DEIGHAN
WEALTH ADVISORS

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MARKET COMMENTARY

U.S. Markets Hit New Highs

Unless you've been living under a rock for the past few months, you've likely read countless headlines detailing the rise of the Dow Jones Industrial Average and the S&P 500 Index. Both are broad measures of U.S. stock market performance, and now, after five and a half long years, these two indices have finally recaptured highs last seen in 2007.

This is exciting news, and there's been plenty of euphoria going around. Analysts have been raising earnings estimates, stock funds have been seeing inflows, and clients have been asking for more stock exposure. Everyone, ourselves included, has been enjoying the ride.

Our Role as Disciplinarians

Still, although we like a good rally as much as anyone, it's our job to bring discipline to the investing process. This is one of the most important things we offer clients, because discipline is something capital markets and investors often lack.

In 2008 and early 2009, we spent a great deal of time holding our clients' feet to the fire, keeping their portfolios invested while markets became irrationally oversold. Now, we increasingly find ourselves in the opposite, though equally uncomfortable, position of moderating our clients' exposure to U.S. stocks while they continue to advance.

Why would we do this? Why would we trim stocks just as they're rising? Why might we invest in non-U.S. stocks, or hard assets, or bonds when U.S. stocks have been the clear, recent winner? We have at least a couple responses to these questions.

One is that the future is uncertain, and therefore we must build portfolios that can benefit from, or withstand, a variety of outcomes both positive and negative. We do this by diversifying across sectors, countries, and asset classes. Markets can turn quickly, and having a sound, strategic asset allocation is the best defense against market unruliness.

Another is that a bird in the hand is worth two in the bush. This is a tired truism, for sure, but it's nevertheless relevant. When markets rise, we're happy to bank gains for our clients and move them into either safer assets or assets that offer better relative value. To assume that an investment will continue to rise simply because it has risen in the past is to look only in the rearview mirror. To stretch your discipline merely for the potential of future gain, all while risking a known gain, is tantamount to shaking the bush with both hands while holding your bird by your teeth.

There are times when being disciplined isn't in vogue, and this is one of those times. Yet, discipline is often needed the most when markets are moving strongly in one direction or another.

> *"Discipline is something capital markets and investors often lack."*

What, Me Worry?

For the better part of four years, the U.S. stock market has climbed a "wall of worry." In other words, stocks have risen, though reluctantly at times. Fears about the economy, Europe, the Fiscal Cliff, and so forth, have caused dips along the way.

Recently, however, U.S. stocks have been doing a lot of climbing but not a lot of worrying. The CBOE S&P 500 Volatility Index (VIX) has been sitting around 5-year lows since the beginning of the year. Meanwhile, the Dow Jones and the S&P 500 have risen almost linearly. The last time the VIX was this low was January 2007, near the peak of the last bull market.

It seems the U.S. stock market has

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gotten complacent. Take the Cyprus incident, for example. Investors have understandably become numb to the situation in Europe, which has dragged on for three years now. But the situation in Cyprus barely registered a blip in U.S. markets. Granted, Cyprus is a country with a population smaller than the State of Maine. Yet the precedent set there, that the government can hypothecate depositor assets to bail out banks and politicians, is a dangerous one. There's a reason why Cyprus closed its banks for days and then only partially reopened them with low withdrawal limits. It's because the depositor haircut had, and still has, the potential to trigger bank runs. Depositors in Italy and Spain must be questioning whether or not it makes sense to keep large balances in their national banks, given the precedent set in Cyprus. Meanwhile, U.S. stocks are not accounting for Europe in any meaningful way.

So, why are U.S. stocks ignoring Europe and other economic or geopolitical risks? Well, on the one hand, there have been genuine improvements in the U.S. economy. Housing has bottomed and begun to rebound. Unemployment has dropped to a four-year low. Consumer sentiment is up. The country is working toward energy independence, and so forth. These are all good things, and they warrant a healthy stock market.

But more importantly, the Federal Reserve is distorting capital markets with its continued, massive quantitative easing. For weeks, politicians stoked fears about the $85 billion sequester and its potential impact on the economy. To put this into perspective, the Fed is injecting $85 billion of stimulus into capital markets every month via its purchase of Treasuries and mortgage-backed securities. Such stimulus has artificially kept interest rates low, spurring the economy.

However, what it's also done is make it impossible for investors to earn a return on investment without taking inappropriate risks. Therefore, investors large and small have increased their allocations to riskier asset classes, like stocks, to meet their return goals. In other words, the Fed's monetary stimulus has been a major tailwind for U.S. stocks. In the absence of this tailwind, stocks would be lower today. Quantitative easing has acted as a backstop for U.S. stock markets, dampening volatility and allowing for, even rewarding, the complacency we're witnessing now.

Not Fed Up Yet

At some point the Fed will need to end, or even reverse, its easy money policy, at which time stocks should correct and interest rates should start to rise. The hope is that that the Fed gets its timing right and applies the brakes only once the economy is healthy enough to absorb the higher capital costs that come with higher interest rates. The Fed has stated that quantitative easing will continue until unemployment is below 6.5%, so long as inflation does not exceed 2.5%. If history is any indication, however, the Fed will do a poor job of timing its exit strategy. After all, it was easy money in the 2000's that led to the housing bubble and poor Fed timing that caused it to pop.

With no specific end date to go by, investors have been left to fend for themselves in determining when interest rates might rise. For our part, we've been both opportunistic and proactive. After taking advantage of very successful high yield and convertible bond markets in 2012, which allowed us to outperform while still keeping portfolios relatively short-term, we've sold most of these assets. The bulk of our credit exposure in fixed income portfolios now resides in senior floating rate loans, which stand to fare better in a rising rate environment, and international bonds, which are less impacted by the Fed's policies. The average duration of client bond portfolios is less than three years, again a precaution against rising rates.

An American Phenomenon

Despite rising stock prices, and despite market complacency, investors don't necessarily have it easy today. Bonds return very little, and U.S. stock markets, by some measures, are fairly valued. This means investors must be discriminating when deciding where to park their money. Over the past five years, U.S. stocks, as measured by the S&P 500 Index, have risen a cumulative 26.8%. Foreign developed nation stocks, on the other hand, have declined a cumulative 7.2% over that time, as measured by the MSCI EAFE Index. Emerging market stocks have been flat at a cumulative 1.05% over five years.

This means U.S. stock returns have been a bit of a phenomenon. Over the long term, we don't view this sort of outperformance as being sustainable. Therefore, we continue to find foreign stocks attractive, especially relative to high-flying U.S. stocks. To that end, we've maintained our foreign stock allocations and in some instances increased them. At a time when American markets are expensive, foreign markets offer better long-term value.

Have a Wonderful Spring

Old Man Winter hasn't given up quite yet, but the days are longer and spring is right around the corner. Soon we'll all be in our gardens and flower beds, clearing out the dead leaves, laying down mulch, and planting things for the future. It's this sort of discipline we bring to bear on portfolios. Like gardening, investing can be a muddy process. But when done with thought and care, both can be rewarding.

We appreciate the confidence you place in us. From everyone here at Deighan Wealth Advisors, we wish you a happy spring!

Matthew T. Skaves, CFA
Chief Investment Officer

MAKING THE BEST OF LOW INTEREST RATES

"It was the best of times, it was the worst of times," reads the uneasy first line of Charles Dickens' classic novel, *A Tale of Two Cities*. Though things are vastly different now, this classic phrase nonetheless applies to the conundrum of today's historically low interest rates.

For some individuals, low interest rates are a Cinderella-like opportunity. Homebuyers, for example, have the chance to finance a fifteen year mortgage for less than 3%. For other individuals, however, low interest rates have been a burden. Savers, for instance, have had to jump through hoops to eke out gains of 1-2% or less. For many individuals, such as students and credit card customers, interest rates haven't dropped at all.

Clearly, for a lucky few, these are very good times. For many others, not so much. Fortunately, depending on your particular situation, there are things you can do to make the best of this bifurcated interest rate environment and improve your personal balance sheet.

First and foremost, if you own or plan to own a home, be sure to take full advantage of historically low mortgage rates. Even if you financed only a year ago, double-check that you've locked in the lowest mortgage rates possible on all of your real estate debt. Do a little research. Many banks are offering fifteen-year home mortgages under 3% with no points and low closing costs.

For example, lowering your mortgage rate from 3.5% to 2.8% on a $245,000 mortgage could save you $80 a month. Over fifteen years, this translates into $10,000 in savings. Better yet, if you can afford higher monthly payments, then you could shorten your mortgage term to ten years and save upwards of $34,000 over the life of the loan. This is serious money.

Of course, your particular outcome will depend heavily upon closing costs and the length of time you intend to own the property. Spend some time using an online financial calculator, like the one available at bankrate.com, to calculate how much refinancing might save you. One caveat: Don't provide your personal information to websites or else you will be plagued by inquiries from mortgage brokers. Alternatively, you could skip the web and work directly with local banks and credit unions.

As you explore your options, understand that spreads are thin and banks aren't making a lot of money on mortgages right now. You may have to negotiate heartily with your current mortgage holder to get refinanced. Be prepared, if necessary, to move your mortgage, but honor your current bank and let them know that you'll stay if they provide similar, competitive terms. It will pay off.

If you're a student, or if you have children nearing college age, be careful about taking on too much student debt right now. If it's not bad enough that higher education costs continue to rise, college loan rates remain high too. Currently, the best government-backed rate for student debt is 6.8%. For Parent PLUS loans the rate is 7.9%.

What to do? First, an ounce of prevention is worth a pound of cure. Start saving early with 529 Plans. For useful tips, see our Fourth Quarter 2011 edition of *Investment Quarterly*, available on our website. If college is near, then students and parents should look aggressively for scholarship opportunities, no matter how small. They can add up to seriously defray costs. See your school guidance counselor and look online at sites like mainecf.org and fastweb.com. Weigh the financial packages offered by accepting colleges, and, as hard as it might be, choose a college using your head, not your heart.

If you have a lot of high-interest student debt and you have available equity in your home or other real estate, then consult with your tax professional to determine whether swapping one for the other makes financial sense. Paying down student loan debt with a home equity loan could save a bundle.

SOUNDBYTES

In January, Matt Skaves traveled to Boston to attend the 2013 Schwab Investment Outlook. Jeremy Grantham, Chief Investment Strategist at GMO, was the keynote speaker.

In February, we sponsored Penobscot Theatre's production of *The Sugar Bean Sisters*, a Maine premier.

In March, Jenifer Wilson attended the Rotary District 7790 President Elect Training Seminar in St. Georges, Quebec in preparation for her upcoming year as President of the Bangor Rotary Club.

In March, we co-sponsored the Bangor Symphony Orchestra's production of Vivaldi's *Four Seasons*, featuring guest violinist, Lara St. John.

Just recently, Jenifer Wilson attended the Schwab Leadership Forum in Boston where she had a chance to share ideas with peers and Schwab's leadership team. She also learned about Schwab's strategic initiatives.

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MAKING THE BEST OF LOW INTEREST RATES Cont.

Lastly, most of us have some type of consumer debt unrelated to our homes or educations. Whether it's a car loan, a boat loan, or a credit card balance, be smart about consumer debt. Avoid carrying credit card balances beyond the 30 day grace period. Even in a low interest rate environment, credit card rates are anything but low. Try not to get sucked in by low introductory offers that promise 0% for six months; they often have fees and other tricks attached.

Credit card debt can mount up quickly, because interest rates are usually in the double digits. If you have credit card debt and you also have sufficient savings to pay it off, then by all means pay it off. There's no reason to be paying 15% on consumer debt while your savings sits in the bank paying you 0.15%. The only time this might not make sense is if your savings is your only emergency reserve and you're anticipating a change in employment.

These may be neither the best, nor the worst, of times, but they are interesting times indeed. Interest rates will normalize eventually, but in the meantime we offer these tips to help you make better financial decisions beyond just investing. As always, please call if you would like to discuss this topic further.

Jean M. Deighan, JD, CF®
Chief Executive Officer

INVESTMENT CHANGES

The following investment changes were made in the most recent quarter. Depending on your holdings and investment policy, these changes may or may not apply to you.

Removed
Fairholme Fund
Ticker: FAIRX

Fairholme Fund rebounded nicely in 2012, outperforming 99% of its large cap peers. We've been reducing exposure to this fund for some time now, and decided to make our final exit based on its recent strength.

Removed
Miller Convertible Fund
Ticker: MCFAX, MCIFX

Miller Convertible provided a boost to fixed income portfolios throughout 2012. We continue to like the manager, but have decided to eliminate convertible bond exposure from client portfolios at this time. Convertibles have bond and equity-like characteristics, making them more volatile than other bonds.

Removed
PIMCO High Yield Bond Fund
Ticker: PHYDX

This is another fund we continue to like, but it doesn't currently have a role in client portfolios. We have reduced high yield bond exposure after a stellar performance in 2012, preferring instead to hold floating rate loans.

Added
RidgeWorth Floating Rate Fund
Ticker: SAMBX

This is a best in class fund with low expenses for its category. Its investment style pairs nicely with our other floating rate fund, Oppenheimer Senior Floating Rate Fund (OOSAX).

Added
PIMCO All Asset Fund
Ticker: PASDX

PIMCO All Asset is a go-anywhere fund with the mandate of beating inflation plus 5%. Since the fund's inception, manager Rob Arnott has managed to beat this benchmark by 150bps. We are using the fund as an inflation hedge.

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