THE LONG RUN

"People will forget what you said, people will forget what you did, but people will never forget how you made them feel."

--Maya Angelou

After eight years of writing fairly accurate quarterly letters (what we said) and providing above-average performance returns (what we did), we surpassed a fairly significant milestone this quarter. Clients have now entrusted us with over $1 billion of their money. While few of you may remember the specific content of these letters or your exact returns, we recognize that we have earned your trust and made you feel confident in our guidance. We thank you for choosing to work with us.

As we anticipated, financial markets have been somewhat more volatile over the past three months, though the direction has continued to be upwards. While it has been nearly two years since the overall stock market has suffered a sizable correction, we did see the stocks of more speculative companies sell off in the beginning of this year. We view this as healthy and still believe in the attractiveness of our current holdings. Overall, the S&P 500 stock index advanced by 5.2% during the quarter and is up by 7.1% through June 30. The MSCI World Index also increased by 4.2% and 4.9% for these three- and six-month periods.

With stocks at all-time highs and valuations at slightly above-average levels, we are often asked why we haven't reduced equity weightings by a greater amount this year. Although we pay strict attention to keeping what we believe is the proper balance of investments for each individual client in this changing environment, we still believe that there are enough unrecognized, long-term, positive trends to warrant our investment stance. As Wall Street focuses on the short-term movements of interest rates, inflation, and the economy, it really is the long-term unfolding of major trends that moves asset prices and builds wealth over time. By keeping our attention on critical and defining trends, we hope to continue to provide positive long-term returns – and to keep earning your trust.

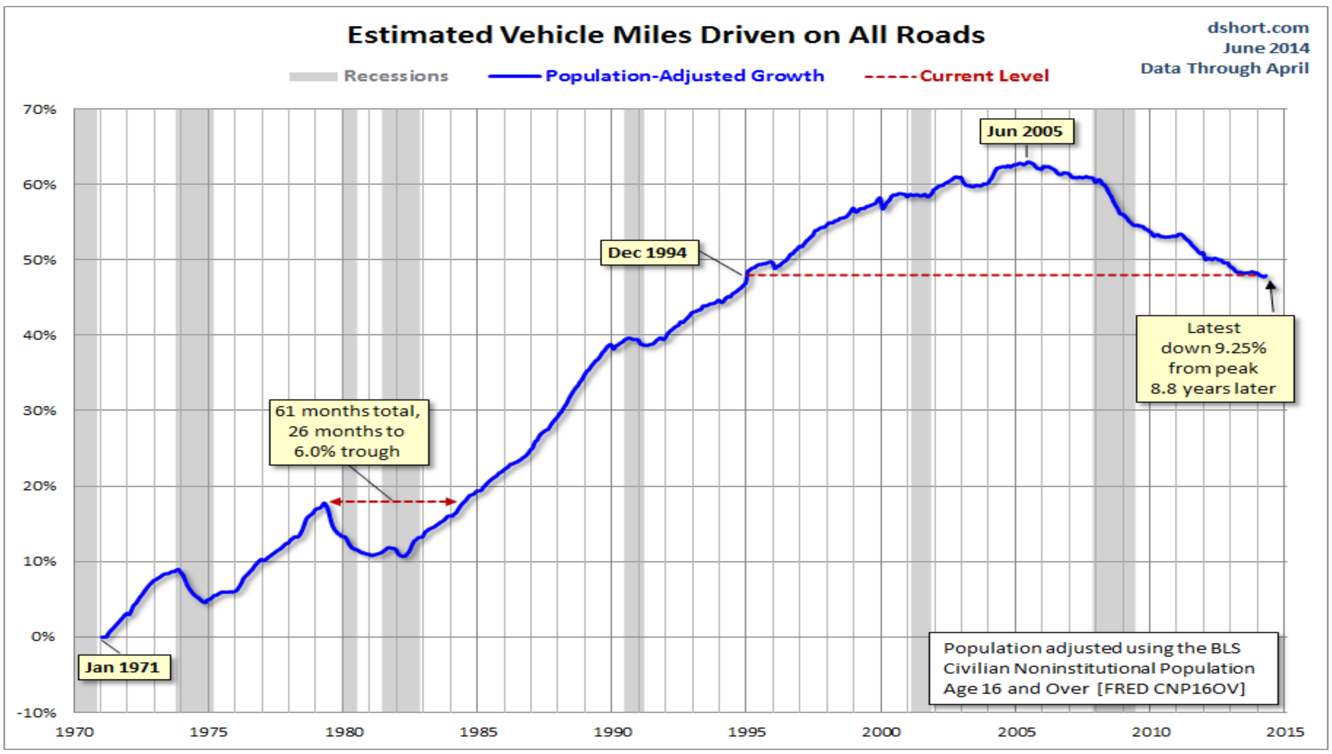
Probably the largest unrecognized change in our economy has to do with demographics. While Baby Boomers have dominated economics and politics for forty years, their time is winding down. According to the Census Bureau, the two largest five-year age cohorts next year will be 20-24 years old and 25-29 years old. It will no longer be the boomers. The incoming wave of these Millennials will drive the country in a new direction.

In economic terms, the consensus view of the Millennials is not a positive one. Statistics have shown that about one-half of people in the U.S. under the age of 25 lives in their parents' homes. They are thought to be stuck in low quality, poor paying jobs with bleak futures. The reality is that – while the weak job market has certainly delayed entry into the workforce – a higher percentage of Millennials has opted for college than in any other previous generation. While the Census Bureau counts those in college as still living in their parents' homes, the truth is that there are no more non-college-attending Millenials under the age of 25 at home than there were in other generations. What we do have is a large pool of educated workers about to enter a workforce that is growingly in need of them.

One-third of small businesses say they cannot fill jobs because of unqualified applicants. This is on top of a labor market that is quietly looking a lot healthier. Over 200,000 jobs have been created in each of the last five months. This hasn't happened for fifteen years. High-quality/high-paying jobs made up two-thirds of last month's new jobs. College-educated Millennials entering this improving market is a distinct positive for the U.S. and partly explains why our economy has been doing better than other parts of the world.

Wall Street views this improving labor market as a negative, fearing a pickup in wage inflation. Our view is somewhat different. There is no doubt that large age cohorts bring some inflation. We see this with apartments and starter homes where the Millennials are being increasingly active. And we will see it with wages after years of subdued wage growth. We think this wage inflation is good inflation, however, as it will support an improving standard of living. We would be more concerned about inflation if we saw prices of energy and commodities rising. We view that as bad inflation as it often leads to lower standards of living.

We currently do not see bad inflation – particularly in energy prices – picking up. This is largely due to the Millennials changing their habits. While the story of the U.S. finding more oil and gas is a well-told tale, less well recognized is the drop in energy demand here in the U.S. As the following chart shows, Millennials don't drive as much, and per capita miles driven are showing a historical decline. We are also amazed at the potential of alternative energies to impact traditional energy usage. On recent sunny and windy days in Germany and Australia, electricity prices dropped to zero as solar and wind energy were able to meet a significant portion of overall energy needs. As storage is paired with solar in the U.S., we will also move down this path in coming years.



Another productive investment theme that follows the Millenial demographic: Healthier living. A recent study showed obesity declining in New York City students, and sales of unhealthy products are plummeting. The consumption of carbonated soft drinks is now dropping at a faster rate than smoking. Frozen dinner sales are dropping at about a 10% rate while fresh food sales are soaring.

Granted, there are still things to be worried about. Interest rates should rise, and this could prove to be particularly troublesome for Japan, Portugal, Greece and certain emerging nations. There is certainly a bubble in the pricing of these countries' bonds. We also note the reversal of the previous trend toward globalization and cooperation as regional conflicts are arising (China and Japan, Russia and Europe, Shia and Sunni). Any of these could push us to change our investment strategy. Rest assured, we stand ready to adapt what we say and what we do as events unfold.