McLEAN ASSET MANAGEMENT CORPORATION

Occam's Razor

October 2013

WHAT IS OCCAM'S RAZOR?

Occam's Razor is a principle attributed to William Occam, a 14th century philosopher. He stressed that explanations must not be multiplied beyond what is necessary. Thus, Occam's Razor is a term used to "shave off" or dismiss superfluous explanations for a given event. This concept is largely ignored within the investment management landscape. This newsletter will "shave off " popular investment misinformation and present what is important for achieving long-term investment success.

Why Think Globally?

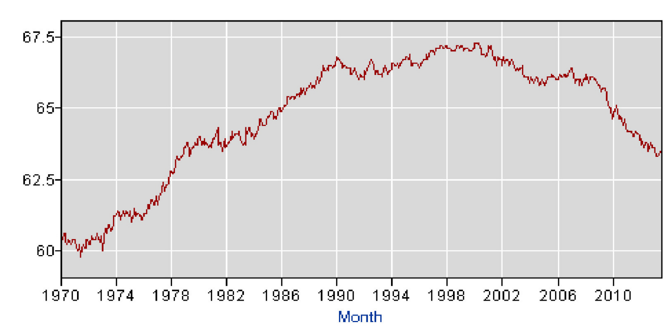
"I believe that capitalism has been the most effective ideology we have known in taking people out of extreme poverty"

-Campaigner and U2 Frontman Bono, in a September interview with The Guardian

With all the media focus on our homegrown governance issues, it is important for all of us to remember there are other parts of the globe where parks remain open; where the gridlock in the national capitals is traffic-related, and not political. Places where economies and free markets are growing. More on that later, as we address some of these homeland issues.

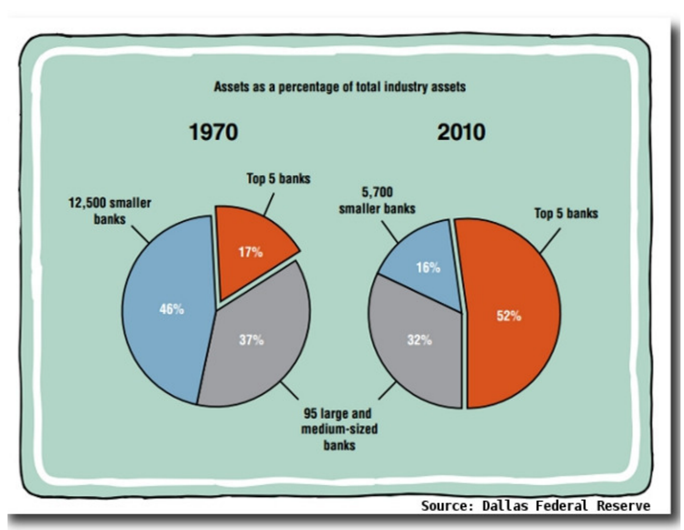
The recent political landscape is something we have all had to deal with for quite some time, but consider it from a different viewpoint. Remember the old saw about Mussolini making the trains run on time. Let's look at some of the positives and the negatives we're facing right now – bad news first:

- With an intransigent unemployment rate hovering around 7%, the labor force participation rate at a level not seen since the 70s (see chart below), rising health care costs and the specter of companies having to cover full time employees that has resulted in limited hiring, what can be positive about the employment picture?



- Real estate and construction have not fully recovered from pre-2008 levels, and levels of foreclosed real estate remain historically high. The annual foreclosure rate is still 47% higher than in March of 2006, although the rapid pace of activity is reducing the outstanding inventory at a current rate of more than 20% per year.

- Fully 52% of all banking assets are held by the top five banks, all of which, either nearly failed in 2008, or experienced significant liquidity problems. Those banks are not participating in traditional banking, preferring instead to borrow from the Fed at historically low rates, and arbitrage that borrowing through government



securities purchases.

- ♦ At the political level, nothing seems to get done until both sides are pushed to the brink of a standoff. It happened as the year began with the resolution of the "fiscal cliff", and this month with the government shutdown, bringing the Feds to the brink of running out of cash until a deal was struck.
- ♦ Reflecting our budget deficits and quantitative easing (Fed purchases of US Government securities), the US dollar is weak, increasing prices of imported goods like energy. Our deficit is now permitted to increase to $17.5 trillion. The next deadline is January 15 for both the next round of sequestration, and the debt ceiling limit.

All of this might seem dire, except:

- ◊ Businesses have taken advantage of the hiring environment by encouraging ever higher levels of productivity from their employees. This is reflected in strong earnings all across the markets, and therefore strong equity market growth.
- ◊ Investors have taken a renewed interest in real estate to buy up bargains in anticipation of higher future prices.
- ◊ Borrowers have taken advantage of lower rates to refinance and cut their expenses.
- ◊ Credit Unions have stepped up to be many consumers' lender of choice, along with community and even Canadian banks doing business in the US. Many of these institutions did not get involved in the sub-prime mortgage debacle of the last decade, and they retain strong capital ratios. Most use Federal funds as well, but actually use them to strengthen their lending assets.
- ◊ Seemingly nothing gets done at the political level, yet deals are still struck - and they stick. A tax act was passed at the 11th hour early this year, resulting in a permanent tax code with historically low rates on investments for most brackets. The fiscal cliff was averted. Shortly after, sequestration actually implemented, resulting in budget cuts across many agencies, and a cut in Federal spending which reduced the seemingly intractable Federal deficit. Also, the Affordable Care Act (ACA) payroll taxes went into effect this year for many taxpayers, resulting in additional Federal revenues without the resulting expense, as the ACA has not been fully implemented. The estimated Federal deficit will decline to about $600 billion this year. That is still high, but below the levels of the past few years.
- ◊ The term "government shutdown, "is a bit of a misnomer, because the government doesn't *fully* shut down. In official parlance, they're called "spending gaps," a term the experts prefer to use. They've been imposed 17 times since 1976, the year Congress began its revised budgeting process. Six of these shutdowns were during the Reagan administrations, and the last was during the Clinton administration. These types of political battles do not necessarily have a negative economic outcome. Following the Clinton era shutdown, compromises were reached on long-standing welfare reforms and Medicare funding. Medicare taxes today are imposed on all wage income, and the welfare reforms lasted until the Obama administration halted them in 2009.
- ◊ Certain sectors of the economy are performing very well, most notably energy. Net imported energy has declined to levels not seen since the 1980s. This year, we are poised to overtake Russia as the world's largest producer of natural gas, and will be the world's largest producer of hydrocarbons. Additions to the world's known energy reserves increased by 11% last year just as a result of new discoveries in the US.
- ◊ Our trade deficit reached a 10-year low in 2010. Our weak dollar fomented resurgence in domestic manufacturing, as US exported goods have an increased advantage on world markets. Some economists believe recent surges in imports reflect growing strength in the US economy, as well as growth of the economies of our trading partners. Global competition has increased, with many regions and countries locked into a battle to suppress currency prices, making domestic stimulus increasingly attractive to many countries - especially in Japan and Europe

What does this all mean?

Since climbing out of the 2008 downturn, we have been in a slow growth economy. Because of the political landscape in Washington, along with a number of long term issues, many individuals and businesses have chosen to ignore what government is doing (or not doing) and make their own decisions and plans regardless. Because the political/ government systems are deemed not to work, business and individual decision making does. It appears that today's healthcare issues have exacerbated the employment issues, as some employers favor the hiring of part-time employees. It is likely not a good thing for many workers who feel two or more part-time jobs are necessary to keep their families afloat, but it is the reality for many. US multi-national corporations keep profits overseas to escape our high corporate tax rates and borrow here at our low rates as required to pay off shareholders. Individuals and corporations do what they need to, to act in their own economic self-interest - in spite of the machinations of government "planners".

But enough about the US, let's go back to the global economic outlook and performance:

- Much of the world shows GDP growth at rates higher than the US. Save the declining economies of southern Europe, there are many bright spots, even in the long term slow growth economies of Africa.

- Brazil overtook the UK last year as the world's fifth largest economy, having overtaken France in the sixth spot in 2006. Brazilian President Lula da Silva, described the situation when he was elected: "The country had no credit, had no working capital or financing or income distribution. What kind of capitalism was that? A capitalism without capital. I decided then that it was necessary to first build capitalism, then make socialism, we must have something to distribute before doing so."

- For this quarter, after lagging behind US market performance for the past five years, global market performance ex-US increased to double digit levels. Year to date, both are strong. But given the comparative GDP growth rates, the importance of a strong international allocation is affirmed.

- The importance of development and capital investment appears to be having other positive effects. World Bank Group economists found that if developing countries continued their strong growth rates in the coming seven years – far from a given - the global poverty rate would dip below 10 percent for the first time since such figures were first reported in the World Development Report in 1990. Since 1990, when 43 percent of the people living in developing countries lived in poverty, global poverty has been in a steady retreat. An estimated 1.9 billion people lived in poverty in 1990, and that number fell to 1.2 billion in 2010.

So global growth is strong and trending well, especially for the developing markets that most need the growth to raise their standards of living. Interestingly, the nations of most concern from a financial standpoint include some of the globe's wealthiest, including the US. There is a strong effort on the part of many of those nations to keep their currencies weak, through their loose monetary policies. By "printing money", their products retain competitiveness on world markets. The US and Japan have more in common with Greece and Italy when it comes to public debt levels as a percentage of GDP. Many nations of South America and Africa have lower debt levels and stronger relative currencies, which makes the import of products from wealthier nations more expensive to them. Will those emerging nations push the International Monetary Fund, the World Bank and other international watchdog groups to put pressure on wealthier nations to get their fiscal act together? They could. Is there a risk that a simultaneous deleveraging and monetary tightening could cause a financial meltdown? It is possible, but many believe the way to prevent that is by stronger economic growth. That will continue to encourage invested capital to flow to all markets, rather than to debt or fixed investments. Simply put, given bond yields are at or near historic lows, many investors will need to ensure they hold the necessary global equity exposure to achieve long-term financial goals. In light of this low interest rate environment, it is a good time to be an owner of goods, and perhaps not so good to be a lender. The lending of funds is however, the safety net for capital.

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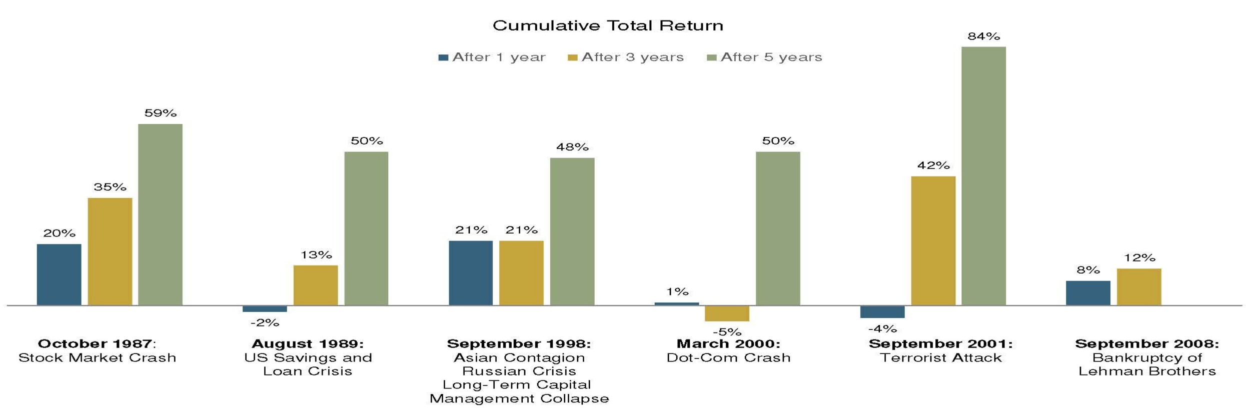
The Market's Response to Crisis

Performance of a Normal Balanced Strategy: 60% Stocks, 40% Bonds



Balanced Strategy: 7.5% each S&P 500 Index, CRSP 6-10 Index, US Small Value Index, US Large Value Index; 15% each International Value Index, International Small Index; 40% BofA Merrill Lynch One-Year US Treasury Note Index.

The S&P data are provided by Standard & Poor's Index Services Group. The Merrill Lynch Indices are used with permission; copyright 2012 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. CRSP data provided by the Center for Research in Security Prices, University of Chicago. US Small Value Index and US Large Value Index provided by Fama/French. International Value Index provided by Fama/French. International Small Cap Index compiled by Dimensional from StyleResearch securities data; includes securities of MSCI EAFE countries in the bottom 10% of market capitalization, excluding the bottom 1%; market-cap weighted; each country capped at 50%; rebalanced semiannually. Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.

This chart shows performance of a balanced investment strategy following a few historical crises. Each crisis is labeled with the month and year that it occurred or peaked. The subsequent annualized returns start from the first day of the month following each crisis. Although a global investment strategy would have suffered losses immediately following most of these events, the financial markets recovered over time, as indicated by the positive three- and five-year cumulative returns. Negative events such as these may tempt investors to flee the financial markets. But diversification and a long-term perspective can help investors apply discipline to ride out the storm.

The deep thoughts behind these concepts are not likely ones that many investors think when they put their funds to work. However, a portfolio with a base of assets invested in the US, but strong international positions in both developed and emerging markets not only makes financial sense, it helps and participates in the perpetuation of growth in the global economy. Rather than simply offering only charity, an investment in this type of 'Bono Capitalism' creates jobs, stimulates trade, and sparks economic development. In short, it's a way to 'do good', by doing well. Our clients have been, and are, positioned this way. And that continued course is the long-term place to be. We encourage all to think of that when the next political 'crisis du jour' erupts in the US. In the long run, it won't matter or be remembered much, because today's media headlines of concern are not the first, and definitely won't be the last.

This newsletter is published by: **McLean Asset Management Corp.**
Phone: (866) 827-0636 | www.mcleanam.com