Lucien, Stirling & Gray Advisory Group, Inc.

THIRD QUARTER REPORT 2014

October 2014

LUCIEN, STIRLING & GRAY ADVISORY GROUP
"Smart Decisions About Serious Money"
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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

"When feeling seasick due to rough seas, keep your eyes on the horizon."

Advice to passengers on ocean liners

We are pleased to provide you with our report for the period ending September 30, 2014.

In our report for last quarter, which was sent out sometime in late July, we warned of the possibility of misbehaving financial markets. By the end of June, investor sentiment had clearly become more upbeat after a long period of disbelief and negativity. Equity market volatility had remained low for an extended stretch, allowing potential market participants to gradually lower their guard, and economic statistics were showing noted signs of improvement. The general public, so-called "Mom & Pop investors", were finally showing an interest in getting invested again because it was becoming harder and harder to deny the steady improvement in the U.S. economy.

For the uninitiated, these were obvious signals that the future looked bright and clear, and many early-stage conversations we had with prospective clients reflected that sentiment. For the more seasoned among us, it was an obvious time to conduct some lifeboat drills, and to remind all of our dear readers of the historical record, and of the regular, though thoroughly unpredictable, frequency of sharp corrections that have forever characterized every asset class – so we did.

As I write this missive in October, it's clear that was a timely exercise. Equity market volatility increased markedly in late July with a sharp drop, followed by a strong rebound in August, and another sharper drop beginning in mid-September. It continues apace. Interest rates too are gyrating more than one might normally (whatever that means) expect. Oil and commodity prices have dropped quickly. And the U.S. dollar has gained strength rapidly, such that the otherwise tepid behavior of many foreign equity markets has been translated into noticeable corrections for U.S. investors in those asset classes.

"volatility is not risk – the real risk is inappropriate behavior in response to that volatility"

Perhaps even more predictably, the tenor of conversations has changed rapidly too. What had been a steady flow of new prospective clients talking enthusiastically about their investment plans has now shifted to nervousness, hesitation, worry, and maybe even a few instances of fear. It may seem counter-intuitive that I say so, but in the long run this is a good thing for true investors.

This is what a correction *feels* like. An actual bear market *feels* even worse. We don't know if this current decline will turn into a bear market (and neither does anyone else who is telling you the truth) but make note of your emotions – because those emotions are why it's so hard for most people to invest when prices are low – even though intellectually they know that's what they're logically supposed to do. Why? Because sharp declines and financial market disruptions never happen in a vacuum – they are always accompanied by at least one perceived crisis that dominates the hyperbolic news cycle and winds up our anxiety level – and anxiety freezes people.

Remember the last time we experienced a sharp decline of any note, in the 3rd quarter of 2011 when the U.S. equity market fell just slightly more than 19%? Sovereign defaults were the crisis du jour then. According to the media and political demagogues who seized the moment in order to further their own interests, Greece (a country with a GDP about the size of Rhode Island) was going to collapse, pulling all of Europe and the civilized world with it forever into a dark abyss. Politicians here were playing a game of chicken over debt-ceiling negotiations, threatening default on U.S. Government debt obligations if we didn't implement drastic austerity measures and Standard & Poor's responded to the irresponsible behavior by downgrading the credit rating of the U.S. Government. In the long run, it proved to be a great time to add to a thoughtfully allocated portfolio – but the majority did just the opposite.

Before that it was the Fukashima nuclear plant, and before that something else. Now it's ISIS (or ISIL, depending on who's pounding the table) and the Ebola virus… Next time it will be some other crisis, real or perceived, and the cycle will continue. It has always been thus. Financial markets forever fluctuate, sometimes more than others, and people always react with greed and excitement after those fluctuations are up and anxiety and regret after they are down. In the end, therefore, long-term financial success is not so much a function of how the investments behave, but how investors themselves behave. Because for a well-planned and thoughtfully allocated portfolio, volatility is not risk - the real risk is inappropriate behavior in response to that volatility. So focus on getting the behavior right, and in the fullness of time all else will work out. I'm sure of it.

Thank you again for your confidence and trust.

Thomas G. Twombly
President

INVESTMENT COMMENTARY

U.S. and international stock markets were subject to increased volatility throughout the July – September period as currency markets fluctuated substantially and economists grew increasingly cautious about the potential for a general slowdown in global growth.

Domestically, large-cap equities fared better for the quarter as a whole than did small and mid-cap holdings. Despite falling by 1.4% in September, the S&P 500 eked out a gain of 1.1% for the quarter, while the Russell 2000 fell by almost 7.4% and the S&P 400 mid-cap index declined by almost 4%. Healthcare, technology, and telecommunications stocks were among the top-performing sectors for the period, while energy, utilities, and industrials were responsible for much of the overall drag.

International equity markets were a mixed bag in local currency terms. However, a rapidly strengthening dollar in relation to other world currencies meant that U.S. investors experienced declines in those asset classes for the quarter as a whole, with particular weakness in September. The MSCI EAFE index declined by 3.8% in the final month of the period, bringing the overall decline to 5.8% for U.S. based investors. The largest European markets actually fell fairly modestly in local currency terms, with France declining by .6% and Germany by 3.7%. But the robust performance of the dollar translated into overall declines of 8.3% and 11.2% respectively for U.S. investors. The Pacific region saw similar results, with Japan rising by 5.9% for the quarter in local currency, but experiencing a decline of 2.2% when translated back into U.S. dollars. Ex-Japan, a modest .9% decline for the region as a whole in local currency turned into an overall decline of 5.9% for those of us in the United States.

U.S. fixed-income markets also provided a mixed bag. TIPS (Treasury Inflation Protected Securities) weakened during the quarter by 2%, while longer-dated U.S. Treasuries strengthened. The benchmark 10-year Treasury note ended the quarter with a current yield of 2.49%, increasing slightly in value as investors grew concerned about slowing economic growth and bid interest rates down from 2.53% at the beginning of the quarter. High-yield corporate bonds were among the poorest performers in the fixed-income markets during the last three months. Prices fell in what has become a very extended market as concerns about slowing growth and the potential for declining corporate revenues finally trumped the increase in value that many holders of these securities have come to expect from a decline in interest rates.

Despite recent turmoil, there is still ample evidence of a continued strengthening in U.S. economic growth. The global economy too, while certainly not breaking any records, is still growing as a whole. We believe that many financial market participants, still suffering the lingering after-effects of an extended period of crises and over-sold catastrophes, are exhibiting considerably less patience and discipline than they should in allocating capital for the long term. The Bureau of economic Analysis reported that second quarter GDP growth in the United States increased at an annual rate of 4.6%. The third quarter of this year also posted the strongest quarter since 2006 for light vehicle sales, and housing starts continue to climb slowly and steadily out of a deep trough set several years ago. While the recent sharp drop in the price of oil has certainly impacted energy company stocks, which in turn have contributed to weakness in the overall index, the long-term effects of this development could be quite positive for many other parts of the economy. Substantial production of oil in the United States and abroad has resulted in a steady reduction in the price of gasoline and energy costs in the U.S., and it's been estimated that as much as $60 billion will be cut from the nation's energy bill between 2013 and 2015. This means that consumers as a whole are experiencing a meaningful reduction in transportation and energy costs, and now have money that can go to other parts of their budgets. Unemployment now stands at 5.9%, which is now lower than the long-term average, and household debt-service has fallen rapidly in the last six years to now stand at the lowest it's been since the early days of the Reagan administration.

A strong dollar means that U.S. purchasing power overseas has increased, and many foreign companies that sell goods and services into U.S. markets are likely to benefit in the long run. With the value of the stocks of many such companies trading below comparable U.S. valuations, we continue to believe that patient investors will benefit from holding solid allocations to international equities. Media hype to the contrary, the world economic system is not falling apart. Keep the faith, and keep your eyes on the far horizon.

Conservative Growth Model

3rd Quarter	YTD	1Year	3 Year	5 Year	10 Year
-2.80%	0.55%	5.31%	8.55%	6.30%	5.24%

Inception Date 06/03/1999

Core Growth Model

3rd Quarter	YTD	1Year	3 Year	5 Year	10 Year
-3.25%	0.93%	6.84%	12.57%	7.60%	6.00%

Inception Date 05/31/2003

Growth Model

3rd Quarter	YTD	1Year	3 Year	5 Year	10 Year
-4.54%	-1.02%	3.79%	12.34%	7.36%	7.15%

Inception Date 10/16/1992

Specialty Model

Diversified Growth Model

3rd Quarter	YTD	1 Year	3 Year	5 Year	10 Year
-3.45%	0.92%	9.23%	17.27%	10.98%	7.18%

Inception Date 10/31/00

Education Models

UT ORP

3rd Quarter	YTD	1Year	3 Year	5 Year	10 Year
-3.02%	0.81%	6.62%	14.03%	7.67%	5.78%

Inception 08/10/1999

Retirement Growth

3rd Quarter	YTD	1 Year	3 Year	5 Year	10 Year
-3.55%	1.85%	8.25%	14.88%	9.21%	6.80%

Inception Date 06/03/1999

Growth & Capital Preservation

3rd Quarter	YTD	1 Year	3 Year	5 Year	10 Year
-1.83%	1.62%	6.24%	9.93%	6.65%	5.71

Inception Date 11/30/2001

Upcoming Events

Lucien, Stirling & Gray invites you to attend our

23rd Annual
Holiday Party and Open House

December 11, 2014

RSVP: 512-458-2517 or by email to info@lsggroup.com

General Market Results

	3rd Qtr	YTD	One Year	Three Year	Five Year	Ten Year
CPI	-0.21%	2.06%	1.58%	1.59%	1.95%	2.28%
Barclays Agg Bond	0.17%	4.10%	3.96%	2.43%	4.12%	4.62%
S&P 500	1.13%	8.34%	19.73%	22.99%	15.70%	8.11%
DJI	1.87%	4.60%	15.29%	19.02%	14.85%	8.15%
S&P 400	-3.98 %	3.22 %	11.82%	22.43%	16.37%	10.29%
Russell 2000	-7.36%	-4.41%	3.93%	21.26%	14.29%	8.19%
NASDAQ	1.93%	7.59%	19.14%	22.99%	16.18%	9.01%
MSCI EAFE	-5.83%	-0.99%	4.70%	14.16%	7.04%	6.80%
MSCI EM	-3.36%	2.75%	4.66%	7.56%	4.76%	11.03%

Lucien, Stirling & Gray Advisory Group, Inc. is a Registered Investment Advisory firm providing fee-only asset management, fiduciary-level advice and financial planning services to individuals, corporations, trusts and foundations.

For more information about our firm, please visit our website at www.lsggroup.com • Model holdings may change due to ongoing management • Sector and style breakdown is constructed with the best available information and therefore is only as accurate as the available information • Past performance is no guarantee of future results • It is impossible to invest directly in indices • Percentages may not equal 100 due to rounding

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