Market Commentary

2ND QUARTER 2013

Economic Summary

It was the best first half of the year since 1999. It would be unrealistic to assume the second half of the year will be as good. We expect interest rates to continue to rise (whether or not the Federal Reserve raises them), which may slow advancing stock prices. Holders of long-maturity bonds should be more concerned. Rising interest rates are a normal result of an expanding economy and a function of increased loan demand. Bond investors are just now beginning to feel the pinch from the June back-up in interest rates. You can lose money investing in bonds. Investors have poured money into bond mutual funds and out of equity funds in huge numbers, so there could be more pain in the bond market, especially for those investors who have stretched maturities searching for yields (CHART 1).

Just the initial hint of the end of quantitative easing caused interest rates to spike up sharply. The Fed Chairman said he was "perplexed" at the bond market's behavior. Imagine the market moving without Ben saying it could. Ben Bernanke is beginning to sound like King Canute, demanding that the tide recede. In actuality, the Federal Reserve's activities are becoming less and less impactful on real economic activity. When Chairman Bernanke retires in January 2014, the Fed will likely unwind some of the $85 billion per month purchases of U.S. Treasury securities and mortgage bonds. This will be good news and will allow market interest rates to be set by supply and demand, instead of Fed manipulation and distortion of asset prices.

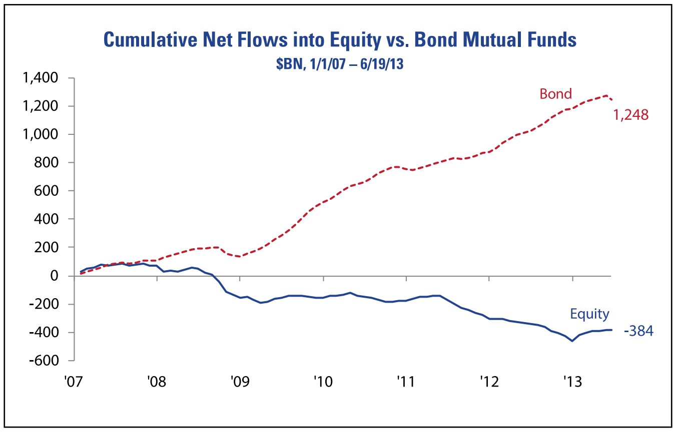

Chart 1

SOURCE: STRATEGAS RESEARCH PARTNERS
"QUARTERLY REVIEW IN CHARTS", JULY 1, 2013

Underlying the favorable stock market performance of the past six months is the strong and growing stream of corporate profits. Plus, corporations generally have strong and liquid balance sheets with low debt levels. Are things perfect with the economy robust and nothing but clear skies ahead? No, not by any means.

Climbing a Wall of Worry

There's an old expression that the stock market climbs a wall of worry. It's amusing to watch pundits and talking heads on TV, droning on about uncertainty in the capital markets. When is there not uncertainty? No one knows the future, so it's always uncertain. We make our investment decisions based on companies' fundamentals, their prospects for growth, their management strength and their ability to successfully allocate capital. And, we look to buy stocks that meet

Past performance does not guarantee future results.

Economic Summary (continued)

our criteria when they are on sale. That is the essence of value investing – to invest with imperfect information in good companies at reasonable prices.

In our opinion, the stocks in our portfolios represent companies with excellent businesses, which are well-positioned to grow faster than the economy. Most enjoy pricing power, which will become important when inflation returns, and that may happen sooner than most people expect (despite what the Fed says). Another characteristic of the companies we invest in is that they often have boards that allocate capital in a shareholder-friendly manner. They buy back stock to reduce the outstanding shares and utilize free cash flow to increase dividends. With interest rates so artificially low, investors have flocked to companies with high yields, like utilities and real estate investment trusts. We instead have focused our research on companies that have good growth prospects for revenues and earnings, which should allow them to increase their dividends regularly.

With the growth potential comes capital appreciation potential, and regularly increasing dividends provides a rising stream of income. It is a powerful combination. In addition, these well-managed companies often have a durable competitive advantage (Warren Buffett calls it a moat), which should allow them to earn above-average returns and at the same time be self-financing. Some of these companies have issued debt recently to take advantage of the ultra-low interest rates, but many of them have little or no debt. With strong balance sheets, they are in control of their own destiny much more so than companies with excessive debt.

Fixed Income Summary

While rates rose in the past quarter, we feel the shorter maturity bonds in our portfolios offered better protection of principal than longer-maturity bonds, which we don't own, many of which were down from 5% to 10% during the period. We've long been expecting rates to rise, as the Fed would eventually reduce and stop its QE's. So we positioned our portfolios defensively against such a rate rise. The short-maturity bonds in our portfolios should outperform long-maturity bonds as the world transitions back to normal interest-rate policy. Thus, the opportunity to generate income from bond portfolios should increase considerably.

It's probably fair to say that in the 100-year history of the Federal Reserve, investors have never been so incredibly focused on every utterance of its Chairman. Indeed, you cannot turn on the TV or open a newspaper without seeing Bernanke's name. He's everywhere. Importantly, though, the interaction of the economy and stock market is too complex to focus solely on the activities of Ben Bernanke.