Winter 2014

THE ADVOCATE

The Goldilocks Conundrum

Why You Should be Prepared for an Estate Tax Audit
Jeremiah Coder and G. Michelle Ferreira

What Does the Affordable Care Act Mean for Business?
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The Golden Ticket Trap
Jim Parker

Cravens & Co.
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Winter 2014

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A Note from the Principal

As we embark into to 2014, for the first time in the past several years, I detect a bit of wind at our back. Despite the cold weather, ten degrees as I write this, the sun is shining and I feel a sense of optimism that things are moving in the right direction. Sure, the big issues are still to be addressed and petty politics are still the norm in Washington, but I believe we are making the transition from "not getting any worse" to "getting better". Sometimes with all the negative news of disasters, wars, and greed, we forget that the human experiment is still fundamentally intact and advancing.

I found support of my "progress thesis" in the United Nations' Millennium Development Goals Report. Many of their 2015 targets are on the way to being met, or indeed already met. Their target for half of the number of people in the world living on less than $1.25 per day was achieved in 2010; the proportion of undernourished people fell from 23% of the developing world in 1990-92 to under 15% in 2010-2012; and more than 2 billion people gained access to improved sources of drinking water - the last two statistics really puts into perspective how fortunate we are to live in America. The list goes on but suffice it to say that never in history have so many people across the globe lived so comfortably.

Other encouraging developments such as new energy production (and new forms of energy), robotics, nanotech, the ongoing communications revolution, and the amazing discoveries in biotech are all unfolding before our eyes.

Trade across the globe is expanding and, for the first time in a long while, we are even seeing some cooperation in Washington. An ebb and flow thing, to be sure, but the tide is clearly lifting more boats than ever.

Last year's gains in the investment markets may be difficult to duplicate but there is no definitive reason to believe we won't continue to make progress. Invariably, declines follow advances and so on as markets search for equilibrium but growing GDP around the world bodes well for positive results.

In this edition of The Advocate, we offer details on the, ever evolving, Affordable Care Act, warn against lack of preparation and detail when it comes to estate planning, share contrasting opinions about the process of investing from two of our valued partners, and provide our recap of 2013 along with our current thoughts on the markets. We hope you will find these articles interesting as well as helpful.

Thank you for allowing us to serve you this past year and, more importantly, for your trust and friendship. These are gifts we never take for granted and are committed to earning them all over again in 2014. We look forward to a year of progressing together toward the most important goals for us all; health, wealth and the time to enjoy them.

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What Does the Affordable Care Act Mean for Business?

Chris Owens
Relationship Manager
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Advisors

Whether you love it or hate it, supported it or didn't, the Affordable Care Act is here to stay….at least for now. So what does that mean for employers; what do you need to know about the ACA? Well, there are a lot of answers to that little question; so, let's begin at our present point on the timeline and look at it piece by piece. In 2014, we can expect several points of the ACA to come into effect. Not every point will result in a direct compliance obligation for every employer, but will have some effect on each one, either directly or indirectly. The ACA is very much a numbers game and understanding the numbers is the only way to win.

So where to begin? Well, a good place to start would be employer size. Because the ACA mandates that all large employers provide fair and affordable coverage to its employees, a determination of size must be made in order to determine whether or not this mandate is applicable to you. The ACA defines a "large" employ-er as any employer who employed an average of 50 or more full time equivalent employees on business days during the preceding calendar year. So how do we de-termine whether or not we have 50 employees? Well, for the purposes of this calculation, the key word is equivalent. The ACA says that any employee who works an average of 30 hours per week is considered full time. But the law isn't just looking for what is tradi-tionally considered full time employees; but rather, it's looking for full time equivalent employees. The ACA requires an employer to add together the total monthly hours of all part time employees and divide by 120. This formula will give an employer his number of monthly full time equivalent employees. Add this number together with the total number of regular full time employees, and an employer will arrive at his total number of full time employees. This is the num-ber used to determine employer size under the ACA. If you get to 50 after these calculations, then the man-date applies to you and, under the law, you will have to provide fair and affordable coverage to your em-ployees or be penalized. One thing to note, the employ-er mandate has been postponed to take effect until Jan-uary 1, 2015; however, it's a good idea to begin these calculations now as these numbers will be used for determination in 2015.

Now that we know our numbers, we can do some ex-trapolation based on what we know. If you have reached the magic number of 50 full time equivalent employees then you must comply with the employer mandate. Fair and affordable coverage must be offered to all of your full time employees. Sounds easy, right?Well, maybe, but compliance doesn't stop here. Now we need to look at the type of coverage offered; mean-ing, the actual benefits within the plan. Beginning in 2014, ACA regulations require all individual and group health plans to provide an essential health bene-fits package. Compliant plans must include a list of ten comprehensive benefits, to include maternity and newborn care and pediatric oral and vision care. Keep in mind, the essential benefits package is non-nego-tiable; it must be included in every plan offered, whether it's needed and wanted or not. Making sure your plan includes this will keep you within the letter of the law. Next, your new plan must meet the mandat-ed minimum of a 60% actuarial value. Simply put, your plan must pay for at least 60% of covered medical expenses incurred within the plan. Finally, the plan offered must be deemed affordable. And what consti-tutes affordable? Well, the employee only portion of the yearly premium cannot exceed 9.5% of his or her modified adjusted gross income. Because there is no way for the employer to truly know what an employ-ee's total household income is, the employee's income, alone, may be used for the purposes of calculating the affordability of a plan. Here are a few considerations to remember. As an employer that doesn't comply with the mandate, you will be fined $2000 per employee, minus the first 30, per year. For example, you have 50 employees and you don't comply, you will pay $40,000 per year in fines (50-30=20, 20 x $2,000=$40,000). On the other hand, if you do offer a plan but it doesn't meet the criteria set forth within the ACA, you will be fined$3000 per employee, minus the first 30, per year. Back to our example, you still have 50 employees but your plan doesn't comply then you will be fined $60,000 per year (50-30=20, 20x$3,000=$60,000). Remember, it's a numbers game.

But what if you didn't reach the magic number of 50 full time equivalent employees? What will you have to do in this situation? Well, the short answer is nothing. There are no requirements with which to comply. However, the ACA, to some degree, does incentivize small employers to offer qualified health coverage to its employees. For tax years 2014 and beyond, employ-ers who purchase coverage through the state exchange will be able to claim a tax credit of up to 50% of the employer's contribution toward the employee's health insurance premium, provided the employer contributes at least 50% of the total premium cost. This credit is available to businesses employing less than 25 people, have average annual wages of less than $50,000 per employee, and will be available for two years. Businesses with 10 or fewer full time employees and have average annual wages of less than $25,000 per employee may claim the full credit. The credit will phase out as firm size and average wages increase; therefore, it won't always be available.

So far we've covered the direct effects from the ACA that businesses can expect in 2014, but what about the indirect effects? These are a little more subjective, but

sound arguments, nevertheless. Beginning in 2014, the ACA imposes an "annual fee" on the fully insured market that serves most small business employers and those who purchase individual policies. You and I would call this a "tax", and, for the purposes of this discussion, we should keep in mind who really pays taxes imposed on business. In 2014 the amount of that fee will be 8 billion dollars, distributed across health insurers. 2015-16 will see a fee of 11.3 billion dollars, 13.9 billion in 2017, and 14.3 billion in 2018. After 2018 the fee will increase according to an index based on net premium growth. This fee (tax) will almost certainly be passed through to the consumer in the form of high-er premiums, creating a perpetual increase in premi-ums year after year. After all, as premiums increase, the fee increases…and as the fee increases, premiums increase. According to the CBO, self-insured plans will be mostly exempt from the fee, leaving the burden to be primarily borne by small business and the self-em-ployed. And that's just one way premiums will likely increase as a result of this fee. Another is from a likely move by insurers to offset an increased liability in cor-porate income taxes incurred as a result of increased premiums collected. Let's look at an example. Douglas Holtz-Eakin explains it this way: an insurer responds to a $1,000,000 fee by raising premiums by $1,000,000, thereby incurring $350,000 in corporate income taxes (35% x $1,000,000). In turn, the after tax profits of the insurer will drop by $350,000. If, instead, the insurer raises premiums by $1,538,462, it will incur a corporate tax liability of $538,462 (35% x $1,538,462), completely offsetting the tax. The corporate tax will likely amplify the total impact of this annual fee by approximately 54%, according to Holtz-Eakin. $87.4 billion in first decade taxes could result in $134.6 billion in premium increases. The law of unintended consequences is in full force!

This has been a short summary of what businesses can expect for 2014. What I've written is only an abbreviat-ed version of what the ACA has planned for the imme-diate future. Further guidance and closer examination concerning the ACA and your business is available by contacting Cravens&Co, LLC.

*****UPDATE*****

- **As of February 10, 2014, the United States Treasury Department issued a statement postponing the employer mandate for medium sized employers (50-99) for an additional year, making January 1, 2016 the effective date for compliance.**
- **The new regulations clarify that small employers (less than 50) won't have to fill out any forms or complete other paperwork in 2015.**
- **Large employers (100 or more): The January 1, 2015 deadline still applies to this group, but there's some good news for large employers, too. To avoid any penalties, they were initially required to provide coverage to 95 percent of their full-time employees in 2015; however, the new regulations lowered the standard to 70 percent for 2015 before increasing the requirement to 95 percent in 2016.**

Why You Should be Prepared for an Estate Tax Audit

Jeremiah Coder and G. Michelle Ferreira
Greenberg Traurig, LLP

Most individual taxpayers are fortunate enough to never have to endure a painful interaction with the IRS beyond filing their personal income tax returns. Budgetary pressures in recent years have constrained the IRS's ability to devote significant resources to effective routine enforcement of individual income tax return filings. But the low "audit coverage" in the individual arena is not reflective of the scrutiny for estate tax return filers.

Significant IRS Interest in Estate Tax Returns

Every taxpayer expecting to be subject to a federal estate tax return filing requirement faces the high proba-bility of audit. The number of estate tax returns has dropped dramatically over the past few decades, in part due to the increasing exclusion amount that negates the need to file a Form 706, "United States Estate (And Generation-Skipping Transfer) Tax Return." While the unified credit against estate tax once stood at only $1 million in the early 2000s, Congress has repeat-edly raised the credit amount in successive estate tax legislation; the current exemption amount is$5,250,000 per individual.

As a result, the number of estate tax returns has plummeted over the past decade, from over 70,000 returns filed for the 2003 tax year to less than 10,000 returns for 2011. This has enabled the IRS to use its existing estate tax personnel to look at a higher percentage of filed estate tax returns.

IRS employees in the Service Center go through each filed Form 706 manually and handpick which returns are selected for audit. According to the IRS Statistics of Income Bulletin, in fiscal year 2012, the agency had an audit coverage rate of 30 percent for estate tax returns. The IRS reviewed 3,762 returns out of 12,582 filed returns. Of importance to estate tax filers is the IRS recommended $1.14 billion in additional tax owed from the audited returns, with an average of $304,500 additional tax due per return. Large estate tax returns received even higher scrutiny: returns for estates with valued assets between $5 and $10 million had an audit rate of 58 percent in fiscal year 2012, while returns with assets higher than $10 million were audited at a 100 percent rate. Thus, estate tax return filers with assets in excess of $10 million can expect an audit in every cir-cumstance.

These statistics emphasize that high net-worth taxpayers need to carefully plan their estates in conjunction with competent tax professionals in order to ensure that any likely audit by the IRS is not only handled appropriately, but that the issues reviewed by the government are adequately documented and can survive intense scrutiny. The IRS is under pressure to reduce the tax gap, and estate tax returns offer a convenient avenue for the agency to assert additional tax due if the return presents issues that an IRS agent can challenge.

Numerous Pitfalls Possible

There are numerous steps in the estate planning process that can eventually lead to disputes with the IRS if the taxpayer and the estate planning professional are not vigilant. It is advisable to engage a tax professional to ensure that the planning process contemplates potential audit issues to adequately prepare for interactions with the IRS after a return has been filed.

FISCAL YEAR 2012 IRS EXAMINATION OF ESTATE TAX RETURNS

Estate Size	# of Returns Filed	Returns Examined	Audit Rate	Recommended Additional Tax (in thousands)	Average Recommended Tax Per Return
Under $5M	9,404	1,362	14.5%	$ 116,748	$ 85,718
$5-$10M	2,241	1,313	58.6%	$ 138,375	$ 105,388
Over $10M	937	1,087	116.0%	$ 890,517	$ 819,243
Total	12,582	3,762	29.9%	$ 1,145,640	$ 304,530

Areas that the IRS often focuses on in an estate tax audit include:

- valuations of property and business interests;
- discounted valuations of assets;
- unreported and undocumented gifts;
- potential conflicts among advisers and return preparers; and
- documentation of inter-family transfers.

Valuations of property that form the basis of a trust, charitable gifts, or business succession strategies are highly susceptible to attack by the IRS if technical rules are not precisely followed. Likewise, the discount rates applied to transfers of interests in family limited partnerships and closely held businesses are frequently challenged by the IRS, requiring the use of experts and production of extensive financial and business documentation. New valuation report requirements for certain assets in the Code add new challenges for filing an estate tax return. The IRS often tries to disallow deductions for interest paid when the estate borrows funds from a closely related business entity in order to pay the estate tax. Also, the existence of unreported gifts sometimes arises during audit of an estate tax return. And it may not always be obvious to a client or adviser that conflicts of interest are present among potential parties when a plan is being implemented. A tax professional can provide guidance on these issues so that a decedent's return is prepared and filed with proper documentation while following the legal requirements of the transactions reported on the estate tax return.

Key Take-Away

Anticipating challenges to an estate tax return is a reality in today's environment and advisers need to pre-pare their clients. Adding professionals familiar with issues surrounding estate tax audits into the estate planning process may reap long-term benefits by anticipating potential issues should the IRS carefully re-view an estate tax return searching for additional revenue.

Tax Advice Disclosure: To ensure compliance with requirements imposed by the IRS under Circular 230, we inform you that any U.S. federal tax advice contained in this communication (including any attachments), unless otherwise specifically stated, was not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any matters addressed herein.

This was prepared by Jeremiah Coder and G. Michelle Ferreira of Greenberg Traurig, LLP.

Forget the Glitz... Successful Investing is Hard Work

Ken Solow, CFP®, CLU®, ChFC®
Chief Investment Officer
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If you are looking for a movie about power, money, sex, drugs, yachts, Lamborghinis, high-pressure sales tactics, stock manipulation, sex, and drugs (did I mention sex and drugs?) then go see the new Martin Scorsese movie, The Wolf of Wall Street, starring Leonardo DiCaprio. The film is based on the memoirs of Jordan Belfort, the founder of the brokerage firm Stratton Oakmont, which functioned as a boiler room selling penny stocks in the 1990s. I don't want to give away the ending, but I will say that if you enjoy watching unimaginable amounts of corruption and debauchery, you are going to love it.

All of which gets me thinking about the admittedly boring world of our Pinnacle investment analysts.

To my knowledge Martin Scorsese has never approached them about doing a movie, and for good reason. The real world of risk managing portfolios entails a lot of hard work and a sound investment process. To illustrate my point, I present to you a sample from our company network where our analysts save their presentations for our weekly Wednesday meetings. This collection gives only a glimpse of the volumes of research being done by the team, since much of it resides in individual folders for each analyst. Nevertheless, if you were a Pinnacle employee and could log into the company network, you'd find these presentations made by the analysts from Aug 28th to November 27th of this year. While it probably isn't the basis for a riveting Hollywood screenplay, I thought it might be illustrative to take a look.

Here are a few of the highlights:

Aug 28th – Data Dump

148 slides are sent to the investment team for study. Randomly looking at slides in the deck reveals that slide #148 is about the Australian Dollar, slide #63 is "% Contribution to GDP from Inventory Investment," and slide # 18 is "Composition of retail and food services."

Aug 29th – Gold and Commodities around crisis events

This is a 10- slide presentation showing the investment performance of gold and commodities after a variety of crises throughout history.

Aug 29th – Sector Review and Other Stuff

20 slides in this presentation including Syria, a proposed trade for Gold, a review of Brazil, and various U.S. sector slides.

Sept. 5th – U.S. Sector Review

46 slides presented by analyst Carl Noble, 14 of which were on the Tech sector and 23 covered Consumer Discretionary. Slide #35 is a recommendation that we continue to overweight the Discretionary sector while keeping a watch on Homebuilders.

Sept. 13th – Consumer Confidence

14 slides in this presentation. Randomly picking slide #8 shows the Bloomberg Consumer Comfort Index and its components.

Sept. 23rd – U.S. Dollar

18 slides about the investment characteristics of the U.S. dollar. Again randomly picking on slide #8: It is a chart of U.S. Dollar versus Japanese and Euro Real In-terest Rate Differentials. (Riveting!) Chart #9 is much tamer, showing Inflation versus the U.S. dollar.

Sept. 25th – Financials

24 slides. Slide #11 is a chart showing that JP Morgan represents 8% of the holdings of XLF, the financial sector ETF we own in client portfolios.

Oct. 1 – Yet another data dump from Rick Vollaro

157 slides… heaven help us.

Oct. 1 – Performance Attribution

10 slides encompassing our monthly look at the drivers of portfolio returns. Slide #8 shows that our under allocation to Telecom Services and to Utilities was a big winner for the month.

Oct. 2 – Fixed Income Options and Ireland

18 slides where slides 5 to 18 were all about considering Ireland as a possible investment recommendation. Slide #8 showed a breakdown in the holdings for EIRL (the ETF for investing in Ireland) where CRH PLC represents 25.96% of the holdings.

Oct. 30 – Defensive Sector Review

10 slides, slide #4 is titled "Bubbling up, or Just Bouncing?" Slide #6 is titled "Earnings don't seem to be the driver."

Nov.14 – Consumer Discretionary

A 66 slide presentation. Slide #15 is "Consensus Forecasts of Operating Earnings Per Share," and slide #28 is "Household net worth versus U.S. consumer spending."

Nov. 27 – Mexico

28 slides on our southern neighbor. Slide #8 shows Unemployment Rates, Slide #11 shows Industrial Production, and Slide #21 is titled, "Valuation looks Overvalued."

Pinnacle's investment process is all about coming up with high probability forecasts for the broad market, sectors, industries, countries, or business cycles. We develop our forecast using a variety of tools that help us to evaluate the weight of the evidence. Once we perform that analysis, our investment committee has to determine the level of conviction we have in our forecast; only then do we recommend changes to the asset allocation of portfolios.

To the extent that we rely on qualitative decision making, it is based on our experience, wisdom, knowledge, and 'right-brained intuition.' I write about this process in Chapter 8 ("Becoming an Investment Expert") of my book, Buy and Hold is Dead (AGAIN). If you want to become one, then I'd argue that there's no substitute for simply hunkering down and doing the work. Lots of it. Over and over again. In that regard, our investment analysts may not look like Leonardo DiCaprio, but they are stars in their own right.

FADE TO BLACK

The Golden Ticket Trap

Jim Parker
Vice President
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In a popular children's story, the young hero pins all his hopes on finding one of a handful of "golden tickets" hidden among millions of candy bars. It seems many people approach investing the same way.

The notion that the path to long-term wealth lies in locating secret and previously undiscovered treasures in the global marketplace of securities is one regularly featured in media and market commentary.

Secret Stocks & Hidden Treasures?

One magazine, for instance, runs a feature called "Fund Managers' Secret Stocks," referring to supposedly "bargain" stocks the pros keep hidden. (How the stocks can be secret when splashed on magazine stands nationally is not explained.)

Likewise, a popular business broadcaster regularly tells its viewers about the "under-the-radar" stocks that Wall Street analysts don't want them to know about.

This stuff sells because it plays to a misconception about how markets work: that they are like beaches after a hot day, full of buried treasures. All you need, in this view of investing, is a virtual metal detector to find the money that people left behind.

You could get lucky this way, of course. But basing a long-term investment strategy on stumbling across the equivalent of a mislaid trinket in the sand or a golden ticket in a chocolate wrapper is not likely to be sustainable.

It's a haphazard approach, reliant on chance and requiring a lot of work that is unlikely to be rewarded. Worse, it means taking unnecessary risks by tying one's fortunes to a handful of securities or to one or two sectors.

Taking big bets on a single sector or commodity is a bit like buying a chocolate bar in the hope of finding a golden ticket. There's an element of pot luck, and you're exposing yourself to idiosyncratic risk related to that sector or industry.

On the subject of hidden treasures, gold itself can have a special allure for investors, particularly in uncertain times. Indeed, the yellow metal has had a couple of spectacular runs, in the 1970s and in the 2000s. But there have been long lean times and significant volatility in between, which makes gold a highly speculative bet.

In early 2013, the Daily Mail in the UK carried the headline, "Gold Set to Shine Even More Brightly in 2013." The rationale was that with investors scouring the world for "safe havens," gold could reach as high as $2,500 an ounce by year end.

As it turned out, gold suffered its biggest annual loss in three decades last year, with its spot price falling 28% in US dollar terms. From an all-time high of $1,920 in September 2011, gold fell to just over $1,200 by the end of 2013.

Now, adopting some exposure to gold may well suit some investors as part of a broadly diversified portfolio, but taking speculative bets on a single commodity, sector, or stock is more akin to blind hope than to anything else.

The popularity of media stories about hidden bargains and undiscovered stocks is understandable. Like townsfolk in a bar overhearing the boasting of gold diggers down from the hills, we desperately want to believe in El Dorado. But this sort of speculation is really no different than gambling.

Sound Investment Strategy

In contrast, sound investment starts with identifying the risks worth taking and minimizing the risks that don't come with an expected reward, like taking a big bet on gold. You can help reduce risk and increase flexibility by diversifying.

It's true that you can get lucky the other way, like the boy in the chocolate factory story. But the chances are against you.

And keep this in mind: The best investment may not be the golden ticket anyway.

Cravens & Co.
WEALTH MANAGEMENT

MARKET REVIEW

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The financial markets encountered strong headwinds but little turbulence on the way to a record-setting year. 2013 has been described as a "year about nothing." In reality, a lot happened—but nothing could challenge the market's profitable run. Investors shrugged off news of a sluggish US recovery, recessions in China and Japan, threats of a US government shutdown, lingering euro zone debt problems, climbing interest rates, worsening turmoil in the Middle East, and stock market glitches.

The US and most developed market indexes experienced double-digit gains for the year. Overall, US stocks were up for the fifth year in a row while daily volatility fell to its lowest level in seven years. The Dow Jones Industrial Average posted a gain of 26.50%, its largest advance in 18 years. The S&P 500 Index had its best year since 1997, returning 32.39%. In the non-US developed markets, the MSCI-EAFE Index returned 22.78%, and all developed country markets in the MSCI indexes had positive returns. Emerging markets were the exception to the worldwide equity advance, as returns in many emerging countries turned negative, with the MSCI Emerging Markets Index returning -2.60% for the year.

During 2013, the yield on the 10-year Treasury note climbed from 1.76% to 3.01%—its largest increase since 2009. Rising interest rates left US fixed income indexes with either flat or negative returns, with longer-term and higher-quality bonds declining the most. TIPS performance was notably poor. Returns in the international bond markets were mixed and emerging market bond index returns were negative.

What Lies Ahead?

While 2013 ended with a momentum driven rally for U.S. stocks, the relative calm of 2013 has turned more turbulent of late. Investors must recognize that 2013 is now in the rearview mirror and it's time to assess what may lie ahead for the investing landscape. Here's how we are viewing the start of 2014…

Economic Landscape is Mostly Encouraging

2014 starts with a major question mark for all investors. The issue comes down to an inflection point in the U.S. business cycle, and what that means for the Federal Reserve in regards to its large scale asset purchase program (LSAP) -- also known as quantitative easing (QE).

The good news is that the economic landscape in the developed world appears to be picking up. Last year the U.S. economy was very resilient as it found a way to grind through the fiscal cliff, the sequester, and another round of budget negotiations that dampened confidence in the recovery for a brief period. This year, with some momentum behind it and less of a fiscal drag in store, the U.S. economy appears poised for further improvement (barring an unforeseen shock). European economies also appear to be slowly healing, though with large divergences between Germany and France starting to appear, and a periphery that continues to slowly lift from the depressionary ashes. The one soft spot in the globe still involves emerging markets countries, where China is muddling through a rebalancing phase and many other parts of the region are suffering from higher rates, weak commodity prices, and higher inflation than what is found in the developed world. Interestingly, the region may get a lift from improving growth in developed markets, which would be a reversal of the dynamic of the past decade that saw emerging countries act as the engine for global growth.

Passing Through the Goldilocks Zone?

Over the past five years, very slow economic fundamentals may have cast considerable skepticism over the rally off of the 2009 bottom, but they also drove the central banks around the world to open up the monetary spigots in an attempt to boost growth rates. In hindsight the environment we've been living through has been goldilocks for risk assets. The odd mix of slow but not recessionary growth rates, flush liquidity, and a wall of worry ended up being the perfect recipe for risk assets to explode higher.

This year many economic fundamentals appear poised to break to the upside. Third quarter GDP was over 4% last year, and though the fourth quarter may have reversed course a bit due to the budget debate, the economy seemed to accelerate again late in the fourth quarter. Here's the conundrum: Better fundamentals are typically considered good for markets as they are good for sales, earnings, and the overall wealth affect. However, if better growth compels the Fed to withdraw stimulus more quickly, how can anyone confidently predict how markets will react?

Overall, liquidity is still expected to increase this year, even if it's to a lesser degree. And even if that's the case, the Federal Funds rate will likely remain near 0% well beyond any near-term improvements in the economy. Nevertheless, markets can be finicky and often respond more to changes at the margin than off absolute levels. The Fed, with new president Janet Yellen at the helm, has already signaled that it will reduce the LSAP program by $10 billion/ month, and the assumption is that as long as economic growth can stomach the reduction, they will continue to gradually wind the bond buying program down during the course of 2014. In other words, the rate of growth in their balance sheet is about to start slowing..

We don't pretend to know exactly how markets will digest this change. It may be that the economy is ready to stand on its own two feet, and that the reduction of QE is a healthy byproduct of a better economy. Perhaps previous Chairman Bernanke has actually managed to create a virtuous cycle despite an army of critics who question the Fed's unprecedented policies of the last few years. On the other hand, one look at a chart of

QE and the S&P 500 reveals that every time the Fed has ended one of their previous QE campaigns (QE1, QE2, Operation Twist, etc.) the environment quickly turned more volatile for stocks. Rather than digging in to either the bullish or bearish camp, we acknowledge that it's hard to have much conviction in a particular market direction at a time when the Federal Reserve is beginning to withdraw its experimental medicine.

Valuation is Now Arguably Expensive

Historically, valuation alone is not a good timing indicator, but investors who ignored it at the extreme were proven foolish. We've written before about the dichotomy between absolute and relative valuation levels, with the conclusion that the market was neither as overvalued as the bears would state, nor as undervalued as many bulls believed. After the tremendous gains of the past few years, the absolute valuation model we monitor is now firmly signaling that the market is overvalued, while the relative valuation models suggest it is still solidly undervalued relative to bonds. While the absolute model's reading is something we have taken notice of recently, its message is still not extreme enough to force major reductions in equity exposure. What it does imply is that the margin of safety in U.S. stocks has deteriorated markedly from what it was just a few years ago.

The message that comes through loud and clear from valuation is that now is not the time to throw caution to the wind and load up on portfolio risk. Instead, it might be time to begin pruning some of the robust gains that have accrued in recent years.

Technicals: Healthy Trends but Frothy Markets

Currently the U.S. and many other developed markets are still in solid uptrends. The old market adage is that "the trend is your friend." If the positive technical story starts with very healthy trends in developed markets, the negative is that intermediate-term sentiment looks complacent, and in the near-term stocks appear to be in overbought territory. As February began, the U.S. stock market had gone 143 days without a 5% decline, nearly three times the typical cycle of 49 days. Like valuation, extended sentiment is not a great timing indicator, but it does serve a warning that the environment is ripe for change when an appropriate catalyst materializes.

Pullback to the Breakout Zone?

Given that valuation is in somewhat expensive territory, the trend is fairly "long in the tooth", and there's uncertainty surrounding the stimulus, it wouldn't be a surprise to see the market take a well-deserved breather sometime over the next few quarters. That seemed to be at hand earlier this months with the major indices all giving back a small portion of last year's gains. One possibility for a market pull back is a retreat to the point it broke out of last year. This wouldn't be devastating, and would actually be a healthy technical development. On the S&P 500, this would translate to a retracement back to the neighborhood of the mid to high 1500's, which is close to 300 points below current levels. Any correction close to that magnitude could be just what the doctor ordered to unwind complacency and take the edge off of extended valuations. As long as the business cycle doesn't appear to be in danger of fizzling out, a material dip would likely set up a great buying opportunity for investors.

Portfolio Positioning

With valuations extended, environmental indicators flashing red, and a major question mark regarding how the market will react to less liquidity, we recently took steps to reduce volatility in our Risk Managed Strategies. Given that business cycle conditions look solid, established trends seem to be in place, and the first few months of the year are typically very favorable for stocks, we remain fully invested in our Market Capture Strategies. As represented by the articles in this quarter's newsletter from two of our advisory partners, these two "core" strategies are structured around very different philosophies and each has its own mandate. Our other strategies are designed to play complimentary roles in the construction and operation of each client's unique portfolio. Rather than speculate as to when to be in and when to be out, we believe better results lie in balance.

Some in the investment community believe that momentum may carry this market much higher before it falls. Others feel it is way over extended and danger lies at every turn. Generally, we take the position that both schools of thought are short sighted. Warren Buffet likes to say that he tries to be fearful when others are greedy and greedy when others are fearful. We like that thought but also believe it would be imprudent and arrogant of us to think we can perfectly time markets. Accordingly, we forge into 2014 with the same mindset as any year before; how do we best help our clients reach their goals. Not surprisingly, our answer is also the same as in past years; leadership, relationship, creativity, and balance.

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It is our goal to help investors by indentifying changing market conditions. However, investors should be aware that no investment advisor can accurately predict all of the changes that may occur in the market.

In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to matu-rity may be subject to a substantial gain or loss.

Indexes cannot be invested in directly, are unman-aged, and do not incur management fees, costs, and expenses.

Commodities investments, such as gold, are speculative and involve special risks related to weather and international political and economic developments.

Your Financial Advocate

You have goals youwant to achieve...places you hope to go...things you want to do...people you desire to spend time with.

These dreams have motivated you over the years to work hard and to sacrifice, so that one day youwould be in the position to live the life you've always wanted. But, more than likely, you're not quite there yet.

Fully realizing your dreams also takes planning and execution to get them "over the top".

At Cravens & Company, we operate as a Multi-Family Office, striving to help successful individuals and their families realize and enjoy their life goals.

Your dreams may include...

...traveling the world with your spouse...
...spending more time on hobbies like photography, or wine collecting, or cooking...
...living on a horse ranch in the country or a cabin in the mountains...
...creating a lasting legacy for your children and grandchildren...
...supporting the charities and causes that you hold dear...

Or,youmaystillbefocusedoncreatingwealthandneed assistance in executing a comprehensive strategy that gives you the confidence to spend your free time on the other things that are important to you. We can help.

At Cravens & Company, we combine comprehensive planning, personalized investment management, tax and estate strategies, and business planning with a proactive, solutions-oriented mindset. The result is a formula and a culture centered on your success; however you define it. In the complex world in which we live, we believe anything less is inadequate.

Since 1996, we've been serving the specialized needs of: family businesses and their owners, professionals, and successful retirees. Over the years our firm has changed andmatured, evolving fromamodel where the individual advisor acts alone in all areas of the client relationship to an ensemble of functional specialists who collaborate on finding comprehensive solutions to our clients' unique situations.

While prudent investment advice is a foundational component of our service, we passionately believe we best serve our clients by bringing all facets of their unique financial picture into view then helping them make decisions in aggregate rather than isolation.

Our goal is to provide each client with the leadership, relationship and creativity needed to allow them to achievetheirlife'sgoalsand,evenmoreimportantly,the confidence to enjoy the journey. After all, what's the point of all the work andworry if you don't get the satisfaction of realizing the results?

At Cravens & Company, we have a team that is by design, ready to work for you. If you have complex financial issues and/or desire a relationship of this type, please contact Jaclyn Booker to arrange an introductory meeting. She can be reached at 931-528-6865 or at jbooker@cravensco.com.

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