



July 17, 2013

“No sight that human eyes can look upon is more provocative of awe than is the night sky scattered thick with stars.” – Llewlyn Powys. Summer is once again upon us, and its stars are shining as bright as ever. The ancients well understood the cosmos, and used the night sky's patterns to navigate their ships, build their cities and even conduct religious rituals. Despite the multitude of points of light visible to the naked eye, they were able to find patterns, cycles and direction from the immensity of the night canopy. Sometimes one may feel that the vast amount of information regarding the capital markets and the economy is much like looking at the night sky. Every day, hundreds of data points come at us like so much digital buckshot; it is easy to be overwhelmed. How can we keep track of this massive amount of data? How can we determine which of these “points of light” are important, useful or unique? The good news for investors is that tools do exist which can bring focus, illuminate the hidden, and make sense out of chaos - - much like stargazers today use their modern telescopes.

Second Quarter Review

For the quarter, stock market returns were strong. In fact, the first six months of 2013 represented the best six-month period for the S&P 500 since 1999. The quarter did experience some drama however. After the announcement by the Fed that it might taper its bond buying activity sooner than expected, stocks took a hit with the S&P 500 dropping 2.5% in one day. Although equities were able to finish the quarter strong, commodities and bonds tumbled badly. The yield on the U.S. ten-year Treasury note rose from 1.62% to 2.49%. Given this big move in bond prices, it's no surprise that retail investors pulled large amounts of capital out of bond funds during the quarter, reversing a multi-year trend. Gold experienced heavy declines early in the quarter as well, as well as its largest one-day drop ever (over 10%). Gold is down over 25% from its 2012 high.

In Europe, this quarter brought improving business and consumer sentiment as well as some positive economic data. The Eurozone Purchasing Managers' Index (a reliable economic indicator of future growth) reached its highest level in over a year with June's report of 48.8. The European Central Bank aided this positive sentiment by reducing its policy rate to 0.5%, cementing its accommodative monetary policy for the time being. Even long-torpid Japan showed some surprising activity in the quarter. Following the announcement of a comprehensive reform and stimulus package from Japan's Prime Minister, Shinzo Abe, Japanese stocks moved up sharply – up over 35% from late last year to May's highs. Yet, the enthusiasm about “Abenomics” was short lived as investors, skeptical of the ability of the government to achieve meaningful economic reforms, took profits, driving the Topix down nearly 20% over the last 6 weeks. The emerging markets continue to underperform despite most of these economies being in much better shape than in past corrections.

Here is what the second quarter looked like by the numbers:

Index	2nd Qtr 2013	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	2.9%	15.2%	18.9%
S&P 500	2.9%	13.8%	20.6%
NASDAQ	4.2%	12.7%	16.0%
Russell 2000	3.1%	15.9%	24.2%
MSCI EAFE	-1.0%	4.1%	18.6%
MSCI EAFE Small Cap	-3.3%	4.4%	19.8%
MSCI Emerging Markets	-9.1%	-10.9%	0.3%
Barclays Aggregate Bond	-2.3%	-2.4%	-0.7%
Barclays Municipal Bond	-3.0%	-2.7%	0.2%
Dow Jones Commodities	-10.2%	-11.8%	-9.2%

A Glimpse into the Vastness of Possibilities

On these warm summer nights there is nothing more pleasant than to spend the evenings outside looking at a clear sky full of stars. This simple activity reminds us of the vastness that lies beyond our Earth. Space has always fascinated humankind, and astronomers since the invention of Galileo's first telescope have tried to see more, see farther and see deeper. The launch of the Hubble Space Telescope in 1990 provided us with a state-of-the-art tool to explore space as never before. With its two incredibly

accurate mirrors, and unencumbered by earth's atmosphere, the Hubble telescope provides scientists with the means to see the vast cosmos in ways impossible from earth. The current estimated observable universe (the farthest distance humans can see) is about 93 billion light years in diameter. This size seems infinite to most of us, and it is hard to believe that the entire universe is much larger than that and is constantly expanding. Our own galaxy (considered a small galaxy) contains about 100 billion stars, with our sun being only one of them. The total number of galaxies may be innumerable.

Facing the seemingly infinite size of space, one might wonder how to start exploring and even drawing conclusions about it. Thanks to the Hubble Space Telescope, astronomers from all over the world can now look at the universe in clearer, more focused fashion. One way to use this tool is to explore and further research a topic about which the scientist already has some knowledge. Thanks to this incredible technology, this research can reveal clearer facts than those already accepted. For example, the Hubble telescope has helped scientists to narrow the possible age range of the universe down to about 13 to 14 billion years, from the previous estimate of between 10 to 20 billion years. Additionally, the Hubble Space Telescope has greatly advanced observations of the evolution of space and its components. Another benefit of this highly advanced technology is that it plays a major role in discovering new phenomena, such as the discovery of dark energy (a mysterious force causing acceleration in the expansion of the universe). The Hubble Space Telescope is a monumental achievement for humankind, as it illuminates what is hidden in the vast darkness of space and uncovers otherwise invisible secrets of the universe.

Narrowing the Landscape

Much like the vastness of outer space, the universe of investable assets available to investors can be equally overwhelming. Globally, there are over 7,000 mutual funds, 5,000 stocks, and 1,000 ETFs available to the investor. With a list so intimidatingly long it may not be clear where to begin. It is easy to get wrapped up in what looks "good" or what looks "popular." The untrained eye generally can see little beyond a price chart. The voices in the media and other places will constantly tell investors to buy this or sell that, ironically creating only more confusion in the name of providing clarity. Is there a tool out there that can help investors narrow their choices, increase focus and find some hidden wonders?

Yes there is. This tool is the stock screen. In simple terms, a stock screen is a database search function that allows the user to identify stocks that fit a certain set of defined parameters. These parameters allow the investor to narrow in on a smaller set of stocks that might merit investment consideration. There is no right or wrong number of parameters to define. No matter the outcome, the important part is which parameters you choose to define. These screens use such company fundamentals such as share price, market capitalization, earnings, cash flow, P/E ratio, book value, etc. More sophisticated screens will employ technical factors such as price momentum, valuation metrics, insider transactions, and so forth.

We at Wolf Group Capital Advisors use stock screens to populate the individual equity portion of our client portfolios. Because we mostly focus on mid-sized value stocks, our screens center on this part of the investing universe. Given the technological advancements over the last few decades, many sophisticated stock screens are readily available to professionals and amateurs alike via the Internet. Each month we peruse a large number of these screens, looking for new names to consider adding to our Buy List. We have learned that there is no one "best" screen out there, and that only by using a number of them can we find new gems hiding in plain sight.

Once our screens have identified a suitable number of new stocks, we then apply our fundamental analysis of the names to determine which one might belong on the Buy List, or more to the point, make money for our clients! Our value bias often leads us to stocks with lower P/E, price-to-book and/or price-to-cash-flow ratios. We like companies with market capitalizations between \$1 billion and \$35 billion. Our contrarian bent often leads us to names that may be unloved, undiscovered or perhaps even a little ugly. The main goal of our screening/analysis exercise is to find stocks which trade at a large discount to our estimate of their fair, or intrinsic, value.

Stock screens also allow us to move from the entire universe of investable assets to the creation of a 30-35 name individual portfolio that has excellent risk/reward characteristics, sector balance, and great growth potential. We never invest in stocks that some broker may be recommending to us, or that we read about in the media. The stock screen allows us to select stocks in a wholly analytical and dispassionate fashion. We think our track record with stock selection presents a reasonably strong case for the merits of such an approach.

Finding the Unexpected Exceptional

Every day astronomers from around the world make use of the Hubble Space Telescope to observe the universe, looking for unknown details, developments and surprises. Thanks to the telescope, scientists can narrow down the seemingly infinite cosmos into a small frame which they then will screen for further information. With this exceptional tool, scientific knowledge has been and continues to be accumulated and enhanced. Transferring about 120 gigabytes of data every week, the Hubble Space Telescope data has been used for over 10,000 scientific articles. Given the high demand of the Hubble's services, the review committee approves only about 200 of the 1,000 submitted proposals every year. With a clearly stated purpose for their research, the scientists will screen the cosmos for the needed information in the short time span given to them. Sometimes, by searching for the undiscovered details that others miss, scientists come across something truly unexpected and absolutely exceptional.

In similar fashion, we monitor and study the market every day, trying to discover unknown qualities of a security that no one else has noticed before. Given the power of the Internet, anyone can access tons of data about the equity market; however, knowing what data to use remains a monumental challenge. Yet, just like space, the market is extremely vast and full of endless possibilities. Using stock screens allows us to

narrow down the seemingly infinite combinations of stocks and helps us to create attractive portfolios.

It is not just about knowing what is out there, it is about the correct use of the highly sophisticated tools in order to narrow down one's search to illuminate specifics about already existing knowledge. The core of value investing is about finding those stocks that seem to be undervalued by the market for whatever reason. Being able to recognize these equities among thousands of others may result in above market returns. Screening the market is about finding details others might have simply missed and finding specific information that we may have not expected to be there. And sometimes, just like astronomers, we come across a truly exceptional stock that surprises and has so far not received the attention it should have (we could give the reader many examples of this...) .

Advanced tools used to simplify an infinitely large set of data and to magnify a specific subset that may contain hidden and unexplored qualities are not only used in the fields of Finance or Astronomy. Doctors use CT-scans to take a closer look at injuries and determine appropriate methods of treatment. Scientists utilize an array of microscopes to examine objects that appear invisible to the naked eye, one such example being the electron microscope. The Hubble Space Telescope and stock screens are among these tools that enable industry professionals to illuminate what has always been in front of them in such a manner that they may discover something new.

Where Science Ends and Art Begins

Provided with all of the highly developed scientific tools that allow us to explore our world, one has to remember that science has its limits. Even with the massive amount of data provided by the Hubble telescope, scientists find their assumption proven wrong again and again. Hubble is not expected to be useful much beyond the end of 2013. By that time, the James Webb Space Telescope should be ready to collect new data on the universe's origin and composition. This newer, even more elaborate telescope will certainly provide new data challenging many established theories. The same proves to be true for our stock screens: no screen will identify with absolute confidence a winning investment. Even with the best tools, professional investors still make faulty decisions about stocks. Technology can help us only halfway up the mountain - after which point it is up to human intuition, experience, and reasoning. The ability for humans to interpret what a computer algorithm or a combination of mirrors cannot see is the void *Art* fills in both investing and stargazing.

Therefore it is important to keep in mind that there is no one best way to invest; there is no one golden tool that will allow you to be unfailingly successful. Amid the multiple choices available, we have chosen the mid-cap value approach with a strong emphasis on diversification. There have been and will be in the future times when this approach is not in favor, does not work as well as it has lately. That is fine. A huge body of work does exist supporting the merits of value investing and mid-cap investing over the long term. We believe in this orientation and it is this strong conviction in our way of investing that carries us and our clients through challenging times.

The Outlook

The second quarter's volatility probably worried a large number of investors. Some people worry that the market has moved up so much that it must be vulnerable to some kind of "crash." Some investors are quick to "sell first, ask questions later" as evidenced by the market's reaction directly after Mr. Bernanke's comments on the Fed's Quantitative Easing program. Despite these reactions to developments, the market was able to log positive returns.

We continue to think that the key fundamentals driving the U.S. stock market remain in place. We believe that the bull market, which began in March 2009, is going to continue. The funds flow data shows a continued increase in equity inflow; retail investors are just starting their return to the equity market. Although we do not necessarily think the "Great Rotation" (investors selling bonds to buy stocks) is a *fait accompli*, we would note that the U.S. bond market is much bigger than the stock market. This suggests that any incremental shifts from bonds to stocks (were it to happen) could easily move stock prices higher. With the Fed's hinting at a tapering in its bond-purchasing program, short-term rates are expected to rise, but this does not necessarily mean bad news for the stock market. Nonetheless, it is easy to expect that going forwards bond investors will likely achieve total returns no higher than their yield to maturity. We continue to favor equities over bonds.

The earnings season is just under way, and all eyes will be on not only the earnings figures themselves, but on revenue growth and, of course, the outlook. We think that earnings expectations are sufficiently low now that many companies are likely (yet again) to beat expectations. Remember that the reason the Fed may be backing off from its highly accommodative monetary policy is that the economy might be moving to a higher growth phase. This has all kinds of positive implications for the stock market.

Sincerely,

Wolf Group Capital Advisors