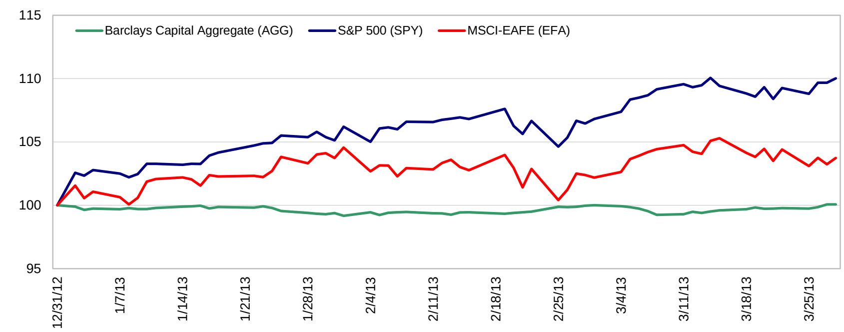
Ron Kelemen, CFP® | Mary Way, CFP®, CPA | Larry Hanslits, CFP®

2013 First Quarter Update

April 2, 2013

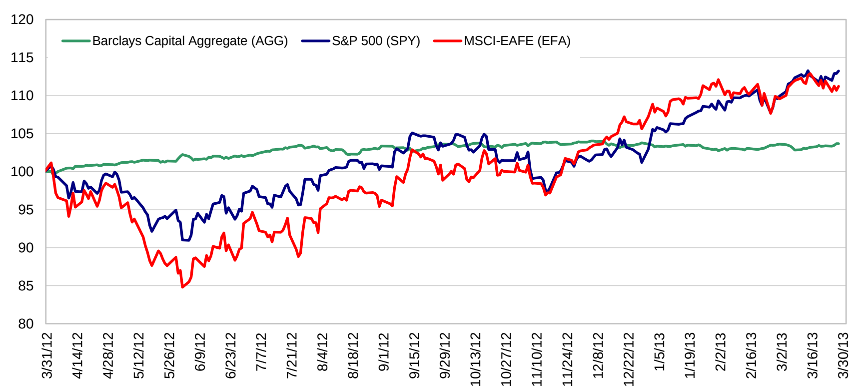
Happy Spring! This quarter was noteworthy for three reasons. First, the Dow and the S&P hit new records to close above their previous record levels set in 2007. Second, it was the quarter where it seems that the US markets have decoupled from the political worries coming out of Washington and Europe. And third (but not so noteworthy) the substantial returns in the domestic stock markets remind us once again that markets get most of their work done in very short time spans.

One Quarter Performance (Indexed to a starting level of 100, through 3/31/13)
(Exchange-traded fund data used as a proxy for index performance. Source: Yahoo! Finance.)



Look carefully at both of these charts, taking note of the approximate dates of the dips in this past quarter and the past 12 months. *(The blue represents domestic US stocks, red represents international stocks, and green represent a mixture of corporate and government bonds.)* The low points generally represent periods of bad news and a lot of "financial noise" coming out of Washington or Europe.

One Year Performance (Indexed to a starting level of 100, through 3/31/13)
(Exchange-traded fund data used as a proxy for index performance. Source: Yahoo! Finance.)



In retrospect, all that worry and handwringing wasn't necessary. The Fiscal Cliff? What Fiscal

500 Liberty Street SE, Suite #310
Salem, OR 97301
(503) 371-3333
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Cliff? Wall Street took off after a compromise deal was struck, leafing those on the sidelines behind. The so-called sequester is being overshadowed by the continued progress on Main Street, especially with turnaround in the housing market. The budget talks currently underway in the halls of Congress haven't been accompanied by a fearful Wall Street hanging on every announcement (such as we saw in the summer of 2011 during the debt ceiling debates).

Two common questions we get these days are "Is the stock market overvalued?" and "Are we at a market top?" ***We believe the answer to both is that the stock market appears to be at a fair value--they aren't cheap like they were four years ago and neither do they seem to be overly expensive.*** Stock prices are influenced by a number of factors, but the primary driver over the long term is corporate profits and the growth in profits over time.

The Lemonade Stand Analogy

Imagine you are buying a company; say a lemonade stand on a busy corner in a state where it is hot much of the year. The company has two employees and after paying them, the stand earns $1,000 of profit in a year. It's for sale for $3,000, or three times the annual earnings. This seems fair to you because in three years you'll own the stand outright and all the profits going forward will accrue to you. Now imagine the same scenario but this stand is growing its profit by 20% a year. This stand has a secret recipe that everybody loves, there is the potential for opening several more stands and customers are clamoring for this product. This stand would sell for more than three times earnings. You might have to pay $10,000 (or 10 times earnings) for this business. It would be worth this higher multiple because it is growing its earnings and the outlook is good. And if you had to borrow to finance this growth, interest rates are extremely low.

Now take this lemonade stand example as it might apply to thousands of publically-owned businesses across the country, many with increasing sales to expanding markets abroad, and nearly all of them using newly-discovered technologies to do things more efficiently. That is the stock market in a nutshell. But of course there are other influences as well.

Because the marketplace for stocks (businesses) is so large and liquid the price of those businesses competes with other types of investments such as bonds, real estate, gold, and bank deposits. Also the expectations for growth change with the outlook on the economy. From time to time people panic (the sky is falling!) and the price of businesses (or real estate or whatever) get really cheap. That's what happened in 2008.

Then vs. Now

The Dow at 14,500 or the S&P 500 at 1550 are just numbers, not walls or ceilings. They have no ability to predict the future. They are psychological benchmarks that either elate us or hide what is really happening at the company—or lemonade stand—level.

In March 2000, for example, the S&P 500 at the level of 1527 was trading at over 25 times forward earnings with a dividend yield of 1.1%. Since then, earnings have roughly doubled and dividends are up to a level of 2%. Likewise, in 2007 the market was selling at a reasonable multiple of forward earnings, but interest rates on 10-year Treasuries were 4.7% vs. 1.9% now. ***So, from a valuation point of view, today's market is a lot healthier than in 2000 or 2007.***

Characteristic	March 2000	October 2007	March 2013
S&P 500 Index	1,527	1,565	1,569
P/E Ratio (fwd. earnings)	25.6x	15.2x	13.8x
Dividend Yield	1.1%	1.8%	2.0%
10-Yr. Treasury	6.2%	4.7%	1.9%

(Source: JP Morgan "Guide to Markets")

Right now we're in between high and low extremes. Stocks are trading at about 16 times last year's earnings, compared to the 20-year average of 19 times. And unlike 2000 and 2007, when sentiment was very bullish, sentiment today remains pessimistic, which means there is still a lot of cash on the sidelines that has nowhere to go but into very low interest-bearing accounts earning less than inflation.

Today's sentiment is much more benign than four years ago. Back then, the fear was palpable. Even though the stock market had hit bottom a month earlier and started to recover, our April 8, 2009 quarterly letter to clients had a much different tone. We spent much of the letter addressing questions that seem to surface at each market low. *"Why aren't we in cash until this is over?" "How is your money invested?" "Why didn't you see this coming and get me out of the market?" "When will I get back to even?" "How are you doing, and are you guys going to survive this?" "Why don't you change your strategy?"*

We got through it; our clients got through it, most of them holding course. We didn't alter our strategy at the bottom, but we made tactical adjustments that have positioned us nicely to enjoy the market recovery. So today, with boogeymen always present (this time it is Cyprus and North Korea) we stand in a better place with market valuations that are fairly priced in a recovering economy. The exception is in the government bond asset class. Interest rates can't get much lower, so bond prices will ultimately go down when interest rates start rising again.

We made no major portfolio changes in the past quarter.

Asset Class Weightings as of March 31, 2013

(Compared to our normal long-term allocations)

Asset Class	Underweight ← Neutral → Overweight				
FIXED INCOME					
Government	X				
Corporate					X
Foreign			X		
EQUITIES					
US Large Cap					X
US Mid Cap				X	
US Small Cap	X				
ALTERNATIVE					
Real Estate		**X**			
Commodities			**X**		

You can look forward to enjoying your performance reports, which we will send separately in 10-12 days. They won't mirror the double-digit stock market returns because of their diversified positions in bonds and international assets, but we know that you will definitely be pleased.

Meanwhile, please find attached our latest disclosure Form ADV-2A on file with the Securities and Exchange Commission, which contains no major changes.

Your questions are always welcome. Thanks again for giving us the honor of serving you.