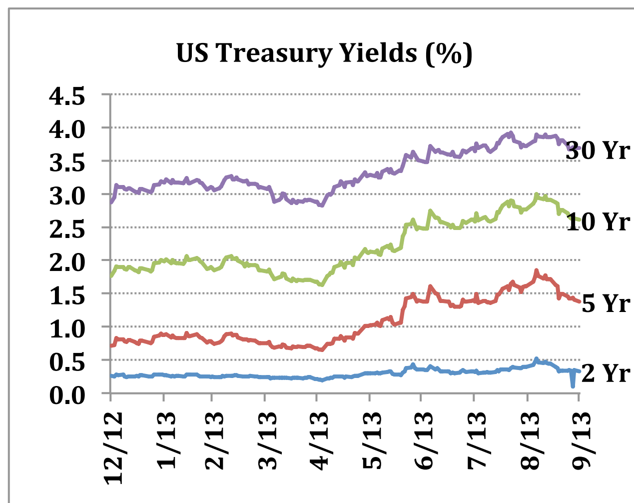
Investment Update
Third Quarter 2013

Markets:

Equities: The S&P 500, Midcap and Smallcap US stock market indexes have returned 20-30% through September, with smaller-company stocks leading the way.
MSCI's EAFE foreign developed markets index has returned 14.5% in 2013, with better economic performance in Europe, especially in the major economies of France and Germany.
MSCI's emerging markets index has returned -6.9% in 2013, mainly because of poor performance from markets in Brazil, India and China; emerging markets have now underperformed for more than two years.

Bonds: Yields spiked from very low April levels, but backed off from September highs following a surprise Fed decision on September 13 to delay QE tapering; Barclays' US government and corporate bond market indexes show negative returns for the year-to-date ranging from -0.8% for intermediate bonds to -8.7% for long bonds.



Economy:
Overall, not much has changed since the second quarter. The good news is that our economy is still growing (though slowly) and US corporations are still reporting very good profits. North American oil and gas production is soaring, with the US poised to surpass Russia as the world's largest producer. Among the not-so-good news: although the unemployment rate is gradually improving, the ranks of the under- and unemployed still grow; the prospect of a Washington D.C. fight over the federal budget and debt limit looms, again. The Fed has recently backpedaled from the relatively vague timeline for ending quantitative easing that was discussed in the second quarter, meaning that the Fed's $85 billion monthly bond purchases continue for the time being.

The possibility of a federal government shutdown over the budgeting process does not overly concern us, as more than 80% of federal spending will continue during the relatively short time that any shutdown is likely to last. Nor are we very worried that the debt limit debate will lead to a default -- no-one really wants this to happen; therefore, it probably won't.

We do still expect the Fed to end QE in the next year or so. This will inevitably put upward pressure on interest rates and downward pressure on bond prices, and we continue to prefer shorter bond maturities. Equity market volatility will be part of the adjustment to the eventual end of QE, but we still see stocks as relatively attractive.

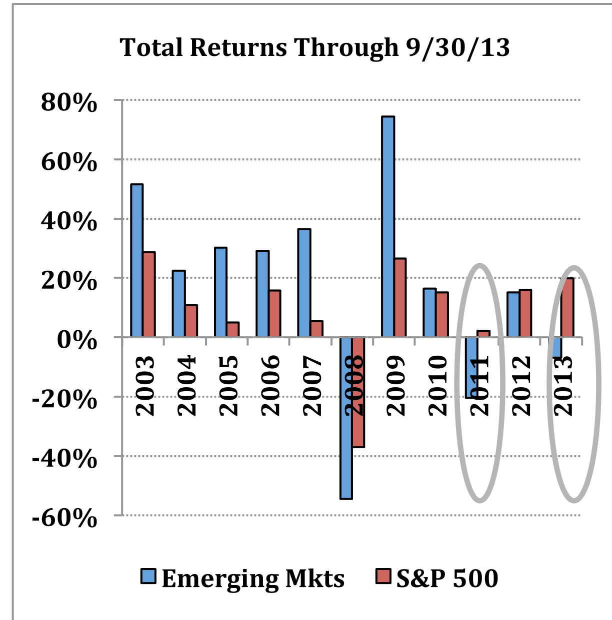
Overseas there has been some better news. European growth, though still weak in the peripheral countries, has turned slightly positive.
China's growth, which has decelerated from greater than 10 annually in 2010 to just below 8% now, seems to be stabilizing. A new Five Year Plan to be unveiled at the next National People's Congress in November is expected to continue China's move toward a more balanced economy with less emphasis on capital investment and more on domestic consumption.

88 Broad Street • Boston, Massachusetts 02110
Tel (617) 624-0800 • (800) 900-4401 • Fax (617) 624-0801 • E-mail bfo@bosfam.com

Emerging Markets:

Emerging market stocks have significantly underperformed US stocks since late in 2010. The difference in returns of roughly 10 percentage points per year is so large that revisiting the long-term case for investing in emerging markets is worthwhile.

The great potential for economic growth in the world's less-developed economies is one of the main reasons that emerging market investments have become an important part of many investors' strategies. In 2000, emerging markets represented about 22% of the global economy, now they represent more than 37%.



The fact that they are growing from a much smaller base is part of the equation. Another key contributor to this fast growth has been the spread of economic freedom around the world as socialism has declined relative to more market-based alternatives. The fall of the Berlin Wall in 1989 and China's admission to the World Trade Organization in 2001 have been major milestones.

Greater freedom has tended to unencumber latent talents and ambitions and allowed capital to be allocated more productively, which has raised standards of living and increased economic growth potential. Many emerging market economies have now developed beyond the point of being highly dependent on cyclical natural resource-based industries, and have large and growing consumer bases and increasingly sophisticated finance and service sectors. We think that this fundamental trend will continue.

A plausible explanation for emerging markets' underperformance this year is that rising interest rates in the US, with more to come as QE eventually ends, have attracted capital from emerging markets back to the US. This capital flow reversal has in turn triggered concerns that another emerging market crisis may be in the making. As recently as 1997-98, a similar change in capital flows wreaked havoc on emerging market economies and sparked Russia's sovereign debt default, the Asian currency crisis, and emerging market equity losses of 40%.

A comparable widespread crisis is much less likely today, as emerging market economies are fundamentally in a much better position to manage this sort of headwind after more than a decade of growth and development. Compared to the late 1990's, as a group they have much less external debt, interest payments on that debt are much smaller relative to GDP, and central bank foreign currency reserves are much higher.

Despite their recent disappointing performance, we continue to think that emerging markets, over the long term, will deliver faster economic growth than the developed economies. The underlying trends driving this faster growth are durable. We think that investments in emerging markets will add to portfolio returns and improve diversification. The recent several years of poor performance provide an opportunity to add exposure at lower, more attractive valuations.

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