfort or address issues - or so we think. We would argue that many of these new influences make market cycles feel even longer to people today than in the past, making it harder to bear pain, confusion, discomfort, and, yes, risk, which is really at the heart of investing well.