TFC Financial Management

October 16, 2013

INVESTMENT LETTER - THIRD QUARTER, 2013

A View from the Vineyards in Bordeaux (as reported by Jim Joslin)

Sometimes to gain perspective, it's best to get out of town, remove oneself from the psycho-babble on CNBC, read material not normally required, and attempt to reframe the big picture.

Recently, while touring a small 12-hectare, tenth-generation, privately-owned Grand Cru Classé vineyard in Saint-Émilion, one was struck by how in our era of nanosecond, algorithmic trading, for others the *long-term* is a vastly different context. Today, paying a 6-figure, sometimes 7-figure, Euro sum per hectare (100 meters X 100 meters) for prime vineyard land, to say the least, implies a long view rate-of-return expectation. But, at 105 euros per bottle at retail, perhaps the payback is closer than might be suspected.

It is harvest time here in Saint-Émilion, so all able-bodied members of the owner's family no matter where they live, have returned to hand-pick this year's growth. Even in France some semblance of entrepreneurship survives. But concern about what goes on elsewhere in the globe seems minimal.

The Impasse in DC (Just Another Disturbing Geopolitical Saga or Harbinger of Our Mobile Interconnected World)

Here, across the Atlantic, the political stand-off in Washington rates front-page headlines, but below-the-fold importance. For us, the stand-off seems all-consuming; for the media in Europe it is merely another indication that the U.S. is losing ground as it declines from its perch as a one-time superpower. The fact that a single group can stall an elected government on a matter of principal seems a puzzlement; after all, isn't politics supposed to be the art of compromise?

But something else may be operating behind the curtain. A trend only just beginning to emerge in today's internet, interconnected environment. Due to the 2008-2009 financial market meltdown, for investors, in many ways private risk has been replaced by government risk. This, by implication, pits large institutions against smaller constituencies, states against the Federal government in the U.S., special interest groups and the individual vs. BIG whatever. In these new circumstances SMALL can organize across heretofore tightly defined, but now expanded, boundaries. A kind of organized anarchy can arise. BIG could become stymied by SMALL.

So the farcical stand-off in Washington, the unruly "Occupation" movements, the recall votes and rallies in Madison, etc., are probably all symptomatic of marshalling efforts of the future in the battle between SMALL and BIG using the mobile information technology as a call to arms. For a more detailed discussion of this, see Nicco Mele's book, *The End of Big: How the Internet Makes David the New Goliath*. In it he coins the phrase "radical connectivity" which would seem to convey how the internet is undermining the power of large institutions.

Possibly, this is a preview of coming attractions. Tim Meckel's impressions (below) gained during his few days in Germany provides some insight into Merkel's post-election challenges.

Musings from the Tent (as reported by Tim Meckel)

As Chief Compliance Officer, I must add the following disclaimer: Many of the musings from the tent were ascertained over the course of a three-day visit to Munich last week. As such, the euphoric nature of the comments may need to be dampened to a certain degree. Even so, it was very interesting to get a "first-hand" glimpse into the European environment post the Angela Merkel re-election.

Merkel's re-election to a third term is generally being viewed as a good thing across many borders in Europe. She will not only attempt to create a coalition between her party and the Social Democrats (Sozialdemokratische Partei Deutschlands or SPD) and possibly the Greens (environmentalist political party) as well, but will continue to build support for a more unified approach to increasing the speed of the recovery in Europe as a whole. Economic conditions seem to be improving as evidenced by a topping out of unemployment rates even in Spain.

Unlike here in the U.S., one of the main drivers of the improving economic conditions has been the return of the consumer. After declining for nearly 24 months consecutively, Consumer Confidence has improved markedly this past quarter. Following a similar trend, Retail Sales ended a two year freefall by posting positive year over year growth in three out of the last four months. Additionally, infrastructure projects will be a large contributor to employment over the next decade. While the useful life of most nuclear power plants is approximately 15-20 years, projects are already underway for massive investments in renewable power. Most of the renewable energy exists in Northern Europe while a large percentage of demand resides in the South. Consequently, a major upgrade of transmission lines and Europe-wide grid is mandatory. These projects are just in their infancy and, as one would expect, require billions of euro in investment.

U.S. politics continue to bemuse most Europeans and, as such, they view this latest incident as just another installment of Groundhog Day. Throughout the Eurozone crisis, TFC has held a mild underweight to European equities out of an abundance of caution. Based on both qualitative and quantitative measures, we feel that it may now be time to revert back to a more normal weighting in these markets.

TFC's Portfolio Strategy:

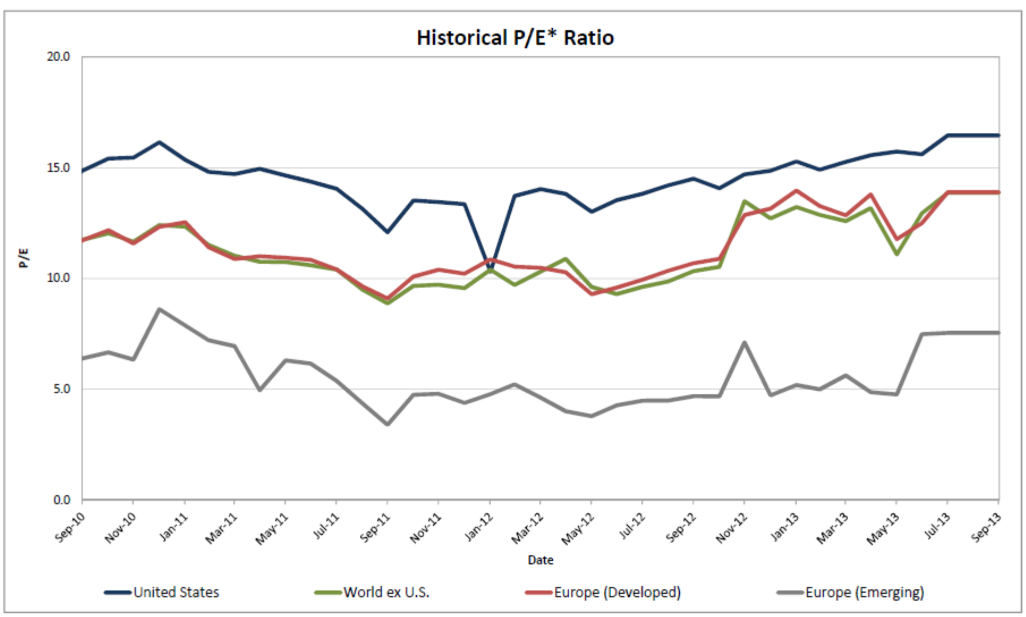
Equities

Initial impressions of our on-the-ground "research" efforts in Europe suggest many countries/economies within the Eurozone share reasons to be optimistic. Admittedly, anecdotal evidence collected over a visit to Germany or a tour of French vineyards hardly constitutes an actionable investment thesis. However, for those of us situated on this side of the pond who choose to ignore the plethora of negative headlines or the latest television tease, and instead focus on the economic and political reality, corroborating evidence of real fiscal reform and a burgeoning recovery in Europe does exist.

The prospect of economic improvement and the ensuing corporate earnings growth which typically leads to positive stock market returns, represents only half of the valuation equation--the denominator in a price/earnings (P/E) ratio. The dollar value investors must pay for this potential earnings growth, or the numerator in a P/E ratio, has historically proven to be more predictive of future investor returns, and thus garners much of our attention. For this very reason our investment approach focuses significantly on asset class pricing, which ultimately drives the typical value bias within your TFC managed portfolios.

Since the end of the 3rd quarter of 2009, the S&P 500 Index (a proxy for U.S. large capitalization stocks) has gained 14.7% on an annualized basis. Over that same four-year period developed European stocks returned 7.1%, while emerging European stocks returned 3.9%, significantly underperforming the S&P 500 by 7.6% and 10.7%, respectively.

As illustrated below, the severity of this underperformance has created substantial valuation gaps. U.S. stocks now trade at 16.5x twelve-month consensus earnings estimates, while developed European stocks trade at 13.5x and emerging European stocks trade at 7.5x, both meaningful discounts to the U.S.. Given our prognosis of Europe discussed above and the relative discount to the U.S. at which European stocks now trade, shifting assets out of the U.S. into Europe seems prudent. Over the coming weeks we will finalize our due diligence efforts and reallocate approximately 3-5% of your equity portfolio into a fund focused strictly on investing in European stocks.



* Earnings = twelve-month forward earnings estimates
Source: Standard and Poors/Citigroup

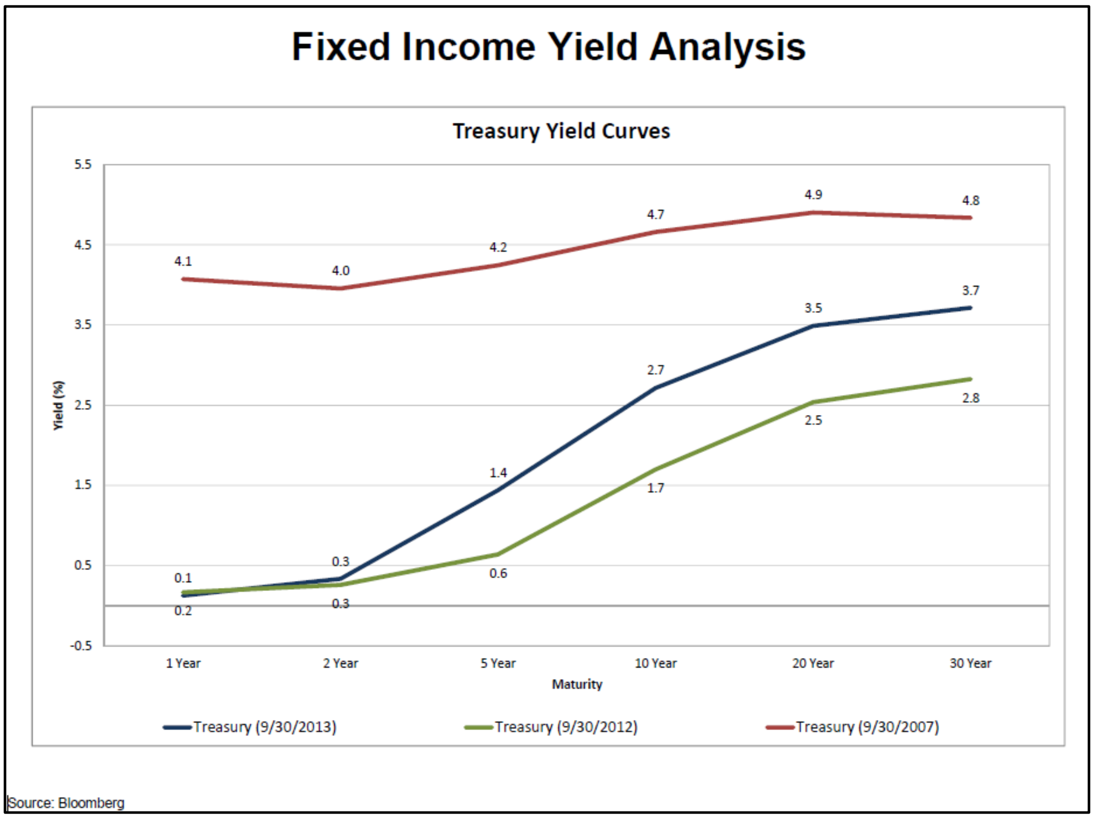
Fixed Income

Meanwhile, on the fixed income side . . . "Don't fight the Fed" plays on. Following the September 17-18 Federal Open Market Committee (FOMC) meeting, Ben Bernanke and the Fed's surprising decision not to pare back Quantitative Easing or announce a time frame of when they would begin to reduce their

$85B monthly bond-buying program gave a quick boost to bond markets. The 10-year Treasury yield has since dropped back to 2.6% after rising to 2.9% in early September.

However, the Fed has simply delayed tapering awaiting further positive and reinforcing data on the U.S. economy, particularly on employment and housing. If and when the U.S. and other key global economies strengthen further, as we and our economic research sources expect, rather than weaken, there will be upward pressure on interest rates beyond the Fed's market support.

The graph below illustrates the U.S. Treasury yield curve for three time periods: 09/30/13, 09/30/12 and 09/30/07, before the financial crisis. Clearly, current yields are a long way from normalization, but the secular transition towards higher rates has begun.



Since May 2013, when Ben Bernanke commented on the possibility of reducing the Fed's bond purchases (QE3) before year end, yields have increased and bond prices have dropped, with the longest duration bonds reflecting the largest declines. From May 2, 2013 to September 30, 2013:

- -21% for Vanguard Extended Duration Treasury Index I Fund (VEDTX) with an average duration of 26 years
- -12% for the iShares Core Long Term U.S. Bond ETF with an average duration of 13 years
- -7% for the iShares TIPS ETF with an average duration of 8 years. (TFC sold clients' TIPS fund holdings in May.)
- -3% for the iShares Core Total U.S. Bond Market ETF (Barclays Aggregate Bond Index) with an average duration of 5 years
- -1% for the iShares Core Short Term U.S. Bond Market ETF with an average duration of 2.6 years.

We believe our short term (3-year average duration), diversified, high-quality positioning in global developed market sovereign debt, high quality corporate and tax-exempt bonds will best insulate fixed income portfolios from much of the continued volatility and uncertainty in U.S. bond markets. Net outflows from bond mutual funds, intermediate and long term funds in particular, have totaled over $81B since April.

As always, we welcome your comments and questions.

Sincerely,

Jim

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