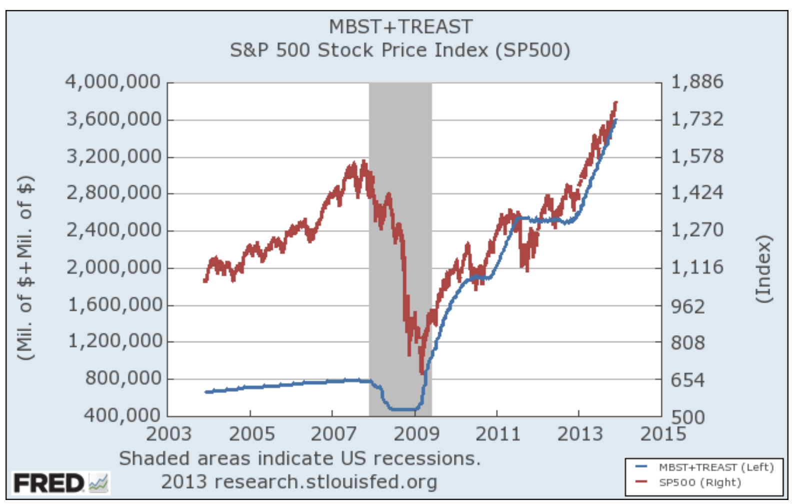
Annual Review and Outlook – Fourth Quarter 2013

US Economy and Capital Markets:

2013 in the United States was an unusual year in that, in hindsight, it was not a year to be diversified. The usual diversifier, bonds had a down year and most bond categories other than high-yield, lost money in 2013. Another favorite diversifier, emerging markets, also lost money in 2013. US stocks in general continued their inexorable march higher.

The catch phrase for the U.S. Markets in 2013 has to be, "It's all about the QE". Quantitative Easing (QE) is the Federal Reserve policy designed to promote GDP growth by increasing the money supply by buying billions of dollars of debt issued by the U.S. Treasury and others. Of course from a common sense perspective we all know that you can't pay off debts with IOUs and that "stealing from Peter to pay Paul" always comes with consequences – intended and otherwise. Particularly in 2013, the Federal policy of QE served to punish savers, make bonds unattractive and left stocks as the only game in town. In the chart below, the blue line represents QE purchases of bonds by the Federal Reserve and the red line is the price of the S&P 500 index.

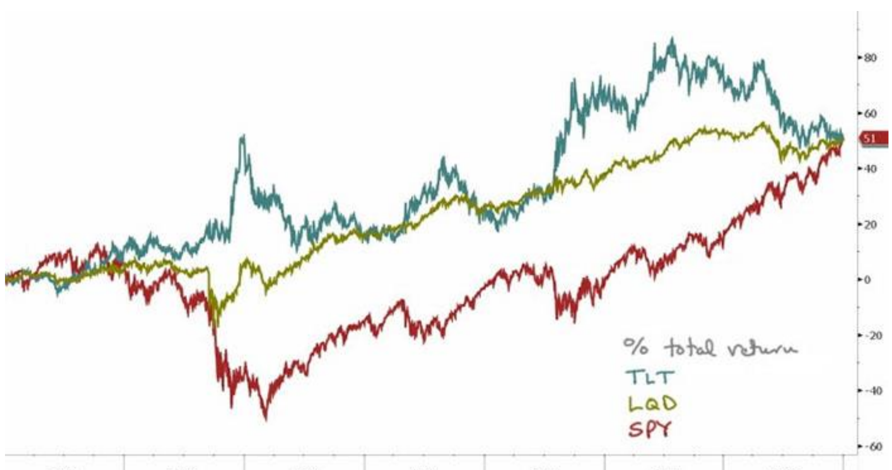
We entered the year believing that the U.S. economy was still struggling and from most published economic indicators that was true. We have yet to see a real positive effect of Quantitative Easing on organic GDP growth but we have seen a serious expansion in debt spending as a result. However in 2013 from a U.S. stock market perspective, that didn't much matter. Spurred on by very low interest rates and QE the U.S. stock markets had one of their best years since 1987, while the U.S. Bond Markets had one of their worst in recent memory.



Portfolios:

During 2013, our portfolios suffered from too much diversification. Our positions in "cheap countries" fared well with Greece +25%, Ireland +43% and small cap India +22%. Japan also was a stellar performer up +41%. These positions were offset by poor performance in emerging markets, natural resources and miners which were a serious drag on results. What we believed were cheap assets got even cheaper. On the fixed income side of things our concerns about the bond market and subsequent focus on shorter durations was correct but these positions added little to the portfolios' bottom-line. Our managed futures positions made only a few percent, less than expected, primarily because of the lack of volatility in stocks during 2013. Given that the primary driver for stocks of late has been QE, our cautious risk-first approach in this environment of QE and an expensive US stock market led us to underweight positions in U.S. equities which resulted in below market returns. In hindsight, while rational, the underweighting in US stocks was a mistake.

Although our portfolio diversification was not rewarded in 2013, we are still proponents of diversified investment portfolios. The following exhibit illustrates why. After 7 years, US stocks (SPY), long-term US treasuries (TLT) and corporate bonds (LQD) all returned approximately 50% each. Over the course of the 7 years, all three investments had periods of outperformance as well as periods of underperformance, yet interestingly they all ended at the same point. The chart provides a few key takeaways: 1. Markets are cyclical; 2. No one asset class always outperforms and 3. Things can and do change quickly.



Our portfolio allocations in 2013 were based on several factors. First, the policy of Quantitative Easing by the Fed had never been tried before and it could, and has created, "phony GDP", the consequences of which are unknowable. Second, from a normalized earnings standpoint, the U.S. market started the year expensive with a 10-year cyclically adjusted PE ratio (CAPE) of 21 and finished the year even more expensively with a CAPE above 25. With a long term average

CAPE of 16.5 that means U.S markets went into the year 27% over-valued and ended the year 54% over-valued. Starting valuations of equity investments have demonstrated a strong impact on future returns. Investing in stocks with a CAPE of 20-25 has on average yielded 10 year annualized returns of ***just 0.9%***. In our opinion the prospect of so little return in light of such high valuations seemed to be a dangerous proposition. Thirdly, stock markets typically experience a 10% correction at least once a year. It has now been more than a year and a half since we had such a correction. Our concern has been that in a period of time with a never before contemplated Federal Reserve policy, limited GDP growth, artificially elevated corporate profits and expensive market valuations, the markets have behaved overly exuberantly - this won't last forever. Retrospectively, when the stock market has faltered during the past 3 years, the declines were kept in check by reaffirmation of QE policy by the Federal Reserve.

Although the CAPE is not a good short term indicator, at valuation extremes, as the following table illustrates, the cheapest countries do tend to be good places to invest and the expensive countries tend to be losers. Note that the US stock market performance in 2013 was highly unusual given its valuation.

Country	cape on Dec 31, 2012	ETF	2013 RETURNS		
Greece	2.6	GREK	24.91%	20.74%	**BOTTOM 5 CAPE**
Ireland	5.0	EIRL	45.58%	21.11%	**BOTTOM 10 CAPE**
Argentina	5.2	ARGT	15.04%		
Russia	7.2	ERUS	-0.88%	**<<<< OUTLIER**	
Italy	7.4	EWI	19.07%		
Austria	8.4	EWO	11.48%		
Spain	8.5	EWP	31.91%		
Portugal	9.5	PGAL			
Belgium	10.3	EWK	24.60%		
Israel	11.1	EIS	18.30%		
Canada	18.3	EWC	5.31%		
SouthAfrica	18.5	EZA	-7.47%		
India	19.3	INDY	-3.99%		
Malaysia	20.1	EWM	7.84%		
USA	21.1	VTI	33.45%	**<<<< OUTLIER**	
Chile	21.2	ECH	-23.90%		
Mexico	21.2	EWW	-1.58%		
Indonesia	24.7	EIDO	-23.14%		
Colombia	33.5	GXG	-15.01%	-5.39%	**TOP 10 CAPE**
Peru	33.7	EPU	-25.42%	-17.81%	**TOP 5 CAPE**

As of December 31, 2013, the USA is the second most expensive country in the world trailing only Sri Lanka. The CAPE takes time to play out and does not indicate when market turns may occur. Historically, it has proven to be a very good predictor of intermediate and long-term stock market returns.

Although our concerns about stock and bond valuations have not abated, we have come to the belief that not being in line with the Federal Reserve and fighting the price trend of the stock market is not the best position to maintain in this environment and as a result we have made changes to the portfolios to reflect that change in beliefs. We do this while continuing to keep in mind that the U.S. market is long overdue for a significant correction or bearish cycle.

To better align our portfolios with the current trends, we have added more equity exposure to our portfolios by increasing allocations to the sector model and trending US stocks. As long as our indicators are "risk on" we will maintain this exposure. When our indicators go "risk off" we will reduce exposure to protect against the downside. During 2013, we overrode some of our objective indicators that suggested increased exposure to stocks was warranted. We will not make that mistake in 2014. Importantly, those same indicators will help us determine when to reduce exposure to stocks if and when that time comes. We continue to like the cheap country investments and we believe that natural resources and gold miners will perform more positively in 2014 (miners are +14% to +22% through January 21). We also expect 2014 to be a more typical, volatile market environment which will be constructive for our managed futures investments.

One common mistake is to chase performance. It is human nature to extrapolate the past (that which we know) into the future. Last year's winner is the best place to be this year too! (Not usually). However, chasing performance often disappoints due to the cyclical nature of markets and the rapidity with which they can change. We believe that our analytical tools will enable us to participate in continued uptrends while protecting against significant downtrends when that time comes.

Strategy performance through the first 3 weeks of January, 2014:

Investment	**Return through 1/21/2014**
Bonds	+1.58%
Sector Model (US stocks)	+11.65%
US Small Cap Stocks	+1.1%
Japan stocks	-0.85%
Cheap Countries stock	+0.94%
Gold stocks	+17%
Resources/Real assets	+8%
Managed futures	+2%
Average Growth portfolio	**+3.57%**
Average Conservative portfolio	**+3.07%**
S&P 500	-0.2%
Barclays Bond Index	+0.91%

To date, in 2014, our diversified investment portfolios are performing well. The above returns through the first 3 weeks of the year are averages and any individual portfolio may have experienced varying performance from that shown. We don't expect that performance to date will continue in a linear fashion for the remainder of the year, but the rebound in cheap resource and mining stocks is very positive and the increased market volatility year to date is welcome.

Thank you for your continued trust and support.

Trevor Holsinger and Steve Small