



Johnston Investment Counsel

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The Frugal Habits of Millionaires



The word "millionaire" typically conjures up images of a lavish, jet-setting lifestyle, but behind the scenes, that may not always be the case. Like Warren Buffett, who famously still lives in the relatively modest

house in Omaha, Nebraska, that he bought in 1958 for \$31,500, many millionaires (and billionaires) live a modest, if not downright frugal lifestyle--a lifestyle that may have helped them become millionaires in the first place.

We've all heard the saying "It takes money to make money." So how can you find extra dollars to save and invest? If you're looking to improve your financial position, consider putting some of these habits into practice.

Cultivate a frugal mindset

Many people equate being frugal with being cheap, but that's not really correct. Being frugal means carefully watching your dollars and not spending more than you need to--a trait many millionaires employ. To help cultivate a frugal mindset, get in the habit of asking yourself this question: "With a little extra effort and/or sacrifice on my part, is there any way I can save money here?" Having a frugal mindset can really help when it comes time to playing the role of American consumer, where temptation is everywhere.

Buy wisely and sparingly

We all need "stuff" now and then; the key is not overdoing it or overpaying for it. Try to buy mostly what you really need, not what you really want. Money you save can then be used to build your savings and investment accounts.

Don't let the price tag of your car, home, or designer suit define your character. For example, a reliable car that safely gets you from Point A to Point B may be completely sufficient for your needs. According to the book *The Millionaire Next Door*, the top car brand among millionaires is Toyota, not Mercedes or BMW. Even Mark Zuckerberg, the billionaire founder of Facebook, has been spotted driving an Acura TSX, an entry-level luxury car whose

base price is about \$30,000. The bottom line? As you move up the net worth ladder, avoid the temptation to elevate your "status" by overspending on luxury goods.

You can be smart about everyday consumer purchases, too. You might be surprised to learn that many millionaires clip coupons, buy in bulk, wait for sales, scour eBay and Craigslist for deals, limit clothing purchases, fly coach, avoid credit cards, and save half their restaurant meal for lunch the next day--habits that can free up cash for the occasional splurge.

Shun debt

Debt is bad. Well, mostly. At times taking on debt is necessary, for example when buying a home or attending college, because without it, many people won't have saved enough money. But generally speaking, you should be leery of taking on debt for things that cause you to live beyond your means. Remember, every dollar you borrow today is a dollar you'll have to pay back tomorrow, with interest.

People who turn a modest financial base into wealth often do so by living frugally, saving regularly, investing wisely, and avoiding debt. By contrast, people who end up in a perpetual cycle of debt are often those who spend and borrow excessively to support an unsustainable lifestyle.

Take action

What do CEOs Tim Cook (Apple), Ursula Burns (Xerox), Robert Iger (Disney), and Indra Nooyi (PepsiCo) have in common? They're all up by 5:00 a.m., hitting the gym, reading, working. As Benjamin Franklin famously quipped: "Early to bed and early to rise makes a man healthy, wealthy, and wise." And indeed, many millionaires and leaders aren't couch potatoes. They don't sit around waiting for things to happen; they make things happen--by getting up early, working hard, looking for opportunities, constantly educating themselves, taking calculated risks, networking, staying active, and generally trying to improve themselves day in and day out. And with the explosion of information online 24/7, learning new things has never been easier.

February, 2014

The Frugal Habits of Millionaires
Filing Your 2013 Federal Income Tax Return

Bonds vs. Bond Funds: Which Is Better
When Interest Rates Rise?

Are you ready to retire?



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Filing Your 2013 Federal Income Tax Return

For most people, the due date for filing a 2013 federal income tax return is April 15, 2014. Here are a few things to keep in mind this filing season.

Lots of changes to consider

While most individuals will pay taxes based on the same federal income tax rate brackets that applied for 2012, a new 39.6% federal income tax rate applies for 2013 if your taxable income exceeds \$400,000 (\$450,000 if you're married filing jointly, \$225,000 if married filing separately). If your income crosses that threshold, you'll also find that a new 20% maximum tax rate on long-term capital gain and qualifying dividends now generally applies (in prior years, the maximum rate was generally 15%).

You may also need to account for new taxes that took effect in 2013. If your wages exceeded \$200,000 in 2013, you were subject to an additional 0.9% Medicare payroll tax--if the tax applied, you probably noticed the additional tax withheld from your paycheck. If you're married and file a joint tax return, the additional tax kicks in once the combined wages of you and your spouse exceed \$250,000 (if you're married and file separate returns, the tax kicks in once your wages exceed \$125,000). One thing to note is that the amount withheld may not accurately reflect the tax owed. That's because your employer calculates the withholding without regard to your filing status, or any other wages or self-employment income you may have received during the year. As a result, you may end up being entitled to a credit, or owing additional tax, when you do the calculations on your return.

And, if your adjusted gross income (AGI) exceeds \$200,000 (\$250,000 if married filing jointly, \$125,000 if married filing separately), some or all of your net investment income may be subject to a 3.8% additional Medicare contribution tax on unearned income. Additionally, high-income taxpayers (e.g., individuals with AGIs greater than \$250,000, married couples filing jointly with AGIs exceeding \$300,000) may be surprised to see new limitations on itemized deductions, and a possible phaseout of personal and dependency exemptions.

New home office deduction rules

If you qualify to claim a home office deduction, starting with the 2013 tax year you can elect to use a new simplified calculation method. Under this optional method, instead of determining and allocating actual expenses, you simply

multiply the square footage of your home office by \$5. There's a cap of 300 square feet, so the maximum deduction you can claim under this method is \$1,500. Not everyone can use the optional method, and there are some potential disadvantages, but for many the new simplified calculation method will be a welcome alternative.

Same-sex married couples

Same-sex couples legally married in jurisdictions that recognize same-sex marriage will be treated as married for all federal income tax purposes, even if the couple lives in a state that does not recognize same-sex marriage. If this applies to you, and you were legally married on December 31, 2013, you'll generally have to file your 2013 federal income tax return as a married couple--either married filing jointly, or married filing separately. This affects only your federal income tax return, however--make sure you understand your state's income tax filing requirements.

2013 IRA contributions--still time

You generally have until April 15 to contribute up to \$5,500 (\$6,500 if you're age 50 or older) to a traditional or Roth IRA for 2013. With a traditional IRA, you may be able to deduct your contribution (if you or your spouse are covered by an employer plan, your ability to deduct some or all of your contribution depends on your filing status and income). If you make contributions to a Roth IRA (your ability to contribute depends on your filing status and income) there's no immediate tax benefit, but qualified distributions you take in the future are completely free from federal income tax.

Filing for an extension

If you're not going to be able to file your federal income tax return by the due date, file for an extension using IRS Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. Filing this extension gives you an additional six months (to October 15, 2014) to file your return. Don't make the mistake, though, of assuming that the extension gives you additional time to pay any taxes due. If you don't pay any taxes owed by April 15, 2014, you'll owe interest on the tax due, and you may owe penalties as well. Note that special rules apply if you're living outside the country or serving in the military outside the country on April 15, 2014.



2013 is the last year to take advantage of:

- Increased Internal Revenue Code (IRC) Section 179 expense limits (\$500,000 maximum amount decreases to \$25,000 in 2014) and "bonus" depreciation provisions
- The \$250 above-the-line tax deduction for educator classroom expenses
- The ability to deduct mortgage insurance premiums as qualified residence interest
- The ability to deduct state and local sales tax in lieu of the itemized deduction for state and local income tax
- The deduction for qualified higher education expenses
- Qualified charitable distributions (QCDs), allowing individuals age 70½ or older to make distributions of up to \$100,000 from an IRA directly to a qualified charity (distributions are excluded from income and count toward satisfying any required minimum distributions (RMDs) for the year)



Don't forget that some savings or investment vehicles, such as bank savings accounts, may benefit from rising interest rates.



Before investing in a mutual fund, carefully consider its investment objectives, risks, expenses, and fees, which can be found in the prospectus available from the fund. Read the prospectus carefully before investing.

Bonds vs. Bond Funds: Which Is Better When Interest Rates Rise?

The Federal Reserve has said it expects to begin raising its target rate sometime in 2014. Since bond prices fall when interest rates rise, it may be a good time to pay increased attention to any fixed-income investments you have. Here are some factors to consider when you review your portfolio.

Maturity dates and duration

One way to address the threat of rising rates is through maturity dates. Long-term bonds may pay a higher coupon rate than short-term bonds, but when rates rise, long-term bond values typically suffer more. That's because investors may be reluctant to tie up their money for long periods if they expect a bond's interest payments may suffer by comparison when newer bonds that pay higher rates are issued. The later a bond's maturity date, the greater the risk that its yield eventually will be surpassed by that of newer bonds.

A bond fund doesn't have a maturity date, and your shares may be worth more or less than you paid for them when you sell. However, there is another way to gauge the sensitivity of either a bond or a bond fund to interest rates: its duration, which takes into account not only maturity but also the value of future interest payments. The longer the duration, the more sensitive a security is to interest rate changes.

To estimate the impact of a rate change, simply multiply a security's duration by the percentage change in interest rates. For example, if interest rates rise by 1%, a bond or bond fund with a duration of 3 years could be expected to lose roughly 3% in value, while one with a 7-year duration might fall by 7%. (Though interest rates currently have little room to fall, the same principle would apply; a 1% decline in rates should result in a 3% gain for a bond fund with a 3-year duration.) Though this hypothetical example doesn't represent the return of any specific investment, you can apply the general principle to your own holdings.

Diversification

Since rising rates affect most bonds, diversification provides only limited protection against rate increases. To balance yields with the threat of rising rates, you can diversify across various segments of the bond market (for example, investment-grade corporate, high-yield, Treasuries, foreign, short/intermediate/long-term, and municipal debt). Bonds don't respond uniformly to interest rate changes. The differences, or spreads, between the yields of various types can mean that some categories are under- or over-valued compared to others. Funds may offer greater

diversification within each segment at a lower cost than individual bonds, providing greater protection against the impact of a potential default by a single issuer. However, diversification alone doesn't ensure a profit or prevent the possibility of loss, including loss of principal.

Flexibility

Holding individual bonds allows you to sell a specific bond on your own timetable or hold it until it matures. That flexibility has two advantages. First, if you hold to maturity, unless a bond's issuer defaults, you know how much you'll receive when the principal is repaid. Rising interest rates may cause a bond's market value to fluctuate in the meantime, but if you hold it to maturity, that fluctuation may not be an issue for you, especially if predictable income is your highest priority.

Second, it can help you manage your tax liability; if a specific bond has lost value, you can sell it and declare the loss on your federal income tax return. You may be able to instruct your broker to sell specific shares of a bond fund to harvest losses for tax purposes, but in general it's more challenging to manage tax liability as precisely with bond funds. For example, capital gains or losses generated by a fund manager's trading are passed through to individual shareholders each year, which can affect your tax liability. Also, a bond fund's value can be affected by your fellow investors. Since an open-end fund must redeem investors' shares daily, strong selling can force a fund to sell holdings to meet redemption demands, which can have implications for other shareholders.

Laddering individual bonds also can help provide flexibility to adjust to rising rates. Laddering involves buying a portfolio of bonds with varying maturities; for example, a five-bond portfolio might be structured so that one of the five matures each year for the next five years. As interest rates rise, each bond that matures can be reinvested in a newer instrument that offers a higher yield.

Liquidity

A mutual fund will redeem your shares at the end of every business day. An individual bond traded on the open market may not have the same liquidity, and you could have difficulty finding a buyer who's willing to pay the asking price. However, individual bonds are priced and traded throughout the day; only closed-end funds and exchange-traded funds have that flexibility, not open-end mutual funds.



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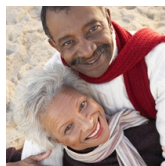
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Are you ready to retire?

Here are some questions to ask yourself when deciding whether or not you are ready to retire.

Is your nest egg adequate?

It's obvious, but the earlier you retire, the less time you'll have to save, and the more years you'll be living off of your retirement savings. The average American can expect to live past age 78. (Source: CDC, "Deaths: Preliminary Data for 2011") With future medical breakthroughs likely, it's not unreasonable to assume that life expectancy will continue to increase. Is your nest egg large enough to fund 20 or more years of retirement?

When will you begin receiving Social Security benefits?

You can begin receiving Social Security retirement benefits as early as age 62. However, your benefit may be 25% to 30% less than if you waited until full retirement age (66 to 67, depending on the year you were born).

How will retirement affect your IRAs and employer retirement plans?

The longer you delay retirement, the longer you can build up tax-deferred funds in your

IRAs--remember that you need compensation to contribute to an IRA. You'll also have a longer period of time to contribute to employer sponsored plans like 401(k)s--and to receive any employer match or other contributions. (If you retire early, you may forfeit any employer contributions in which you're not yet fully vested.)

Will you need health insurance?

Keep in mind that Medicare generally doesn't start until you're 65. Does your employer provide post-retirement medical benefits? Are you eligible for the coverage if you retire early? If not, you may have to look into COBRA or a private individual policy--which could be an expensive proposition.

Is phasing into retirement right for you?

Retirement need not be an all-or-nothing affair. If you're not quite ready, financially or psychologically, for full retirement, consider downshifting from full-time to part-time employment. This will allow you to retain a source of income and remain active and productive.



How much can I contribute to my IRA in 2014?

The amount you can contribute to your traditional or Roth IRA remains \$5,500 for 2014, \$6,500 if you're 50 or older. You can contribute to an IRA in addition to an employer-sponsored retirement plan like a 401(k). But if you (or your spouse) participate in an employer-sponsored plan, the amount of traditional IRA contributions you can deduct may be reduced or eliminated (phased out), depending on your modified adjusted gross income (MAGI). Your ability to make annual Roth contributions may also be phased out, depending on your MAGI. These income limits (phaseout ranges) have increased for 2014:

| Income phaseout range for deductibility of traditional IRA contributions in 2014 | |
|---|-----------------------|
| 1. Covered by an employer-sponsored plan and filing as: | |
| Single/Head of household | \$60,000 - \$70,000 |
| Married filing jointly | \$96,000 - \$116,000 |
| Married filing separately | \$0 - \$10,000 |
| 2. Not covered by an employer-sponsored retirement plan, but filing joint return with a spouse who is covered by a plan | |
| | \$181,000 - \$191,000 |

| Income phaseout range for ability to fund a Roth IRA in 2014 | |
|--|-----------------------|
| Single/Head of household | \$114,000 - \$129,000 |
| Married filing jointly | \$181,000 - \$191,000 |
| Married filing separately | \$0 - \$10,000 |



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Has a Correction Started? Does it Matter?

For the first time since 2010, January stock market returns were negative (around -3.5%). During the course of the month, investors experienced heightened volatility as several days had returns of +/- 1%. This combination makes many investors wonder if we are now in the early stages of a new bear market or, if the past five years should be considered an interim market rally inside of a longer-term bear market.

The answer, of course, is that nobody knows -- not the Fed economists, not the fund managers, not me, and not all the "talking heads". What we **do** know is that it is often a mistake to sell into market downturns, which unfortunately happens more frequently than we realize.

Many may be surprised that in the summer of 2011, the markets pulled back by almost 20% -- nearly twice the traditional definition of a "market correction". But, since then, the market has come roaring back and rewarded patient investors. There were corrections in the spring of 2010 (-16%), and the spring of 2012 (-10%), but almost nobody remembers these sizable bumps on the way to new market highs. Indeed, many probably look back at the time since March, 2009 as one long largely-uninterrupted bull market.

Bigger picture, since 1945, the market has experienced 27 corrections of 10% or more, and 12 bear markets where U.S. equities lost at least 20% of their value. The average decline was 13.3% over the course of 71 trading days. Perhaps the one statistic that really matters is that after every one of these pullbacks, the markets returned to record new highs. Most of the time, the turnarounds were an unexpected surprise to investors. The market often seems to move contrary to investors expectations.

We may get a full 10% correction or even a full bearish period out of these negative trading days, and we may not. But history suggests an important lesson: if we do get a correction or a bear market, we may not remember it a few years later if the markets recover as it has in the past. The people who lose money in the long term are not those who endure a painful market downturn, but the people who panic and sell when the market turns down.



High Returns -- for Whom?

Insurance companies are supposed to be in the boring business of pricing risk. For example, the company will estimate the number of people who will have a car accident and the subsequent costs to repair and/or pay any hospital bills. All of us will pay premiums that, in the aggregate, should pay for the expected losses, as well as the insurance company's administrative costs and profit.

But some insurance companies offer products that are more exciting and creative – as well as being more complicated and profitable. Consider equity index annuities -- where you give the insurance company your money to invest, and the company guarantees that you will get at least all your money back at the end of a certain period of time -- even if stock prices fall into a black hole and never re-emerge. If stock prices go up you get to participate in that growth.

Heads you win, tails you don't lose. Sounds compelling, right?

Despite the popularity of these products since the market downturn in 2008, there are a few considerations. One is that it is a contract that lasts for several years and the investor has limited liquidity (with any type of a guarantee). The second is equity index annuities tend to be expensive – in a variety of ways. Surrender charges, what you pay if you want your money back too early, are typically in the 12% to 15% range. In addition, the underlying investment options are often expensive. But, for many insurance companies, the major profit driver is the way your return is calculated.

Typically, you will be told that, in return for the guarantee that you'll get your money back, you have to give up some of the upside. The contract may specify that you'll get 80% of the upward movements of the stock market.

Since the market has historically gone up about 70% of the time, you are leaving real money on the table. In addition, what many investors may not realize is that they generally do not receive the dividends the underlying stocks are paying (since the investor technically does not own the underlying stocks). That approximately 2% falls right to the insurance companies bottom line.

In 2006, two PH.D's compared a sample equity-indexed annuity with a simple stock and cash investment, and found that the annuity would turn out less beneficial to its policyholder more than 96% of the time. Another approach (<http://www.cbsnews.com/news/risk-free-stock-investing/>) is to build your own annuity. If an investor has \$10,000 to invest and a 10-year time horizon, they could invest \$7,228 into a CD (currently paying 3.3%) with the remainder (\$2,772) into a low-cost stock market index fund. Even if the stock value falls to zero, the investor would be guaranteed of having \$10,000 at maturity. Total annual cost is about .05%.

Comparing the do-it-yourself annuity with the insurance industry's alternative makes it clear just how profitable equity index annuities can be – for the insurance company that is.

Capital Market Review and Outlook

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Executive Summary

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Capital Market Returns

- For stocks, 2013 will go down as one of the better one-year returns in history. U.S. stocks dominated developed and emerging markets.
- For other asset classes, 2013 returns were pretty poor as both bonds and commodities had negative returns.

Economic Conditions

- Most indications are that the economy will continue its slow and stable progress. Consumers and businesses appear to be healthy, but not to the point where economic growth will overheat.
- The unemployment rate is declining and business appear to be hiring. Inflation is expected to rise, but not significantly.
- Real estate conditions have improved (sales, prices, and construction).
- The FED has announced that it will start to reduce its stimulus but will be “data driven” on how quickly changes are made. While interest rates rose in the intermediate- to long-term maturity segments during 2013, they did not move too much in the shorter maturity segments. This will probably start to change during 2014.

Stock Market

- Mid- and small-cap stocks outperformed large stocks during 2013. Growth slightly outperformed Value.
- Valuations have risen to ten-year highs. While perhaps not significantly overvalued, it is difficult to say the U.S. market is undervalued.
- While valuation is poor short-term predictor, it does seem to provide insights on longer-term expectations. Current valuation levels suggest extremely modest future stock returns.

Bond Market

- High yield bonds were the only bond segment (except cash) that had a positive return during 2013. This was the first negative return for the U.S. bond market since 1999 and the lowest calendar-year return since 1994.
- Intermediate- and longer-term yields rose by about 1% during the year. Bonds with maturities below four years still do not provide a yield above the rate of inflation.
- JIC expects continued poor performance from bonds. We believe it will be difficult to “earn your coupon” -- regardless of quality. Another negative return year is a possibility.

Asset Class Returns

| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>Annualized Returns</u> | |
|-------------------------|-------------------------|--------------------------|-------------------------|-------------------------|---------------------------|------------------------|
| | | | | | <u>3 Year</u> | <u>5 Year</u> |
| U.S. Stock 28.3% | U.S. Stock 16.9% | U.S. Bond 7.8% | U.S. Stock 16.4% | U.S. Stock 33.6% | U.S. Stock 16.2% | U.S. Stock 18.7% |
| U.S. Commodity 18.9% | U.S. Commodity 16.8% | U.S. Inflation 3.0% | U.S. Bond 4.2% | U.S. Inflation 1.2% | U.S. Bond 3.3% | U.S. Bond 4.4% |
| U.S. Bond 5.9% | U.S. Bond 6.5% | U.S. Stock 1.0% | U.S. Inflation 1.8% | U.S. Cash 0.1% | U.S. Inflation 2.0% | U.S. Inflation 2.0% |
| U.S. Inflation 2.8% | U.S. Inflation 1.4% | U.S. Cash 0.1% | U.S. Cash 0.1% | U.S. Bond -2.0% | U.S. Cash 0.1% | U.S. Commodity 1.5% |
| U.S. Cash 0.2% | U.S. Cash 0.1% | U.S. Commodity -13.3% | U.S. Commodity -1.1% | U.S. Commodity -9.5% | U.S. Commodity -8.1% | U.S. Cash 0.1% |

Economic Conditions

Executive Summary: Economic Conditions

General Economy & Financial Conditions

- The U.S. economy continues its slow but steady improvement. A variety of “future focused” indicators all suggest that, economic activity will improve. The indicators do not suggest such rapid growth that the economy is in danger of overheating. There appears to be little chance of a near-term recession.
- Financial conditions seem to have normalized. Loan officers are willing to make consumer loans and are also seeing higher demand.

Consumer

- The consumer appears to be in relatively good shape. Retail sales and personal consumption expenditures are rising at a reasonable level. However, growth in real disposable income is quite modest.
- Since the Great Recession, the consumer has done much to improve their balance sheet. Debt as a percent of disposable income is at the lowest level in over a decade.

Business

- Current business conditions as well as expected new orders suggest continued growth and improvement in the business segment of the economy.

Labor

- While the unemployment rate remains too high, it has declined significantly during the past few years. Unemployment is currently in the 7% range with expectations that it will continue its descent during 2014.
- Businesses have been hiring and the continued employment outlook (the net percent of employers hiring) is improving.

Real Estate

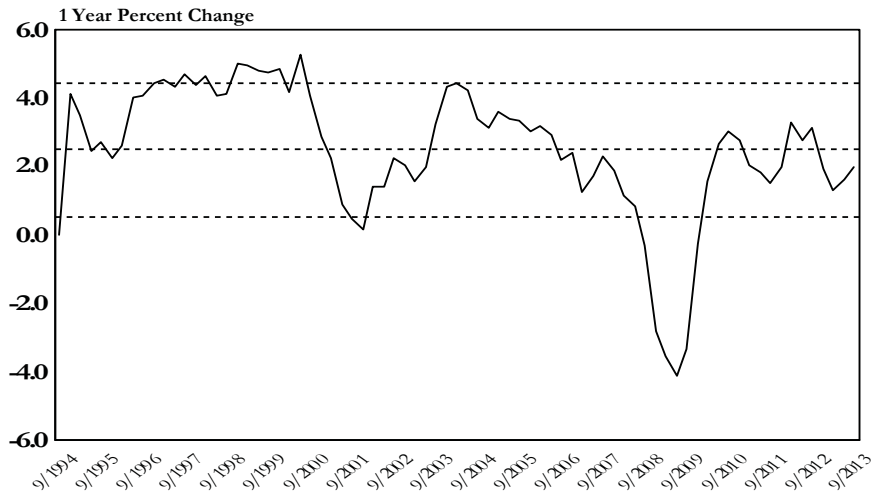
- Real estate activity has clearly picked up. Both sales and prices have been increasing. Housing starts have also picked up which is another positive sign for the general economy.

Summary

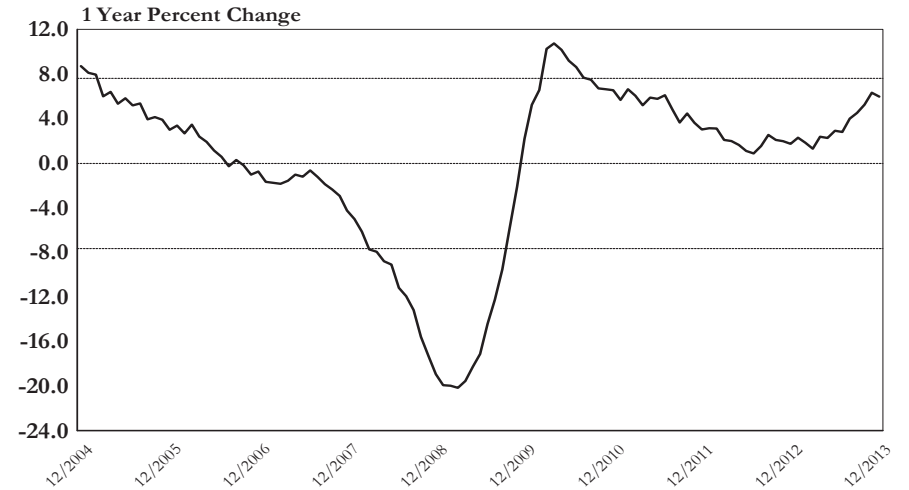
- There is little doubt that the economy is improving for both consumers and businesses.
- In response, the Federal Reserve has indicated it will start to reduce some of the extra stimulus it has had in place for the economy. This is a good and necessary measure.
- We take the FED at its word -- that it will be gradual in its approach. Reducing some stimulus, evaluating the impact over several months before deciding if the next stage is necessary. It does not appear the FED wants to risk taking stimulus away too soon and jeopardize the current positive economic conditions.

Economic Conditions: General Economy

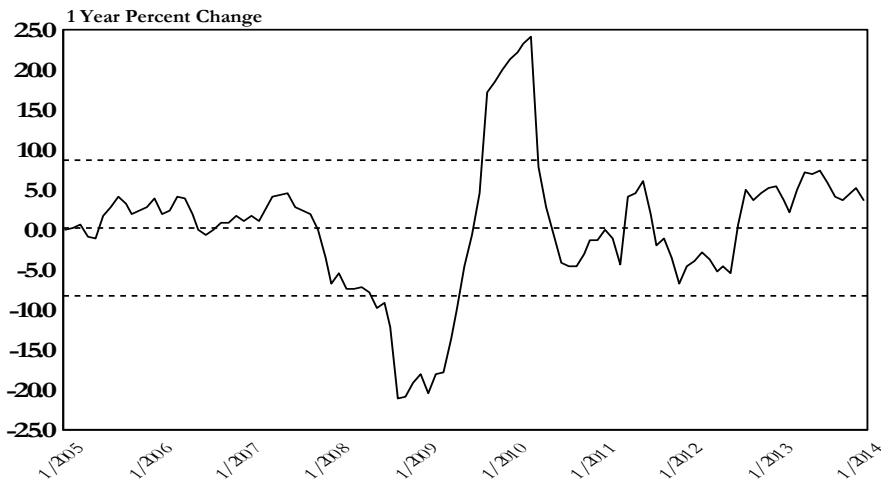
Gross Domestic Product



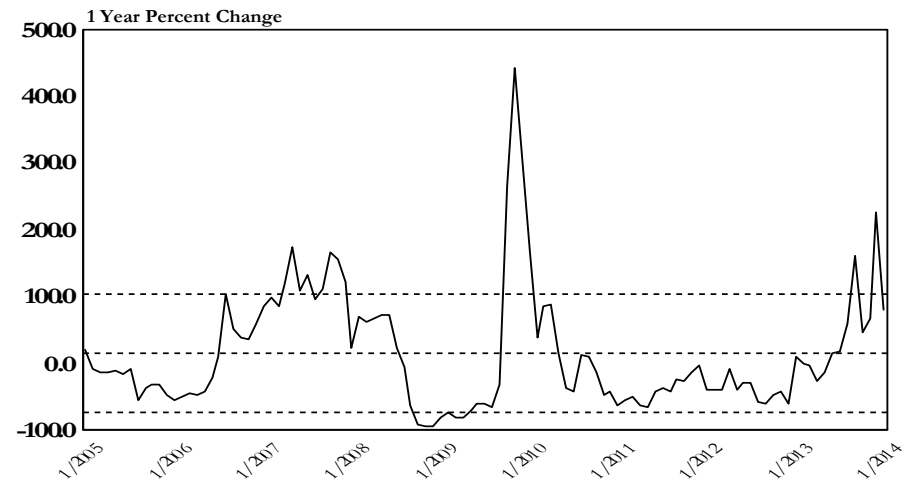
Leading Economic Indicators



ECRI Weekly Leading Index



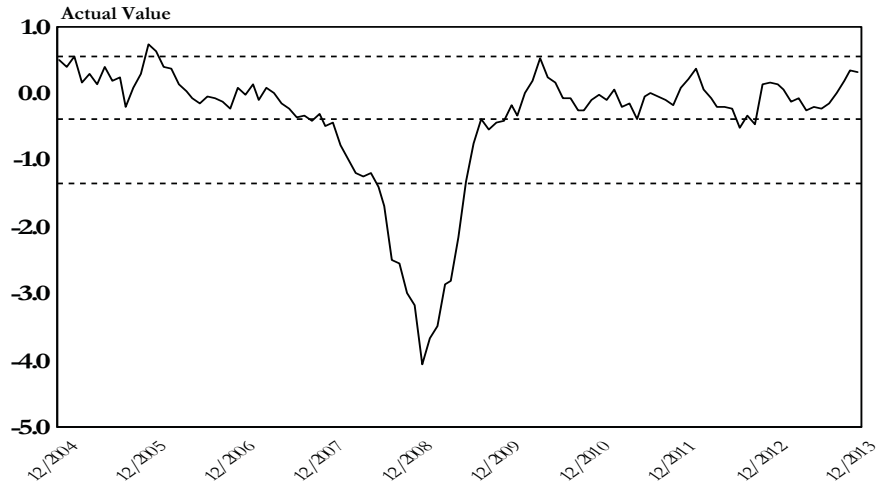
Baltic Dry Index



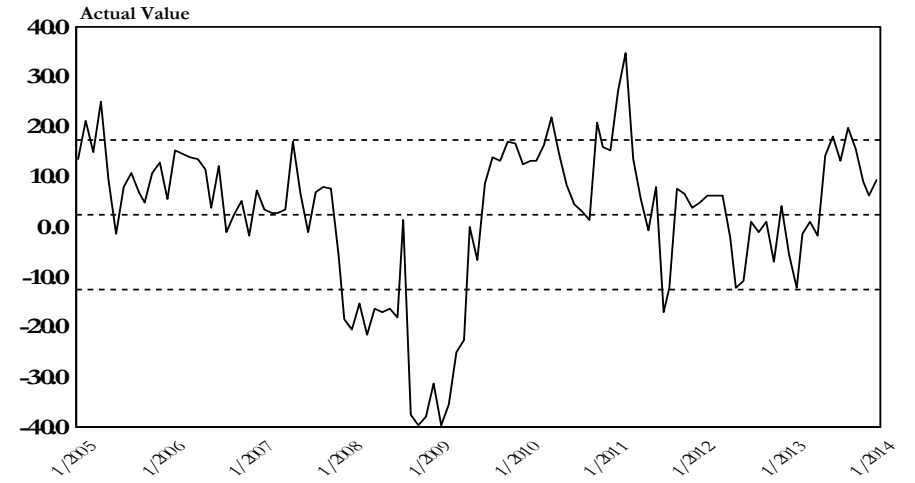
- The charts on the next two pages all tell a similar story. The U.S. economy appears to be steadily improving as nearly all indicators are above their respective historical average. However, it does not appear that economic growth is so robust that the economy is in danger of overheating.

Economic Conditions: General Economy (continued)

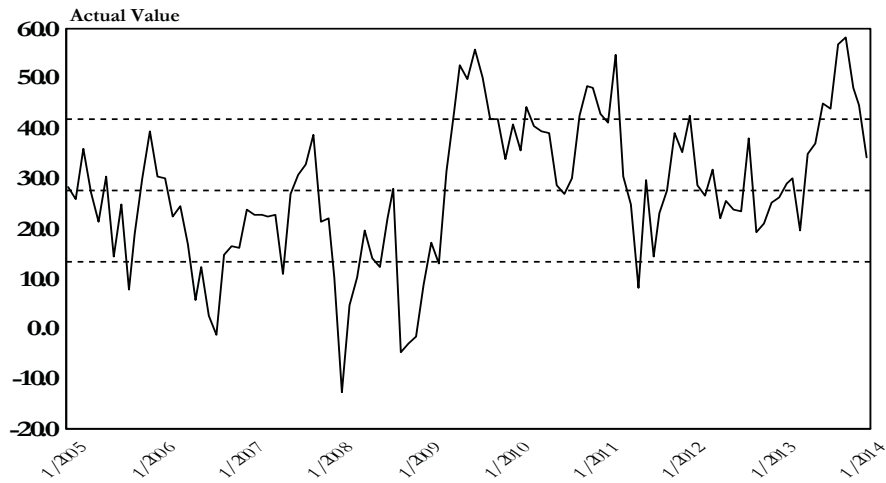
Chicago Fed: National Activity Index - 3 Month Moving Avg



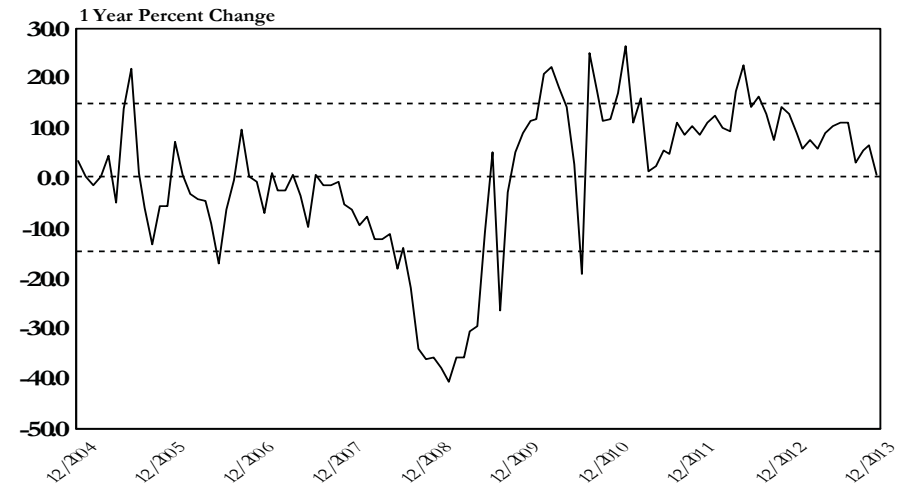
Fed: General Activity - vs. Prior Month (Diffusion)



Fed: General Activity - 6 Months Ahead (Diffusion)

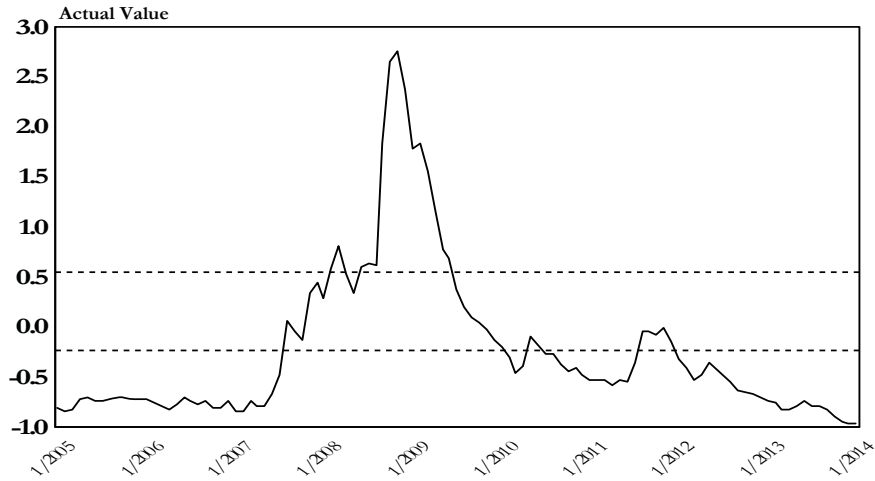


Auto and Light Truck Sales

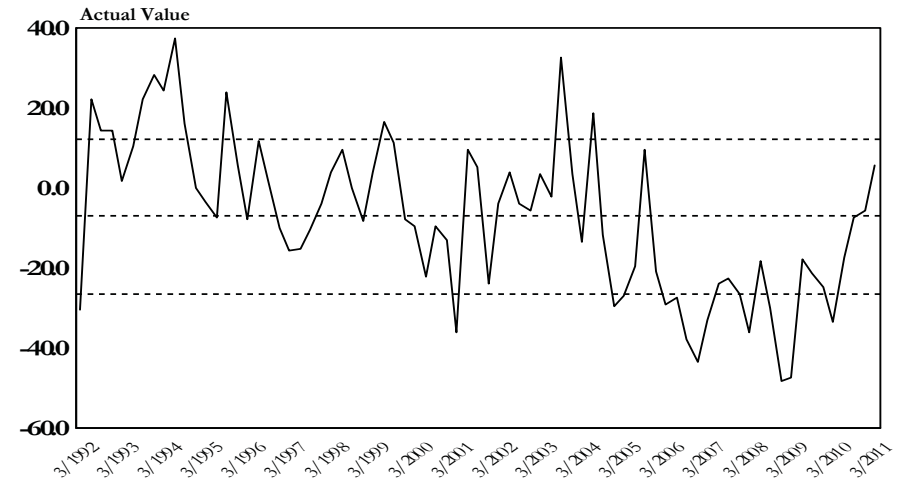


Economic Conditions: Financial Conditions

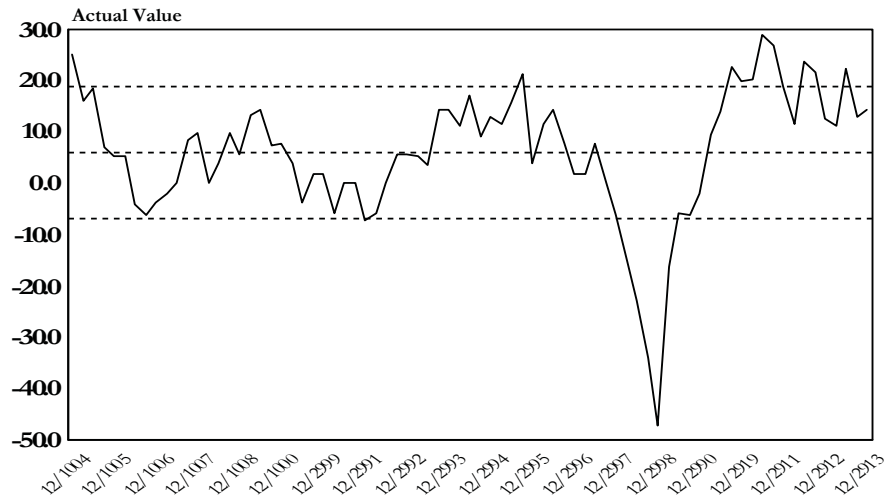
Chicago Fed: National Financial Conditions Index



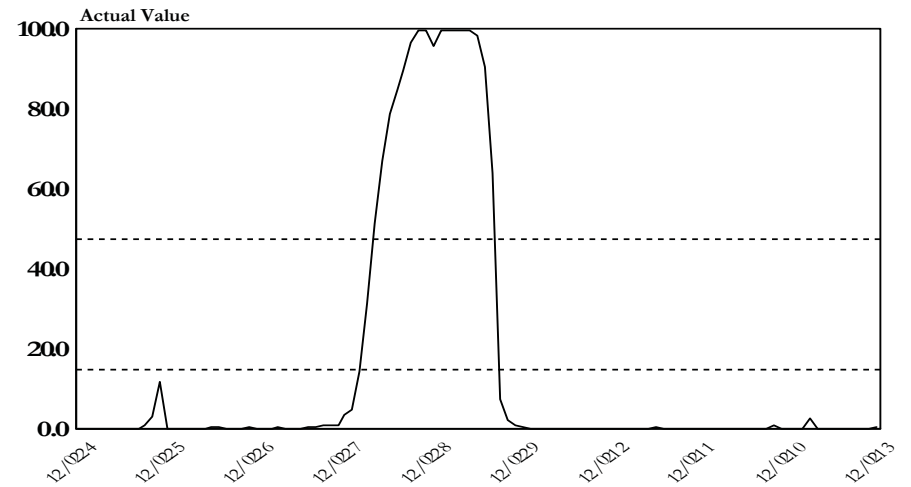
Loan Officer Net % Stronger Demand for Consumer Loans



Loan Officer Net % Willingness to Make Consumer Loans



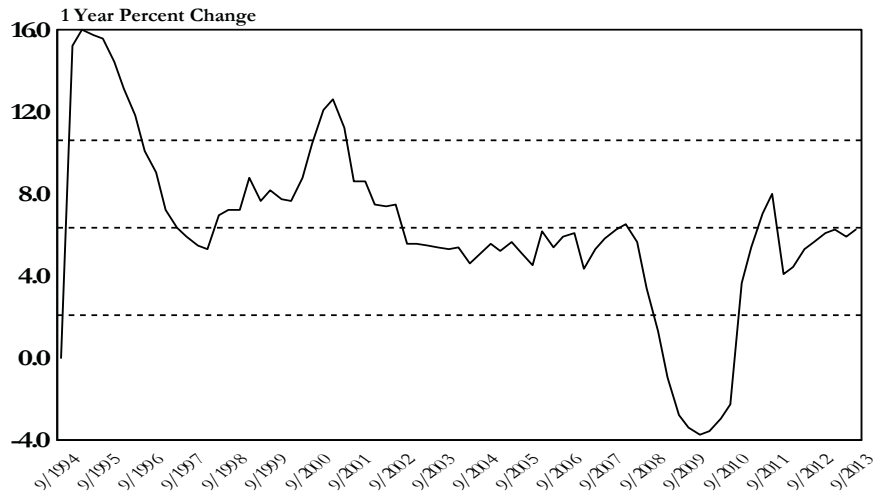
U.S. Recession Probabilities



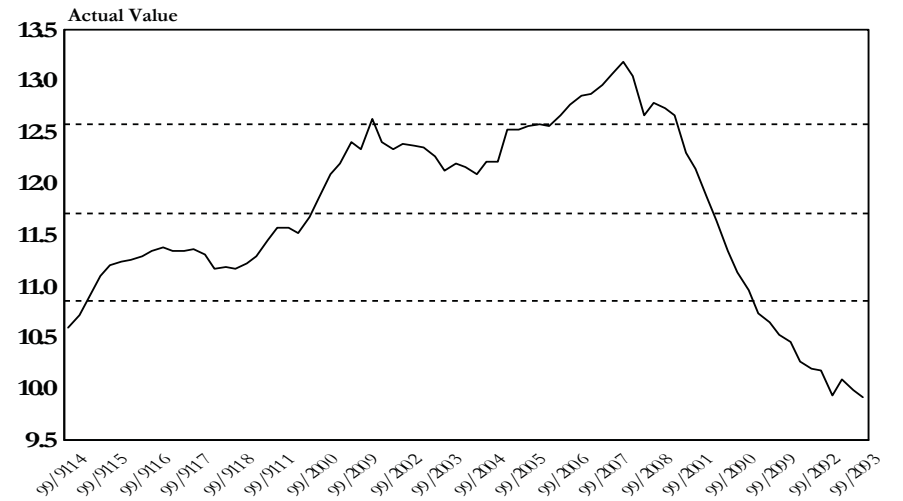
- Financial conditions appear to have returned to “normal”. In fact, it appears that there is significant demand as well as the willingness to make consumer loans.
- The probability of a near term U.S. recession appears to be remote.

Economic Conditions: Consumer (continued)

Household Consumer Credit Debt Outstanding

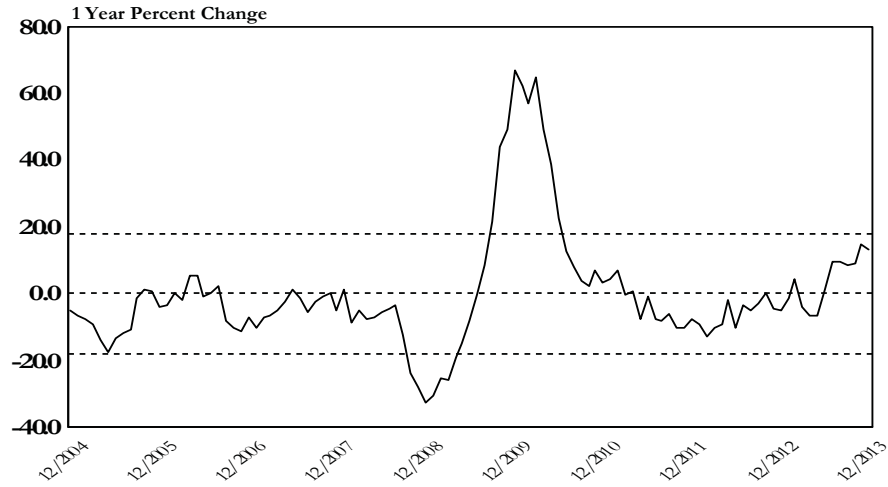


Household Debt As Percent Of Disp. Income

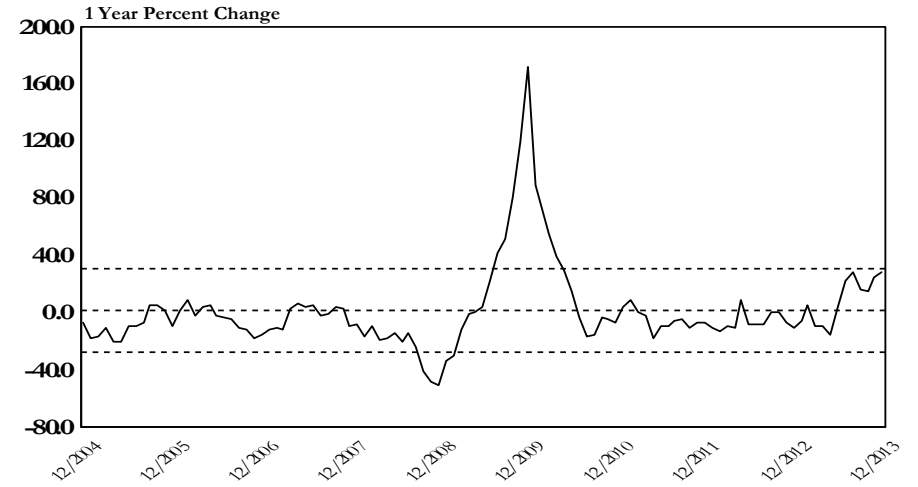


Economic Conditions: Business Conditions

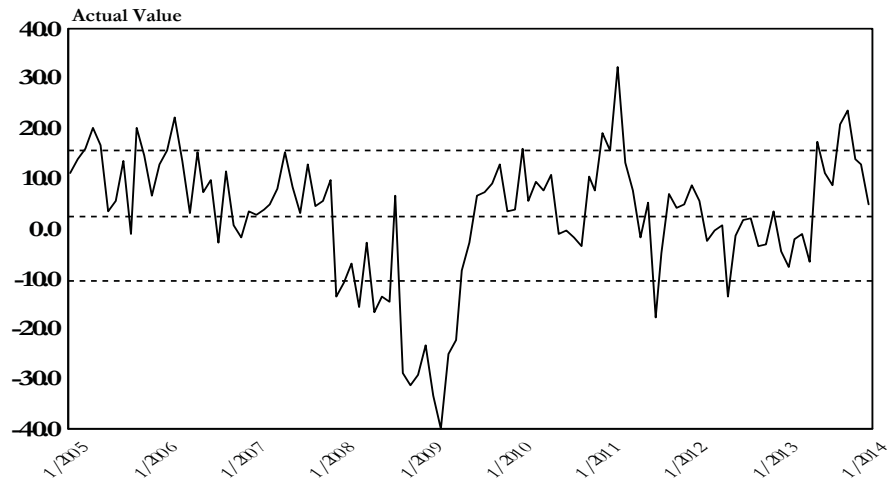
ISM Manufacturing: Purchasing Managers Index



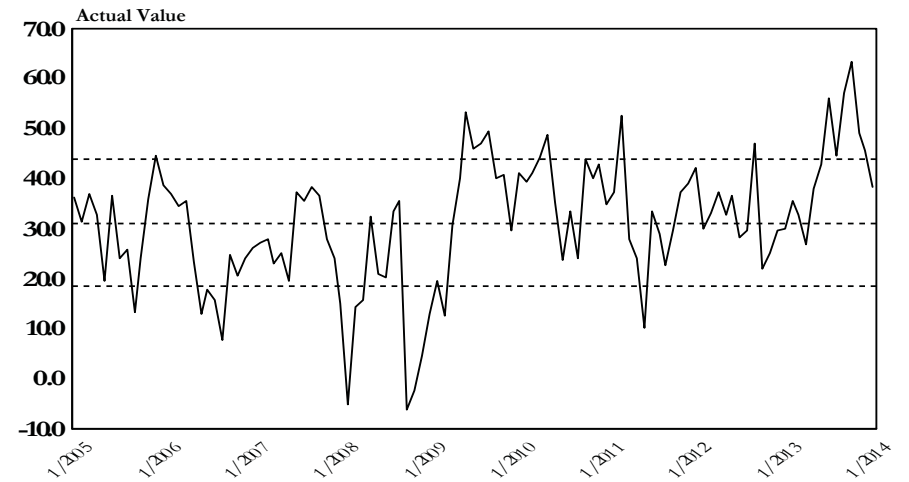
ISM Manufacturing: New Orders Index



Phili Fed: New Orders - vs. Prior Month (Diffusion)



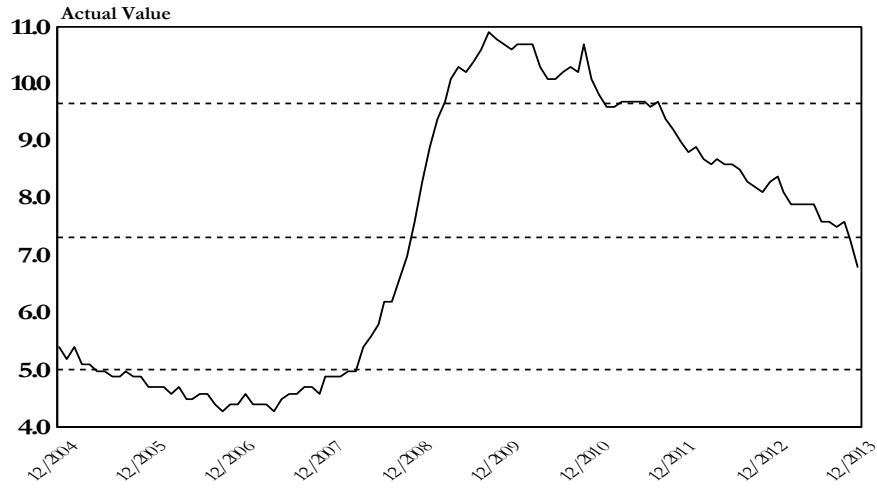
Phili Fed: New Orders - 6 Months Ahead (Diffusion)



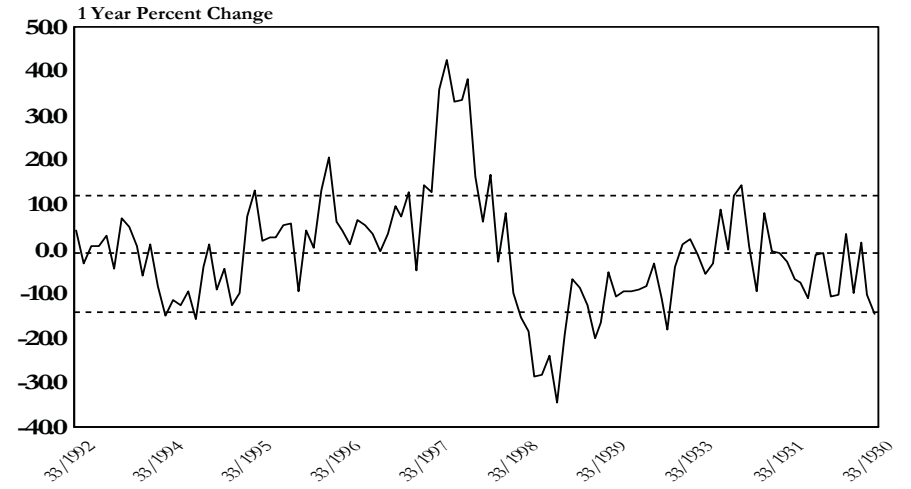
- Current and expected business conditions (as measured by new order indices) point to continued improvement in the general economy.

Economic Conditions: Labor

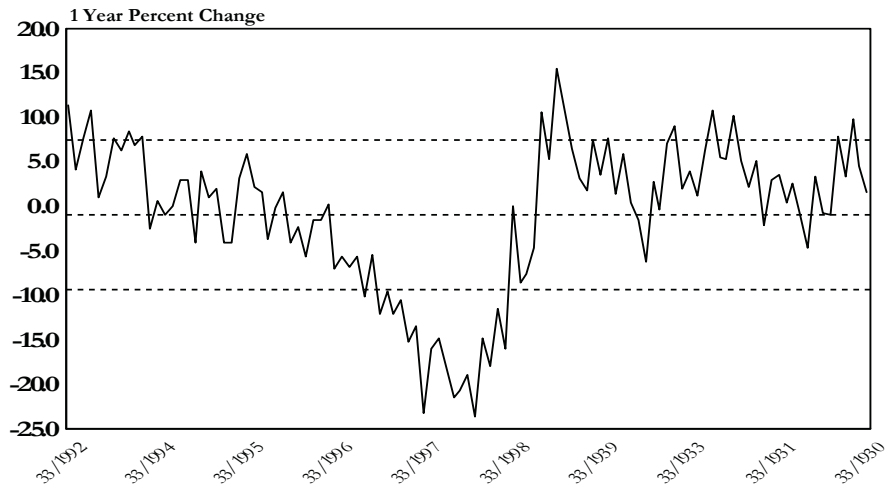
Unemployment Rate



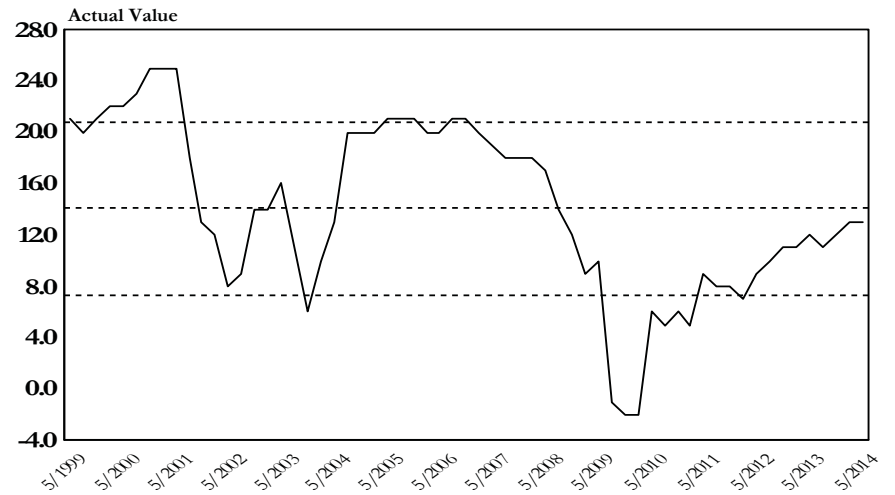
Layoffs and Discharges: Total Nonfarm



Hires: Total Nonfarm



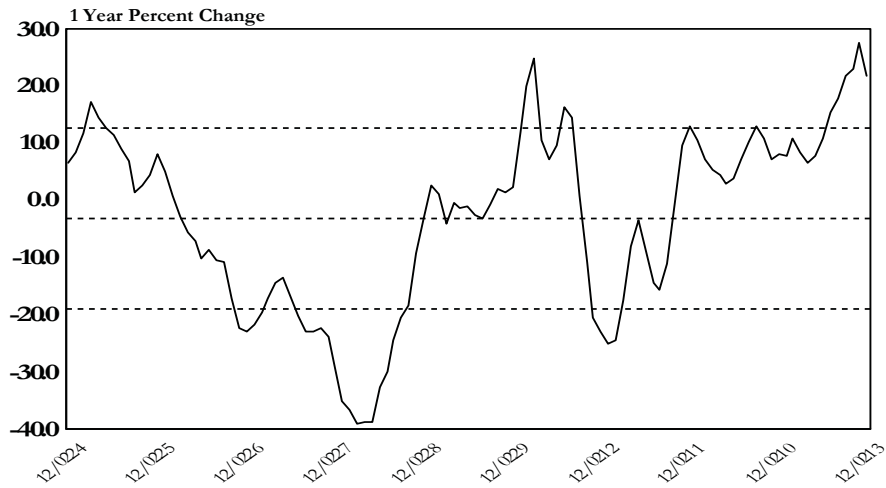
Manpower Employment Outlook (Net % Hiring)



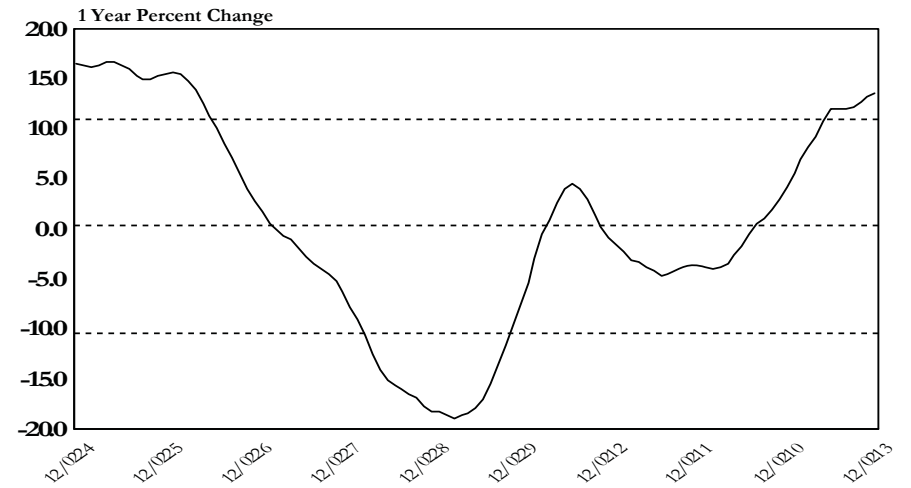
- There has been continued and steady improvement in the labor market.

Real Estate

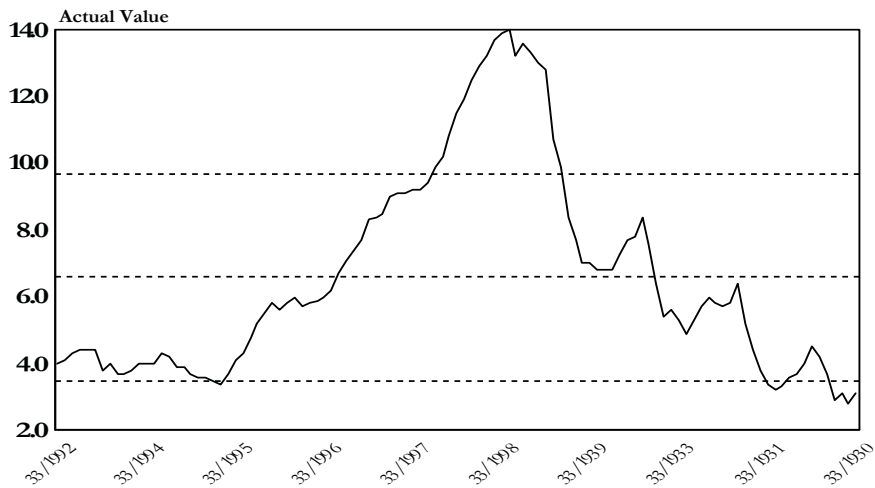
Case Schiller Sales In 20 Largest Markets



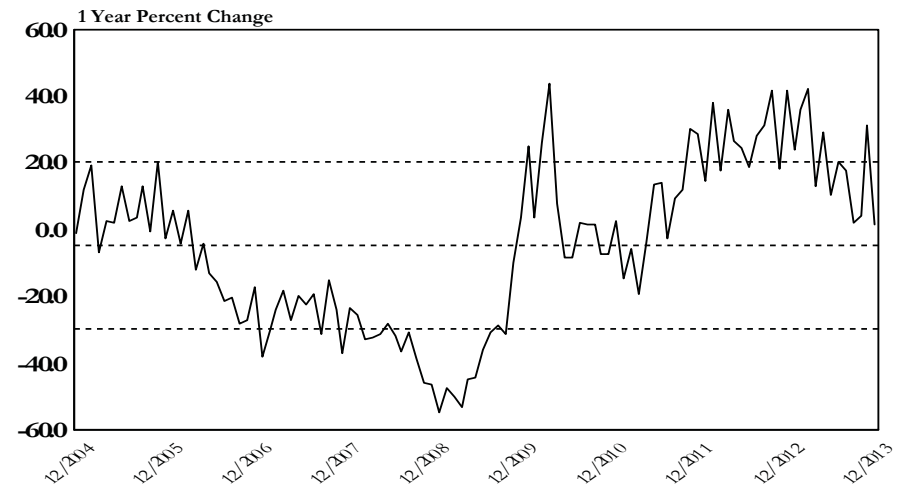
Case Schiller Home Price Index: 20 Largest Markets



Median Number of Months on Sales Market



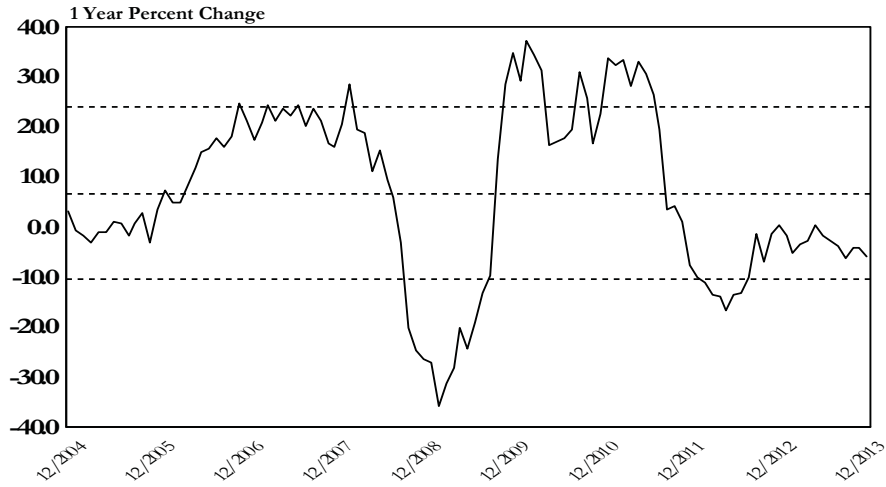
Housing Starts



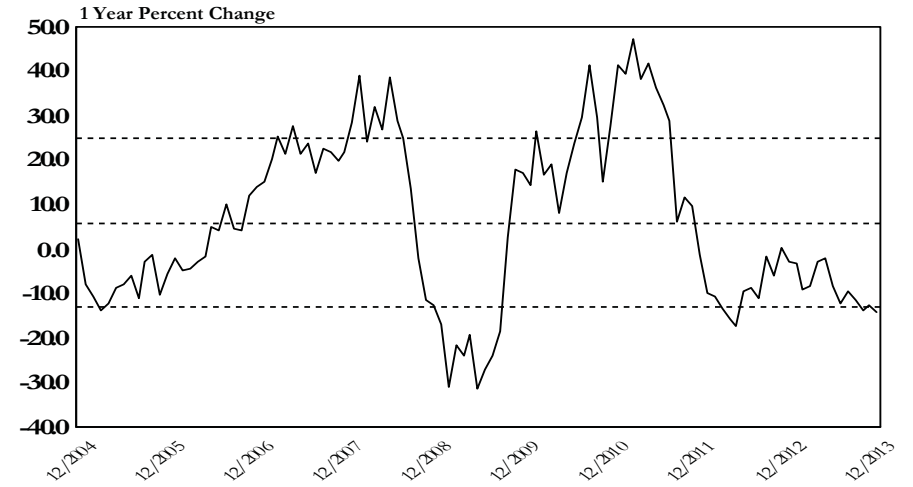
- Real estate, on a variety of factors, has clearly picked up. Sales, but perhaps more importantly, prices have been increasing.
- The length of time it takes to sell a home has fallen to ten-year lows -- probably a sign of improved demand. Housing starts have also picked up which is a good sign for the general economy.

Commodities

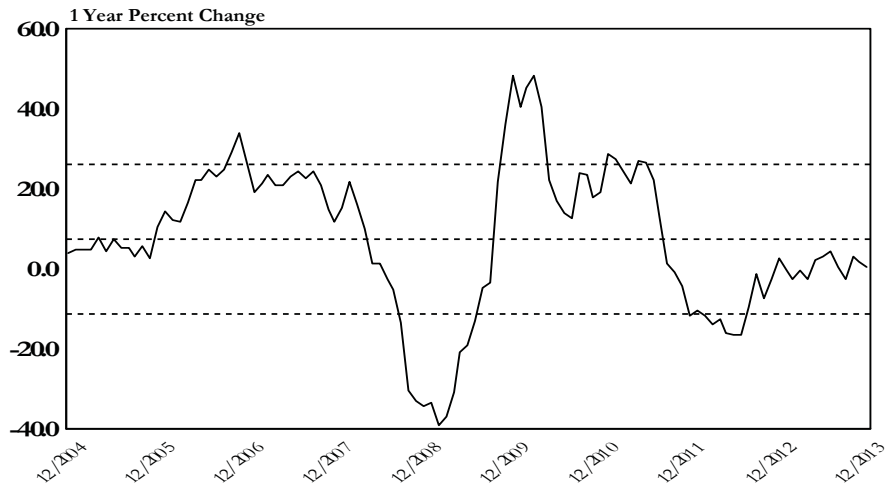
CRB Commodity Spot Index



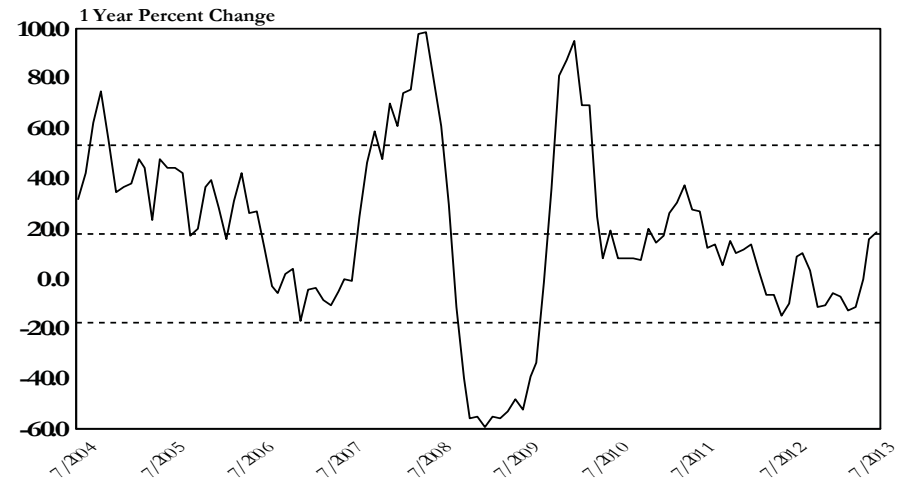
CRB Foodstuffs Spot Index



CRB Raw Industrials Spot Index



Spot Oil Price (West Texas Intermediate)



- While individual commodities may be more volatile, the broad commodity index did not experience dramatic price changes during 2013.

Stock Market

Observations

- What a year in the stock market! During nearly all of 2013, the stock market was either going up or staying level. The biggest decline for the year (from the markets highs) was -6% (which is quite unusual).
- During 2013, U.S. stocks returned 33.6%, substantially outperforming developed international returns of 22.8% and the emerging market return of -5.0%. The difference between U.S. stock returns and emerging markets is one of the largest on record. By company size, the smaller the company the better the performance. Micro-cap stocks returned 55.8%, small stocks returned 38.8%, mid-cap stocks 34.8%, and large stocks 33.1%. By investment approach, growth stocks had a slight edge over value stocks (34.2% versus 32.7%). However, within the developed international markets, value stocks outperformed growth stocks.
- JIC believes that any short term forecast of stock market returns should be met with a great deal of skepticism. There are simply too many variables and unknowns that can affect short-term returns. With that said, trends can be an extremely powerful force and the current trend seems to be up.
- However, valuation does matter. While not providing particularly meaningful insights into short-term market movements, valuation does seem to provide more useful information on what investors could expect over a multi-year period.
- Valuations today are higher than during the Great Recession (not surprising) and are either approaching or exceeded their ten-year highs. In addition, investor optimism for stocks seems to have grown while stocks “fear factor” has significantly declined.
- While valuations are higher, that does not necessarily mean they are extreme (and we do not believe they are).
- Future stock returns are comprised of essentially three things: dividend yields, future earnings growth, and changes in valuation multiples. It is much easier to have higher future stock market returns if you start from low valuation levels and move toward higher valuation levels (the wind would be at your back).
- At current valuation levels, JIC does not believe multiple expansion will provide much future support for stock returns. JIC believes earnings growth and dividend yields will be the key drivers of future stock market returns.
- Assuming 2014 consensus earnings are achieved, JIC believes it will be difficult for mid- and small- stocks to exhibit any significant positive returns without multiple expansion to the 20x earnings range. Large stocks do not require the same level of multiple expansion to produce positive returns.
- Using history as a guide, JIC evaluated subsequent five year stock returns when the starting point was current valuation levels (using normalized earnings). While there are a few exceptions, most subsequent five-year stock returns near existing valuations are in the -5% to 5% range -- significantly below long-term averages.
- JIC believes that, at existing valuation levels, investors should moderate their longer-term stock market return expectations (over a multiple-year period) to the low-to-mid single digits. Unfortunately, we do not know the pattern (or the timing) of how these returns will be achieved. While most investors prefer gradually rising markets each year, it seems that the market has a tendency to grow to excess and then have a more meaningful correction.

Broad Stock Market Returns

| | <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>Annualized Returns</u> | |
|--|---------------------------|---------------------------|---------------------------|---------------------------|--------------------------|---------------------------|---------------------------|
| | | | | | | <u>3 Year</u> | <u>5 Year</u> |
| | Emerging Market 74.5% | U.S. Real Estate 28.5% | U.S. Real Estate 8.7% | U.S. Real Estate 17.8% | U.S. Stock 33.6% | U.S. Stock 16.2% | U.S. Stock 18.7% |
| | Dev. Intl Large 31.8% | U.S. Stock 16.9% | U.S. Stock 1.0% | Dev. Intl Large 17.3% | World 26.7% | World 11.5% | U.S. Real Estate 16.7% |
| | World 30.0% | Emerging Market 16.4% | World -5.5% | U.S. Stock 16.4% | Dev. Intl Large 22.8% | U.S. Real Estate 9.5% | World 15.0% |
| | U.S. Real Estate 28.6% | World 11.8% | Dev. Intl Large -12.1% | World 15.8% | U.S. Real Estate 2.5% | Dev. Intl Large 8.2% | Dev. Intl Large 12.4% |
| | U.S. Stock 28.3% | Dev. Intl Large 7.8% | Emerging Market -20.4% | Emerging Market 15.1% | Emerging Market -5.0% | Emerging Market -4.5% | Emerging Market 12.1% |

Stock Market Returns By Company Size

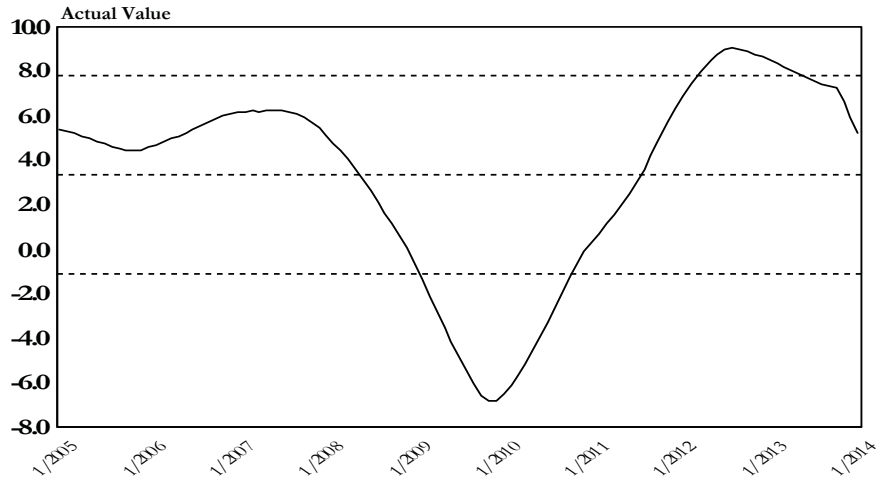
| | | | | | | <u>Annualized Returns</u> | |
|--------------------------|---------------------------|--------------------------|---------------------------|---------------------|---------------------|---------------------------|--|
| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>3 Year</u> | <u>5 Year</u> | |
| Emerging Market 74.5% | U.S. Micro 32.6% | U.S. Real Estate 8.7% | U.S. Micro 23.4% | U.S. Micro 55.8% | U.S. Micro 20.3% | U.S. Micro 27.4% | |
| U.S. Micro 45.2% | U.S. Real Estate 28.5% | U.S. Large 1.5% | U.S. Real Estate 17.8% | U.S. Small 38.8% | U.S. Large 16.3% | U.S. Mid 22.4% | |
| Dev. Intl Small 43.2% | U.S. Small 26.9% | U.S. Stock 1.0% | Dev. Intl Large 17.3% | U.S. Mid 34.8% | U.S. Stock 16.2% | U.S. Small 20.1% | |
| U.S. Mid 40.5% | U.S. Mid 25.5% | U.S. Mid -1.5% | U.S. Mid 17.3% | U.S. Stock 33.6% | U.S. Mid 15.9% | U.S. Stock 18.7% | |
| Dev. Intl Large 31.8% | Dev. Intl Small 19.4% | U.S. Small -4.2% | Dev. Intl Small 16.9% | U.S. Large 33.1% | U.S. Small 15.7% | U.S. Large 18.6% | |

Stock Market Returns By Investment Approach

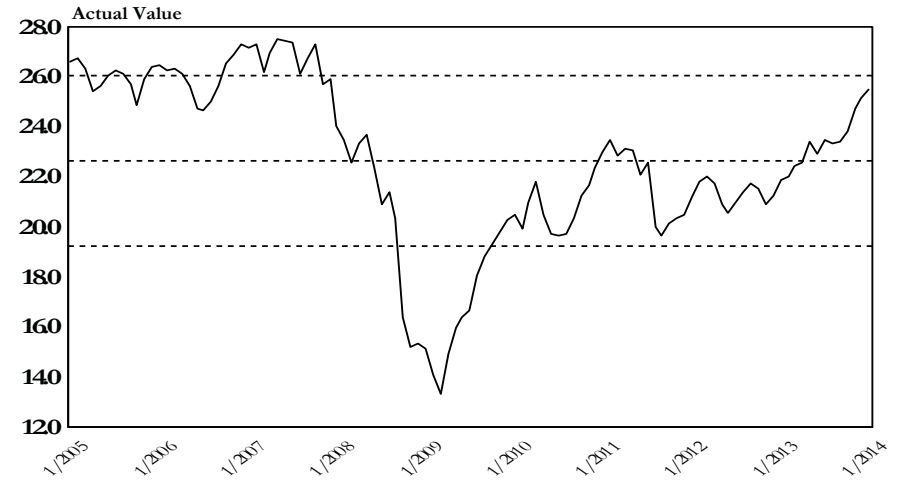
| | | | | | <u>Annualized Returns</u> | |
|---------------------------|---------------------------|----------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>3 Year</u> | <u>5 Year</u> |
| Emerging Growth 79.8% | Emerging Growth 18.3% | U.S. Growth 2.2% | Emerging Growth 20.1% | U.S. Growth 34.2% | U.S. Growth 16.5% | U.S. Growth 20.6% |
| Emerging Value 79.4% | U.S. Growth 17.6% | U.S. Value -0.1% | Dev. Intl Value 17.7% | U.S. Value 32.7% | U.S. Value 15.9% | U.S. Value 16.7% |
| U.S. Growth 37.0% | Emerging Value 17.0% | Dev. Intl Growth -12.1% | U.S. Value 17.5% | Dev. Intl Value 23.0% | Dev. Intl Value 8.3% | Emerging Growth 14.8% |
| Dev. Intl Value 34.2% | U.S. Value 16.2% | Dev. Intl Value -12.2% | Emerging Value 17.2% | Dev. Intl Growth 22.6% | Dev. Intl Growth 8.0% | Emerging Value 13.3% |
| Dev. Intl Growth 29.4% | Dev. Intl Growth 12.2% | Emerging Value -20.0% | Dev. Intl Growth 16.9% | Emerging Growth -0.4% | Emerging Growth -2.2% | Dev. Intl Growth 12.8% |

Stock Market

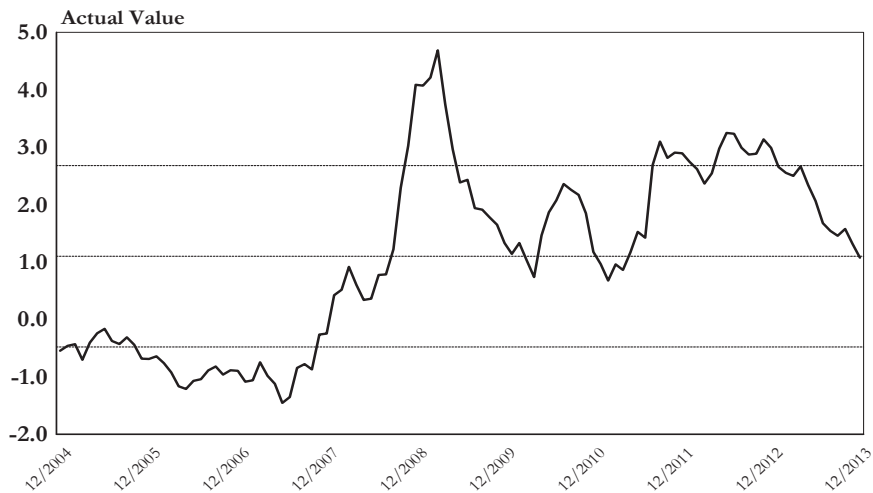
1-Year S&P 500 Earnings Growth Using 10-Year Average Real Earnings



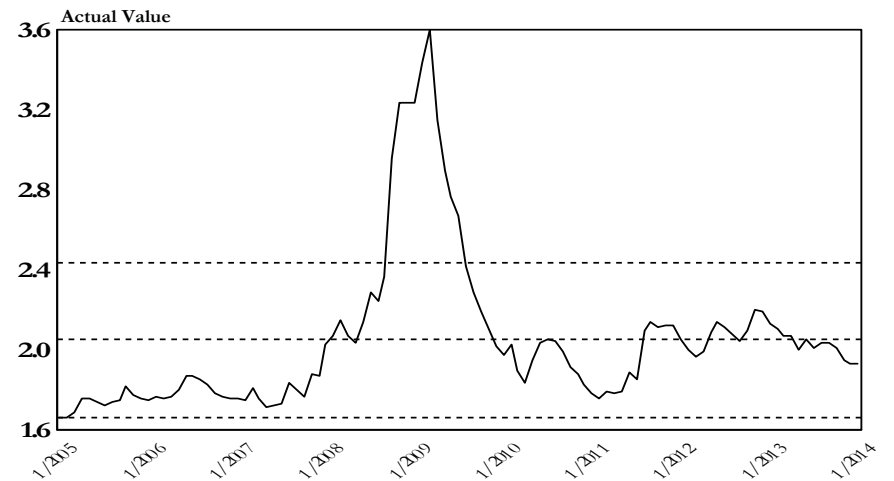
S&P 500 PE Using 10-Year Average Real Earnings



Earnings Yield Using 10-Year Average Real Earnings Less 10-Year Treasury Yield



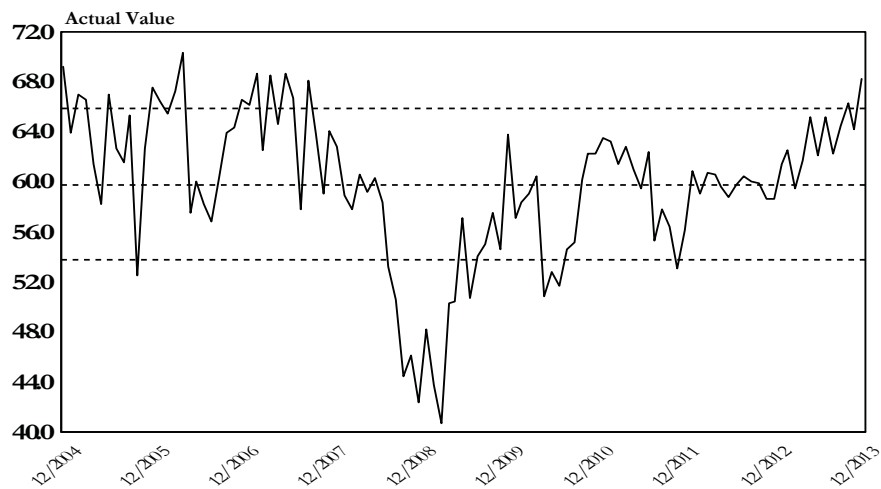
SP500 Dividend Yield



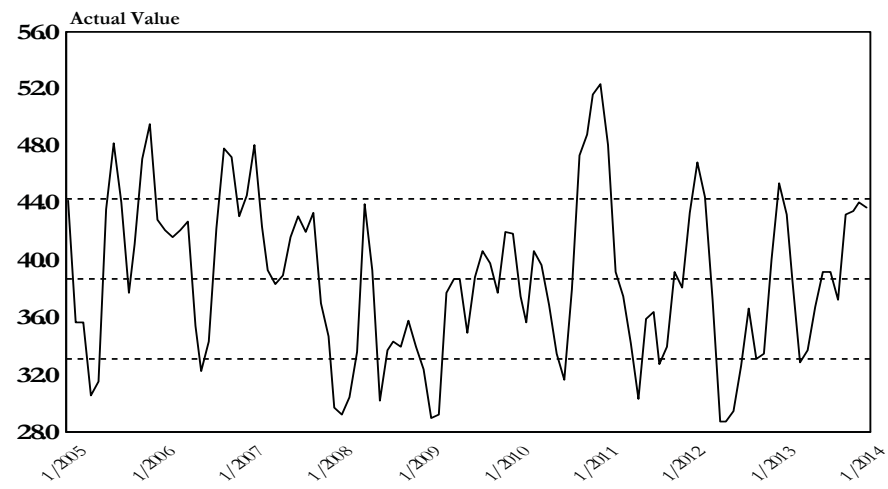
- Valuation multiples, using 10-year normalized earnings, have risen significantly from the lows of 2008. In fact, they are approaching their 10-year highs.
- Investors also compare the earnings yield (the inverse of the price/earnings ratio) to the yield of other investments. JIC subtracted the 10-year Treasury yield from the earnings yield. The current result is essentially at the 10-year average. However, if the 10-year Treasury were at “normal” levels, this chart would likely show the stock earnings yield much closer to the bond yield -- implying a less attractive valuation.

Stock Market (continued)

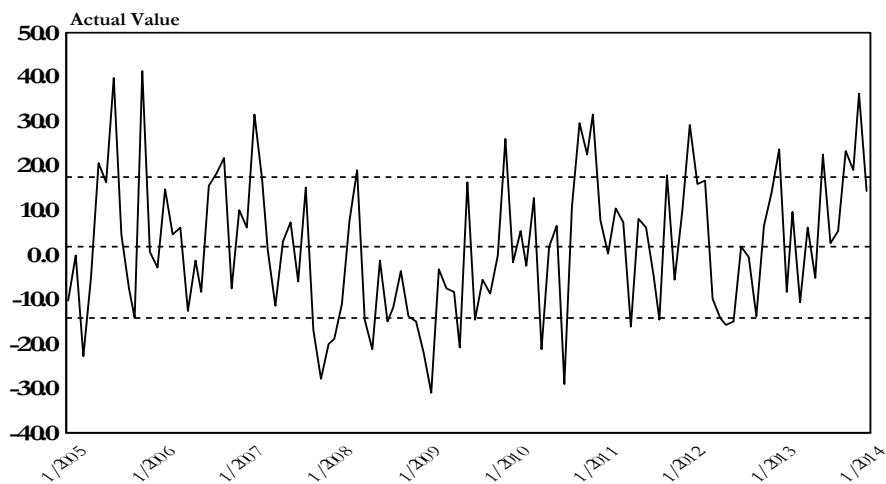
AAII Survey: Stock Allocation



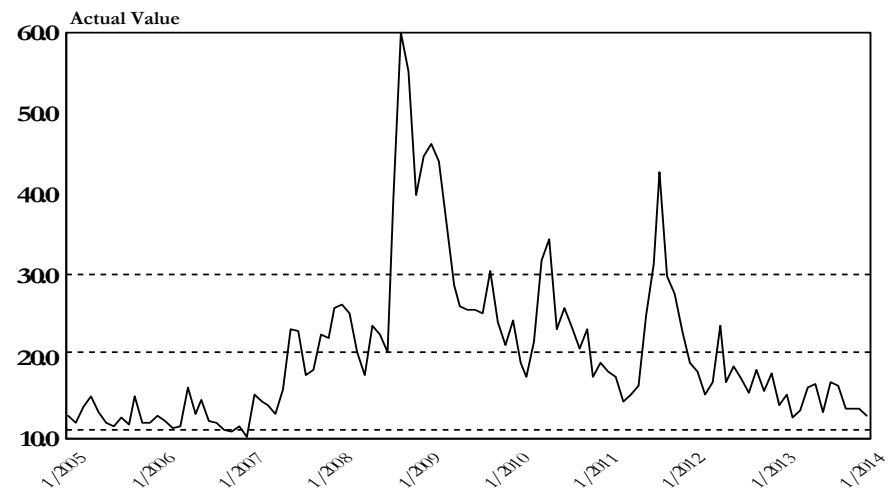
AAII Percent Bullish 8-Week Average



AAII Bull/Bear Investor Sentiment Spread



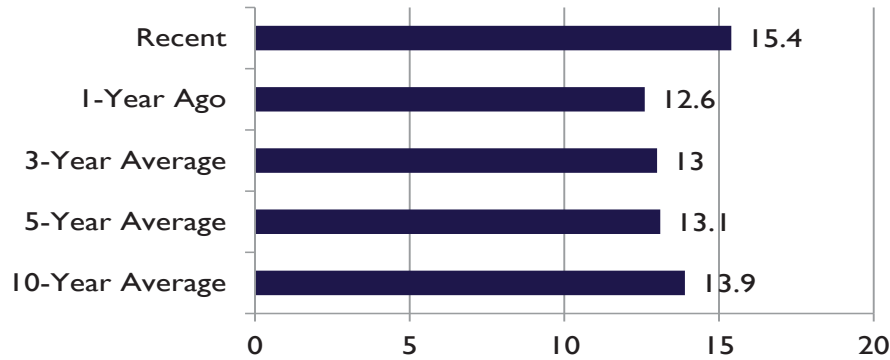
CBOE Volatility Index



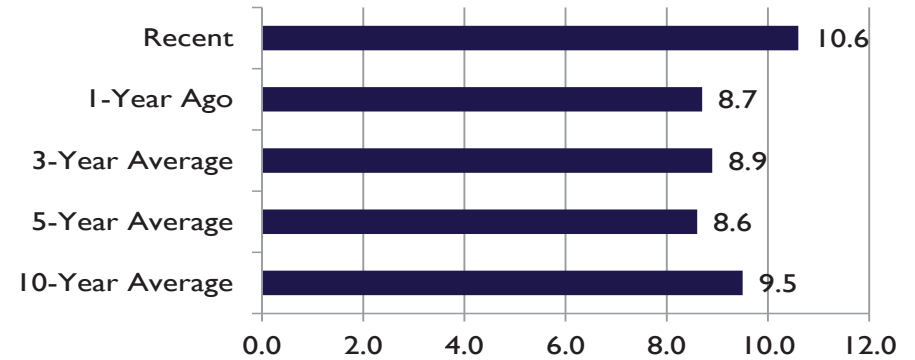
- The various AAII charts all provide a similar message - that the individual investor is clearly more upbeat about stocks. In addition, their optimism is at higher than normal levels (plus one standard deviation from the average).
- The volatility index is an estimate of future stock market volatility. At present, the volatility index has declined to the lowest levels since before the financial crisis. It appears investors are relatively complacent about the expectations of future stock market volatility.

Stock Valuation Measures: SP 500 Index

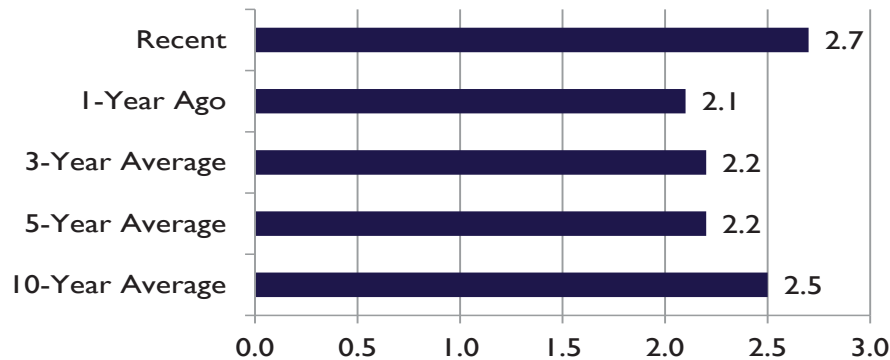
Price to Earnings



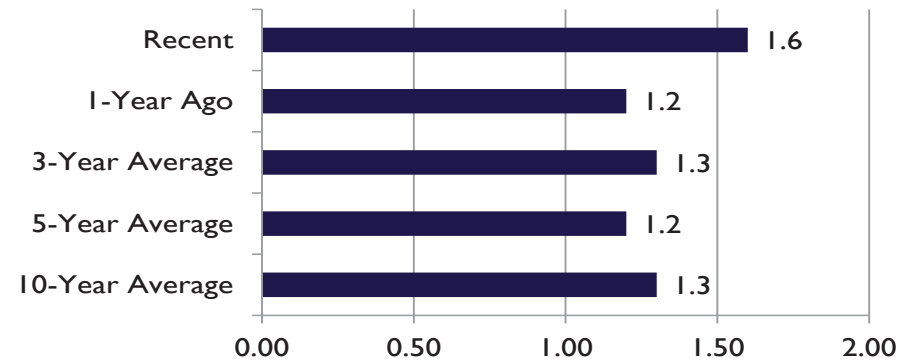
Price to Cash Flow



Price to Book Value

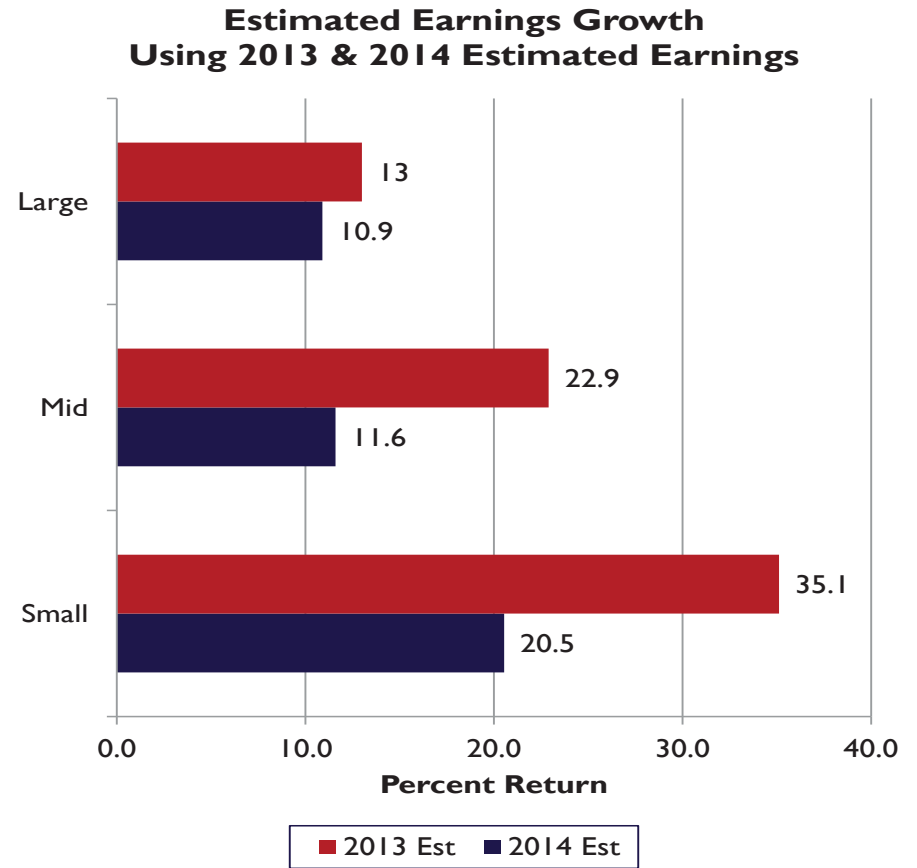
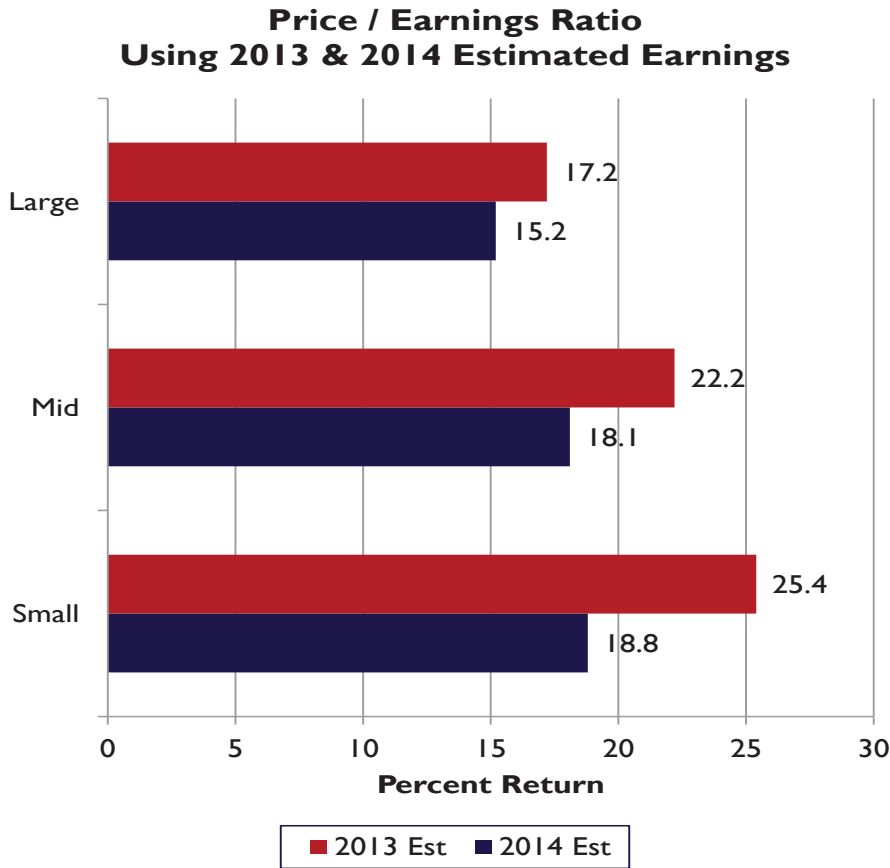


Price to Sales



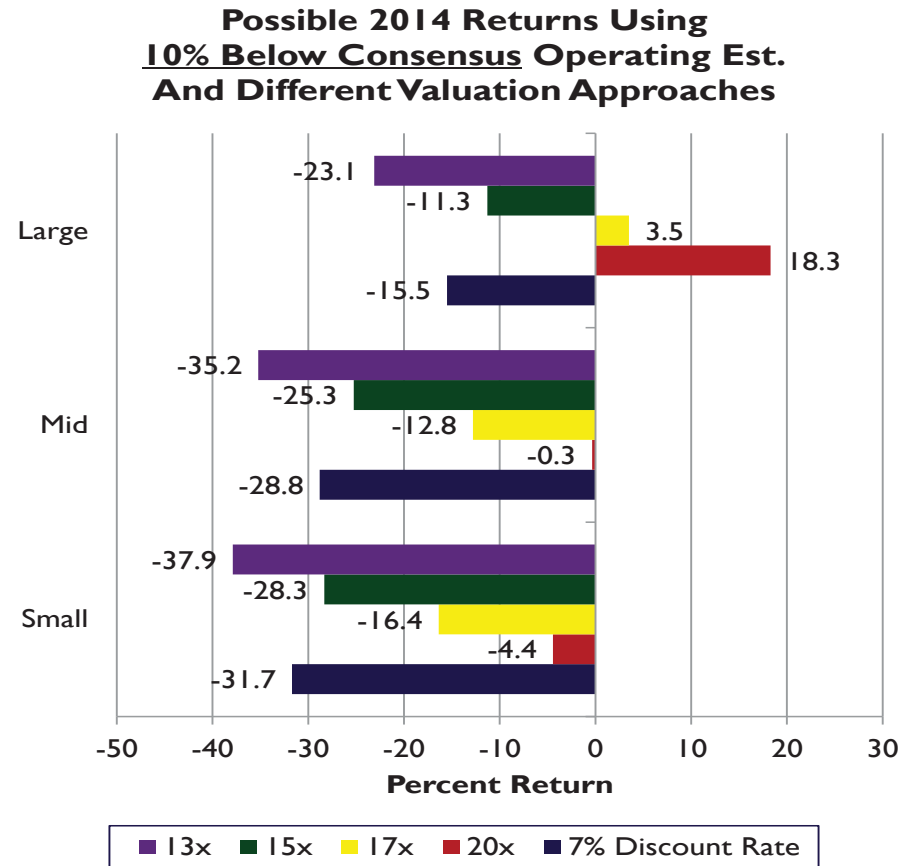
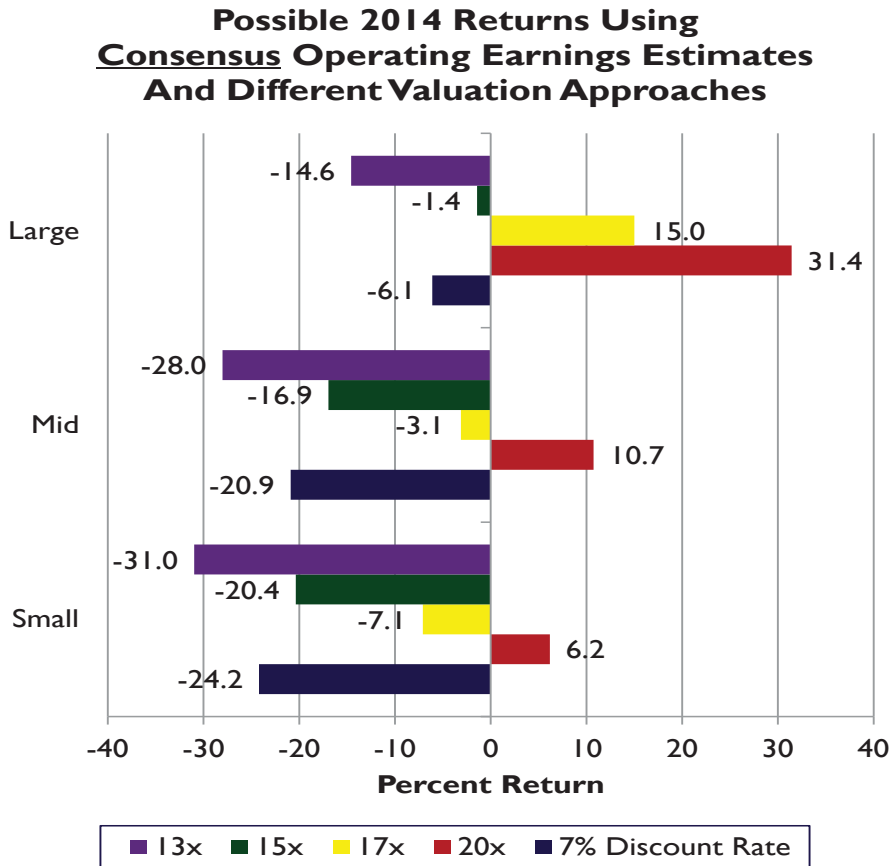
- Current valuations, based on a variety of measures, are above their 10-year averages. This does not necessarily imply significant over valuation (compared to full market history).
- JIC believes it is difficult to make the case that the current stock market is significantly undervalued. In addition, JIC believes continued stock market multiple expansion is less likely.

Price / Earning Multiples & Expected Earnings Growth By Company Size



- Price/earnings ratios for large-company stocks are significantly below those of mid- and small company stocks.
- 2014 expected earnings growth is expected to be reasonably strong. However, we are skeptical that small stocks will produce nearly twice the earnings growth of large-and mid-company stocks.

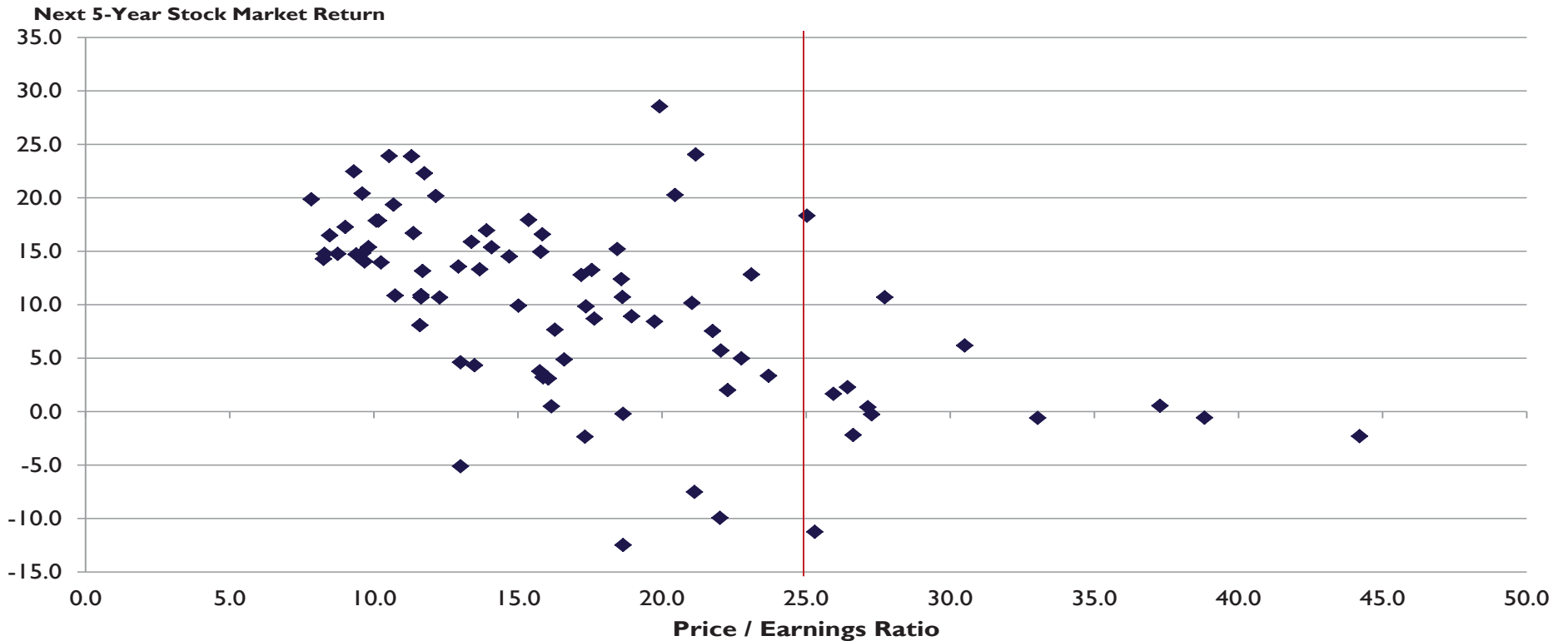
Possible 2014 Stock Returns By Company Size (Consensus & 10% Below Consensus Estimates)



- Assuming consensus earnings are achieved during 2014, it will be difficult for mid- and small-cap stocks to produce positive returns without multiples expanding to 20 times earnings. Large stocks could produce positive returns without the same level of multiple expansion.
- Often times, as the year progresses, earnings estimates are reduced. If 2014 consensus earnings were reduced by 10%, it would be extremely difficult for mid-and small company stocks to produce a positive return. Large stocks may be able to have positive results, but multiples will have to remain above 17x earnings.

PE Ratio vs. Next 5-Year Stock Market Returns

**Price / Earnings Ratio (10-Year Normalized Earnings) vs. Next 5-Year Stock Market Return
Calendar Year Data (1926 to Present)**



- This chart plots the price/earnings ratio (using 10-year normalized earnings) on the horizontal axis with the subsequent five-year stock market return on the vertical axis. The vertical red line shows the current normalized price/earnings ratio.
- While there are exceptions, most of the future 5-year returns at existing valuation levels are generally between 5% and -5%.
- Historically speaking, future five-year returns have tended to be higher when valuation levels are much lower.

Other 30% Plus Return Years, Valuation Levels, & Subsequent 5-Year Returns

| Year | Year Ending Return | Year-End Normalized P/E Ratio | Next 5-Year Return |
|------|--------------------|-------------------------------|--------------------|
| 1927 | 37.5% | 18.7x | -12.5% |
| 1928 | 43.6 | 25.3 | -11.2 |
| 1933 | 54.0 | 12.3 | 10.7 |
| 1935 | 47.7 | 16.2 | 0.5 |
| 1936 | 33.9 | 21.1 | -7.5 |
| 1938 | 31.1 | 15.8 | 3.8 |
| 1945 | 36.4 | 15.0 | 9.9 |
| 1950 | 31.7 | 11.3 | 23.9 |
| 1954 | 52.6 | 15.8 | 15.0 |
| 1955 | 31.6 | 18.9 | 8.9 |
| 1958 | 43.4 | 17.4 | 9.9 |
| 1975 | 37.2 | 10.3 | 14.0 |
| 1980 | 32.4 | 9.4 | 14.7 |
| 1985 | 32.2 | 11.7 | 13.2 |
| 1989 | 31.5 | 17.7 | 8.7 |
| 1991 | 30.5 | 18.4 | 15.2 |
| 1995 | 37.6 | 25.0 | 18.3 |
| 1997 | 33.4 | 33.0 | -0.6 |
| 2013 | 32.4 | 25.2 | ??? |

- This chart shows years (since 1926) in which the stock market returned above 30%. It also shows the price/earnings ratio as of that year-end (using 10-year normalized earnings) and the next five-year stock market return.
- With the exception of 1995 (the beginning of the internet bubble) future 5-year returns have not been particularly strong with price-earnings ratios at existing levels. Of course, history can only be a guide and is not necessarily a predictor.

Bond Market

Executive Summary: Bond Market

Observations

- Investment-grade bond markets did not perform well during 2013. U.S. bonds, municipal bonds, and developed international bonds all produced negative returns for the year. The one exception was the high-yield bond market which returned 7.4%.
- The U.S. bond market return of -2.0% was the first negative return since 1999, and the lowest calendar-year return since 1994. Bond returns typically do not perform well in rising interest rate environments.
- During the year, investment-grade bond yields (with maturities above three or four years) increased by approximately 1%. While bond yields are above inflation in the intermediate- and longer-term maturity segments, they remain below inflation in the shorter maturity segments (producing a negative real return).
- JIC believes it is prudent to expect further increases in interest rates. Conventional financial wisdom suggests bond investors seek to earn a return above the rate of inflation.
- Recent inflation has been “well contained” and has generally been below 2%. In addition, future inflation expectations, while higher than 2%, are within a reasonable range of 2.5% to 3.0%. In short, the market does not currently expect dramatically higher inflation.
- High-yield bond yields have declined to a 10-year low (and are extremely close to a historical low). While the quality spread (the yield pickup by investing in high-yield bonds over treasuries) is 4%, that is low by historical standards.
- Given a stable to strengthening economy, JIC believes high-yield bonds will continue to outperform investment grade bonds. However, JIC expects much lower future high-yield bond returns (compared to the last three-year return of 9.3%). During the next few years JIC believes it will be difficult for most bond investors -- including high yield bond investors -- to “earn their coupon” as we expect some depreciation as the result of rising interest rates.
- JIC expects to maintain a below target bond allocation, keep a shorter-maturity portfolio, as well being broadly diversified within the various bond segments.

Broad Bond Market Returns

| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>Annualized Returns</u> | |
|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-------------------------|----------------------------------|----------------------------------|
| | | | | | <u>3 Year</u> | <u>5 Year</u> |
| Emerging Bond 29.8% | Emerging Bond 12.2% | U.S. Inflation Protected 13.6% | Emerging Bond 17.4% | U.S. Inflation 1.2% | Emerging Bond 6.1% | Emerging Bond 11.7% |
| U.S. Muni 12.9% | Dev. Intl Bond 6.8% | U.S. Muni 10.7% | U.S. Inflation Protected 7.0% | U.S. Cash 0.1% | U.S. Muni 4.8% | U.S. Muni 5.9% |
| U.S. Inflation Protected 11.4% | U.S. Bond 6.5% | U.S. Bond 7.8% | U.S. Muni 6.8% | U.S. Bond -2.0% | U.S. Inflation Protected 3.5% | U.S. Inflation Protected 5.6% |
| U.S. Bond 5.9% | U.S. Inflation Protected 6.3% | Emerging Bond 7.3% | U.S. Bond 4.2% | U.S. Muni -2.6% | U.S. Bond 3.3% | U.S. Bond 4.4% |
| Dev. Intl Bond 3.9% | U.S. Muni 2.4% | Dev. Intl Bond 5.9% | U.S. Inflation 1.8% | Dev. Intl Bond -5.1% | U.S. Inflation 2.0% | Dev. Intl Bond 2.4% |

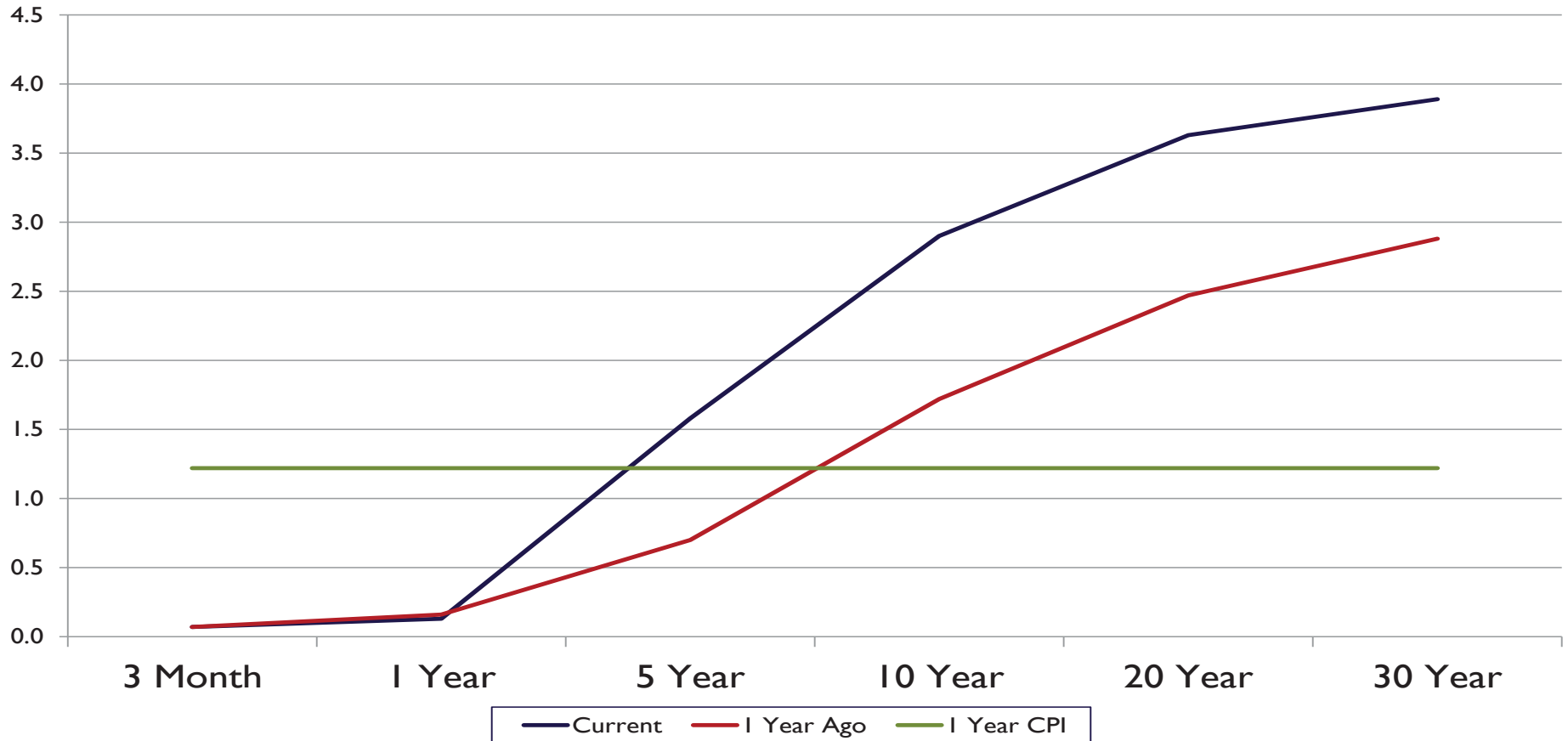
Bond Market Returns By Quality

| | | | | | <u>Annualized Returns</u> | |
|-------------------------------|------------------------------|------------------------------|-------------------------------|-------------------------------|------------------------------|-------------------------------|
| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>3 Year</u> | <u>5 Year</u> |
| U.S. High Yield 58.2% | U.S. High Yield 15.1% | U.S. Muni 10.7% | U.S. Muni High Yield 18.1% | U.S. High Yield 7.4% | U.S. High Yield 9.3% | U.S. High Yield 18.9% |
| U.S. Muni High Yield 32.7% | Emerging Bond 12.2% | U.S. Muni High Yield 9.2% | Emerging Bond 17.4% | U.S. Bond -2.0% | U.S. Muni High Yield 6.8% | U.S. Muni High Yield 11.8% |
| Emerging Bond 29.8% | U.S. Muni High Yield 7.8% | U.S. Bond 7.8% | U.S. High Yield 15.8% | U.S. Muni -2.6% | Emerging Bond 6.1% | Emerging Bond 11.7% |
| U.S. Muni 12.9% | U.S. Bond 6.5% | Emerging Bond 7.3% | U.S. Muni 6.8% | Emerging Bond -5.3% | U.S. Muni 4.8% | U.S. Muni 5.9% |
| U.S. Bond 5.9% | U.S. Muni 2.4% | U.S. High Yield 5.0% | U.S. Bond 4.2% | U.S. Muni High Yield -5.5% | U.S. Bond 3.3% | U.S. Bond 4.4% |

Bond Market Returns By Sector

| <u>2009</u> | <u>2010</u> | <u>2011</u> | <u>2012</u> | <u>2013</u> | <u>Annualized Returns</u> | |
|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|----------------------------------|
| | | | | | <u>3 Year</u> | <u>5 Year</u> |
| U.S. Corporate 16.0% | U.S. Corporate 8.5% | U.S. Inflation Protected 13.6% | U.S. Corporate 9.4% | U.S. Cash 0.1% | U.S. Corporate 5.1% | U.S. Corporate 7.9% |
| U.S. Inflation Protected 11.4% | U.S. Inflation Protected 6.3% | U.S. Government 9.0% | U.S. Inflation Protected 7.0% | U.S. Mortgage -1.4% | U.S. Inflation Protected 3.5% | U.S. Inflation Protected 5.6% |
| U.S. Mortgage 5.9% | U.S. Government 5.5% | U.S. Corporate 8.4% | U.S. Mortgage 2.6% | U.S. Corporate -2.0% | U.S. Government 2.7% | U.S. Mortgage 3.7% |
| U.S. Cash 0.2% | U.S. Mortgage 5.4% | U.S. Mortgage 6.2% | U.S. Government 2.0% | U.S. Government -2.6% | U.S. Mortgage 2.4% | U.S. Government 2.3% |
| U.S. Government -2.2% | U.S. Cash 0.1% | U.S. Cash 0.1% | U.S. Cash 0.1% | U.S. Inflation Protected -8.6% | U.S. Cash 0.1% | U.S. Cash 0.1% |

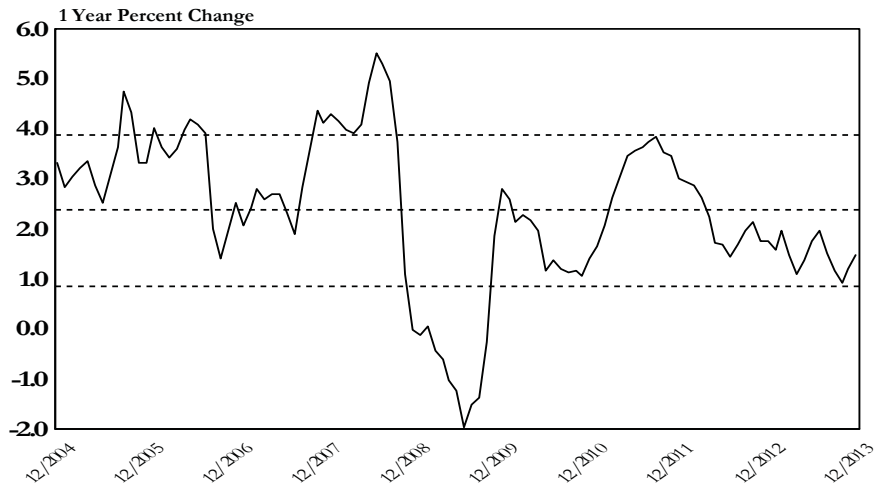
Treasury Yield Curve vs. Inflation



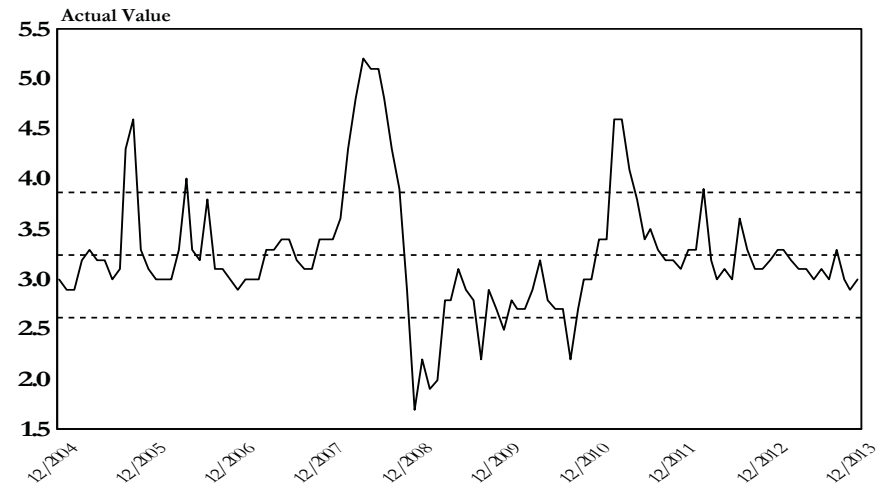
- Compared to a year ago, Treasury interest rates with more than one year to maturity have substantially risen (by approximately 1%).
- However, even with the rise in interest rates, Treasury yields with one- to four- years to maturity are still below the rate of inflation -- producing negative real returns. Eventually, all interest rates should rise to provide a return above the rate of inflation.

Interest Rates

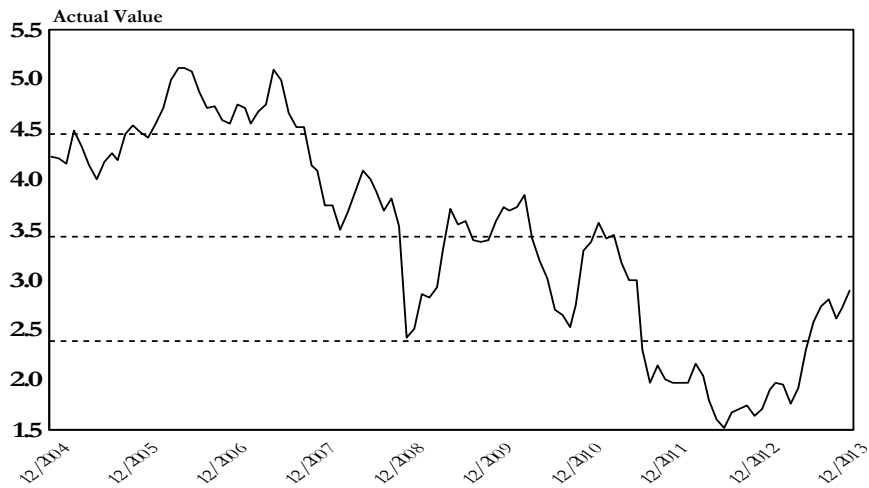
Consumer Price Index



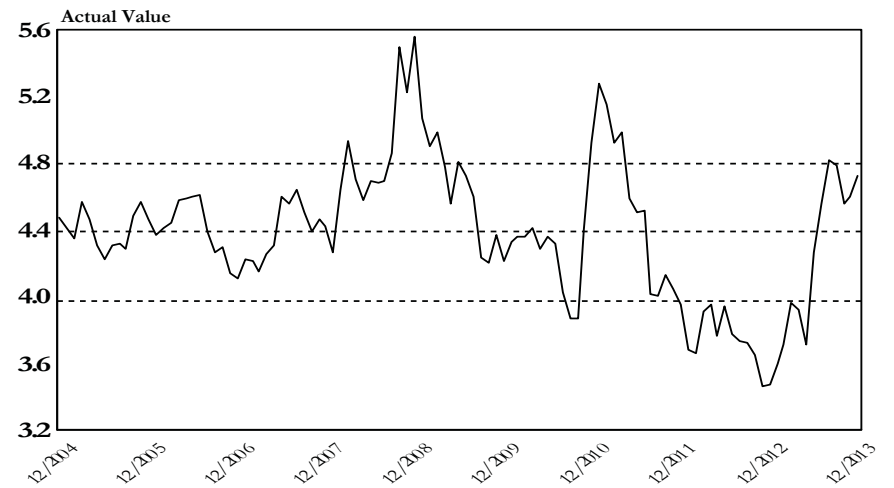
University Of Michigan Inflation Expectations



10 Year Treasury



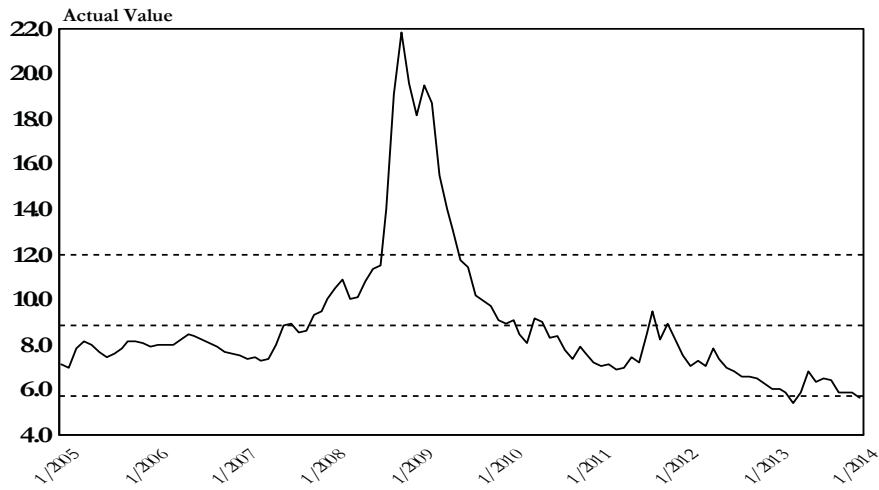
Bond Buyer 20-Bond Municipal Bond Index



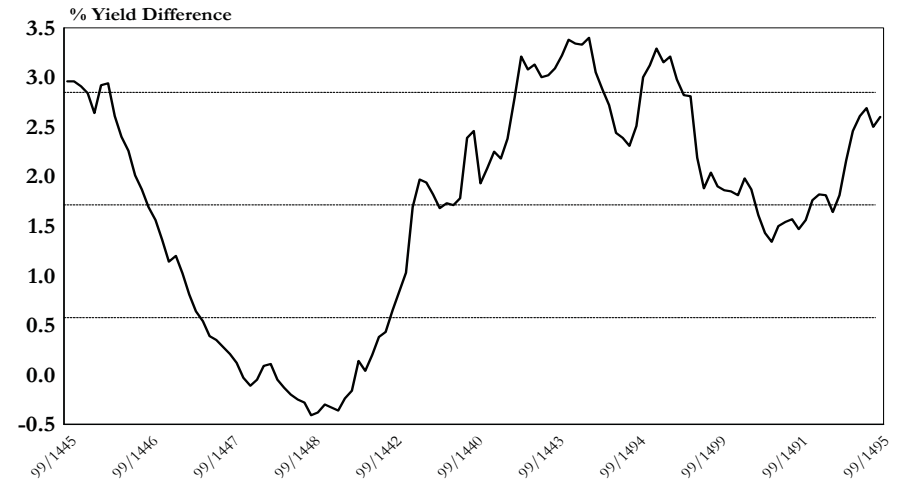
- Recently, inflation has been below 2%. In addition, while inflation expectations are higher, the market certainly does not expect “runaway” future inflation (probably in the 2.5% to 3.0% range).
- During the first half of 2013, interest rates rose quickly in response to the Fed’s initial tapering comments. Both treasuries and municipal bonds increased by approximately 1% during the year.

Interest Rates (continued)

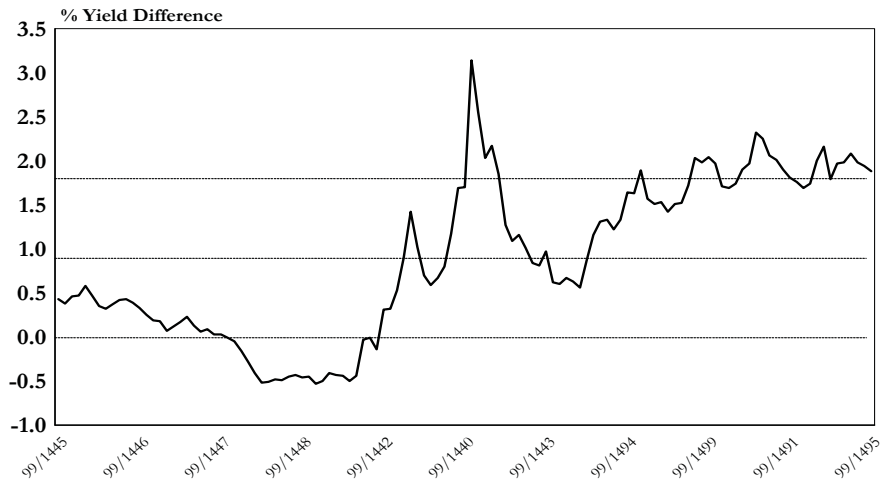
ML High Yield



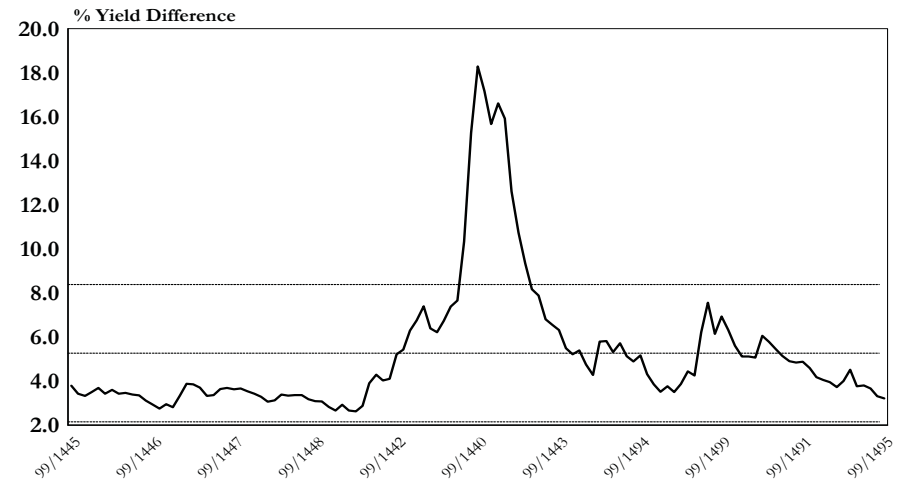
10 Year Treasury Less 1 Year Treasury



Bond Buyer 20-Bond Municipal Bond Index Less 10 Year Treasury



ML High Yield Less 10 Year Treasury



- Yields on high-yield bonds declined from over 20% during the financial crisis to 10-year lows (currently around 6%). The “quality spread” (high-yield bond yields less 10-year treasury yields) has declined substantially as well, but is still over 4%. Although, this is a result of treasury yields that remain abnormally low.
- Given the uncertainty with state and local budgets, municipal bond yields, relative to treasuries, are significantly above their ten-year historic average.