

# WASHINGTON CROSSING ADVISORS

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About Washington Crossing Advisors  
WCA strategies are offered through the Stifel Score Program (Research-Driven Portfolios). The management team has worked together for the past 20 years as market strategists and portfolio managers.

About Stifel  
Founded in 1890, Stifel is one of the leading financial services firms in the U.S., providing full-service brokerage and investment banking services. Stifel is a leading underwriter and advisor for companies and a top provider of trade execution and securities distribution with nationally recognized research and a suite of asset management strategies.

## TACTICAL ASSET ALLOCATION QUARTERLY

### Executive Summary

Growth is getting back on track for the U.S. economy after a surprising contraction in the first quarter. Economic growth, low volatility, and easy money still dominate the investing environment. Not surprisingly, valuations have grown more rich, tempering our expectations for returns from here.

### U.S. Economic Growth Resumes

All signs point toward continued growth at mid-year. The start to the year was rough to be sure, but most of the recent economic news appears positive. Monthly jobs data is better this quarter than last, demand for large and small consumer items remains steady, and manufacturing activity appears solid. We expect that generally weaker signals from overseas will improve as inventories are worked off.

Improving wealth is part of the reason the real economy is maintaining forward momentum. According to the Federal Reserve, the value of financial assets owned by U.S. households stands at a record \$67 trillion, compared with a low watermark of \$45 trillion during the last recession. Household real estate is now valued at \$23 trillion, compared with \$20 trillion, over the same period. Meanwhile, the total amount of household debt is essentially unchanged and outstanding mortgage debt continues to fall. Mortgage debt has fallen just about every quarter for the past 24 quarters — a key sign that balance sheet repair has not yet fully run its course.

We are mindful that good times cannot continue indefinitely and are watchful for areas where prospective returns might look unappealing. Spreads have tightened considerably in credit markets, merger and acquisition activity is robust, and central banks seem increasingly challenged by how best to foster an environment conducive to recovery without stoking new asset bubbles.

### Portfolio Posture

Portfolios are tilted toward equities in keeping with indications of economic performance (which are mostly positive). Recently, we added emerging markets back to the portfolio (13.3 times trailing earnings) and reduced small cap exposure (18x trailing earnings). Gold is being closely monitored for signs of improved stability in relative price performance, along with the rest of the commodity complex. Within fixed income, a shorter and higher credit quality tilt seems appropriate given tight spreads and expectations for eventual rate increases as the economy continues to mend.

# STIFEL

### Fixed Income

Interest rates remain exceptionally low. Rates available on short-term Treasuries remain near zero and market expectations for the timing of eventual rate increases continue to slip.

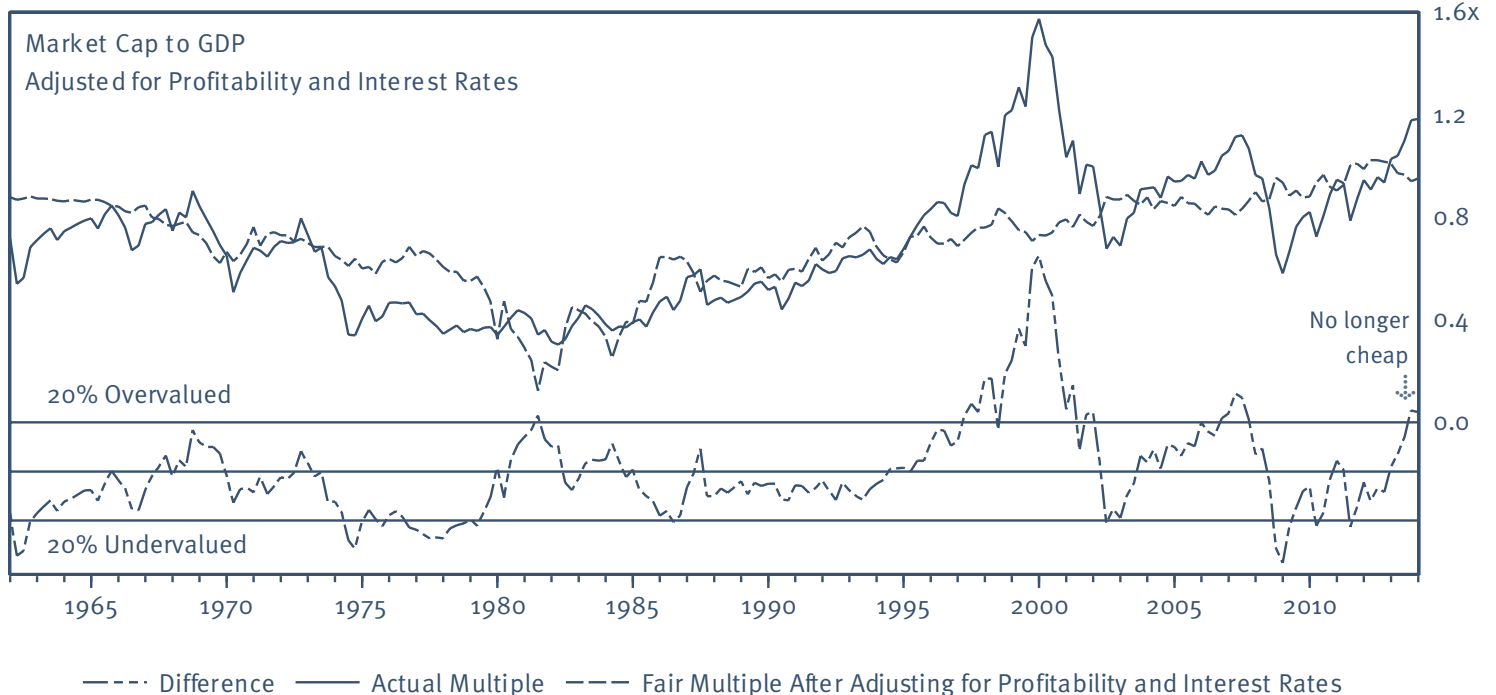
A year ago, it was thought that interest rates would be moving higher by now. Today, the market sees rates starting to move higher by the middle of next year. The fact that quantitative easing continues to be wound down, and that the Fed's own forecasts for interest rates are edging higher, support the idea that the era of the zero interest rate policy may be nearing an end.

Economic progress underpins rate expectations. We are five years into economic recovery and the unemployment rate appears likely to move down and through 6% within the next 12 months. At the same time, consumer prices are up about 2% in the past year, roughly in line with the Fed's stated target rate. Given these assumptions, we would expect short-term rates should be closer to 2-3%. Nonetheless, the U.S. economy is still operating below potential, which is encouraging the Fed to hold rates down longer than they likely would otherwise.

Looking farther afield from short-term, high-grade paper, investors will find higher yields out the Treasury curve. About 2.5% higher yield can be had buying a 10-year Treasury, but that yield is just slightly ahead of expected inflation. Historically, the 10-year gave investors a return about 2% *more* than the expected rate of inflation. We are underweight longer term bonds in portfolios.

Spreads on corporate bonds are not far from past cycle lows. The spread between the Moody's Baa Bond Index and Long-Term U.S. Treasury yields has narrowed to 1.4%. We saw spreads this tight during the mid-1990s and during the 2004-2005 economic expansion, but significant further tightening from these levels does not seem likely. We are tactically underweight long-term investment grade and high yield corporate debt in asset allocation portfolios.

Ultimately, the availability of low cost financing is a positive for real investment in the economy and economic growth. Equities, therefore, offer a potential alternative for long-run prospective returns under a recovery scenario.



## Equities

We are overweight stocks. There are two reasons for this. First, we continue to see the economy on a recovery path based on the data we regularly survey. Second, expected returns appear attractive compared with alternatives such as cash or bonds where yields are low compared to inflation and spreads are tight.

Some caution, however, is warranted. We have seen a significant revaluation in stock prices from the March 2009 low. While earnings improvement explains much of the move, we expect earnings growth to moderate from here. Multiples are no longer below historic averages, and underlying profit margins are already elevated. While multiples and margins can boost near-term performance, they are easily swayed by the economic winds and are the weak reeds of a bull case.

Fortunately, the more important engine of returns is plowing forward again. The U.S. economy continues to grow and is benefitting from improvements in technology and still-rising capital investment. The economy is today far bigger than it was 10 or 20 or 30 years ago, and stock values are moving along with that growth. The link between the economy and markets matters most over time because the relentless advance of the economy drives the profits that dictate stock prices.

Where do stock values stand in comparison to the economy? The official statistics put the U.S. economy at about \$18 trillion and the stock market is valued at roughly \$21 trillion. Corporate profits are nearly \$2 trillion. So we can say the U.S. stock market is worth about 1.2 times gross domestic product (GDP). This is far from the peak multiple of 1.6 times set back in 2000, but it is well above the 50-year average (0.7 times).

To be fair, however, the return on competing investment like bonds is low and profits are high. Certainly, there should be some recognition of this. The chart to the left shows the actual multiple of GDP compared with an "adjusted" multiple that takes into account today's higher profits and lower bond yields. As you can see, even after accounting for these factors, today's market multiple just isn't cheap (bottom portion of chart, left).

Return expectations from here need to be adjusted to accommodate the fact that starting valuations are currently higher than normal. We continue to pay close attention to changes in fundamentals and value. One subcategory where we still see value is Emerging Markets.

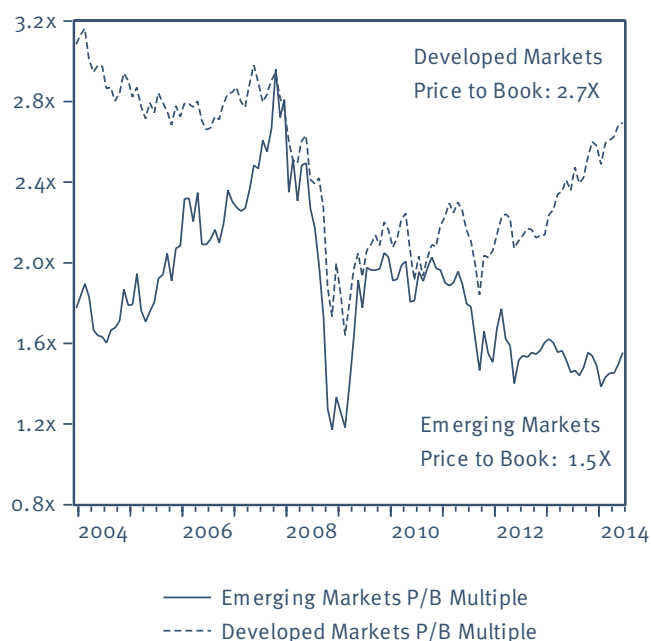
## Why Emerging Markets Now

We recently reintroduced Emerging Markets (EM) to portfolio allocations. EM now represents better value than developed markets (DM) on almost every measure we track. On a price-to-earnings basis, the MSCI Emerging Market Index carries a multiple of 13.3x versus DM at over 18x trailing earnings per share. On a price-to-book basis, multiples have moved lower for emerging markets and higher on developed markets as well (chart below).

After a period of slippage in growth relative to the developed world, we believe (based on our forecast of the WCA Foreign Conditions index) that foreign activity is set to stabilize and eventually improve. The three main reasons for re-entering emerging markets at this time are:

- Our view that emerging markets are one of the few market areas that offer some obvious value.
- The growth differential between EM and DM is narrowing — momentum is shifting in favor of EM.
- Weaker than previously expected growth in the U.S. may lead the Fed to a more dovish posture than would be the case otherwise (good for commodities and foreign currency).

Emerging Market Multiples are Relatively More Attractive After a Period of Underperformance



### FUNDAMENTAL CONDITIONS UPDATE

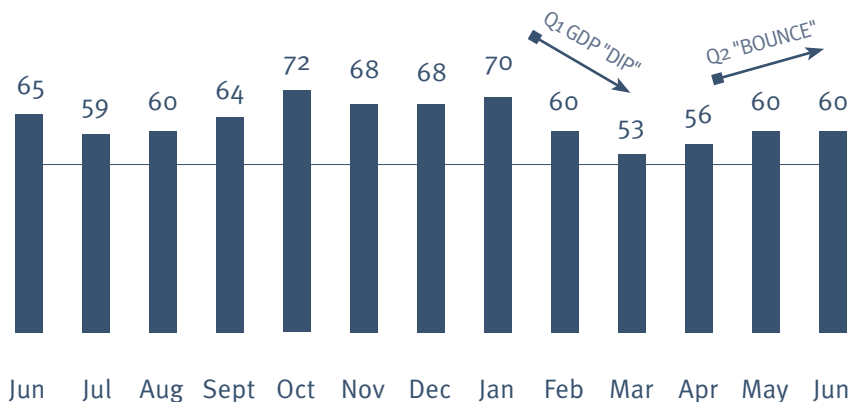
The second quarter showed a "bounce" in activity from the first quarter's "dip." The first quarter gross domestic product registered the first quarterly decline in three years during the first quarter. Steady final demand and the fading of weather effects and inventory drag are helping to right the ship. Foreign conditions are relatively weak, but we believe these trends are likely to reverse in the months ahead.

#### WCA Fundamental Trend Indicators

	Last Quarter	Most Recent	Change
Credit and Capital Markets	64	67	Higher
U.S. Economic Conditions	50	72	Higher
Foreign Conditions	45	39	Lower
Fundamental Conditions	53	59	Higher

#### WCA Fundamental Conditions Barometer

Rising /Above 50 = Lower recession odds



#### A Barometer for Assessing Changing Conditions

We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions.

Analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions.

From each category of data, we create 3 diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks); while readings below 50 would indicate potential deterioration (potentially favoring bonds).

The WCA Fundamental Conditions Index combines the 3 underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

LAST QUARTER PORTFOLIO CHANGES

	Conservative		Balanced		Moderate Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Bonds	Core Bonds	15%	10%		5%		0%	
	Floating Rate Securities	15%		10%		6%		0%
	Cash & 1-3 Year Treasuries	17%		10%		4%		5%
	Mortgage-Backed Bonds	11%		6%		0%		0%
	7-10 Year Treasuries	0%		0%		0%		0%
	10+ Year Treasuries	0%		0%		0%		0%
	Investment-Grade Corp Bonds	9%		7%		3%		0%
	High-Yield Corporate Bonds	3%		2%		2%		0%
	International Treasury Bonds	0%		0%		0%		0%
Equities and Other	Domestic Stocks	9%	18%		27%		29%	
	Large-Mid Cap Growth	3%		6%		9%		12%
	Large-Mid Cap Value	3%		6%		9%		12%
	Small Cap	5%	-2%	5%	-3%	5%	-5%	6%
	Developed Foreign Markets	5%		12%		18%		22%
	Emerging Foreign Markets	2%	+2%	3%	+3%	5%	+5%	5%
	Gold	0%		0%		0%		0%
	REITs	3%		5%		7%		9%
Subtotal Bonds & Cash	70%		45%		20%		5%	
Subtotal Equities & Other	30%		55%		80%		95%	
Total	100%		100%		100%		100%	

Second Quarter Changes:

Emerging markets offer better relative valuations. Allocation increased to neutral vs. underweight.

Domestic small-cap reduced to neutral on valuation.

Tactical Positioning

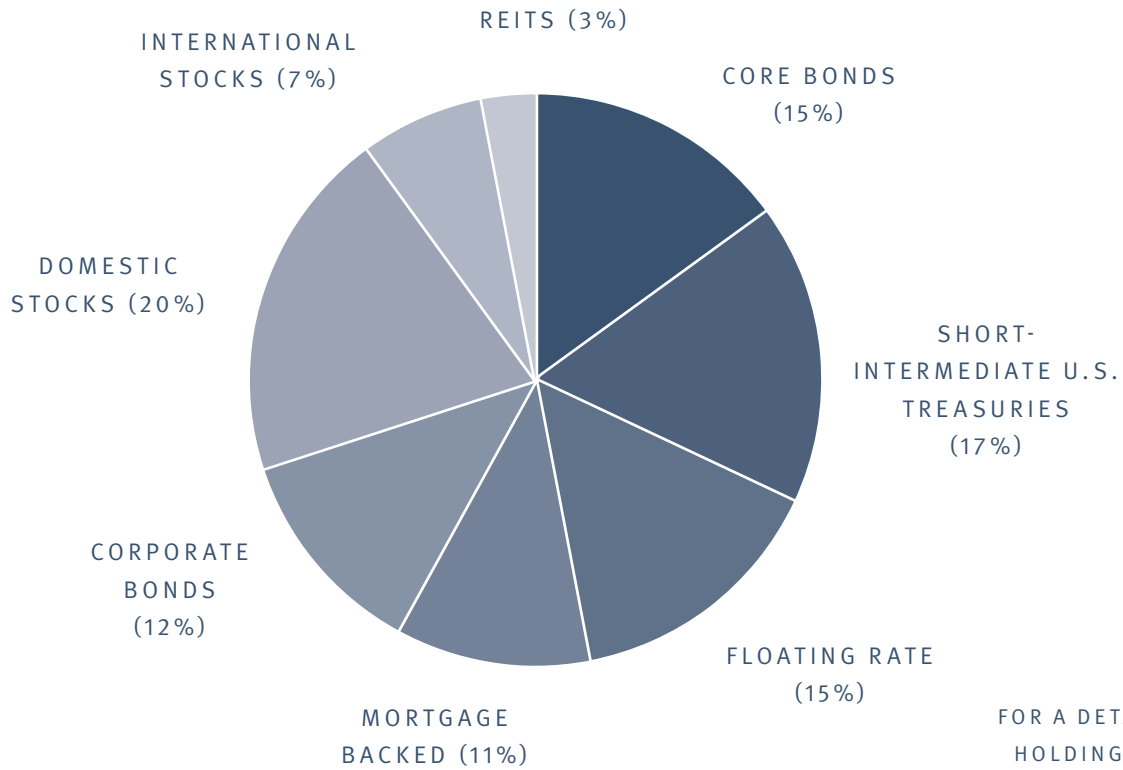
Modestly overweight equities on still-improving fundamentals.

Shorter bond duration given low real yields, positive inflation, and expectations for growth (portfolio tactical bond duration near 3.5 years vs. 5.9 year strategic target).

Underweight gold on unclear relative price trend, improved financial system confidence, and constrained inflation outlook.

## Conservative Portfolio

CONSERVATIVE PORTFOLIO  
EQUITY POLICY RANGE: 0-50%  
CURRENT EQUITY EXPOSURE: 30%

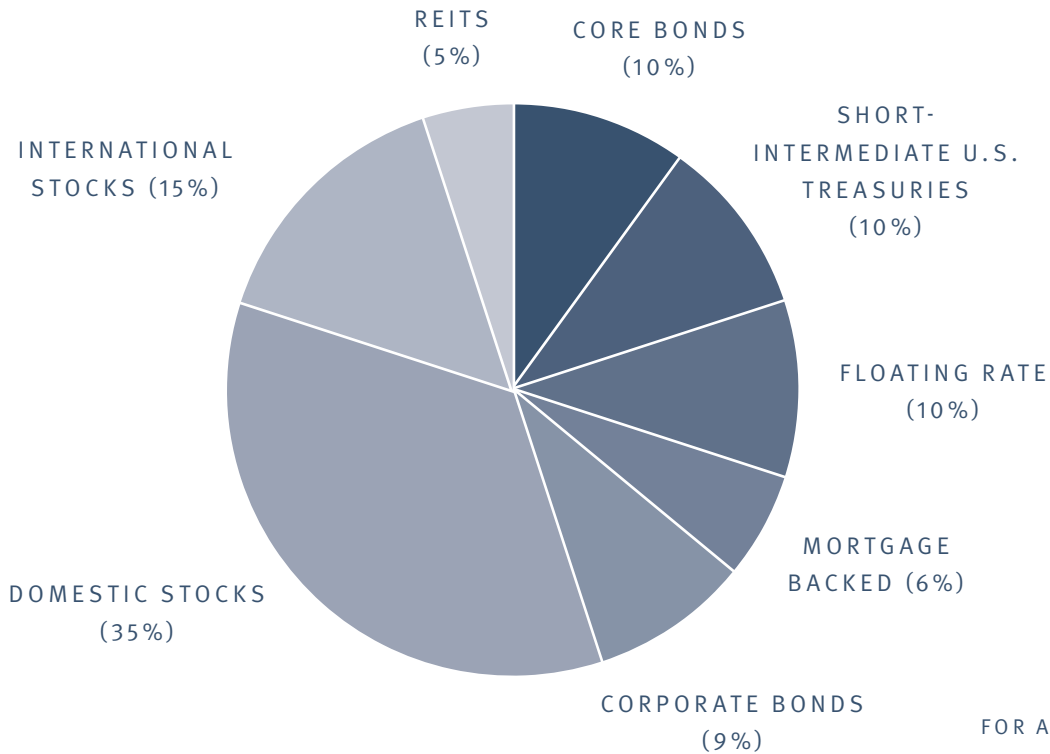


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

### Portfolio Description

The CONSERVATIVE PORTFOLIO invests between 0-50% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 25% stocks and 75% bonds. This portfolio offers the most conservative mix of stocks and bonds relative to the other portfolios mentioned herein. Investors with a short-to-medium investment horizon of at least 5 years or lower risk tolerance who desire modest growth may prefer this option over a portfolio with greater exposure to stocks.

BALANCED PORTFOLIO  
 EQUITY POLICY RANGE: 25-75%  
 CURRENT EQUITY EXPOSURE: 55%

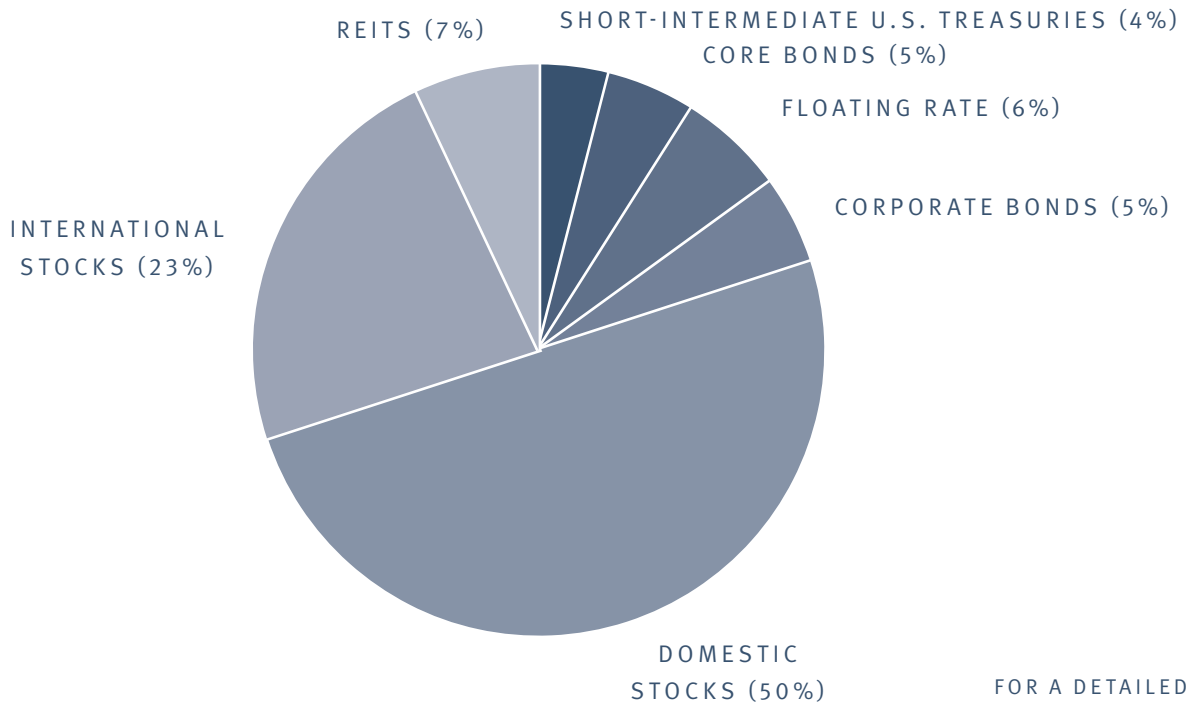


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

Portfolio Description

The BALANCED PORTFOLIO invests between 25-75% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 50% stocks and 50% bonds. The portfolio provides a mix of stocks and bonds without a bias toward either. It may be appropriate for investors with a time horizon of at least 10 years with a moderate risk tolerance.

MODERATE GROWTH PORTFOLIO  
EQUITY POLICY RANGE: 50-100%  
CURRENT EQUITY EXPOSURE: 80%



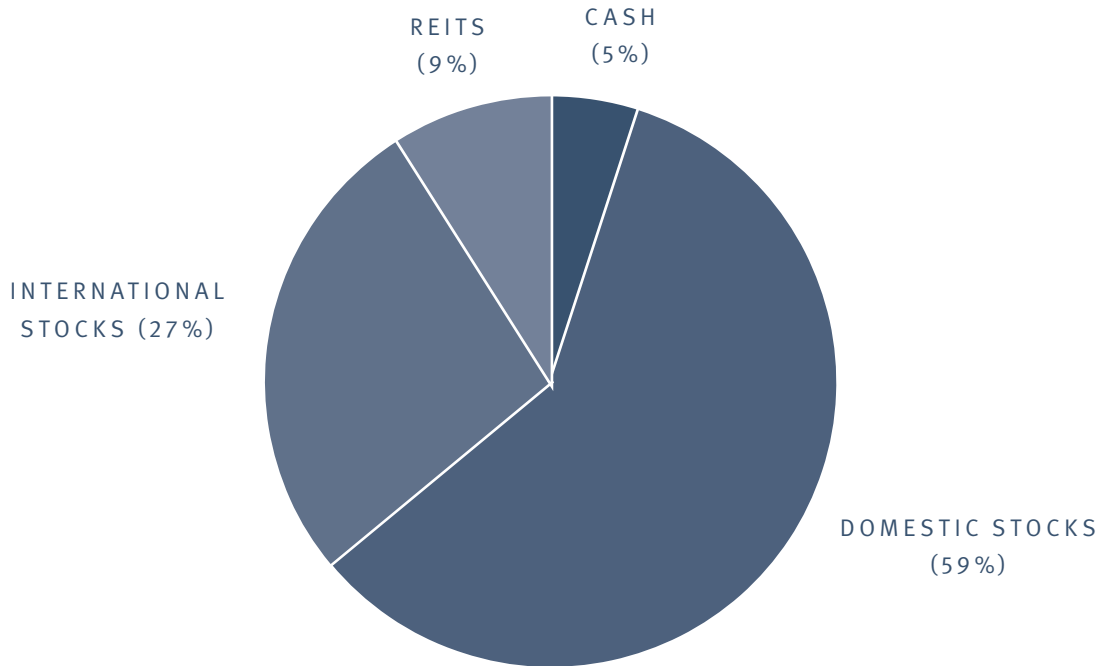
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### Portfolio Description

The MODERATE GROWTH portfolio invests between 50-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 75% stocks and 25% bonds. Because the portfolio invests primarily in stocks and secondarily in bonds, the portfolio may be appropriate for investors with a time horizon of at least 15 years or those who seek principal growth with a moderate amount of income.



AGGRESSIVE GROWTH PORTFOLIO  
 EQUITY POLICY RANGE: 80-100%  
 CURRENT EQUITY EXPOSURE: 95%



FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

### Portfolio Description

The AGGRESSIVE PORTFOLIO invests between 80-100% in equities based on fundamental market and economic conditions. The strategy seeks to provide a risk-adjusted return, over time, better than that of a fixed portfolio comprised of 90% stocks and 10% bonds. Because of the high degree of exposure to stocks, investors in this portfolio should have an investing time horizon of at least 20 years or be able to accept greater variability of returns associated with stock market investing.

# WASHINGTON CROSSING ADVISORS

## Forecasts and Assumptions

### FORECASTS AND ASSUMPTIONS: ECONOMY

	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Estimate)	2013 Growth	2014 Growth
Real Gross Domestic Product	15,052	15,471	15,761	16,077	1.9%	2.0%
Gross Domestic Product	15,534	16,245	16,800	17,390	3.4%	3.5%
Consumption	10,712	11,150	11,502	11,982	3.2%	4.2%
% GDP	69%	69%	69%	69%		
Investment	2,232	2,475	2,670	2,755	7.9%	3.2%
% GDP	14%	15%	16%	15.8%		
Government Spending	3,159	3,167	3,126	3,186	-1.3%	1.9%
% GDP	20%	19%	19%	18%		
Exports	2,101	2,196	2,260	2,332	2.9%	3.2%
% GDP	14%	14%	14%	13%		
Imports	(2,670)	(2,743)	(2,757)	(2,871)	0.5%	4.1%
% GDP	-17%	-17%	-17%	17%		
Government Deficit	(983)	(869)	(468)	(522)		
% GDP	-6%	-5%	-3%	-3%		
Total Private Saving	3,445	3,541	3,616	3,497	2.1%	-3.3%
% GDP	22%	22%	22%	20%		
Households & Institution	1,071	1,097	996	1,036	-9.3%	4.0%
% GDP	7%	7%	7%	6.0%		
Business Saving / Profits	2,374	2,444	2,505	2,461	2.5%	-1.7%
% GDP	15%	15%	15%	14%		
Employment (Nonfarm Payroll)	132,828	135,064	137,395	140,143	1.7%	2.0%
Employment (Private Sector)	110,882	113,176	115,541	117,852	2.1%	2.0%
S&P 500 Operating EPS	\$96.48	\$103.08	\$108.44	\$115.00	5.2%	6.0%
Inflation Index (GDP Deflator)	103.2	105.0	106.6	108.2	1.5%	1.5%

Historic data provided by Bureau of Economic Analysis (NIPA Tables 1.1.5 / 5.1) for GDP, Bureau of Labor Statistics for employment, and Standard & Poor's for S&P 500 earnings. Forecasts and assumptions provided by Washington Crossing Advisors. Government deficit includes Federal, State and Local.



## DEFINITIONS AND DISCLOSURES

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The MSCI EAFE Index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of emerging markets. The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately \$11 billion, and the median market capitalization is approximately \$3.5 billion. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 Index. The average market capitalization is approximately \$490 million, and the median market capitalization is approximately \$395 million. The Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values.

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.