MARKET LETTER

MARKET PERSPECTIVE — THIRD QUARTER 2013

FORWARD PROGRESS

by George W. Hosfield, CFA
Principal and Chief Investment Officer

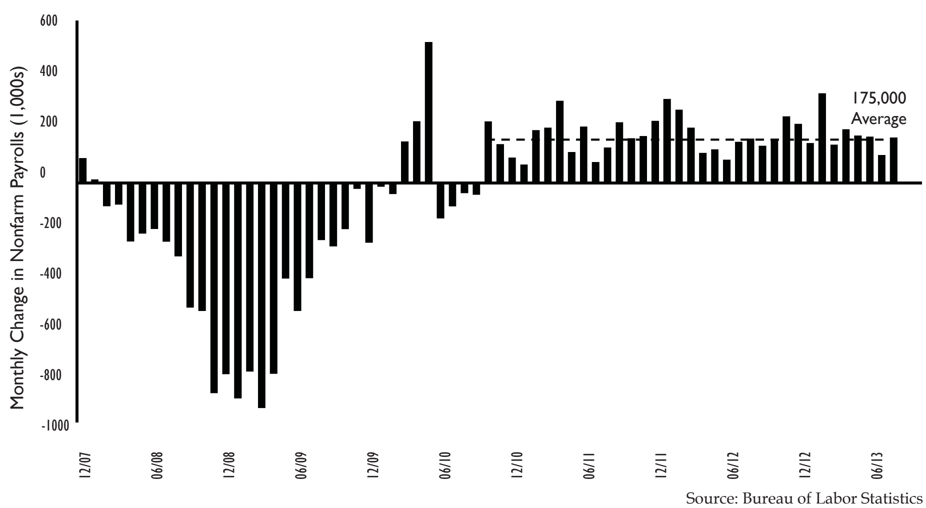
Policy risk has returned to capital markets, with the recent fiscal showdown in Washington overshadowing a host of housing, jobs and manufacturing data indicating slow but steady GDP growth. While economic activity and the level of inflation have remained stable, chatter from the Federal Reserve about "tapering" its monthly bond purchases has introduced drama and volatility into the bond market. Against this backdrop, 10-year U.S. Treasury yields reached highs of 3 percent on September 5, substantially above the 1.75 percent rate at which the year began.

While the Fed's decision to delay tapering was widely panned, policymakers achieved their goal of stalling the upward march in interest rates, as higher cost mortgages were beginning to threaten the rebound in housing. Slow-but-steady employment growth reflects gains in housing, the renaissance of U.S. energy production, and "re-shoring" of U.S. manufacturing, all important contributors to the continuing economic expansion. With inflation well contained, the Fed remains focused on stimulating job growth.

Our modestly below-benchmark duration in client bond portfolios reflects a belief that rates will trend higher, but with the 10-year Treasury yield approaching nominal rates of GDP growth, we don't foresee anything more dramatic.

Meanwhile, corporate America is in good shape. Balance sheets are much stronger, productivity gains are driving record earnings and robust cash flow is stimulating merger and acquisition activity. Mid single-digit earnings growth in a low inflation environment is a good combination that should allow P/E multiples to expand further, thus supporting our constructive view of equities.

Steady but Uninspiring Job Growth



Source: Bureau of Labor Statistics

IN THIS PUBLICATION

Founded in 1975, Ferguson Wellman is a privately owned investment advisory firm, established in the Pacific Northwest. With more than 600 clients, the firm manages $3.4 billion in assets that comprise union and corporate retirement plans; endowments and foundations, and individuals with portfolios of $2 million or more.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth. – Marcus Aurelius

A FINE MESS

by Dean M. Dordevic
Principal

"Blessed are the young, for they shall inherit the national debt." —Herbert Hoover[1]

It's been five years now since U.S. Treasury Secretary Henry (Hank) Paulson, Jr. made his fateful decision to "let Lehman go;" an event that brought Wall Street to its knees and pushed the global financial system to the knife edge of an abyss. We are loathe to criticize his decision, even with the benefit of hindsight, since it's so very hard to argue that Mr. Paulson's thinking was not fully well-intentioned. At its core, Secretary Paulson was acting to defend the so-called "moral hazard." The now almost antediluvian notion that no bank is, or was, too big to fail. Absent the moral hazard, there exists one and only backstop—that being the balance sheet of the sovereign—which in this case is that of the U.S. Federal Reserve.[2]

Perhaps we are fortunate that Mr. Paulson was a creature of Wall Street (Goldman Sachs) and not a politician. As every trader knows, when a very large position goes against you, it's generally best to quickly cut your losses. Knowing his background, and with his Lehman gamble now in tatters, Mr. Paulson did what in hindsight was reasonably predictable. Quickly realizing his mistake, he reversed course almost overnight, moving heaven and earth to bail out then rapidly collapsing insurer American International Group (AIG). With counter party risk, at once complex and often poorly understood, the plumbing of the financial system was tied together like never before. A brush fire had now become an inferno.

With stock prices crashing and the situation growing ever more dire, Secretary Paulson would ultimately be tasked with *saving the banking system itself*. The program he would create, the Troubled Asset Relief Program (TARP), would now absorb a variety of financial instruments that would soon distill from the crisis. The Fed's once pristine balance sheet (pre-crisis composed entirely of U.S. Treasury securities) would now mop up this flow of detritus. The Fed's balance sheet would quickly balloon from just under $1 trillion pre-crisis to over $3 trillion. Where would our country and the global financial system be five years hence? There were certainly many dire predictions at the time and it was indeed anyone's guess as to the eventual outcome since we were sailing far into uncharted waters. As one financial publication correctly proclaimed at the time, "We are all Keynesians now."[2]

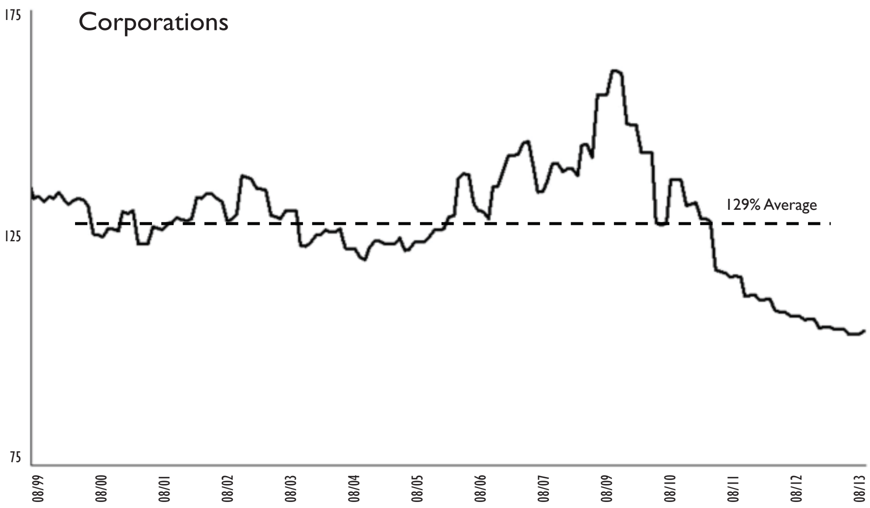
In the days, weeks and months following the onset of the financial crisis, both the U.S. and the global economy quickly entered recession. Many economists described the fallout as a so-called "balance sheet recession." Others concluded correctly that since government, individual and corporate balance sheets were collectively at the root of the problem, it was only reasonable to assume that perhaps a lengthy process of balance sheet re-liquification and repair, that is, *deleveraging*—would offer the surest remedy. But the balance sheet deleveraging process is, by its very nature, fraught with peril. It can last decades and bring upon hyperinflation or even deflationary spirals. Even more troubling, they are frequently badly managed since they come along about once in every adult lifetime. As a result, policy makers either haven't studied them or are poorly equipped to act quickly and do the right things.[3]

Some deleveragings have been very ugly, bringing about great economic pain, social upheaval and even war. But the news is not all bad. In an important and widely read financial white paper, written now nearly two years ago, veteran investor and hedge fund manager Ray Dalio of Bridgewater Associates deftly analyzed the history of deleveraging. Some have called Dalio the next George Soros. Dalio's analysis focused on six episodes: (1) The U.S. in the 1930s, (2) The UK in the 1950s and 1960s, (3) Japan over the last two decades, (4) The U.S. from 2008 through now, (5) Spain today and (6) The Weimar Republic in the 1920s. What Dalio concluded is that what appears to matter most is the *size and pace of four critical factors* associated with the deleveraging process. They include: debt reduction, austerity, wealth transfer and debt monetization. But getting the mix of these frequently countervailing forces right is not easy to say the very least. Since each factor impacts both growth and inflation differently, getting the balance just right is the difference between good deleveraging and bad. But Dalio discovered that deleveraging episodes can indeed be "quite beautiful" too, especially when accompanied by orderly adjustments in production and consumption balances as well as debt-to-income ratios.[3, 4]

What Dalio found was that each outcome was different because of the amount and pace each of the four paths to deleveraging varied. He found that each episode fell into one of three groups:

(1) Ugly deflationary deleveraging, (2) Ugly inflationary deleveraging and (3) What he dubbed "beautiful deleveraging." Ugly deflationary and inflationary episodes revolve principally around money-printing episodes that are either too robust or too timid relative to the levels of both nominal interest rates and inflation present in the economic system at the time. Beautiful deleveraging, on the other hand, encompasses those times where enough "printing" occurs to balance and offset the inevitable deflationary pulse, coming primarily from debt reduction and austerity. Positive, albeit weak, growth persists combined with falling levels of debt-to-income ratios. Dalio also added that it was critical that GDP growth exceed the prevailing level of nominal interest rates.[3,4]

Corporate Balance Sheets Strongest in 20 Years



S&P 500, ratio of total debt to total equity, quarterly

Source: U.S. Federal Reserve

In the U.S., the post-crisis deleveraging process that followed in the wake of our debt-driven boom unfolded in two stages. First, there was a contraction in income - followed then by reflation and growth. Because the response from the Fed was so swift (both guaranteeing debt and aggressively printing money), the contractionary period lasted for *only six months* versus over three years in the 1930s. Additionally, there has been reflation and debt reduction through an appropriately correct mix of modestly rising nominal incomes, coupled with mostly orderly defaults and fairly steady levels of debt repayment. From a historical perspective, says Ray Dalio, "Thus far, this (U.S.) deleveraging would win our award (as) the most beautiful deleveraging on record. The key (variables) going forward will *be for policy makers to maintain balance so that the debt-to-income ratio keeps declining in an orderly way."*[3,6]

For Mr. Paulson, the engineering of the TARP bailout was his crowning achievement as Treasury secretary. While TARP was hugely unpopular at the time, most economists now credit it, and the extraordinary measures taken by the Federal Reserve, with the U.S. avoiding Mr. Hoover's fate and another Great Depression.[2]

Of the $700 billion originally pledged via TARP, more than $600 billion was ultimately dispensed. Of the 780 investments made by the Treasury, 501 resulted in a profit. Adjusted for dividends and interest paid, all but about $50 billion has been recouped thus far.[7] Whether the financial markets were the beneficiaries of an amazing streak of luck or the skill and fortuitous decision making of our leaders is something for historians to sort out. But nearly two years later, as the S&P 500 hits new highs almost daily, Mr. Dalio's conclusions are looking less like a forecast and more like a reasonably good roadmap for both what has transpired since the crisis in 2008 and what our future may hold.

Household Debt Service at Best Levels in 30 Years

Debt payments as percentage of disposable personal income, seasonably adjusted

Source: FactSet

Weapons of Reason footnotes and sources:

1. Francis Cavanaugh, "The Truth about the National Debt," *Harvard Business Review Press*, 1996.
2. Andrew Ross Sorkin, "Five Years after TARP, Misgivings on Bonuses," *The New York Times*, August 27, 2013.
3. Ray Dalio, "An In-Depth Look at Deleveraging," *Bridgewater Associates*, February 2012.
4. Charles Roxburgh et al, "Debt and Deleveraging: Uneven Progress on the Path to Growth," *McKinsey Global Institute*, January 2012.
5. Tony Hallada, "U.S. Deleveraging Almost Complete," *Clifton Larson Allen Wealth Advisors Special Report*, July 2013.
6. Sandra Ward, "Ray Dalio on Deleveraging," *Barron's*, May 21, 2012.
7. Paul Kiel and Dan Nguyen, "The State of the Bailout," September 18, 2013.

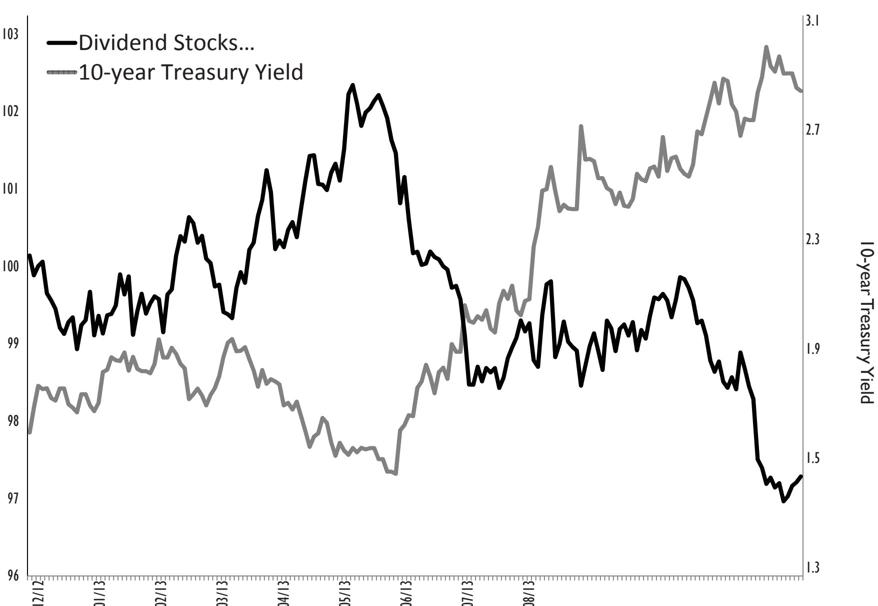
WILL RISING INTEREST RATES BE A HEADWIND FOR DIVIDEND STOCKS?

by Jason D. Norris, CFA
Senior Vice President of Research

The recent spike in longer-term interest rates has brought questions regarding its effect on equities; specifically, dividend paying stocks. While we believe that rising rates shouldn't have a negative effect on the equity markets (as long as rates remain below 5 or 6 percent); higher yield stocks may see a bit of a headwind.

When we look at the first chart, we can see when yields were trending lower earlier this year. Dividend-paying stocks were performing better than the broad market (by roughly 300 basis points through April). However, when the yield on the 10-year Treasury began to rise in May, dividend payers began to underperform and continued to do so through mid-September to the tune of 500 basis points.

Dividend Stocks Relative to Interest Rates



Source: FactSet

Dividend stock relative performance is calculated using the Dow Jones Dividend Index relative to the Russell 1000

Some sectors were hit harder than others. While utilities and REITs led the markets higher early in the year, they were the laggards recently.

Healthcare, however, bucked the trend and outperformed over both time periods. The healthcare sector is one that balances income and growth and we believe this was key.

When we look out at the next few years and forecast the 10-year Treasury to trend closer to 4 percent, does that mean that investors should stay away from dividend strategies? We would answer that with … it depends.

Ferguson Wellman's *Large-Cap Dividend Value* strategy focuses on more than just yield. A key component to our security selection is cashflow and dividend growth. For instance, 90 percent of our holdings have increased their dividends in the last 12 months compared to 54 percent in the S&P 500.

We believe that this balance should reduce our exposure to rising interest rates. However, we are not immune. Since our *Dividend Value* strategy consistently yields above the broad market, we will see some effect.

While this strategy tends to lag in strong "up markets" like we have experienced this year, it tends to offer better downside protection. Due to the balance of growth and yield, this strategy has consistently showed lower volatility (15 percent lower than peers) while delivering total returns in the top 25 percent relative to other large-cap peers.

Never let the future disturb you. You will meet it, if you have to, with the same weapons of reason which today arm you against the present. – Marcus Aurelius

STOP MAKING SENSE

by Elizabeth A. Olsen
Marketing and Communications Manager

Ray Dalio: A hedge fund investor, Ray Dalio is known to have an uncanny ability to predict economic trends, particularly as it pertains to changes in exchange rates, inflation and GDP growth. Dalio founded Bridgewater Associates in 1975, which has become one of the world's leading hedge funds with approximately $120 billion assets under management. **(page 2)**

Deflation: A general decrease in the price of goods or services. **(page 2)**

Deleveraging: An attempt by any party (individual, business or government) to decrease its debt. **(page 2)**

Keynesians: Economists who adhere to the views of British economist John Maynard Keynes. His views emphasized the need for deficit spending by government to stimulate business investment. **(page 2)**

Moral hazard: Most commonly refers to a situation in which a party will take on risk because the costs that could incur will not be felt by the party taking the risk. In other words, it is any situation in which one party makes a choice as to how much risk to take while some other party bears the cost if things go poorly. In today's post-crisis world this term is used more frequently to allude to the idea of an institution being "too big to fail." **(page 2)**

P/E multiples: Price/Earnings multiples are also known as price/earnings ratios. They are the measurement of how much buyers are willing to pay for shares in a company and the number is based on the company's earnings. It is calculated by dividing the current price of a share in a company by the most recent year's earnings per share of the company. **(page 1)**

George Soros: A Hungarian-American investor and philanthropist, Soros is known as "The Man Who Broke the Bank of England," pocketing over $1 billion during the Black Wednesday UK currency crisis of 1992. In September of 2013, Forbes ranked Soros as the nineteenth richest person in America. **(page 2)**

Reflation: Reflation is the general increase in the cost of goods or services. **(page 3)**

Re-shoring: The opposite of off-shoring, the act of bringing jobs back to their country of origin. *(page 1)*

TARP: The acronym for Troubled Asset Relief Program, which gave the U.S. Treasury the authorization to spend $700 billion. The Treasury has made 708 investments with TARP funds, 508 of which have resulted in profit. The profits add up to $44.4 billion and the losses amount to $5.7 billion. There are still 185 investments outstanding. **(page 2)**

The Weimar Republic: The name given to the federal republic established after the German revolution. It was formed in 1919 and existed for 14 years. It was named for Weimar, the city where the constitutional assembly took place. The Weimar Republic faced many economic challenges, but managed to successfully reform their currency, among other advancements. **(page 2)**

For additional resources, you may contact us at info@fergwell.com for a copy of our Glossary of Investment Terms or visit our blog at blog.fergusonwellman.com for more definitions.

Communication And Education Sources:

Business Dictionary
Investopedia
Wikipedia
Forbes
ProPublica.org
The New Yorker
Dictionary.com
RayDalio.com

Let not your mind run on what you lack as much as on what you have already. – Marcus Aurelius

INVESTMENT SERVICES · THIRD QUARTER 2013

by Helena B. Lankton
Senior Vice President
Wealth Managment
Committee Chair

by Donald L. Rainer
Senior Vice President
Institutional Services
Committee Chair

FOR INDIVIDUALS

There are many changes that have been implemented this year regarding taxes. Examples include the increase in capital gains tax rates, the new 3.8 percent Medicare tax and generally higher income tax brackets.

It's not too early to start year-end planning to offset realized gains and income where possible. Working with your accountant, we can determine how you are positioned with regard to the new tax rates and take appropriate action.

Coordinating with you and your estate planning attorney, we can start making arrangements for year-end gifts to charities and family members well before the December rush. We can also assist in exploring the benefits of setting up a donor advised fund.

Taking this approach affords all of your professional advisors time to collaborate to determine the best course of action for you and your family.

FOR INSTITUTIONS

We are often asked about asset allocation when meeting with trustees or investment committee members. Whether it is a retirement plan or a spending policy rate that is targeted, allocation to different asset classes plays a critical role.

With equity markets near all-time highs and interest rates at a volatile juncture, it is a good time to review your investment policy. While we do not advise changes for short-term gain, reviewing the policy to make sure it is still functioning for the betterment of the organization or plan is appropriate.

Our portfolio managers can help decision makers to have constructive discussions around asset allocation and investment policies. Please let your portfolio manager know if you would like to discuss your investment policy at a future meeting.

THE LAST WORD · THIRD QUARTER 2013

FOND FAREWELL

Ginny Marsh has worked for more than 24 years at Ferguson Wellman. Originally hired as an administrative assistant, she has supported Mark Kralj for over 18 years. She has worked with numerous clients who are families that span multiple generations, many of whom are located in Southern Oregon.

Ginny plans to fill her time working on her two homes on the coast and in Boring, Oregon, as well as traveling and learning how to paint with watercolors.

COMMUNITY ENGAGEMENT

As we have been preparing for our *2014 Investment Outlook* season, we have also been invited to speak to a number of organizations this fall. In September, George Hosfield, CFA, was invited by Umpqua Private Bank to speak at the CFO Conference hosted by The Partners Group. He was also the keynote speaker at the "Who Will Own the Forest?" national timber conference where he gave our views on the economy and capital markets.

Jim Rudd spoke on a nonprofit panel for the Oregon Society of CPAs regarding board cultivation and recruitment and Don Rainer represented Ferguson Wellman at a WVDO workshop covering donor strategies. As always, we welcome any opportunity to share our investment views and to contribute to discussions regarding philanthropy.

Our logo features a bronze coin of Marcus Aurelius Antonius, Emperor of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of meditations that reveal a mind of great humanity, natural humility and wisdom.