



Johnston Investment Counsel

Gregory A. Johnston, CFA, CFP, QPFC, AIF
President & Chief Investment Officer
2714 N. Knoxville
Peoria, IL 61604
309-674-3330
gjohnston@jicinvest.com
www.jicinvest.com

Saving or Investing: Is There a Difference?



Financially speaking, the terms "saving" and "investing" are often used interchangeably. But the concepts behind these terms actually have some important differences. Understanding

these differences and taking advantage of them may help you in working toward financial goals for you and your family.

Saving

You may want to set aside money for a specific, identifiable expense. You park this money someplace relatively safe and liquid so you can get the amount you want when you need it. According to the Securities and Exchange Commission brochure *Saving and Investing*, "savings are usually put into the safest places, or products, that allow you access to your money at any time. Savings products include savings accounts, checking accounts, and certificates of deposit." Some deposits may be insured (up to \$250,000 per depositor, per insured institution) by the Federal Deposit Insurance Corporation or the National Credit Union Administration. Savings instruments generally earn interest. However, the likely tradeoff for liquidity and security is typically lower returns.

Investing

While a return of your money may be an important objective, your goal might be to realize a return on your money. Using your money to buy assets with the hope of receiving a profit or gain is generally referred to as investing. Think of investing as putting your money to work for you--in return for a potentially higher return, you accept a greater degree of risk. With investing, you don't know whether or when you'll realize a gain. The money you invest usually is not federally insured. You could lose the amount you've invested (e.g., your principal), but you also have the opportunity to earn more money, especially compared to typical savings vehicles. The investment is often held for a longer period of time to allow for growth. It is important to note, though, that all investing involves risk,

including the loss of principal, and there is no assurance that any investing strategy will be successful.

What's the difference?

Whether you prefer to use the word "saving" or "investing" isn't as important as understanding how the underlying concepts fit into your financial strategy. When it comes to targeting short-term financial goals (e.g., making a major purchase in the next three years), you may opt to save. For example, you might set money aside (i.e., save) to create and maintain an emergency fund to pay regular monthly expenses in the event that you lose your job or become disabled, or for short-term objectives like buying a car or paying for a family vacation. You might consider putting this money in a vehicle that's stable and liquid. Think of what would happen if you were to rely on investments that suddenly lost value shortly before you needed the funds for your purchase or expense.

Saving generally may not be the answer for longer-term goals. One of the primary reasons is inflation--while your principal may be stable, it might be losing purchasing power. Instead, you may opt to purchase investments to try to accumulate enough to pay for large future expenses such as your child's college or your retirement. Generally, saving and investing work hand in hand. For instance, you may save for retirement by *investing* within an employer retirement account.

Why is it important?

Both saving and investing have a role in your overall financial strategy. The key is to balance your saving and investing with your short- and long-term goals and objectives. Overemphasize saving and you might not achieve the return you need to pursue your long-term goals. Ignore saving and you increase the risk of not being able to meet your short-term objectives and expenses. Get it right and you increase your chances of staying on plan.

November, 2014

Saving or Investing: Is There a Difference?

Open Enrollment Season Is Here: Give Your Benefits a Check Up

Investor, Know Thyself: How Your Biases Can Affect Investment Decisions

Do I have to pay an additional tax on investment income?



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The decisions you make during open enrollment season are important, because you generally must stick with the options you've chosen until the next open enrollment season. The exception to this is if you experience a "qualifying event" such as marriage, divorce, or the birth of a child, in which case you'll be able to make changes outside of the open enrollment period.

Open Enrollment Season Is Here: Give Your Benefits a Check Up

Open enrollment season is your annual opportunity to review your employer-provided benefit options and make elections for the upcoming plan year. To get the most out of what your employer has to offer and potentially save some money, take time to read through the enrollment packets or information you receive before making any benefit decisions.

Review your health plan options

Even if you're satisfied with your current health plan, compare your existing coverage to other plans your employer is offering for next year. Premiums, out-of-pocket costs, and benefits offered often change from one year to the next and vary among plans. You may decide to keep the plan you already have, but it doesn't hurt to consider your options.

Some tips for reviewing your health coverage:

- Start by reading plan materials you've received in your open enrollment packet and find out as much as you can about your options. Look for a "What's New" section that spells out plan changes.
- List your expenses. These will vary from year to year, but what you've spent over the course of the last 12 months may be a good predictor of what you'll spend next year. Don't forget to include co-payments and deductibles, as well as dental, vision, and prescription drug expenses.
- Reevaluate your coverage to account for life changes. For example, getting married, having a baby, or retiring are events that should trigger a thorough review of your health coverage.
- Consider all out-of-pocket costs, not just the premium you'll pay. For example, if you frequently fill prescriptions, you may save money with a plan that offers the broadest prescription drug coverage with the lowest co-payments, even if it charges a higher premium than other plans.
- Compare your coverage to your spouse's if he or she is eligible for employer-sponsored health insurance. Will you come out ahead if you switch to your spouse's plan? If you have children, which plan best suits their needs?
- Take advantage of technology. Some employers offer calculators or tables that allow you to do a side-by-side comparison of health plans to help select the best option.

Decide whether to contribute to a flexible spending account

You can help offset your health-care costs by contributing pretax dollars to a health flexible spending account (FSA), or reduce your

child-care expenses by contributing to a dependent-care FSA. The money you contribute is not subject to federal income and Social Security taxes (nor generally to state and local income taxes), and you can use these tax-free dollars to pay for health-care costs not covered by insurance or for dependent-care expenses.

If your employer offers you the chance to participate in one or both types of FSAs, you'll need to estimate your expenses for the upcoming year in order to decide how much to contribute (subject to limits). Your contributions will be deducted, pretax, from your paycheck.

One thing to watch out for this open enrollment season: Because of a change to the "use-it-or-lose-it" rule, employers may now allow participants the chance to roll over \$500 of health FSA funds that are unused at the end of one plan year to the next plan year. So before you decide how much to contribute to your health FSA, read through your employer's materials to see whether this change will apply to you--employers aren't required to adopt this new carryover approach. If your employer has not, you'll lose any contributions you don't spend by the end of your benefit period (including any grace period). And remember, you must enroll in a health or dependent-care FSA each year; enrollment is not automatic.

Find out what other benefits and incentives are available

Many employers offer other voluntary benefits such as dental care, vision coverage, disability insurance, life insurance, and long-term care insurance. Even if your employer doesn't contribute toward the premium cost, you may be able to conveniently pay premiums via payroll deduction.

To avoid missing out on savings opportunities, find out whether your employer offers other discounts or incentives. Common options are discounts on health-related products and services, such as gym memberships and eyeglasses, or wellness incentives such as a monetary reward for completing a health assessment.

Get the information you need

Ask your benefits administrator for help if you have any questions about your benefits, the options available to you, or enrollment instructions or deadlines. You generally have only a few weeks to make important decisions about your benefits, so don't delay.



Investor, Know Thyself: How Your Biases Can Affect Investment Decisions



In psychology, "heuristics" refers to the mental decision-making short-cuts that individuals develop over time based on past experiences. While heuristics can be helpful in avoiding unnecessary deliberation, they can also lead to misleading biases that can derail even the most well-thought-out financial plan.

Traditional economic models are based on a simple premise: people make rational financial decisions that are designed to maximize their economic benefits. In reality, however, most humans don't make decisions based on a sterile analysis of the pros and cons. While most of us do think carefully about financial decisions, it is nearly impossible to completely disconnect from our "gut feelings," that nagging intuition that seems to have been deeply implanted in the recesses of our brain.

Over the past few decades, another school of thought has emerged that examines how human psychological factors influence economic and financial decisions. This field--known as behavioral economics, or in the investing arena, behavioral finance--has identified several biases that can unnerve even the most stoic investor. Understanding these biases may help you avoid questionable calls in the heat of the financial moment.

Sound familiar?

Following is a brief summary of some common biases influencing even the most experienced investors. Can you relate to any of these?

1. **Anchoring** refers to the tendency to become attached to something, even when it may not make sense. Examples include a piece of furniture that has outlived its usefulness, a home or car that one can no longer afford, or a piece of information that is believed to be true, but is in fact, false. In investing, it can refer to the tendency to either hold an investment too long or place too much reliance on a certain piece of data or information.
2. **Loss-aversion bias** is the term used to describe the tendency to fear losses more than celebrate equivalent gains. For example, you may experience joy at the thought of finding yourself \$5,000 richer, but the thought of losing \$5,000 might provoke a far greater fear. Similar to anchoring, loss aversion could cause you to hold onto a losing investment too long, with the fear of turning a paper loss into a real loss.
3. **Endowment bias** is also similar to loss-aversion bias and anchoring in that it encourages investors to "endow" a greater value in what they currently own over other possibilities. You may presume the investments in your portfolio are of higher quality than other available alternatives, simply because you own them.
4. **Overconfidence** is simply having so much confidence in your own ability to select investments for your portfolio that you might

ignore warning signals.

5. **Confirmation bias** is the tendency to latch onto, and assign more authority to, opinions that agree with your own. For example, you might give more credence to an analyst report that favors a stock you recently purchased, in spite of several other reports indicating a neutral or negative outlook.
6. The **bandwagon effect**, also known as **herd behavior**, happens when decisions are made simply because "everyone else is doing it." For an example of this, one might look no further than a fairly recent and much-hyped social media company's initial public offering (IPO). Many a discouraged investor jumped at that IPO only to sell at a significant loss a few months later. (Some of these investors may have also suffered from overconfidence bias.)
7. **Recency bias** refers to the fact that recent events can have a stronger influence on your decisions than other, more distant events. For example, if you were severely burned by the market downturn in 2008, you may have been hesitant about continuing or increasing your investments once the markets settled down. Conversely, if you were encouraged by the stock market's subsequent bull run, you may have increased the money you put into equities, hoping to take advantage of any further gains. Consider that neither of these perspectives may be entirely rational given that investment decisions should be based on your individual goals, time horizon, and risk tolerance.
8. A **negativity bias** indicates the tendency to give more importance to negative news than positive news, which can cause you to be more risk-averse than appropriate for your situation.

An objective view can help

The human brain has evolved over millennia into a complex decision-making tool, allowing us to retrieve past experiences and process information so quickly that we can respond almost instantaneously to perceived threats and opportunities. However, when it comes to your finances, these gut feelings may not be your strongest ally, and in fact may work against you. Before jumping to any conclusions about your finances, consider what biases may be at work beneath your conscious radar. It might also help to consider the opinions of an objective third party, such as a qualified financial professional, who could help identify any biases that may be clouding your judgment.



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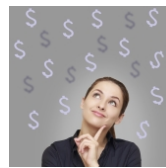
Gregory A. Johnston, CFA, CFP,
QPFC, AIF
President & Chief Investment
Officer
2714 N. Knoxville
Peoria, IL 61604
309-674-3330
gjohnston@jjcinvest.com
www.jjcinvest.com

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Do I have to pay an additional tax on investment income?

You might, depending on a few important factors.

A 3.8% net investment income tax is imposed on the

unearned income of high-income individuals. The tax is applied to an amount equal to the lesser of:

- Your net investment income
- The amount of your modified adjusted gross income (basically, your adjusted gross income increased by an amount associated with any foreign earned income exclusion) that exceeds \$200,000 (\$250,000 if married filing a joint federal income tax return, and \$125,000 if married filing a separate return)

So if you're single and have a MAGI of \$250,000, consisting of \$150,000 in earned income and \$100,000 in net investment income, the 3.8% tax will only apply to \$50,000 of your investment income.

The 3.8% tax also applies to estates and trusts. The tax is imposed on the lesser of undistributed net investment income or the excess of MAGI that exceeds the top income tax bracket threshold for estates and trusts

(\$12,150 in 2014). This relatively low tax threshold potentially could affect estates and trusts with undistributed income. Consult a tax professional.

What is net investment income?

Net investment income generally includes all net income (income less any allowable associated deductions) from interest, dividends, capital gains, annuities, royalties, and rents. It also includes income from any business that's considered a passive activity, or any business that trades financial instruments or commodities.

Net investment income does not include interest on tax-exempt bonds, or any gain from the sale of a principal residence that is excluded from income. Distributions you take from a qualified retirement plan, IRA, 457(b) deferred compensation plan, or 403(b) retirement plan are also not included in the definition of net investment income.



How can I manage the net investment income tax?

If you are subject to the 3.8% net investment income tax, there are strategies that may help you manage that tax. The tax is applied to the lesser of

your net investment income or the amount by which your modified adjusted gross income (MAGI) exceeds the applicable income tax threshold. MAGI is basically adjusted gross income plus any associated foreign earned income exclusion. Any strategy you consider should be directed at the appropriate target.

If your net investment income is greater than your MAGI over the threshold, then your focus should be aimed at reducing your MAGI. Conversely, if your MAGI over the threshold is greater than your net investment income, you should try to reduce your net investment income.

Here are a few strategies that may help you manage the net investment income tax:

- Before selling appreciated securities, consider whether you can offset the gain with capital losses. Likewise, if you have any capital loss carryforwards, you should review your portfolio for capital gain opportunities to make use of the capital losses.

- Consider gifts of appreciated securities to tax-qualified charities.
- If passive income is from a business, offset passive income with passive losses. If you don't have passive losses, you may be able to convert the passive income to non-passive income (not subject to the tax) by becoming more active in the business.
- You may be able to reduce your MAGI by increasing contributions to a traditional IRA, 401(k), or 403(b).
- Consider investments that may have growth potential but typically do not generate dividends.
- Generally, any gains in tax-deferred annuities and cash value life insurance are not reportable as income unless withdrawn, which may help reduce both your MAGI and your net investment income.

While any of these alternatives may help reduce your net investment income or your MAGI, they may also affect your financial planning. So before implementing strategies to reduce or eliminate exposure to the net investment income tax, consult with a tax professional to help with your specific situation.



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Capital Market Review

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Visit us online
jcinvest.com

Office
2714 N. Knoxville
Peoria, Illinois 61604
t 309.674.3330
tf 877.848.3330
f 888.301.0514



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Executive Summary

The U.S. economy has been operating in a consistent, low-growth mode for years. We see no reason why this scenario would change. Consumer and employment are doing fine. Inflation is tame. Employers would like to hire more, but there is a skills gap. This may put future pressure on wages. Housing market should be doing better but banks remain reluctant to lend.

U.S. Federal Reserve is starting toward the path of interest rate normalization. Most believe first interest rate hike occurs in 2015. Subsequent hikes will likely be gradual and probably take 2-3 years to reach a normalized interest rate level.

Worldwide economic growth is a big disappointment. Another European recession is not out of the question. Policymakers are starting another round of stimulative policies. Political conflicts/instability appear to be widespread.

Given this backdrop, U.S. stock and bond returns have exhibited modest, but positive returns year-to-date.

JIC recommends investors maintain modest future return expectations.

Economic Conditions

The U.S. economy appears to be in a consistent lower-growth mode. It is hard to imagine 4% or 5% economic growth for any sustained period of time. In short, 2% to 2.5% economic growth now seems to be the expectation. Perhaps we can get to 3% on the high end.

Consumer spending is relatively stable (and growing), and the employment picture has improved. The unemployment rate continues to decline and employers appear willing to hire if they could find qualified candidates. Wages are rising consistent with inflation, but we may soon see more upward pressure.

By now, the expectation is that the housing market would be operating on “all cylinders”, but that has not occurred. In some parts of the country affordability is an issue but, more importantly, banks remain tightfisted in providing credit. To highlight the point, the news media recently reported that Ben Bernanke (the former Fed Chairman), could not refinance his mortgage.

During the past year, the Federal Reserve started to scale back its quantitative easing program (i.e. bond buying) and it will probably be stopped by the end of this year. While the Fed is starting toward the path of interest-rate policy normalization, there does not appear to be any consensus when changes to short-term interest rates would occur.

The Fed has made it very clear they will be data driven. Most observers believe the initial rate hike will occur sometime next year. This economy has had so many “fits and starts”, we suspect the FED, once interest rate hikes begin, will be gradual with follow-up hikes (assuming inflation remains tame). We expect it may take 2-3 years before short-term rates will approach a “normalized” level.

Worldwide economic growth, particularly in the Eurozone, has been a significant disappointment. In fact, Europe has not shown any growth in the recent quarter. China’s growth seems to have peaked and Japan’s economic growth has been affected by the tax hike that occurred earlier this year.

2015 will likely be the year in which we see a decoupling of economic policy. The U.S. (and probably the U.K.) may start increasing interest rates, but the European Central Bank may not only further reduce interest rates but is seeking other non-traditional policies to stimulate their economies.

Significant geopolitical concerns may also be dampening

economic growth. The conflict between Ukraine and Russia continues, the ongoing conflict in the Middle East, most notably in Iraq and Syria, the uncertainty surrounding the vote for Scottish independence (ultimately unsuccessful), and the selective default on Argentinian debt reminds us that the world remains a dangerous place and upheavals can have economic consequences.

Stock Market

Given this backdrop, it is remarkable how well the U.S. equity markets have held up. While volatility spiked during October, recent rallies have recovered most of the losses that occurred earlier in the month.

The broad U.S. stock market (as measured by the Russell 3000) was flat for the third quarter, but has a year-to-date return (through September 30) of 6.9%. However, that masks some of the performance differences between company size segments. For example, small stocks returned -7.4% during the third quarter and -4.4% YTD. Mid-cap stocks also had a difficult third quarter returning -1.7%, but have performed similar to large stocks on a YTD basis.

There has been little performance difference between investment approach segments (value, core, and growth) on a YTD basis.

Year-to-date, Healthcare, Technology, and Utilities have been the best performing sectors with returns between 13.9% and 16.6%. Sector laggards have been Consumer Discretionary, Energy, and Industrials -- clearly sectors that are more economically sensitive. These sectors have returned between 0.9% and 3.2% on a YTD basis.

International stocks -- both developed as well as emerging markets -- have lagged U.S. stock market returns. Developed international returned -5.9% during the third quarter and -1.4% YTD. Emerging markets third quarter return was -4.3% and their YTD return is 0.3%.

At current valuation levels, JIC recommends investors keep their long-term stock market return expectations modest. We know dividend yields are around 2%, and that valuation levels are at or above their historical averages. However, above average valuation levels can last for many years -- particularly given low the level of long-term interest rates. In short, we would not count on higher multiples to drive future stock returns. Perhaps the best case scenario would be “static” valuation multiples (as opposed to declining).

Higher-than-expected earnings growth would likely benefit future stock returns. This is possible, particularly

if worldwide economic growth improves above current expectations.

We suggest investors keep modest future return expectations -- for both stocks and bonds.

Stock investors should expect a level of return volatility and, generally speaking, their holding period needs to be well over five years to recover from any future stock market declines that will inevitably occur. Even with stocks at their current level, we expect that over any reasonable length of time, stocks will outperform bonds.

Bond Market

Investment grade bond returns were poor during 2013 (negative) as interest rates rose. Consensus expectations were that interest rates would probably continue to rise during 2014. The consensus has been proven wrong as interest rates have declined across most maturity segments. Recent stock market volatility further lowered yields. At present, 10-year Treasury yields are around 2.4%.

Given the decline in yields, it is not surprising that bond returns have been pretty competitive this year -- and much higher than their yield would suggest. U.S. bonds returned 4.1% YTD while developed and emerging market bonds have returned 0.3% and 8.0%. The rising dollar clearly impacted developed market bond returns.

Corporate bonds have, once again, been the best performing sector returning 5.7% compared to the mortgage-backed bond return of 4.2% and government bond return of 3.0%. For the first time in several years, high yield bond returns (3.5% YTD) have underperformed investment grade bonds.

Bond yields remain extremely low -- hardly providing any return above inflation. AAA corporates currently yield 2.68% while BBB corporates (the last tier of investment grade) yield 3.63%. Today's investment grade bond buyers should probably have a one- or two-year total return expectation between the 2.5% to 3.5% range -- and it stands to reason if interest rates rise -- total returns could be lower.

Summary

The good news is that the U.S. economy is clearly one of the strongest major worldwide economies. The bad news is that, while growing, it is at best moderate growth. We do not foresee major changes to U.S. economic growth -- we simply think it will remain modest. Developed international markets will hopefully start to show some economic improvement, but we suspect that will not be showing up in the data for another year or more.

Stock Returns For Periods Ending September 30, 2014

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>1 Year</u>	<u>3 Year</u>
<u>Nationality</u>						<u>Developed Country</u>			
U.S. Market	0.0	7.0	17.8	23.1	15.8	U.S.	0.0	17.8	23.1
Developed Intl	-5.9	-1.4	4.3	13.6	6.6	Canada	9.3	23.6	0.4
Emerging Market	-4.3	0.3	1.8	4.5	1.9				
<u>Size</u>						<u>Europe</u>			
Large	1.1	8.3	19.7	23.0	15.7	France	-0.1	25.1	1.6
Mid	-1.7	6.9	15.8	23.8	17.2	Germany	-0.2	26.8	4.6
Small	-7.4	-4.4	3.9	21.3	14.3	Italy	-1.7	48.0	-1.3
Micro	-7.3	-4.7	6.8	27.5	16.6	United Kingdom	5.0	22.1	6.0
<u>Approach</u>						<u>Pacific</u>			
Value	-0.9	7.0	17.7	23.7	15.1	Australia	1.8	15.6	1.1
Core	0.0	7.0	17.8	23.1	15.8	Hong Kong	6.7	14.3	5.0
Growth	0.9	6.9	17.9	22.4	16.4	Japan	6.5	8.0	4.8
<u>Sector</u>						<u>Emerging Market</u>			
Cons Discretionary	0.3	0.9	11.8	26.3	21.5	China	3.5	12.7	-2.3
Cons Staples	2.0	7.2	16.5	18.2	15.4	India	12.1	25.6	-0.8
Energy	-8.6	3.2	11.9	16.9	12.5	Korea	6.4	23.3	1.1
Finance	2.3	7.4	18.5	27.6	11.0	Czech Republic	0.1	21.0	-13.0
Healthcare	5.5	16.6	28.4	28.8	19.7	Hungary	1.5	-17.4	-17.7
Industrials	-1.1	2.9	16.8	24.8	17.3	Poland	-2.2	19.2	-6.6
Technology	4.8	14.1	29.3	22.3	16.0	Russia	9.8	6.4	-10.2
Materials	0.2	8.9	20.5	22.0	13.2	Brazil	5.7	8.8	-13.0
Telecomm	3.1	7.5	13.3	15.2	14.0	Mexico	6.2	5.7	3.2
Utilities	-4.0	13.9	17.1	12.3	12.1				

Stock Fundamentals As Of September 30, 2014

	<u>United States</u>		<u>Developed</u>		<u>Emerging</u>					
	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>	<u>Current</u>	<u>1 Year Ago</u>				
Price/Earnings Current	18.7	17.3	15.9	15.2	12.8	11.2				
Price/Forecast Earnings	17.4	15.8	15.1	14.1	12.0	11.0				
Price/Book	2.6	2.4	1.6	1.5	1.6	1.5				
Price/Cash Flow	11.3	10.5	8.8	8.6	7.5	7.0				
Price/Sales	1.6	1.5	1.0	1.0	1.2	1.1				
Forecast LT EPS Growth	10.3	9.5	9.7	7.9	11.7	12.1				
	<u>Est. P/E Ratio</u>		<u>Est. EPS Growth</u>		<u>Fair Value Returns</u>		<u>Fair Value Returns</u>			
	<u>2014</u>	<u>2015</u>	<u>2014</u>	<u>2015</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>	<u>13x</u>	<u>17.5x</u>	<u>7% DR</u>
Large	16.3	14.2	16.3	14.2	-20.2	7.5	-12.3	-8.5	23.1	0.5
Mid	19.1	15.9	19.1	15.9	-32.0	-8.5	-25.3	-18.2	10.1	-10.1
Small	20.3	15.6	20.3	15.6	-36.0	-13.9	-29.7	-16.4	12.5	-8.2

Bond Returns And Characteristics For Periods Ending September 30, 2014

	<u>Returns</u>					<u>Bond Yields</u>	<u>Last</u>	<u>1 Year</u>	
	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>		<u>Qtr</u>	<u>Qtr</u>	<u>Ago</u>
<u>Nationality</u>						Fed Funds	0.09	0.10	0.08
U.S. Market	0.2	4.1	4.0	2.4	4.1	Prime Rate	3.25	3.25	3.25
Developed Intl	-5.4	0.3	-1.1	-1.4	1.2	3 Month Treasury	0.02	0.04	0.02
Emerging Market	-0.6	8.0	9.7	7.9	8.0	1 Year Treasury	0.11	0.10	0.12
						3 Year Treasury	1.05	0.90	0.78
						5 Year Treasury	1.77	1.68	1.60
<u>Maturity</u>						10 Year Treasury	2.53	2.60	2.81
Cash	0.0	0.0	0.0	0.1	0.1	30 Year Treasury	3.26	3.42	3.79
Short-Term	0.0	0.6	0.8	0.9	1.5	Muni Bonds	4.13	4.35	4.79
Intermediate-Term	0.0	2.2	2.2	2.0	3.4	Mortgage (30-Year)	4.16	4.16	4.49
Long-Term	1.0	13.0	12.9	4.7	8.0				
						5 Year TIP	0.10	-0.29	-0.17
<u>Sector</u>						10 Year TIP	0.46	0.37	0.66
Corporate	0.0	5.7	6.6	4.8	6.1	30 Year TIP	1.05	1.11	1.50
Government	0.3	3.0	2.3	1.1	3.1	1 Year Inflation	1.58	2.07	1.15
Mortgage	0.2	4.2	3.8	2.1	3.5				
						AAA Corporate	2.68	2.51	2.76
<u>Other</u>						BBB Corporate	3.63	3.42	4.03
High Yield	-1.9	3.5	7.2	11.1	10.6	BB Corporate	4.99	4.30	5.22
Inflation Protected	-2.0	3.7	1.6	1.3	4.5	High Yield	6.26	5.28	6.47
Municipal	1.5	7.6	7.9	4.6	4.7	Emerging Market	2.74	2.62	3.01

10-Year Sovereign Bond Yields

Relative Comparisons

<u>Developed Mkts</u>	<u>Qtr</u>	<u>Last</u>	<u>1 Year</u>		<u>Qtr</u>	<u>Last</u>	<u>1 Year</u>
		<u>Qtr</u>	<u>Ago</u>			<u>Qtr</u>	<u>Qtr</u>
United States	2.54	2.601	2.71				
Canada	2.20	2.26	2.69	<u>Implied Inflation</u>			
France	1.34	1.75	2.51	5 Year	1.67	1.98	1.77
Germany	1.01	1.38	2.00	10 Year	2.06	2.22	2.14
Italy	2.37	2.85	4.46	30 Year	2.19	2.28	2.26
United Kingdom	2.50	3.00	2.83	<u>Spreads</u>			
Euro Zone	1.01	1.38	2.00	Maturity (10-1yr)	2.42	2.50	2.69
Australia	3.61	3.74	4.05	Maturity (30-10yr)	0.73	0.82	0.98
Hong Kong	2.06	2.17	2.33				
Japan	0.53	0.60	0.71	AAA - 10 Yr	0.15	-0.09	-0.05
				BBB - 10 Yr	1.10	0.82	1.22
<u>Emerging</u>				BB - 10 Yr	2.46	1.70	2.41
Brazil	11.77	11.98	11.52	Municipal	1.60	1.75	1.98
China	3.93	3.84	3.98	High Yield - 10 Yr	3.73	2.68	3.66
India	8.48	8.67	8.37	Emerging - 10 Yr	0.21	0.02	0.20
Russia	9.30	8.68	7.66				

Commodity, Real Estate, & Currency Returns For Periods Ending September 30, 2014

	<u>Qtr</u>	<u>Ytd</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>
<u>Commodity</u>					
DJ UBS Commodity	-11.8	-5.6	-6.6	-5.3	-1.4
CRB Commodity Spot	-4.6	3.9	1.3	-2.0	4.9
CRB Fat & Oils	-1.8	24.3	2.1	-4.5	9.9
CRB Foodstuffs	-6.3	16.0	5.3	-2.7	6.7
CRB Livestock	-2.4	20.5	6.6	1.1	13.5
CRB Metals	-1.1	-5.1	0.2	0.9	5.7
CRB Raw Industrials	-3.3	-3.8	-1.3	-1.6	3.7
CRB Textiles & Fibers	-5.4	-7.1	-6.9	-5.0	-0.2
<u>Agriculture</u>					
Coffee	6.6	67.3	59.7	-8.4	7.8
Corn	-24.7	-23.4	-37.4	-19.1	0.8
Soybean	-22.2	-13.8	-15.8	-2.8	2.8
Sugar	1.0	26.3	21.4	-12.6	-0.8
Wheat	-11.9	-15.0	-15.9	-8.8	5.0
<u>Energy</u>					
Oil	-11.3	-4.7	-12.2	2.9	6.1
Unleaded Gas	-8.5	2.2	-2.0	-0.9	6.1
<u>Metals</u>					
Aluminum	8.2	14.4	13.0	-4.6	1.6
Copper	0.7	-4.7	-4.0	-6.1	2.1
Gold	-3.1	1.1	-8.2	-11.2	4.4
Nickel	-3.2	29.5	30.7	-4.0	0.7
Zinc	7.8	16.2	24.2	3.4	4.1
<u>Real Estate</u>					
MSCI U.S. Reit	-3.1	14.0	13.3	16.6	16.0
MSCI World Reit	-3.7	6.8	5.8	14.5	10.2
<u>Currency</u>					
	<u>U.S. Dollar Returns</u>				
Euro	5.5	6.4	3.6	2.2	2.5
Japan	5.3	3.8	8.3	11.8	3.3
U.K.	3.8	0.6	-2.5	-1.1	0.0
Brazil	4.6	-0.4	3.3	10.2	5.1
China	-1.5	1.1	0.3	-1.3	-2.1
India	1.9	-1.5	-4.3	8.5	4.7
Mexico	1.9	1.7	1.4	0.4	-0.3

Current Economic & Financial Conditions

	Percent Change					Data As Of
	3 Month		6 Month		1 Year	
	3 Month	Annualized	6 Month	Annualized		
Gross Domestic Product	1.1	4.6	0.6	1.2	2.6	June/2014
Leading Economic Indicators	2.0	8.1	3.8	7.7	7.7	August/2014
ECRI Weekly Leading Index	-0.8	-3.0	0.6	1.3	2.2	September/2014
Commercial and Industrial Loans At All Commercial Banks	2.6	10.9	5.3	10.9	12.3	September/2014
Retail Sales	0.4	1.6	1.9	3.8	4.0	September/2014
Retail Sales (Excluding Food Service)	0.4	1.6	1.9	3.8	4.0	September/2014
Real Disposable Personal Income	0.7	2.8	1.8	3.6	2.7	August/2014
Industrial Production	1.1	4.4	1.9	3.9	4.3	September/2014
ISM Manufacturing: Purchasing Managers Index	2.4	9.7	5.4	11.1	1.1	September/2014
4-Week Moving Average of Initial Claims	-6.4	-23.3	-8.1	-15.5	-6.3	September/2014
Hires: Total Private	-2.4	-9.1	-1.2	-2.4	1.1	August/2014
Job Openings: Total Private	6.1	26.6	17.3	37.6	23.4	August/2014
Consumer Price Index	0.0	-0.1	0.8	1.7	1.7	September/2014
Consumer Price Index Less Food and Energy	0.2	1.0	0.9	1.8	1.7	September/2014
New One-Family Houses Sold	10.0	46.6	16.7	36.1	33.0	August/2014
Median Sales Price of Homes Sold	-2.9	-11.1	0.3	0.7	2.8	March/2014
S&P 500 Earnings	2.3	9.3	2.9	5.9	13.4	June/2014
CRB Commodity Spot Index	-4.6	-17.0	-4.0	-7.9	1.3	September/2014
Spot Oil Price (West Texas Intermediate)	13.6	66.7	10.5	22.1	19.0	July/2013
Gold Price	-7.5	-26.8	-5.8	-11.3	-8.3	September/2014

	Actual Value / Diffusion Index				Data As Of
	Current	3 Months	6 Months	1 Year	
	Value	Ago	Ago	Ago	
Phili Fed: General Activity - vs. Prior Month (Diffusion)	22.5	17.8	9.0	20.0	September/2014
Phili Fed: General Activity - 6 Months Ahead (Diffusion)	56.0	52.0	35.4	57.0	September/2014
Chicago Fed: National Activity Index	0.5	0.2	0.5	0.3	September/2014
St. Louis Financial Stress Index	-1.2	-1.5	-1.3	-1.0	September/2014
Loan Officer Net % Tighter Criteria Consumer Loans	-13.0	-9.3	-7.0	-3.6	September/2014
Loan Officer Net % Willingness to Make Consumer Loans	15.7	11.6	15.5	13.0	September/2014
Consumer Sentiment	82.5	81.9	81.6	82.1	August/2014
Manpower Employment Outlook (Net % Hiring)	13.0	13.0	13.0	11.0	August/2014
Unemployment Rate	6.0	6.2	7.0	7.5	September/2014
University Of Michigan Inflation Expectations	3.0	3.1	3.2	3.3	September/2014
AAMI Survey: Stock Allocation	66.7	67.0	67.2	64.5	September/2014
AAMI Bull/Bear Investor Sentiment Spread	13.6	16.1	2.6	5.4	September/2014
AAMI Percent Bullish 8-Week Average	42.2	35.6	37.5	37.3	September/2014
CBOE Volatility Index	16.3	11.6	13.9	16.6	September/2014
3 Month Treasury	N/A	N/A	0.1	N/A	September/2014
1 Year Treasury	0.1	0.1	0.1	0.1	September/2014
5 Year Treasury	1.8	1.7	1.6	1.6	September/2014
10 Year Treasury	2.5	2.6	2.7	2.8	September/2014
30 Year Treasury	3.3	3.4	3.6	3.8	September/2014
5 Year TIP	0.1	-0.3	-0.1	-0.2	September/2014
10 year TIP	0.5	0.4	0.6	0.7	September/2014
30 Year TIP	1.1	1.1	1.3	1.5	September/2014
Bond Buyer 20-Bond Municipal Bond Index	4.1	4.4	4.5	4.8	September/2014
ML BBB	3.6	3.4	3.7	4.0	September/2014
ML High Yield	6.3	5.3	5.6	6.5	September/2014
ML AAA-A Emerging Market	2.7	2.6	2.8	3.0	September/2014

A diffusion index is the difference between the percent of respondents expecting an increase less those expecting a decrease.



Why Losses Really Do Matter

Everybody who told us that the steep market drops earlier this month wouldn't last can rightly claim they're right. When the S&P 500 was down 7.4% during a two-week selloff, there was no way to know whether we'd have to endure more of the same. Staying the course turned out to be exactly the right strategy, but that doesn't mean that we shouldn't be concerned about downside risk. In fact, during the downturn, all of us should have been working hard to keep our portfolios from falling as far and as fast as the American indices.

Isn't this a contradiction? There is no contradiction between holding on during market downturns and building portfolios that are unlikely to keep pace with a bear market free-fall. You hold on because no living person knows when the stock markets will recover, but history tells us that they always do seem to recover and eventually deliver returns that are higher, on average, than the returns you get when the money is safely stored under your mattress.

But you also pay attention to downturns because the further your portfolio falls, the harder it is to recover. There's actually a rational reason why you tend to fear losses more than you enjoy your gains.

The mathematics show the asymmetrical effect of losses vs. gains. If your \$1 million portfolio loses 10%, falling to \$900,000, then it requires an 11.11% gain to get you back where you started. It doesn't seem fair, but that's how it is. A 20% loss requires a 25% gain, and if your portfolio were to drop 40%, you'd need a subsequent 66.67% gain to climb back to your original \$1 million nest egg.

Chances are, you know how we fortify portfolios against losses: we include a variety of different types of assets--including bonds which, against every single market prediction at the start of the year, are actually delivering positive returns almost all the way across the maturity spectrum. We include foreign stocks, which haven't exactly been knocking the lights out this year, but which will, someday, offer strong gains when the U.S. markets are weakening. All of these different movements tend to have a calming effect on the portfolio's returns, not always in every circumstance, but fairly reliably over time.

The result? A smoother ride puts more money in your pocket. If an investor experienced returns of +20% and -10% in alternate years over the next 20 years, a \$100,000 portfolio would grow to just under \$216,000. If a more diversified investor experienced a smoother ride of 10% a year, her portfolio would grow to just under \$673,000. The power of steady compounding is a marvelous thing to see. The drag of losses can be debilitating to a portfolio's growth.

You won't experience either of those trajectories, of course. But if you can somehow avoid the worst of the market's falls, even if it means never beating the market during the up-cycles, you raise your chances of long-term success. If you can do this and remain invested through a lot of uncertainty, like we experienced earlier this month, chances are you'll enjoy better long-term returns than a lot of the "experts" you see screaming at you to buy or sell on the cable finance channels.

Oh, and that 7.4% drop? The S&P 500 will have to go up 7.99% to recover the ground it lost in that two-week period.



“Good” Budget News For A Change

One leading candidate for the “most under-reported story” of 2014 is the remarkable drop in the U.S. government’s budget shortfall. The final numbers announced by the U.S. Treasury for fiscal 2014 (ending September 30) shows a \$483 billion deficit. That’s about \$1 trillion lower than the record \$1.4 trillion deficit recorded in 2009. As a percentage of the U.S. Gross Domestic Product, the deficit came in at 2.8%--below the average of the last 40 years.

Digging into the numbers a bit, the government collected just over \$3 trillion in the past 12 months, which comes to 17.5% of America’s total GDP. That’s up from \$2.8 trillion last year, largely the result of a stronger economy, but also reflecting higher tax rates on higher-income Americans. Meanwhile, spending was essentially flat; rising from \$3.45 trillion to \$3.50 trillion, reflecting decreased defense spending and cuts in the unemployment insurance program, flood insurance and disaster relief, crop insurance, the Supplemental Nutrition Assistance Program and a variety of housing programs.

If there is bad news in this picture, it’s that Social Security, Medicare and Medicaid are taking over an ever-larger share of the budget, and these costs have been rising much faster than inflation. “Entitlement” expenses are not discretionary; they are basically written contracts with the American people. Medicaid in particular is worrisome; while discretionary expenditures are down almost totally across the board, Medicaid spending growth came in at 10.2% in 2014, and is projected to rise 14.3% next fiscal year.

How does all this affect you? Notice that the partisan budget bickering has quietly faded away. Congress has extended government funding several times without fanfare, and is expected to do so again during the lame duck session after the elections. This might induce the rating agencies to give American bonds back their A+ credit rating.

We may see a tax reform bill sometime next year, which will certainly lower the U.S. corporate tax rate, and may address America’s tangled individual tax code. Earlier this year, a House bill proposed to repeal dozens of tax credits, deductions and tax preferences, including the mortgage interest exemption and deductions for charitable contributions. The legislation would create two individual income tax brackets at 10% and 25%. Another proposal would replace most current federal taxes with a 23% national retail sales tax.

And you may hear more about reforming Social Security, Medicare and Medicaid. The Social Security fix is relatively straightforward; for persons under the age of 50 today, full benefits would be deferred a year or two, to reflect the fact that people are living (and capable of working) longer. Medicare proposals have ranged from giving total discretionary control to states, to creating a voucher system that would cap benefits for each participant.

Finally, all of us who are recommending Roth conversions have to pause when we see proposals that would replace income taxes with a sales tax.

The premise of a Roth conversion is that you are paying, today, equal or lower taxes on the converted retirement dollars than you would be paying in the future. If future marginal tax rates go down to zero, and all government revenues are shifted to a sales tax, the Roth equation is dramatically changed. Yes, this is unlikely, but even the unlikely contingencies have to be factored into today's financial decisions. After all, who thought the budget deficits would fall below 3% of GDP so quickly?