Financial Management Group
Building and Preserving Client Wealth Since 1989

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Financial Management Group
Economic & Investment Outlook
Second Half 2013

During the first half of 2013, the U.S. equity market indices experienced significant advances as compared to the foreign equity markets, and most especially to that of the emerging markets

The chart below illustrates how the disparities in investment returns in the short-term subsequently shift and regress to the mean over the longer-term:

Index	2nd Qtr.	YTD	3 year*	10 year*	20 year*	Description
S&P 500 Index	2.91%	13.82%	18.45%	7.30%	8.64%	Large-Cap Stocks
Russell 1000 Growth	2.06%	17.44%	18.68%	7.40%	7.76%	Large-Cap Growth Stocks
Russell 1000 Value	3.20%	14.39%	18.51%	7.79%	9.30%	Large-Cap Value Stocks
Russell 2000 Growth	3.74%	11.80%	19.97%	9.63%	6.94%	Small-Cap Growth Stocks
Russell 2000 Value	2.47%	15.90%	17.33%	9.30%	10.33%	Small-Cap Value Stocks
MSCI – EAFE	-0.73%	4.47%	10.55%	8.16%	5.49%	International Stocks
MSCI – Emerging Market	-7.95%	-9.40%	3.72%	14.02%	7.69%	Emerging Market Stocks
Barclay's Aggregate Bond Index	-2.32%	-2.44%	3.51%	4.52%	5.93%	Domestic Bonds
*Denotes returns annualized as of June 30, 2013.						

Portfolio diversification does not necessarily always produce the best overall result in the short-run, but with active asset class rebalancing should maximize reward with less risk in the long-run

The extreme dispersion of market behavior during the first six months of this year typically resurfaces the controversy about whether or not a diversified portfolio is best. Simply, the short answer is that diversification does not necessarily always produce the best overall result in the short-run. However, once again we remind you that smart investing requires a long-term perspective with a win-by-not-losing outcome that can only be achieved via a diversified portfolio structure.

The current market environment may seem reminiscent of the late 1990’s, when the S&P 500 Index reached new market highs on a regular basis, driven primarily by the performance of a narrow group of technology stocks. During that time while the U.S. large company domestic market provided double-digit returns, the other equity asset classes, particularly international equities, REITs, and emerging markets provided less spectacular outcomes.

As a result, many investors fell into the false belief that the U.S. technology sector would continue to dominate endlessly, and rejected diversification. Instead, they concentrated their investments in large company domestic stocks, particularly technology mutual funds and individual holdings such as Dell, Sprint, Intel, Lucent, AT&T, and others. Unfortunately, this greedy short-term investment mentality turned to financial grief when the technology bubble did burst with a vengeance.

Fortunately, the fundamentals for today’s equity markets are really not so similarly comparable to the late 1990’s. Unlike then, currently the valuations for most segments of both the domestic and international equity markets remain attractive with the potential for further growth seeming warranted.

Domestically, many companies are now flush with cash as a result of severe cost cutting measures and restricted expansion activities since the 2008 financial crisis and recession. Our expectation is that as growth continues to manifest in the global economy the excess cash will be deployed for mergers and acquisitions, new employment, technology, equipment purchases, stock buy backs, and increasing dividends to shareholders. These activities are typical during a period of economic growth and the actions themselves help to provide additional reinforcement for growth and higher securities valuations.

Internationally, we expect the emerging markets to rebound strongly within the next twelve months, and a reason why we are maintaining the established strategic target allocations for the emerging markets within the portfolios. Also, noteworthy is that the European crisis has become more stabilized now because the monetary policy of the Eurozone's Central Bank seems more committed to preserving the Euro. Solutions are now being formulated to go beyond fiscal austerity measures, which should improve the outlook for European economic recovery and growth.

Don't let the year-to-date 2013 short-term equity performance results for the international asset classes camouflage the long-term benefits of international equity diversification

An often stated belief is that diversification is losing its importance due to globalization. However, although correlations do tend to become closer during an extreme financial crisis such as in 2008, as long as there's a gap amongst the returns of different asset classes, there are significant diversification benefits.

A review of the asset class performances since the 2008 crisis reveals that each year there has been a wide dispersion of returns, and reinforces that diversification remains important. For example, as shown in the above chart, the S&P 500 Index is up 13.82 percent through June 30th, while the MSCI Emerging Market Index was down -9.40 percent. This reflects a large dispersion of returns.

Also notice that other stock asset classes such as U.S. large and small value stocks outperformed the S&P 500, while international asset classes underperformed. And this relative performance was the reverse of what happened in 2009, 2010 and 2012, when international funds outperformed U.S. funds.

While we understand that the dispersion of returns matters, and in the short-term can cause questioning about the merits of diversification, when we structure a diversified portfolio, we prefer to combine asset classes that have lower correlations in order to reduce risk and increase overall returns in the long-run.

With this in mind, we evaluate the correlation data for various asset classes to see which international asset classes provide the greatest diversification benefits. The below table shows the correlations for the period January 1994-March 2013. The data for international indexes is provided by Dimensional Fund Advisors (DFA).

	S&P 500	Russell 2000	DFA EAFE	DFA EAFE Small	DFA EAFE Small Value	DFA Emerging Markets
S&P 500	1.00					
Russell 2000	0.81	1.00				
DFA EAFE	0.80	0.75	1.00			
DFA EAFE Small	0.68	0.70	0.94	1.00		
DFA EAFE Small Value	0.65	0.66	0.91	0.97	1.00	
DFA Emerging Markets	0.73	0.73	0.80	0.78	0.75	1.0

The correlations reflect why we include international diversification in portfolios even though for the first half of this year the international investment returns have underperformed when compared to the performances of the domestic holdings.

Moreover, the benefits of international diversification are even greater when investing in international small stocks, international small value stocks and emerging markets than when investing in the international large stocks that are in the EAFE index. Interestingly, international small-cap stocks and small value stocks have even a lower correlation to U.S. small stocks than do international large stocks.

Therefore, because of the lower correlation and the higher expected long-term returns of international small-cap, small-cap value, and emerging market holdings, we include an allocation to them when constructing portfolios.

The investment outlook for fixed income and cash is not as favorable as for equities

As we have forewarned in previous communications, interest rates are now starting to rise. Although Federal Reserve officials have been issuing conflicting statements as to the timing, a change in U.S. Central Bank's monetary policies is inevitable, which will result in further increases for interest rates. Accordingly, our investment asset allocation policy at this time is to continue to tactically overweight equities, both within the U.S. and international markets, with a corresponding underweight to fixed income.

Earlier this year we also took steps to limit the fixed income holdings to mostly short-term, high quality bonds in order to ensure that these holdings will provide a stabilizing anchor to the portfolio, while at the same time providing a funding mechanism for rebalancing opportunities.

The multi-strategy asset class will become an increasingly critical component to client portfolios

Investments in this asset class are selected based upon their risk characteristics and exhibit low correlations to the performance of traditional equity markets. Examples of specific holdings include convertible securities, international and domestic real estate, currencies, and merger and acquisitions.

Some the holdings are intended to be conservative in nature, protecting the portfolio during periods of volatility while others are intended for long term growth, but will experience larger upward and downward movements during shorter periods of time.

By maintaining consistent exposure to a diversified array of 15-20 individual asset classes, client portfolios will have every opportunity for growth and by making tactical shifts, over and above periodic rebalancing and profit taking opportunities, we seek to add value, especially during periods of elevated volatility.

At FMG, our team of financial planning and investment management professionals works closely together to ensure opportunities are not overlooked for adding value to your financial situation. In our opinion, wealth building and preservation must include not only investment management, but also financial planning activities such as cash management, debt management, tax planning, college funding, retirement planning, and estate preservation.

Our firm has the capacity for accepting new clients and the most important resource for us to grow and enhance the value of our services is satisfied client and professionals who are willing to refer us to us

Please feel free to refer others to us by offering at no charge, an introductory consultation to determine if and how we might be able to assist others with our comprehensive wealth management services.

We welcome discussing further with you our Economic & Investment Outlook for the remainder of 2013. Please feel free to contact us at any time by telephone at 513-984-6696 or via our websites at www.fmgonline.com and www.quietmillionaire.com.

FMG Investment Policy Committee