Lane Asset Management

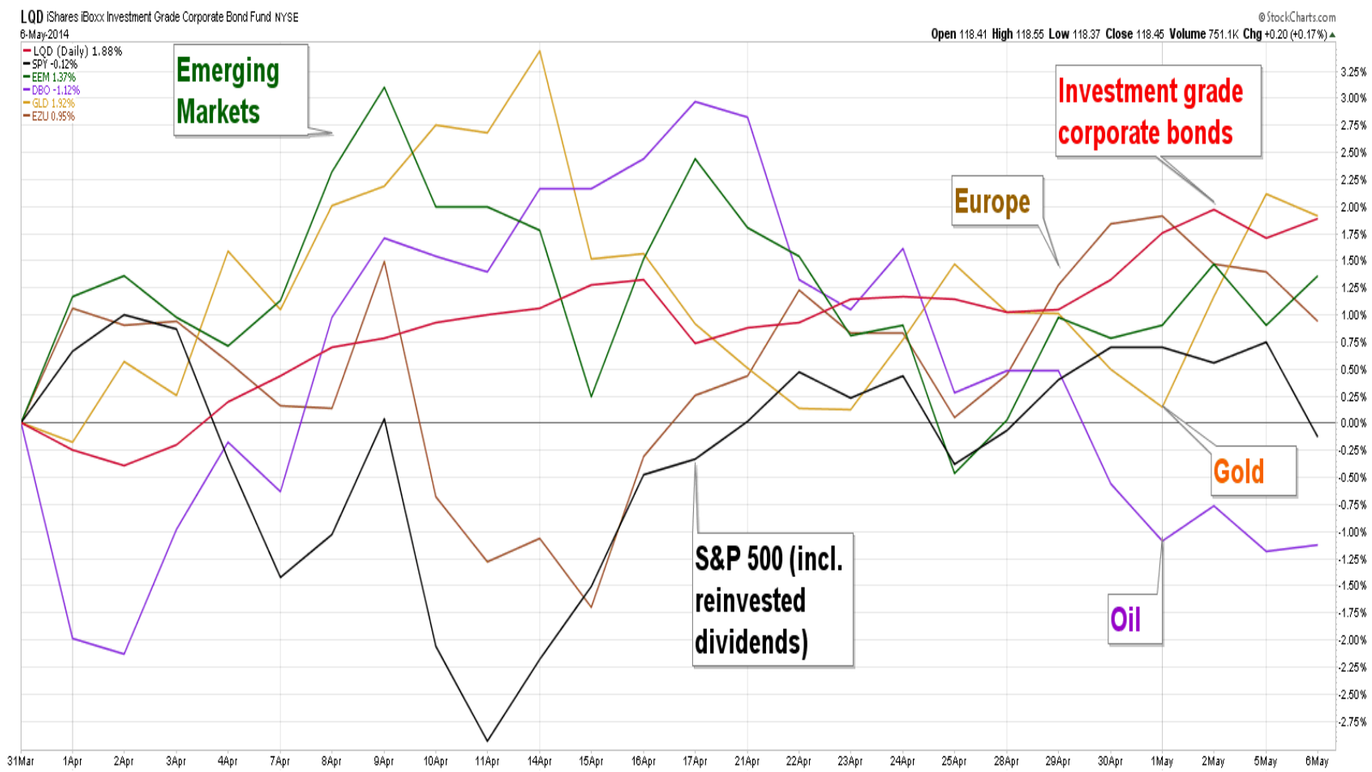
Stock Market Commentary

May 8, 2014

One of the hardest things to do as an investor is to have patience when confronted with uncertainty. I'm convinced that the long term outlook for equities is positive, certainly U.S. equities. But I'm equally convinced that the short term outlook has more downside risk than up. As investors, we have a choice of reducing risk now and hoping to get back into the market at a better time or riding through the next 6-12 months with a long term plan. Although there is room for measured adjustments along the way, the choice we make should leave us with an ability to sleep at night. Keep financial goals in mind, both short term and long, as you decide the best course of action for you.

Market Recap for April 2014

As the chart below shows, the markets were schizophrenic in April and the beginning of May. Apparently, since no one can ever know for sure over a short period of time, the key drivers of April's performance seemed to be a combination of the conflict in Ukraine, supportive comments from Fed Chair Yellen, improving economics (including non-farm payrolls, durable goods, retail sales, strength and breadth in the Conference Board's Leading Economic Indicators, and U.S. industrial production), mediocre 1st quarter corporate earnings. and weak 1st quarter GDP growth (revisions to come). Less obvious, the markets may also be reacting to analyst comments about extended market valuations (certainly true on many measures) and forecasts of an eventual correction, profit-taking from 2013, and general nervousness.



Investment Outlook

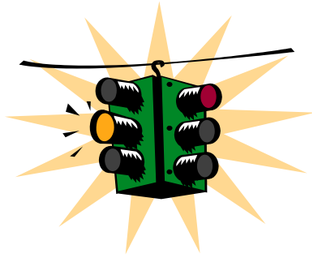
On a long term basis, equity performance generally follows corporate earnings though market valuations ebb and flow. As Vanguard noted at the beginning of the year, changes in market valuations has been the largest single component of 10-year real (inflation-adjusted) returns in the market going back to 1935. Perhaps not surprising, that component has been "mean reverting," meaning under-valuations are eventually offset by overvaluations and vice versa.

My view is that actual earnings and earnings outlooks will be remain muted for several more years, at least, but that doesn't mean they will be negative. Thus, equity performance will not be what we've seen (enjoyed) in the last 5 years (17.6% for the S&P 500) but more like the 9% of the last 20 years or possibly 4-8% of the last 10-15 years. With interest rates destined to rise, returns from fixed income will also be far below the last 20 years' performance. The bottom line is that investors should lower expectations and maintain a diversified portfolio reflective of their short and long term investment horizon.

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.

Lane Asset Management

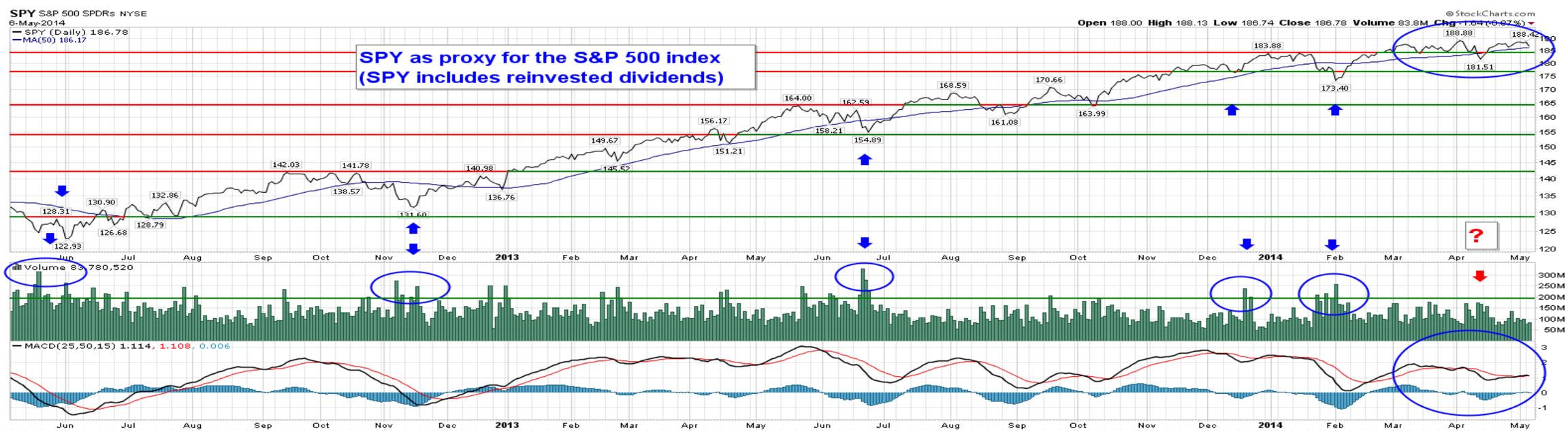
S&P 500 Total Return (SPY)



Last month I made the analogy of seeing the S&P 500 performance like a duck in a pond — little movement on the surface, but lots of thrashing underneath. It certainly looks like that occurred again in April (see page 1) as SPY barely budged from my last report on April 8th to this one on May 8th but not without a lot of action in the interim.

What we do have now, though, is more information about how the year may be shaping up from both a fundamental and technical perspective. On the fundamental side, the U.S. economy continues to make modest gains. 1st quarter corporate earnings reported by Zacks are up 1.4% over the same period last year for the 75% of S&P 500 companies that reported through May 2nd, 3.3% if the financial sector is excluded. Revenue growth was also a modest 2.2% year-over-year (3.0% ex-financials). Though many analysts are expecting a better outcome as the year progresses, especially with the view that weather had a lot to do with the 1st quarter, lowered guidance from many companies doesn't portend a very strong year.

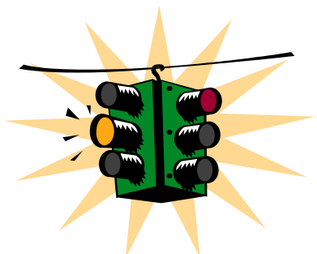
On the technical front, SPY is still having trouble escaping from the line of support near $185 (around $1,850 on the index). Trend is still positive, barely, and momentum remains weak. The spike in volume mid-April does not seem to have been enough to give SPY "escape velocity." While I don't yet see signs of a major correction, I believe the risk here, to the extent there is one, is to the downside. Therefore, I would remain cautious and prepared for a correction in the 5-10% range.



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.**

Lane Asset Management

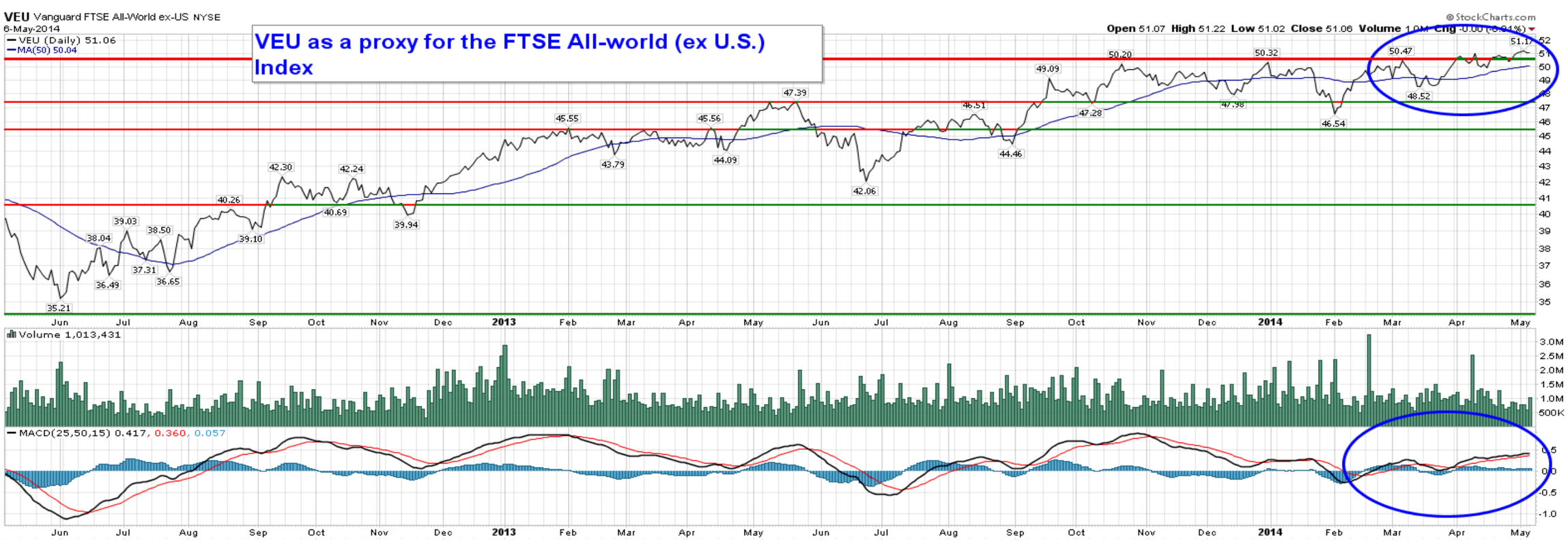
All-world (ex U.S.) Equities (VEU)



International equities, represented here by Vanguard's VEU, outperformed the S&P 500 in April and actually have a more constructive technical outlook: rising trend AND rising momentum. Of course, this is a bit surprising on account of the turmoil in Ukraine and the possible impact this could have on Europe. Clearly, investors don't see it that way, at least, not yet.

VEU has been knocked back from the line of resistance at $51 quite a few times in the last 6 months but now looks poised to break free. As I've mentioned in the past, I find the best way to invest international, other than through large cap U.S. companies, is to identify countries or regions that are showing sustained growth. Using the country-specific ETFs as a guide, I'm now finding a few more countries showing relative strength, including Belgium and Italy (both of whom have been outperforming the S&P 500 for several months) and Canada and Brazil (whose outperformance is more recent).

As I indicated last month, I am still supportive of increasing the international allocation on a selective basis but, considering the risks in Europe, at least, would do so on a measured basis.



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.**

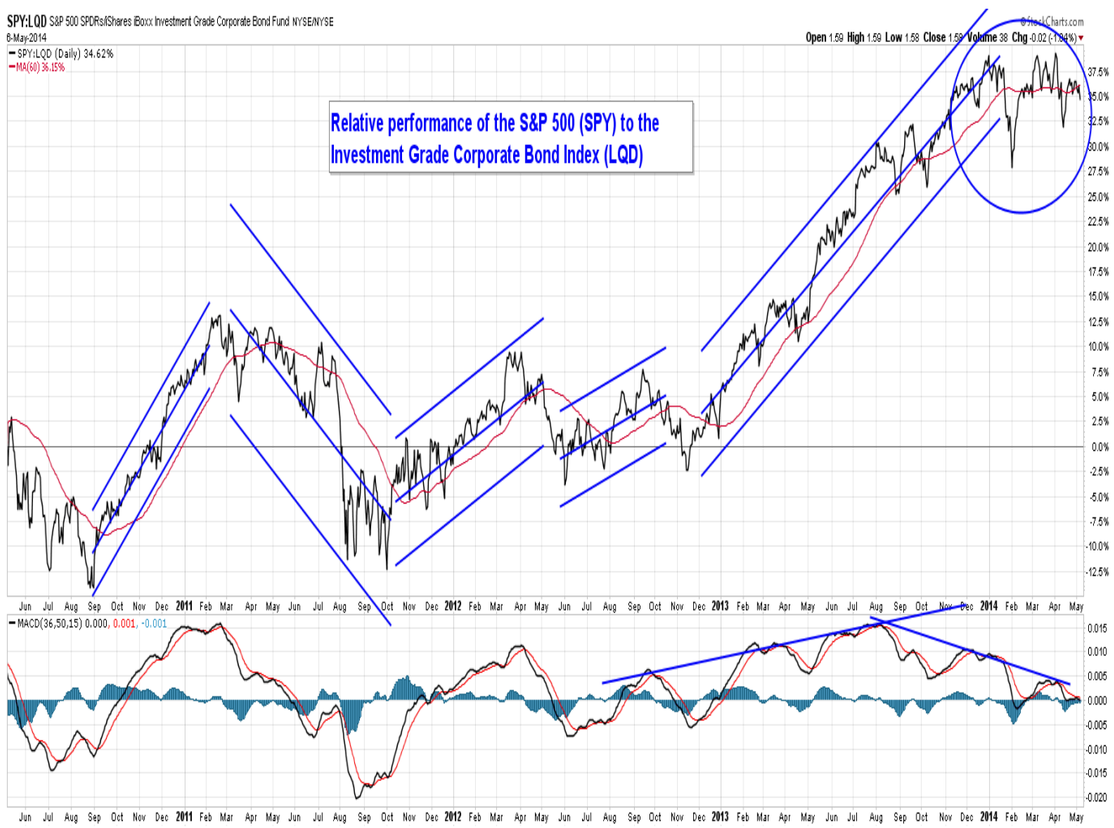
Lane Asset Management

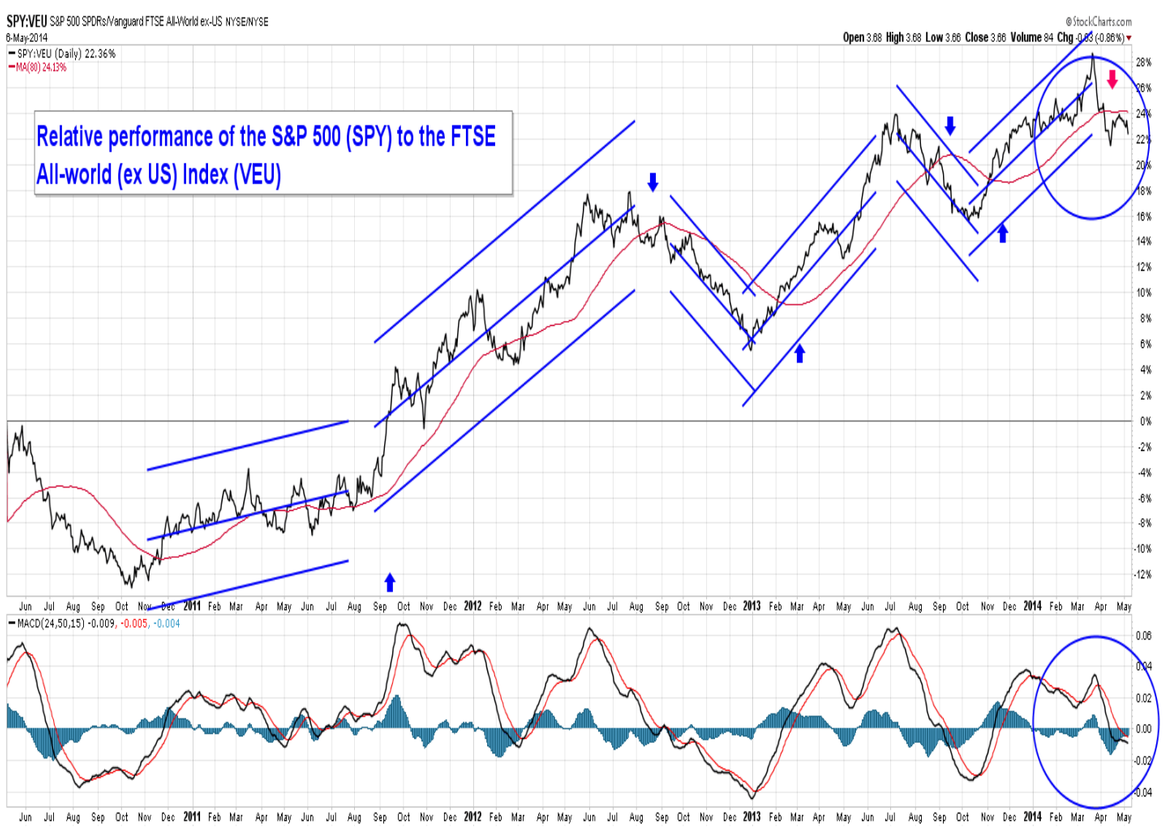
Asset Allocation and Relative Performance

Asset allocation is the mechanism investors use to enhance gains and reduce volatility over the long term. 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 bond index (LQD) on the left, and to the Vanguard All-world (ex U.S.) index fund (VEU) on the right.

On the left, we see a bit of a tradeoff occurring between domestic equities and bonds. Looking back, this type of balanced performance does not seem to last very long. Noting the continuing weakness in the momentum (favoring bonds) and the extraordinary results in 2013, we may indeed be observing a reversal in leadership. I don't think we are quite there yet, but this is something that should be watched carefully.

On the right, we seem to be also on the verge of a shift in relative performance in favor of international equities. For investors with an international component to their strategic (long-term) benchmark, it may now be time to add a bit of exposure directly to international equities with a focus on selected countries showing sustained outperformance.





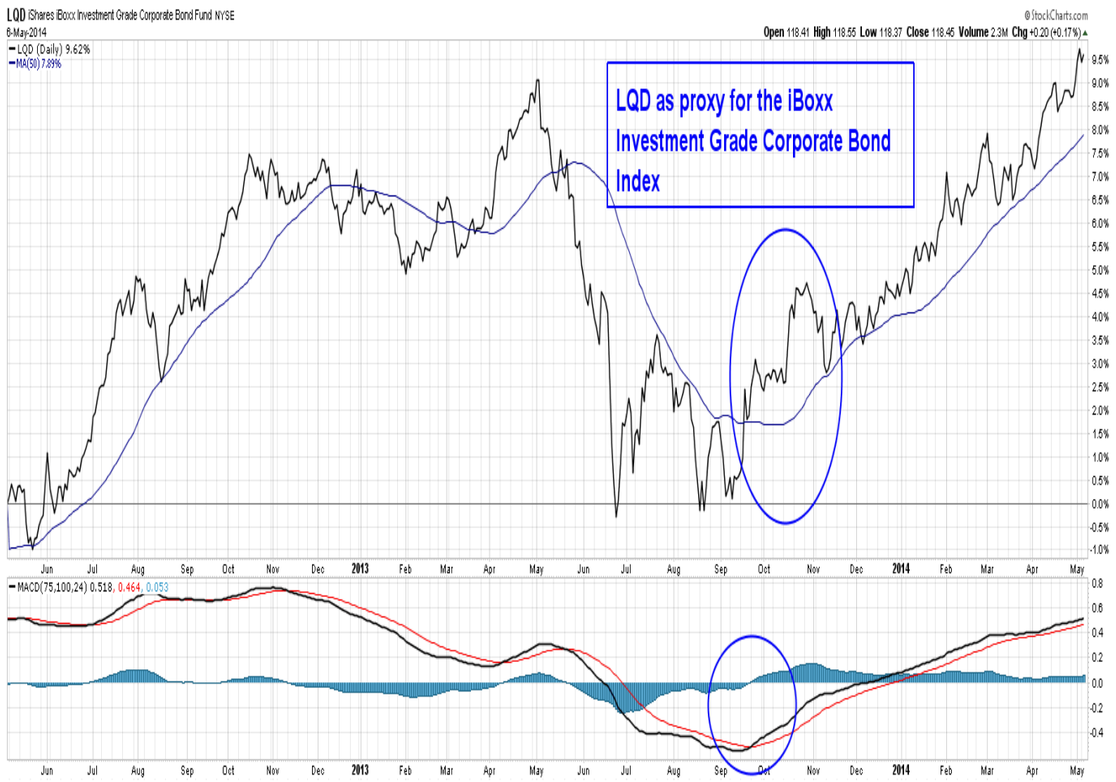
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade Corporate Bond Index, respectively. Their prospectuses can be found online. **Past performance is no guarantee of future results.**

Lane Asset Management

Income Investing

I haven't been a fan of investment grade bonds (represented below by LQD) since interest rates spiked a year ago. While rising rates would not bode well for longer duration bonds such as those in LQD, rate stabilization and the interest rate outlook (see the next page), not to mention risk aversion among investors, has led to a recovery in longer duration bonds and LQD that looks viable for months to come. That said, as a measure of diversification is good for equities, it is also good for income-oriented investments. Therefore, it is useful to consider alternatives, such as preferred stocks, floating-rate banks loans, convertible bonds, short-term high yield corporate bonds and REITs to gain diversification to the longer duration bonds in LQD.

Recently, I've been highlighting the relative performance of convertible bonds but with recent equity weakness there are better alternatives. This month I am focusing on preferred stocks which, although also long term in nature, have the kind of attractive yields and lower volatility that have contributed in recent months to strong relative performance. While LQD continues to be attractive on a technical and fundamental basis, I recommend investors with an income objective select a balance among a number of viable alternatives.

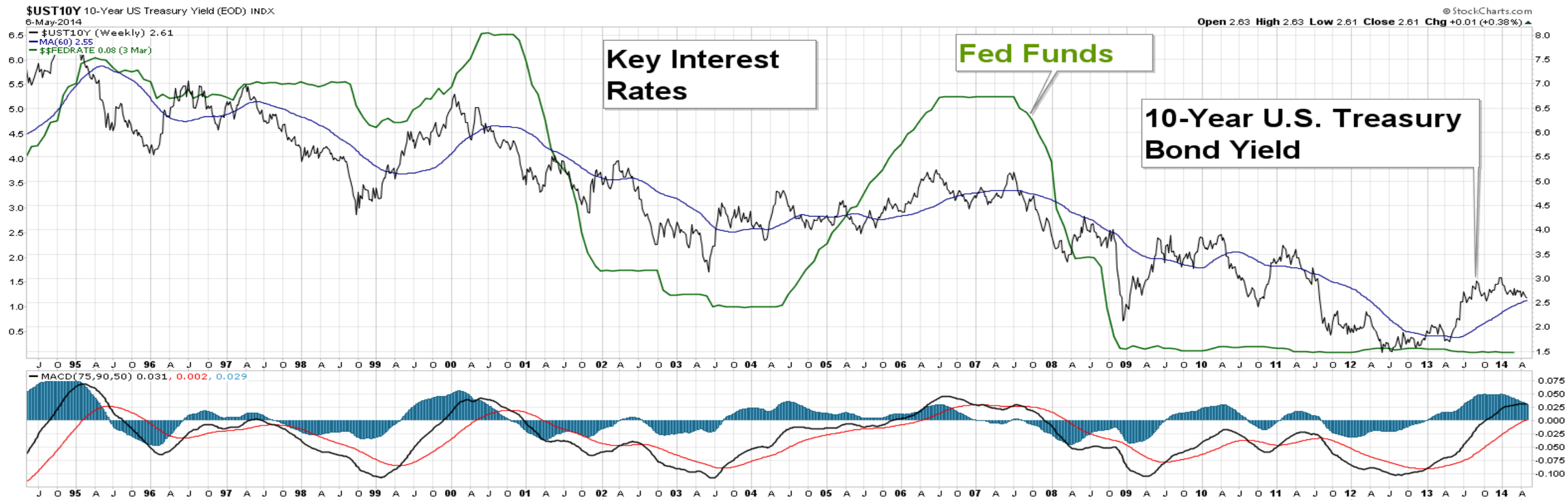


PFF seeks to track the investment results of the S&P U.S. Preferred Stock Index (TM) which measures the performance of a select group of preferred stocks . LQD is an ETF designed to match the experience of the iBoxx Investment Grade Corporate Bond Index. Prospectuses can be found online. **Past performance 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. 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 prior 20 years resulting in 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 in the next few years — perhaps in the 4-5% range in the view of some analysts. This has given me caution about investing in longer term bonds. 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, recently published annualized inflation rate is closer to 1.5% (up from 1.1% last month). While this suggests the Fed could tolerate additional inflation without attempting to raise the Fed Funds rate, there is a "great debate" among commentators about when the expected increased in the Fed funds rate will take place. In fact, Gavyn Davies of the Financial Times recently made a persuasive case that interest rates will stay low for much longer than some folks have thought owing to low rates of business investment and demand for funds (this was certainly borne out in the Q1 GDP estimate), excess savings in emerging economies, and investor demand for bonds despite low historical yield. As mentioned last month, the concern I've had about imminently rising rates is looking increasingly premature.



Disclosures

Edward Lane is a CERTIFIED FINANCIAL PLANNER™. Lane Asset Management is a Registered Investment Advisor with the States of NY, CT and NJ. Advisory services are only offered to clients or prospective clients where Lane Asset Management and its representatives are properly licensed or exempted. No advice may be rendered by Lane Asset Management unless a client service agreement is in place.

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.**

Periodically, I will prepare a Commentary focusing on a specific investment issue. Please let me know if there is one of interest to you. As always, I appreciate your feedback and look forward to addressing any questions you may have. You can find me at:

www.LaneAssetManagement.com
Edward.Lane@LaneAssetManagement.com

Edward Lane, CFP®
Lane Asset Management
Kingston, NY