Q2 NEWSLETTER

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PILOT WEALTH MANAGEMENT

A Street Corner Moment

By Jason Lesh, President & Managing Principal

Those of you that know me well have heard me say, probably more than once, that during the life of a business there are less than a handful of times where there exists an opportunity to significantly step on the gas pedal. I am proud to say that for our account, Pilot is experiencing one of those moments. I am excited to announce that we have acquired Activate Leadership, a leadership and organizational development consultancy, and it's founder Rick Thomas has joined our firm as Principal and Director of Human Capital. To fully explain the *why* behind the acquisition, a bit of backstory helps.

Three and a half years ago I was standing on the street corner having just sold an amazing company. In my pocket was a cashiers check for more money than I ever had before and yet I was full of self-doubt and a whole lot of questions. What did I just do? How will this affect my family? What will I do next?

It was in the answers to these questions that I learned what a great teacher hindsight is. I eventually connected with Nick Fisher and we founded Pilot Wealth Management to not just help invest client's money, but help them with some of the most important decisions of their lives. To not only help them when they have their street corner moment, but also be standing with them in the years leading up to it, and far into the future.

The overriding goal for Pilot is to create lasting impact for our clients. We do this. But when we started Pilot, I thought we were different because we actually focused on investing. We are phenomenal investors (in my humble opinion), but I realized this was only one of the reasons why our clients

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decided to work with us.

What hindsight has taught us is our clients choose to work with us because they trust us. And because we empathize with them. We truly do have (and require) an intimate relationship with our clients. My experience with startups and financial strategies only goes so far. And Nick's immense experience investing in the markets was still not enough. I concluded that whether our clients knew it or not, they were hiring us to help them achieve their dreams.

Again, hindsight speaks loudly here, and we have learned that simply managing and speaking to the needs of financial capital isn't enough for our clients to achieve their dreams. It's necessary that we acknowledge and invest in the *human capital* of our clients as well: the relationships, the shared goals and sense of purpose. In helping define the values and strategy, husbands, wives, business owners and professionals know that they are on the right path. In this we truly begin to achieve significance in the work.

Enter Rick Thomas and Activate Leadership. This is what he does. And under the umbrella of wealth management, this is what we do. The power of our combined services and backgrounds is incredible. We have collaborated and worked together with a handful of clients over the past year, and after many months of discussions, retreats and strategy sessions, we can finally share our excitement with you.

My goal for this firm is to create lasting impact and to have deep and meaningful relationships with our clients. We do that already which is why I love my job. And adding Rick to the team only strengthens what we have to offer.

Thank you for your continued support and I look forward to introducing you to Rick in the near future.

All the best,

Jason Lesh
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Confessions of a Recovering Engineer

By Rick Thomas, Director of Human Capital & Principal

It is with great excitement that I write this as a partner of the Pilot team. As I have shared this pending development with those familiar with my work in Activate Leadership, more than once I've been asked, "what does leadership development have to do with wealth management?" It is a great question and my response is one I will share with you, however, a little background first for those I haven't had the opportunity to meet just yet.

Yes, I am a leadership coach, consultant, corporate head shrink, management voodoo doctor, you name it…I've been called it. How I got here, however, is a more interesting story that what I am called. I started my career in the mid-80's as a wide-eyed plastics engineer from Western Washington University, certain to make my mark in the world making gazillions of plastic things. And that I did, from 1986 to 2005, where my career took me halfway across the globe, developing new processes, scoping new markets and all the while meeting phenomenal people.

It was what happened in the mid-90's, however, that ultimately lead to my career pivot to leadership development. The 90's was a difficult period for manufacturing in the US, and as a partner in a plastics manufacturing business at the time, we found ourselves squarely in the bulls eye of what Ross Perot famously coined "that sucking sound" as business headed to Mexico and China. We were in a fight for our very survival, challenged to reinvent ourselves multiple times through the following ten years to maintain viability. While the

business not only survived, it began to thrive even, and yet the larger payoff for me personally came in the learning from the experience; understanding how to create a strategic blueprint that encompasses the vast array of tools necessary for a business to excel in the market not only in the short term, but sustaining the success over the long run.

I was so invigorated by these experiences that I left manufacturing in 2005 to start my consulting practice devoted to helping business owners create blueprints for their own enterprises. This has been my passion for nearly eight years and it has been very fulfilling work, creating value and lasting relationships with outstanding clients. It was late last year, however, after having collaborated with Nick and Jason with a Pilot client, that the conversation came up regarding a potential merger of our services. As novel as the idea sounded to us, we challenged ourselves to ask the questions from the client's perspective, "Why would you do this? How does this add value to my business?"

It was in answering these questions that the idea went from something that we could do, to something we were compelled to do. We recognized there is a profound correlation between the health of the client's financial capital, and the health of the client's human capital, specifically the leadership, disciplines and culture within the client's enterprise. Combined, this approach allows us to go broad and deep, ultimately create lasting impact. For us, that is the definition of value creation and where we desire to be with our clients. As Jason succinctly puts in, "I want to be able to speak at their funeral, or they speak at mine." It's what comes in between that truly matters to us. We hope it does to you as well.

For the Pilot clients, I look forward to the opportunity to meet each of you, and likewise to the Activate clients, to introduce Nick and Jason when the opportunity presents itself. In the meantime, I look forward to future contributions in the quarterly newsletters, which will be expanded to cover the issues of human capital and the meandering confessions of a recovering engineer.

All good things!

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Quarterly Commentary

By Nick Fisher, Portfolio Manager & Principal

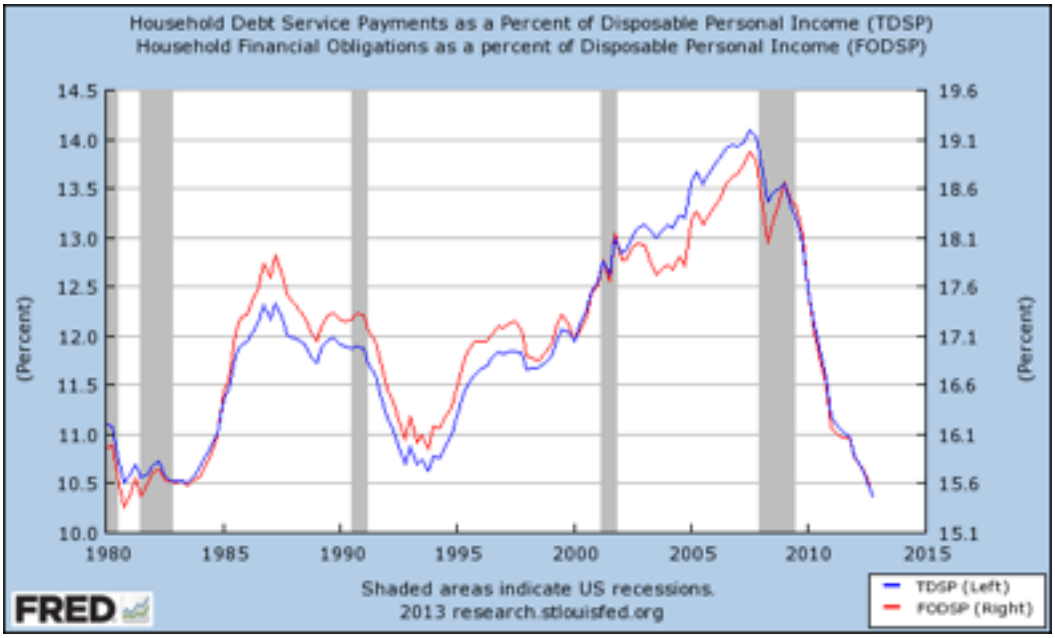
Having a small farm outside Sherwood and being someone interested in cultivating my green thumb, we planted a few pinot noir vines last year. In the vineyard, vintners are often at the mercy of the climate and weather. The delicate, thin skinned, Pinot Noir grape, for example, needs a minimum number of growing degree days, but not too much, as raisins make for poor quality wine.[1] The result of all this science is to compare vintages, for example the 2008 oregon pinot noir vintage is considered outstanding, primarily because of the exceptional cool growing season and dry harvest. To expect a 2008 vintage and a dissimilar 2009 vintage to yield the same value would be foolish. Both the climate (ie. location of the vineyard), but also the weather in an individual vineyard, are crucial. So it is with investments.

It's not what you don't know that kills you; it's what you know for sure that ain't true.
-Mark Twain

1. A growing degree day or unit is calculated by the number of degrees averaging the high and low temperatures equaling greater than 50 degrees.

To compare this recession to any recession, other than debt deflationary recessions (ie. 1870's, 1930's in the US, 1990's in Japan) is also foolish. Comparing interest rates, and stock prices to trends of the last 20 or 30 years is unwise. This is corroborated and evident in the data. Economic growth has been abnormally sluggish compared to anything but those time periods. Interest rates are ridiculously low and the equity risk premiums are attractive…unless you compare them to a similar vintage.

We are still in the midst of a debt-deflation cycle. In this cycle, consumer, corporate and government sectors are forced to deleverage from unusually high debt levels. The first half of the cycle may be nearing completion, with corporations and consumers having normalized their debt levels.



Deleveraging in the government remains. Unfortunately, the Federal Reserve has the very delicate job of combining growth and inflation to normalize the debt levels. Interest rates are going to play a key role and the recent increase we have seen will not help us out. The Federal Reserve's Quantitative Easing (QE) program has been manipulating the market to achieve stability. Reportedly, as much as 85% of stock movements over the last couple years have been attributed to QE, rather than earnings growth. As the Fed now contemplates how to taper off their bond purchases, the market has responded with nervousness. Pimco's Mohamed El-Erian has labeled this current state "stable disequilibrium." With stagnant economic growth, deleveraging on the government side may take longer than the Fed hopes. Of course the Fed's economists have optimistically predicted stronger growth every year than what has materialized. We seem to be putting a whole lot of faith in the economists at the Fed. It is no wonder why investors are beginning to lose faith.

Interest Rates

We certainly may have seen the lows in the bond market, but technically speaking we have not broken the trend line yet. According to Crestmont Research, the interest rate move we have seen is not uncommon. In fact, 98.5% of the time, over a 6 month period interest rates at some point along

the yield curve will move 50 basis point (0.5%). We have heard many economists, advisors and investors suggest that the 30 year bull market in interest rates has come to an end and interest rates are bound to rise precipitously. I don't think they are considering the repercussions of this idea.

Undoubtedly interest rates will eventually rise, but when interest rates rise, so does the debt service on the now massive national debt. The congressional budget office (CBO) has stated in their Budget and Economic Outlook (released early this year) that they expect interest rates on the 10 year Treasury bond to rise to 5.2% by 2017. With an average debt maturity around 60 months, the treasury will be forced to refinance the national debt at rates much higher than the current levels. Not including future deficit spending, the debt service on our current nearly $17 trillion in debt will begin to approach $1 trillion dollars. That is in debt service alone and does not include the nearly trillion dollars of expected government spending outside of interest payments. Furthermore, it assumes we are able to forgo a recession in the meantime. Perhaps we should remain skeptical of the economists' ability at the Federal Reserve; after all they have failed to accurately project any of the recent economic maladies we have faced. Needless to say, I expect the Federal Reserve to attempt to keep interest rates in a trading range for quite some time.

Investment Themes

Our investment themes discussed at the beginning of the year:

1. Large Cap technology has underperformed thus far
2. Financials: Regional banks are performing very well, but investment banking has been slow
3. Home construction has returned, and related stocks have performed very well
4. Natural Gas is still too cheap
5. Cloud computing and social networking stocks are still overvalued

Emerging market stocks have been a terrible place to be invested recently and we have been underweight for quite some time. As expectations for economic growth in China have plummeted, so have expectations in other emerging markets. As promised we have begun to increase our weighting to more of an "equal weight" from an under weighting.

We expect slow growth economically and plenty of opportunity created through volatility in the coming months.

Recent Readings

By Nick Fisher, Portfolio Manager & Principal

It is sometimes beneficial to hear the contrarian point of view, as the crowd is often wrong in the investment world. Most people expect interest rates to continue rising. In the Hoisington Investment Management Co. Quarterly Review and Outlook Van Hoisington and Lacy Hunt lay out a case for an extended period of low interest rates. We currently have very little signs of inflation, slow gdp growth, weak consumer fundamentals and anti-growth policies. Their graph says it all.

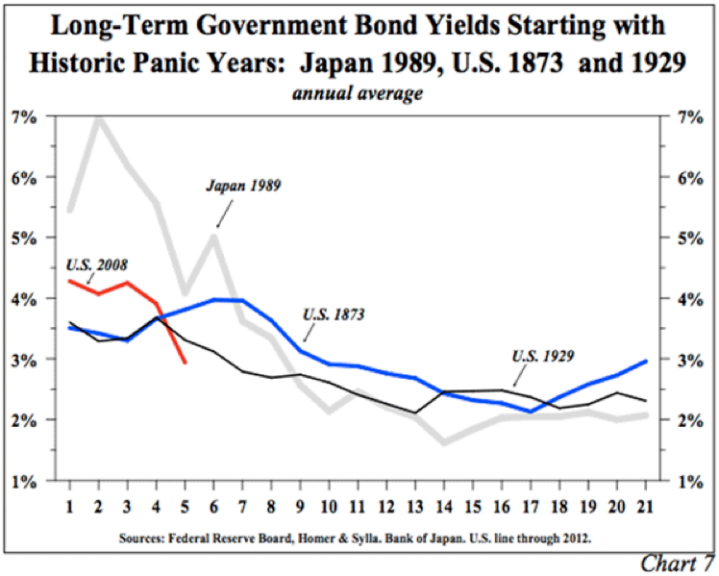


Chart 7

Recent Readings

By Rick Thomas, Director of Human Capital & Principal

It's an uncommon occurrence when I make it through a book cover to cover. I'm happy to report, however, that I've hit the back cover on two books so far this summer: Michael Lewis's *The Big Short* (OK, yeah, I know…not the most current read, but given I'm orbiting in the financial world more closely these days I thought it wise to know what the hell a CDO was. Wow, what a page turner!), and Steven Ambrose's *The Victors*. Well, okay this one is even older (1998) and by some accounts a rehash of his *Citizen Soldiers* and a few others. That said, I am always compelled by good history told from the human perspective, and like David McCollough (*John Adams, 1776, Truman*), Ambrose delivers. In addition, there is a significant leadership lesson told in *The Victors* that I've been pondering since I finished the book in late June.

In Ambrose' description of the allied action on D-Day, it is clear that the invasion did not go as planned. Far from it. The weather on D-Day was not in allies favor, the naval bombardment failed to dislodge much of the fortifications on key beachheads in Normandy, the 82nd Airborne airdrops were scattered all over the place and when the infantry was finally able to punch through to the hedgerows, they were wholly unprepared for these centuries old natural barriers that even the Sherman tanks could not penetrate. All this against a Nazi Wehrmacht that was highly skilled with superior engineering in weaponry and embattlements. And yet the allies persisted and ultimately claimed victory. While there are as many opinions as there are days in the year why this was the case, Ambrose draws one distinction that provides profound insight into why the allied forces, and in particular, US forces were successful. It was simply the mindset of the leadership on the ground, leading the fight. They were average Joes from small town America. And they had something that the Nazi's had no answer for—the ability to think independently and be opportunistic in dealing with the conditions they were dealt. Take the hedgerows for example. The Sherman tanks could not penetrate them, however the farm boys took over and began improvising with various "snouts" on the front of the tanks to be able to pierce the thick growth. They succeeded. In contrast, as the allies eventually made it past the fortifications along the Atlantic seawall, in many places the German artillery was in position to repel the attack but never did because they were waiting for orders from Berlin for approval. This dependence on hierarchy and rigid control proved to be fatal in their cause.

I am fascinated by this distinction in leadership as I see this as relevant today as ever. In business, those that are successful have learned to distribute authority and responsibility, allowing employees to act opportunistically and think on their feet. Conversely, there are still those businesses that operate by command and control and they suffer for it, repeatedly. If you are curious about your business, read *The Victors* and give some thought to how your business is structured. I'd love to hear your thoughts and I'll even buy the coffee!

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