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Maryland Capital Advisors

INVESTMENT COMMENT **April 8, 2013**

1st Quarter Review and Strategy Update

1st Quarter global capital markets performance was led by strong returns from US Risk investments. This followed the 4th Quarter where US returns lagged International Developed and Emerging Markets (see Table 1). *Overall global Risk investments generated +6.6% this quarter versus +3.1% the previous quarter (MSCI All-Country World Index).*

Most recently, markets have been focused on implications of the latest iteration of Europe's financial crisis – this time in Cyprus. To-date, European policymakers have taken a reactionary, piecemeal approach to the Financial Crisis and the Cyprus response was no exception. On March 28th, Cypriot banks reopened following a restructuring that included: (1) an involuntary conversion of 60% of deposit account balances over €100,000 into bank capital (expected to be largely written-off), (2) "temporary" limits on withdrawals and transfers-out of Euros from Cyprus. While there are unique aspects[1] to the Cypriot bank crisis, investors have wondered: "Are bank depositors in other European countries at risk of loss?", "Is the imposition of controls on Cypriot Euros a first-step in the break-down of monetary union in the Eurozone?"

Table 1: Selected Asset Classes March 29, 2013	**4th Quarter**	**1st Quarter**
SELECTED RISK ASSET CLASS SEGMENTS		
US Large Cap	+0.3%	**+10.7%**
US Large Cap Value	+1.6%	**+12.0%**
US Small Cap	+1.9%	**+12.3%**
US Small Cap Value	+3.2%	**+11.4%**
International Large Cap	**+8.4%**	+3.7%
Emerging Markets	**+8.0%**	-3.5%
International Real Estate	**+9.5%**	+4.4%
US Real Estate Investment Trusts	+1.7%	**+8.4%**
SELECTED LOW RISK ASSET CLASS SEGMENTS		
US Treasury 1-3yr Notes	+0.0%	+0.1%
US Treasury 7-10yr Notes	-0.4%	+0.1%
US Treasury 20-30yr Bonds	-1.6%	**-2.4%**
US Treasury Inflation-Protected	+0.6%	-0.3%
Inv Grade Short Duration	+0.5%	+0.4%
Inv Grade Intermediate Duration	+0.9%	+0.3%
Inv Grade Long Duration	+0.6%	-0.7%
Mortgage-Backed Securities	-0.4%	+0.1%
International Bonds (Non-Dollar)	-0.0%	**-3.3%**
EQUITY INDICES		
MSCI All-Country World Index	+3.1%	**+6.6%**
S&P 500 Index	-1.0%	+10.5%
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	+0.2%	+6.5%
DFA 60/40 Fund	+2.6%	+5.2%
DFA 25/75 Fund	+1.2%	+2.4%
OTHER NOTABLE MARKET DATA		
Gold (Exchange-traded fund)	-5.7%	-4.7%
Euro/$ Exchange-Rate	+2.6%	-2.8%

Source: Bloomberg Professional

Note: Returns include reinvested dividends.

We certainly do not have answers to these questions, but we continue to follow evolving economic, political, and financial market events with great interest. Investors with globally-balanced portfolios may be tempted to speculate on which market segments are likely to outperform in the next period. However, it is best to follow a disciplined asset-allocation strategy that establishes long-term targets for each Risk segment. We monitor these portfolio exposures and, when actual versus targeted exposures warrant, we adjust portfolio holdings back to targets. ***During the last week of the 1st Quarter, we rebalanced client portfolios to targeted Risk exposures – we sold Risk (stock market) investments and bought Low Risk (bond market) investments.***

[1] Cypriot banks have very little Equity and Senior Debt on their balance sheets. Customer Deposits were the major source of funding bank loans and, therefore, depositors were near the front-of-the-line when loan losses occurred.

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Market psychology during the 1st Quarter became increasingly optimistic on stock market performance and correspondingly negative on bond market returns. One headline even read "Bonds are riskier than stocks"[2]. *Did we rebalance portfolios by selling stock investments (Risk) and purchasing bonds that might be even riskier? Short answer: unequivocally "no".* The risk at the center of this article is interest-rate risk. We have frequently highlighted[3] how we manage interest-rate risk in the Low Risk portion of client portfolios, but it bears revisiting. First, what is interest-rate risk?

> "Interest rate risk is the risk that arises for bond owners from fluctuating interest rates. How much interest rate risk a bond has depends on how sensitive its price is to interest rate changes in the market. The sensitivity depends on two things, the bond's time to maturity, and the coupon rate of the bond.[4]"

What does interest-rate risk look like? Table 2 illustrates the comparative price sensitivity of selected bond investments. Note that the negative price impact of interest-rates rising 1 or 2 percentage points decreases as the time-to-maturity decreases. *Headline-grabbing articles on bond risk generally refer to the price sensitivity of 10 or 30-year bonds.* As a core tenet of our investment approach, we constrain the average interest-rate risk of the Low Risk portion of each portfolio to be in-line with shorter-term bond investments. Why? Because the goal of the Low Risk assets is capital preservation, while the Risk assets are designed for growth and maintaining purchasing power. This element of our investment strategy comes with a trade-off – during times of extreme risk-aversion, when global capital flees to high quality bonds, the positive price-sensitivity of our Low Risk exposure is also limited. In short, interest-rate risk cuts both ways, but portfolios with shorter average interest-rate risk will benefit from reinvestment opportunities when/if interest-rates rise.

Table 2: Interest-Rate Risk	**Price Sensitivity**	
March 29, 2013	**Yield +1%**	**Yield +2%**
US Treasury 30-Year Bond	-17.2%	-30.6%
US Treasury 10-Year Note	-8.6%	-16.4%
US Treasury 5-Year Note	-4.7%	-9.2%
US Treasury 3-Year Note	-2.9%	-5.6%
Vanguard Short-Term Bond*	-2.3%	-4.6%
DFA Short-Term Extended Quality*	-2.8%	-5.6%

** Funds we use as Low Risk investments*

Sources: Maryland Capital, Bloomberg, Dimensional, Vanguard

In addition to maintaining an overall low level of interest-rate risk, the Low Risk portion of client portfolios includes bonds that pay variable rates of interest. These bonds generate yields that increase as interest-rates or inflation rise.

1st Quarter Highlights

Risk Assets

- US markets generated strong returns and outperformed both Developed International markets (+3.7%) and Emerging Markets (-3.5%).
- Emerging Markets was the only Risk segment that generated a negative return.

Low Risk Assets

- For the second quarter in a row, interest-rate risk was a negative contributor (note negative returns on long-maturity US Treasury segments). Our Low Risk exposures, on average, have low interest-rate risk and generated modest, positive returns this quarter.
- International (Non-US Dollar denominated) bonds generated negative returns largely due to strength of the US Dollar versus Euro and Yen currencies.

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[2] money.cnn.com, February 20, 2013, (http://money.cnn.com/2013/02/20/investing/bonds-risk-stocks/index.html)

[3] See articles under the Library tab at marylandcap.com, including October 8, 2011 and January 6, 2013

[4] Ross, Westerfield, Jordan (2010). Fundamentals of Corporate Finance. New York: McGraw Hill / Irwin

Update on our Asset Allocation Strategy

Portfolios have performed well. As noted above, recent strong gains in Risk investments caused us to rebalance holdings back to target during the last week of March. In the face of solid US stock market strength, the financial media have been hyping investors to take more risk –i.e. buy stocks, sell bonds. Such "advice" may or may not result in short-term gains, but it is not a prudent long-term strategy. We understand the emotion and appreciate the near-term frustration of earning low yields on your safe, short-term investments. But remember, these safe assets are what maintain a degree of stability in your portfolio and sacrificing that safety for additional potential return jeopardizes the integrity of your investment strategy. *Maintaining focus on the performance of your entire portfolio, while sticking with the discipline, is key*. Overall portfolio design coupled with periodic rebalancing during optimistic as well as pessimistic times will allow us to prudently achieve risk-balanced growth.

The helpful comments of Paul Cucchissi and Shelley Quade are greatly appreciated