



**MUTUAL FUND COMMENTARY  
FOR THIRD QUARTER ENDING  
SEPTEMBER 30, 2013**

The stock market continued its strong performance for the year and the third quarter amid issues out of Washington. The S&P 500 Index was up 5.24% during the third quarter and 19.79% so far this year. The market continues to benefit from the easy money policies of the Federal Reserve and the indication of tapering the bond buying program has subsided. Inflation has remained muted and the Fed is more focused on lowering the unemployment rate and spurring economic growth. Bonds and bond funds have seen pressure this year with the Barclays Aggregate Index up 0.57% for the third quarter, but down 1.89% for the year with interest rates rising.

The United States avoided default with a last minute “compromise” from Congress. The fight over the new health care law and the debt ceiling caused some volatility in the markets and a 16 day government shutdown. The likelihood of default was remote given the worldwide economic implications of a default, but uncertainty increased volatility in the markets. The compromise funded the government through January 15 and postponed raising the debt ceiling until February 7. Congress essentially punted the decision which sets up

another showdown regarding the debt ceiling at the beginning of next year. There will inevitably be fighting between the Democrats and Republicans which will probably infuse uncertainty into the markets again.

President Obama nominated Janet Yellen to be the next chair of the Federal Reserve. Yellen currently serves as vice-chair of the Fed and, if confirmed by the senate, will succeed Ben Bernanke when his term ends in January. She will be the first woman to chair the Federal Reserve in its 100 year history. This news is positive for the equity markets because Yellen agrees with the quantitative easing policies Bernanke employed and is likely to continue the policies. Eventually, quantitative easing needs to be paired back and the economic numbers will drive when tapering begins sometime next year.

I just participated in a conference call with Dr. David Kelly, the Chief Global Strategist of JP Morgan Funds. Many topics were covered in the call, but he focused on the outlook for the economy and the valuation of the equity markets. Dr. Kelly believes the economy will pick up at the end of this year and beginning of next year as long as issues in Washington don't derail the growth. He discussed that Fed tapering has been postponed until next year, but not canceled. On the topic of market valuation, Dr. Kelly believes stocks are still a little cheap, but not very cheap, meaning he doesn't think markets are overvalued yet. He mentioned that historically when interest rates rise from low levels,

stocks tend to go up and since rates are still at low levels a rise in interest rates could help equity markets. Dr. Kelly prefers equities over fixed income going forward and recommended underweighting fixed income when appropriate. His estimates for a ten year time horizon are 6% annually for equities and 3-4% annually for fixed income if you allocate more towards corporate and higher yielding bonds.

Given the strong returns of the equity markets, some of our equity funds have performed well this year. To highlight a couple of the funds widely held, Baron Growth Fund (BGRFX) is up 28.12% and T. Rowe Price Growth Stock Fund (PRGFX) is up 24.33% through September 30. These funds have done well this year, but they also have strong long-term performance records. It is important to monitor fund performance versus relative benchmarks over different periods of time, but better to focus on long-term performance. This shows how funds perform through market cycles and if the managers add value over an index. Many mutual funds have performed well this year and outperformed the markets. It is important to look at what level of risk a fund is taking to create the outperformance and how the portfolio manager managed downside risk over longer market cycles. Some funds that take on less risk can lag hot markets or riskier funds over shorter time periods,

but good portfolio managers show their worth during risk cycles and over the long-term.

There are discussions about whether or not the stock market is overvalued given the strong run this year and over the last few years. The Dow Jones Industrial Average and the S&P 500 Index have hit all-time highs. There may be periods of flat returns or even corrections in the equity markets because returns have been so strong. Economic growth should help the stock market, but a lack of economic growth could lead to equities becoming overvalued. Company earnings need to continue to justify stock prices for the market to rise from these levels. According to JP Morgan, 70% of companies have beaten earnings estimates so far this earnings season. Issues out of Washington or geopolitical risks can also add uncertainty to the markets. Bonds will continue to struggle during periods of rising interest rates and looking out five to ten years stocks still seem like a better investment going forward.

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October 30, 2013