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.

STIFEL

TACTICAL ASSET ALLOCATION QUARTERLY

Each quarter, we measure changes in fundamental factors that we believe may impact portfolio performance in the months ahead. We do this to square present-day realities with long-run forecasts, and to address some of the risk that usually accompanies recessions. Not to be confined only to playing defense, we also try to identify positive trends so that we may take advantage of improving growth. Whether bullish or bearish in our tactical viewpoint, we always strive to maintain a disciplined and objective view of circumstances while guiding the ship.

A Life's Journey

The full investment journey lasts a lifetime, but like life, decisions must be made a day at a time. Each investor's portfolio is built to carry them to an eventual destination, but like any journey, getting to that destination involves a series of waypoints. Our job is to help set these waypoints and guide the ship while keeping a weather eye on the ever-changing investing environment.

To do this, we continually ask ourselves two key questions: “Are fundamentals moving in a direction that suggests growth? Are assets priced reasonably compared to underlying fundamentals?” If the answer to these questions is “yes,” then we will look to be more opportunistic in markets. If the answer is “no,” then the decision will be to adopt a more cautious posture. Hence, we are engaged at all times in the management of portfolios and are willing to “trim the sails” as necessary based on incoming information. This tactical approach is the opposite of other approaches, which make no attempt to alter direction regardless of how the current fact pattern is evolving.

Today's Weather Report

Most of our navigational instruments are pointing toward continued growth, and stock valuations appear generally within reason. We continue to have some reservations about long-term bonds, though, given low yields and the likelihood that global monetary policy will tend to become less “easy” over time. We are also mindful that the foreign exchange value of the U.S. dollar is near multi-decade lows. In the pages that follow, we will discuss each of the sub-asset groups in turn and highlight our rationale for holding each in portfolios today.

Portfolio Posture

Equity exposure is slightly above “neutral” given modest growth, and bond exposure is slightly below long-run targets given low and rising yields. Gold remains sidelined given lack of positive momentum and in light of stable inflation expectations.

The Way It Is

It is easy to become distracted by headlines, which makes it all the more important to have a objective view of facts. So while Syria, budget negotiations, and the Fed all are important, the reality is that they are only relevant from an investment decision point of view in terms of how they impact the fundamentals of markets and the economy.

Our View of Domestic Trends

Stocks are still performing better than bonds, indicating that confidence is increasing. Yields on the long end of the Treasury curve are much higher than short-term rates, suggesting anticipated growth and some inflation. Indicators of risk within the financial system are relatively low and declining, indicating that confidence in banks is rising. Analysts' forecasts for earnings continue to rise, implying that the perceived underlying value of most businesses is also rising. Overall, most leading economic indicators we follow are still pointing toward continued growth.

We believe, therefore, that the economy is still expanding and that recession odds are relatively low in the months ahead. There is general acceptance of the slow growth scenario among strategists, economists, and analysts. The 2% growth consensus forecast also seems about right to us but still denotes progress, in our book.

If we were headed back into recession, we would expect to see a smaller percentage of the population employed (we are not); automobile sales declining (we are not); orders rates contracting (we are not); and consumption falling (we are not). At best, we can confirm that the economy is continuing along a recovery path even if the slow pace of recovery means quite a bit of slack still remains. For now, the direction still appears positive.

A Pickup Overseas

So far this year, growth outside the United States has been poor. Emerging markets (EM) have been particularly hard hit as selling prices for many companies have come down, and as wage pressures have increased. More generally, these economies are again proving to be highly sensitive to our own credit cycle. The threat of an end to quantitative easing introduced additional pressures and increased risks relating to EM currencies this year. The fact that the Fed has delayed the tapering of asset purchases has provided some near-term relief.

Elsewhere, the last couple of months have brought an improved tone in terms of the data flow from places like Europe, Japan, and China. Collectively, these regions have reported a slight pickup in production, which suggests that output in these areas may finally be bottoming out while valuations in those equity markets look relatively more attractive. This sets up the potential for some near-term better performance, in our view.

At What Price?

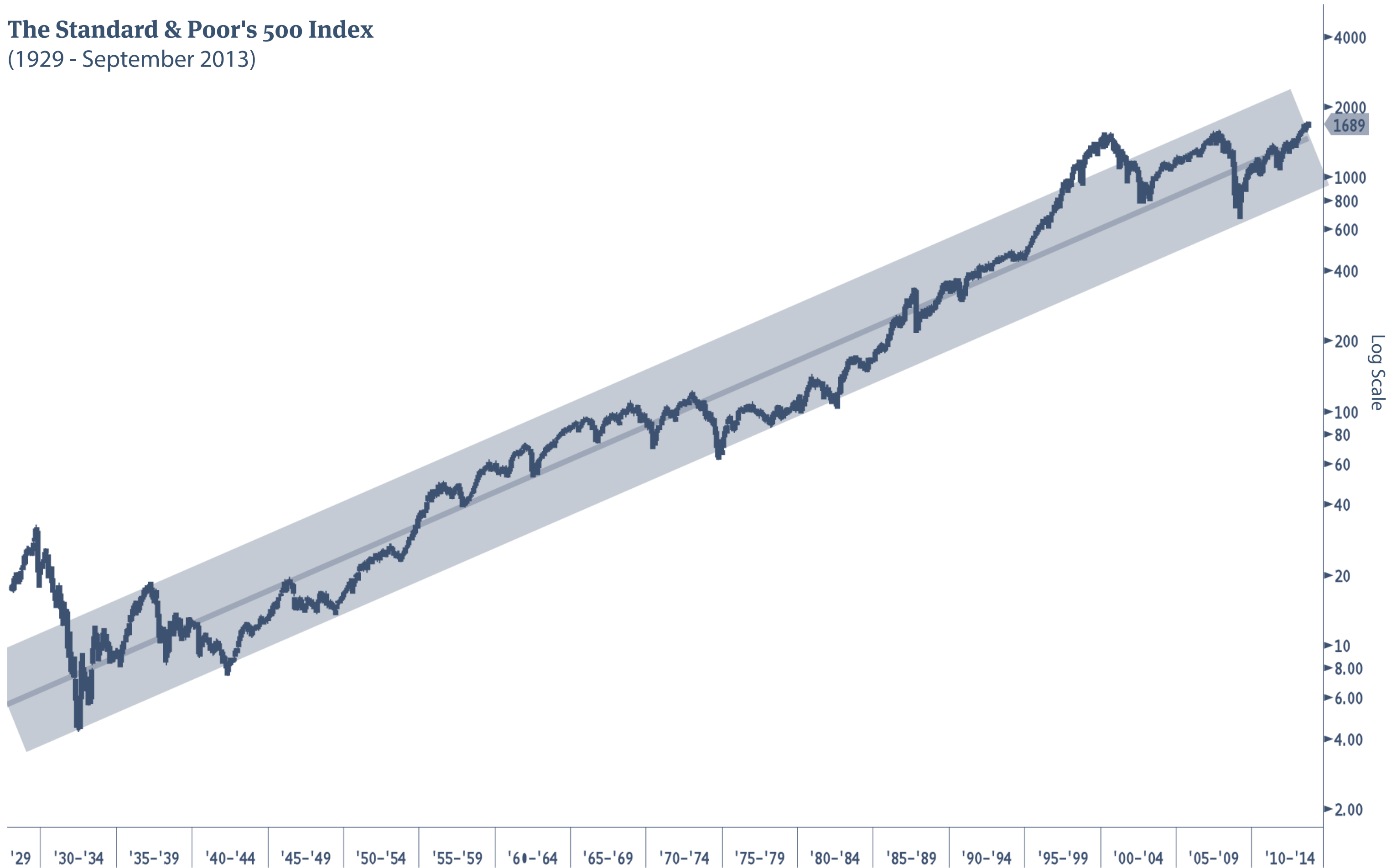
With the “slow growth” case still the lead contender over the “recession case,” we are reminded that price is also important. Just what price would be too high for comfort when thinking about the stock market? We think that a level of 1,800-1,850 on the S&P 500 would warrant caution, as it would imply a market that has moved too fast given underlying fundamentals. With the S&P 500 trading below 1,700, we are not overly concerned about excessive valuation given underlying earnings power.

Speaking of earnings, we expect only modest growth from here given already high profit margins and slow sales growth. In light of these facts, we are basing our valuation of the S&P 500 on $112 in 2014 earnings (below concesnsus of $122). Using a multiple range of 13 to 16.6 times forward earnings[1], we estimate a “fair value” range for the S&P 500 of roughly 1,460 to 1,860. The midpoint of that range is 1,660, near where the market is trading today.

We are, therefore, hard pressed to make the case that the market is priced at an exceptionally high level. We are nowhere near the lofty multiples of just over a decade ago when the S&P 500 routinely traded near 30 times earnings against a background of rising interest rates. So long as the growth case supports our earnings outlook, we have no justification based on earnings multiples to raise or lower equity exposure.

From a broader long-term trend perspective, we see that the S&P 500 is trading not far above the midrange of the historic trendline (chart, next page). While periods of overvaluation can be seen clearly in the boom years of the 1920s and 1990s, and depressed valuations can be seen in the 1930s, 1940s, 1970s, and in 2008-2009, today's levels appear to be far from past extremes of over-pessimism and over-optimism.

[1] Average yearly range of forward diluted EPS multiples (1967-2012); Data: Standard & Poor's Analyst Handbook



Conclusion

Are fundamentals moving in a direction that suggests growth?

In our view, the answer is "Yes." Most of the data we monitor is still pointing toward growth. It is true that growth is slower than in past recoveries. There is nothing new or interesting in recognizing that fact. We are living in the post debt-bubble era, where U.S. households are still in the process of repairing their balance sheets. Governments are also cutting deficits, which is also weighing on growth.

On the other hand, investment is increasing as a percent of GDP, and our trade deficit is falling, which is helping growth. The lessening of consumer debts, the increase in household cash balances, and the return of household wealth to pre-crisis levels are all positives. These improvements are the result of a painful, reparative process that creates some drag today, but paves the way for greater stability and growth down the road.

Washington will continue to argue about the deficit, but the real arguments are less about whether to add or cut debt and more about what programs get funded and which do not. Ultimately, the debt ceiling will be increased, since the full faith and credit of the United States depends on it.

We are not overly concerned about valuations. We see the market as slightly ahead of fair value, but not excessively so. Thus, when we ask if stocks are fairly priced relative to underlying fundamentals, we must answer, "Yes."

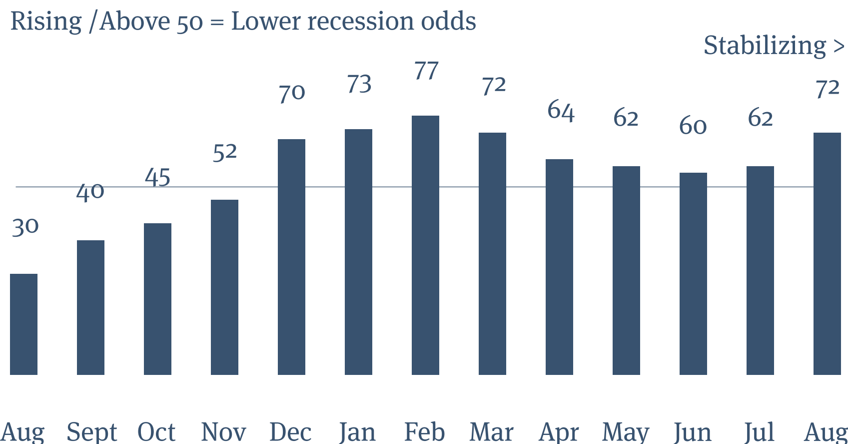
FUNDAMENTAL CONDITIONS UPDATE

The WCA Fundamental Conditions Barometer (below) slipped from elevated levels earlier this year and through the spring and summer months. The Federal Reserve's recently lowered growth estimates for 2013 highlight that process of slowdown. However, we see recent stability in the index, which gives us cause to believe that fundamentals may pick up from here.

WCA Fundamental Trend Indicators

	Last Quarter	Current (Preliminary)	Change
Credit and Capital Markets	65	50	Lower
U.S. Economic Conditions	55	72	Higher
Foreign Conditions	60	85	Higher
Fundamental Conditions	60	72	Higher

WCA Fundamental Conditions Barometer



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 to 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.

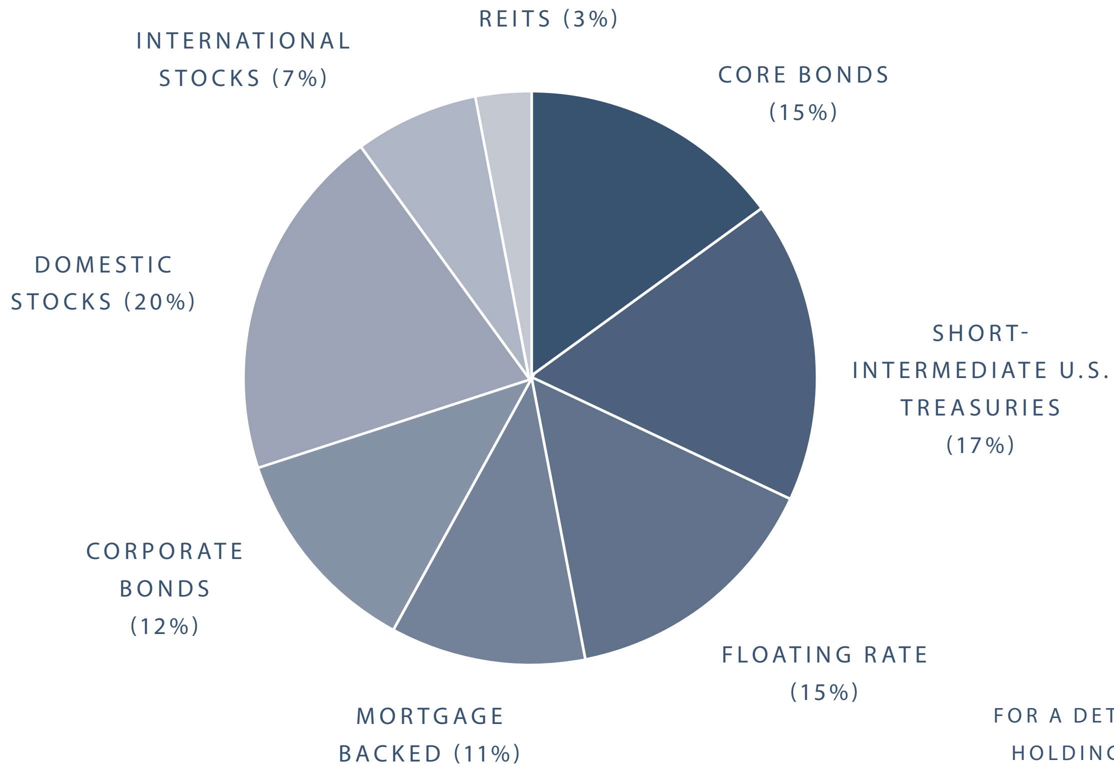
LAST QUARTER PORTFOLIO CHANGES

	Conservative		Balanced		Moderate Growth		Aggressive Growth	
	Current	Change	Current	Change	Current	Change	Current	Change
Core Bonds	15%		10%		5%		0%	
Floating Rate Securities	16%		10%		6%	+2%	0%	
Cash & 1-3 Year Treasuries	16%	+6%	10%		4%	+1%	5%	-5%
Mortgage-Backed Bonds	11%	-5%	6%	-5%	0%	-6%	0%	
7-10 Year Treasuries	0%	-6%	12%		0%	-2%	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%	
Domestic Stocks	7%	+2%	15%		22%	+7%	24%	+9%
Large-Mid Cap Growth	3%		6%		9%		12%	
Large-Mid Cap Value	3%		6%		9%		12%	
Small Cap	7%	+5%	8%	+5%	10%	+5%	11%	+5%
Developed Foreign Markets	5%		12%		18%		22%	
Emerging Foreign Markets	2%		3%		5%		5%	
Gold	0%	-2%	0%		0%	-7%	0%	-9%
REITs	3%		5%		7%		9%	
Subtotal Bonds & Cash	70%	-5%	45%	-5%	20%	-5%	5%	-5%
Subtotal Equities & Other	30%	+5%	55%	+5%	80%	+5%	95%	+5%
Total	100%	0%	100%	0%	100%	0%	100%	0%

We took a small step forward by adding smaller capitalization stocks to the mix. With our barometer showing some encouraging signs of stability, we are expecting continued growth over the next few quarters, at least. We are also mindful that a return to normal government deficit levels, and the potential for a return to normal investment levels, implies that growth should pick up toward the later part of 2014. At the same time, with the delay in Fed tapering and the selection of Janet Yellen as "heir apparent" to chair the Fed, the table seems also to be set for a continued highly accommodative monetary policy.

Early in the quarter, we added to our all-cap U.S. equity position and reduced gold (weak relative performance and early signs of stabilization in our barometer). Additionally, we further boosted our focus on domestic equities through an increase in small caps late in the quarter. These stocks tend to have an advantage over multinationals when the domestic economy is providing cyclical leadership, and the dollar is relatively strong.

Conservative Portfolio

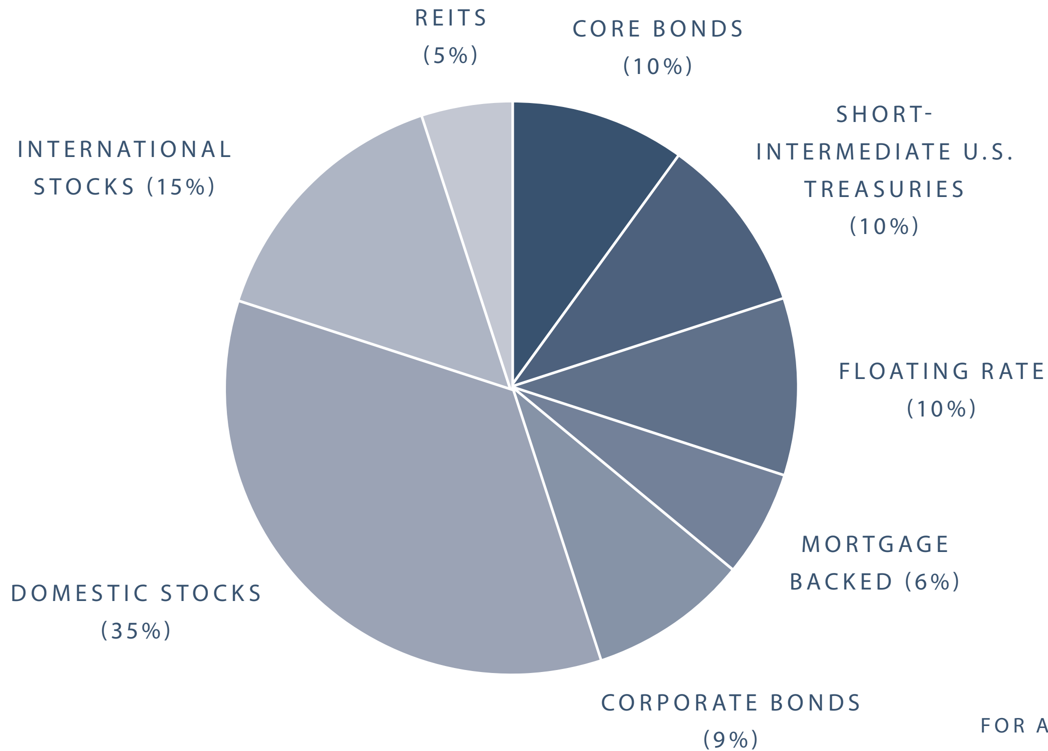


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

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%



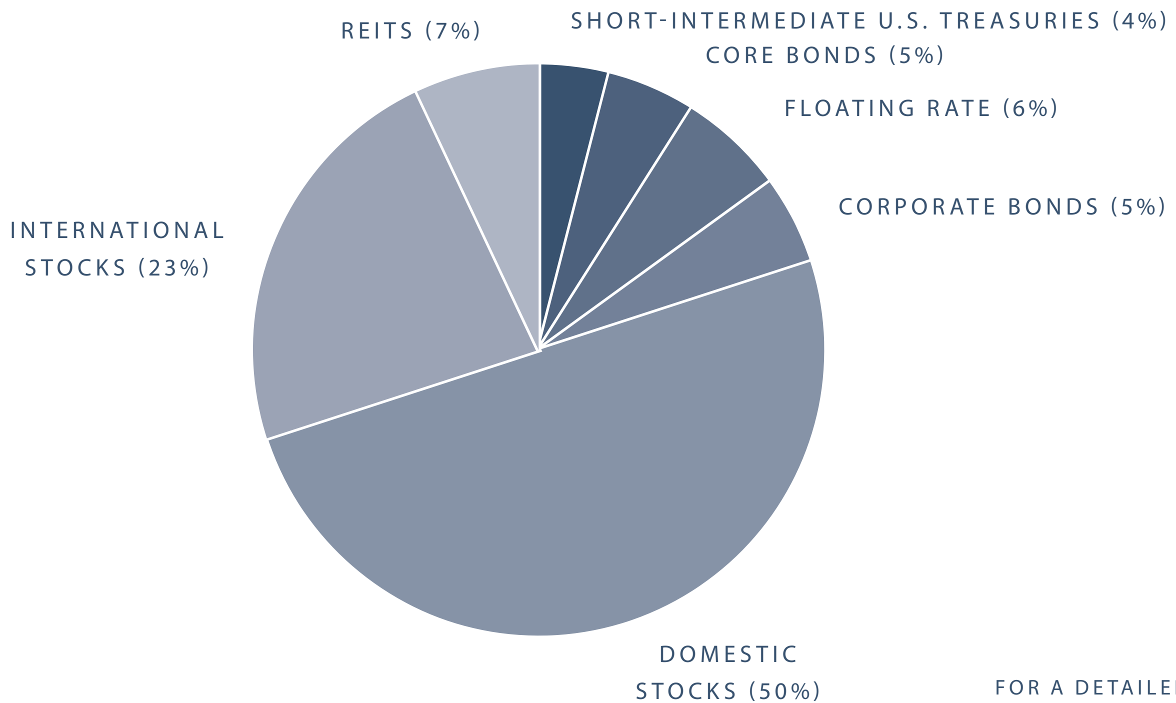
FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

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

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

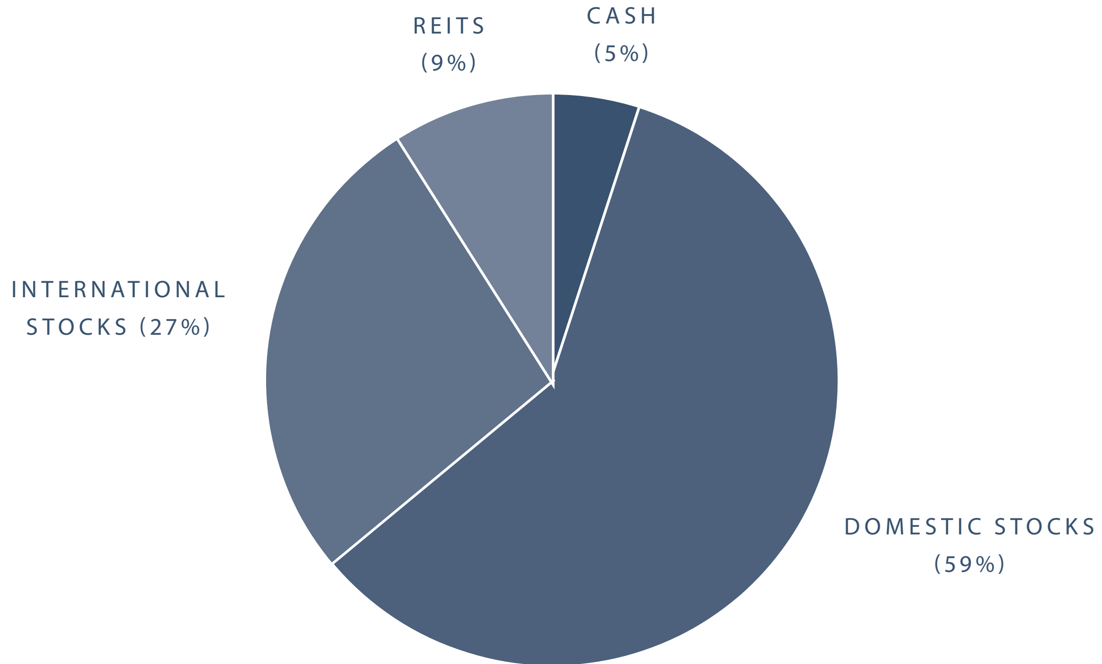


FOR A DETAILED LIST OF HOLDINGS, INCLUDING SUB-ASSET CLASSES, SEE PAGE 5

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.

FORECASTS AND ASSUMPTIONS: ECONOMY

	2011 (Actual)	2012 (Actual)	2013 (Estimate)	2014 (Estimate)	2013 Growth	2014 Growth
Real Gross Domestic Product	13,299	13,593	15,811	16,270	2.2%	2.9%
Gross Domestic Product	15,076	15,685	16,862	17,621	3.8%	4.5%
Consumption	10,729	11,120	11,578	12,096	3.8%	4.5%
% GDP	71%	71%	69%	69%		
Investment	1,855	2,062	2,690	2,939	8.7%	9.3%
% GDP	12%	13%	16%	17%		
Government Spending	3,060	3,063	3,153	3,150	-0.5%	-0.1%
% GDP	20%	20%	19%	18%		
Exports	2,094	2,184	2,359	2,534	7.4%	7.4%
% GDP	14%	14%	14%	14%		
Imports	(2,662)	(2,744)	(2,918)	(3,099)	6.4%	6.2%
% GDP	-18%	-17%	-17%	-18%		
Government Deficit	(1,542)	(1,358)	(1,332)	(1,145)	-11.6%	-14.0%
% GDP	-10%	-9%	-8%	-7%		
Government Revenue	(1,518)	(1,705)	(1,820)	(2,005)	9.7%	10.1%
% GDP	-10%	-11%	-11%	-11%		
Private Saving	2,828	2,840	3,630	3,739	2.5%	3.0%
% GDP	19%	18%	22%	21%		
Households & Institution	791	780	1,116	1,143	1.7%	2.5%
% GDP	5%	5%	7%	6%		
Business Profits	2,036	2,060	2,514	2,596	2.9%	3.2%
% GDP	14%	13%	14.9%	14.7%		
Employment (Nonfarm Payroll)	132,498	134,691	136,442	138,761	1.3%	1.7%
Employment (Private Sector)	110,548	112,817	114,509	117,372	1.5%	2.5%
S&P 500 EPS	$96.26	$100.73	$105.77	$112.11	5.0%	6.0%
Inflation Index (GDP Deflator)	103	105	107	108	1.6%	1.6%

Bureau of Economic Analysis NIPA Tables 1.1.5 / 5.1

NOTES

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 information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, and you cannot invest directly in an index.

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.