MARKET OVERVIEW
SECOND QUARTER, 2013

INDEX	2ND QUARTER %	1 YEAR %	3 YEAR %	5 YEAR %
Dow Jones Industrial	2.92	18.87	18.23	8.64
NASDAQ Composite	4.15	15.95	17.29	8.22
Standard & Poor's 500	2.91	20.60	18.45	7.01
Russell 1000	2.65	21.24	18.63	7.12
Russell Midcap	2.21	25.41	19.53	8.28
Russell 2000	3.08	24.21	18.67	8.77
Barclay US Aggregate Bond	-2.32	-0.69	3.51	5.19
MSCI World ex. US	-1.61	17.07	9.43	-0.84
MSCI Emerging Markets	-8.08	2.87	3.38	-0.43
COUNTY OF SAN BERNARDINO 457(b) PLAN PERFORMANCE	**1.57**	**20.21**	**15.30**	**6.25**
COUNTY OF SAN BERNARDINO 401(k) PLAN PERFORMANCE	**1.56**	**20.05**	**15.10**	**6.30**
COUNTY OF SAN BERNARDINO RMT PLAN PERFORMANCE	**0.57**	**16.02**	**13.93**	**6.26**

EQUITY MARKETS

Investors should be very satisfied with the performance of equities during the first six months of 2013. Year to date the Dow Jones Industrial Average (DJIA) is up 15.20% and the broader index, the S&P 500 was up 13.82%. However, the second quarter was not much of a contributor to the year to date strong performance. The DJIA was up only 2.9% for the second quarter and the S&P 500 was also up 2.9%.

June was a particularly bumpy month for stocks. The S&P 500 was down 1.34% for the month of June. Despite having its first losing month in June since October, 2012, the S&P 500 had its best first six (6) month performance since 1998.

On May 8, the DJIA closed above 15,000 for the first time. This is an impressive turnaround in the four (4) years since the DJIA hit bottom at 6,547 on March 9, 2009.

On July 5th the Russell 2000 index of small companies closed above 1,000 for the first time at 1,020. As a historical perspective, the DJIA first closed over 1,000 on November 14, 1972. The focus on the small cap stocks is important because many analysts consider small cap stocks a leading indicator for the overall equity markets. A small cap rally also indicates that investors are willing to take risks.

As of June 30th, 54% of companies with a market capitalization of at least $100 million were making dividend payouts, up from 52% at the end of 2012; 54% is the highest figure since 1994. After the dot com bust in 1999, that figure fell to 38%. Among smaller companies, as determined by a market cap of less than $100 million, the proportion of dividend paying companies has always been smaller, but it too is growing. The current figure is 31%, up from 28% at year end and is higher than at any time since 1984.

The value of gold has dropped significantly. Gold spiked at almost $1,900 an ounce in 2011. It closed the second quarter at $1,231. Gold thrives when inflation fears are high and this is not one of those periods. The high unemployment numbers, slowing growth in China and the very weak economies in Europe all point to global economic weakness. The surge in the value of an ounce of gold started after the credit rating of the United States was cut by Standard & Poor's in August, 2011. The Fed's bond purchasing programs also drove up the value of gold as investors thought these programs would lead to greater inflation. According to Global Hunter Securities, an investment bank, the line between profits and losses for underground mines in the U.S. and Canada is between $1,200 and $1,250.

In December, 2012, a survey of money managers conducted by Russell investments predicted that Emerging Market stocks will outperform all other classes of stocks and bonds. The first six (6) months of 2013 point to a completely different direction. Emerging Market stocks continue to struggle. In fact, the MSCI Emerging Markets Index has slumped 13% this year and the difference in performance to the S&P 500 is greater than at any time since 1998. The Emerging Markets have been negatively impacted by slower growth in China and political unrest in Turkey and Brazil. China's Shanghai Composite is down 13% and the Brazil Bovespa Index is down 22% year to date. Since May 31, when Istanbul erupted into violence, the Turkey ISE National 100 Index has fallen 13%.

The Barclays U.S. Aggregate Bond Index was negative at -2.32% for the second quarter and is now negative year to date -0.69%. Losses were driven by a combination of rising yields and widening corporate credit spreads. For example, the yield on the U.S. 10 year Treasury rose 36 basis points to 2.49%. A record $76.5 billion poured out of bond funds in June. That significantly exceeded the previous record of $41.8 billion that moved out of bond funds in October, 2008.

STYLE COMPARISONS*				*Performance includes dividends
INDEX STYLE	2ND QUARTER %	1 YEAR %	3 YEAR %	5 YEAR %
RUSSELL 1000 GROWTH	2.06	17.07	18.68	7.47
RUSSELL 1000 VALUE	3.20	25.32	18.51	6.67
RUSSELL MIDCAP GROWTH	2.87	22.88	19.53	7.61
RUSSELL MIDCAP VALUE	1.65	27.65	19.53	8.87
RUSSELL 2000 GROWTH	3.74	23.67	19.97	8.89
RUSSELL 2000 VALUE	2.47	24.76	17.33	8.59

Over the one (1) year period value continues to outperform growth but during the second quarter only in the large asset class did value outperform growth. Analysts typically favor growth over value as it indicates greater investor confidence in the equity markets. Value presents a more defensive position.

In the second quarter there were four (4) categories where active equity managers outperformed their respective indexes. The two asset categories where active management had the biggest tailwinds against the indexes were midcap blend and small value. 90% of active mid cap blend managers and 93% of the small cap value managers beat their index in the second quarter of 2013. Only 8% of the large cap blend managers beat their respective indexes in the second quarter and only 14% of the mid cap value managers beat their index.

SECTORS

Unlike the first quarter when all eleven key sectors finished in positive territory, only seven (7) sectors had positive performance for the second quarter.

Defensive Super Sector – In contrast to the first quarter, 2013 when defensive stocks were the best performing sector with a return of 15.01%, the Defensive sector only provided a second quarter return of 1.96%. While Investments with steady, robust cash payouts are difficult to find, many investors favored growth stocks over dividend paying stocks. **Utilities** stocks as a sector was down -1.76%. FirstEnergy Corp. fell more than 10% during the quarter and Exelon Corp., UNS Energy Corp and American Electric Power Co. all fell 7% or more. Utilities were hard hit when the Fed announced on June 19 that they may slow down bond purchases and allow interest rates to increase. Investors who bought utility stocks for yield determined that the less risky 10 year Treasury bonds were a safer investment. Only the **Healthcare** sector had a moderately strong return with a return of 4.05% led by Theravance, (a biopharmaceutical company), with a return of 63% in the second quarter. Aetna and WellPoint had quarterly gains of just under 25%.

Cyclical Super Sector – This super sector provided the best performance in the second quarter with a 5.17% return. Individual sector performance could be described as "the best of times and the worst of times". Two (2) sectors had the best returns and two (2) had the worst returns of the eleven total sectors. The **Basic Materials** sector was the weakest performer of all sectors with a quarterly return of -3.95%, followed by **Real Estate** with a negative return of -3.20%. The companies exposed to gold led the downturn in the Basic Materials sector. Allied Nevada Gold and Royal Gold, Inc. fell 60% and 40%, respectively. The two best performing sectors in the Cyclical Super Sector were **Financial Services**, 8.07% and **Consumer Cyclicals,** 6.76%. Financials were led by two (2) insurance companies, MetLife and Hartford, with returns in excess of 20%. Wells Fargo and JPMorgan Chase also contributed double digit returns.

The **Sensitive Super Sector** continued to perform weakly with a positive performance of 1.16% for the second quarter. The **Technology** sector provided some of the biggest winners and losers. Heavyweights such as Microsoft, Cisco and Intel all posted double digit returns. Microsoft rose 21%. Offsetting the gains of the sector's largest companies was the poor performance of Aruba Network, (offers remote networking solutions), SolarWinds Inc. and LivePerson Inc., (provides live chats for customers of their clients), each falling more than 30%. One solar company, First Solar, had a 66% return for the quarter as renewed optimism regarding the firm's technology drove up its share price. The one (1) sector that provided strong performance for the Sensitive Super Sector was **Communication Services** with a return of 4.92%. This sector was led by T Mobile US and Clearwire with share price increases of 69% and 54% respectively.

ECONOMIC ISSUES

Consumer faith in the economy hit a five (5) year high in May. Consumer confidence jumped to 76.2 according to the Consumer Board, a private research group. That is compared to 69 in May. Another measurement of consumer optimism is the Thomson Reuters/University of Michigan Consumer Sentiment report. The June reading was 84.1. This is a little lower than the 84.5 reading in May; that number was the highest in six (6) years. Consumer confidence is an important statistic as consumers account for 70% of the economy. Higher income households showed greater optimism about their wealth and incomes, while lower income households reported less optimism. Families in the top third of incomes were more optimistic than at any time since the June, 2007 survey.

Ben Bernanke, Chairman of the Federal Reserve Board, reported on May 22 that government spending cuts are restricting economic growth. He added that he would like to see interest rates rise because of the low interest rates credited to savers utilizing CDs and bank accounts. He is concerned that conservative investors/savers will make risky choices if returns are hard to come by otherwise.

The International Energy Agency recently published a five (5) year outlook for oil production and demand. In that report, the agency examines where the oil is coming from and where it is going. The changing world oil picture is driven by the increase in oil production in the U.S. Drillers, inspired by strong prices and armed with improving technology, learned how to produce oil from previously inaccessible rock under several U.S. states.

U.S. production reached 7.4 million barrels a day in May. That is 48% higher than it was in 2008. Production is expected to rise in Canada, Brazil and Columbia as well. At the same time that oil production is up, oil demand in the U.S and other developed countries is expected to fall

as a result of improved vehicle efficiency and weak economic growth. U.S. oil imports have fallen 22% over the last seven (7) years. The prediction is that the U.S., Japan and Europe will use less oil in the future and the demand for oil will grow in the Middle East and Asia.

As U.S. oil production booms, more oil is being transported by railroads. According to the Association of American Railroads, 10,840 carloads of oil were transported in 2009. In 2012, the number of carloads transporting oil was 233,821. This increase in the transportation of oil is one of the key reasons that the Dow Jones Transportation Index has exceeded the DJIA by 153 basis points over the past one (1) year and 193 basis points year to date.

Auto sales jumped in June 9.2% over sales in June, 2012. Sales of new models were up across the board. Pickup trucks had big sales increases over 2012 as businesses were buying pickup trucks. The top two (2) vehicles sold were the Ford F Series with 68,000 vehicles sold, followed by the Chevrolet Silverado with over 43,200 vehicles sold. Fuel conscious consumers bought a high percentage of cars that are energy efficient with high miles per gallon consumption rate. General Motors had its best sales month since 2008 with sales of 265,000 vehicles and led all automobile companies in sales.

Our latest full month economic readings indicate that for the first quarter business investment was only a scant 0.4%. The current expectation is that the annualized growth for 2013 will be 1.8%. Capital spending by U.S. businesses remains 4% below its pre-recession level. Total output by manufacturers in May was 5% lower than its 2007 average. Business owners still have a crisis of confidence, even though there is cause for optimism. Interest rates remain low for those creditworthy businesses. A boom in domestic energy production has lowered costs and boosted U.S. competitiveness. Nonfinancial U.S. corporations are sitting on more than $1.8 trillion in cash and liquid assets are up 30% from 2008 according to the Fed. All of this has pushed corporate profits to more 12% of the overall economy, a post World War II high.

FEDERAL RESERVE BOARD

Since the financial crisis of 2008, the Fed has taken unprecedented actions to reduce interest rates in an effort to stimulate borrowing and economic growth while also bringing down the unemployment rate. The Fed has indicated that the bond buying program would end when the unemployment rate hits 7.0% and the Fed will not raise short term interest rates until unemployment reaches 6.5%. The caveat to their plans is inflation; as long as the inflation rate stays below 2.5% they indicate that these goals will be followed.

The markets are fragile; they react to the news of each day. On June 19, the Fed indicated that if the economy continues to improve they would scale back the amount of bond buying that has provided stimulus to the equity markets. The DJIA declined by 206 points that day. Also, that announcement brought additional days of decline in the capital markets. Then some economic data was published that indicated the economy was not growing as well as expected. The equity markets rallied as investors took the negative news to indicate that the Fed will not be scaling back their bond buying program anytime soon.

In a survey conducted by USA Today, three (3) out of four (4) economists surveyed said their economic outlook supports the Fed's tentative blueprint for phasing out the bond purchases. Dissenting economists believe Bernanke's comments went too far, too soon, because the

economy is not yet strong enough to start announcing future plans. There are a small minority of economists who think a premature winding down of its bond buying program indicates that the Fed may also go back on their commitment to keep short term interest rates low.

UNEMPLOYMENT

The unemployment rate was 7.6% as of March 31, 2013. As of April 30th the unemployment rate was 7.5%. This is the lowest rate since December, 2008. The May and June unemployment rates are 7.65%. Private companies added 210,000 jobs in April while governments reduced employment by 11,000 jobs. In May a net 195,000 jobs were added to the economy.

202,000 jobs were added to the economy in June while federal, state and local governments cut 7,000 jobs. The original estimate for June was 135,000 and economists expressed concern that if the number of new jobs was less than 135,000 economic growth would stall. Investors were concerned that if the job growth was higher than 135,000 the Fed would act sooner to reduce bond purchases. So, there was much trepidation and great interest in the June job growth numbers. When it was announced that not only did the June job growth exceed the estimate by 60,000 jobs but that the April and May job growth was increased by 70,000 jobs the equity markets first faltered, and then rallied, ending the day up.

The unemployment rate has not receded very much despite the continued job growth, because the job growth since the end of the recession has basically kept pace with the population growth. Also, as more jobs are created more workers who had stopped looking for work, and are therefore not counted as unemployed, have re-entered the job market and are now counted as unemployed. Another reason the unemployment rate has not declined is that unlike other recoveries from recessions, this is the first recession since World War II that the government has not added jobs and have actually contributed 1% to the unemployment rate. The Sequester has had the impact of reducing 40,000 federal jobs over the last several months.

The Affordable Care Act gives employers an incentive to hire part-time workers rather than full time workers because employers may be compelled to provide health insurance to the latter group and not the former. The underemployment rate increased to 14.3% from 13.8%. The underemployment rate includes the unemployment rate, those who have stopped looking for work and those who are working part-time but would prefer a full time job. There are now 8.2 million involuntary part-time workers.

The Misery Index is an economic indicator designed to help determine how the average citizen is doing economically. It is calculated by simply adding the inflation rate to the unemployment rate. The current Misery Index as of June was 8.96%. The Misery Index was 12.87% at its highest in November, 2011.

HOUSING

The number of existing homes for sale for May was up 3.3% over April according to the National Association of Realtors. The data indicates that homeowners who were putting off selling their homes until home prices rose to more acceptable levels are now entering the housing market.

The supply of existing homes for sale in May was at 5.1 months. That means that if no other homes come on the market for sale the existing supply would be exhausted in 5.1 months. In California, May's data shows just a 2.6 month supply. Nationally, the median time homes remained on the market before selling was just 41 days in May, down from 72 days a year ago.

In May, existing home sales nationwide were up a robust 4.2% from April and almost 13% from one year earlier. Mortgage rates increased 1% in June over the rate in late May. This is the biggest one (1) month increase in mortgage rates in 26 years. Rising interest rates may dampen home price gains.

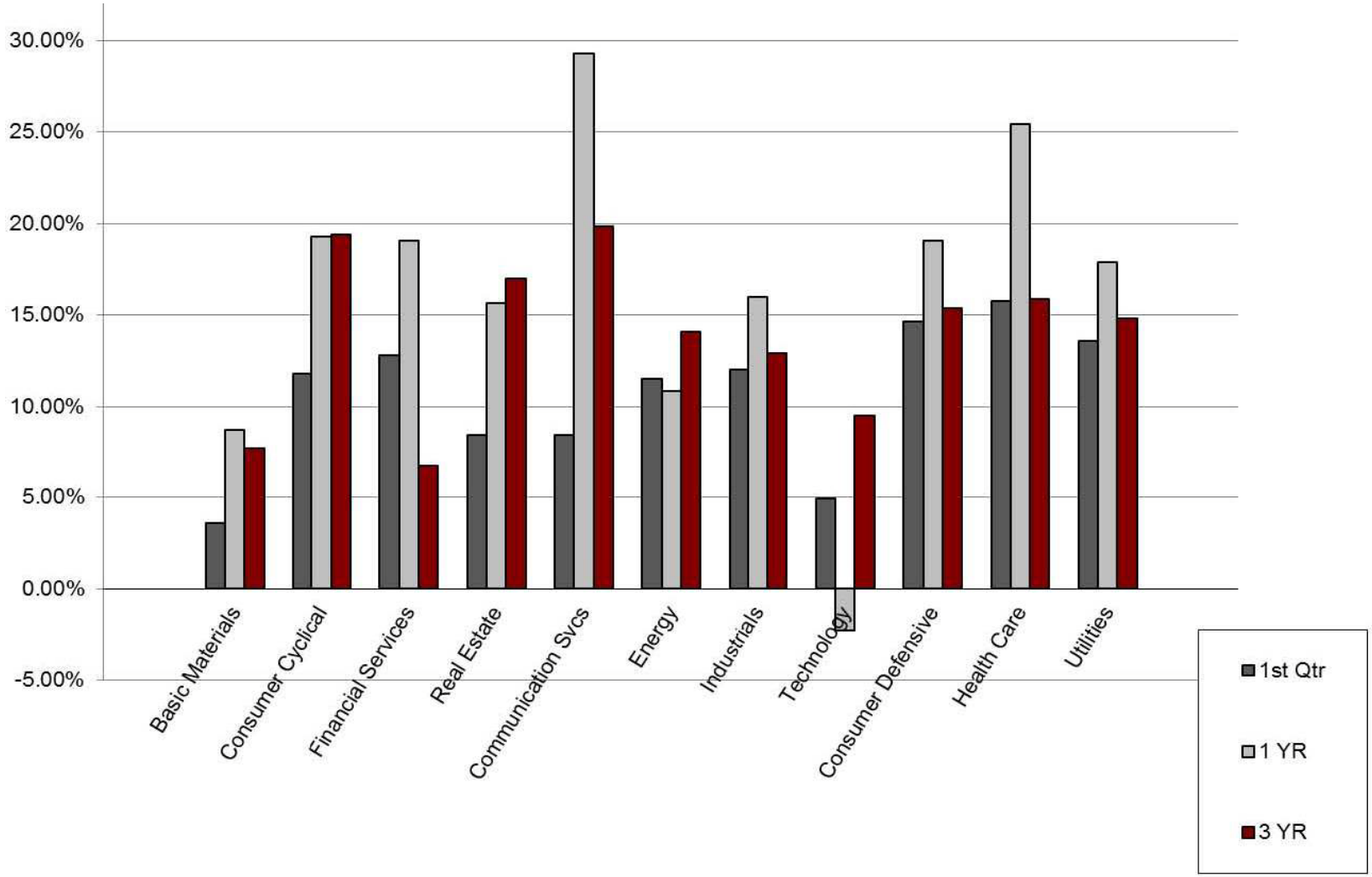
Existing home sales in June fell 1% to a seasonally adjusted rate of 5.08 million according to the National Association of Realtors. The annualized sales pace from January through June is the strongest first half year home sales since 2007. New home sales in June hit their highest level in more than five (5) years. The supply of new homes remains tight as the inventory is 3.9 months; a six (6) month supply is considered normal. The median price of new homes sold in June was $249,000, up 7.4% from one year earlier. While residential construction accounts for about 2.5% of the GDP, economists estimate that for every single family house built at least three (3) full time jobs are created.

As home prices rise more homeowners get back to above water. According to CoreLogic, as of March 9.7 million homeowners, nearly 20% of homeowners with mortgages, owed more on their homes then they were worth. That is down from 11.1 million as of December, 2011. In May home prices increased 12.2% over a year earlier according to CoreLogic. Home prices rose in 48 states from a year earlier, with the only exceptions Delaware and Alabama. The greatest increase in home prices occurred in the West led by Nevada, 26%, California, 20.2%, Arizona, 16.9%, Hawaii, 16.1% and Oregon, 15.5%.

The interest rate on a 30 year mortgage jumped up to 4.51% as July 11, according to mortgage giant Freddie Mac. The rate was 3.35% as of May 2nd. The average interest rate on 30 year mortgages dating back to World War II is 6.5%. As housing has been a major driver in the economic growth, it is important to see how this rise in mortgage rates will affect home sales, both new and re-sales. A slowdown in housing could bring economic growth to a halt. Nationally, there was a 1% increase in applications for mortgages tied to home sales the week of July 12th. This follows a decline in home sales of 1.2% in June.

CONCLUSION

If the outlook is for improved economic growth that would then lead the Fed to taper its easy money policies. An improved economic outlook could encourage investors to move from the current emphasis on defensive stocks to growth stocks that are more sensitive to the economy because they offer greater opportunity for price appreciation. In terms of asset categories, growth stocks could again take the lead from value stocks. Slowing growth globally is still a pothole for equities. However, equity strength could come from rising consumer spending, business expenditures to replace outmoded equipment, continued improvement in reducing unemployment and gains in housing.

Volatility will continue as investors wish for the return of the Goldilocks days. In June the DJIA went up or down by 100 points or more for eight (8) straight days; the longest such streak since October, 2011. However, an increase of 100 points or more is less of an event today than it was in 2011 when on October 21 the DJIA was 11,808; the June, 30, 2013 value was 14,910. Regardless, the capital markets are experiencing substantial volatility and this will continue. If the markets moderate to some degree we should see a large number of IPOs, (particularly technology companies) brought to the market. 175 private companies have filed Draft Registration Statements with the SEC. If the economy continues to improve we think growth stocks will outperform value stocks.

Morningstar Sector Comparisons