# Blankinship & Foster, LLC
## Quarterly Investment Review

## First Quarter 2014

Global markets experienced a choppy quarter but ended mostly positive. Headwinds were plentiful, including the continued slow economic recovery in the United States and Europe and the change of leadership at the Federal Reserve ("the Fed"). In addition, there were geopolitical developments such as Russia's annexation of Crimea and further evidence that China's growth is slowing amidst government efforts to manage a credit bubble.

Domestically, U.S. stocks were positive for the quarter. U.S. economic growth was hampered by severe winter weather that likely depressed some of the short-term indicators of the economy's health. Overall, though, the picture remains one of modest but steady growth with a solid rebound in housing alongside persistently slow-to-recover employment. More on the economic environment below.

Developed international stocks were basically flat for the quarter. This was largely due to a sizeable decline in Japan, where a new sales tax is the latest hurdle as the country tries to achieve sustainable growth and recover from two decades of deflation. Many European markets rose against a backdrop of slow growth but still-high unemployment and very low inflation (and deflation fears).

Emerging markets have struggled amidst ongoing concerns about economic growth and instability in places like Ukraine (most recently), Turkey, Syria and Venezuela. These issues have been a headwind over the past year and led to small first quarter losses for emerging-markets stocks.

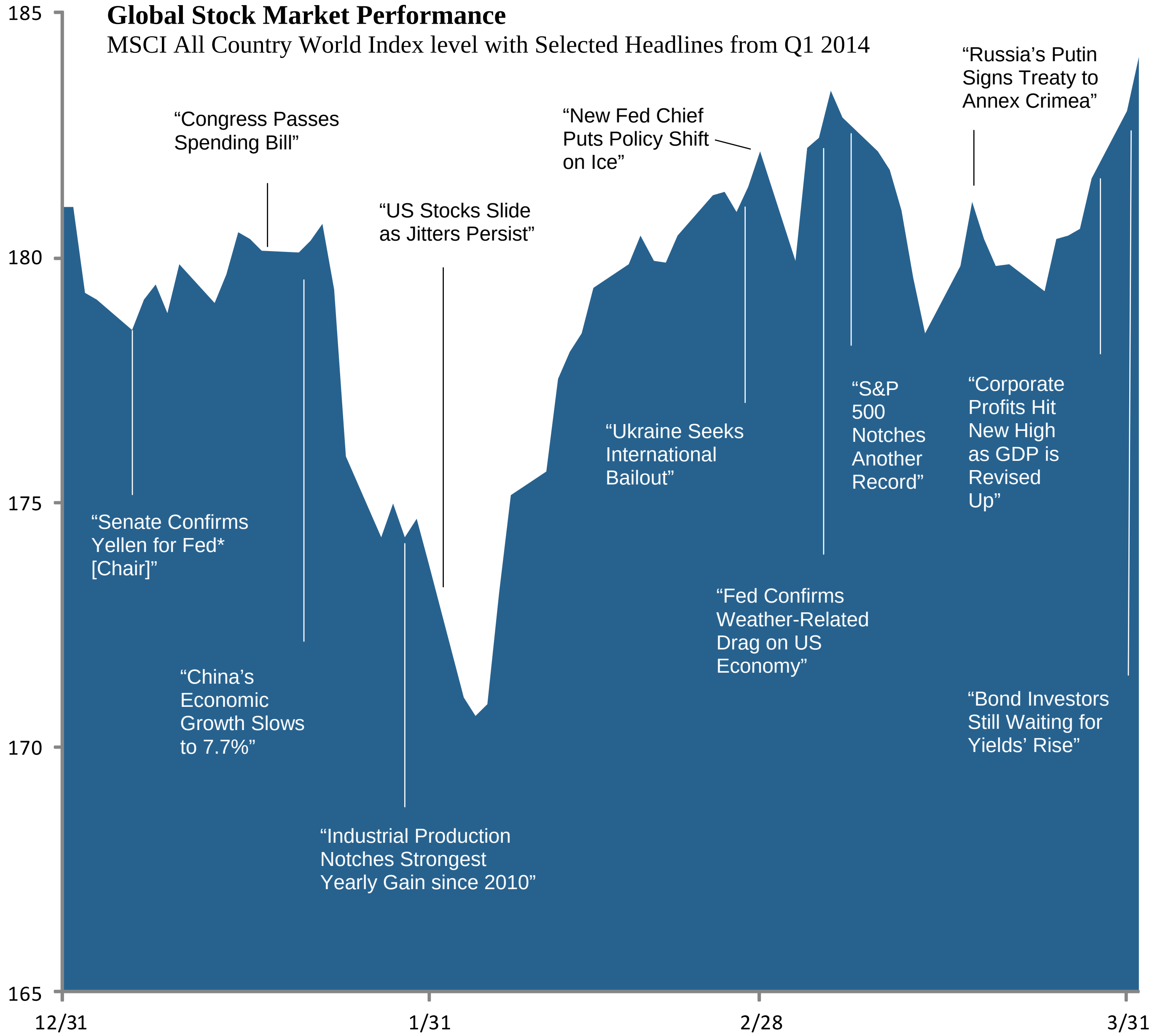
Core (investment grade) bonds were among the quarter's stronger performers, reinforcing the important role they can play during uncertain times. Municipal bonds were another positive spot in the quarter. State and municipal economies have shown considerable improvement as economic revival have helped to rejuvenate anemic tax revenues.

| Asset Class | Index | Quarter | YTD | Last 12 Months | 3 Years | 5 Years |
|---|---|---|---|---|---|---|
| *Stocks* | | | | | | |
| Large Cap Stocks | S&P 500 | 1.8% | 1.8% | 21.9% | 14.7% | 21.2% |
| Mid Cap Stocks | Russell Midcap Index | 3.5% | 3.5% | 23.5% | 14.4% | 25.6% |
| Small Cap Stocks | Russell 2000 Index | 1.1% | 1.1% | 24.9% | 13.2% | 24.3% |
| Global Stocks | MSCI All Country World Index | 1.1% | 1.1% | 16.6% | 8.6% | 17.8% |
| International Stocks | MSCI EAFE Index | 0.7% | 0.7% | 17.6% | 7.2% | 16.0% |
| Emerging Markets Stocks | MSCI Emerging Markets | -0.4% | -0.4% | -1.4% | -2.9% | 14.5% |
| *Bonds* | | | | | | |
| US Bonds | Barclay's Aggregate Bond | 1.8% | 1.8% | -0.1% | 3.7% | 4.8% |
| Intermediate Treasury Bonds | Barclay's Interm. Treasury | 0.6% | 0.6% | -0.8% | 2.5% | 2.3% |
| Short-term Bonds | Barcap 1-5 Yr Govt/Credit | 0.4% | 0.4% | 0.4% | 1.9% | 2.8% |
| Money Market/Cash | US 3 Month T-Bill | 0.0% | 0.0% | 0.1% | 0.1% | 0.1% |
| *Others* | | | | | | |
| Real Estate | DJ US Real Estate | 8.7% | 8.7% | 2.1% | 9.2% | 27.1% |
| Commodities | Goldman Sachs Commodity | 2.9% | 2.9% | 1.1% | -3.4% | 6.8% |

*Source: Morningstar*

## Global Stock Market Performance

MSCI All Country World Index level with Selected Headlines from Q1 2014




Returns in US dollars. Graph Source: Dimensional Fund Advisors, Morningstar. It is not possible to invest directly in an index. Performance shown does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results. Selected headlines are not necessarily indicative of any impact they may or may not have had on the market. **Board of Governors of the Federal Reserve System*

**Economic Environment**

It has been five years since the end of the worst financial crisis since the Great Depression. The recovery has faced uncertainty along the way, including Washington policy, unprecedented central bank intervention and even the weather. Still, the U.S. economy never suffered a double-dip recession as many had feared it would. Instead, this recovery will soon rank as the sixth longest period of growth on record, even though economic data suggest we are not yet up to full capacity.

*The chart above shows the change in global equity markets throughout the quarter. Juxtaposed over the market performance are some of the key events that occurred during the quarter. Sometimes as we get to the end of a volatile period, it's difficult to look back and remember everything that happened along the way.*

Economic fundamentals suggest we are still mid-way through a long expansionary phase. The economy is growing steadily, the labor market continues to improve and inflation remains low. During this recovery, we have seen moderate growth averaging just over 2% per year—below the average growth rates during prior recoveries. Despite this, Gross Domestic Product (GDP) in 2014 is likely to grow at a rate closer to 3%, near the long-run historical average of 3.1%.

Corporate investment, government spending, exports and increasing consumption should add to GDP this year. Consumers have seen a significant recovery in household net worth and confidence, and have dramatically improved their personal wealth by steadily reducing debt. Economic drag from the government sector has also improved with the effects of federal budget sequestration, local and state spending cuts and government shutdowns generally behind us, at least for now. Furthermore, as corporations reach higher levels of capacity utilization and new peaks in employment, they are also likely to increase investment spending, contributing to the recovery. Finally, while the U.S. continues to be a net importer of foreign goods and services, a boom in U.S. energy production has caused exports to grow more rapidly than imports, so the balance of trade favors better economic growth as well.

Turmoil in the emerging markets is leading us to revisit our investment thesis for emerging markets bonds and stocks as well. We have seen that, despite their better balance sheets and better long-term economic fundamentals (such as lower debt levels) relative to developed markets, emerging-market countries do not have as much control over their monetary policies. This has created volatility in short-term capital flows in and out of these countries' financial markets, causing increased volatility in asset prices. Because these outflows can contaminate fundamentals, and we cannot confidently predict when sentiment will worsen and when outflows will occur, the risks we perceive today with emerging-markets investing are slightly higher than they were a year ago.

This higher volatility and susceptibility to capital flight weighs heavily against better valuations and better economic fundamentals in these emerging countries. While we maintain a favorable long-term view of emerging-markets asset classes, we are reviewing our emerging-markets local-currency bond positions. At the same time, we are taking into account our assessment of the valuation risk posed by stocks in general. While stocks are not egregiously expensive (yet), they are definitely not cheap and we still do not believe they warrant a full portfolio weighting at current valuations.

At the same time, conditions have improved in Europe, which is generally seen as beginning a recovery from their double-dip recession following the financial crisis. The European recovery seems to have broadened beyond Germany despite long-term challenges like high unemployment and a generally uncompetitive labor force. European banks remain weak and credit growth has yet to recover. This could weigh on economic activity going forward, but governments are generally loosening austerity policies which should help improve conditions. In general, a broader European recovery should create revenue growth, margin expansion and, as here in the U.S., better employment and labor conditions over the coming years.

Overall, we remain mindful that we have not yet achieved "normal" economic status. The potential for a sharp slowdown in China's economy is one risk that concerns us. We also remain skeptical as to how the Fed will unwind its very large balance sheet (assuming it does) and normalize interest rates without major market upheaval. While it is possible the Fed succeeds in doing so, there are plenty of alternate outcomes that need to be factored into our decision making.

More broadly, there are a number of concerns and uncertainties that we must weigh in our investment decisions. The core question we attempt to gauge in each situation is how material these risks are and the likelihood of them playing out. By definition, if a risk scenario we were insuring against does not play out, then there will be a cost. But longer term we believe that cost can be recovered from other investment decisions we make. Ultimately, our asset class weightings rest on our assessment of the risk and return potential for each asset class as well as the objectives and risk threshold of each portfolio. These are our foremost and ongoing considerations as we manage our portfolios and work with you to help achieve your goals.