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INVESTMENT MANAGERS

INVESTMENT PERSPECTIVE | SEPTEMBER 2014

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MARKET COMMENTARY

Third quarter reinforced analysts' early views for the year that the easy money has been made and future stock returns will be more modest and have greater volatility. Large cap stocks in the S&P 500 gained only 1.1% in the quarter but are up 8.3% for the year so far. The large cap stocks of the DJIA are up 1.9% for the quarter and 4.6% for the year. Small cap stocks in the Russell 2000 retreated and were down –7.4% for the quarter and –4.4% year-to-date. International stocks in the MSCI EAFE were also down –5.9% for the quarter, resulting in a –1.4% loss for the year. Emerging market stocks did slightly better than developed markets and were only down –4.3% for the quarter but that decline erased previous gains for the year. Bond returns for third quarter were basically flat leaving year-to-date gains of 4.1% for the Aggregate Bond Index.

First quarter GDP was revised up from a dismal -2.9% to a slightly better -2.1%. Early reports that the contraction was weather related seemed to be confirmed by the strong rebound in second quarter reflected by GDP growth of 4.6%. GDP growth has averaged 2.2% the last five years so this strong growth is encouraging. In the second half of the year, GDP growth is projected to be around 3% which is more in line with the 3.27% average US GDP Growth from 1947 to 2014. Although the Fed projects long-term GDP growth to only be 2.2%—quite a bit below the long term average—the next couple of years should be good as they expect near 3% GDP growth in 2015 and 2016.

GDP growth goes hand in hand with earnings growth over the long term. So far, the stronger GDP growth has been accompanied by good corporate earnings. JP Morgan estimates that second quarter earnings on the S&P 500 will reflect 11.7% year-over-year growth.

2014 BENCHMARK RATES of RETURN

INDEX	THIRD QUARTER	YTD
S&P 500	1.1%	8.3%
DJIA	1.9%	4.6%
NASDAQ	1.9%	7.6%
Russell 2000	-7.4%	-4.4%
International	-5.9%	-1.4%
Fixed Income	0.2%	4.1%

Price earnings ratios and other valuation measures are higher than the past 10 years and now hover around their 25-year averages. Even at these higher levels, stock prices can continue to rise as long as earnings are growing and there is liquidity in the markets. Longer-term, slower economic growth is expected to weigh on corporate earnings and result in stock returns below the 10% average stock return benchmark many people target.

Also, at these higher valuations, investors tend to be more nervous and that can result in more volatility. Shocks to the system can cause liquidity to dry up fast as no one wants to buy and everyone wants to sell. In that environment, prices can fall quickly creating more anxiety and leading to more selling. Pullbacks in stock prices may provide purchasing opportunities for long-term investors who have cash available for investment or who have invested in fixed income securities that could be reallocated to stocks.

Geopolitical risks linger in the Middle East, as well as Eastern Europe. However, it seems the US markets have more often reacted negatively to positive economic news. When the economy shows strength, analysts and investors worry that the Fed will begin to raise interest rates sooner rather than later. They anticipate that rising rates could hurt the economy if done too soon or too quickly.

By year end, the Fed will end its bond purchasing activities. Consensus seems to be that the Fed will begin to raise short-term interest rates mid-2015, but some think it could be as soon as March. In June, the Fed projected that the Fed Funds rate would be 1.13% at the end of 2015 and 2.50% at the end of 2016. For the past few years, the Fed Funds target rate has been between 0% and 0.25%.

Many times rising interest rates on the short end are accompanied by a shift up in the yield curve reflecting higher longer term yields as well. Now, some analysts believe the yield curve may flatten as short-term rates rise if foreign central banks continue buying US debt for

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MARKET COMMENTARY

(continued from previous page)

safety. If inflation in the US remains in check and economic growth is not too strong, we may not see long-term rates rise as much as analysts previously expected. Many are already trimming their forecasts. Yields on the 10-year Treasury this quarter remained near 2.5%.

In the current environment, many analysts are favoring stocks over bonds for long-term returns. A well diversified portfolio includes stocks in order to capitalize on their growth opportunities. A well diversified portfolio would also include bonds to provide stability and safety. With stock valuations high and their return potential muted at these higher valuations, it may even behoove investors to have some reserves invested either in fixed income or money market securities that could be reallocated into stocks on pullbacks. Patience and discipline will be important to help keep emotions from overly influencing investment decisions. If you have questions about the strategies used in the management of your account, please do not hesitate to talk with your portfolio manager.

FINANCIAL PLANNING

Planning for retirement in a slower growth economy

With slower long-term economic growth projected, people will likely need to save more money to reach their goals. They will no longer be able to include robust returns in their asset growth projections.

Unfortunately, slower economic growth could also affect their ability to save. Pay increases may not come as frequently or be as good as in the past. They may experience periods of unemployment.

Depending on their current age, social security benefits could be lower if it isn't fully funded by the time they retire, further reducing their disposable income. Healthcare costs are also a concern as they can become a larger drain on financial resources and also cut into the money available to spend.

Many of these things are beyond their personal control. However, everyone has the ability to control the amount of money they save and the amount of money they spend. It may mean tightening the belt more now not only so that you can save more, but so you don't become accustomed to a lifestyle that would be unsustainable in retirement. Cambridge Advisors is here to help you with your financial planning and retirement planning needs.

QUESTION: *Are corporate earnings as good as they look?*

ANSWER: Many companies have been able to grow their earnings in the double digits even though the economy hasn't been that great. Since many investors base their decisions at least partially on future earnings growth, this has helped stock prices continue to rise.

Investors should look more closely at those earnings per share figures. Part of their growth has been because there are fewer shares outstanding. The panic of the Great Recession resulted in many companies cutting costs and growing cash reserves. After those cash reserves were deemed unnecessary, many companies used that cash to buy back shares of their company stock. Since there were less shares outstanding, the earnings per share of the company rose. Some companies then began to issue debt and use those proceeds to also buy back shares. Earnings per share continued to rise, but this strategy is unsustainable. At some point, they won't be able to borrow additional funds and earnings per share growth will slow.

If these companies had they used their cash reserves and debt proceeds to invest in themselves (expand, develop new products, buy smaller competitors, become more productive), they still could have grown their earnings. Moreover, that growth would have been sustainable. Now, if they've exhausted their borrowing capabilities, their ability to invest in themselves for long-term growth has been reduced. This is one reason why the Fed and analysts are projecting lower economic growth after 2016. In our analysis we look for companies that are growing revenues as well as earnings.

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CAMBRIDGE ADVISORS NEWS

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Serious about your future