Inside Views From an Investment Management Leader

UPDATE

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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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Economic Review & Outlook

Domestic Economy Transitioning?

Mitch Pletcher
President
Chief Investment Officer

The US economy has struggled for the last two years to transition from recovery mode to self-sustaining growth. Secular themes of over-consumption and debt are the rot in the kitchen that we have yet to eradicate. Recent data however has sent markets to new highs and has economists shaking their heads in disbelief. Its been 5 years since the economy hit rock bottom in march of 2009. Is the sky clearing or is this just another pause in a long storm?

The recent data that has got everyone up out of their chairs involves strong gains in jobs in recent months of over 220k/month, improving expectations for corporate earnings – 2014 estimates now at 11.7%, and positive steady trends in confidence and debt reduction by consumers (Pg. 4 Fig. 1). All of this has turned into an improving picture for consumption. Every good economic cycle of the past 50 years has had prevalent and notable consumption themes driving it.

For the US economy to get off its duff and move we need a theme or two to develop. There clearly is a return of manufacturing to US soil as Wages in china rise and shipping costs grow. Corporate spending on plant and equipment has risen over the last year evidencing this welcome theme. Rockwell's automation division is humming with new orders for factory equipment for manufacturing facilities here in America. Healthcare demand is growing and benefiting US providers, but pinching consumers and business with the costs. Leisure spending from the affluent part of our population that is in retirement is notable as well.

Consumer confidence in America is rising, and with it, increasing demand for autos, transportation services, leisure activities, and consumer electronics. All of these themes for consumption are good but the best is still the rising consumption from China and India. These to population superpowers have middle classes that are growing and consuming. And better yet, the secular headwinds of debt and overconsumption are calm in this part of the world, as these emerging market consumers did not have access to capital and did not overconsume as a result.

Expectations for GDP for the second quarter stand at 3.9%, rebounding strongly from the surprise we had in the first quarter where the economy contracted by 2.9% due in part to weather related activity (Pg. 4 Fig. 2). While there is clearly still a focus by consumers to reduce debt that will continue for years, consumer wealth has risen nicely. The DJIA is now over 17000 and rising, The Case Schiller index of home prices has advanced 23.5% since 2011, and as a result, household net worth has risen from $68.9 trillion in 2007 to $83.5 trillion today.

The improving trends in the economy cannot be ignored but must be watched carefully to confirm what appears to have begun. We remain optimistic.

Financial Market Review & Outlook

Markets Move Higher

Mitch Pletcher
President
Chief Investment Officer

Financial markets trended broadly higher in the second quarter of 2014 after a poor start. Equity markets reacted negatively to a weak GDP report in April and first quarter earnings reports that were well off estimates. GDP contracted 2.9% in Q1, and earnings of the S&P fell 3.4% from Q4. These reports, combined with continuing soft data out of China, ignited fears that a stall in the three year-long recovery might be unfolding. Treasurys and defensive areas rallied on the unexpected news of economic weakness. Fortunately better economic data surfaced as the quarter progressed with strong gains in employment and an associated rise in confidence. Fed Chairman Yellen then affirmed the Feds commitment to accommodative policy adding more fuel to the engine driving equities, and boom, the quarter turned out to be broadly positive for stocks and bonds. The S&P 500 advanced 5.2%, with most large-cap indices marking the same performance. Small-cap and high growth areas were hit hard early in the quarter by the fears of an economic stall, causing temporary corrections of 10.0 to 20.0% in some indices. Small-cap growth (IWO) rose a modest 1.7%, while small cap value (IWN) was up a 2.4%. Internet stocks (PNQI) ended the quarter up 3.2%, struggling on news that Twitter and Facebook were seeing weak trends in usage growth.

The foreign markets changed course slightly in Q2. European stocks (EZU) rose a modest 2% after leading the equity markets for several prior quarters, and emerging markets (EEM), which had lagged for several quarters, sprang to life with a gain of over 6.0%.

High-quality fixed income areas, which had been in a steady decline in 2013, rallied on the news of a possible economic stall and held their gains as the quarter ended. Long-dated Treasurys (TLT) gained 4.8%, high-quality corporates (LQD) gained 2.9%, and mortgage bonds rose 2.4%. Distressed debt which had led the bond market for two years paused a bit as money rotated back to quality.

REITs continued to outperform, posting another great quarter following similar gains in Q1. Apartment REITs (REZ) rose 7.5%, retail space (RTL) rose 6.9% and commercial property (FNIO) gained 4.2%.

Concord's Growth portfolios were mixed in Q2. Dynamic Growth (DG) rose 3.0%. Diversified equity (DE) rose 5.2%, matching the S&P 500. Allocations to high growth areas and distressed debt that paused in Q2 held back absolute performance; however, risk adjusted performance was strong.

The revised outlook for earnings is notable and gives stocks room for upside. Wall Street analysts are now expecting S&P 500 earnings to advance 11.0% this year and 15.0% next year. The earnings reports now underway for Q2 will give a hint if the analysts are correct with their recent positive revisions. The continuance of the equity rally hinges on these reports. We remain cautious but optimistic.

Table 1: Stock & Bond Market Returns — 6/30/14

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
Large Cap Growth (IWF)	5.1%	26.8%	Small Cap Value (IWN)	2.4%	22.5%
Large Cap Value (IWD)	4.9%	23.4%	Small Cap Growth (IWO)	1.7%	25.1%
Europe Asia Far East (EFA)	4.2%	23.2%	Emerging Markets (EEM)	6.2%	14.2%
Invest Grade Bonds (LQD)	2.9%	8.9%	High Yield Bonds (HYG)	2.2%	11.0%
Interm Treasurys (IEF)	2.4%	3.0%	Mortgage Bonds (MBB)	2.4%	4.3%

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

Table 2: Real Estate & Commodity Returns — 6/30/14

	Quarterly Change	Trailing 12 Mos		Quarterly Change	Trailing 12 Mos
DJ US Real Estate (IYR)	7.0%	12.3%	DJ Commodity Index (DJP)	0.0%	8.1%
NAREIT Industrial/Ofc (FNIO)	4.2%	13.3%	Goldman Commodity (GSG)	2.9%	10.1%
NAREIT Residential (REZ)	7.5%	8.2%	Gold (GLD)	3.6%	7.5%

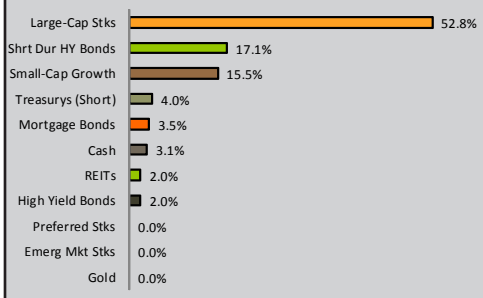
Source: Bloomberg, Barclay's Global Investors ETFs. Actual performance including dividends.

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.

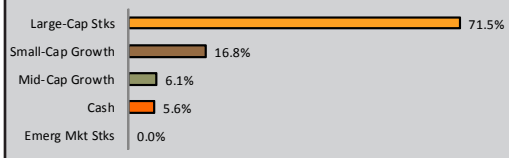


Growth

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.



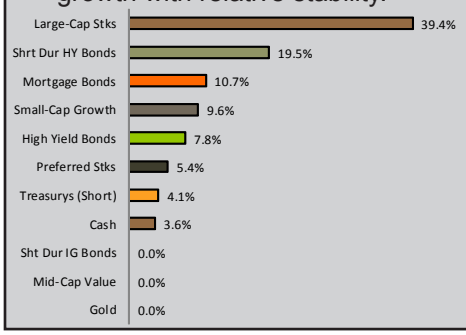
Focused REIT

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 the Second Quarter

Equity sectors broadly performed well in the second quarter of 2014, albeit with mixed leadership. Utilites continued to outperform on the year, with P/E valuations now markedly streched above their long-run averages. Beta-heavy sectors, like technology, regained some relative ground in the second quarter but remain well below their historical valuation average according to their current earnings expectations. However, the remaining leadership came from less cyclical sectors, including healthcare and consumer staples and energy.

Sector Performance Review *6/30/14*

	Quarterly Change	Trailing 12-Months
Energy	12.3%	30.7%
Utilities	7.7%	21.1%
Technology	6.0%	32.7%
Materials	5.5%	32.0%
Consumer Staples	4.9%	15.8%
Healthcare	4.6%	30.8%
Telecom	4.1%	7.7%
Industrials	3.8%	29.3%
Consumer Discretionary	3.3%	21.7%
Financials	2.5%	18.5%

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

Fixed Income Review

By Kyle Aron

Leadership Continues

Kyle Aron
Senior Analyst

Fixed income continued its reign as a top performer for the year following the second quarter of 2014. Treasury yields furthered their decline amid investor interest that was more than sufficient to outweigh the steady exit of the Federal Reserve as a major buyer. 30-Year Treasury yields ended the quarter at just 3.4%, nearly 17% below where they began the year. Treasurys across the majority of the yield curve exhibited similar patterns.

The S&P 500 ended the second quarter up 5.2%, bolstered by strengthening economic data. Gold (GLD), amidst a modest uptick in inflation expectations, posted a solid gain for the quarter of 3.4%. REITs (IYR) continued their outperformance in the second quarter, up nearly 7.0%.

Much of the interest in fixed income, Treasury debt in particular, is likely attributable to the heavy sell-off that occurred in this space throughout 2013. Alongside a now more visible timeline for the Federal Reserve's interest rate increases (a clearly distant event), fixed income appears a seemingly good value. Investors were reassured in the second quarter that the finale of the Fed's tapering is to be a separate and distinct event from their eventual targeted increase in interest rates. This has led the way for renewed investor appetite this year, helping long-dated Treasurys (TLT) to a quarterly gain of nearly 5.0% and a gain year-to-date of 12.9%. Similarly, mid-dated Treasurys (IEF) ended the quarter up 2.4% and are up 5.3% in 2014.

According to the most recent Federal Reserve projections, policy consensus indicates that the Federal Funds target interest rate is unlikely to be anything over 1% before 2016. On the back of this visibly far off timeline, leveraged fixed-income instruments, like many of PIMCO's utilized by Concord, have soared. PHK (broad leveraged debt), part of Concord's high income portfolio, ended the quarter up 11.6% and is up nearly 24.0% for the year – more than triple the return of the S&P 500. PCM (leveraged commercial mortgage-backed debt) ended up 2.6% for the quarter, bringing its year-to-date return to 9.4%. Notably, Bill Gross, the founder of PIMCO, was reported as recently having increased his holdings of PIMCO's leveraged fixed income funds to 10.0% of his total net worth, or over $200 million. This followed Gross purchasing nearly $60 million of these funds in the second quarter of this year alone.

Other segments of fixed income have generally matched or beaten the equity markets for the year, with only mortgage and corporate debt issues failing to outpace the S&P 500. Speculative-grade fixed income (HYG) was up 2.3% for the quarter and is up 5.0% for the year. Likewise investment-grade fixed income (LQD) returned 2.9% for the quarter and 4.2% year-to-date. Mortgage debt (MBB) finished the quarter up 2.4%, up 4.2% for the year. Emerging market corporate debt, meanwhile, put in strong quarterly and year-to-date performance, up 4.6%, and is up 8.6%, respectively.

Overall, we believe fixed income remains a risky environment. Although the Federal Reserve has indicated that the timeline for targeting higher interest rates is far off, they have maintained an ebb and flow of their policy support based upon incoming economic and market data. As of July 7th, in-line with continued strength in various economic indicators, some of the major banks have moved forward their forecast dates for the initial increase in the target Federal Funds rate. Previously set for the first quarter of 2016, both JP Morgan and Goldman Sachs are now anticipating this increase could come as early as the third quarter of 2015. Given our general theme of improving economic data, fixed income remains relatively less attractive than other asset classes at present.

A Word From Our Advisory Team

Jill Pletcher
Vice President
Senior Financial Advisor

Retiring with Comfortable Income and an Appropriate Asset Allocation

Maintaining an appropriate asset allocation for an income investor can be challenging. Most individuals feel inclined to rearrange their portfolios significantly as they retire. We typically find investors wanting to turn their portfolio of stocks and real estate investments, which they relied upon to build the nest egg that allowed them to retire, into a balanced portfolio of stocks and bonds. This was fine in the past when bonds and fixed annuities almost guaranteed 5-8%. However, today the return on these income vehicles is a modest 2-3%. Hence the review of your asset allocation should look heavily first at your non-investment sources of income before making big changes in your investment assets to bonds or annuities.

Pensions and social security have turned out to be good reliable sources of income for retirees, many times meeting or exceeding a person's lifestyle needs in retirement. Pensions and social security can be looked at as a fixed income investment with tremendous value. For example: if you receive $50,000 annually in Social Security income, you conceivably have an asset that has a value of over $1 million, as that is how much capital would need to be invested to generate $50,000 annually from a moderate risk bond fund or annuity. Social Security is backed by the US government, similar to government bonds (Treasurys) that only yield 1-3%. Social Security also has a Cost of Living Adjustment that has slightly beat inflation over the last 30 years (Fig. 3). Bond funds and annuities generally don't bring this perk to the table.

So, should you put your investment capital in bonds or annuities? The answer hinges on how much income you need above and beyond your pension and Social Security. If you don't need much, then you don't need much of an allocation to bonds or annuities. Unfortunately bond and fixed annuity returns are quite low today and the outlook is not bright for a recovery in rates. Investing in untimely income investments without the real need for the income may be a mistake. Don't let the lure of a guarantee from a cleverly disguised distressed insurance company push you into an untimely fixed annuity.

Economic & Financial Market Charts

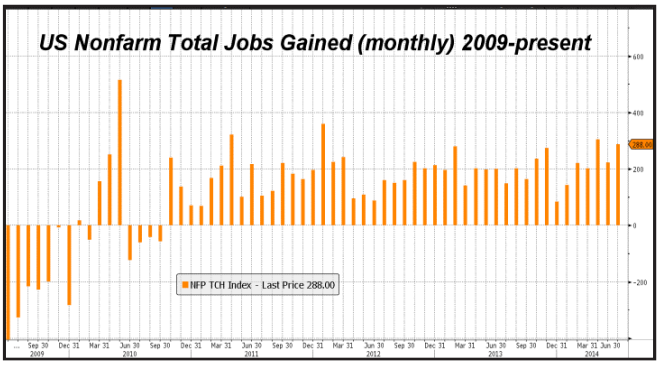


Figure 1 - Source: Bloomberg Financial

Graph of US Nonfarm Payroll gains during and after the Great Recession

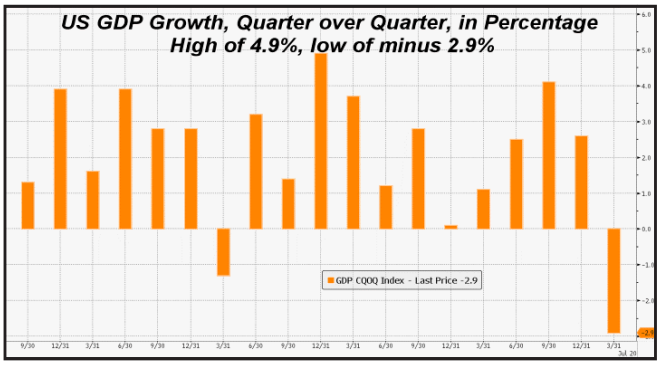


Figure 2 - Source: Bloomberg Financial

Graph of US GDP quarterly growth rate, experiencing a large one-time decline in Q1 2014

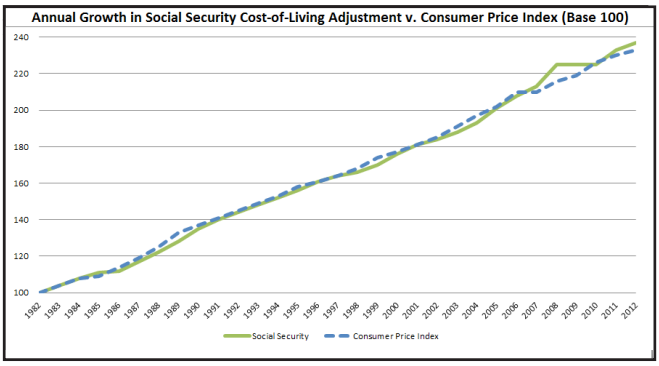


Figure 3 - Source: SSA; FRED

Annual growth in Social Security Cost-of-Living Adjustment (green) v. Consumer Price Index (blue)

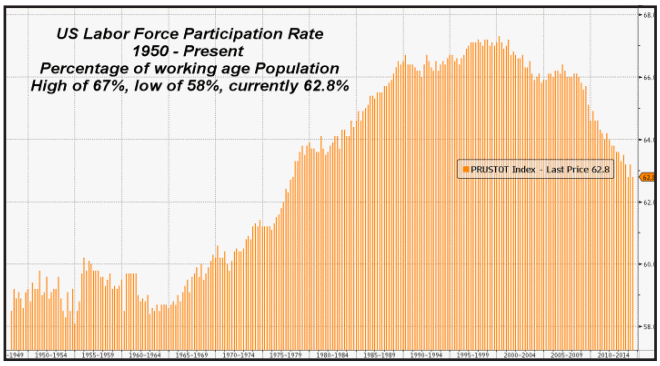


Figure 4 - Source: Bloomberg Financial

Graph of US Labor Force participation rate declining to levels not seen since the late 1970's