Lane Asset Management

Stock Market Commentary

March 8, 2014

The stock market is moved by expectations, both short term and long. The last couple of months have been a good illustration as news caused by economic and geopolitical volatility seems to be giving way to longer term expectations of an improving U.S. and world economy.

Ultimately, stocks represent a claim on corporate earnings. According to Zacks, Q4 total earnings for the S&P 500 reached a new all-time quarterly record although revenue growth has been challenging and guidance continues to be downbeat (as it has for over a year). The balance of the year will be interesting, indeed.

Market Recap for February 2014

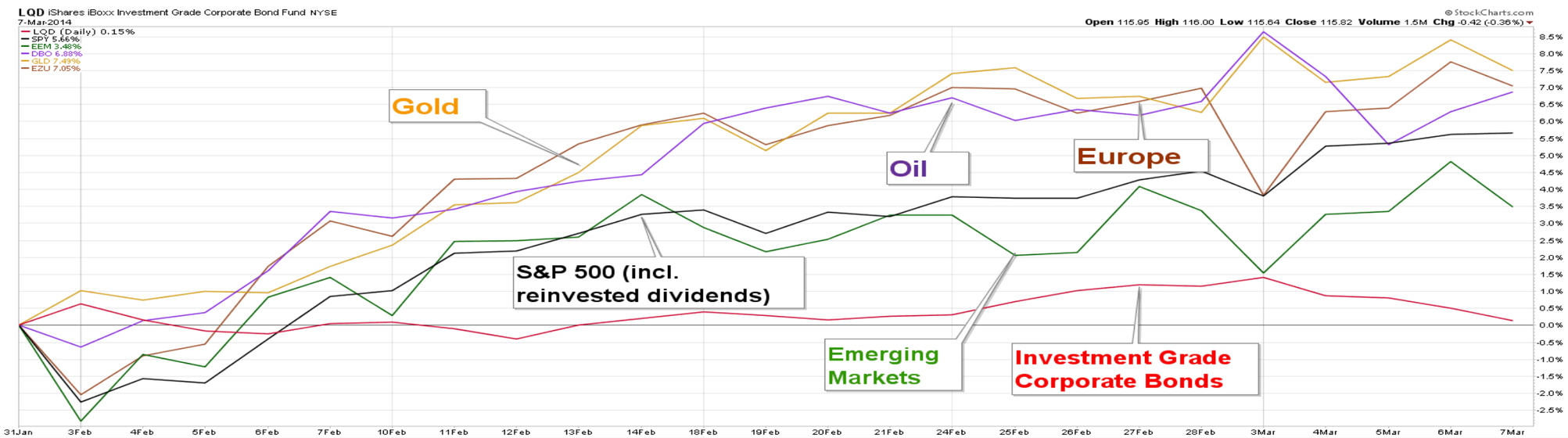
February was a strong month for the S&P 500, but beyond a bounce-back from an oversold January, it's hard to see what justified a 4.6% increase (not counting what's happened in early March). Weather played an important role in economic performance for the month leading, it seems, to investors discounting most negativity. On the plus side, corporate earnings provided few negative surprises and were on track for a roughly 9% improvement over Q4 2012. As the month wound down, news got even more positive with the St. Louis Fed president expressing optimism about the economy, manufacturing showing the strongest monthly improvements since May 2010 (according to a Markit survey), inflows to equity funds being the strongest in 12 weeks and offsetting withdrawals earlier in the year, and new home sales reaching a 5-year high.

I've extended the chart to show the first week in March and the initial impact and subsequent recovery to the conflict in the Ukraine. It's too early to say that crisis is behind us, but it appears that the investor reaction is downplaying any significant impact to the markets overall — so far.

Investment Outlook

My 2014 outlook remains constructive with a full year total return gain for the S&P of 8%, about a 6% total return from the time of this writing. This may not seem like much after last year's performance but I think will emerge as periodic strong advances are punctured by short term corrections.

From an investment standpoint, I would maintain a strategic (long term) asset allocation with an emphasis on domestic equities, short duration high yield and floating rate bonds and convertible bonds. From a sector perspective, I remain partial to pharmaceuticals and technology for the time being, despite a recent sell-off.



The charts on the following pages use mostly exchange-traded funds (ETFs) rather than market indexes since indexes cannot be invested in directly nor do they reflect the total return that comes from reinvested dividends. The ETFs are chosen to be as close as possible to the performance of the indexes while representing a realistic investment opportunity. Prospectuses for these ETFs can be found with an internet search on their symbol. Past performance is no guarantee of future results.

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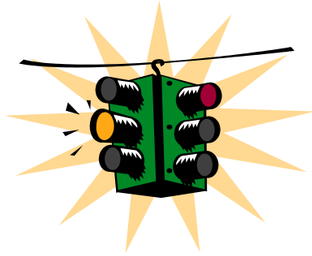
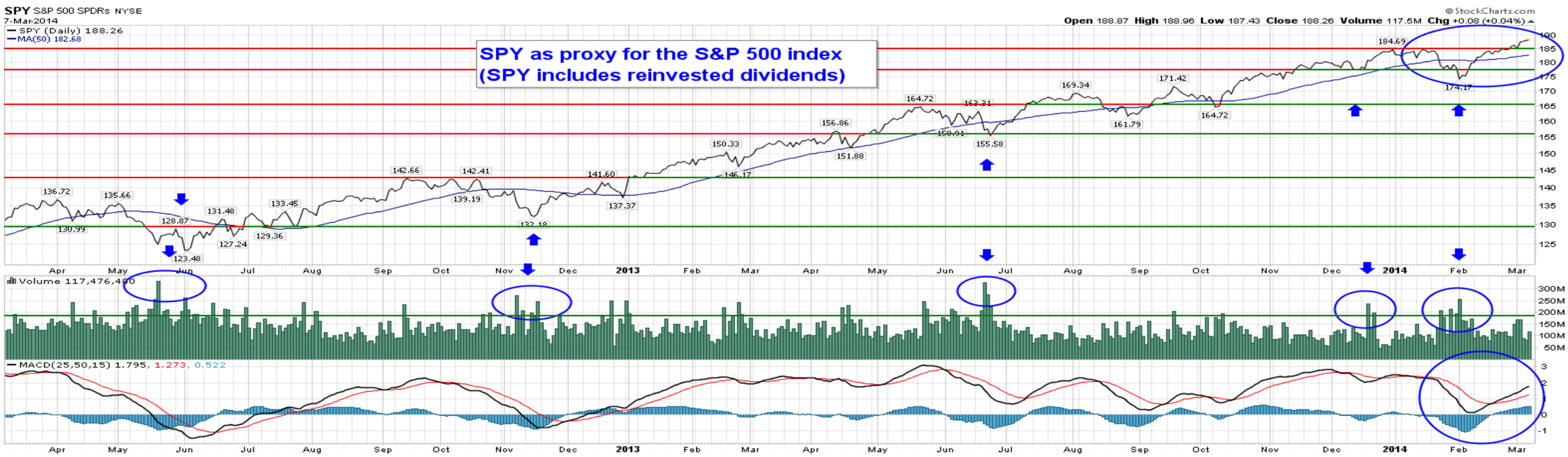
S&P 500



Last month I said that "some sort of a correction was underway...consider taking some risk of the table in measured amounts...this will pass and present a decent buying opportunity." While concerned about the loss of momentum, I also said that price was sitting on a line of support and that the spike in volume that occurred at the end of January with the market dip had, in the past, been indicative of a reversal to the upside.

Well, the correction was much shorter-lived than I had expected. While the suggestion to take some risk off the table proved unnecessary, I don't regret the advice keeping in mind that there are no market signals that are totally reliable, the history of 10%+ market corrections and lack of one in 2013 makes one likely in 2014, and that any shift in asset allocation should be done in measured amounts. What was very interesting to me was the repeat effect of the pattern of volume spikes associated with price reversal to the upside. Keeping in mind that past performance is no guarantee of future results, the repetition of this pattern is striking.

As of the beginning of March, the S&P 500 has completely recovered from its January loss and is now reestablishing positive price trend and momentum. The next couple of months will bring interesting technical developments. If SPY can make $185 a new line of support and maintain trend and momentum in March, I think that will bode very well for the year as a whole (absent a geopolitical crisis). For now, I remain cautious but hopeful.



SPY is an exchange-traded fund designed to match the experience of the S&P 500 index adjusted for dividend reinvestment. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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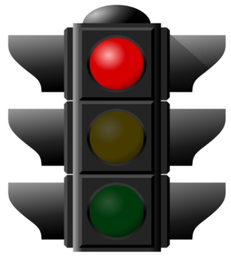
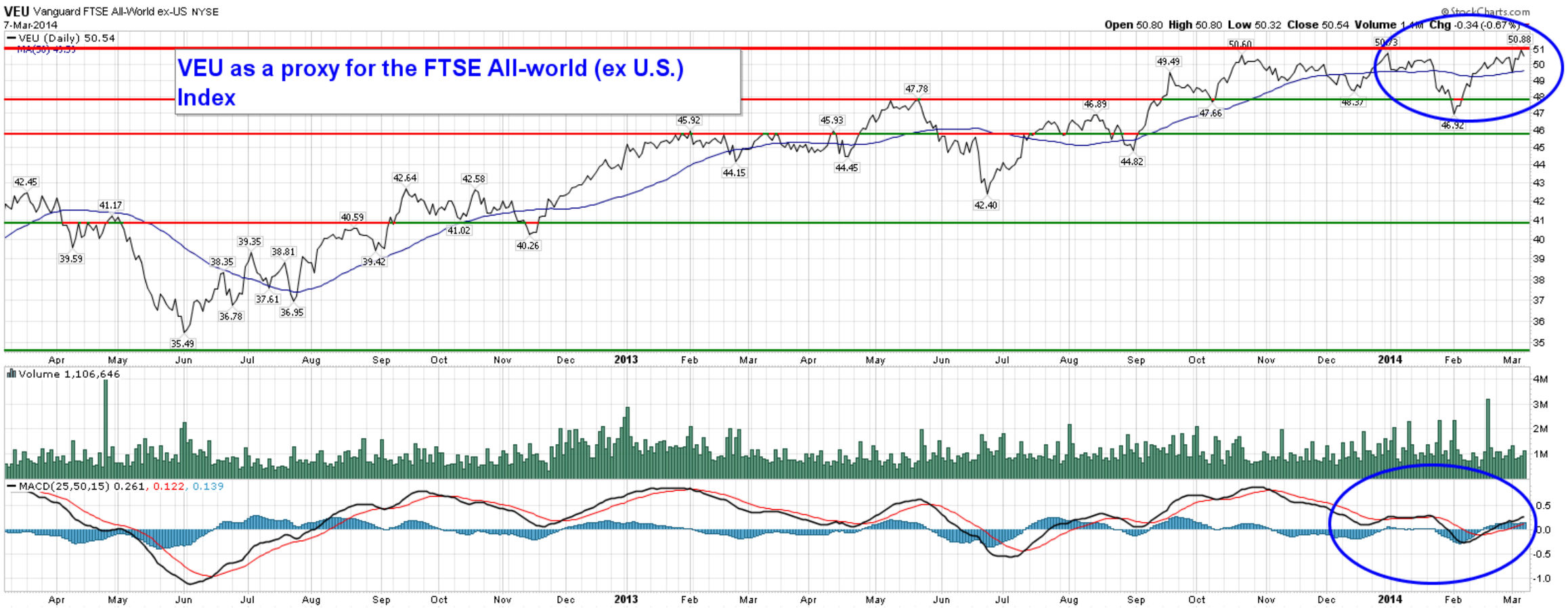
All-world (ex U.S.)

International equities, represented here by VEU, recovered sharply and completely from the January fall by bouncing off support at about $48 and now face resistance at $51 for the fourth time in 5 months. Price trend represented by the 50DMA has been without a clear signal for the last three months while momentum (MACD) picked up a bit in February. As I've said in recent months, I cannot see a compelling reason to hold a broad index of international equities at this point and there are very few individual countries that countries that are sustaining an outperformance relative to the S&P 500 (Belgium being one in recent months).



The bottom line at this point, as I said last month, should be to limit — or eliminate — broad international exposure (U.S. equities already provide a measure of exposure to international economies). While a number of countries and regions might be properly categorized as "cheap," I can't see a strong reason from a technical perspective to make more than a modest investment for the time being.



VEU is an exchange-traded fund designed to match the experience of the FTSE All-world (ex U.S.) Index. Its prospectus can be found online. **Past performance is no guarantee of future results.**

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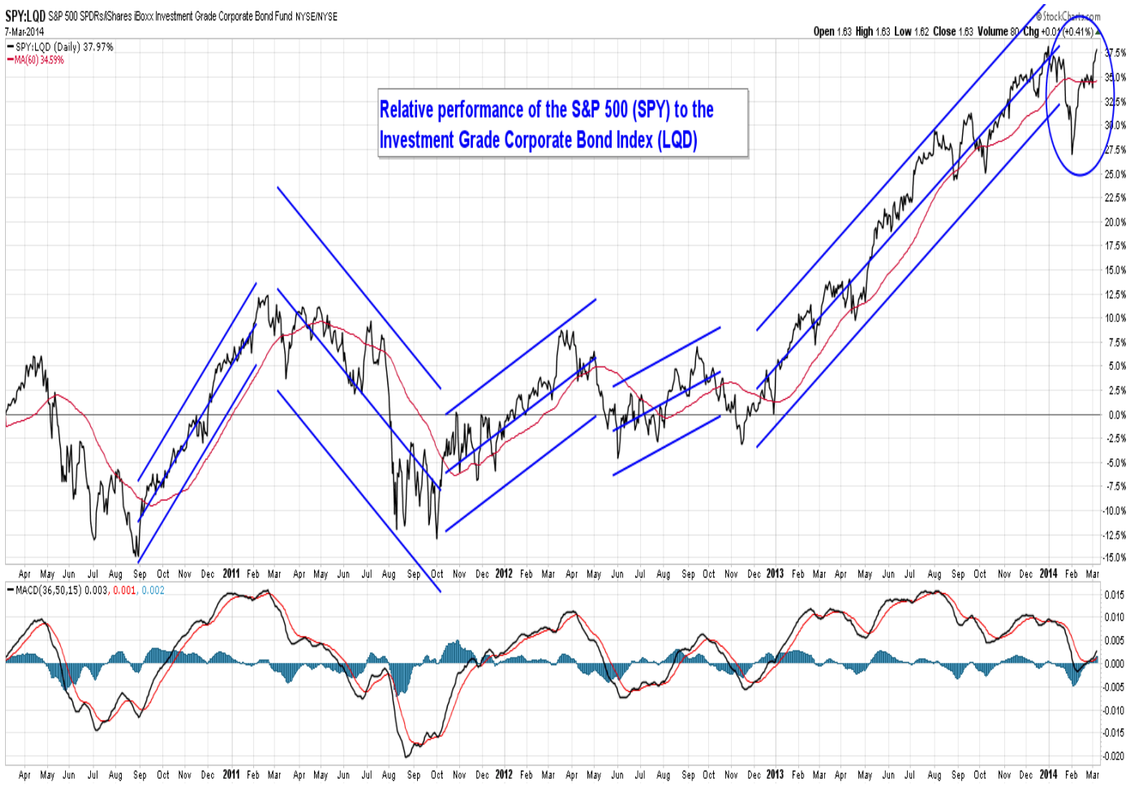
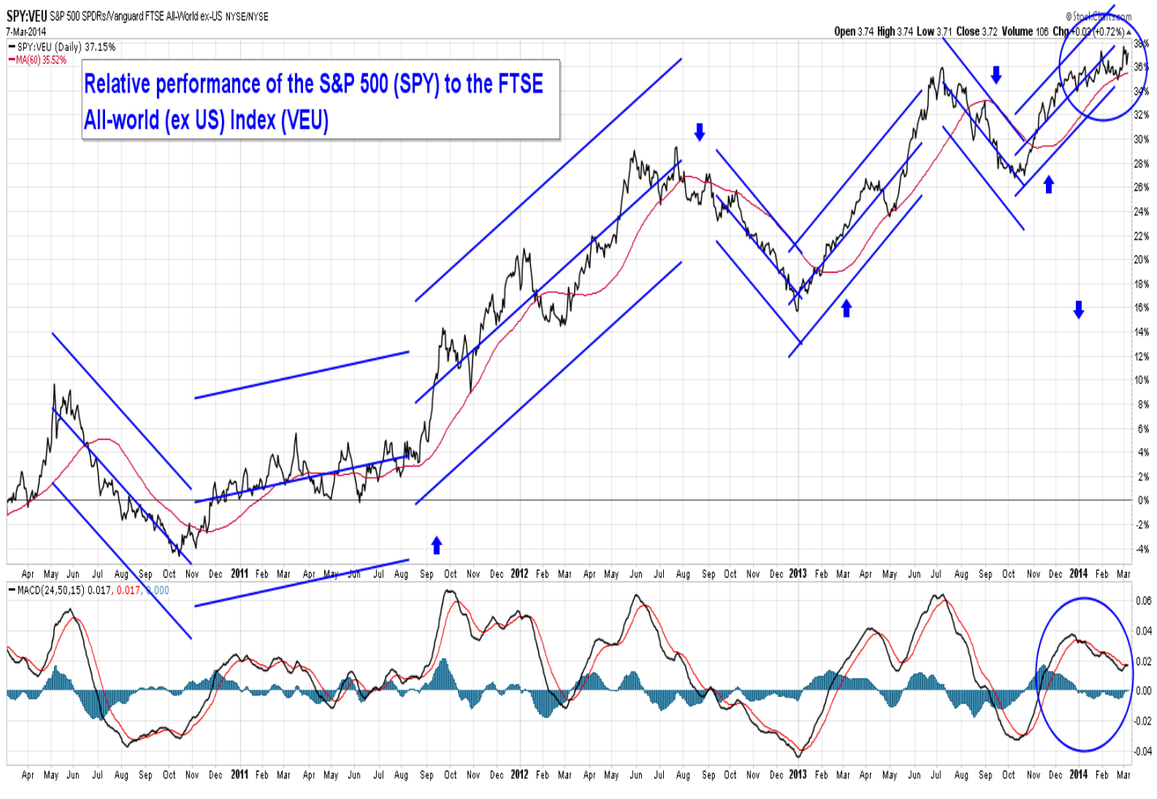
Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. Commonly, investors choose an allocation that reflects their risk tolerance and reallocate at prescribed times, say, semi-annually, or when the actual percentage allocation deviates from the longer-term strategic plan. One useful tool I've found for establishing and revising asset allocation comes from observing the relative performance of major asset sectors (and within sectors, as well). The charts below show the relative performance of the S&P 500 (SPY) to an investment grade corporate (IGC) bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

Following January's equity correction, relative strength has returned to equities over IGC bonds. That said, 2013 was an extraordinary year for equities relative to bonds and not one that I expect to see repeated in 2014. Rather, while still favoring equities, I expect a pattern more like the one that occurred in 2012 for this year. A balanced portfolio of domestic equities and income-oriented securities reflecting an investor's strategic (long term) allocation is recommended for now. Despite the loss of momentum that domestic equities experienced in February relative to the broad international index, as long as the trend of the relationship favors domestic equities, that's where I would place my emphasis.





SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

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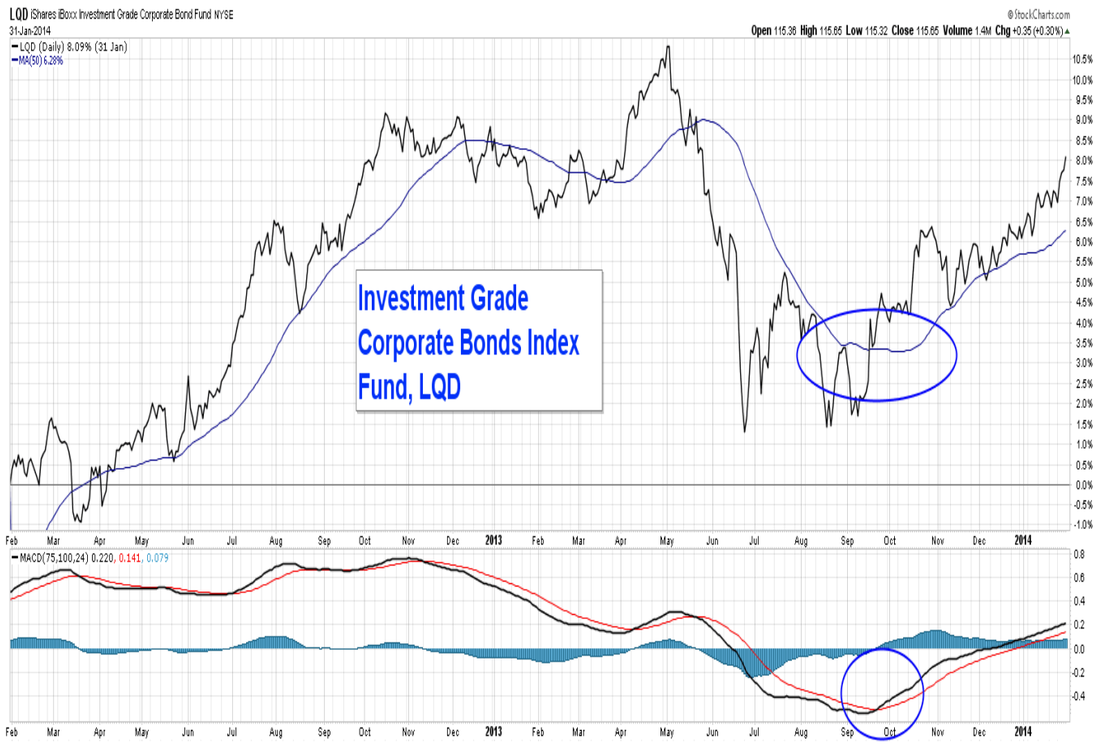
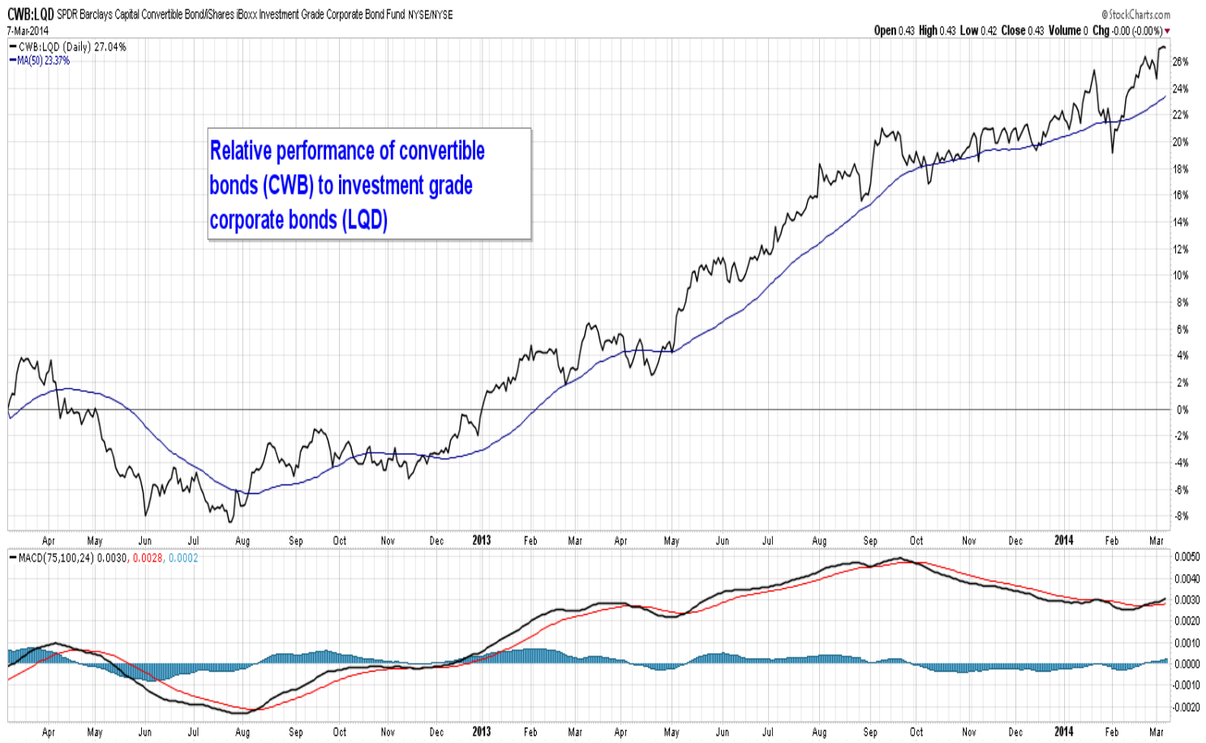
Income Investing

I haven't been a fan of investment grade bonds (represented below by LQD) since interest rates spiked following Bernanke's May 2013 speech suggesting the Fed's QE program would begin to be curtailed in the Fall. Even though rates have somewhat stabilized since then and LQD has recovered nicely, the consensus longer term view for interest rate risk is to the upside, and this will not bode well for the longer duration bonds in the LQD index when it begins to materialize. In the meantime, however, there are good income-oriented investment alternatives, such as preferred stocks, floating-rate banks loans, convertible bonds, and short-term high yield corporate bonds, that provide diversification to the broad IGC bond index with less interest rate risk.

This month I highlight the relative performance of convertible bonds, represented by CWB, the Barclays Convertible Securities fund. What's interesting about convertible bonds is that they represent a hybrid security with characteristics of both bonds and equities. As shown in the relative performance chart on the right, CWB was unaffected by the rate increase that caught LQD by surprise last May and, though not shown in the chart, has less volatility than equities. While convertible bonds should not be the only substitute for straight bonds, I do recommend them for a portion of the income-oriented allocation.



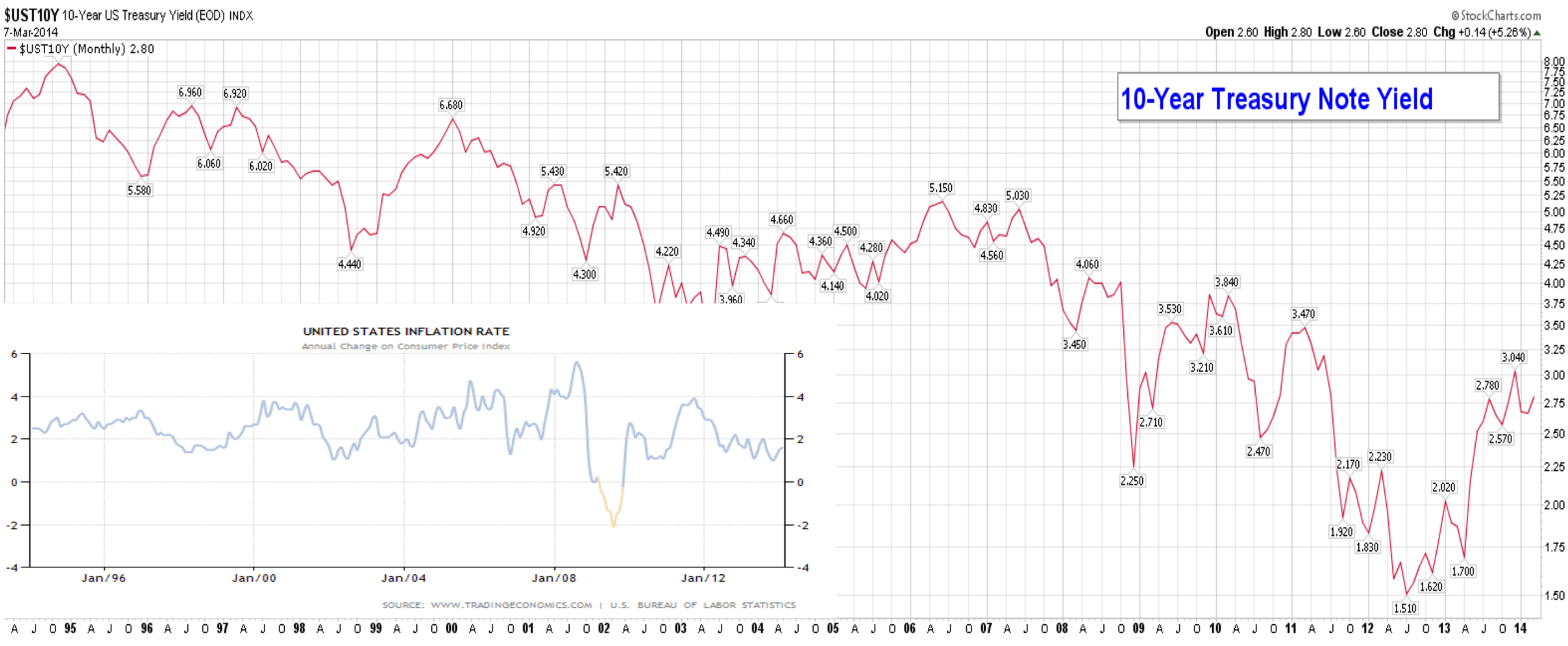


CWB is the SPDR® Barclays Convertible Securities ETF corresponding to the experience of the Barclays U.S. Convertible Bond > $500MM Index. LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. **Past performance is no guarantee of future results.**

Interest Rates and Inflation

Shown below is a 20-year history of the 10-Year U.S. Treasury Note yield and, in the insert, a 20-year history of the U.S. inflation rate. The yield on the 10-year Treasury Note is seen as a benchmark rate that influences almost all other rates and is said to be the most popular debt instrument in the world. Until Bernanke's speech last May forecasting the end of the Fed's bond purchase program, the 10-year yield had been generally declining over the last 20 years. This corresponds to the success of bonds and bond funds over this period. Now that the yield seems to have reversed course and the Fed is winding down its bond purchases, the expectation is for the 10-year yield to gradually move to a more "normal" or sustainable rate — perhaps in the 4%-5% range. This is what gives me caution about investing in longer term bonds at the present time.

Meanwhile, inflation over the 20 years has hovered around 2% which corresponds to the Fed's preferred rate for long run price stability and maximum employment. Today, the annualized inflation rate is closer to 1.6% — suggesting that the Fed could tolerate additional inflation without attempting to raise the Fed Funds rate.



Disclosures

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Investing involves risk including loss of principal. Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity. Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Investors should consider the investment objectives, risks, and charges and expenses of mutual funds and exchange-traded funds carefully for a full background on the possibility that a more suitable securities transaction may exist. The prospectus contains this and other information. A prospectus for all funds is available from Lane Asset Management or your financial advisor and should be read carefully before investing.

Note that indexes cannot be invested in directly and their performance may or may not correspond to securities intended to represent these sectors.

Investors should carefully review their financial situation, making sure their cash flow needs for the next 3-5 years are secure with a margin for error. Beyond that, the degree of risk taken in a portfolio should be commensurate with one's overall risk tolerance and financial objectives.

The charts and comments are only the author's view of market activity and aren't recommendations to buy or sell any security. Market sectors and related exchanged-traded and closed-end funds are selected based on his opinion as to their usefulness in providing the viewer a comprehensive summary of market conditions for the featured period. Chart annotations aren't predictive of any future market action rather they only demonstrate the author's opinion as to a range of possibilities going forward. All material presented herein is believed to be reliable but its accuracy cannot be guaranteed. The information contained herein (including historical prices or values) has been obtained from sources that Lane Asset Management (LAM) considers to be reliable; however, LAM makes no representation as to, or accepts any responsibility or liability for, the accuracy or completeness of the information contained herein or any decision made or action taken by you or any third party in reliance upon the data. Some results are derived using historical estimations from available data. Investment recommendations may change without notice and readers are urged to check with tax advisors before making any investment decisions. Opinions expressed in these reports may change without prior notice. This memorandum is based on information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned. The investments discussed or recommended in this report may be unsuitable for investors depending on their specific investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors. All prices and yields contained in this report are subject to change without notice. This information is intended for illustrative purposes only. **PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.**

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