Douglas S. Weiss, CFA

Registered Investment Advisor

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Client accounts rose slightly in the June quarter and continue to roughly keep pace with the strong year to date growth of the S&P 500. At quarter end, common stock represented roughly two thirds of client holdings, with the balance allocated to high yielding real estate investment trusts and preferred stocks, as well as low yielding short maturity bonds. I continue to think this portfolio balance will reduce losses somewhat during stock market pullbacks while still providing exposure to the upside potential of stocks. I did shift client portfolios more towards stocks during the quarter as I think specific stocks currently offer an attractive balance of risk and reward, whereas most other investment classes appear fully valued.

Notes on the June Quarter

After months of steady gains, most markets fell in June. Bonds were particularly hard hit, as investors worried that the Federal Reserve would reduce its purchasing of long dated treasuries and mortgage bonds. Ten year treasury rates rose 20% in a matter of weeks, and mortgage bond rates increased by similar amounts. I have tried to limit the sensitivity of your holdings to increases in long term treasury rates by avoiding low coupon long term bonds but a few of our holdings were nevertheless affected by the bond sell-off.

In particular, a few of our real estate investment trusts (REITS) lost value in June, although there was some recovery later in the month. The selling pressure in this group strikes me as unwarranted. For example, one of our larger REIT holdings, RAIT Financial Trust, fell almost 20% in June from the multi-year high it reached in late May, despite stability in the company's underlying earnings outlook.

RAIT continues to be an attractive holding going forward. It yields 7%, which is higher than many of its peers, and will likely raise the dividend an additional 50% over the next year, based on expected earnings growth. Its yield would then approach 10%, a yield that is well above most other REITs and should provide price support even if treasury rates rise further.

For the most part, our high yielding preferred stocks held their value. Most of these securities yield close to 8% with a very high likelihood of continued payment. That yield continues to look attractive relative to other fixed income securities.

General Outlook

The economy continues to grow slowly, as it has for the past few years. That slow rate of growth has meant that unemployment remains relatively high even four years after the end of the last recession. However the environment has been, and remains, relatively benign for corporations and by proxy their stocks, as earnings have been supported by modest top line growth together with cost cutting. A number of corporations also have built up substantial cash balances beyond what is needed to run their businesses. The investment of these funds could support still better earnings.

As always though, there are risks to the sustainability of global economic growth, which in turn impacts corporate earnings. Some of those risks are coming from other parts of the world.

One concern is recent evidence of slowing economic growth in China, which is now the second largest sovereign economy in the world, just behind the United States. Slowing growth in China negatively impacts export sales for the rest of the world. China's government faces a number of challenges as it manages growth, including oversight of a banking sector with large exposures to high risk real estate loans. While the timing is uncertain, China's government may need to mitigate losses on those loans to avoid more serious problems, such as bank failures and depositor losses.

878 Lawrenceville Rd ▪ Princeton, NJ 08540
Phone: 585.969.2726 ▪ Fax: 866.202.2204 ▪ Website: www.dswinvestment.com

European debt markets, a major source of anxiety last year, have been stable this year. Still, few of the problems arising from the shared EURO currency have been solved. Southern European economies remain deeply depressed and the sustainability of a single currency for the region remains uncertain. That issue could reemerge to affect markets.

Back at home both the stock and bond market were negatively affected last month by Federal Reserve Chairman Ben Bernanke's observation that the Fed would likely reduce purchases of bonds later this year. Those purchases have helped keep interest rates low, providing some support for housing and financial markets. A too-early down-sizing by the Fed of its bond purchases could weaken the pace of economic recovery. Somewhat reassuringly, the Fed has stressed that any change in policy will be contingent on the economic outlook remaining positive.

Comments on Specific Holdings

Our best performing investment for the June quarter was Entravision, a Spanish language broadcaster which I wrote about at the end of March. Entravision has more than doubled in value in just the last three months, reflecting the company's expanding reach with Hispanic consumers, combined with a general improvement in investor sentiment towards broadcasting stocks. While I continue to like Entravision's long term outlook, the stock looks fairly valued at current prices.

A few of our high dividend paying stocks reached multi-year price highs in May, but gave back those gains in June as investors indiscriminately sold high dividend paying stocks. Macquarie Infrastructure, an owner of oil storage terminals, fell more than 15% from its May high, despite weeks earlier having reported substantial earnings growth and a positive outlook.

Macquarie's well located oil storage terminals in New Jersey and Louisiana should be able to expand capacity and raise storage rates further over the next several years, supporting earnings growth. The company plans to raise its dividend this year to a level that will represent close to a 7% yield at its current stock price.

I recently began purchasing shares of Merck Pharmaceutical for accounts. For the last several years I avoided pharmaceutical stocks due to patents expiring on drugs that were important to the companies' earnings. As those patents expired, cheaper generic forms of the drugs were introduced, hurting sales and profits for the original manufacturers. For example, sales of Pfizer's cholesterol management drug Lipitor fell from more than $11 billion in 2009 to less than $3 billion last year, largely as a result of competition from generic drugs. Other drug companies had similar, if less dramatic, sales and earnings reductions because of patent expirations. Those sales losses made it very difficult for drug manufacturers to grow their earnings in recent years.

That may be changing due to the development of a class of drugs called immunotherapies that work by either suppressing an immune response, in the case of treatments for auto-immune diseases like Crohn's and Rheumatoid Arthritis, or activating an immune response, as in the case of certain cancer treatments.

Because immunotherapies target conditions with limited existing treatment options, they face limited competition. And because they are often comprised of proteins created from living cells, they are more difficult and expensive to copy and mass produce then traditional small molecule pills. Taken together, that means these drugs can be highly profitable, and remain profitable well beyond their patent expirations.

Immune suppression drugs such as Humira and Remicade have been available for a number of years and are two of the largest selling drugs in the world. Immune activation drugs are newer, but could ultimately be just as important.

Merck has one such drug in early development with significant promise – an immune activation treatment for melanoma and potentially for other cancers. The drug, one of several 'anti-PD-1' therapies in development (Bristol Myers also has one), works by shutting down a naturally occurring brake in the immune system (the PD-1 molecule), making the immune system a more effective antagonist to cancer cells. In very early studies the therapy has been effective in the treatment of late stage melanoma, a condition for which effective treatment hardly exists. Merck is putting substantial resources behind this drug. I believe the company will also leverage its research in this area to introduce other immunotherapies in coming years.

I have added new investments in several less well-known companies. Among these is Motor Parts of America (MPAA), a re-manufacturer of car alternators and starters which it sells to 'do-it-yourselfers' and auto shops. The business is well suited to the current economy, as financially extended consumers try to keep their cars on the road longer. The stock trades at an attractive valuation because its financial results included a separate auto parts business, purchased in 2011, which was losing money. MPAA recently closed this business. Once the company has removed all remnants of that unprofitable acquisition its earnings will appear substantially higher and I believe the stock will trade higher in turn.

As always, let me know if you have questions or comments.

Sincerely,

Doug

Note: This information is intended as a discussion of past account performance and investment strategy. It is not a recommendation to purchase any specific security or type of security. An investment in securities involves the risk of loss.