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Quotes:

To acquire money requires valor, to keep money requires prudence, and to spend money well is an art.
Berthold Auerbach

More people should learn to tell their dollars where to go instead of asking them where they went.
Roger Babson

Money is better than poverty, if only for financial reasons.
Woody Allen

The way to stop financial joyriding is to arrest the chauffeur, not the automobile.
Woodrow Wilson

The quickest way to double your money is to fold it in half and put it in your back pocket.
WIll Rogers

Economic Recovery Continues Despite Headwind

June will mark the fourth year of GDP growth since the recession ended in 2009. While first-quarter GDP growth was revised downward to 1.8% from the 2.4% original estimate, the economy is expected to have picked up steam in the second quarter. Housing was and will continue to be a driving force: national home prices are up over 10% this year, and activity as measured by the number of pending home sales is back near 2006 highs. A tight inventory and the prospect of higher mortgage rates are driving hesitant consumers to move now.

Index	*6/30/2013*	*YTD*
Dow Industrials	**14,909.60**	**13.8%**
S&P 500 Index	**1,606.28**	**12.6%**
Russell 2000	**977.48**	**15.1%**
MSCI EAFE	**1,638.94**	**2.2%**
Global Bond Index	**443.49**	**-4.8%**
10-Year Treasury yld	**2.52%**	

In aggregate, the US economic recovery continues, but at a below-average pace. As the equity in their homes recovers, Americans are feeling better. With a modestly improving labor market and stock market gains, consumer confidence is increasing. Because of austerity in government spending, the private economy has had to carry much of the load. We feel like an Olympic sprinter with an open parachute strapped to his back: our strength and resilience show not in our speed, but in our ability to make progress despite handicaps.

Overseas, Europe's self-imposed austerity has mired the continent in recession with debilitating unemployment. Recently, though, the region appears to be making progress in addressing debt, although recovery has been hamstrung by the lack of growth. Over the last four months, Europe's leading economic indicators have improved, but recovery has not been universal across the Euro zone, with France, Spain, and Greece still lagging.

In the western hemisphere, Brazil's economy is expected to grow by 3% this year, but consumers, under pressure from nearly 6% inflation, are now rioting in the streets. China's citizens aren't rioting publicly, but the domestic banks are clamping down on lending requirements, sharply cooling off the real estate market. The government could step in and force the banks to increase lending, but Chinese leaders are worried about inflation and the risk of creating a real estate bubble. It's a reasonable concern, considering the damage that could occur if the real estate bubble bursts instead of shrinking gradually. Even though growth in China is slowing, we still expect 6% growth in the current year.

The most robust growth is expected in the emerging markets. While these stocks may be the most volatile investments we own, with valuations nearly 50% lower than the US and dividend yields close to 3%, we view these positions as a key component in our allocations. Emerging markets are being recognized again for what they are: dazzling markets with dynamic growth potential, but prone to considerable risk from political and cultural unrest.

Rising Interest Rates on the Way?

Last week, Federal Reserve Chairman Ben Bernanke outlined how the Fed will begin to taper down the massive monetary stimulus known as quantitative easing (QE). The short-term market reaction was swift and negative, but the Fed responded to this 'taper tantrum' with immediate reassurances.

By way of background, QE was an extraordinary measure instituted by the Fed to stimulate the US economy while we continued our recovery from the financial crisis of 2008-09. The Fed has been buying $85 billion worth of bonds per month, flooding the financial system with liquidity, thereby increasing the money supply. The goal was to get banks to lend and push down interest rates, making debt attractive for borrowers.

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Safety in Numbers:
Schwab Security

Online hacking of bank and brokerage accounts is nothing new: you've heard us recite the safety mantra many times. Use strong passwords. Don't include your account number in any emails. Let us know if you suffer any kind of security breach, from a suspected email hack to full-blown identity theft. We're here for you.

What you may not know is that Schwab is also here for you. Schwab requires only two things: you must keep your account access private, and report unauthorized activity as soon as you notice it.

The key point is to keep your account access information secure and safe: in particular, never include your password or login details in emails. We will not ask you for your Schwab password or login. If you take advantage of our account aggregation services, we may need login details for other accounts: we will ask for these by phone or fax or in person, never through email.

If any of your accounts are hacked, notify Schwab immediately at 1-800-515-2157. Call us as well: we'll help you handle the breach.

For more details on Schwab's security policies and your protection, visit schwaballiance.com and review the SchwabSafe security measures.

Interest Rates

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The Fed made it clear from the start that when the economy showed enough strength, the Fed would begin to unwind the QE program. Citing many positive data points from employment gains to household wealth, several years of slow but steady growth and significant progress in deficit reduction, the Chairman indicated that the phase-out process would occur sooner than expected. When tapering starts, the Fed will not replace all maturing bonds, and the supply of money will contract. Since the cost of anything rises when there is less of it, the cost of money – that is, interest rates – will rise.

June's market pullback may have been due to the Fed's comments, or news of the slowing Chinese economy, or any number of other world events. The media can and does sensationalize anything to juice up ratings: only a couple of days after the market swooned, we began seeing some bounceback. We have to keep our sights on the longer term. Long-term bonds will likely continue to lose value as interest rates normalize. Even holders of shorter-term and flexible bond positions need to be prepared for disappointing returns.

In light of this, clients might ask whether we should sell all fixed income positions. But even in an uncertain rate environment, bonds still have an important role in a diversified portfolio: as a stabilizer when a world event increases equity volatility, and as a sustained income source continually reinvested at current rates. In addition, there is always the possibility that the prevailing expectations are wrong.

Over the last several years, we have moved our clients' fixed income positions into a more defensive posture and we have foregone some gains along the way. We believe that we have positioned our fixed income allocation to limit exposure to a rising rate environment without sacrificing the diversification benefits that bonds bring to a portfolio. As the saying goes, you don't want us to put all your eggs in one basket.

The Diversification Recipe

We constantly preach the importance and necessity of diversification as the strategy to help clients achieve their long-term financial goals. But in the last two quarters, with the Dow Industrial Stock Index up 13.8% year-to-date and the S&P 500 chalking up 12.6%, clients pose the question, "Why do we even hold other asset classes?" The answer requires explanation and a visit to some basic investment theory.

Every asset class has both risk and return attributes. In our earliest meetings with clients, we describe the portfolio construction process, what we in the business call "asset allocation." Think of it as a recipe for cooking up investment returns. Craig Isrealsen, in his book *7Twelve*, compares asset allocation to making salsa. You have tomatoes, onions, garlic, cilantro and more. No one wants to take a bite of one in isolation: that might make you gag. The magic is in the combining of the ingredients.

Like good salsa, our portfolios have multiple ingredients that, evaluated by themselves, could be too risky or unattractive to use alone. (Think jalapeños.) For example, the average annualized return on stocks over the last 40 years is approximately 10%, but with substantial downside risk: that 10% return carried potential exposure to a nearly 50% decline as recently as 2008.

At the other end of the spectrum are bonds. Sticking to our salsa analogy, today we'd say our bonds most remind us of limes: bitter and unpleasant on their own, but still complementary to our other ingredients. Bond yields have crept up recently, yet remain meager; our stocks of tomatoes appear riper and more tempting. We know, however, that all markets have cycles and any fruit can spoil. We remember that the acidity of our limes helps preserve the freshness of our portfolios over time.

We ask clients, "What is your Maalox moment?" — that is, how much risk are you willing to bear? No client says, "Sign me up for the portfolio where I give you all my money and next year it could be worth just half as much." This is why we can't simply get the returns of an all-stock portfolio when the markets are moving straight up . No one reliably or consistently times the markets. We are unwilling to risk our clients' future by taking that level of risk. By the same token, we cannot measure the success of our portfolios by comparing them with the all-stock Dow or the S&P. We all have long-term needs and objectives. Our asset allocation must reflect that time frame. Over these multi-year horizons, diversified portfolios have allowed clients to meet their goals with substantially less risk by implementing a diversified investment strategy.