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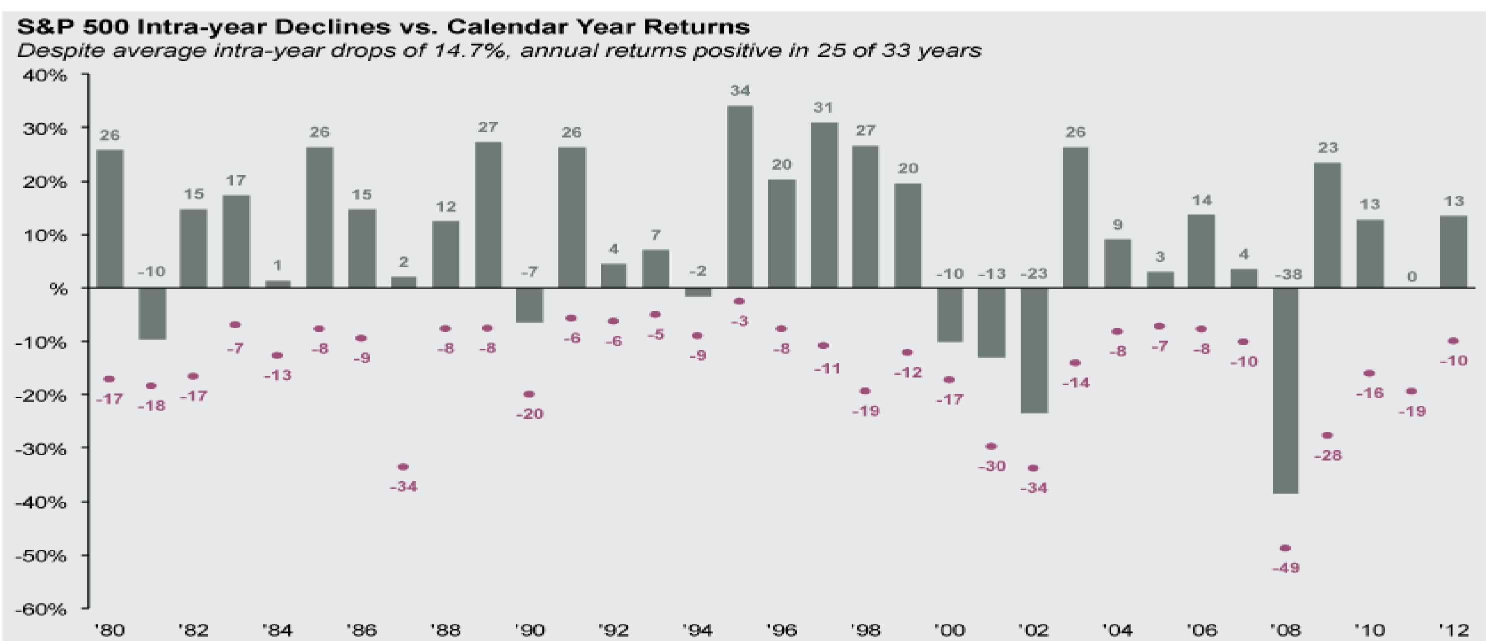
REVIEW & OUTLOOK: SECOND QUARTER 2013

REVIEW

At the end of last year we worried about Europe, the fiscal cliff, and sequestration. However, investors surprised us by ignoring these risks, and stock prices rose. During the second quarter of 2013, attention shifted to the Federal Reserve. Improving economic conditions led some to predict that the Fed would start to reduce their monthly bond purchases. Those predictions sent the market skidding downwards. Shortly thereafter, negative news about the economy made investors think that the Fed would continue with its current program for the foreseeable future - and the market rose. Perhaps that negative economic news offered stock investors some confidence. From its peak on May 21st until June 5th, when it (mostly) recovered, the S&P 500 Index dropped 3.6 %. However, the remarks made by Federal Reserve Chairman Ben Bernanke on June 19th regarding possible reductions in future asset purchases by the Fed, coupled with the fear that China might be facing a banking crisis, sent stock prices down sharply once more. Following Bernanke's remarks, the S&P 500 Index dropped 4.8% from June 19th to June 24th. Bernanke's comments were not at all surprising, but emotional investors panicked, causing the downturn. While the S&P 500 Index had a total return of 2.9 % for the quarter (including dividends), the total decline for the period from May 21st to June 24th was -5.8%. For some perspective, since 1980 the average intra-year drop is -14.7%. The following figure from JP Morgan illustrates the largest drop for each year, along with the return for every calendar year. Despite the volatility during the second quarter, the total year-to-date return for the S&P 500 Index was 13.9%, making it the best first-half return since 1998.

While analyzing history is a helpful and necessary endeavor, it does not provide a dependable guide for the future, especially when you consider that we have never had the sort of expansionary policies in place that the Federal Reserve has right now. Nor have we ever tried to reverse the sort of stimulus program currently in place. But speculation, forecasting, and analysis aside, market declines are emotionally challenging for every investor.



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2012.
Data are as of 3/31/13.

J.P.Morgan
Asset Management

We understand that volatility is unnerving. At Waycross, we have added additional asset classes to our portfolios to increase diversification and reduce volatility. We are also using broad market index ETF's (Electronically Traded Funds) as a tool to allow our clients to remain invested in equities when attractive stocks cannot be identified.

For example, during the second quarter, analysts forecast negative earnings growth for a larger number of stocks than we have experienced in the past. Additionally, there was a huge divergence in price performance among stocks unrelated to fundamentals. Given the sharp rise in the stock market this year, and the uncertain outlook; we sold or reduced a number of positions, increasing the allocation to cash. We invested some of that excess cash in the ETF's mentioned above. As we identify attractive individual stocks, we will begin to replace those ETF's.

A Note on Bonds

In the last Review and Outlook we noted that bond interest rates have fallen for many years. This has resulted in bond prices rising, and strong bond returns for the past three decades. Higher interest rates in the future will push bond prices down. On June 19th, Bernanke stated that interest rates should remain low for the foreseeable future (especially short-term rates). But there is fear that rates will rise as the economy improves and the Fed unwinds its current stimulus program. Interest rates did rise in the second quarter of 2013, and bond returns were negative.

The following table shows the expected impact of changes in interest rates on bond prices (figures provided by JP Morgan; based on certain assumptions about how the price of different bonds relate to each other).

US Treasury Years to Maturity	Change in Price with a 1 % **Rise** in Interest Rates	Change in Price with a 1 % **Drop** in Interest Rates
2 yr.	-1.9 %	0.5 %
5 yr.	-4.9 %	3.7 %
10 yr.	-9.2 %	9.2 %
30 yr.	-20.3 %	20.4 %

While bonds can still be used to reduce volatility in a portfolio, we have to be extremely careful about their maturity and quality.

Outlook

The economic outlook for the U.S. continues to be slow growth, with no significant inflation into 2014. Reductions in public sector spending should reduce growth slightly in the second half of 2013, and some sectors will suffer from a weaker global economy. Europe and developing economies (particularly China) still present challenges. Significant economic uncertainty around the globe can, and does, affect our financial markets.

Market forecasts encompass a wide range, from cheerful optimism to dismal pessimism. Improving employment data, better housing and car sales, and increasing consumer confidence all point to improving economic conditions, and suggest that the stock market could easily maintain its current level. However, the market is driven less by fundamentals, and more by emotion and speculation about how well the Fed can manage a reduction in asset purchases. For the short term, we are worried about possible resultant volatility and downside risk. However, we believe that the fundamentals are strong enough, combined with positive economic conditions, to warrant remaining invested.