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October 30, 2013

Dear Clients, Colleagues, and Friends,

Thank you for your continued trust and loyalty to Clark Dodge Asset Management. We are very pleased to provide you with our analysis of the global capital markets, which we hope offers insightful perspective on the key issues impacting your investments.

"The investor of today does not benefit from yesterday's growth."

– Warren Buffett, Berkshire Hathaway

Surprise! Another Strong Quarter of Growth

U.S. stocks ended the third quarter having gained almost 5% despite some significant headwinds. Perhaps even more surprising is that U.S stocks have advanced roughly 20% during 2013, as strong corporate earnings and the impact of the Federal Reserve Bank's stimulus have combined to lift stock market indices to historic record highs. Although data may point to an economic recovery; many believe that growth will stall when Federal Reserve winds down its quantitative easing program. The fragile labor market and difficulty many experience finding employment indicate levels of weakness not apparent when focusing on near term equity market performance.

Earlier this year, we temporarily felt the impact of higher interest rates; a sharp upward spike was quickly reversed as the Fed announced that it would not begin "tapering" the third phase of its QE program. Geopolitical tensions temporarily added to the market's fears; grindingly slow diplomacy temporarily headed off the escalation of armed conflicts in the Middle East.

Despite the real and perceived risks that cause us to worry about the possibility of another severe economic setback - possible U.S. government shutdowns and debt ceiling limits, the capital markets continue to push forward. This year's U.S. stock market behavior illustrates why we don't advocate market timing. We strive to focus on the larger economic picture and long-term time horizons; trading on short-term events often leads to portfolio underperformance. Emphasizing risk adjusted returns rather than performance at any cost - we seek to deliver a lower risk investment solution towards client objectives.

International Equities Play Catch-Up in Third Quarter

One of the strongest performing asset classes during the quarter was non-U.S. developed market equities; which gained over 10%. The pendulum seems to have re-centered from overly pessimistic economic concerns and the sovereign debt issues that plagued many individual countries, particularly in Portugal,

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Italy, Greece and Spain. European Central Bank policy is becoming more accommodative and a return to positive Eurozone GDP growth is likely to drive an improving earnings profile in 2014.

Europe now appears to be in much better economic condition despite the drag of a number of long-term structural challenges. The task of integrating a highly-fragmented European banking system remains a primary area of concern as reforms are complicated by political instability and voters' fatigue with austerity measures.

Still, growth prospects in the region are improving and cheap valuations suggest that equities are broadly more attractive. With sentiment turning more positive, investors seem more willing to build exposure to European equities as capital flows are picking up. We are cautiously optimistic about broad Eurozone market growth and believe that those equity markets should no longer be excluded nor underweighted in a portfolio as conditions warrant their inclusion. Our research indicates that European stocks are trading at 1.3x book value; approximately 25% discount to their long-term average valuation and a 50% discount to the book value of U.S. stocks. Finally, fears over the Euro maintaining its status as a regional base currency seem much less pressing than 12-18 months ago.

Asset Class Performance 9/30/13 Index	Q3 2013 (%)	Year-to-Date (%)	1-Year (%)	3-Year (%)	5-Year (%)
U.S. Large Cap Equity (S&P 500)	5.2	19.8	19.3	16.3	10.0
U.S. Large-Cap Growth[1]	8.1	20.8	19.3	16.9	12.1
U.S. Large-Cap Value[2]	3.9	20.5	22.3	16.3	8.9
U.S. Small-Cap Growth[3]	12.8	32.5	33.1	20	13.2
U.S. Small-Cap Value[4]	7.6	23.1	27.0	16.6	9.1
International Equity: Developed[5]	10.9	13.4	20.4	5.2	3.2
Emerging Markets [6]	5.0	(-6.4)	(-1.5)	(-2.8)	4.6
Commodity Total Return[7]	2.1	(-8.6)	(14.4)	(3.2)	(5.3)
U.S. Real Estate[8]	(3.2)	2.33	4.7	12.1	5.3
U.S. Aggregate Bond[9]	0.6	(2.0)	(1.7)	2.9	5.4
U.S. Municipal Bond (7 Years)[10]	0.8	(2.3)	(0.8)	3.4	5.8
U.S. Three-Month Treasury Bill[11]	0.02	0.07	0.1	0.1	0.2

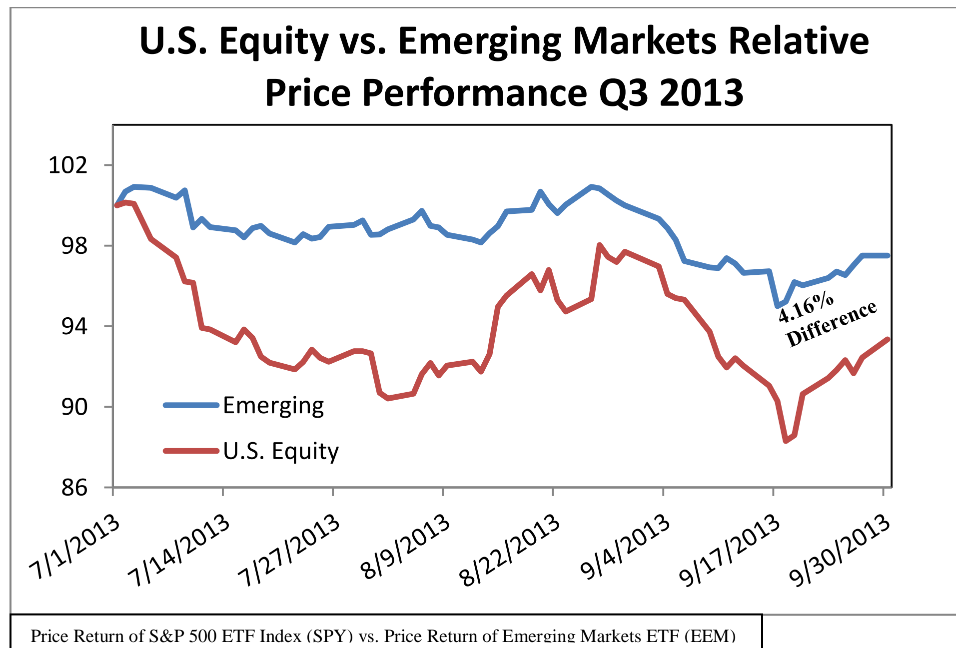
1) Russell 1000 Growth Index 2) Russell 1000 Value Index 3) Russell 2000 Growth Index 4) Russell 2000 Value Index 5) MSCI EAFE Index 6) MSCI Emerging Markets Index (gross div.) 7) Dow Jones-UBS Commodity Index Total Return 8) Dow Jones US Select REIT Index 9) Barclays US Aggregate Bond Index 10) Barclays Municipal Bond Index 7 Years 11) Bank of America Merrill Lynch Three-Month US Treasury Bill Index

Conflict and Tension: Nothing New in the Middle East

During 2013, ongoing events in the Middle East have repeatedly disrupted most investment markets. Although immediate risk factors seem to have moderated, long-term issues still simmer and a new crisis could develop overnight. The prospects for an agreement with Syria over its chemical weapons and negotiations with Iran over its nuclear program offer hope for decreased tension in the area. However, the region is engulfed in constant turmoil (note the recent terrorist attack in Kenya) and faces the prospect of tighter oil supplies and higher prices.

Growth Prospects Improving in Emerging Markets

As greater levels of risk have become more acceptable, Emerging Markets (EM), which had been under pressure for most of the calendar year, saw their benchmark gain roughly 5% during the quarter. This gain pared the YTD 2013 loss for the asset class to 6.4%. Most traditional value metrics for emerging markets (price-to-earnings, price-to-book, and price–to-cash flow) suggest that many EM equities are now cheap relative to both historic levels and developed equity markets. This suggests an attractive entry point to for an asset class with appealing diversification benefits. Sector risks include market volatility related to the U.S. budget debate and the recent drawdown in sovereign foreign exchange reserves, which increase the pressure among many emerging market countries to raise their local interest rates. However, we believe the net upside potential in this sector outweighs its related risk.



Price Return of S&P 500 ETF Index (SPY) vs. Price Return of Emerging Markets ETF (EEM)

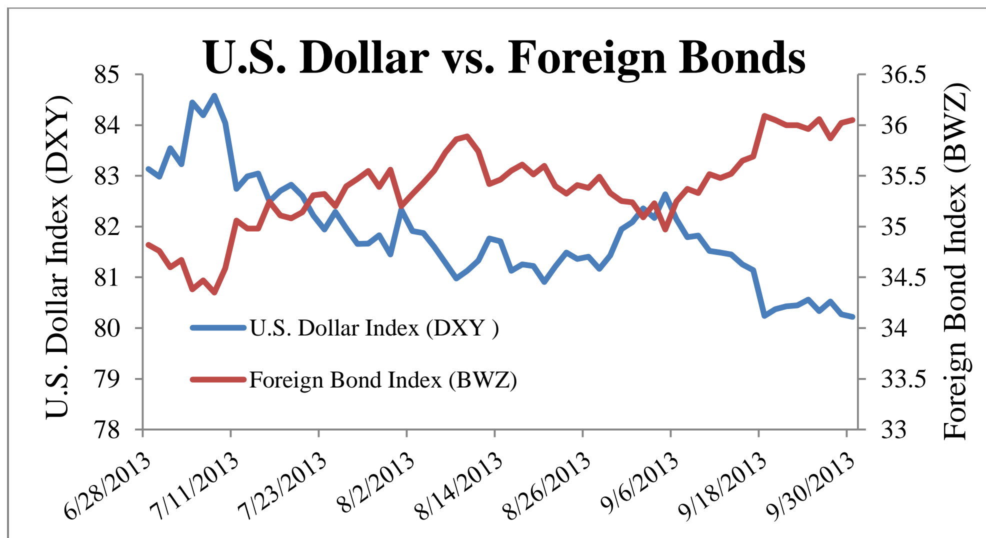
The Impact of Delayed Decision-Making

In our first report this year, we noted that 2013 is the year of the snake in the Chinese calendar. We wrote then…."one attribute of those born under this sign is a savoir-faire regarding financial affairs. Let's hope that the New Year bestows such dexterity of hand and mind on our elected officials in Washington." No such luck.

We narrowly escaped a debt default and suffered through more than two weeks of a government shutdown as our elected lawmakers negotiated a "non-decision"; therefore, we face a similar deadline during early 2014. The political tension and complexity of the bargaining will likely be a drag on the economy and heighten the risk of market volatility. The level of dysfunction in Washington has not been ignored by foreign governments. A further weakening of the dollar in the near-term combined with uncertainty over the pace of Fed tapering could prolong the gradual decline we've experienced over the last six months.

Our Strategy For Your Portfolio

Many of our clients expressed their concerns over a potential default on US government debt. Having temporarily averted a "worst-case scenario", we breathe only a bit easier. However, your portfolio includes allocations to commodities (including gold) and foreign currency bonds. Our research indicates that in the unlikely event that the US actually defaults on its bonds these asset classes will stabilize the portfolio. The following illustrates how these asset classes performed against US$ investments:



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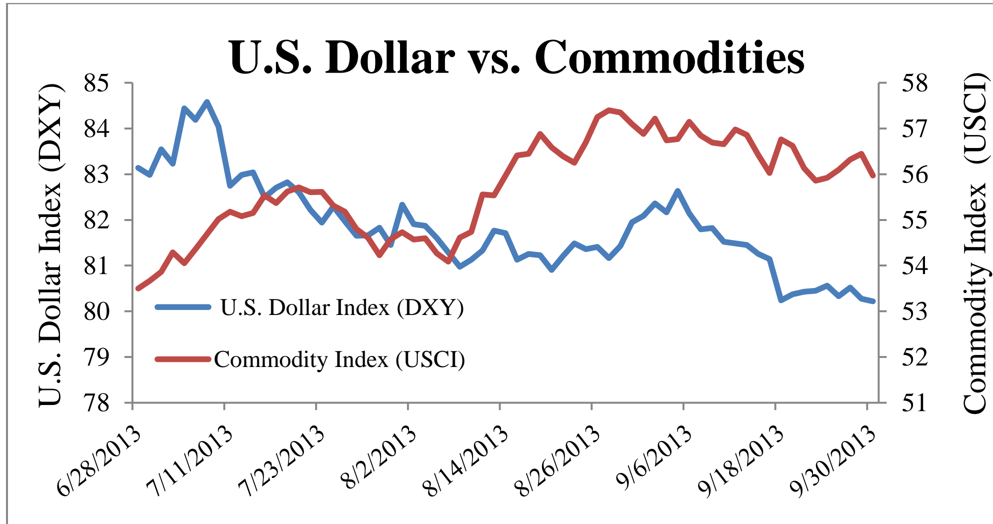

Additionally, your equities are allocated amongst domestic and international (developed and emerging market) markets and are broadly diversified across many industries and cultures – worldwide exposure in a nutshell. Corporate and household balance sheets are in better shape than they have been in years – with extraordinary cash balances to better weather market extremes.

We view the markets "ho hum" reaction to the recent budget debate followed by a rally to record highs as an encouraging indicator. We expect no significant change or accommodation between political parties between now and the February 2014 deadline; only a series of short-term deals instead of a long-term comprehensive budget solution. This suggests that the Fed is likely to maintain an accommodative monetary environment for the short-term. One potential silver lining: a weaker dollar combined with no tapering would support emerging market growth and stronger commodities pricing. In effect, the accommodative domestic policy should drive global GDP growth. The U.S. dollar weakening in the third quarter may be foreshadowing for more to come. The table below shows third quarter comparisons of major currencies vs. the U.S. dollar.

U.S. Dollar vs. Major Currencies	Q3 2013
Pound	-0.21%
Yen	-1.22%
TW Basket (Broad)	-1.23%
Australian Dollar	-2.11%
Canadian Dollar	-2.56%
TW Basket (Major Currencies)	-3.09%
Euro	-3.97%
Swiss Franc	-4.43%
Swedish Krona	-4.84%
New Zealand Dollar	-7.28%

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Fed Policy: How Long Can QE Last?

Certainly the Fed's "no-taper" announcement was a pleasant surprise for investors, but it did confirm that the U.S. economic recovery remains soft. The Fed now faces a Catch-22: 1) how to communicate its intent to taper without causing dramatic rate swings; and 2) whether it can successfully de-link this type of action from its current zero interest rate policy. Since the Fed's surprise "no taper" announcement we remain cautious about the near term potential for rising rates.

In our opinion, the "no tapering" announcement represented a missed opportunity to begin an uncomfortable deleveraging process that will only become more problematic the longer it is pushed back. We understand that tightening financial market conditions played a part in the decision – FOMC meeting minutes indicated that the near term rise in interest rates played a role in the Fed's decision to forego the tapering.

Narrow job and income growth tend to drag or prevent economic recovery; cheap money has been a main driver of this rally; financial market conditions (rising housing and stock markets) have provided the main source of support for the recovery in the form of providing a wealth-induced incentive for spending.

We like so many others ask: How can the Fed taper without tightening financial market conditions? In our opinion, the answer is to strengthen forward interest rate guidance and emphasize that this guidance is a more important tool for monetary policy than quantitative easing. Janet Yellen's formal nomination to Chair the Fed has (we hope!) permanently ended the controversy as to whether her dovish bias will continue to heavily influence future monetary policy.

The Fed also indicated that any move to begin tapering will be dependent upon the strength of new economic data. Having made its shift in September, the recent chaos in Washington almost guarantees that the Fed will not announce a move to taper in its October meeting (at the end of the month), leaving expectations for the first taper to occur sometime during early 2014.

One class benefitting from the extended monetary stimulus this year has been real estate. The S&P/Case-Shiller Home Price Indices, which measure U.S. residential real estate prices, tracks the changes in the value of residential real estate both nationally and in 20 metropolitan regions. Both indices rose greater than 7%, reflecting more positive sentiment to the housing market in general and aggressive buying of previously "unsalable housing stock" in markets previously experiencing the greatest decline. Areas hardest hit by the economic 2008-2009 recession: Florida, Las Vegas, Arizona and Southern California - saw their local markets jump roughly 25%. While these markets have much ground to cover before they approach previous peak levels, the trend is very encouraging.

The State of the Muni Market: Headline Risk vs. Attractive Income

The market is closely following the Commonwealth of Puerto Rico and the City of Detroit credit quality crises. Puerto Rico is potentially a much bigger issue than Detroit, since the yields on many Puerto Rico credits have risen dramatically in the last few months; some bonds are trading in the range of 60 cents on the dollar. Puerto Rico has approximately $70 billion of outstanding debt and is held widely by many individuals and mutual funds attracted to Puerto Rico's triple tax-exempt status and yield that tended to be higher than comparably rated securities. Continued deterioration in their credit worthiness and ability fund to operations could potentially negatively impact the entire muni market.

Detroit's filing was the largest-ever municipal market bankruptcy. The emergency manager has stated he would like to freeze Detroit's two pension funds by the end of the year and shift workers into 401(k) style plans. This announcement occurred just before an investigation revealed that pension funds had made up to $2 billion in overpayments over the past 23 years; a series of bad investments exacerbated the loss of pension assets and that nearly one-half of the city's compensation claims were found to be either fraudulent or highly questionable.

Performance in the municipal market has been mostly driven by interest rate action since late May, when the Fed first alluded to slowing its bond-buying program. While muni bonds underperformed over the summer, we saw a sharp reversal in momentum after the September 18 "no taper" announcement; an acknowledgement that the market had been oversold.

Beyond these two "headline makers" we find the fundamentals in the broad market to be stronger than they have been during the previous five years. The municipal bond market continues to look attractive; high-quality paper, under 10 years, offers tax- equivalent yields of approximately 5%, a compelling proposition for investors able to endure near-term volatility. Our position since January was that municipal bonds will not repeat the total returns of 2011 and 2012 – rising interest rates tend to modestly reduce the value of your bond principal. However, we believe that the sector remains a high-quality, relatively low-volatility option for investors focused on tax-advantaged income and capital preservation.

Summing It All Up

For the near term, most major issues feared by the market in August have been resolved favorably. Syria is destroying their chemical weapons and they have scheduled a "peace conference" for November. Iran and leading Western countries are holding "unprecedented" denuclearization discussions – a modest benefit from these events is the quiet decline of crude to under $100 a barrel.

In Europe, Angela Merkel, Germany's Chancellor, won re-election and hopes to have a cohesive coalition in the near future. Silvio Berlusconi, the most controversial presence in Italian politics for decades has left office – it appears permanently. Mario Draghi, the ECB President continues to draw accolades for his work; we anticipate further monetary easing for during early 2014.

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Domestically, both Houses have overcome their differences to craft a temporary solution to the fiscal crisis. We hope that Yellen proves to be a guiding and calming force on the markets. The recent government shutdown impacted growth but not permanently. The China "hard landing" noise has quieted (although growth isn't necessarily accelerating either).

Simply put, "the more things change, the more they stay the same" – nod to Alphonse Karr. Planning is as much art as it is science.

We strive to enhance our ability to provide you with the highest level of personalized investment and advisory services. Thank you for the trust that you place in us.

With our kindest regards,

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The production of this material would not be possible without our team. Thanks especially to the contribution of Fred Munk, Craig Marson and John Bannan.

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