Inside Views From an Investment Management Leader

UPDATE

January 2013

About our Company

Company Profile:

Concord Investment Counsel is a private, boutique investment firm who has helped our clients grow and protect their wealth since 1991.

Key Offerings:

- *Personal wealth management*
- *Proactive investment strategies*
- *Proprietary research*
- *A professional team*
- *Fee-only services*

Distinguishing Values:

- *Passion for excellence*
- *Strategic focus*
- *A disciplined process*
- *Prudent risk management*
- *Comprehensive client care*
- *Superior long-term performance*
- *Sound judgment*
- *Objective Analysis*

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In the News

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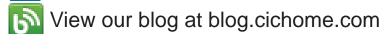
Why wait for paper when you can get the latest thoughts from your wealth manager in real time? Economic updates from Mitch Pletcher are seen first in real time by following Concord Investment Counsel around the web. Tune in for our exclusive up-to-the-minute commentary!



Economic Review & Outlook

Undermined by Debt & Fiscal Problems

The 4th quarter of 2012 was not much different than the majority of the year as most gauges of economic activity continued to move ahead, albeit still on paths of only modest improvement. 2012 was mostly a year of uncertainty regarding the state of the economy. There were no quick-fix solutions found to the serious problems that grip our economy. Unresolved fiscal issues and enormous amounts of debt were bantered about for months, but in the end politicians did not take any drastic steps to change things nor did voters.

There was, however, notable progress throughout 2012 and the 4th quarter. Housing has come to life with statistics on new home starts, home sales, and pricing all improving throughout the year and accelerating in the 4th quarter. Home ownership, which rose to over 70% of US households during the last cycle, has now fallen back to levels just modestly above where we were in 1995.

Retail sales made new all-time highs in every quarter of the year and consumer confidence, although well off its highs, improved steadily. Industrial production and manufacturing slowed a bit in 2012 and are still well off levels of the last cycle but are improving. The energy industry was strong in North America and production continues to rise, positioning the US to soon become largest oil producer in the globe. Oil prices and recent earning trends from producers don't align with this, however, as the energy sector was undoubtedly pumped up in price during the last cycle (similar to housing). Energy, just like housing, is now faced with this dilemma.

Mitch Pletcher
President
Chief Investment Officer

Employment gains were well below the trend of 200,000/month that even a modest recovery produces. These trends remained discouraging but are realistic given where we are economically and politically. Entitlement programs are seemingly still needed to keep the economy moving but yet discourage people from seeking employment or job-retraining work.

What's missing in our economy that is prevalent in a good cycle is a strong consumption engine! With consumers and governments overburdened with debt, neither are in a position to spend strongly on anything. Corporate America is ripe with cash and has strong balance sheets that are ready to be used but remain in neutral until they see a reason to invest in their businesses. Corporate spending tends to lag other spending so this is also a dry well. The only hope for near term help would be consumption from emerging markets and the ebbing middle class that China, India and Brazil have. This is and will likely be the best thing we have for our economy for the next few years.

We remain optimistic.

Financial Market Review & Outlook

2012 - A Great Year for Financial Markets

Mitch Pletcher
President
Chief Investment Officer

Markets rallied strongly in 2012 with most of the gains coming in the 1st and 3rd quarters, aligning with economic data that was bumpy throughout the year. The 4th quarter's data was actually good but the elections and the fiscal issues postponed the discounting of the progress into the first week or so of the new year. Leadership across asset classes was mixed during 2012. Recovery assets did the best with REITS (IYR +18.2%), US stocks (SPY +16.0%), Emerging Market Stocks (EEM +19.1%), and distressed fixed income (HYG +11.7%) leading the way and investment grade corporate debt (LQD +10.6%) not far behind. The pessimists were not rewarded in 2012 as most recession asset classes lagged for the year. Long Treasurys were up a modest 2.6% (TLT), short Treasurys (SHY +0.3%) and gold produced 6.6%.

The equity market in the US was driven mostly by low interest rates driving investors to embrace risk and improving economic conditions that made it feel ok. Earnings growth generally drives leadership in stocks but during periods such as 2012 when growth was tepid dividends became appealing as alternatives to the lack of strong growth. The gap between what the dividend yield in stocks is compared to the return in Treasurys widened to historical levels. Stocks normally yield half or less than what a 10-year Treasury returns, but in 2012, the dividend in stocks was more than Treasury yields. This continues to be the case and will likely cause investors to favor stocks again over Treasurys in 2013.

Table 1: Stock & Bond Market Returns — *12/31/12*

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
Large Cap Growth (IWF)	-1.2%	15.2%	Small Cap Value (IWN)	3.2%	18.0%
Large Cap Value (IWD)	1.6%	17.4%	Small Cap Growth (IWO)	0.5%	14.8%
Europe Asia Far East (EFA)	8.4%	18.7%	Emerging Markets (EEM)	8.0%	19.0%
Invest Grade Bonds (LQD)	0.6%	10.5%	High Yield Bonds (HYG)	3.3%	11.5%
Interm Treasurys (IEF)	-0.4%	3.6%	Mortgage Bonds (MBB)	-0.5%	2.0%

Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

Table 2: Real Estate & Commodity Returns — *12/31/12*

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
DJ US Real Estate (IYR)	1.7%	18.1%	DJ Commodity Index (DJP)	-6.5%	-2.1%
NAREIT Industrial/Ofc (FNIO)	0.6%	18.0%	Goldman Commodity (GSG)	-3.0%	-0.6%
NAREIT Residential (REZ)	3.7%	13.1%	Gold (GLD)	-5.7%	6.6%

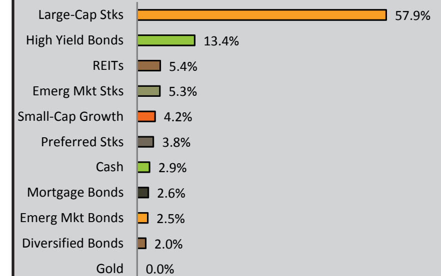
Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

CIC Managed Accounts

Growth Portfolios

Dynamic Growth

A dynamic blend of stocks, bonds, commodities, REITs, and cash for growth investors with a bias toward timely asset classes.

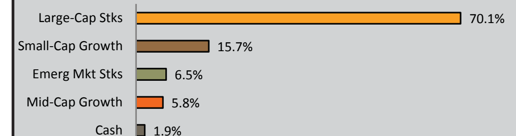


Growth

A portfolio of large- and mid-cap US stocks that are industry leaders with strong brands and timely products.

Diversified Equity

A global, all-cap equity portfolio following economic trends across capitalization and geographic ranges.



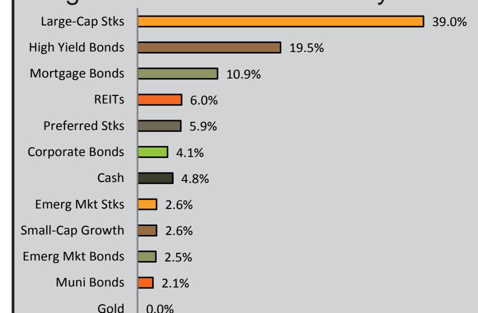
Focused REIT

A portfolio of companies whose primary business is owning and leasing real properties.

Balanced Portfolios

Asset Allocation for Income

A portfolio of stocks, bonds, and cash for moderately-conservative investors seeking income and growth with relative stability.



Equity Markets: Consumption Drives Growth

Earnings growth drives leadership in the stock market, while consumption generally drives earnings. Every market cycle has consumption themes which are either secular or cyclical in nature. Here's what is active in this market cycle.

Secular Consumption Themes:

- **Theme:** Global demand for wireless devices, digital media and cloud computing power. Demand growth is a product of industry's ability to innovate. Sector: Technology
- **Theme:** Global demand from wealthier and growing emerging market populations for meat and poultry to support more "western-like" eating habits, as well as growing demand for technologies that provide greater agricultural yields.

  Sector: Materials
- **Theme:** Global demand for energy as population grows as well as increasing demand for the technologies that make it viable to extract natural resources from the farthest reaches of the earth. Sector: Energy
- **Theme:** Increasing demand for healthcare as population ages, as well as growing demand for new and better products provided by innovation in the development of life-saving drugs, devices, and services. Sector: Healthcare

Cyclical Consumption Themes:

- **Theme:** The return of mild consumer discretionary spending balanced against purchasing decisions based on need instead of want. Sector: Consumer Discretionary/Staples
- **Theme:** Pent-up demand within the enterprise upgrade cycle. Sector: Technology
- **Theme:** The re-surfacing of emerging market infrastructure spending. Sector: Industrials
- **Theme:** Credit market stabilization and a return of demand for investment banking products and services. Sector: Financials
- **Theme:** The return of demand for manufactured products.

  Sector: Industrials, Energy

Commentary: Cyclical sectors showing leadership

As the economy and consumers come back to life, cyclical sectors have rotated back into leadership. Strengthening economic data coupled with accommodative fiscal and monetary policy has driven a risk-on lean in 2012. The financial sector continues to rebound from low valuations as new financial regulations continue to be digested. Record-highs in retail sales have put it back in-line with its long-term trend. As a result, the consumer discretionary sector put forth powerful performance for the year, up nearly 25%. Assuming the accommodative policy and positive economic data trends continue, watch for cyclical sectors to continue their leadership in 2013.

Sector Performance Review *12/31/12*

	Quarterly Change	Trailing 12-Months
Financials	5.1%	26.7%
Industrials	4.9%	16.9%
Materials	3.3%	16.6%
Consumer Discretionary	2.9%	24.8%
Healthcare	0.1%	18.7%
Consumer Staples	-1.4%	10.9%
Utilities	-2.4%	1.7%
Energy	-2.6%	4.0%
Technology	-5.2%	14.2%
Telecom	-5.6%	18.9%

Data based upon Russell 1000 Index and GICS sectors. Source: Bloomberg Financial

Fixed Income Review

By Kyle Aron

Eying Interest Rates

Kyle Aron
Senior Analyst

Despite ending 2012 teetering on the edge of the so-called "fiscal cliff", US markets held their ground to finish the year with strong positive performance. The continuation of accommodative policy by the Federal Reserve has been markedly effective in steering investors towards risk assets, with the S&P 500 (SPY) ending 2012 up 16.0%. Corporate bonds also fared well, with high-yield (HYG) returning 11.7% and investment-grade (LQD) up 10.6%. Both financial preferred securities (PGF) and commercial mortgage bonds (PCM) saw outsized returns for the year, up 20.3% and 23.0% respectively. The risk-on trade coupled with depressed domestic yields was a boon for emerging-market government bonds (EMB), up nearly 17.0% for the year. As expected, long-term Treasurys lagged, up just over 2.5%.

The market remains sharply focused on monetary and fiscal policy developments both domestically and abroad. Among the more notable events for the year, Fed Chairman Ben Bernanke explicitly stated the conditions under which the Fed expects to tighten monetary policy. In the Fed's December meeting, Mr. Bernanke outlined unemployment at or below 6.5% and a near-term inflation outlook above 2.5% as conditions warranting tighter monetary policy. Assuming a continuation of current trends in inflation, hiring and a slight linear growth in the labor force participation rate, the Fed forecasts that we will likely reach these conditions in 2015.

The fixed income landscape is now more treacherous than ever as investors have firmer expectations for the timeline of future monetary policy. Duration risk remains a preeminent hazard in a rising interest rate environment, particularly in many high-quality fixed income instruments that appear to be low-risk investments. For example, TLT, a fund consisting of long-term Treasurys with an average maturity 28 years, currently has a duration of 16.9; that is to say, for a 1.0% increase in interest rates, the market price of the fund is expected to see a 16.9% decline. Likewise LQD, a fund of investment-grade corporate bonds with an average maturity of 12 years, has a duration of 7.7. These durations risks have been exacerbated by record-low yields on the majority of fixed income instruments.

Given these circumstances, we continue our lean toward distressed and emerging-market debt going into 2013. This debt typically offers higher yields at comparably shorter maturities, helping reduce duration risk and providing a backstop of higher interest payments to offset the negative effects of rising rates. Spreads also continue to favor high yield debt. The spread between high-yield corporates and 10-year Treasurys ended the year at 4.5, after closing 29% from 6.4 at the beginning of 2012. Investment-grade corporate spreads narrowed by a staggering 42% to end the year at just 1.5.

Further bolstering the case for higher-yielding fixed income segments is strengthening economic data - notably the estimate-beating GDP growth for Q3 2012. Coming in at an annualized 3.1%, Q3 GDP was significantly above estimates of 2.7% and was higher year-over-year by 1.8. Given the resolution of the fiscal cliff at the beginning of 2013 and assuming the improving economic fundamentals continue, we will continue to hold this fixed income stance. Broadly, however, we remain cautious of the bubble into which the majority of fixed income asset prices have ballooned.

A Word from Our Advisory Team

Jill Pletcher
Vice President
Senior Financial Advisor

What You Need to Know About the "Fiscal Cliff" Resolution

In typical nail-biting fashion, Congressional policymakers led the US off the "fiscal cliff" on December 31st only to reach out a hand in mid-air and grab hold of a deal the following day. While the agreement resolved many important issues, there remain several key items without solutions.

Many tax-related ambiguities were firmly resolved. As a result, the majority of Americans will see an increase in their taxes. Even the bottom 20% of earners, averaging just over $11,000 in income, will pay approximately $120 more annually with the expiration of the payroll tax cuts of 2010. Congress decided not to act to extend this cut of 2%, meaning payroll taxes will rise for employees from 4.2% to 6.2%.

Long-term capital gains taxes will rise from 15% to 20%. There is an additional 3.8% tax levied on investment income starting in 2013, including all capital gains, for individuals with incomes above $200,000 (or $250,000 for joint filers). This 3.8% tax is being implemented as a funding mechanism for Affordable Care Act passed in 2010.

In a win for wealthy families, the estate tax was not rolled back to a $1 million exemption (as was scheduled to occur without Congressional action). Instead, the exemption limit per person was set at $5 million, to be indexed at inflation annually thereafter. The tax on amounts over the exemption was raised from 35% to 40%. Unfortunately, many high-earners will see a hit to their current incomes as the top marginal tax rate was raised to 39.6% from 35% on income over $400,000 (or $450,000 for joint filers).

Other issues tackled by the agreement include indexing the AMT to inflation, preserving earned income and childcare tax credits, and (again) extending benefits for the unemployed.

However, important issues remain unresolved by the deal struck on January 1, 2013. Spending cuts intended to reduce the deficit were largely excluded. Proposed cuts in Medicare reimbursement to doctors were left out. The proposal to modestly reduce Social Security benefits and enact a higher eligibility age also failed to appear in the final agreement. Other scheduled domestic and military spending cuts, amounting to $110 billion, are being sequestered - essentially avoided - to be revisited later this year.

Even worse, the US is again projected to reach its debt limit on March 27th, 2013. In fact, the debt ceiling was reached on Dec 31, 2012, but stop-gap measures are allowing the Government to continue operation for an additional few months. The last time the US grappled with its debt ceiling in August 2011, Standard & Poor's credit rating agency downgraded US Government debt. The result was a market sell-off in the surrounding weeks of nearly 13%.

While the deal reached at the beginning of this year is commendable, it is clear that many challenges still loom over the US. If the divisive partisanship of the past few years continues, it may not be long before we are again left staring down an all-too-familiar cliff.

Economic Charts

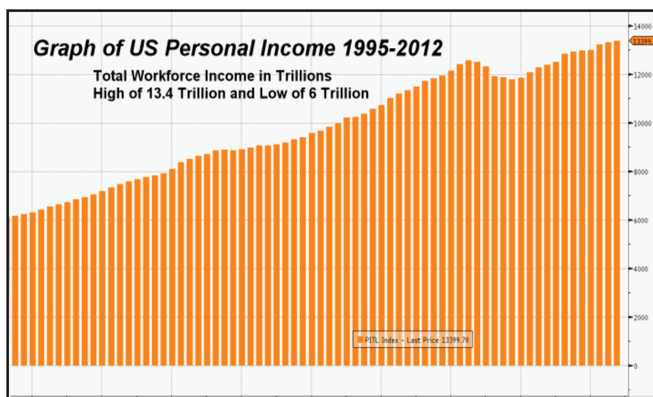


Figure 1 - Source: Bloomberg Financial

Graph of US Personal Income showing a steady rise and all-time highs in 2012

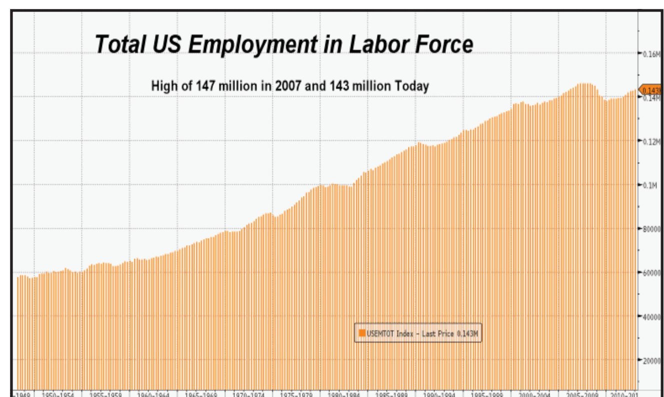


Figure 2 - Source: Bloomberg Financial

Graph of Total US Employment seen closing in on pre-crisis highs during 2012