BCN ADVANTAGE: 2014 ANNUAL REPORT

January 2015	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	2.29% [1 2 3]	6.92% [1 2]	3.59% [1 2]	0.25% [1 2]
Jan ' 97 = $100,000 [4]	$675,457	$451,468	$306,830	$154,399
Beta (2014):	0.33	1.00	0.50	0.00
Risk Adjusted Return:	2.32%	6.92%	3.59%	0.25%

1 Performance results are based on the Fidelity Mid-Cap Fund (7.1% for 2014), the Vanguard Index 500 Fund (13.5% for 2014), the Dodge & Cox International Fund (0.1% for 2014) and an average money market return of 0.25%. The results may not reflect the actual performance of BCN Advantage clients. Past performance does not guarantee future results.
2 Performance results show the year-over-year change to net asset values and do not include the reinvestment of dividends (if any) other than interest earned from the money market fund.
3 Performance results are net of BCN Financial management fees.
4 BCN Financial Inc. is the registered investment advisor. Performance from January 1997 to June 1998 was provided through Quest Securities as the registered investment advisor.

2014 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2014	25%	75%
2	05/01/2014	25%	75%
3	08/01/2014	25%	75%
4	11/01/2014	25%	75%
5	12/31/2014	25%	75%
	Present	25%	75%

A Tale of Two Markets

For 2014, the S&P 500 climbed 11.4% to 2,059, the Dow gained 7.5% to 17,823 and the Nasdaq rose 13.4% to 4,736. While large-cap stocks had a good year, small and mid-caps stocks moved mostly sideways. As a result, only 8 percent of U.S. diversified stock funds beat the S&P 500 in 2014, returning only 7.9% on average. In 2013, when small-cap stocks were on fire, nearly 62 percent of funds beat the S&P 500. 2014 was a year of U-turns. The major indexes pulled back five times – and threatened to go negative as late as mid-October – before ending the year on a 13% run. It has been more than 3 years since the S&P 500 last saw a correction of 10 percent, the fourth-longest streak on record. Earnings for the S&P 500 ended 2014 nearly 9% below estimates made when the year began. And projected Q4 2015 earnings are exactly flat compared to year-ago estimates.

For 2014 overall, the economy grew a moderate 2.4 percent. Since the recession ended in 2009, GDP has averaged 2.2 percent a year, far below the gains typical after a deep recession. Monthly payrolls rose an average 246,000 in 2014, up 27% from 2013. The jobless rate fell to 5.6% (lowest since June 2008), but the drop largely reflected a decline in the labor force, as the participation rate fell to 62.7%, a 34-year low. A record 92.9 million Americans are no longer part of the labor force. Average hourly earnings fell outright in December, with the year-on-year gain cooling for a third straight month to 1.7%.

Household net wealth soared 44% from the end of 2008 to a record $81.3 trillion at the end of Q3 2014, but upper-income households were the only ones to see gains. Median net worth was down 40% vs. 2007 for middle-income households (from $158,400 to $96,500) and lower-income households (from $18,000 to $9,300). Debt as a share of disposable income has fallen dramatically — to 103% from the 2007 peak of 130% — but it's still 10 percent higher than in 1997.

Only 30 percent of Americans report being better off financially than they were five years ago. Median household income, adjusted for inflation, is about $54,000 today, nearly 5% lower than when the recession began. In 84% of U.S. counties, inflation has outpaced median income since 2007. Fifty million Americans remain below the poverty line, and the number of food stamp recipients have increased 38% in the last six years. Among the emerging risks is the nation's $1.3 trillion in unpaid student loans.

Can the U.S. Economy Stand Alone?

"Many participants regarded the international situation as an important source of downside risks to domestic real activity and employment.” [Fed minutes, December 2014].

- **Japan:** With domestic consumption stuck a rut, the Bank of Japan enacted its latest quantitative easing that included a promise to buy even more government bonds and allocate 25% of pension funds to equities (up from 12%). The Halloween announcement dropped the Yen an incredible 3%, sent Japan’s equity markets up an astounding 5% and was the primary reason for the U.S. market's sudden V-reversal off the October 15th lows.
- **Europe:** The EU fell into outright deflation in December. The ECB said it would purchase sovereign debt from March 2015 through the end of September 2016, despite the likelihood that spendthrift countries will slacken their economic reforms. The new quantitative easing will release 60 billion euros a month into the economy. Only 20 percent of purchases would be the responsibility of the ECB. Critics say this casts doubt over the unity of the euro zone and its principle of solidarity.
- **China:** Despite stimulus efforts from China's central bank, HSBC warned that the data could get worse. In its annual report, the BIS warned of the risks brewing in emerging markets, setting out early warning indicators of possible banking crises in a number of jurisdictions, most notably China.
- **Russia:** Standard & Poor's downgraded Russia's credit rating to non-investment grade for the first time in more than a decade. The downgrade underlined investors' fears about the unpredictability of Putin's foreign policy and the collapse of the ruble. Morgan Stanley forecasts a -5.6% recession for Russia’s economy in 2015.
- **Greece:** Syriza, Greece’s new governing party, promised to write off much of the country's debt of 322 billion euros. The EU must decide before February 28th whether to extend an additional 7 billion euros of bailout money. If the cash is not released, Greece could default within weeks. Emergency funding would then be cut off to Athens, potentially forcing it to print its own currency.

The End of the Line?

In their mid-2014 report, the Bank for International Settlements (BIS), described “euphoric” financial markets that have become detached from reality. “The trade-off is now between the risk of bringing forward the downward leg of the cycle and that of suffering a bigger bust later on.” The Fed is hoping to achieve liftoff at the same time Europe, China and Japan are likely to keep easing. History shows that sharp movements in foreign exchange result in something breaking somewhere in global markets.

Critics of activist monetary policy point to the dependency concern – investors have become so overconfident in central-bank support they are relying on nothing else. There is enough data out there to suggest that U.S. stock markets are toppy: the Q-ratio, corporate equities to GDP (the Buffett Indicator), Shiller CAPE, margin debt. One area that stands out is the corporate bond market. Investors are barely being compensated for the risks they’re taking. In 2007, a three-month certificate of deposit yielded more than junk bonds do today.

Why are the markets so worried about Fed rate hikes, especially when the Fed funds rate will likely remain below 1.25% through 2015? Investors and corporations have never before been this leveraged, not even in 2000 or 2007. Total margin debt is fast approaching $500 billion. CEOs have leveraged their balance sheets to repurchase shares. High-grade and junk-rated bond sales exceeded $1 trillion in 2014, allowing corporations to be the major net buyer of U.S. equities. As borrowing costs rise, stock buybacks will be scaled back, undermining a key support for the bull market. Corporate earnings will suffer – from the steady drag of higher interest expense. And no one knows how bond investors will react once the fear of rising interest rates takes hold. If government bonds revert to their yields prior to 2010, 10-year treasuries would plummet 23%. With so much downside risk in treasuries, high-yield debt is even more mispriced.

The Fed is expected to begin raising rates in June. Further delay would be a colossal admission of failure. The Fed quadrupled its balance sheet to $4.48 trillion and tripled the duration of its holdings, all unprecedented. If the economy still cannot stand on its own after seven years of zero interest rates and three rounds of quantitative easing, why should we believe Fed policy will ever work?

We Make Our Profit When We Buy

The illusion of central bank control is in full force. Zero interest rates have made investors willing to accept any risk, no matter how extreme, in order to avoid the discomfort of getting nothing at the moment. But what if cash suddenly has the buying power to purchase stocks at 2009 prices? There is a truism in investing: We make our profit when we buy. We do that by investing when market conditions are favorable, and by remaining defensive when market conditions are dangerous. As a result, we protected our clients during the 2000 dot-com implosion and again during the 2008 financial collapse. We moved aggressively back into stocks within days of the market bottoms in October 2002 and March 2009. And we remained 100% invested for all but 5 months prior to going defensive in 2013. So we don't mind aggressive allocations, as long as the conditions are right. But now it not the time.

As always, we look forward with great optimism. We appreciate your faith and confidence. And we are eager to apply the lessons learned for your benefit.