We believe that valuations in publicly traded securities are stretched, and, although we have seen a move higher in interest rates and stocks have sold off from their high levels, investors are faced with choices that offer generally lower expected returns based on historic measures of return. Today, with the S&P 500 hitting 1650 and the yield on the 10 year US Treasury Note moving abruptly from 1.70% to 2.15%, there are generally two schools of thought on the minds of investors.

First, with financial assets pushed to extreme valuations, current relative value in the equity and bond markets does not reflect the mediocre economic recovery and the risks inherent in the market. Investors in this camp believe that it is prudent to take some risk off the table and book some profits. In contrast, the second school of thought is that as long as the Federal Reserve continues its accommodative monetary policies through its asset purchase program, financial assets will continue to move higher. Investors in this camp believe that stock prices will continue to rise regardless of the mediocre economic environment.

We fall into the first category and believe that markets are pushed to extreme valuations. With that said, we believe that we will be in this environment for a while. The challenge facing investors is how to allocate capital to earn a fair return without being overexposed to risk. With the coordinated central bank monetary policies driving interest rates down and inflating stock prices, we believe traditional asset allocation is challenged in today's market. This article discusses our views and changes to our asset allocation for the second half of 2013.

Economics 101

Before we discuss investment strategy, it is important to revisit how we believe the current economic machine works. The basic elements of economic policy are rooted in both fiscal policy and monetary policy. *In order to have sustained economic growth both need to work together.* However, over the past five years following the financial crisis, partisan politics in Congress have been an impediment to developing fiscal policy initiatives that help business formation, private credit expansion and job growth. In the absence of meaningful fiscal policies, the Federal Reserve has stepped in and flooded the market with liquidity. This is the lubricant that keeps the economic machine working smoothly by facilitating credit expansion. At the same time, the banks needed to bolster capital. As the impaired banking system rebuilt its capital base to support the diversified business, there was very little lending activity which contributed further to the economic malaise.

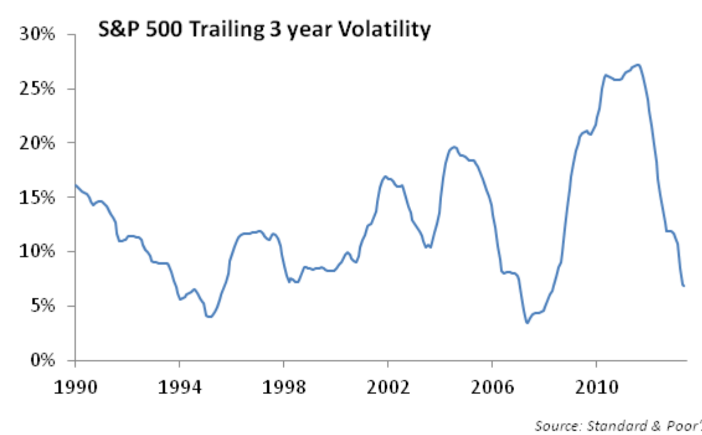
During the period from 2008 to 2013, banks increased their tier 1 capital ratios from 5.56% to 11.30%, and reserves increased dramatically from $7 billion to $2 trillion according to Federal Reserve data. Under any other "normal" economic cycle, the economy would have moved into a recession as private capital expansion dried up. However, the incentive the Federal Reserve created through their *quantitative easing* programs allowed banks to sell assets to the Fed in the open market and free up their capacity to do other financial engineering.

It is important to remember that this is a huge experiment in monetary policy we are living through and has never been attempted before. *The belief that the Fed has is that they can manipulate interest rates to low levels by expanding their balance sheet and buying mortgage-backed securities in the open market. In turn, this will allow consumers and businesses to refinance their debt at lower rates which will* *help reduce interest expense and improve profit margins, which could spur growth. The risk we see is that these monetary policies have distorted the pricing of risk in the market and it will be extremely difficult for the Fed to move away from these aggressive policies given the fragile economic environment.*

In order to experience sustained economic growth, both monetary policy and fiscal policy need to work together. In our view, there are no fiscal policy initiatives to support meaningful small business growth. To the contrary, the costs and risks to start a business or expand an existing business are too high, and entrepreneurs are not compensated adequately for the risk. This paradigm is a reflection of the current dynamic that exists in the public market where investors are not compensated for the risk.

Changes to our Asset Allocation for the remainder of 2013

The single biggest challenge facing investors today is that there is simply no income to be earned in the public markets. The yield on the Barclays US Aggregate index is a measly 1.8%. The ten year US Treasury has a yield to maturity of 2.12%. The Barclays High Yield index, which historically yielded near 9%, now yields 6.06% after reaching a low of 4.95% last month. And, the S&P 500 has a dividend yield of 2.2%. Income is the buffer for total return, and without reasonable income we need to rely on outsized capital appreciation in order to achieve total returns near historic levels. The conundrum we are facing is that this market is not conducive to producing high levels of price appreciation.



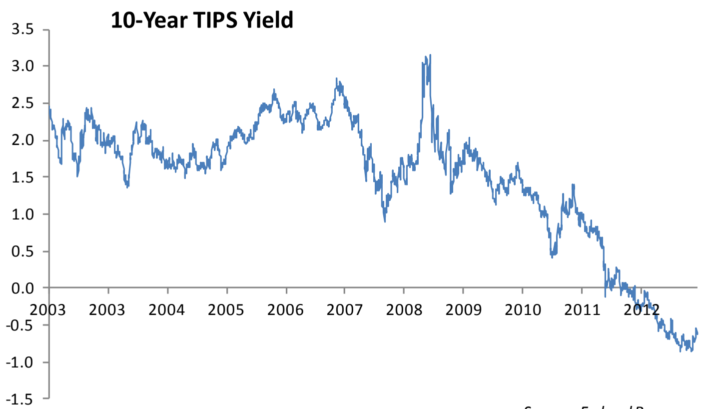
Critical to our asset allocation decision is our risk analysis. *We are concerned that the blanket of easy monetary policies from the central banks of all the developed countries has helped to mask the real risk in the market.* Three year trailing volatility on the S&P 500 has declined sharply from 22% in 2011 to less than 10% today. At the same time, trailing three year volatility for high yield has declined from 15% in 2011 to 8% today. We believe that these risk measures are not indicative of expected risk in a normalized market and investors are not adequately compensated for the risk. Any adjustment to the Fed's quantitative easing programs would likely result in a spike in volatility.

At this point, it is our belief that coordinated aggressive monetary policies from the central banks of the developed countries following the financial crisis have helped to mute volatility, not unlike Novocain numbing the patient before a tooth extraction. As a result, we aren't feeling the real risk that exists in the market. This has caused us to alter the shape of our fixed income allocation, reduce the equity basis and reallocate to specific alternative asset strategies with low expected volatility.

Fixed Income

The risk free rate is near a 1.75%. This is the riskless rate of interest to which all risk premiums are applied. With inflation running around 2.0%, that puts the real rate of return at a -0.25%. In today's market, fixed income investors are experiencing negative real rates of return.

While we believe fixed income is an important asset class, our analysis of expected returns for the general fixed income markets are between -3.0% and +2.40% with expected volatility in the 3.7% to 5.6% range. *The question is: why would any rational investor allocate a portion of the portfolio to an asset class that has a high probability of earning a negative return over the next 24 months. Our best answer is: because the returns are not correlated with domestic equity returns and it is an asset class that still can preserve wealth during periods of heightened volatility.* The challenge now is to find an asset class other than domestic broad market bonds that has the potential to earn a higher return with a similar expected risk profile.



Source: Federal Reserve

Given the risk of the Federal Reserve beginning to slow its asset purchase programs and potentially higher interest rates as a result, we believe the best relative value in fixed income is in short duration bonds. We would rather own a credit-based bond portfolio with a duration of one year and a yield of 1.8%, than an investment in Treasury Inflation Protection securities (TIPs) which offer investors a negative yield in today's market. We believe that controlling the reinvestment of proceeds offers a better hedge against rising inflation than the untested performance of TIPs in a rising inflationary environment.

High yield, measured by the Barclays High Yield Index, has a yield to worst of 6.06% which represents a spread of 464 over US Treasury notes. This is off of the lowest yield in recorded history, but still low by historical measures and we see very little upside opportunity in the broad high yield market and have reduced our allocation to high yield to zero.

We still have an allocation to senior bank loans and believe that this part of the fixed income market can provide a reasonable rate of return and provide some protection during periods of rising interest rates.

Equities

Our analysis of expected returns described in the 2013 issue of *Asset Allocation + Risk Management* highlighted an S&P Index valuation that could hit 1620, resulting in a 15% annualized return for domestic equities. With the S&P 500 surpassing 1660 by May, we are concerned that valuations have moved into overvalued territory. *In the current economic environment, with structural problems impeding business formation, job growth and credit expansion, we do not expect to see a significant growth in top line revenue. In addition, we believe further margin improvement is limited from current levels.* Most companies have already taken steps to improve productivity through cutting head count and managing vendor payables. Many companies have already taken advantage of the low interest rate environment and lowered their borrowing costs. In addition, rising healthcare costs and regulatory compliance costs will further compress margins.

The domestic equity markets are responding more positively to news of sustained stimulus from the Fed and ignoring marginal economic fundamentals. This is a problem for us. As a result, we are inclined to reduce our allocation by 5% initially with an additional 5% if the S&P 500 approaches 1700. At the same time, historic volatility is significantly lower than levels of two years ago. We believe that current volatility underestimates the risk in the domestic equity market.

China's economy looks to be growing slower than we originally anticipated for 2013. We are concerned about growing tightening credit conditions in China and the impact that will have on its banks and economy. Historically, China's financial system has been closed to foreign investors and China's banking system is not thoroughly integrated into the global banking system. While China is not a global international lender, at the margin tightening in credit will impact Chinese companies' ability to borrow which, in turn, will impact Chinese manufacturing and exports. It will remain to be seen if tightening credit conditions in China impacts the banking system of the developed countries.

We continue to view the situation in Europe as fluid and remain on the sidelines with respect to specific investment exposure to the Euro-zone. The International Monetary Fund recently reclassified Greece as an emerging economy. Cyprus, Spain and Portugal are living through severe austerity measures which are impacting the standard of living and forcing a shift in population out of southern European countries. Ultimately, we expect that the European Union will be reconstituted in some form. And, while this is not necessarily a bad thing, it remains to be seen how the market will adjust to the news of a change in the lineup of countries supporting the euro currency.