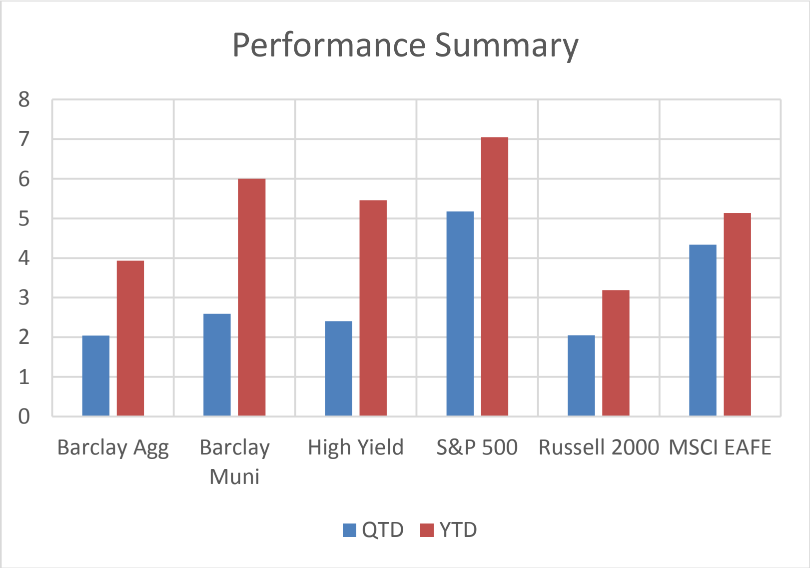
2Q Investment Commentary

By the AWM Team

Our Perspective on the Quarter and the Year to Date

Performance for the major asset classes was strong across the board in the second quarter. Markets rose despite poor economic growth, rising geopolitical tensions in Iraq and Ukraine and continued uncertainty around global monetary policy. The S&P 500 was up a robust 5.23% for the quarter and is now up 7.14% for the year. Small-cap stocks again lagged large-caps as they have all year. The Russell 2000 was up 2.05% for the quarter and is up 3.19% for the year. Developed international stocks performed well as the European Central Bank and Japan took further action to combat long-term deflation risks. International developed markets were up 4.34% for the quarter and emerging markets roared back after a poor first quarter, up 6.71%.

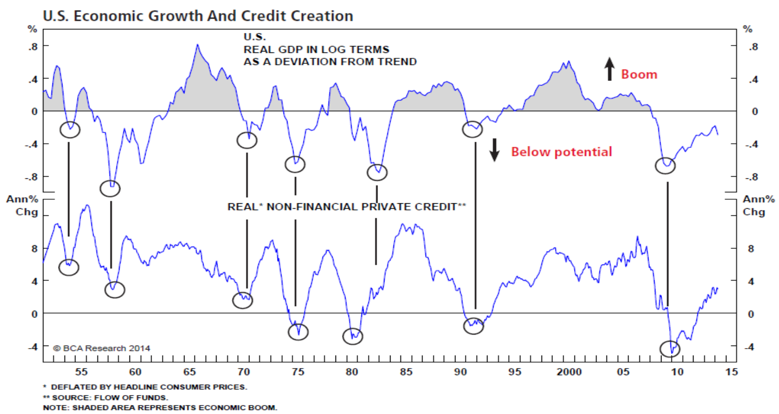


In economic news, U. S. GDP for the first quarter was revised down to -2.9%, making it the largest drop since the first quarter of 2009. Weather had a big impact on the first quarter GDP report and economic growth is expected to rebound in the second half of the year. However, the fact remains that the economic recovery continues to be subpar. Other economic indicators were more positive, including continued improvements in the labor market.

Bond performance continued to surprise, as yields on the 10-year Treasury moved to 2.53%, down from 3.04% at the end of 2013. The Federal Reserve has managed to keep expectations for rates in check, even as they continue to scale back their monthly purchases of bonds. The Barclays Aggregate Bond index was up 2.04% for the quarter, and is up 3.93% for the year. Municipal bonds continued their strong performance, up 2.59% for the quarter and 6% for the year. The strongest performers for the quarter were emerging market bonds, up over 4% and Treasury Inflation Protection Securities (TIPs) up 3.78%. The main drivers being an increase in the currencies of many emerging markets relative to the dollar and increased concerned about inflation. We expect both of these drivers to be more temperate going forward.

Our Current Views and Portfolio Positioning

Economic growth continued to disappoint in the first half of the year. A brutal winter contributed to negative growth in the first quarter. We expect that the “weather effect” will dissipate and the economy should get back on track in the second half of the year. However, we are in the camp that economic growth is likely to remain below its long-term potential due to structural forces that have not been resolved. The Bank Credit Analyst (BCA) has referred to the past five years as the “cycle-less cycle”, due to the fact that we have not seen a return to a boom economy that usually follows a severe recession. The main culprit is weak credit growth which is leading to a lack of "re-leveraging" from the private sector, as seen in the chart below.



We believe that sustained but slower economic growth has led market participants to adopt the view that the Fed will keep the Fed Funds at a very low real rate for an extended period of time; PIMCO refers to this as the "New Neutral". This view of lower rates for longer has caused a re-rating of valuations for financial assets. The "multiple" or valuations for stocks has increased and are now arguably in "over-valued" territory in the U.S.; with large-caps moderately overvalued and small-caps more so.

Given that stock valuations look a little stretched and we have not seen a correction of 10% or more in over two years, we would not be surprised to see a significant pull back in the second half of this year. However, if the Fed is able to maintain control of interest rates at such low levels we expect investors will stick with stocks due to a lack of alternatives. Suggesting that stock markets have the "potential" to be driven to much higher levels as a result of aggressive monetary policy, even if we see a sizable correction in the short-term.

We currently view valuations in foreign developed markets as more attractive on several metrics and recommend overweighting these positions in portfolios. Based on valuation, we expect foreign developed markets to outperform the U.S. over the next five years. We also find valuations in the emerging markets (EM) relatively attractive. However, due to greater volatility and potential risks our preference is to invest with foreign fund managers that have the ability to allocate to EM rather than having a dedicated position.

As we evaluate fixed income (bonds) we see very few bargains for investors. In fact, we think certain areas, such as high-yield, are entering bubble territory as investors chase higher yields. The best case that can be made for bonds today is for diversification and risk management purposes. Bonds should be the part of the portfolio that provides "ballast" to riskier asset classes such as stocks. We recommend a below benchmark duration weighting and that investors reduce exposure to the riskiest parts of the bond market.

We continue to recommend some alternative asset exposure, which may include the following categories: diversified arbitrage, long-short, global macro and real return strategies. We believe they offer comparable or better returns compared to the traditional asset classes stocks, bonds and cash over the next few years, and may reduce overall portfolio risks given their relatively low correlations to traditional assets.

Volatility in the markets has been extremely low this year. Key risks that could surprise markets and increase volatility are: an inflation scare; escalating geopolitical risks; energy prices; China slow-down or crisis; and an increased focus on mid-term elections.

Of course, some of the above are widely watched and already priced into markets, it is usually something unexpected that starts a correction.

Asset Class Views

Asset Class	View*	Comments
Equities		
U.S. Large Cap	↔	Markets have reached a moderately overvalued level, with pockets of good values still available in select in high quality stocks
U.S. Small/Mid Cap	↓	We believe this segment of the market is overvalued and should be underweighted, if they outperform large-caps it will be because they are becoming "bubbly"
International Developed	↑	Valuations are more attractive and should be over-weighted relative to U.S. stocks
Emerging Markets	↔	We think valuations are reasonable and long-term potential is good; however we are recommending investors get exposure from diversified international funds, not direct
Fixed Income		
Investment Grade	↓	Valuations look rich; keep exposure for risk management and diversification
High-Yield Bonds	↓	Starting to look "bubbly" and would reduce positions; likely to have substantial risk if economy slows down or we enter another recession
Municipal Bonds	↔	Valuations look a little rich, however they still make sense for high tax-bracket investors
TIPS	↓	Valuation is rich, however they can make sense as a hedge against inflation
Floating-Rate Loans	↔	Investors flooded into this asset class in '13 and started to mildly exit in '14, we are cautious near-term but would upgrade our rating on pull backs
Emerging Markets	↔	Valuations have increased based on this year's strong performance; rather than dedicated exposure we prefer to invest with diversified Int'l manager's that have a broad mandate
Alternatives		
Absolute-Return/Alternatives	↑	We like this asset class and believe it can improve the risk/reward profile of portfolios that hold traditional asset classes
REITs	↔	Valuations look a little overvalued; we like the asset class but would wait for pull backs to add broad exposure; selectively we may buy individual REITs
Commodities/Gold	↔	We view gold as an "insurance" asset and recommend holding small positions

*** ↔ Neutral weight ↓ Underweight ↑Overweight**

U.S. Stocks

Market Performance, Second Quarter 2014

Index	Q2 2014	YTD
S&P 500	5.23%	7.14%
Russell 1000	5.12%	7.27%
Russell 1000 Value	5.10%	8.28%
Russell 1000 Growth	5.13%	6.31%
Russell Midcap	4.97%	8.67%
Russell 2000	2.05%	3.19%

Source: Morningstar

- Equity markets had a strong quarter. The S&P 500 was up 5.23% in the quarter and 7.14% YTD. Stocks may be driven higher as investors have few alternatives.
- Small cap stocks started the quarter slowly, but after a 5.32% gain in June they finished the quarter up 2.05%. YTD small caps continue to lag, up 3.19% for the year.
- Growth and value had similar returns for the quarter, up a little over 5%, YTD value still has the upper hand, up 8.28% vs. 6.31%. Our outlook is neutral.

International Stocks

Market Performance, Second Quarter 2014

Index	Q2 2014	YTD
MSCI EAFE	4.34%	5.14%
MCSI EME	6.71%	6.32%
MSCI BRIC	7.97%	4.85%

Source: Morningstar

- International stocks led the rally as European markets showed signs of stabilizing and the U.S. dollar weakened relative to global currencies. Valuations look attractive relative to the U.S.
- Emerging markets roared back in the quarter, up over 6%; led by a bounce back in the BRIC countries. We expect volatility to remain high for EM stocks.

Fixed Income
Market Performance, Second Quarter 2014

Index	Q2 2014	YTD
Vanguard Total Bond Index	1.94%	3.85%
Barclays Muni Bond	2.59%	6.00%
Barclays US Corp High-Yield	2.41%	5.46%
JPM GBI- EM Global Diversified	4.02%	5.99%
iShares TIPS Bond	3.78%	5.76%
BofA Merrill Lynch 3 month Treasury Note	0.00%	0.03%

Source: Morningstar

- Fixed income continued to surprise investors during the quarter as interest rates eased lower, generating a 1.94% return for core bonds during the quarter. Fed actions and geopolitical risks may continue to keep rates at relatively low levels, in general we are underweight core bonds.
- Muni bonds continued their strong performance during the quarter up 2.59% and are now up 6% YTD. They remain attractive for high marginal tax-brackets.
- Emerging market bonds were the leader for the quarter, driven by strengthening EM currencies they generated a 4.02% return. We expect volatility to remain high.

Alternative Assets
Market Performance, Second Quarter 2014

Index	Q2 2014	YTD
PIMCO All Asset All Authority	3.97%	6.31%
AQR Diversified Arbitrage	0.27%	1.38%
Gateway	1.92%	2.52%

Source: Morningstar

- In general, alternative strategies performed in-line with our expectations for the quarter. The asset class is growing rapidly, with many marginal providers entering the market investors need to remain selective.
- We continue to recommend a moderate 8-9% allocation to alternatives for their diversification benefits and expected contribution to overall portfolio risk-adjusted return.

Appendix:

Benchmark Definitions

U.S. Equity		Description
S&P 500	Index	The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.
Russell 1000	Index	The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe and includes approximately 1000 of the largest securities. The Russell 1000 represents approximately 92% of the U.S. market.
Russell 1000 Value	Index	The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.
Russell 1000 Growth	Index	The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap	Index	The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.
Russell 2000	Index	The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.
International Equity		**Description**
MSCI EAFE	Index	The EAFE (Europe, Australasia, Far East) index consists of 21 developed market country indexes, excluding the US & Canada. It is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets.
MCSI EME	Index	The index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets and includes 23 emerging market countries in the index.
MSCI BRIC	Index	The index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the following four emerging market country indexes: Brazil, Russia, India and China.

Fixed Income		Description
Vanguard Total Bond Index	Index Fund	This index measures a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States—including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.
Barclays Aggregate Bond	Index	The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS sectors.
Barclays Muni Bond	Index	The U.S. Municipal Indices cover the USD-denominated long term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.
Barclays US Corp High-Yield	Index	The index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market and excludes Emerging Markets debt.
JPM GBI- EM Global Divers	Index	The index tracks returns for actively traded external debt instruments in emerging markets. Included in the index are US-dollar denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities.
iShares TIPS Bond	ETF	The iShares TIPS Bond ETF seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds.
BofA Merrill Lynch 3 month Treasury Note	Index	The 3-month US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue.
Alternative Assets		**Description**
PIMCO All Asset All Authority	Mutual Fund	The investment seeks maximum real return, consistent with preservation of real capital and prudent investment management. The primary benchmark for the fund is the S&P 500, with a secondary objective of Consumer Price Index +650 basis points.
AQR Diversified Arbitrage	Mutual Fund	The investment seeks long-term absolute (positive) returns. It invests in a diversified portfolio of instruments, including equities, convertible securities, debt securities, loans, warrants, options, other types of derivative instruments.
Gateway	Mutual Fund	The investment seeks to capture the majority of the returns associated with equity market investments, while exposing investors to less risk than other equity investments. The fund invests in a broadly diversified portfolio of common stocks, while also selling index call options and purchasing index put options.