Inside Views From an Investment Management Leader

UPDATE

July 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!

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Economic Review & Outlook

New Course for the Fed

The Federal Reserve has been hinting for the last month or two that policy may be changing course soon. Investors have grown uneasy as this delicate period begins. The impact for the equity and bond markets is unclear to many. As a result, equities have paused as the new posture is weighed against valuations and growth expectations already priced into the stock market. The bond market has been hit with heavy selling as investors try to get in front of likely FED action in the months and years to come.

Many believe that the economy is not yet strong enough for the oxygen mask to be removed from the sick patient, pointing to still high unemployment and modest GDP (pg. 4, figs. 1,2). Others believe that the change is overdue, referencing almost frothy conditions in housing in some areas of the country, along with a fed balance sheet that has grown to 3.5 trillion (pg. 4, fig. 3).

As in most situations with extreme differences the reality of things likely lies in the middle. Strong well rooted consumption is the foundation for good cycles of growth. The US economy is in fact still weak and does not have any compelling consumption engines behind it. Consumption of housing is indeed strong here in southern California but the buyers are mostly investors and not homeowners. Nationwide home prices are up a mere 5% or so over the last year. The pockets of strength in housing are likely a by product of the same theme that has pushed the stock market to all time highs. Investors are being forced to embrace risk by Fed policy that has given them 0% returns on risk free avenues.

Mitch Pletcher
President
Chief Investment Officer

The emerging parts of the globe are enjoying better consumption and the growing middle class is binging on American consumer products. Car growth is double digit in China and India and the hunger for oil continues to grow. Domestically healthcare demand is growing and benefits many players. Mobile computing, cloud infrastructure, and digitization of data have slowed but continue as an engine of growth. The best growth in our economy is coming from companies leveraged to these themes.

The burden of debt the globe has digested has held back consumption in the mature parts of the world and will likely continue to be an obstacle for years. As a result confidence is low, asset prices are not advancing, and earnings forecasts for corporate America are dismal. Given the reality of this situation the Fed will be careful about policy decisions. The Fed however is very aware that the stimulus that it has provided the economy has pushed its balance sheet to over 3.5 trillion (pg. 4, fig. 3). Thus far it has not been problematic for the dollar, nor has it caused fears of inflation. Tight lending standards for banks and new Basel rules for assets at banks have kept a lid on currency in circulation (pg. 4, fig. 4).

Fed policy will likely remain the same for another six months. We remain optimistic.

Financial Market Review & Outlook

Markets Pause

Mitch Pletcher
President
Chief Investment Officer

The whiff of new Fed policy drove investors into action with many asset classes changing course in the second quarter. Fixed income markets saw the news as a threat to the stability that these markets have enjoyed since 2008. High quality debt was sold across the board. Investors globally feared that the Fed's 85 billion per month purchase program would end soon and that the 2.5 trillion position that the Fed has been building could be put on the table as well at some point.

Equity investors were not as troubled by the news but still moved to the doors after a great rally in the first month of the quarter and what might have been a great quarter for stocks turned out to be just a good quarter (S&P 500 +2.9%). Leadership in the equity market was lackluster with most market caps and sectors recording similar performance. The outliers involved consumer stocks (XLY) which gained over 6.0% for the quarter, and emerging markets (EEM) which nearly lost ten (-10.0%) percent in the quarter. Emerging markets are leveraged to the manufacturing of tech products which have paused in demand. Consumer products contrarily are gaining favor in emerging areas of the world.

REITS changed course in the quarter. Like equities the first month's gain evaporated, but in the case of REITs the end result was a loss of 2-5% for most players (IYR -3.5%). Real estate is heavily leveraged with debt and investors are sensitive to rates and fed policy. Commodities continued their trend lower in the quarter. The Fed news was not bright for anyone hoping for a turn for asset prices.

The market has come a long way since the bottom in early 2009 and valuations are still compelling but the sharp contrast to fixed income that existed over the last few years has faded. The dividend yield of the S&P 500 is now 1.9% versus the ten year treasuries yield of 2.5%. This positions stocks as still cheap relative to historical standards. PE ratios are still quite low (14.5) for stocks relative to history, but relative to growth, valuations look a bit different. The outlook for growth needs to improve for the PE of 14 to expand.

The CIC Dynamic Growth Portfolio lagged its bogey in the second quarter due to an overweight position in technology and AAPL as well as a distressed bond position that could not keep up with equities any longer. The CIC Fixed Income Portfolio continues to outperform its benchmarks by large margins due to overweighting in distressed debt as well as shorter durations than the bogey.

Table 1: Stock & Bond Market Returns — 6/30/13

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
Large Cap Growth (IWF)	1.9%	16.6%	Small Cap Value (IWN)	2.5%	24.4%
Large Cap Value (IWD)	3.2%	25.0%	Small Cap Growth (IWO)	3.6%	23.5%
Europe Asia Far East (EFA)	-0.9%	18.3%	Emerging Markets (EEM)	-8.8%	0.3%
Invest Grade Bonds (LQD)	-4.3%	0.3%	High Yield Bonds (HYG)	-2.2%	6.1%
Interm Treasurys (IEF)	-4.1%	-3.5%	Mortgage Bonds (MBB)	-2.1%	-1.5%

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

Table 2: Real Estate & Commodity Returns — 6/30/13

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
DJ US Real Estate (IYR)	-3.5%	7.9%	DJ Commodity Index (DJP)	-10.2%	-9.2%
NAREIT Industrial/Ofc (FNIO)	-2.6%	10.7%	Goldman Commodity (GSG)	-6.4%	1.2%
NAREIT Residential (REZ)	0.0%	9.9%	Gold (GLD)	-22.9%	-23.2%

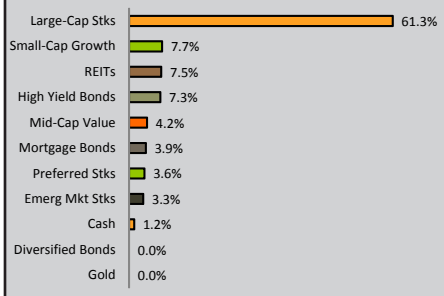
Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

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.

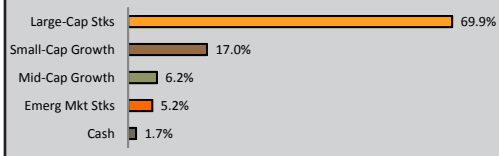


Growth

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.



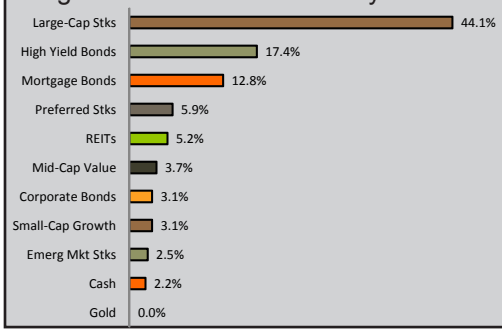
Focused REIT

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: Mixed Leadership in Equities

Strengthening labor data (hours worked, earnings, unemployment claims, total payroll additions) helped fuel the consumer discretionary sector to lead the equity markets in the second quarter of 2013. Healthcare also had strong results as new regulations draw nearer, which most consider a net positive for providers and other healthcare companies. Look for continued outperformance in consumer related sectors as a sizeable rise in year-over-year home prices has many households feeling richer and has pulled many homeowners out from underwater.

Sector Performance Review *6/30/13*

	Quarterly Change	Trailing 12-Months
Consumer Discretionary	7.0%	33.4%
Financials	5.8%	32.2%
Healthcare	3.9%	28.1%
Industrials	2.3%	24.4%
Telecom	2.0%	13.1%
Technology	1.1%	7.7%
Consumer Staples	0.7%	18.2%
Energy	-0.7%	17.7%
Materials	-2.2%	12.2%
Utilities	-2.3%	8.4%

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

Fixed Income Review

By Kyle Aron

Easing off Easing?

Kyle Aron
Senior Analyst

If you're feeling like nearly every article in this segment is about the Fed - *you're right*. Such is life in the fixed income world during this unprecedented time of quantitative easing. While fixed income instruments remain at historically low yields, keen observers must keep a watchful eye on the language and policy intentions of Ben Bernanke and their implications.

In his June statement, Bernanke views "downside risks to the outlook for the economy and labor markets as having diminished since the fall." The Fed raised its projections for GDP growth next year and improved expectations for unemployment in light of continued positive economic data in the second quarter of 2013. Housing indicators had significant upside surprises, while most other economic segments came in at or near expectations for positive growth. Bernanke feels "if the incoming...data are broadly consistent with [their] forecast, the committee currently anticipates that it would be appropriate to moderate the pace of [bond] purchases later this year."

Bernanke's statements rattled markets across all asset classes. While conditions warranting the scaling back of support indicate positive economic progress, investors remain concerned about unwinding the substantial level of Fed accommodation. Stocks were the only major asset class to finish the quarter positive, with the S&P 500 up nearly 3.0%. More interest-rate sensitive assets like fixed income and REITs finished in the red. Gold was also negative for the quarter as inflation remained subdued in Q2. The Fed went as far as to lower inflation expectations for 2013 by 0.3% and 2014 by 0.2%, aiding gold in its worst quarterly performance since 1968, down 23.0%. Overall, the quarter was marked by assets generally adjusting to the notions of impending tapering in quantitative easing and an ultimate rise in interest rates. We all knew we'd find ourselves here eventually.

Duration-heavy fixed income segments were among the worst performers in Q2. Long-term Treasurys (TLT), with a duration of 16.8, were down 6.7%. Likewise investment-grade corporate bonds (LQD), with a duration of 7.6, ended the quarter down nearly 5.0%. PCM, a leveraged mortgage derivative fund, lost over 10% in the quarter. High-yield corporate bonds, with relatively lower duration risk, were down a modest 2.2%.

In light of current interest rate conditions, several unique short-duration focused ETFs have come to market. PIMCO's HYS, with exposure to ultra short-duration high-yield corporate bonds, outperformed for the quarter and was down a mere 1.5%. CSJ, a similar investment-grade offering, was down just 0.3%. Rotation into shorter duration instruments, as we've advocated for some time now, has been a good source of alpha generation.

Additionally, some fixed income instruments are now oversold. PCM, for example, is trading closest to its net asset value in over four years. Utilizing similar leverage at the time, PCM weathered the rising-rate environment and associated higher borrowing costs of the mid-2000's notably well. PCM is trading at a fair value and should see good total returns as fixed income markets stabilize.

Going forward, fixed income presents a unique challenge as it defies its long-standing claim as a conservative portfolio component. Proper risk management and focus on the right risk elements are essential.

A Word from Our Advisory Team

Jill Pletcher
Vice President
Senior Financial Advisor

Concord's Dynamic Growth Portfolio is Truly Dynamic with some Help

Concord's Dynamic Growth Portfolio is and has been our most popular investment strategy. Our ability to manage risk, access complicated markets, adapt quickly to changing trends in drivers of markets, requires wisdom and great judgement, but also necessitates liquidity. Underlying that last thought is perhaps the best innovation of the last decade for investors. The advent of the Exchange Traded Fund. ETFs come in several flavors, mostly issued by Barclays as iShares. These securities give investors access to almost any asset class and/or market in a highly diversified, liquid, and inexpensive format. They differ from mutual funds in that they are not front-end or back-end loaded with fees. Usually not actively managed, most ETFs mirror an index and hence carry only modest administrative fees. They are bought and sold on an exchange just like a stock which at Charles Schwab generally means $8.95 to buy or sell any amount.

The ETF has allowed our Dynamic Growth portfolio management team to enter and exit successfully many high risk markets in a diversified liquid manner. As a result we added alpha to our clients portfolios with successful trades over the last few years in: emerging markets bonds, distressed debt, derivatives, commodities, Treasurys, TIPS, and emerging market stocks. Currently we are shortening duration and improving credit quality of our debt portfolio without having to sell a single individual bond. We are leveraging opportunities in China's rapidly growing middle class through sector ETF's that provide consumer goods China wants and needs.

The ETF has helped us improve our performance and made your portfolio simpler.

Economic Charts

Figure 1 - Source: Bloomberg Financial
Graph of US unemployment showing still elevated levels and a pause in downward trend during Q2 2013

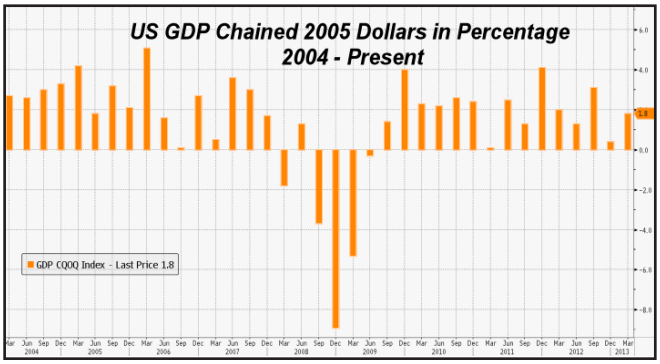


Figure 2 - Source: Bloomberg Financial
Graph of US GDP showing a slow but positive level of growth

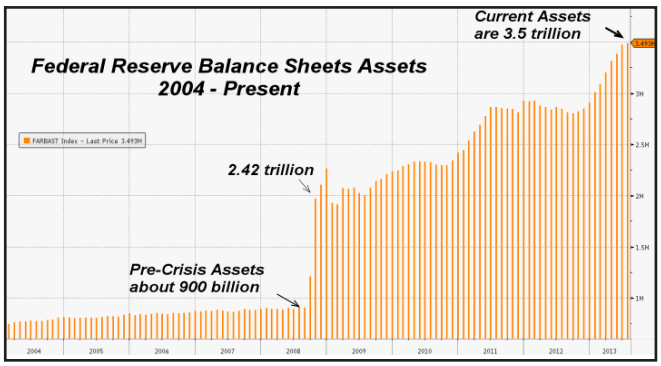


Figure 3 - Source: Bloomberg Financial
Graph of Federal Reserve balance sheet assets, which have grown considerably since the recession

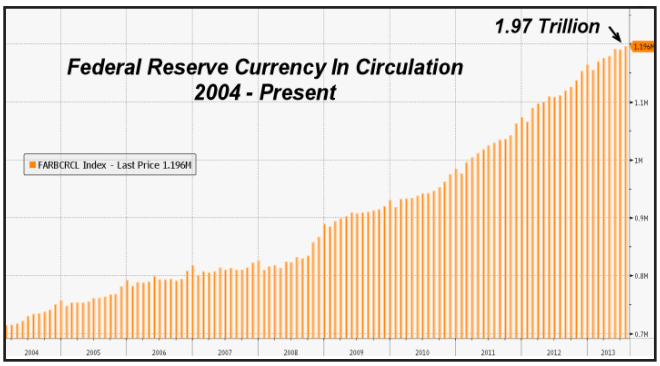


Figure 4 - Source: Bloomberg Financial
Graph of US currency in circulation, which has held a steady pace of growth despite the Fed's loose policy