ABULS, BONE & ELLER GROUP

OF

RAYMOND JAMES®

OCTOBER 2014

## IN THIS ISSUE



# LOOKING INTO THE CRYSTAL BALL

*"You don't climb mountains without a team, you don't climb mountains without being fit, you don't climb mountains without being prepared and you don't climb mountains without balancing the risks and rewards. And you never climb a mountain on accident – it has to be intentional."*

- Mark Udall

We spent a couple of days at an industry conference and many days of conference calls and manager visits during the past quarter. The conference was a Raymond James semi-annual retreat for discretionary managers hosted by our asset management services group. It is a good group of some of our brightest and forward-thinking peers, hosted by some of Raymond James better support teams in the investment management area and always has an outstanding group of industry professionals outside Raymond James as contributors and guest speakers. We always find it informative and return with some constructive ideas to help improve our investment policy or our practice management.

There were two sessions and themes that left an impression on us from the last conference; bench-marking investment performance and portfolio model management. We have actively produced portfolio performance for over 20 years in one form or another. Many of you have known nothing else. However, as it compares to other financial advisers this was as rare as a Cubs World Series victory 20 years ago. And today, though not as rare as it was 20 years ago, performance reporting remains a rarity for retail clients even today.

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Chris Davis, portfolio manager of the Davis New York Venture fund, in their 2014 fall commentary addressed some concerns about passive versus active management and the likelihood of active management out-performing over the long-term. He wrote the following, "These characteristics include an alignment of interests, significant experience, a willingness to look different, a long-term time horizon, a consistent and disciplined framework, and individual accountability." We would like to think we embody all of these in our investment management process. As it relates to portfolio performance and benchmarking, 'individual accountability' is the reason we considered it necessary to provide our investment performance many years ago; i.e. accountability to ourselves for our internal objectives and accountability to our clients for the success in achieving your goals.

Particularly since the financial crisis, there has been an industry push to deemphasize performance in financial advisory practices. Generally, it is because performance has been difficult to achieve with the tech and telecom crisis followed by the financial crisis of 2008. We have always considered our performance reports one of the most transparent and honest expressions in black and white of how we make a contribution to your financial well-being

In the majority of our earlier years, portfolio performance was a positive conversation due to exceptional markets and our allocation to asset classes that proved to be favorable in the global financial markets. In the last several years, performance has sometimes lagged our benchmarks. In the long-term we are still pleased with the performance results. And as we look at our current investment policy, we remain confident our results will support your financial goals and meet the expectations and high professional standards we have set for our work on your behalf.

Investment performance can be analogized to the engine in a car. Without it, things will not move forward. However, much like the engine is not the only vital or important aspect of a car (consider the absence of no brakes or lights for a brief second), portfolio performance is only one aspect of wealth management. Other contributors such as a written financial plan, proper insurance planning, adequate savings, intelligent tax management, thoughtful estate plans, and maybe the most important 'behavioral management or counseling' during personal and market crises all add up to our value proposition in helping your family achieve financial success. The 'value of advice' contains all of these elements and more.

Portfolio model management was another topic of note at the conference. In laymen terms this means what is your plan for investing. When we talk to other advisors or individual investors we are frequently concerned by the lack of an articulate plan others have for their investments. Additionally, we are often alarmed at the frequent reconstruction some advisors and investors have of their investment plan.

For 30 years we have been witness to some of the best money managers in the world. Without exception, they have remained true to their core philosophies and processes and they are never year in and year out at the top of performance rankings. They have been willing to be **out of favor** in the short-term to be **favored** in the long-term.

We describe our investment style as being active, strategic, global, value-oriented asset allocators. It too has its ups and downs. **'Active'** often means contrarian and we will zig when others are zagging. **'Strategic'** means we are longer-term in our planning and it will often take longer for our expectations to be realized. **'Global'** entails looking at asset classes across the world and all the financial, political, social and monetary dynamics that encompasses. Getting all those variables to cooperate based on our analysis is often not a concise and quick result. **'Value-oriented'** requires one to be early in setting the foundation for future investment returns. Value suggests buying when prices are lower and generally out of favor. Assuming the pricing analysis is correct, the timing aspect to realizing the value is impossible to predict in any short-term period.

Our global and value-orientation attributes contributed to better performance during the early 2000's and has been a detractor leading into 2014. Our small cap over-weight and growth stock under-weight contributed to performance in the early 2000's. Our early exit from small cap stocks in the last 5+ years detracted from performance. In 2014 our small cap over-weight is beginning to show its potential promise and we remain confident in our convictions.

Another of our strong conviction today lies in our international allocation. The US stock market has significantly out-performed the broad international stock markets in the last 5 years. For example the S&P 500 has returned 15.70% and the MSCI EAFE has returned 6.56% for the 5 years ending September 30, 2014.

The mixed news coming out of Europe and to some extent Japan has beaten down security prices in international markets. By some estimates, US equities are trading at a 60% premium to international stocks and an 80% premium to emerging market stocks on a price-to-book valuation metric (Brandys Investment Partners July 2014 'International Equities Now: the Why and How').

As we watch the managers of active allocation funds and global equity funds, we have noticed a growing allocation to international stock in their portfolios. In many instances, international stocks now represent the most heavily weighted asset class in the portfolio. This is particularly true for price-conscious value investors.

One theme espoused from several of our management visits recently was a disconnect between corporate profits and valuations in the US and internationally. Corporate profits in the US are riding elevated levels. A frequent question is whether they can sustain their current pace. When combined with faster rising security prices, the earnings growth story raises questions about the sustainability of higher US stock prices.

On the other hand, corporate profits in Europe are analyzed by many to be lower than average in the current economic cycle. If this is true, and they have the ability to return to just average metrics, when combined with lower stock prices the potential return for international stocks is compelling. We are witnessing our international managers notably increasing their allocation to European and Japanese stocks. As value investors, we are encouraged by what appears to be a mispricing in this asset class and our manager's active plan to take advantage of the opportunity.

## THE ABULS, BONE & ELLER EQUITY ALLOCATION AS OF SEPTEMBER 30, 2014:

| | |
|---|---|
| Large Cap Value | 22% |
| Large Cap Growth | 22% |
| Small Cap Value | 1.5% |
| Small Cap Growth | 0% |
| International Large Cap | 25.5% |
| International Small Cap | 4% |
| Emerging Markets | 6.50% |
| Natural Resources | 4.5% |
| Allocation Funds | 10% |
| Cash | 4% |
| Total | 100% |

## THE ABULS, BONE & ELLER INCOME ALLOCATION AS OF SEPTEMBER 30, 2014:

| | |
|---|---|
| Core Bonds | 60% |
| Global Bonds | 20% |
| Multi-Sector Income | 10% |
| Allocation Funds | 10% |
| Total | 100% |

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## REQUIRED DISCLOSURES

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# HELP US HELP YOU

The group of Abuls, Bone & Eller is committed to providing you the highest possible level of service. Last quarter we addressed our most popular request with the most questions– funds disbursements. This quarter we would like to clarify Letters of Authorization – the two types and the requests which most often require them.

## ONE TIME LETTER OF AUTHORIZATION

The one-time authorization is most frequently used when requesting a check, wire, or journal of funds to a third party. Any recipient other than the Raymond James account owner is considered a third party. We do have forms for each of the above types of transactions; please call our office for more information. If you decide to forward your own, please supply the following:

- **THIRD PARTY CHECK REQUEST OR WIRE TRANSFER**
  - o Transfer amount
  - o Third-party name, address and relationship
  - o Wires only, please add–
    - ■ Recipient bank name, routing number and account number
  - o Any additional information required by the recipient to ensure proper credit (i.e. reference information, further credit to, etc.)
  - o Signature of all account owners
    - ■ The signature(s) must be on your request and any subsequent pages supplied by a third-party (such as a bank, title company, plan administrator, etc.)
- THIRD PARTY JOURNAL REQUEST (To/from a Raymond James Account)
  - o Account Name
  - o Account Number
  - o Dollar amount or securities to be moved
  - o Signature of all account owners.

## STANDING LETTER OF AUTHORIZATION

A standing letter of authorization is created when a client anticipates frequent check requests, wire transfers or journal requests to the same third-party recipient. Just as the one time letter, we can provide you a form or you can supply your own. Please provide the same information as above but specifically indicate that you are granting standing authorization. Once approved, this is valid for up to two years.

## COMING IN 2015!

eSignature is Raymond James' solution to provide an easy, efficient, and secure method to obtain electronic signing of eligible Raymond James forms while ensuring the identity of the signing parties. Raymond James has partnered with DocuSign to provide this safe and secure online document-management service. This is currently in beta testing and is expected to be available within the 1st quarter of 2015. Until then please forward your signed request via scan and email, fax or mail. We cannot accept authorization via phone or typed email.

# PORTFOLIO CAPITAL GAINS IN 2014

We are tax conscious investors and employ managers who exhibit low turnover in most cases. Yet, this year is shaping up to be a year we are anticipating portfolio income, in particular capital gains, will be larger than average. Capital gains are anticipated to be more than average for two reasons.

First we expect fund capital gain distributions to be larger than average. In a typical year we might estimate equity fund capital gain distributions at 2% of the current market value; e.g. $500,000 market value would produce $10,000 of capital gain distributions and $1500 of capital gain tax. We are anticipating equity fund distributions to be approximately 5-6% on average in 2014. The markets are in the fifth year of a profitable stock market cycle. As a result, the managers of stock funds have unrealized gains in their portfolios. With current valuation levels higher and stock price sell targets being reached, fund managers are selling positions and realizing larger than average gains.

The second reason for more realized gains is due to our active rebalancing of portfolios in 2014. In general, we were more active than normal in selling equity allocations and rebalancing to income investments. As the stock market has grown proportionately faster than the fixed income markets, we have trimmed equity allocations to balance the portfolio allocation between equity and income investments.

For some investors, portfolios are in a distribution phase. These portfolios have potentially required more sales of equity assets, as well. As interest rates have reached 30-year lows, the amount of income portfolios can generate from interest and dividends is low; i.e. 2.50% to 3.50%. Therefore, in some cases the sale of principal is required to supplement the lower portfolio yields available today.

The good news is that portfolios have experienced good gains and the capital gains will be taxed at the federal level at a 15% marginal rate in most instances. None of this is applicable to tax qualified accounts such as IRAs.

Do not hesitate to contact us about an estimate of your portfolio taxable income. You may want to share these estimates with your tax preparer. Any adjustments to quarterly taxes can be made in the fourth quarter filing if necessary.

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## HINDSIGHT IS 20/20

*"It isn't the mountain ahead that wears you out; it's the grain of sand in your shoe."*

\- Robert W. Service

The equity markets climbed to their highest levels in history during the third quarter. The third quarter 2014 saw the return of volatility in the financial markets. We have talked about an absence of downside volatility in the equity markets for several quarters. With hints of evidence that global GPD may be slowing, notably the Eurozone, the global markets experienced wide swings in price changes. Additionally, the markets seem to be pricing risks with more discretion as riskier assets such as US small cap stocks (Russell 2000 index -7.40%) experienced significantly larger losses during the quarter than the US broader market (S&P 500 1.10%).

As we complete this writing on October 10, the equity markets have continued their sell-off. The major averages are approaching a 5% decline from the peak. Long-term an annual peak to trough decline of approximately 14% is average. We are not alarmed by this move. In fact a move down of 10-15% from peak levels may be helpful to attract some capital that remains on the sidelines and serve as a reminder that the equity markets do experience price swings.

Due to the economic concerns in Europe, the international equity markets were under-performers for the quarter. Germany is the driver for the European economy. There was weakness in economic output for Germany during the 3rd quarter and it dragged markets down with it. The German market in dollar terms was down -11.20% during the quarter.

| Index | Description | 3Q14 | 10-Yr Annualized |
|---|---|---|---|
| Russell 2000 | Small US Stocks | -7.40 | 9.10% |
| S&P 500 | Large US Stocks | 1.10 | 7.40% |
| MSCI EAFE | International Stocks | -5.80 | 7.40% |
| Diversified EM | Emerging Markets Stocks | -3.40 | 11.50% |

Drilling down to a deeper view of the US equity markets shows an even larger disparity in US equity returns. For the quarter, there was a 10.10% return differential between large cap growth 1.50% and the least performing small cap growth -8.60%. Year to date performance differences are even larger with large blend stocks at 8.30% and small cap growth stocks at -4.70%.

## 3Q2014 US EQUITY RETURNS

| | Value | Blend | Growth |
|---|---|---|---|
| Large | -0.20% | 1.10% | 1.50% |
| Small | -8.60% | -7.40% | -6.10% |

## YTD 2014 US EQUITY RETURNS

| | Value | Blend | Growth |
|---|---|---|---|
| Large | 8.10% | 8.30% | 7.90% |
| Small | -4.70% | -4.40% | -4.0% |

We have been actively over-weighting our US equity allocation in our model portfolios to large cap stocks during the current market cycle. With the sale of the balance of our small cap growth position in July of 2014, we have the smallest allocation to small cap stocks in our memory. To date we have only a 1.50% allocation to US small value stocks in our 100% equity allocation. This has proved to be a positive for performance year to date and our expectations are for continued large cap stock out-performance for the for-seeable future.

US fixed income experienced positive returns in the 3rd quarter. The 10-year treasury yield was relatively flat during the quarter; i.e. 9/30/2014 yield of 2.52% versus a 6/30/2014 yield of 2.53%. Surprisingly to most, the 10-year treasury has provided a strong return of 6.93% year to date. Dropping yields across the board have boosted bond prices and provided more attractive total returns than many anticipated beginning 2014.

Year to date total returns for fixed income investors have been attractive. Emerging market returns are leading all asset classes with a total return of 8.0%; followed by municipals 7.20% and mortgage –backed debt at 4.20%.

| Index | Bond Description | 3Q14 | YTD |
|---|---|---|---|
| Gbl High Yield | Global Low Quality | -3.3 | 2.6 |
| MBS | Mortgage Backed | 0.2 | 4.2 |
| Gbl Corporate | Global Corporate | -2.3 | 2.9 |
| Barclays Agg. | A Market Weighted Blend | 0.2 | 4.1 |
| Municipal | Intermediate-Term Municipals | 1.5 | 7.2 |
| Treasury | US Treasuries | 0.3 | 3.1 |
| EMD | Emerg Markets Local Currency | -5.7 | 0.0 |
| TIPS | US Treasury Inflation Protected | -2.0 | 3.7 |
| EMD USD | Emerg Market Debt – US $ | -0.6 | 8.0 |
| Gbl Sov | Global Government Debt | -5.3 | 0.3 |

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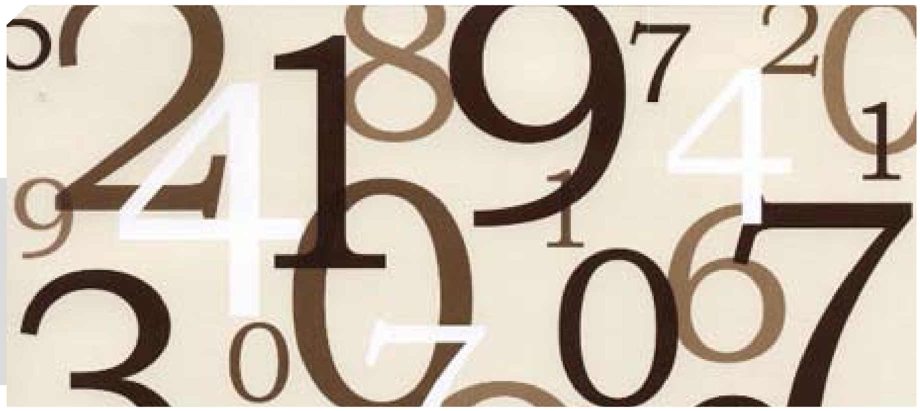

# A LOOK AT THE NUMBERS
## AS OF 09-30-2014

| | Current Yield | Last Quarter | Last 12 Months | Last 3 Years | Last 5 Years | Last 10 Years |
|---|---|---|---|---|---|---|
| Major Indexes | | | | | | |
| DJIA | 2.29 | 1.87 | 15.29 | 19.02 | 14.85 | 8.15 |
| S&P 500 | 2.04 | 1.13 | 19.73 | 22.99 | 15.70 | 8.11 |
| NASDAQ | 1.36 | 2.24 | 20.61 | 24.57 | 17.51 | 10.06 |
| RUSSELL 2000 | 1.45 | -7.36 | 3.93 | 21.26 | 14.29 | 8.19 |
| EAFE | 3.56 | -5.88 | 4.25 | 13.65 | 6.56 | 6.32 |
| Bloomberg Commodity Index | - | -11.83 | -6.58 | -5.34 | -1.37 | -1.04 |
| FTSE NAREIT REIT Index | 3.93 | -2.48 | 13.17 | 17.17 | 16.17 | 8.53 |
| Equity Asset Classes | | | | | | |
| U.S. Large Cap Value | - | -0.55 | 16.35 | 21.41 | 13.69 | 7.19 |
| U.S. Large Cap Growth | - | 0.68 | 16.24 | 21.28 | 14.60 | 8.26 |
| Mid Cap Value | - | -3.42 | 13.56 | 22.86 | 15.01 | 8.68 |
| Mid Cap Growth | - | -2.29 | 10.05 | 20.14 | 14.82 | 9.07 |
| Small Cap Value | - | -7.14 | 6.31 | 20.98 | 13.57 | 8.01 |
| Small Cap Growth | - | -5.80 | 2.78 | 20.06 | 14.84 | 8.63 |
| Foreign Large Cap Value | - | -5.96 | 4.62 | 13.01 | 5.84 | 5.67 |
| Foreign Large Cap Growth | - | -5.29 | 3.24 | 13.18 | 7.37 | 6.62 |
| Emerging Markets | - | -3.47 | 4.81 | 7.92 | 4.28 | 9.83 |
| Fixed Income Asset Classes | | | | | | |
| CD – 1 Year | 0.50 | | - | - | - | - |
| CD – 3 Year | 1.45 | | - | - | - | - |
| CD – 5 Year | 2.15 | | - | - | - | - |
| Treasury 5 Year | 1.78 | | - | - | - | - |
| Treasury 10 Year | 2.52 | | - | - | - | - |
| 6 Month T-Bill | 0.03 | | - | - | - | - |
| Muni Bond Index | 2.84 | 1.03 | 5.84 | 3.66 | 3.87 | 3.72 |
| Barclays U.S Agg Bond Index | 2.18 | 0.17 | 3.96 | 2.43 | 4.12 | 4.62 |
| High Yield Bond Index | 5.80 | -1.94 | 7.08 | 10.62 | 10.36 | 7.98 |
| CPI | - | 0.87 | 2.08 | 1.85 | 2.05 | 2.32 |
| Prime Rate | 3.25 | - | - | - | - | - |
| Broker Call | 2.00 | - | - | - | - | - |

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