

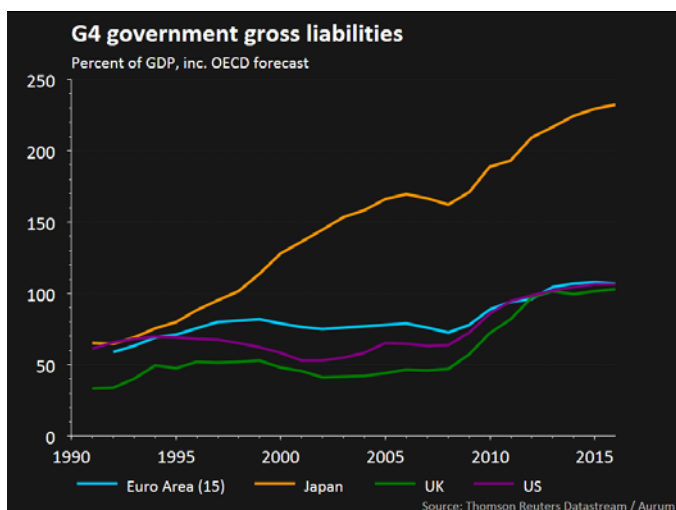


Strategy Newsletter  
3<sup>rd</sup> Quarter 2014

- Japan's economy is surprising investors, does it have a connection to the US?
- Looking beyond index level valuations is important to uncover pockets of risk and opportunity.
- The ending of quantitative easing is again seeing interest rates fall and bond prices surprise on the upside.
- Alternative asset classes performed well.

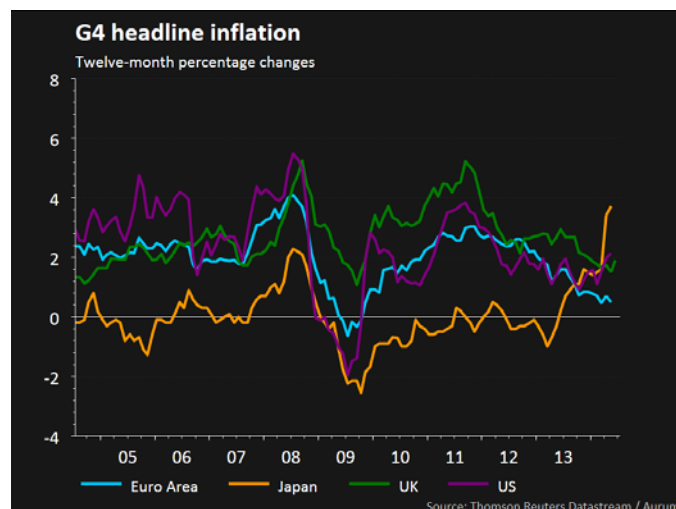
**Big Picture**

The developed world is awash in debt. Japan's gross government liabilities stands at 232% of its GDP while the UK, Euro Area, and the US all are around 100% of GDP.



As debt increases in an economy, it has a lower marginal effect on growth. This is something we are observing in real time each year, as forecasts for GDP come up short of expectations at the beginning of the year. Despite higher debt, interest rates are not exploding higher in a secular fashion, at least not yet. This holds for not only the US, but the four largest developed countries.

For the first time in decades, Japan's monetary and fiscal stimulus may be catching on, bringing more corporate investment, but also spurring inflation higher. It is yet to be seen if it works this time for Japan, or if policy makers will pull back too soon like in previous episodes.



In the US, many economists are voicing concerns about labor shortages in certain areas of the economy, which could put pressure on wages and ultimately inflation measures. At this point though, Fed Chairman Janet Yellen is not concerned about wages or inflation, but it is an area we and our investment managers are watching intently given the feedback to the economy and companies.

## Equity

While global markets had a mini-correction to start the quarter, global equities recovered to post gains across the board. For the first time since the third quarter of 2013, emerging markets outpaced developed markets.

US Equity		2Q 2014
<b>Large Cap Stock</b>		
Dow Jones Industrial Average		2.83%
S&P 500		5.23%
<b>Small &amp; Mid Cap Stock</b>		
Russell Mid Cap		4.97%
Russell 2000		2.05%
<b>Style Indices</b>		
Russell 3000 Value		4.89%
Russell 3000 Growth		4.86%
International Equity		2Q 2014
MSCI EAFE		4.34%
MSCI EAFE Value		5.02%
MSCI EAFE Growth		3.67%
MSCI Europe		3.65%
MSCI Japan		6.69%
MSCI Emerging Markets		6.71%

One only knows in hindsight if a cyclical stock market high is upon us, there simply is no way to truly know until after the fact, and that much is obvious. Yet one of our investment managers, GMO, compares the 2014 global capital market opportunity set as “much worse than 2000 and more confusing than 2007.” In 2000, there were obvious asset allocation fat pitches (for those with the wherewithal to go against the grain), namely in emerging market equities, REITs, and bonds. Compared to then, today there is nothing that is cheap on an absolute basis. While emerging market stocks lagged the last couple of years, outperformance may be more based on reversion to the mean against developed markets and are around fairly valued. In 2007, it was difficult for GMO to find any asset class with sufficient risk and return characteristics.

Today, we see the above average valuations placed on stocks by looking beyond just the indices. Our friends at GaveKal Capital produced a nice analysis, breaking down the S&P 500 into 3 groups by market value, the top 10 companies, then the top 50 companies, and finally the bottom 450 companies.

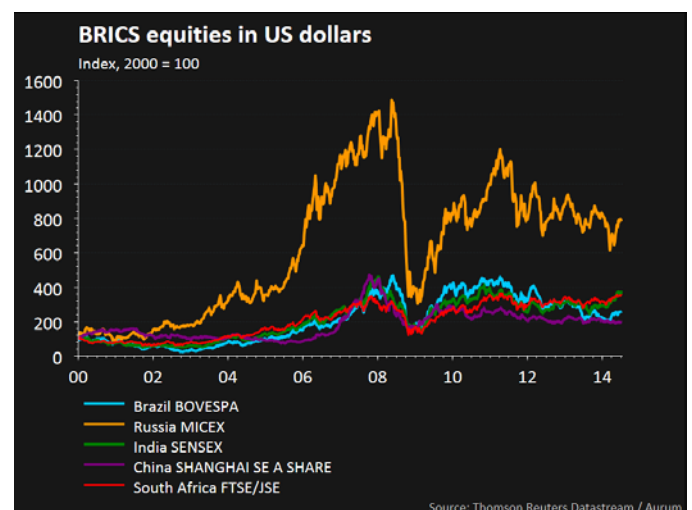
Although these 450 companies make up 90% of the 500 in the S&P 500, they constitute only about half of the value. Looking at a simple average price to earnings ratio based on forward estimates, it stand at 22X, a very high number in historical context.

Forward P/E for S&P 500 Constituents					
Market Cap Category	Market Cap % Total	Earnings % Total	Simple Average P/E *	Weighted Average P/E *	Median P/E
Top 10	18.8%	20.1%	16.6	16.7	16.2
Top 50	48.2%	50.3%	17.5	16.9	16.7
Bottom 450	51.8%	49.7%	21.8	21.2	18.2

Source: GaveKal Capital<sup>i</sup>

The media and investment managers often quote operating earnings and point to them being reasonable, for example the S&P 500 forward operating earnings is at 15.5, yet this excludes ‘one-time’ events, that often times is where management ‘hides’ losses. It pays to look deeper, and it is difficult to say U.S. stocks are anything but above fair value today. Nonetheless, overvaluation is a terrible timing mechanism, but it does offer insight into the margin of safety for investments.

The countries collectively known as the BRICS (Brazil, Russia, India, China, & South Africa) have seen equity market gains come to a halt over the last few years, with essentially no gains for U.S. based investors since 2009. During the same time frame, U.S. equity markets marched steadily higher, except for the 2011 pullback.



Contrarian investment managers we speak with are beginning to find value in Russian stocks, even with the headline and political risks. The Aurum Asset Allocation Frameworks increased the overweight exposure to

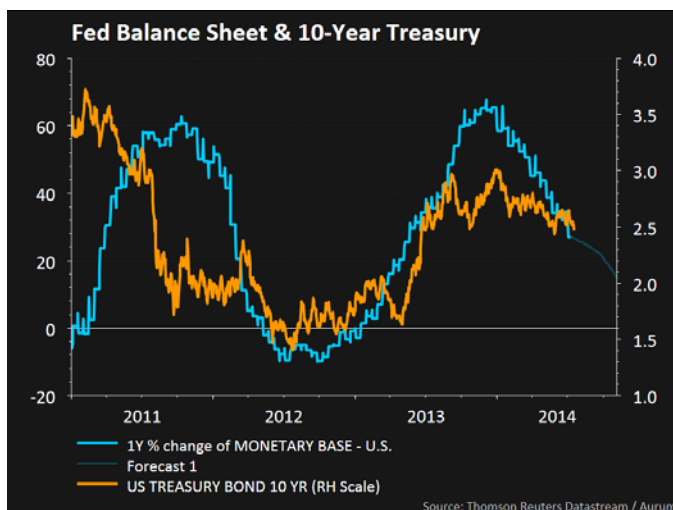
emerging markets during the quarter while decreasing U.S. equities. Portfolios maintained developed market equity exposure, though managers increased exposure to Japan at the expense of Europe.

### Fixed Income

Interest rates surprised again with the 10-year falling during the quarter from 2.72% to 2.52%. Bond indices were up from 2-3% across intermediate maturities and the credit spectrum.

Fixed Income	2Q 2014
Barclays U.S. Aggregate Bond	2.04%
Barclays Corporate Inv. Grade	2.66%
Barclays High Yield Bond	2.41%
Barclays Global ex. U.S. Tres.	2.82%
Barclays Municipal Bond	2.59%

The Federal Reserve wants to get out of the quantitative easing (QE) business. Many regional Fed researchers from San Francisco to St. Louis have written of the lack of efficacy of QE on stimulating the real economy. Hence the taper of asset purchases continues at a measured pace. The graph below has the percentage change in the Fed's balance sheet plotted on the left hand side in blue along with the 10-year Treasury in yellow with its scale on the right side. It has had a close correlation over the last few years. If the taper continues and results in a 0% change in the balance sheet by the end of this year while the relationship with the 10-year holds, it is difficult to see the yield rise from these levels.



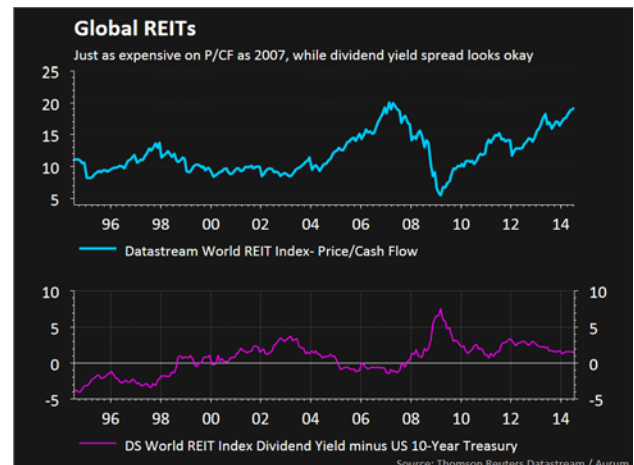
Contrary to popular belief, forecasting interest rates correctly is not a prerequisite for profitable returns for fixed income investing. In fact, most portfolio managers we speak with prefer to focus on areas where they have an edge, analyzing the credit risk of various instruments. Today, our managers continue to like the lower duration risk and ample yield of non-agency mortgages along with corporate asset backed securities, such as airplane or railroad leases. In addition, many managers like longer dated investment grade corporate bonds and mortgages. This area of securities is seeing a strong bid from pensions which are matching future liabilities with assets that will move together (as the long bond interest rate changes, so does the liabilities for pension plans). The Aurum Asset Allocation Frameworks today have a slight underweight to fixed income, an area we have been adding to over the past two quarters.

### Alternative Investments

REITs (Real Estate Investment Trusts) and TIPS (Treasury Inflation Protected Securities) maintained the inverse relationship with interest rates with both asset classes producing positive returns with rates falling.

Alternative Assets	2Q 2014
Hedge Fund of Funds	1.61%
Wilshire REIT	7.22%
Barclays TIPS	3.81%

For REITs though, it just looks like the rich got richer, that is, the asset class value went from expensive to very expensive.



On a dividend yield basis, global REITs seem okay at 4% and 1.5% above the 10-Year Treasury. This is a relative measure though. On an absolute basis, global REITs are as overvalued today as in 2007, with a price to cash flow ratio of 19.3X.

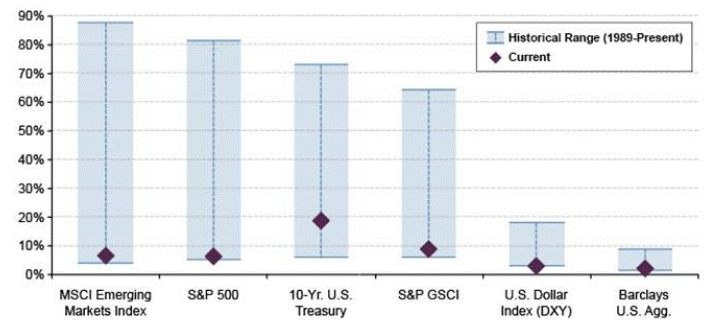
We see value in long/short managers exploiting inefficiencies on a fundamental basis. In addition, macro strategies that take advantage of the inflation seeping into the real economy should provide less correlated exposure for portfolios.

The frameworks have a 0% direct exposure to REITs while one of our alternative managers trimmed some gains in TIPS last quarter. We maintain exposure to diversified alternative strategies, though with a modestly lower allocation to trend-following managers.

**Conclusion**

With the equity and fixed income markets going straight up and fear exiting capital markets, the volatility of

returns (chart below) has fallen to the lowest levels in the last 25 years.



Source: Guggenheim Investments<sup>ii</sup>

It is important to recognize this period of calm will not last forever. Trimming gains in asset classes that have outperformed and rotating capital to fundamentally undervalued areas while keeping a watchful eye on macro data is what we will continue to do on behalf of the clients which have entrusted us with their portfolios.

**Aurum Asset Allocation Frameworks**

	Conservative Income		Conservative Balanced		Moderate Balanced		Aggressive Balanced		Aggressive Growth	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	20%	35%	35%	50%	50%	70%	72%
U.S. Equity	0%	0%	12%	9%	20%	16%	30%	25%	42%	37%
Int'l - Develop. Markets	0%	0%	6%	7%	12%	12%	16%	16%	21%	22%
Int'l - Emerg. Markets	0%	0%	2%	4%	3%	7%	4%	9%	7%	13%
Fixed Income	65%	56%	45%	40%	30%	28%	17%	16%	10%	10%
U.S. Fixed Income	56%	56%	39%	40%	26%	28%	15%	16%	7%	10%
Global Fixed Income	9%	0%	6%	0%	4%	0%	2%	0%	3%	0%
Alternative Invest.	25%	26%	28%	26%	30%	26%	30%	26%	19%	16%
Diversified Strategies	19%	26%	22%	26%	24%	26%	24%	26%	15%	16%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	18%	7%	14%	5%	11%	3%	8%	1%	2%
U.S. Dollar	10%	18%	7%	14%	5%	11%	3%	8%	1%	2%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

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<sup>i</sup> <http://gavekal.blogspot.com/2014/07/decomposing-s-500-pe-ratio-by-market.html>

<sup>ii</sup> <http://guggenheiminvestments.com/perspectives/macro-view/the-tolling-bells-of-complacency>