



Artemis

FINANCIAL ADVISORS LLC

Market Outlook & Strategy

First Quarter of 2013

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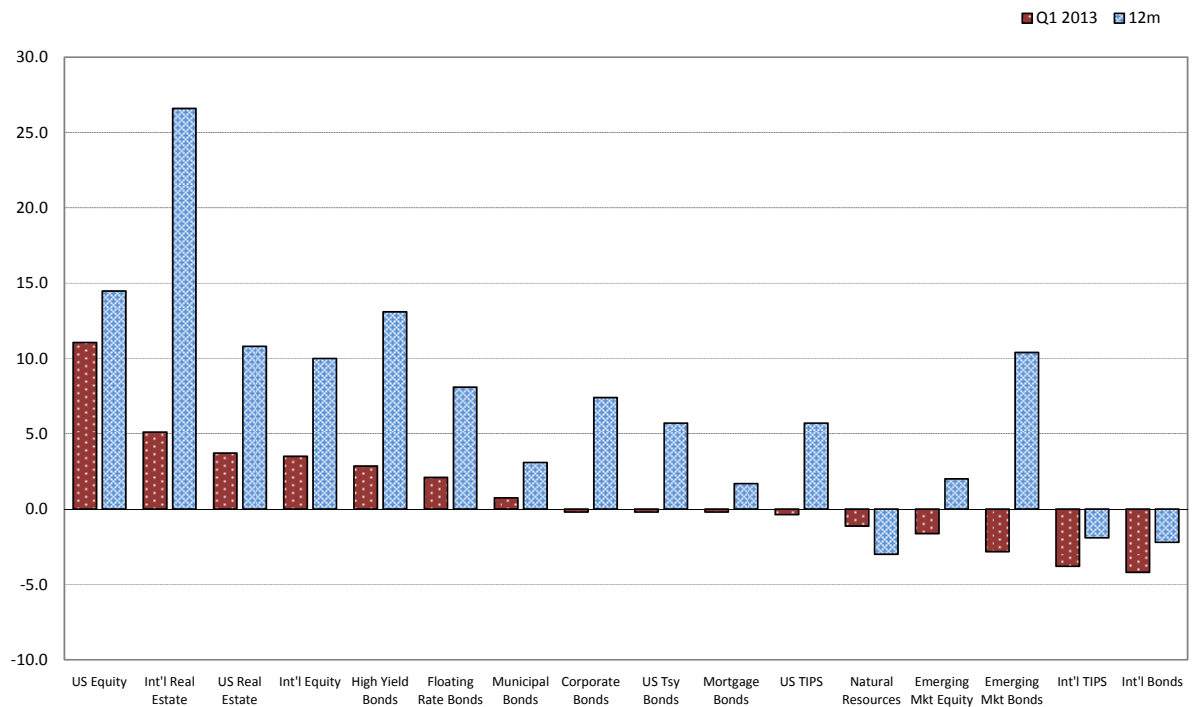
Executive Summary

- For U.S. equity investors, **it was a terrific quarter, with the overall U.S. equity market rising 11.1%**. The U.S. economy performed better than expected, following the decision by Congress to enact spending cuts to avoid the “fiscal cliff.” Equity returns in all other markets except Japan were lackluster; in particular, **emerging-market equity posted a disappointing -1.6% return overall**.
- In contrast, fixed-income returns were much more muted this quarter than they have been in the recent past, due in part to investor fears that the Fed might begin withdrawing support. **For the first time in many years, Barclay’s U.S. Aggregate Bond Index, comprised of traditional high-quality U.S. corporate and government bonds, returned a negative -0.12%**, with long-maturity bonds taking most of the hit.
- This issue’s special focus is on the challenges associated with comparing investment returns across different private wealth management firms and provides guidance for those attempting to do so. **We also publish our investment performance returns since the founding of the firm** and provide some context for interpreting the results.
- In our strategy section, **we reiterate our view that U.S. equities are not overvalued**. Not only do most traditional valuation metrics suggest U.S. equities are still fairly valued (although no longer cheap), low fixed-income yields and central bank commitment are pushing many to invest in equities. Moreover, corporate earnings are much higher than in previous peaks. As such, we are not trimming our clients’ U.S. equity positions in the hope of being able to profit from any near-term sell-off should one occur.
- **We also believe that bond yields are not going up any time soon -- due to the Fed’s stated policy and the fact that there is still a global saving gap (gross private savings less capital formation) of almost \$3.4 trillion**. While we are monitoring the interest-rate sensitivity of our clients’ fixed-income allocations, we are not rushing for the doors.
- We also **continue to favor U.S. and international real estate**, despite the stellar performance of the sector over the last year, as we believe there is still some upside to enjoy.

Markets in Review

For U.S. equity investors, it was a terrific quarter: The overall U.S. equity market gained 11.1%. The increase was largely due to the U.S. economy performing better than expected during the quarter following the agreement by Congress in early January to avoid the “fiscal cliff” that would have required dramatic reductions in spending and risked throwing the U.S. back into recession. Most experts now believe that the outcome of the fiscal cliff and sequestration will lead to a drag of only roughly 1.5 percentage points of GDP in 2013, not the 4-5 percentage points some had feared.

Figure 1: Asset Class Performance in Q1 2013 (percentage points)



Small and mid-sized U.S. company stocks outperformed large-company stocks, and value stocks outperformed growth stocks. This is a good outcome for Artemis clients because most of our clients’ portfolios are tilted toward these segments. The average small-cap-value fund returned 12.3%, better than the average 8.4% advance for large-growth equity.



The only other large market that performed as well this quarter was Japan – up 21.6% for the quarter in local currency – due to the recent election of a new prime minister, who is promising a much more aggressive approach to stimulate the economy. However, this same pronouncement caused the yen to decline by about 10%, so returns in U.S. dollars were a more muted 11.8%.

Even Europe did surprisingly well (up 5.7% in local currency terms and 3.0% in USD), given that the region remains mired in recession. Most of that increase came early in the quarter, as sentiment later deteriorated when both the inconclusive results of the recent Italian election and the bank crisis in Cyprus dominated the headlines. Once again, these events demonstrate that the euro's existential crisis is far from over.

For us, the more puzzling result was the poor performance of emerging markets, which collectively returned -1.6%. There does not appear to be a compelling explanation for the result, particularly given the view by many analysts that China appears to be moving to an early phase of economic expansion with a surge in credit (perhaps too much so) and structural financial reforms. One explanation is that emerging markets are suffering from recession in Europe, a major trading partner. And, of course, for nations that are net natural resource exporters, weak commodities prices are dampening the strength of their recovery and, therefore, their stock prices.

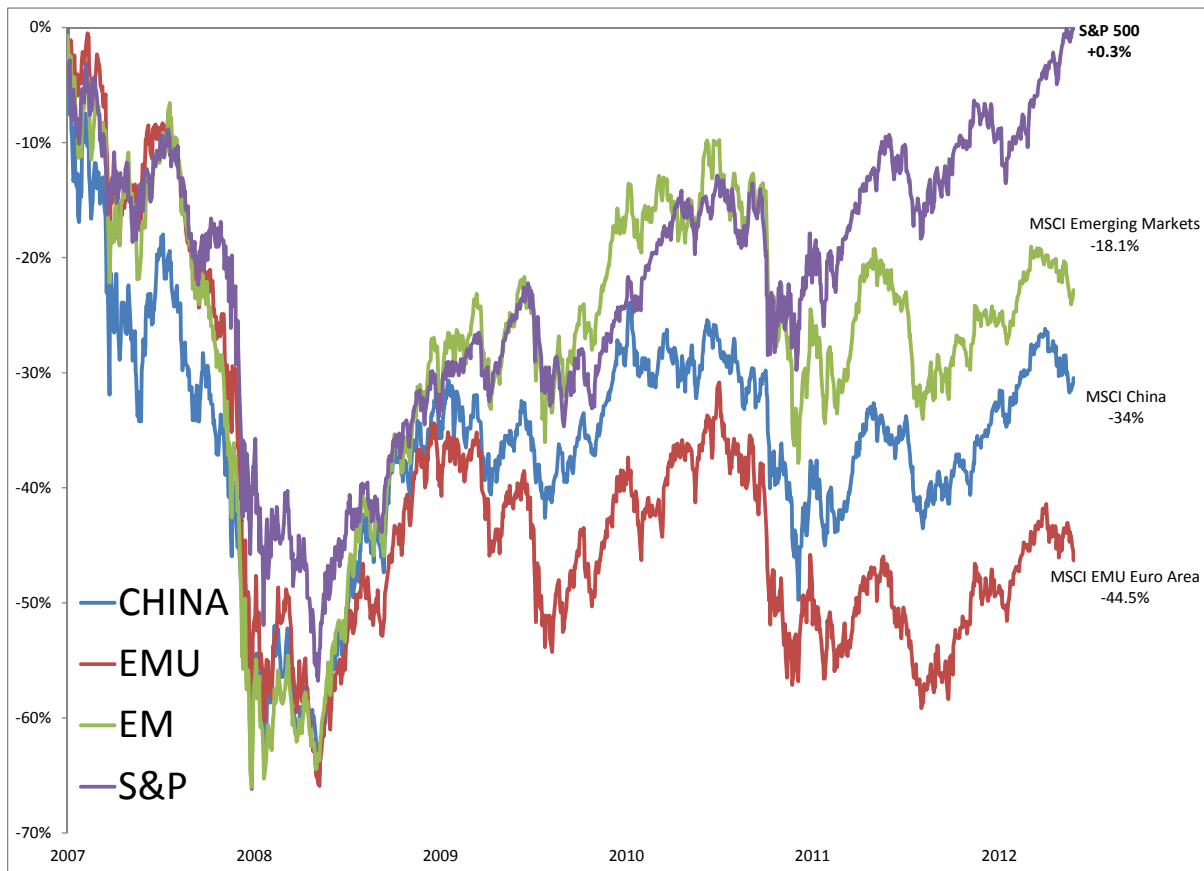
The upshot is that this quarter reinforced one of the more dominant trends of the post-crisis recovery: the relative outperformance of the U.S. market over all others. An index of the entire world's stock market without the U.S. is still down about 29 percent from the level it hit in 2007, with Europe's emerging-market countries lagging the pack (see Figure 2).

In contrast, fixed-income returns were much more muted this quarter than they have been in the recent past, due in part to investor fears that the Fed might begin withdrawing support. For the first time in many years, Barclay's U.S. Aggregate Bond Index, comprised of traditional high-quality U.S. corporate and government bonds, returned a negative -0.12%, and long-maturity bonds took most of the hit. Notwithstanding the prospect of poor fixed-income returns, investors continued to pour more money into fixed-income (\$70.4 billion of net new inflow in Q1) funds than stock funds (\$19.5 billion of net new purchases), and there is a great debate underway as to whether and when flows may shift. In the meantime, yield-seeking behavior continued to pay off in the U.S. as lower credit-quality investments such as U.S. high-yield and floating-rate bonds continued to outperform.



Finally, global real estate continued its march upward (+5.1% for the quarter), posting positive returns for the sixth consecutive quarter. U.S. real estate (shown in Figure 1 as a blended index containing both debt and equity) was not far behind, increasing 3.7%.

Figure 2: Percentage Change in Selected Indexes (since Oct. 9, 2007)



Special Focus: Comparing Performance of Different Investment Management Firms

Last year I had the opportunity to sit on an investment manager selection committee for a large non-profit organization that had decided it was time to review its current manager for its \$10-million portfolio. We initially reviewed nearly 20 proposals and narrowed them down to four finalists, each of whom made a formal presentation to the committee. In the process, we reviewed many different investment styles, service approaches, and investment results.



Comparing investment results across the candidate firms proved to be one of the less fruitful exercises we conducted, and it soon became clear that the committee had not been provided sufficient information to make all but the broadest possible conclusions. The exercise was frustrating and inconclusive for the following reasons:

Is the advisor's fee included? Some firms reported their investment results prior to fees, and others reported net of fees, and others didn't specify how they were reporting. Most firms we looked at charge their clients 0.75%-1.25% of assets under management (AUM) annually on average, so this is by how much annual returns will differ annually if reported on a gross versus net basis. It's the old adage – fees matter.

Are the reported returns actual client returns? Most of the firms provide their clients with quarterly investment portfolio results and commentary, but when it came time to ask them for how their client portfolios had performed in the aggregate or in groups (e.g., conservative vs. aggressive clients), providing this data seemed to be a mission impossible for most. Several firms responded with so-called "model portfolio results" or composite results of a particular strategy they deploy in client portfolios, but others couldn't seem to produce any numbers.

The problem is that model and composite portfolio results can be misleading and often overstate actual client results. For example, client portfolios often have more cash than does a model because a person might soon be purchasing a second home or making a college payment. Individual clients also pay taxes, so while one might be able to implement a good idea in a model in a very timely fashion, in practice it might take much longer to fully implement the idea for a real client because the advisor must consider the tax consequences of doing so.

Do the returns include cash? Needless to say, excluding the lowest-performing asset class will boost return figures. Often, this is cash. Some investment managers argue that since they don't always make the decision as to how much cash to hold, they should not be 'penalized' by including cash returns in their results. At Artemis, we believe cash is an asset class like all others, and the decision to hold cash at times over and above what the client requires is an active investment choice, and so the consequences of the choice should be included in return calculations.

Is any measure of risk reported? Most importantly, not a single firm responded with any measure of risk, although some attempt was made by the committee to control for risk by asking respondents to report performance results for a so-called moderate-risk portfolio/client. Absent any measure of risk, we could not judge how efficiently different

managers were able to achieve their results. In short, it was impossible to judge whether someone's 9% return was any better than someone else's 7% return.

Not surprisingly, I probably wouldn't be writing this critique if Artemis was guilty of the same omissions. Artemis does report aggregate client results. These results are net of fees, they include cash, they comprise all clients, and we (painstakingly) calculate individual client portfolio volatilities to help us understand and monitor the risks we are taking. These results are reported in Figure 3. (A more complete explanation of our methodology and the benchmarks we report is contained in an appendix to this document.)

Figure 3: Artemis Advisor Returns (Net of Fees) Vs. Benchmarks
As of March 31, 2013

	Trailing Total Returns				Volatility		
	3 month	12 month	3 year	Since Inception	12 month	3 year	Since Inception
Artemis Financial Advisors (26-53%)	5.3	9.8	7.6	5.5	6.5	9.4	9.7
Artemis Moderate and Conservative Portfolios (25-51%)	5.1	9.6	7.6	5.4	6.2	9.0	9.5
Artemis Aggressive Portfolios (58-66%)	6.4	11.6	8.0	n/a	8.6	13.8	n/a
Global Blended Index (40%)	2.5	5.9	6.1	4.7	4.6	6.6	9.7
Global Blended Index (65%)	4.1	7.0	11.1	6.3	8.0	10.8	15.0

Artemis returns are measured as the monthly change in aggregate client portfolio values, net of advisory fees, manager fees and expenses, where the weights represent each client's percentage share in aggregate Artemis retirement assets under management. None of the benchmark returns include manager expenses or advisory fees. Artemis Financial Advisors inception date is July 2008. Volatility is the annualized standard deviation of aggregate monthly client returns.

Artemis percent equity indicates the range in the annual average equity allocation in the Artemis aggregate portfolio since July 2008.

See appendix to this document for benchmark definitions and further information.

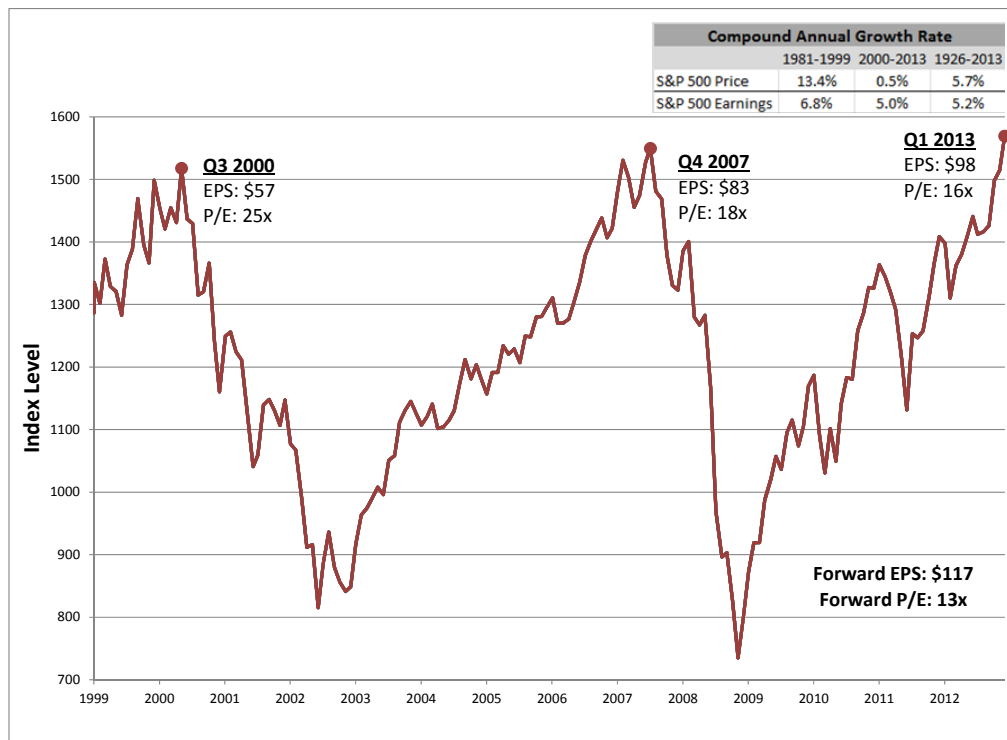
We are generally quite pleased with our overall results. As one very experienced investor once told me, it only takes making two or three good investment decisions over a stretch of

time to “make one’s numbers.” Over the last few years, we think we have made our numbers by overweighting U.S. equity and real estate, by implementing a multi-sector fixed-income strategy (adding some risk in the process), and by proactively putting any cash on hand to work.

Artemis Portfolio Strategy

As I recently wrote in an email to Artemis clients, I do not believe U.S. equities are oversold. Not only do most traditional valuation metrics suggest U.S. equities are still fairly valued (although no longer cheap), low fixed-income yields and central bank commitment are pushing many to invest in equities. Moreover, corporate earnings are much higher than in previous peaks (see Figure 4).

Figure 4: S&P 500 Peaks in Comparison



Source: Fidelity

This does not mean we won’t see some sort of pullback in the market in the next few months; in fact, that seems to have become the pattern over the last few years. Yet trying to time these short-term market adjustments is very difficult because the market has



tended to rebound almost as quickly as it corrects. More importantly, we firmly believe that the U.S. is on a solid path of recovery and that growth may even surprise to the upside later this year. As such, any correction is likely to be short-lived, so we are not currently trimming our client's U.S. equity positions in the hopes of being able to take advantage of any near-term sell-off. However, for new clients who are largely in cash, we are dollar-cost-averaging them into their desired allocations.

In contrast, we continue to tread very lightly with Eurozone equity. While it is obvious that the very distressed euro equity markets have declined precipitously, it is less obvious that they are on the verge of a sharp rebound. Italian politics, austerity budgets, weak confidence, and an expensive euro continue to delay the recovery. We are monitoring the situation closely and stand ready to increase our European exposure when we see some stabilization.

In a previous report (see *Artemis Market Outlook and Strategy Report*, Q3 2012), we discussed in full our opinion that the commodity super-cycle of the last decade may be over, due to an increasing supply response, a strengthening U.S. dollar (commodity prices tend to be negatively correlated with the U.S. dollar as they are priced in dollars), and waning growth in the world economy. All of these factors will act as strong headwinds for (industrial) commodity prices in the future. If so, then those emerging-market countries that are net resource exporters (Brazil, Russia, etc.), may be in for disappointing growth. We are currently reviewing our emerging-market equity strategy with an eye toward tilting the allocation away from such countries.

On the fixed-income front, we are still of the view that bond yields are not going up anytime soon. In addition to the Fed's stated policy of holding interest rates low until the unemployment rate drops to 6.5%, we are in a global savings glut, defined as private sector savings in excess of autonomous investment by the private sector. For example, since the outbreak of the 2008 global crisis, private sector savings as a share the U.S. GDP has soared by 6 percentage points. For Europe, the jump has been even sharper. One estimate is that the savings gap for the developed world at its maximum point exceeded U.S. \$3.9 trillion, and even today, it remains a stunning U.S. \$3.4 trillion. This post-2008 savings surge could have driven the world economy into a downward spiral and is one of the key reasons why central banks have been so busy trying to make saving unattractive relative to spending.

Nevertheless, we are monitoring the duration (i.e., interest rate sensitivity) of our clients' corporate and municipal bond portfolios, and we are continuing to modestly tilt our overall fixed-income portfolios toward more credit-sensitive sectors (e.g., high-yield, floating-rate bonds). Floating-rate funds invest in bank loans made to corporate borrowers, usually those

without an investment-grade rating. Such loans sit at or near the top of a company’s balance sheet and are typically collateralized by the assets and stock of the borrower. The loans pay a coupon based on a floating interest rate, and thereby mitigate interest rate and inflation risk.

We are also adopting a more holistic approach to investing in emerging-market debt, which will also serve to lower the interest-rate risk associated with investing in the asset class. U.S. investors today have three main choices for emerging-market fixed income: emerging-market corporate bonds, generally denominated in U.S. dollars; emerging-market sovereign (i.e. government) debt also denominated in U.S. dollars, and emerging-market sovereign debt issued in local currency (see Figure 5).

Figure 5: Comparison of Emerging-Market Debt Sectors

	EM USD Corporate Bonds	EM US D Sovereign Bonds	EM Local Currency Bonds
Market Size (\$B)	\$494	\$517	\$833
No. of Issuers	330	77	14
No. of Countries	38	48	14
Duration (years)	5.48	7.37	4.65
% Investment Grade	74%	64%	93%
Currency	USD	USD	Multiple

Source: JP Morgan

The market for sovereign debt in U.S. dollars is the longest standing and remains the entry point for most developing emerging-market issuers to access global investors. Most U.S. emerging-market bond funds are heavily weighted toward this segment of the market. But corporate bonds and local currency bonds both offer attractive characteristics. Corporate bonds, for example, feature a larger percentage of higher-quality (investment-grade) bonds than the U.S. dollar-denominated sovereign market and are, on average, shorter maturity that expose investors to less interest rate risk. The same is true for local currency sovereign bonds. Hence, any shift toward owning all three segments of the market instead of only U.S. dollar-denominated sovereign bonds will lower the overall interest-rate sensitivity of the allocation.

Finally, although both U.S. and international real estate have posted some of the highest returns of all asset classes in the last year or more, we are not quite ready to take profit in this sector, as we continue to believe there is still some upside to enjoy.

Appendix: Performance Disclosure

Artemis's aggregate client returns are the monthly percentage change in a weighted average of individual client returns, where the weights represent each client's percentage share in aggregate Artemis retirement assets under management (educational and dedicated portfolios with very different investment objectives are excluded). All Artemis clients are included in this aggregate. Individual client returns are time-weighted, are inclusive of cash, and are net of brokerage fees, fund expenses, and Artemis advisory fees. Returns do not include reinvested dividends.

Individual client portfolio volatility is measured as the annualized standard deviation of monthly portfolio returns. The return is computed as the percentage change in total portfolio value, omitting days in which cash flows and settlements exceeded \$5,000.

The benchmarks we utilize are as follows:

1. Global Balanced 40% Composite Index – An unmanaged index that combines the total returns of the MSCI World Index and the Barclays Capital Aggregate U.S. Bond Index – weightings of 40% and 60%, respectively.
2. Global Balanced 65% Composite Index – An unmanaged index that combines the total returns of the MSCI World Index and the Barclays Capital Aggregate U.S. Bond Index – weightings of 65% and 35%, respectively.

Note: None of the benchmarks include manager expenses or advisory fees.

The performance data shown represent past performance, which is not a guarantee of future results. Portfolio values may be subject to large fluctuations, and significant losses can occur under some market circumstances. Portfolio returns may be adversely influenced by a number of factors, including interest rate risk, credit (default) risk, equity risk, foreign exchange risk, inflation, and general market volatility. All returns are reported before taxes; after-tax returns may differ significantly and will vary from client to client.