CAUBLE & HARRE WEALTH MANAGEMENT

PETER B. HARRE, CFA
Principal

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

July 9, 2013

«MailAdd»

Dear «CLSP»:

During the 14 month period January 2008 through February 2009, the U.S. stock market as measured by the Vanguard Total Stock Market Index fell 48%. Potential losses of this magnitude, even if temporary, are a good reason to not put all your money into U.S. stocks. Diversification into other asset classes helps mitigate risk over time. The first half of 2013 makes this good advice hard to embrace.

During the first six months of this year, the Vanguard Total Stock Market Index fund gained 11.2%. Many other asset classes produced a negative return. The following returns are iShares ETFs in various categories and their respective year-to-date returns through June 30: U.S. Aggregate Bonds (AGG) down 2.5%, International bonds (IGOV) down 5.4%, Emerging Market Bonds (LEMB) down 6%, Emerging Market Stocks (EEM) down 10%, Commodities (GSG) down 5.7%, Gold (IAU) down 28%. International Stocks (EFA) up 4% and High Yield Bonds (HYG) up 0.30% offered the few sources of positive returns.

Markets will always ebb and flow, and declines in value do not always demand a change. One should always consider, however, whether market changes are highlighting a changed environment that deserves attention. For example, I believe that the bond market is worthy of such consideration. The 10 year Treasury note fell to a one year low yield of 1.61% on May 1, 2013. On June 24, 2013, the yield reached 2.67%. This coincided with Federal Reserve Bank Chairman Ben Bernanke's testimony during which he highlighted the Fed's intention to reduce bond purchases in the future.

The decline in interest rates has been taking place for 30 years. That is a long term trend, and if we are at an inflection point in that trend, it suggests that we could be facing a very different bond market over the next 10 years than most investors have ever seen.

There have been huge inflows into bond funds over the last few years. The recent shift to bond fund redemptions coinciding with Bernanke's testimony illuminated a potential issue in the bond markets. Unlike stocks, which trade through exchanges, bonds trade through intermediaries, which are firms that stand between buyer and seller. They hold the bonds until they can be sold to another party. This requires capital on their part. They use their own money to buy the bonds and then hold them in inventory until they can be sold.

The brokerage firms have been subject to new regulations and are capital constrained. As a result, many have decided to hold much smaller bond inventories that could help accommodate client bond

trades. I have seen statistics suggesting that these firms hold 20% of what they used to in 2006 and 2007.

When all of the bond funds and bond ETFs show up with their bonds to sell, they are met with an unenthusiastic group of securities firms. This can cause price changes to be more dramatic at inflection points, with a lot of additional supply that cannot find willing buyers.

I am currently evaluating this situation to determine if it should impact either the types of bonds held or how they are held in client accounts. I do not expect wholesale changes, but more of a shift in strategy to better protect accounts against possible challenges in the future.

As you review your statements, you may notice that the market value of some bond funds has fallen below the cost basis, suggesting a loss. This may or may not be the case. Let me explain. When an open-ended bond fund pays a dividend, either in the form of a capital gain or interest, the market price of the mutual fund declines by the value of the dividend. In order to determine whether money has been made or lost in a fund, one can compare market value vs. cost, but then must do one other thing. You have to also add all dividends that have been received since purchasing the fund.

When I review performance of these funds, I am looking at reports that reflect total returns from all sources: market price changes and distributions. If you have any questions on any funds, please give me a call.

I will end this letter with some discussion on emerging markets. This is an area of potential opportunity. Your account will never have a significant exposure to emerging markets, but we are viewing emerging markets as an attractive sector for a modest investment.

A slide is enclosed that shows estimates by Goldman Sachs Asset Management on the growth and market share of global market capitalization through 2030. The growth they see from 2010 to 2030 suggests a 6% growth rate globally, but dispersed unequally between developed and developing markets. The estimate for emerging markets is growth of 600% versus about 200% for developed markets.

These estimates are not wishful thinking, but are based on what has already been accomplished, and the potential that exists if these trends continue. I will try to summarize a few points.

One key to the growth of emerging markets over the last decade is their success in controlling out of control inflation. We have not experienced high inflation rates in this country for quite some time, so one forgets how damaging it can be on investment plans. When central banks can create a more stable environment of prices, capital can be invested for longer periods of time, and this investment can create a fair amount of economic growth.

Second, reducing the amount of corruption is also important. While corruption can be found in any system, the important factor is the rate and direction of change. Corruption can misallocate capital investment into non-productive activities that do not produce economic growth. If the amount of corruption is declining, and systems move more towards property rights and the rule of law, economic growth will increase.

Finally, labor and capital flows should not be constrained. Protectionism hurts trade and growth. Again, it is the level and direction of change that will determine the direction of economic growth.

Through 2008 and 2009, the S&P 500 lost 20.3% and the Emerging Markets lost 20.5%. Over the next 3 years and 5 months, the S&P 500 has appreciated by 57% and the Emerging Markets have appreciated by 1.9%. Current tumult in some of these markets should be viewed through a longer term lens, and is setting up a good opportunity for investment.

If you would like to discuss our views on emerging markets in more detail, please give us a call.

Sincerely,

Peter B. Harre, CFA