Dear Client,

The third quarter of 2013 witnessed the equity markets hitting record highs after the Federal Reserve’s decision to delay the tapering of bond purchases until future economic data improves. Investors were shocked by the move as most anticipated a small reduction in bond purchases to begin the process of the eventual end to the Quantitative Easing (QE) program by the middle of 2014. The market already began to discount this move by reducing exposure to bonds, which pushed treasury yields on the 10-year bond to 3%. Stocks also traded down as many investors felt the lack of Fed stimulus would lower economic growth, thereby lowering corporate earnings. Instead, the Fed, which has been the most open and communicative on record, completely surprised the market with no change in policy and may have lost some credibility along the way. In addition, the U.S. dollar and emerging markets saw extreme moves due to the Fed’s decision and the U.S. Government’s need to hammer out a budget deal. Meanwhile, the Eurozone nations declared an end to six consecutive quarters of negative economic growth with an increase of 0.3% growth in the most recent quarter.
Market Recap

In our last quarterly letter we stated: “Chairman Bernanke made clear the next move for its Quantitative Easing policy will be a reduction in bond purchases before the end of this year and an end of purchases in the middle of 2014.” That was the general belief held by this author and about 70% of the economists surveyed on Wall Street but the year is not over yet and the Fed has two more meetings scheduled in 2013 to reduce QE. What was made clear by the Fed at its last meeting was its dependency on individual economic reports to guide monetary policy rather than building monetary policy around its dual mandate of stable inflation and full employment. In this case, some of the economic data released within the last quarter was weaker than forecast, so they decided against tapering. Major stock and bond markets rallied on the news, while stocks in particular pushed into record territory after rebounding from an August swoon caused by worries over future Fed policy. Despite a small sell off in the final days of September due to the upcoming showdown in Washington over the debt ceiling, the S&P 500 finished just 2½% below its all-time high set on September 18th.
Equities

Although fears of tapering continued to hang over the U.S. equity markets during the quarter, investors continued to drive equity prices higher and, as a result, stock valuations have started to look “rich” by historical standards. Currently, the S&P 500 is trading at 14.3 times the next twelve months’ worth of earnings, above the average of 12.9 times for the past 5 years and 14 times for the past 10 years.

U.S. based equities reported positive returns for the quarter, with large-cap stocks returning 5.24%, mid-cap returning 7.54% and small-cap stocks returning 10.21%. In addition, all stock sectors turned in positive performance for the quarter, with 9 out of 11 sectors posting double-digit returns. Technology (up 22%) was by far the best performer. Excitement over social-media companies’ results and continued interest in mobile platforms and devices drove shares higher. Consumer cyclical stocks were up 12.6% while basic materials shares rebounded 13.3% during the past 3 months after lagging for some time. Real estate (up 1.6%) and consumer defensive (up 3.75%) were the worst performers.

International stocks turned around in the third quarter after a majority of categories lost ground in the second quarter. Specifically, developed international equities, as measured by the MSCI EAFE Index, returned 11.56% in the third quarter as the Eurozone countries finally pulled out of the recession it had been in since 2011. However, the Eurozone crisis is far from being resolved with stronger economies like Germany providing funding to struggling Eurozone countries to hold the common currency together. Despite the progress being made, the underlying competitiveness and sovereign debt issues that precipitated the crisis remain largely unsolved.

Emerging markets had a mixed quarter, delivering a return of 5.77%, as measured by the MSCI Emerging Market Index. China’s manufacturing sector showed signs of life, and the country’s economy appeared to be rebounding. Still, growth in China remains well below the pace seen just a few years ago as the country continues to negotiate the move from an export and investment-driven economy to a consumption model. Other emerging markets, notably India, had tougher times as higher rates in the U.S. led to capital outflows that depressed currencies and stoked inflation.

Real Assets

Commodities returned 4.78% in the quarter as the U.S. dollar hit a seven month low after investors exited their bullish dollar bets due to the uncertainty around monetary policy and a pick-up in Chinese infrastructure spending. Furthermore, the expectation of higher interest rates pushed investors to sell shares in REITS as competition from investment-grade bonds looked more attractive from a risk versus reward spectrum. As a result, REITS returned -2.86% in the third quarter, as measured by the Dow Jones U.S. Real Estate Index.

Fixed Income

After a rough start to the third quarter for the bond market, the decision by the Fed to keep its foot on the accelerator gave fixed-income investors a reprieve. The yield on the 10-year Treasury bond finished the quarter at 2.6%, up just a notch from its 2.5% level at the end of June, but down dramatically from a high yield just shy of 3%, reached on September 5.

Investment grade fixed income (measured by the Barclays Capital Aggregate Index) gained 0.57% vs. a loss of 2.3% in the previous quarter. High Yield Fixed Income (measured by the Barclays High Yield Index) gained 2.8% as lower rates on investment-grade bonds pushed investors out on the risk spectrum in search of higher yielding assets. Meanwhile, Municipal Bonds (measured by the Barclays Muni Index) lost 0.64% for the quarter, as the city of Detroit’s $19 billion bankruptcy filing in July (largest on record) had far reaching implications for the overall municipal market. Specifically, many investors now look to the Commonwealth of Puerto Rico as the next municipality to file, as it has many of the same issues plaguing it as Detroit. However, the amount of Puerto Rican debt outstanding is multiple times that of Detroit and, as a result, is casting a larger shadow over the broad municipal market and putting downward pressure on prices across all municipal securities.
As risk managers first, our team of investment professionals are constantly monitoring the economic landscape and market factors which may affect our clients’ assets. Since the markets are ever-changing, we must continually assess that our clients’ portfolios are diversified based on the risk they are willing to tolerate. Consequently, through diversification and market experience can we remain focused on optimizing our client’s portfolios to deliver the highest risk-adjusted returns possible.

**Our Forecast and Strategy**

As we noted in our last quarterly letter, we expect some slowing in economic growth from the Sequester and payroll tax increase and the potential for further slowing from a fallout in the budget battle. However, the consumer’s tendency to keep spending at the current rates despite short-term adversity all contribute to the economy’s overall stability and slow growth rate. Moreover, U.S. consumption and employment data have been remarkably stable over the last two years and we don’t expect it to stop. Consequently, we still expect economic growth in the U.S. to range between 2.0%–2.5% for the year.

Although we believe interest rates will eventually move to more normalized higher levels once the Fed decides to reduce its monthly bond purchases, we believe the moves will be slow and methodical as not to negatively impact the economy. As such, we envision the interest rate environment will remain historically low over the next few years and will continue to fuel the housing recovery and its impact on the overall economy. We feel the “Wealth Effect” will spread to home owners as they see an increase in their home values and start to feel more confident in their finances, thereby increasing disposable income spending. Corporate revenue and earnings will increase and ultimately lead to higher stock prices. The potential for growth could be further magnified if corporations take the lead and start spending the estimated $2 trillion dollars sitting in its coffers.

While U.S. large-cap stocks are fairly to slightly over-valued by historical measures, we would continue to invest in the U.S. on any pull back, as the underlying fundamentals remain strong. However, we have a stronger conviction in developed international equities, such as the Euro Zone nations, as they remain inexpensive based on forward-looking earnings estimates and have recently emerged from a long and devastating recession. In addition, we still like the emerging market space, as we feel this area has the greatest long-term growth potential due to a growing workforce and its demand for goods and services from the global market. China is the best example of this, with GDP growth of 7.5%. We expect to see higher infrastructure spending this year lead to greater growth opportunities.

Our forecast for the fixed-income remains the same as in our last report. Although we believe the stage has been set for higher interest rates, we need to be flexible to any change in the fixed-income arena. More importantly, we remain committed to maintaining a high quality to our fixed allocation, as it represents the stability of the overall portfolio allocation. Currently, we are taking a more defensive approach in our bond portfolios, which means we have reduced our price sensitivity to higher interest rates. We are keeping our bond duration below five years by structuring bond portfolios with larger coupons and shorter maturities. In addition, we are utilizing floating rate bonds, high yield and directional strategies that benefit by selling short specific areas of the bond market. Going forward, we forecast the yield on the 10-year treasury bond to range between 2.5%–3.0%.

**Conclusion**

As risk managers first, our team of investment professionals are constantly monitoring the economic landscape and market factors which may affect our clients’ assets. Since the markets are ever-changing, we must continually assess that our clients’ portfolios are diversified based on the risk they are willing to tolerate. Consequently,
Meet a Member of the Enterprise Investment Advisors Team

Jason P. Edgar
Vice President, Senior Portfolio Manager

Jason Edgar is a Vice President and Senior Portfolio Manager at Enterprise Investment Advisors. He is responsible for managing our Large-Cap Equity Core process as well as taxable and tax exempt fixed-income portfolios. He is responsible for in-depth analyses of investment portfolios, research coverage of individual stocks, bonds, mutual funds and alternative investments. Jason has more than 13 years of investment management experience.

Prior to joining Enterprise Investment Advisors, Jason was a Portfolio Manager at Sovereign Bank’s Wealth Management Group in Boston where he helped manage over $1 billion in client assets. At Sovereign Bank, Jason served on the Investment and Trust committees.

Jason played baseball professionally in the Texas Rangers baseball organization and in college at the University of Connecticut, where he graduated with a BA. He is currently a board member of The University of Connecticut’s dugout club.

Currently, he resides with his wife and children in Atkinson, NH.

At Enterprise Investment Advisors, our mission is to help clients achieve their financial goals by providing professional money management, extensive resources and independent, objective advice that you can trust. Enterprise Investment Advisors was established in 1992 and manages $680 million in client assets. Our clients are successful executives, professionals, entrepreneurs, non-profit organizations, private foundations and retirees who desire a financial partnership that can provide access to investment opportunities and alternative strategies.

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