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Maryland Capital Advisors

INVESTMENT COMMENT **July 8, 2013**

2nd Quarter Review and Strategy Update

There were two significant investment themes during the 2nd Quarter:

- Bond market interest-rates moved higher
- US stock market returns out-paced non-U.S. Risk, particularly Emerging Markets

Short-term market fluctuations often cause investors to question elements of their strategy. What follows is an update on questions that may arise due to these latest market themes:

- *Why hold bonds in the Low Risk portion of our portfolio? What can I do when I am worried about higher interest-rates?*
- *Why should I hold non-US Risk investments?*

Before we consider these questions, below is a review of this past quarter's market movements.

2ND QUARTER CAPITAL MARKETS UPDATE

Overall, global Risk investments returned -0.2% in Q2 versus +6.6% in Q1. Geographically, US Risk returns out-paced non-US returns in Q2 and 2013 YTD. Emerging Markets were hit particularly hard, down 8.8% in Q2 and -12.1% YTD.

As global asset-allocating investors, return differences among various Risk segments give rise to rebalancing opportunities. ***We are monitoring the performance gap between US Risk and non-US Risk segments, particularly Emerging Markets for an eventual readjustment back to our targeted portfolio exposures.***

Although precious metals are not an element of our portfolio strategy, it is worth noting that speculators in Gold generated a -26.5% YTD return.

Low Risk investment returns were negative across-the-board in Q2, as interest-rates rose. Fixed-rate bonds and bond funds with longer maturities have greater interest-rate sensitivity. For this reason, investors that had "chased returns" by extending their bond maturities during periods of falling interest-rates, suffered greater loss in this latest quarter. *US Treasury Inflation-Protected bonds were*

Selected Asset Classes June 30, 2013	**2013 YTD**	**2nd Quarter**
SELECTED RISK ASSET CLASS SEGMENTS		
US Large Cap	+14.1%	+3.1%
US Large Cap Value	+15.6%	+3.2%
US Small Cap	+15.4%	+2.7%
US Small Cap Value	+14.2%	+2.5%
International Large Cap	+2.8%	-0.9%
Emerging Markets	**-12.1%**	**-8.8%**
International Real Estate	-1.7%	-5.9%
US Real Estate Investment Trusts	+6.3%	-1.6%
SELECTED LOW RISK ASSET CLASS SEGMENTS		
US Treasury 1-3yr Notes	-0.1%	-0.2%
US Treasury 7-10yr Notes	-4.0%	**-4.1%**
US Treasury 20-30yr Bonds	-7.9%	**-5.6%**
US Treasury Inflation-Protected	-7.7%	**-7.3%**
Inv Grade Short Duration	-0.5%	-1.0%
Inv Grade Intermediate Duration	-3.0%	**-3.3%**
Inv Grade Long Duration	-6.8%	**-6.2%**
Mortgage-Backed Securities	-2.8%	-2.9%
International Bonds (Non-Dollar)	-6.7%	-3.5%
EQUITY INDICES		
MSCI All-Country World Index	**+6.4%**	**-0.2%**
S&P 500 Index	**+13.8%**	**+2.9%**
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	+7.2%	+0.7%
DFA 60/40 Fund	+4.7%	-0.5%
DFA 25/75 Fund	+1.3%	-1.1%
OTHER NOTABLE MARKET DATA		
Gold (ETF)	**-26.5%**	**-22.9%**
Emerging Markets Bonds (ETF)	-5.6%	-6.5%

Source: Bloomberg Professional

Note: Returns include reinvested dividends.

the hardest hit as interest-rates rose and market pricing of inflation protection declined. It was certainly a challenging quarter for bond market participants. In fact, Bill Gross, co-founder of PIMCO and manager of the world's largest bond fund suffered his worst quarterly return (-3.6%) since his Total Return fund began 26 years ago.

PERSPECTIVE ON 2ND QUARTER INVESTMENT THEMES

Interest-rate concerns and the role of bonds in a balanced portfolio strategy

Financial media have trumpeted May and June "surprise" bond market declines with attention-grabbing headlines[1] that have raised some investor anxiety. While the timing of interest-rate moves is always uncertain, the impact of changes in interest-rates to underlying bond values is simple math. Greater interest-rate sensitivity is the risk investors bear when they choose fixed-rate bonds with longer maturities. *By design, our client portfolios have limited interest-rate sensitivity and, therefore, our Low Risk portfolios have not been as "surprised".*

Why hold bonds? What to do if worried about higher rates?

The Library tab on our website contains several updates on our balanced portfolio strategy written before, during, and after the 2007-2009 Financial Crisis. *Note that the role of bonds in our portfolios and our Low Risk investment strategy has remained consistent*[2]. In short, bonds serve as an important means of capital preservation within a risk-balanced investment strategy. *As stipulated in each client's Investment Policy Statement, we constrain the average level of interest-rate risk to maintain greater stability.* We assemble each client's mix of Low Risk investments over time after carefully evaluating the market compensation offered for various bond market risks (credit-risk, interest-rate risk, timing-of-principal payment uncertainty). *Simply stated: our long-standing clients may hold accumulated Low Risk investments comprised of different bond segments than recently-joined clients, but all portfolios have constrained interest-rate sensitivity.* The table below illustrates the total return of selected bond market investments. ***Clients should compare these returns with their Low Risk portfolio returns and note the muted impact of recent interest-rate moves on their portfolio.*** *Investors concerned about higher interest-rates should adhere to an approach that is not reactive, but strategic. At some point we will extend the average interest-rate sensitivity of our Low Risk bond holdings as market compensation for purchasing longer-term bonds increases. However, we will do so only within the interest-rate constraints of our long-term investment strategy.*

Bond Market Performance June 30, 2013	**May 2013**	**June 2013**	**YTD 2013**
SELECTED BONDS			
US Treasury 30yr Bond	-7.10%	-3.92%	-8.79%
US Treasury 10yr Note	-3.44%	-2.98%	-4.76%
US Treasury 5yr Note	-1.30%	-1.27%	-1.58%
US Treasury 3yr Note	-0.25%	-0.33%	-0.19%
SELECTED BOND FUNDS			
Vanguard Short-Term Investment Grade*	**-0.41%**	**-0.88%**	**-0.53%**
Dimensional Short-Term Extended Quality*	**-0.49%**	**-0.81%**	**-0.58%**
Barclays Aggregate Bond Index	**-1.78%**	**-1.55%**	-2.44%
PIMCO Total Return	**-2.15%**	**-2.64%**	-3.02%

** Funds we use as Low Risk investments*

Why hold non-US investments?

The temptation to infer from recent market performance or economic forecasts which countries or regions are most-deserving of our investment capital is, perhaps, human nature – but unfortunately it doesn't work. Such advice is popular and freely-offered in the media. Two years ago we commented on a market writer that advocated investors hold a "large chunk"

[1] See, for example, "A Bond Market Plunge That Baffles Experts", New York Times, June 8, 2013.

[2] Suggest the following Maryland Capital Investment Comments: April 7, 2008; October 8, 2011; April 8, 2013.

(up to 40% of your portfolio) in Emerging Markets stocks[3]. In the two years since that advice, U.S. stocks have returned +28.0% (S&P 500 Index), Global stocks +10.7% (MSCI All-Country World Index), and Emerging Markets -13.0% (MSCI Emerging Markets Index). In short: over-weighting Emerging Market equities was terrible advice.

The rationale for holding globally-balanced Risk assets is strategic: diversification into non-US Risk investments improves risk-adjusted returns, in the longer run. To illustrate the point, the table below shows a popular measure of U.S. large companies (S&P 500 Index) compared with a U.S. Domestic strategy that includes Small and Value stocks, and finally a Global strategy that includes Small and Value stocks.

Benefits of Global Risk Diversification Annualized returns through May, 2013	**5-Year**	**10-Year**	**20-Year**	**Since 1970**	**Risk***
S&P 500 Index	+5.4%	+7.6%	+8.8%	+10.2%	15.53
US Domestic Balanced Strategy Index	+6.3%	+8.9%	+10.7%	+12.3%	16.99
Global Balanced Strategy Index	+4.9%	+10.9%	+10.4%	**+13.6%**	**15.68**
Source: Dimensional Funds					

** Annualized Standard Deviation of monthly returns*

Note the following:

- Diversification from the S&P 500 Index to a balance of Large, Small, and Value companies, enhances return, but raises risk.
- Diversification from a US-only balance of Large, Small, and Value companies into non-US Large, Small, and Value further enhances return, and lowers risk.

Over time, our approach seeks to capture the return-maximizing, risk-minimizing effects of globally-diversified Risk investments. Our periodic adjustments of portfolio exposures to various segments are driven by market segment performance, not our own speculation. One, two, or several underperforming periods do not cause us to modify our strategic targets. We last rebalanced portfolios at the end of March, following strong U.S. Risk returns in the 1st Quarter and may make some adjustments within Risk later this quarter.

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

[3] See *Comment on "Smart" Asset Allocation article*, March 6, 2011, under Library tab at www.marylandcap.com