AN END TO EASY MONETARY POLICY?
In the year-end commentary that follows, we review the big-picture themes underlying the strong equity market returns of 2013, including global monetary policy and economic improvement. Monetary policy—a major source of support for rising global stock markets in 2013—made news last month as the Federal Reserve announced its first actual reduction in its monthly bond buying. In contrast to May of 2013 when Fed Chairman Ben Bernanke began discussing a possible taper, investors took December’s announcement largely in stride. Another key theme for the year overall was U.S. economic improvement, including positive trends in employment and consumer confidence.

MARKET PERFORMANCE
The last month of 2013 looked much like the year overall: U.S. stocks were strongly positive, and international developed markets also gained. For the full year, the S&P 500 Index was up 32.39%—the index’s best showing since 1997. Small and mid cap equities soared even higher. The S&P Mid Cap 400 index closed the year up 33.50%, while the S&P Small Cap 600 ended up 41.34%.

Developed international markets, represented by the MSCI EAFE Index, gained nearly 1.5% in December and 22.78% for the year. Much as in the United States, supportive monetary policy in Europe and Japan was one factor that helped equities. On the economic front, the picture is more mixed. While Europe exited recession, many countries continue to struggle with excessive debt and weak economies. Finally, amidst the positives, emerging markets were strikingly divergent as softer economic growth generated investor concerns and the potential Fed taper roiled markets further.

At the other end of the spectrum, bonds declined as yields rose. The core, investment-grade Barclays U.S. Aggregate Bond Index suffered a rare calendar-year loss, falling 2.02%, its first decline since 1999. Results were driven by a general preference for risk assets as the economy recovers and investors seek higher returns, as well as concerns about potential changes in U.S. monetary policy. This was evident as the higher credit exposure sectors of the market significantly outperformed. Non-investment grade bonds, represented by the Barclays U.S. Corporate High Yield and S&P/LSTA Leveraged Loan Indices, returned 7.44% and 5.29% respectively in 2013.

Commodity and commodity linked investments suffered significant relative losses in 2013. The DJ UBS Commodity Index fell 9.52%, while physical gold fell 27.33% according to the London Fix Gold price. Additionally, while U.S. REITs turned in a 1.22% return for the year, it marked the first calendar year the asset class has underperformed the S&P 500 Index since 2008.

**Total Returns for the fourth quarter and 2013.**

<table>
<thead>
<tr>
<th>U.S. Stock</th>
<th>4Q 2013</th>
<th>Non-U.S. Stock</th>
<th>4Q 2013</th>
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<tr>
<td>S&amp;P 500</td>
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<td>MSCI Europe</td>
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<td>S&amp;P SmallCap 600</td>
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<td>MSCI Japan</td>
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<td>MSCI EM</td>
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<td>Barclays US Corp High Yld</td>
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<td>Barclays US Treas. Long</td>
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<tr>
<td>Value</td>
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<td>33.49</td>
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**Source:** Morningstar (total return in US $)
AN IMPROVING PICTURE
U.S. and global economic fundamentals gradually improved over the past year across a number of dimensions, and seem poise for continued improvement or at least stability in 2014. Unfortunately, the risks related to excessive global debt, subpar growth, and unprecedented government policy since the aftermath of the 2008 financial crisis still remain largely unresolved.

THE GLOBAL ECONOMY SLOWLY STRENGTHENS
At the broadest level, the growth rate for the global economy, which the International Monetary Fund estimates at 2.9% for 2013, improved and seems set to increase at least modestly next year. On a year-over-year basis, the U.S. economy grew at a real (inflation-adjusted) rate of around 2% in 2013 (through the third quarter), Europe finally emerged from recession, and the United Kingdom (2.6%) and Japan (2.1%) also generated modest but positive growth. Emerging-markets’ growth was disappointing overall in 2013, but they should benefit from improved export demand in developed markets in 2014. The leading indicators index produced by the Organization for Economic Cooperation and Development recently rose above 100 and is increasing, which indicates an economic expansion is underway. The indicators are designed to provide early signals of turning points between the expansion and slowdown of economic activity, and are based on a wide variety of data collected by the OECD from its 33 developed country members and a handful of emerging countries.

Manufacturing is a particularly bright spot with the J.P. Morgan Global Manufacturing Purchasing Managers’ Index hitting its highest level since February 2011 and also signifying an accelerating economic expansion. The PMIs are based on monthly surveys that provide advance indication of what is happening in the economy by tracking changes in production, new orders, inventories, employment, and prices.

HOUSING & LABOR MARKET GAINS
Specific to the U.S. economy, there are a number of positives that appear to be extending a trend that began in 2012.

• The housing market continues to improve. The widely followed S&P/Case-Shiller Home Price Index was up 11% from a year earlier, and CoreLogic reports the percentage of homeowners who owe more than their homes are worth fell to 13% (as of the third quarter) compared to 22% a year ago.
• Along with the surging U.S. stock market, the strengthening housing market helps to boost household net worth, increasing consumer confidence due to an increased wealth effect.
• The labor market continues to gradually improve. The net new jobs created in the economy each month averaged a solid rate of nearly 200,000 per month during 2013, and the unemployment rate dropped to 7% in November. While much of this has been driven by a lower than average labor participation rate, it is a good sign nonetheless.

AN IMPROVED DEBT & CREDIT OUTLOOK
Household deleveraging continued and household debt appears to be well along the path toward reaching more sustainable levels. The household debt/income ratio, a measure of the willingness and ability of consumers to increase their borrowing, has dropped 20% from its peak in 2007, and is now back where it was in 2003 and in line with its long-term historical trend. Meanwhile, household debt service and financial obligations ratios remain at historically low levels thanks to extraordinarily low interest rates engineered by the Federal Reserve, along with modest income growth. Furthermore, credit conditions, specifically cost and availability, also continue to improve and remain relatively loose. These indicators bode well for a continued improvement in consumer spending.

INFLATION, MONETARY POLICY & THE BUDGET DEFICIT
Inflation in the U.S. is low and remains well-contained due to subpar growth and significant excess capacity in the economy. In 2013, the price index for personal consumption expenditures—the Federal Reserve’s (Fed) preferred measure of inflation—fell further below its target of 2%. As of November 30, 2013, the core PCE index, which excludes food and energy prices, stood at 1.1%, its lowest level since early 2011. If the economy gains some momentum and unemployment comes down further we will likely see increased wage pressures, which would put some upward pressure on inflation. Rising wages would also pressure corporate profit margins, which remain at/near historical highs.

Developed country central banks are likely to remain highly accommodative at least over the next year or two in terms of holding short-term interest rates at extremely low levels, and in some cases also providing additional liquidity via quantitative
easing bond purchases. Specific to the United States, at its December 18, 2013 meeting the Fed initiated tapering of Quantitative Easing (QE) bond purchases by $10 billion, to $75 billion per month. Fed chairman Ben Bernanke also stated that if the Fed sees continued improvement in labor market conditions along with stable inflation it “will likely reduce the pace of asset purchases in further measured steps at future meetings.” If so, QE would likely be finished before year-end 2014 as there are eight Federal Open Market Committee meetings each year. Equally as important, the Fed also reinforced its intention to keep the federal funds policy rate at near zero for the foreseeable future, including “well past” the point when unemployment drops below 6.5%. Moreover, Bernanke was clear that the Fed remains concerned about inflation that is too low and anticipates keeping rates low at least until inflation clearly moves back toward its 2% objective.

The U.S. federal budget deficit has come down sharply over the past year, and, with the recent bipartisan two-year budget agreement, the drag on GDP growth from fiscal policy tightening will be reduced in 2014. This compares to 2013 when tax increases and “sequester” spending cuts shaved 1.5 percentage points off of GDP growth, according to Congressional Budget Office estimates. The two-year budget deal also greatly reduces the threat of another government shutdown during that span. However, another ugly political fight over the debt ceiling remains a possibility later in the first quarter of 2014. And the need for a credible medium- to longer-term plan for government deficit and debt reduction remains.

While there were many positive developments in 2013, it is important to remember that just because economic fundamentals are improving does not necessarily imply a strong year for the stock market. Valuations, earnings growth, interest rates, and overall investor sentiment/psychology are likely to be much more important drivers of market returns. The stock market is a discounting mechanism, so presumably it already incorporates positives like stronger economic fundamentals as this evidence comes out. So, we would not be surprised to see a decent year for the global economy, but a weaker relative year for U.S. stocks after the very strong rally in 2013.

**RISKS & UNCERTAINTIES REMAIN**

Wage growth and income growth in the United States remain subpar, although both have been increasing since late 2012. Weak income growth implies that consumer spending is likely to be subdued even as consumer deleveraging becomes less of a headwind. With consumption accounting for roughly 70% of U.S. GDP, this suggests continued sluggish economic growth absent a significant increase in consumer borrowing or reduced saving.

Overall U.S. debt levels remain very high and the projected growth in government debt and entitlement spending relative to GDP is still too high to be sustainable over the long term. Resolving this without causing an economic contraction is likely to be challenging, even in a normal growth environment.

Beyond the economics of deleveraging, the situation is made even more challenging due to the U.S. political dysfunction. The ability to forge compromise and progress on the country’s longer-term debt/deficit situation remains highly uncertain, although there may be signs of light reflected in the recent bipartisan budget agreement. It is possible that the political dysfunction hit a low point with the government shutdown fiasco last fall.

Fed monetary policy is still far from normal and, although the QE taper has begun, there remains a great deal of uncertainty as to how the Fed will exit from its zero fed-funds rate policy and unwind its huge balance sheet without causing an economic or market shock. It is possible that the Fed will err on the side of tightening monetary policy (raising rates) too late rather than too early, and that inflation will become an issue for the financial markets. Given the Fed’s policy pronouncements as well as their unpleasant experience with the market’s reaction to last summer’s “taper talk,” we’d put a low probability on the Fed tapering or tightening too aggressively. But policy errors in either direction are certainly possible. The change in Fed leadership from Bernanke to Janet Yellen is unlikely to lead to a significant change in policy.

Despite exiting recession in 2013, the Eurozone economy remains weak, with structural imbalances between creditor and debtor countries that are still unresolved. The banking system is undercapitalized and in need of a credible region-wide banking union backstop. In October, Eurozone inflation fell to 0.7%, which prompted the European Central Bank to make a surprise interest-rate cut to a record low 0.25% to fight the risk of deflation. Meanwhile, Eurozone unemployment remains elevated and risks causing social unrest or crisis within the peripheral regions.

Japan is the world’s third largest economy, so the success or failure of prime minister Shinzō Abe’s wide-ranging plan for
reinvigorating Japan’s economy, nicknamed “Abenomics,” will have important global economic and market implications. This is another manifestation of an unbalanced and weakened global economy, and the extremely aggressive and unconventional policies that are being undertaken to try to turn things around.

**PORTFOLIO POSITIONING & OUTLOOK**

In light of a strong bull market in equities, and a rare loss for diversified bonds, we will discuss our current positioning and asset class outlooks moving forward.

**U.S. EQUITIES:** We continue to maintain a significant allocation to U.S. equity investments in our portfolios, with the primary goal of diversification. Our portfolio remains diversified by size, style, and sector, and we continue to advocate the benefits of both active and passive management styles. The S&P 500 Index is up 128% in the period from January 2009 through December 2013. The index has recorded 4 years of double digit returns in this span, generating an average annualized return of 17.94%. This follows what has commonly been referred to as “The Lost Decade.” From January 2000 through December 2009, the S&P 500 lost 9.10% or almost 1% annually amidst two massive equity market corrections and the worst economic period since the Great Depression. The question then becomes: Where do we go from here? As the chart to the right demonstrates, the S&P 500 does not appear to be in “bubble” territory. The S&P 500 currently trades at a trailing price-to-earnings (P/E) ratio of approximately 17, and a forward P/E ratio of approximately 15. These measures are within historical ranges and well below prior bull market peaks. This would seem to signal that the equity market is fairly valued, and at worst only slightly overvalued based on forward earnings estimates. Interestingly enough, the S&P 500 traded up the entire year of 2013, and was not down on a year to date basis any day. Additionally, daily volatility was the lowest since 2006, with the market suffering only one correction of at least 5%, the least since 1995. That being said, we would not be surprised by a correction in equity prices in 2014. Overall, we believe there are tailwinds that can continue to move equity prices higher, specifically an expanding economy in light of still easy, yet normalizing, monetary policy.

**INTERNATIONAL EQUITIES:** Many international markets have yet to see the economic recovery and robust equity market performance seen in the U.S. European stocks generated strong gains, benefiting from reduced emphasis on austerity measures, progress on structural reforms in some countries, and signs that the region’s recession had ended. Sentiment within the region continues to improve and stocks have climbed on hopes that the economic conditions will continue to strengthen. Slimmed-down companies appear poised to rebound as the economy recovers from a protracted recession. Despite the regions modest economic prospects, including notable weakness in France and Italy, the risk/reward ratio appears more attractive than in many other developed markets, as valuations remain reasonable. Developed stock markets in the Asia-Pacific region posted mixed results and underperformed the broad MSCI EAFE Index. Japan's stock market, measured by the MSCI Japan Index, performed well for the year delivering a 27.16% return. The Japanese economy edged further toward recovery against a backdrop of highly accommodative monetary policies and other economic stimulus measures. While many developed stock markets rose in the past year amid improved corporate and economic fundamentals, conditions in emerging economies were mixed. Stocks in emerging Asian markets advanced, while emerging Europe and Latin American equities declined. Specifically, emerging markets stock equities fell in November and December as growing signs of strength in the U.S. economy raised speculation that the Fed would begin to taper its QE programs. Disappointing economic data across the developing world also impacted investor sentiment as the quarter progressed. Many countries reported weaker-than-expected growth in the third quarter, leading several to cut their 2013 economic forecasts. However, emerging market equities now trade at a significant discount relative to their valuation history and their developed market peers. We believe the current valuations are a compelling long term opportunity for patient investors. Emerging markets may be in early stages of a multiyear growth cycle driven by rising consumption amidst a growing middle class. There remains
a large disparity between the economic importance of emerging markets globally and the market capitalization of their equity markets. We remain confident that emerging markets stocks are an attractive asset class over the medium to longer term.

**FIXED INCOME:** In December 2013, the Fed announced that it will begin tapering its QE programs. Specifically, the Fed announced that it would begin tapering its purchases by $10 billion a month beginning in January 2014, but also reiterated its intention to keep the policy rate low for the time being. While the yield on the 10 year Treasury subsequently rose, the reaction to the tapering was considered mild relative to previous rumors around the Fed tapering its QE programs. The main questions remain: How fast will interest rates rise and how high will rates go? While the answers to these questions are elusive, it is fairly apparent that the longer term trend for interest rates is upward, which will remain a headwind for fixed income investments. While yields are still near historic lows and the global economy improves, rates are expected to rise gradually over the next few years. In 2013 we saw significant interest rate volatility based on economic growth expectations and monetary policy initiatives amidst a low inflationary environment. The yield on the 10-year Treasury fluctuated between 1.85% and 2% for the first quarter before falling to 1.64% by the beginning of May. This began a long upward trend with the 10-year Treasury finishing 2013 at 3.02% and the Barclays U.S. Aggregate Bond Index suffering a rare losing year, down 2.02%. During 2013 we reduced the duration, or interest rate risk, within our bond portfolios, and added moderately to credit exposure. We continue to believe that in a rising interest rate environment we are best positioned short duration (interest rate risk), in the short to intermediate portion of the yield curve, and long credit risk.

**ALTERNATIVE INVESTMENTS:** We continue to use alternative investments as a complement to traditional stock, bond and cash investments. What is an alternative investment? The term encompasses a variety of asset classes, as well as investment strategies. From an asset class perspective, alternatives include private equity, physical commodities, timberland and real estate. Alternative investments also can describe the investment strategies used in managing more traditional investments. These may include long/short, arbitrage, hedged equity, and global macro strategies. Historically, these types of investments have only been accessible on an institutional level. However, as the capital markets evolve and financial innovation has made more alternative investments and strategies transparent and cost effective, we have embraced them in our portfolio management approach. We currently allocate resources to the following alternative strategies:

- **Global Long/Short:** A broad mandate that allows for investments in equity securities, fixed-income instruments, commodities, futures, options, and other investment companies, including ETFs. This strategy may engage in short sales of index related and other equity securities to reduce its equity exposure or to profit from an anticipated decline in the price of the security sold short.
- **Global Macro:** May invest in any market that offers a high probability of return or, alternatively, that provides a high degree of safety in uncertain times. Dependent on the outlook for the U.S. and global economies, allocations are made among stocks, bonds, cash, precious metals, currencies and derivatives instruments.
- **Hedged Equity:** A derivative strategy that invests in a broadly diversified portfolio of common stocks that closely tracks the U.S. equity market, while hedging the portfolio with index call and put options. Through this hedging, the fund seeks to lower the volatility and risk of loss of its underlying equity portfolio.
- **Real Assets:** Investment seeks a long-term total return in excess of inflation by investing in the following “inflation sensitive” asset classes: inflation-indexed bonds, REITs, commodities, master limited partnerships (MLPs), natural resource companies, publicly-listed infrastructure companies, and floating rate debt.

We do not expect these investments to generate equity like returns in strong equity market environments. We view them more as portfolio insurance, generating risk/return profiles somewhere between stocks and bonds, with the ability to potentially mitigate downside risks.

**THE CASE FOR DIVERSIFYING**
In a landmark 1986 study, financial analysts Gary Brinson and Gilbert Beebower analyzed 82 pension plans over a ten year period in an attempt to determine the factors of portfolio returns (“Determinants of Portfolio Performance, Financial Analysts Journal, July 1986”). Their conclusion was that asset allocation was the overwhelmingly dominant contributor to total returns. Diversifying your portfolio makes you less dependent on the performance of any single asset class. Effective diversification requires combining assets that behave differently when held during changing economic or market conditions. This also means that your portfolio returns are not likely to mimic the performance of one asset class or index. While the focus today is on the relative outperformance of U.S equities, we caution clients not to fall victim to what is known as “recency bias,”
the cognitive bias and tendency to place greater weight and importance on recent events. In 2011 the S&P 500 delivered a 2.11% return, effectively the yield from dividends with no capital appreciation, while bonds were up 7.84%. In 2008, the S&P 500 fell 37%, while bonds returned 5.24%. While the safety of bonds or cash (relative to stocks) may be comforting, these investments may not provide the long-term growth potential many investors seek. On the other hand, stocks may provide the greatest return, but they are much riskier than bonds. It is impossible to predict which asset class will be the best or worst in any given year. The performance of any given asset class can have drastic periodic changes, and it is important to view each asset class in the context of an entire portfolio or asset allocation.

ABILITY TO CHANGE
Investment and portfolio management is as much an art as it is a science. There is no crystal ball to help in determining which asset class will provide the best performance in any given year. Moreover, as history has demonstrated, persistent outperformance by any single asset class is unlikely. Returns from year to year can vary significantly. Diversification allows us to capture returns in a variety of asset classes, and minimize the impact of significant losses in any one asset class. Our investment approach does not try to time short-term market moves or turning points. Our asset allocation discipline is to assess potential asset class returns and risks and build diversified portfolios that can perform over a wide variety of economic and market environments. We do not know the timing, but we are confident that investment opportunities will arise over the next few years, driven by market cycles and the timeless human emotions of fear and greed.

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