Lucien, Stirling & Gray Advisory Group, Inc.

Second Quarter Report 2016

July 2016

LUCIEN, STIRLING & GRAY ADVISORY GROUP

"Smart Decisions About Serious Money"

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

We're pleased to provide you with our report for the period ending June 30, 2016.

It's clear we are living through a period of breath-taking change, and it's taking a toll on our collective psyche. Not only is the world unnerved by the recent political earthquake of the "Brexit" vote, but at home our sense of social cohesion is wavering. The horror of police officers gunned down in the streets juxtaposed against marching crowds protesting egregious police misconduct is raw. In France, we've witnessed the maiming and slaughter of hundreds of Bastille Day revelers by a madman in a runaway truck. Now, in Turkey, an apparent coup attempt has triggered reverberating social and political aftershocks that will have impact around the globe. Every day seems to bring new anxieties. It's hard to get your hands around just what's happening – and harder still to know what to do.

It's tempting just to do something, anything, in reaction to the tension you feel inside. That's a perfectly natural human emotion. But especially as it relates to your investments, you must resist it.

Tectonic shifts are occurring all around us. Even exciting developments contribute to the sense of unease. Technological innovation is giving us new capabilities, opportunities and possibilities that we couldn't even imagine a decade ago. But technology is also upending entire industries, jobs and ways of life. Amazon is remaking the entire retail industry. Facebook is transforming media and advertising. HomeAway is forcing huge change in the hotel industry. Netflix is upending network TV and traditional movie distribution channels. The pace of change is amazing.

In an environment like the one we're experiencing now, it's ever more important to think, plan and act purposefully – based on principles.

The list of "disruptors" goes on and on. Old ways and old fortunes are being destroyed. But new opportunities and new fortunes are simultaneously being created. This leaves many feeling unsure of what to do, vulnerable to making the wrong decision, and concerned about being left behind.

At the same time, skepticism, even cynicism, towards the institutions that undergird our society is reaching new heights. Trust is at a low point. Congress is dysfunctional. Political polarization is more extreme than at any period in our lifetimes. The growing social and political tension is palpable. Add to this the facts that interest rates around the world are at their lowest levels in recorded history; income and wealth disparity between the "haves" and the "have-nots" keeps widening; and U.S. stock markets are breaking out to all-time highs. So many things don't seem to make sense. I understand.

These cross-winds goad us away from an attention to nuance, subtlety and the pursuit of wisdom, and towards emotional reactivity. Exhausted and under stress, human beings reflexively resort to simplistic binary distinctions–fight or flight. Feeling instead of thinking becomes the path of least resistance. And then we act out - impulsively. Don't do that.

As hard as it is to do in this maelstrom of emotions, as a long-term investor it's absolutely critical to overcome this temptation towards reactivity. In an environment like the one we're experiencing now, it's ever more important to think, plan and act purposefully – based on principles.

Faith in the future is the most important principle of all. One cannot be a successful investor in anything if your core beliefs are grounded in fear. All the other principles below become moot if you're fearful, so bolster your belief system with these cold, hard facts. The United States of America is a great country. Our economy has no equal around the globe. We have the deepest and most liquid capital markets in the world. The U.S. has spawned, and continues to spawn some of the most creative and productive business enterprises ever known to mankind. Since the worst of the financial crisis in 2009 our economy has created over 14.6 million new jobs. Unemployment has dropped steadily from a high of 10% to 4.7% today, way below the average of the last 50 years, which is 6.2%. Household debt service ratios have fallen like a rock, and are now lower than at any point since 1980. Household net worth is now the highest it has ever been in our history. Wages are starting to rise steadily, banks are in solid shape, and individuals are sitting on more than $12 trillion in cash that will eventually be put to work.

Prudence is a foundational principle of successful investing – and of life. (It's not simply, as a good client once joked: "the girl your great-grandfather had a crush on in high-school.") The dictionary on my bookshelf defines prudence as "the habit of acting with deliberation and discretion. Wisdom applied to practice." Words like judiciousness, circumspection, judgment and sagaciousness are listed as synonyms. Sadly, prudence is a virtue that's vastly out of favor in the current emotion-based climate (financial and political.) The flight into sovereign bonds around the world paying negative interest rates – requiring the lender to pay interest to the borrower – speaks to this. So too does the flood of money fearfully fleeing ownership of the great businesses of the U.S. and the world during a perfectly normal correction, while pouring into 10-year Treasuries offering the lowest yields ever since they first began trading in 1790.

Patience is another principle I've referenced in these missives. Think of it as the poise and composure not to do the wrong thing – in spite of continuous provocation. Again, this is a virtue that's hard to find today. Last August, then again this January and most recently near the end of June we've witnessed some of those provocations – equity market fluctuations that didn't even reach the average intra-year decline of the last 35 years. Yet many perturbed souls compulsively bailed out of artfully designed and diversified equity portfolios in droves – only to see the investments they sold go on to reach new heights as corporate earnings, cash flows and dividends continue their inexorable climb.

Discipline, too, is a critical virtue you've heard me espouse. It's the courage, determination and focus to keep doing the right things – especially during periods of stress and disappointment (when others who are less disciplined appear for a while to be prospering.) The successful long-term investor with a properly designed and diversified portfolio knows that unless the plan changes, the portfolio shouldn't change. Keep doing the right things.

Change and disruption are definitely happening. That is in fact the history of this great country – and indeed of mankind itself. I do not believe we are standing on the precipice of disaster. We may in fact be poised on the cusp of a new age of innovation, social growth and economic revival. Believe it.

Thank you for your confidence and trust.

Thomas G. Twombly

President

INVESTMENT COMMENTARY

We'd like to start off by congratulating (and thanking) all of our clients for your poise during the first half of 2016. Just like the first quarter, the second quarter proved to be a volatile period, and the final days, when markets were subject to yet another bout of anxiety and volatility emanating from the "Brexit" vote, proved this especially true. Though we fielded a number of calls during that time frame, all were simply seeking perspective, understanding and perhaps a small amount of reassurance – which is exactly what you should be seeking from an advisor any time you have a question or concern. Nobody came unhinged, and none of you reacted inappropriately. Well played.

This cool-headed behavior stood in sharp contrast to many other market participants, who exemplified the reactivity that defines the times in which we now live. The three trading days following the surprise outcome of the vote saw a sudden spike in volatility across the globe, prompted in no small part by the false narrative that this was another so-called "Lehman moment." Currency markets in particular convulsed dramatically. The British Pound initially fell by more than -8% against the U.S. Dollar and -11.4% against the Japanese Yen, quickly reaching its lowest level since 1985. The Euro also fell, declining by -2.7% against the Dollar and -6% against the Yen.

Stock markets initially fell sharply as well. In the US, the S&P 500 fell by -3.6% the Friday following the vote, and by approximately -2% the following Monday before beginning a sharp rebound that continues through this writing. The small-cap Russell 2000 fell by -7% in the same time frame before beginning a similar rebound of its own, and a number of prominent overseas indices fell between -7% and -12% before experiencing a powerful rebound that continues well into July. During that brief 2-3 day period many stock funds reported levels of net liquidations that hadn't been seen since 2011 (when the S&P 500 actually dropped -19.4%) indicating that plenty of investor's emotions remain hair-trigger sensitive, and that a great many panicked souls reflexively locked in steep losses at the worst possible time.

Fixed income markets were the overwhelming recipients of the sudden capital flight from equities. Interest rates plunged sharply at the end of the quarter as the aforementioned sellers of equities reflexively bought bonds. The 10-year U.S. Treasury ended the quarter with a yield of 1.49%, down from 1.73% at the beginning of the quarter, and having generated a +7.95% total return since the start of 2016. (The week following the end of the quarter actually saw the lowest rates ever recorded in the 226-year history of these securities, with a yield of 1.36% reached on July 8, 2016.) 30-year Treasuries saw even larger spikes in price, as rates fell to 2.3% by the end of the quarter from 2.61% on 3/31, and provided whopping total returns for the year so far of +16.82%. This is truly an astounding development in a world where fully 74% of sovereign bonds around the globe finished the second quarter with yields below 1%, and where 36% ($11.7 trillion in U.S. Dollars) actually pay negative yields.

For this quarter, small and mid-cap stocks led domestic markets with total returns of +3.8% and 3.2% respectively. Value led growth as investors showed a clear preference for companies with steady earnings and higher dividends, irrespective of their higher P/E ratios. Large-cap stocks provided total returns for the quarter of +2.5%, bringing year-to-date results to +3.8%. The energy sector showed particular strength during the period, rising by +11.6% as investors overall demonstrated confidence that the precipitous drop in oil prices experienced last year has already passed its nadir. The Telecom and Utilities sectors also showed strong but potentially unsettling strength during the quarter, rising by +7.1% and +6.8% respectively. Year-to-date total returns of +24.8% and 23.4% for these two sectors demonstrate the degree to which the compulsive search for current yield dominates the current mood of markets. It also serves as a warning of just how over-valued the traditionally "defensive" side of the equity market has become.

Looking forward, we remain convinced that international diversification and a long-term view are crucial. So too are the patience and discipline to see through the emotional reactions that many are experiencing. It's important to recognize the potential long-range opportunities that will surely emerge, and to avoid the temptation to get overly concentrated in asset classes and sectors that have performed well in the recent past. The good news is that despite these shocks, the global economy continues to grow, albeit at a tepid and halting pace. The US economy also continues to expand, and American consumers continue to find themselves in better and better financial shape.

The strength of the U.S. Dollar makes foreign-made goods and services that much more attractive to American consumers, and conversely makes U.S. exports that much more expensive. Despite the reflexive shock of the "Brexit" vote on international equity markets, many Euro-zone manufacturers that sell their wares into the U.S. and Japan stand to benefit handsomely if economic conditions continue to improve. With much more attractive valuations at this point compared to domestic equity markets, for the patient and disciplined long-term investor we believe these opportunities should not be overlooked. Our portfolio allocations continue to reflect these beliefs.

As always, if you would like to discuss our perspective or your personal situation please do not hesitate to give us a call.

Thanks to our clients for helping make Lucien, Stirling & Gray an awesome place to work!

Austin Business Journal's "Best Places to Work" luncheon, June 2016

General Market Results

	2nd Quarter	YTD	One Year	Three Year	Five Year	Ten Year
CPI	0.88	1.57	0.67	0.95	1.25	1.70
Barclays Agg Bond	2.21	5.31	6.00	4.06	3.76	5.13
S&P 500	2.46	3.84	3.99	11.66	12.10	7.42
DJI	2.07	4.31	4.50	8.99	10.41	7.66
S&P 400	3.99	7.93	1.33	10.53	10.55	8.55
Russell 2000	3.79	2.22	-6.73	7.09	8.35	6.20
NASDAQ	-0.56	-3.29	-2.89	12.48	11.79	8.35
MSCI EAFE	-1.19	-4.04	-9.72	2.52	2.15	2.05
MSCI EM	0.80	6.60	-11.71	-1.21	-3.44	3.88

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