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## Kehoe Investment Services, Inc.

***Registered Investment Advisor***

April 18, 2013

Dear Valued Client:

Enclosed is your portfolio report for the period ended March 31, 2013.

**Equities**

One of the questions you are constantly exposed to is the following: *Is now the time to get in or get out of the stock market?*

We prefer the term equities to stocks. Equity, as defined by Investopedia.com, is "A stock or any other security representing an ownership interest." Equity equals ownership.

For many of our clients the majority of the equity on their personal balance sheet is represented by fractional ownership in hundreds of companies (stocks) plus the extent to which real estate equity, including their home, exceeds the debt secured by the real estate. For purposes of this discussion we will exclude equity in personal assets and business situations.

**Investment Portfolios – Equities + Bonds + Cash**

Your Kehoe Investment Services portfolio consists of equities, bonds and cash. Over long periods of time equities outperform bonds and cash. Why? Typically equities are "riskier" than bonds or cash. We believe a more accurate statement for normal times would be that in the short-run bonds and cash are safer than equities and that in the long-run equities are safer than bonds and cash. This is true because equities are volatile in the short-run but in the long-run both the equity value and the dividend rate for equities increase. Companies also have the ability to raise prices on their goods and services to compensate for factors such as inflation.

Bonds pay a steady rate of interest for a specified period of time. The three things that impact the value of a bond prior to maturity are; the current interest rate, the time remaining until the bond matures and the viability of the entity that issued the bond. If the current interest rate is greater than the interest rate on the bond then the bond value is discounted so that its yield is consistent with the current interest rate. The longer the bond has to go to maturity then the greater the discount to current value since potential buyers of the bond will have to hold this low interest instrument potentially for many years. The discount would be even more severe is there is any hint that the issuing company might not survive.

For the most part, bond interest rates have been declining for thirty years. The yield on quality bonds that are issued today barely exceeds the rate of inflation and that's before being taxed at ordinary income rates. Eventually interest rates will rise (we actually thought it would happen before now). When interest rates do go up, and they will, bond values will fall.

Because bond rates have been falling so consistently for so long bonds have enjoyed returns competitive to the equities markets for the past twelve years. Following are a couple of quotes that accurately depict the current bond situation:

- "Right now bonds should come with a warning label." Warren Buffet
- "Bonds promoted as offering risk-free returns are now priced to deliver return-free risk." Warren Buffet quoting Shelby Cullom Davis in the Feb. 27, 2012 issue of Fortune Magazine

**Real Estate**

We hold real estate investment trusts (REITs) in many of our portfolios. Income producing real estate, both commercial and residential, tends not to be correlated to the movements of the stock market. REITs have historical long-term returns similar to the stock market. Uncorrelated (just because the stock market goes up or down does not mean real estate will follow and vice versa) reduces a portfolio's volatility. Volatility not only causes investor angst, it is detrimental to portfolio return. To illustrate, if you start with $100 in a portfolio and make 10% one year and loose 10% the next year you only have $99. If you increase the volatility to +30% and -30% the result for the same $100 two years later is $91.

In a utopian world you could have assets in a portfolio that were perfectly uncorrelated. When your equity portfolio went up 2 points your perfectly uncorrelated real estate would drop 1 point. Conversely, when real estate went up 2 the equity portfolio would drop 1. This would mean every year would be a winner for your portfolio.

Unfortunately, there is not a perfectly uncorrelated portfolio. K.I.S. uses various ingredients (asset classes) that do not correlate with large-cap stocks. For instance, small-cap, value stocks are more correlated to large stocks than real estate.

**Investment Philosophy**

You may have heard the old saw that the stock market is the only thing people don't buy when it is on sale. From October 2007 to March 2009 the stock market was down over 50%. Today the S&P 500 is close to its all time high.

In our office we have a chart showing returns for the U.S. Total Stock Market Index beginning in 1927. The average rate of return for rolling 30 year time periods ranges from a low of 7.9% (1957 - includes the great depression years) to a high of 14.2% (2004). If we could all be like Star Trek's Mr. Spock (unemotionally logical) market declines would be looked at as opportunities rather than harbingers of tough times.

We are pleased that you, our investors, did not flinch during the last dramatic downturn. You stayed the course and are currently reaping the rewards that the market always has delivered over long periods of time.

We welcome your comments and questions in regard to your quarterly reports.

Sincerely

Judy Kehoe Bob Kehoe