Lane Asset Management

April 8, 2014

Stock Market Commentary

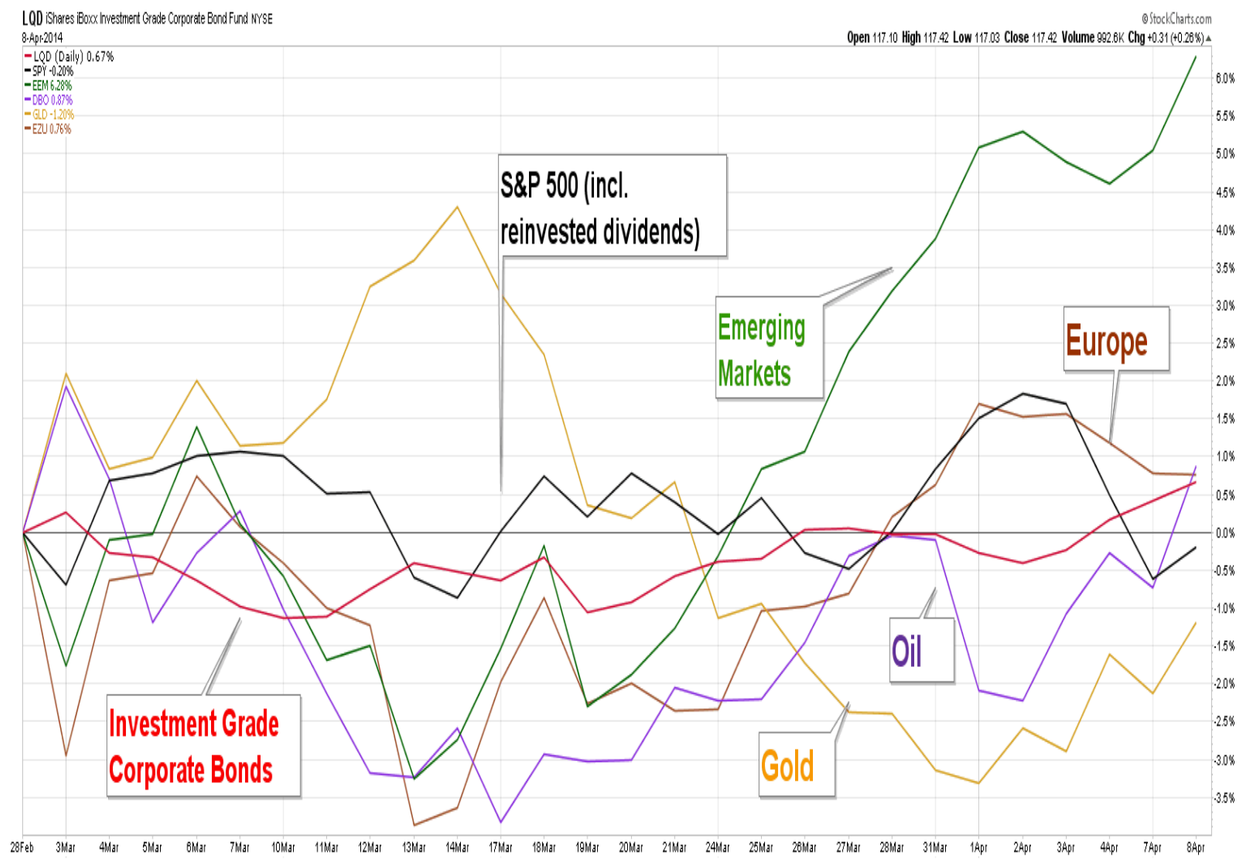
On a year-to-date basis, total return on the S&P 500 has been about 1.3%. My expectation for the year was about 8% while others were forecasting as much as 11.5% (see my January Commentary). To make the "goal," total return from here needs to be 6.5-10%. That could be a stretch.

In addition to the year's performance, I (and many others) also forecast a significant correction during the year, perhaps as much as 10% or more.

I'm now thinking that it's possible we will have a "time" correction rather than a "price" correction. By that I mean we may drift slowly through the year and allow P/E multiples to simmer down over time. That wouldn't be a bad outcome, but prior year volatility would suggest that could be wishful thinking.

Market Recap for March 2014

The factors influencing market moves in March included concerns about the crisis in the Ukraine, anticipation of weak 1st quarter corporate results, slumping Chinese exports, mid-month speech by Fed Chair Yellen raising concerns about an early Fed Funds rate hike, a lower-than-expected result in the Empire State manufacturing index, and a congressional challenge to biotech pricing strategy. The plus side included the Fed's Beige Book reference to a slowly improving economy, a jump in the Conference Board's Leading Economic indicators, and a much-better-than expected increase in the Philly Fed Business Outlook Survey. As a result, the U.S. and European equity markets ended the month little changed as investors waited to see 1st quarter corporate performance. The biggest movers for the month were gold (influenced by Chair Yellen's speech) and emerging markets which, although having a great month, basically just recovered from a disastrous preceding 2 months.



Investment Outlook

My outlook for 2014 remains the same as stated last month anticipating a full year total return for the S&P of 8%, or about a 6.5% 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. First quarter corporate earnings reports are beginning to come out now and will give a strong clue to the prospects for the remainder of the year.

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, especially being hard hit in March.

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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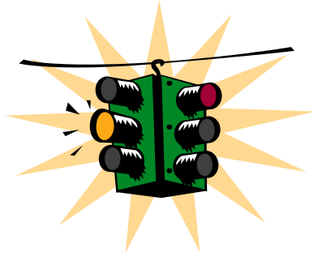
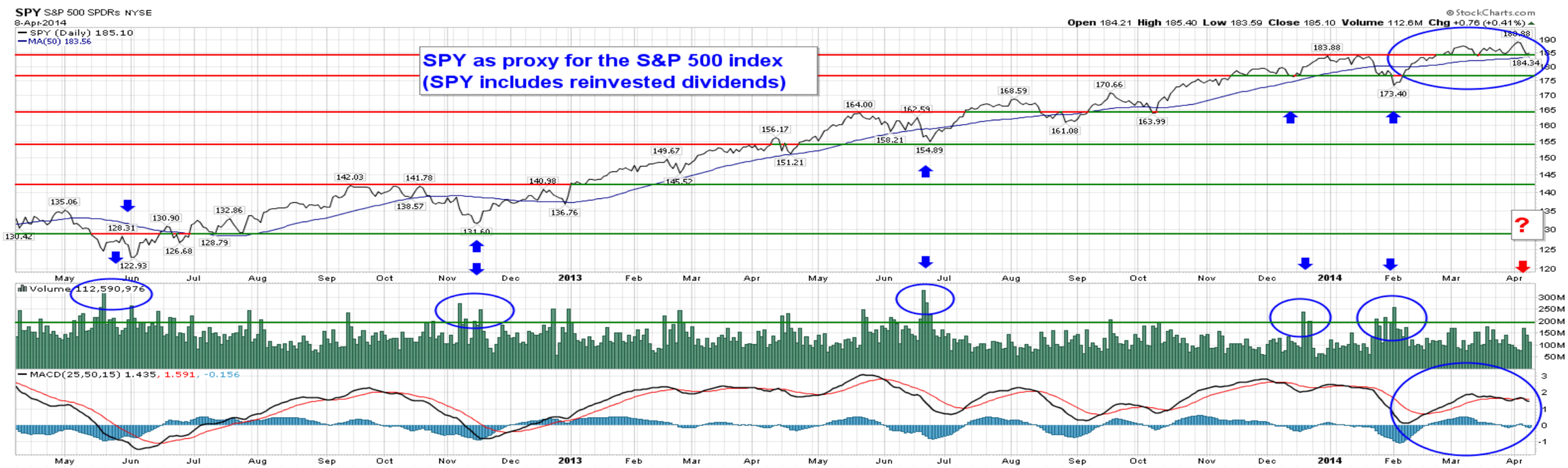
S&P 500 Total Return (SPY)



Last month I said that "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." Well, as we sit today, SPY is having difficulty escaping the gravitational pull of the $185 support line having tested it at least 3 times since the beginning of March.

What I think we are seeing is akin to a duck in a pond: some movement on the surface and violent action going on underneath. As of this writing on April 8th, while SPY is off 1.6% from its recent peak, exchange-traded funds such as the one representing healthcare is off over 4%, the one representing the NASDAQ 100 is off almost 6%, pharmaceuticals off over 9% and biotech off about 17%. What do these sectors have in common? They have all been outperforming the S&P by a healthy margin — the more healthy the margin, the greater the recent correction — and they all represent technological progress, a contributor to GDP growth.

And this leads us to the next questions: is this a normal profit-taking correction and will prior outperformance resume to help pull up the S&P (even if they aren't part of it)? As someone once said, that's a "known unknown." My answer is that while it's too early to know for sure, there is reason to think so as the outperformance has persisted, more or less, for 5 years, especially if you believe technological advancement is likely to continue with a focus on improving living standards. My long term view is optimistic, but we could see volatility along the way.



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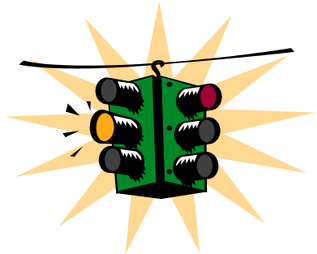
All-world (ex U.S.) Equities (VEU)

International equities, represented here by Vanguard's VEU, like the S&P in March, ended the month just about where they started though the month was much more volatile with swing of about 3.5%. Once again, VEU failed to get past resistance at $51 at both the beginning of March and at the beginning of April. From a technical perspective, there's little support for this broad international equity perspective to do much of anything in the short term.



But there's the rub. As I explore the relative performance of countries and regions for the past 10 years, it's hard to find any that aren't way "underwater" relative to the S&P for at least the last 5 years (although VEU ended March and began April very strongly against the S&P, as shown on the next page). For that reason, from a purely value perspective since the technical support is not yet there, I'm prepared to shift my position on international from a red light to yellow. While it's still true that international exposure can be gained through domestic companies in the S&P, it may be time to slowly build a position in selected regions or countries. Since none look especially strong now, I'd focus on the developed economy in Europe for now as its performance relative to the broader VEU has been in ascendant for about a year. Though riskier, Latin America is recently showing the beginnings of relative strength.

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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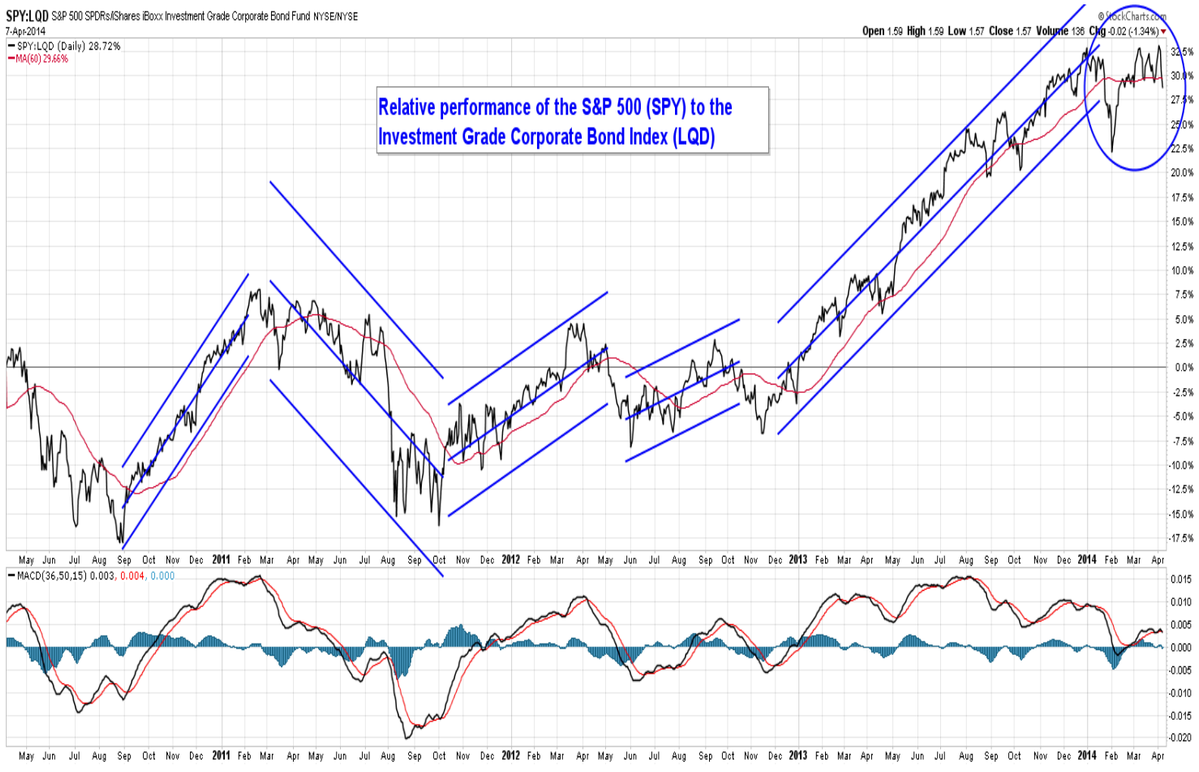
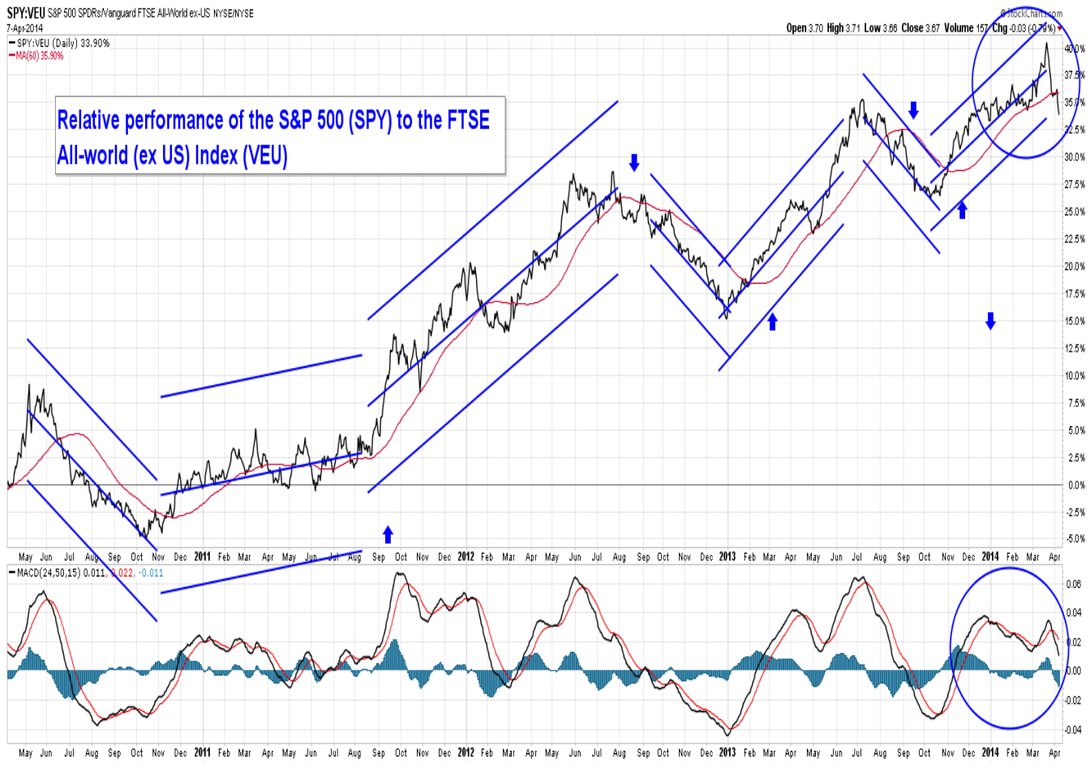
Asset Allocation and Relative Performance

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 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 what is a possible change in the relative performance of equities and bonds, but it is too early to be sure. Personally, even if bonds take the ascendancy, my view remains that equities will outperform for the year ahead (absent some exogenous event). On the right, despite the recent shift in favor of international equities, the trend still favors domestic stocks. However, as suggested on the preceding page, it may now be time to add a bit of exposure directly to international equities with a focus on Europe and Latin America.

Overall, given the lack of solid direction for any of the three major categories, I believe the best course of action is to come closer to one's own strategic (long term) asset allocation.



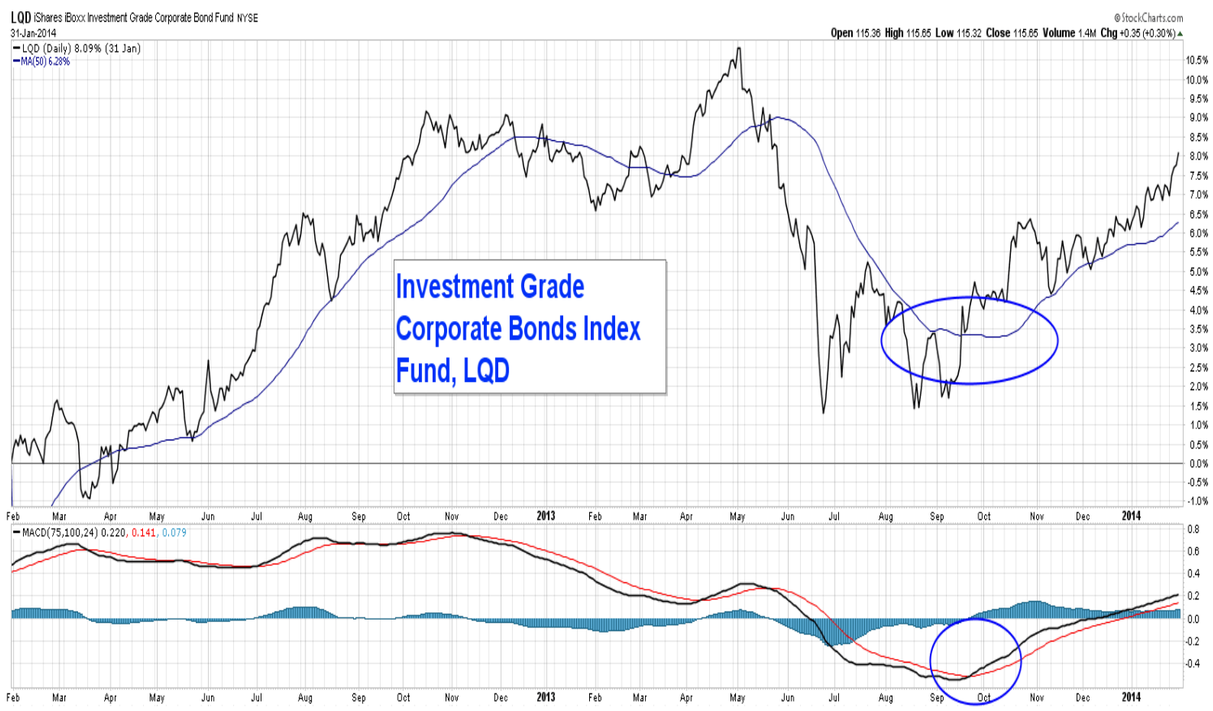


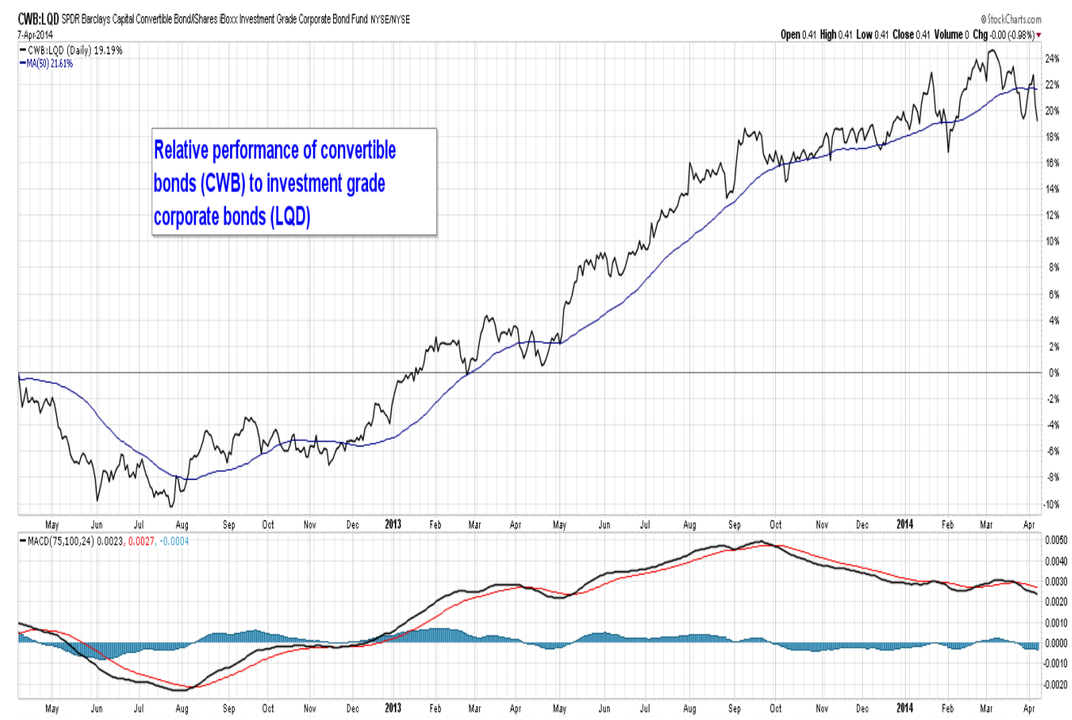
SPY, VEU, and LQD are exchange-traded funds designed to match the experience of the S&P 500, (with dividends), the FTSE All-world (ex US) index, and the iBoxx Investment Grade

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 of 2013 and lead to a pattern of rising interest rates in the near term. 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 the balance of 2014, if not longer. That said, as a measure of diversification is good for equities, it is also good for bonds. Therefore, it is useful to consider income-oriented investment alternatives, such as preferred stocks, floating-rate banks loans, convertible bonds, and short-term high yield corporate bonds, provide diversification to the broad IGC bond index with less interest rate risk.

Recently, I've been highlighting the relative performance of convertible bonds. As the chart on the right below shows, convertible bonds lost steam in March as investors lowered their equity risk appetite (convertible bonds reflect the investment characteristics of both bonds and equities). However, with similar current yields and with continuing recovery in the U.S. and global economy, I believe convertible bonds will continue to be a viable and stabilizing component of the bond portion of investors' portfolios.





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 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, the recently published annualized inflation rate is closer to 1.1% and, if anything, appears to be trending down — suggesting that the Fed could tolerate additional inflation without attempting to raise the Fed Funds rate. In fact, Gavyn Davies of the Financial Times makes 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, excess savings in emerging economies, and investor demand for bonds despite low historical yield. Indeed, the concern I've had about imminently rising rates is looking increasingly premature.

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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