The Lam Group
Investment Management

While 2Q 2013 started strongly, the mere hint of the Fed potentially tapering its bond buying program has created a cloud of uncertainty over the markets. The bulk of the challenges experienced in the second quarter occurred in June 2013 (Table 1). Even though the Fed has not changed its bond buying program, the fear of higher US interest rates have obviously caused problems for the markets globally.

It is worth noting that of the 13 asset classes we include in our globally-diversified portfolios, only two are up this quarter. While the increases in popular US benchmarks such as the S&P 500 dominate the media's attention, very few other asset classes have made positive contributions in 2013 (so far). The rally YTD has not been global or broad-based.

Table 1: Periodic Asset Class Returns as of 6/30/13

EQUITY ASSET CLASSES	June 2013	***2Q 2013***	1Q 2013	***YTD***	**12 Months**	***10 Years****	***10 Years***
S&P 500 Index - Domestic Large Cap Stocks	- 1.34%	+ 2.91%	+10.61%	+13.82%	+20.60%	+ 7.30%	+102.25%
Russell 2000 Index - Domestic Small Cap Stocks	- 0.51%	+ 3.08%	+12.39%	+15.86%	+24.21%	+ 9.53%	+148.43%
MSCI EAFE Index - International Large Cap Stocks	- 3.55%	- 0.98%	+ 5.13%	+ 4.10%	+18.62%	+ 7.67%	+109.41%
MSCI EAFE SC Index - International Small Cap Stocks	- 3.66%	- 2.52%	+ 8.42%	+ 5.69%	+20.88%	+10.38%	+168.51%
MSCI EM Index - Emerging Markets Stocks	- 6.37%	- 8.08%	- 1.62%	- 9.57%	+ 2.87%	+13.66%	+259.91%
DJ US Select REIT Index - Domestic Real Estate	- 1.76%	- 1.29%	+ 7.04%	+ 5.65%	+ 7.69%	+10.68%	+175.93%
S&P Global (ex-US) REIT Index – International Real Estate	- 4.23%	- 8.30%	+ 7.42%	- 1.50%	+14.28%	+ 7.91%	+114.07%
FIXED INCOME ASSET CLASSES	June 2013	***2Q 2013***	1Q 2013	***YTD***	**12 Months**	***10 Years***	***10 Years****
BarCap Aggregate Bond Index - US High-Grade Bonds	- 1.55%	- 2.32%	- 0.12%	- 2.44%	- 0.68%	+ 4.52%	+ 55.60%
BarCap High-Yield Bond Index	- 2.62%	- 1.44%	+ 2.89%	+ 1.42%	+ 9.49%	+ 8.91%	+134.79%
BarCap TIPS Index - US TIPS	- 3.56%	- 7.05%	- 0.36%	- 7.39%	- 4.78%	+ 5.20%	+ 65.96%
DJ UBS Commodities Index - Commodities	- 4.71%	- 9.45%	- 1.13%	- 10.47%	- 8.01%	+ 2.39%	+ 26.62%
Citigroup Non-$ World Govt Bond Index - Non-$ Bonds	- 0.39%	- 3.44%	- 3.82%	- 7.14%	- 5.72%	+ 4.78%	+ 59.51%
JPM EMBI Global Diversified Bond Index - Emerging Markets Debt	- 4.91%	- 5.63%	- 2.26%	- 7.76%	+ 1.13%	+ 8.58%	+127.87%

Sources: Morningstar, JP Morgan, and Dimensional. * Annualized

The recent rise in intermediate-to-long-term interest rates has challenged our portfolio in some less obvious ways. In 2Q 2013, most of our declines were not so much a result of rising interest rates (the majority of the duration in our portfolio was short-to-moderate), but rather due to the *decline in inflationary expectations* (which negatively affected TIPS and commodities) and the *strengthening of the US dollar* (which negatively affected all non-dollar exposures, especially emerging markets debt and equity).

Can a strengthening domestic economy (with lower unemployment) coexist with declining inflation expectations? In the short-run, it seems the market thinks so. However, in the long-run, inflationary pressures may be unavoidable. Asset class behavior for 2Q 2013 illustrates that over narrow periods of time, the capital markets can move in unanticipated directions. This serves as yet another reminder that it is very difficult to successfully predict market direction.

Given the recent performance of domestic stocks and the strengthening of the US dollar relative to non-US asset classes, some may question the benefits of global diversification and whether it continues to make sense to hold non-US asset classes. While it is true that US equity exposures have meaningfully outperformed their non-US equity counterparts over the last six months, one only has to look to last year (2012) or the "lost decade" (2001-2010) to see the importance of holding both non-US and domestic exposures in a globally-diversified portfolio. If we look at the 10 Year cumulative asset class data in Table 1, the rally in US stocks is long overdue.

The suddenness of the June decline is reminiscent of other difficult and unexpected periods in the global markets where central bank action (or inaction) was involved. Unexpected and severe market disruptions caused by the European debt crisis in May 2011 and May 2012, as well as the global financial crisis in 2008-09 have taught us many lessons, the most important being not to panic or overreact.

Keep Calm and Carry On

Of course, one difficult quarter does not lessen our dedication to our globally-diversified investment strategy. Over the long-run, the inclusion of allocations to non-US investments and inflation-sensitive bonds add positively to the performance and risk management of an investment portfolio. However, in exchange for higher expected returns, these asset classes can experience periods of higher volatility that can negatively affect short-term performance. 2Q 2013 (June 2013 in particular) was one of those periods.

The historical resilience of the asset classes that have underperformed this quarter/YTD 2013, such as emerging markets (debt and equity), TIPS and international real estate, give us optimism for the future.