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Financial Market Overview

U.S. stock market performance in 2013 shocked investors with big gains. The fourth quarter of 2013 ended with the Dow Jones Industrial Average posting the best annual return since 1995. The broad U.S. stock market scored its best annual gain in sixteen years. The Dow Jones Industrial Average rose 27% during 2013.

The Total Market Index, the broadest measure of the overall U.S. stock market, was up 10% during the fourth quarter and rose 33% (including dividends) over the entire year. Large, mid-size and small-company stock indexes all posted positive returns ranging from 7% to 10% during the fourth quarter.

International stocks also rose 6% during the fourth quarter. However, the 21% total annual return for 2013 still trails U.S. stocks by nearly 10%. The disparity in performance continues for emerging market (smaller international countries) stocks which are trailing domestic stocks by a significant margin. Emerging markets were up 3.5% during the fourth quarter, but finished the year in negative territory (down 3.5%).

As expected, the total return (income less price decline) for intermediate and long-term bonds (regardless of quality) was negative during the fourth quarter. As the year ended, bond returns declined between -2% and -8%, ending a thirty-year winning streak of positive annual returns. Rising interest rates adversely impact bond values and more interest rate increases are expected. Once again, the most conservative asset class (bonds/fixed income) continues to perform poorly and will continue more of the same negative performance as interest rates rise.

The U.S. dollar continues to decline in value relative to most currencies. Gold prices also declined after posting a positive third quarter performance and ended the year down 25%. Real estate (REITs) posted a flat return during the fourth quarter and a very modest 3% return for 2013.

The following chart displays sample returns of various asset categories during the fourth quarter of 2013:

Yr-to-Date 2013	4th Qtr. 2013	Index Return (*includes dividends reinvested*)
+ 26.5%	**+ 9.5%**	**Dow Jones Industrial Average (^DJI)**
+ 32.3%	**+10.5%**	**Standard & Poor's 500 Index (^GSPC)**
+ 33.5%	**+10.0%**	**DJ U.S. Total Stock Market (VTI)**
+ 33.1%	**+10.3%**	**Large-company stock-Growth (IWF)**
+ 32.1%	**+ 9.9%**	**Large-company stock-Value (IWD)**
+ 35.5%	**+ 8.1%**	**Mid-Size Stocks – Growth (IWP)**
+ 33.2%	**+ 8.5%**	**Mid-Size Stocks – Value (IWS)**
+ 43.3%	**+ 7.9%**	**Small-company stock- Growth (IWO)**
+ 34.3%	**+ 9.3%**	**Small-company stock- Value (IWN)**
+ 21.4%	**+ 6.1%**	**International (EFA)**
- 3.6%	**+ 3.9%**	**Emerging Markets (EEM)**
+ 2.3%	**- 0.8%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 0.2%	**- 0.1%**	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
- 6.1%	**- 2.2%**	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
- 27.1%	**- 7.9%**	**Gold (GLD)**

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A SINGLE ASSET CLASS PORTFOLIO BEATS DIVERSIFICATION IN 2013

A simple plain-vanilla portfolio of only U.S. stocks performed much better than a more complex or diversified portfolio of various asset classes. The more investors diversified their portfolios last year, the worse their performance. The safe category, fixed income (bonds), declined more than 5% during 2013 – its first annual loss in 30 years. International and emerging stocks underperformed U.S. stocks by a wide margin. And given all of the uncertainty last year (budget deficits, political discord, terrorist attacks, implementation of the Affordable Care Act, etc.), it would seem prudent for investors to hold a portion of their portfolio in gold as a hedge against uncertainty, rising interest rates and inflation. Gold closed down over 25% during 2013.

Normally, commodities are worth holding during a rising stock market when accompanied by increased global economic growth. In 2013, U.S economic growth improved less than 3% and international growth was anemic as well. The DJ Commodity Index dropped over 8% last year. The list goes on.

Everyone was caught by surprise. Individual investors and professional investment managers alike had no expectation for 30% gains in U.S. stocks. At the beginning of last year, a poll of 11 top Wall Street strategists predicted the S&P 500 stock index would rise 8.2% in 2013 – the actual return was about 30%.

While financial journalists are busy writing articles today justifying why U.S stocks advanced 30% last year, the truth is there isn't an adequate explanation that supports such a monstrous return for U.S. stocks. Likewise, we were unable to forecast and later provide an adequate explanation for why U.S. stocks declined nearly 40% in 2008. But, who cares this time! If the surprise performance is up and in your favor, just smile, take your gains and move on to the next year.

ECONOMIC AND FINANCIAL MARKET OUTLOOK

If the U.S. and global economies are truly on the verge of regaining moderate economic growth, continuing improvement in job growth, reducing government deficits and continuing improvement in corporate earnings, then the big stock market advance last year was correctly anticipating this improved economic scenario.

The U.S. economy is finally building some momentum. The rate of growth in U.S. Gross Domestic Product (GDP) has improved. The economy grew at a healthy annual rate of 4% in the third quarter and 2.5% over the previous four quarters. A three percent rate of growth in GDP over a long period of time is often considered ideal. Our economy was not robust, but it wasn't as weak as it was in previous years.

While the unemployment rate is still relatively high, it has dropped to 7% from 7.8% over the past year. In addition, consumer confidence (also a good measure for spending) is rising along with the U.S. stock market. Corporate earnings are growing, even though many companies have achieved their earnings growth by cutting costs and not by increasing sales.

Other improvements include the increase in most home prices over the past year. Another measure of investor confidence is their willingness to buy initial public stock offerings. Several successful biotech firms and other companies such as Twitter and Facebook had no problem selling stock to eager investors.

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Overall, our economic circumstances have improved somewhat over the past 12 months. But the improvement in the areas discussed above does not adequately explain why a 30% increase in overall U.S. stock prices is justified. Investor psychology and confidence, world events, politics, day-trading, the momentum of the market and many other factors affect stock prices over the short term. Perhaps the biggest factor affecting the U.S. stock market over the past year was momentum.

As prices rise (whether stocks, gold, real estate, etc.), more investors follow. More importantly, many other asset classes are earning modest, flat or negative returns (real estate investment trusts, emerging markets, gold, bonds, etc.) making stocks even more attractive. Investors have sold several hundred billion dollars of individual bonds and bond mutual funds in 2013. The bond sale proceeds must eventually be reinvested and many alternatives are not attractive. Bank CD's are paying 1%-2%, money market funds earn less than ½%, international stocks are lagging behind the U.S. stock market and gold is plummeting. On the other hand, U.S. stocks have performed surprisingly well.

As a result of stocks singular rise in 2013, it is very likely that money will continue to flow into U.S. stocks and it is a common occurrence for investors who missed out on spectacular returns to follow or chase last year's winner(s). Investors appear to be developing more confidence in holding U.S. stocks.

In summary, when the financial markets deliver a surprising positive rate of return, just accept the good fortune. Looking ahead, everyone must answer the nagging question: Has the U.S. economic situation improved sufficiently to justify a 45% gain in stock prices over the past two years? If not, are we on the right track to achieve economic improvement that will support the stock market gains earned over the past two years and propel the markets higher?

It seems to me the stock market is way ahead of itself (from an economic/growth perspective) but could continue advancing over the short term as more investors jump on board. We simply don't know whether meaningful economic improvement is imminent to justify a 45% advance in stock prices over the past two years or not. The stock market has always had a psychological and forward-looking element to it which dominates prices over the short-term. If actual economic progress doesn't match the earlier anticipated expectations, then the recent stock market advance will not hold.

Our portfolio management strategy remains the same. We will maintain our equity (stock) exposure with preference for stable and mature dividend-paying companies over aggressive growth. New clients or new increases in cash deposits will be invested ratably over time and during lower-risk entry points. Our downside strategy is in place to reduce equity holdings if necessary.

U.S. fixed income or bond investments of any kind – Treasury, corporate or municipal, are very unattractive. Rising interest rates cause bond prices to decline and the longer the maturity of the bonds, the greater the price decline. We expect interest rates to continue rising at a slow or moderate pace over time regardless of the level of economic activity. The longer our government's deficit spending continues, the greater the pressure on rising interest rates. Presently, our primary remaining bond investment is international or

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foreign government bonds denominated in foreign currency.

COPIES OF 2013 INCOME TAX RETURNS

Please send paper or electronic (email) copies of your 2013 income tax returns to our office as soon as they are available. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

Clients who are in the top income tax brackets should expect to pay more taxes by April 15th. The new higher capital gains tax (from 15% to 20%) and the new 3.8% Medicare tax on "unearned income" (interest, dividends, rental income and basically most anything except wages) was in effect for the entire 2013 year. While employers must withhold the 3.8% Medicare Tax for top tax bracket taxpayers, there will be many instances where a two-income family may not owe any Medicare tax on his or her own wages, but the incomes of both taxpayers combined (filing a joint return) may result in a small to large Medicare tax liability that neither spouse had withholding to cover it.

Please review and forward our Income and Realized Gain/Loss Reports to your tax preparer at your earliest convenience. After we receive copies of your Schwab 1099 statements (interest, dividends, gains) in late January and early February, we will review and reconcile Schwab's figures with our records to make sure everything is accurate.

Happy New Year!

Best regards

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