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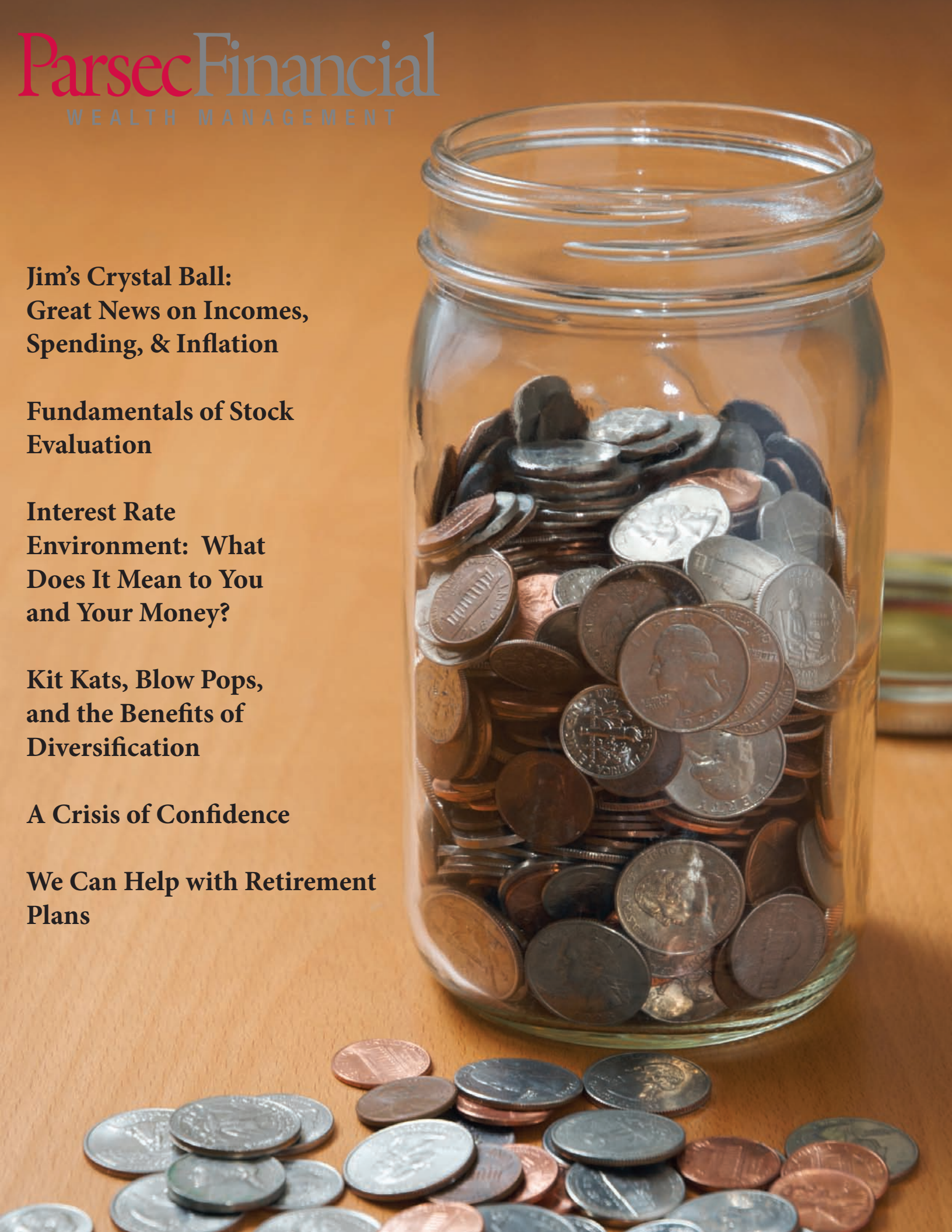

Jim's Crystal Ball: Great News on Incomes, Spending, & Inflation

Fundamentals of Stock Evaluation

Interest Rate Environment: What Does It Mean to You and Your Money?

Kit Kats, Blow Pops, and the Benefits of Diversification

A Crisis of Confidence

We Can Help with Retirement Plans

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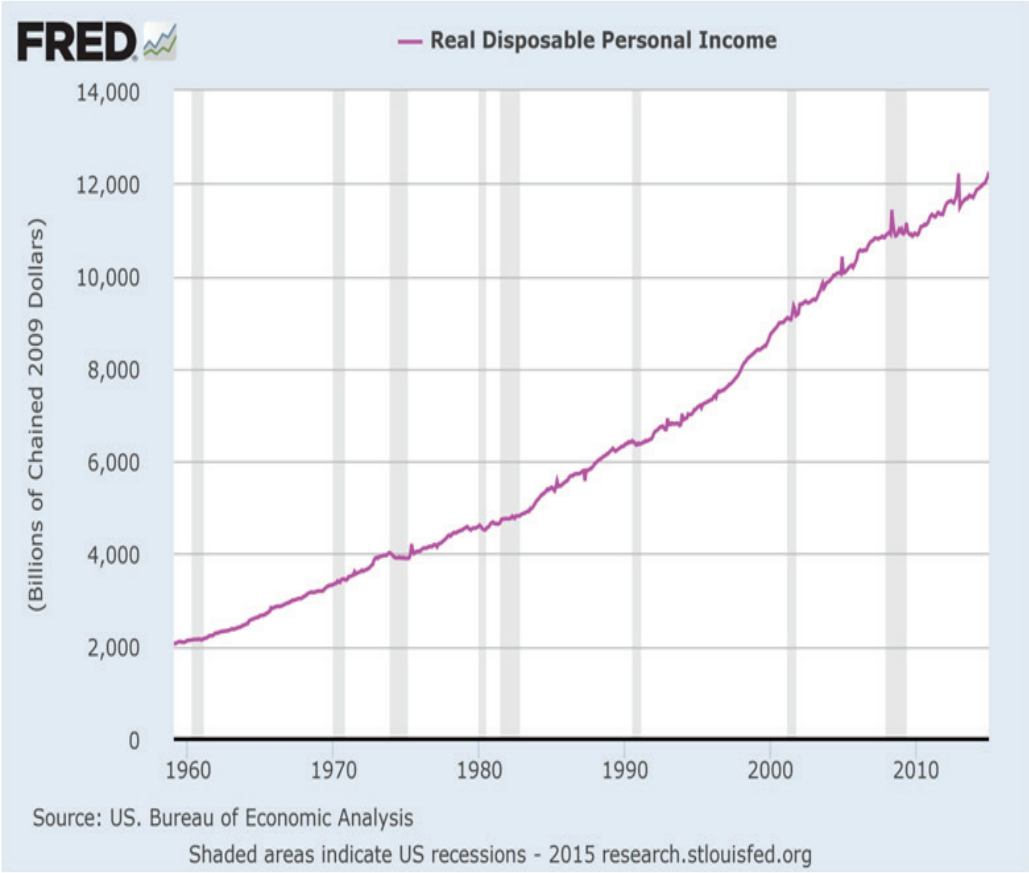
Second Quarter 2015

Great News on Incomes, Spending, and Inflation

The Bureau of Economic Analysis (BEA) hit a trifecta in its March 2 release, "Personal Income and Outlays: January 2015." As the chart below shows, the first piece of wonderful news was that real disposable personal income (DPI), which is what you have left of your income after taxes and inflation, hit a new record in January of $12.246 trillion at a seasonally adjusted annual rate. That finally eclipsed the old record of $12.214 trillion at a seasonally adjusted annual rate set in December 2012. That old record was an unsustainable outlier at the time, which was caused by many people who had the ability to bring income such as bonuses and special dividends forward to avoid the higher tax rates of 2013, doing exactly that.



Conversely, the January 2015 record was driven by a seasonally adjusted increase of $42.4 billion in wage and salary income from December. That accounted for a very healthy 83.5 percent of the total increase in personal income of $50.8 billion, seasonally adjusted. That strong performance of wages and salaries suggests that, driven by ever-growing employment, disposable personal income will set many more records in 2015 and 2016.

Even more astonishingly, real disposable personal income rose by 0.9 percent in January from December. That was the biggest increase since—you guessed it—the 2.84 percent

Great News on Incomes, Spending, and Inflation

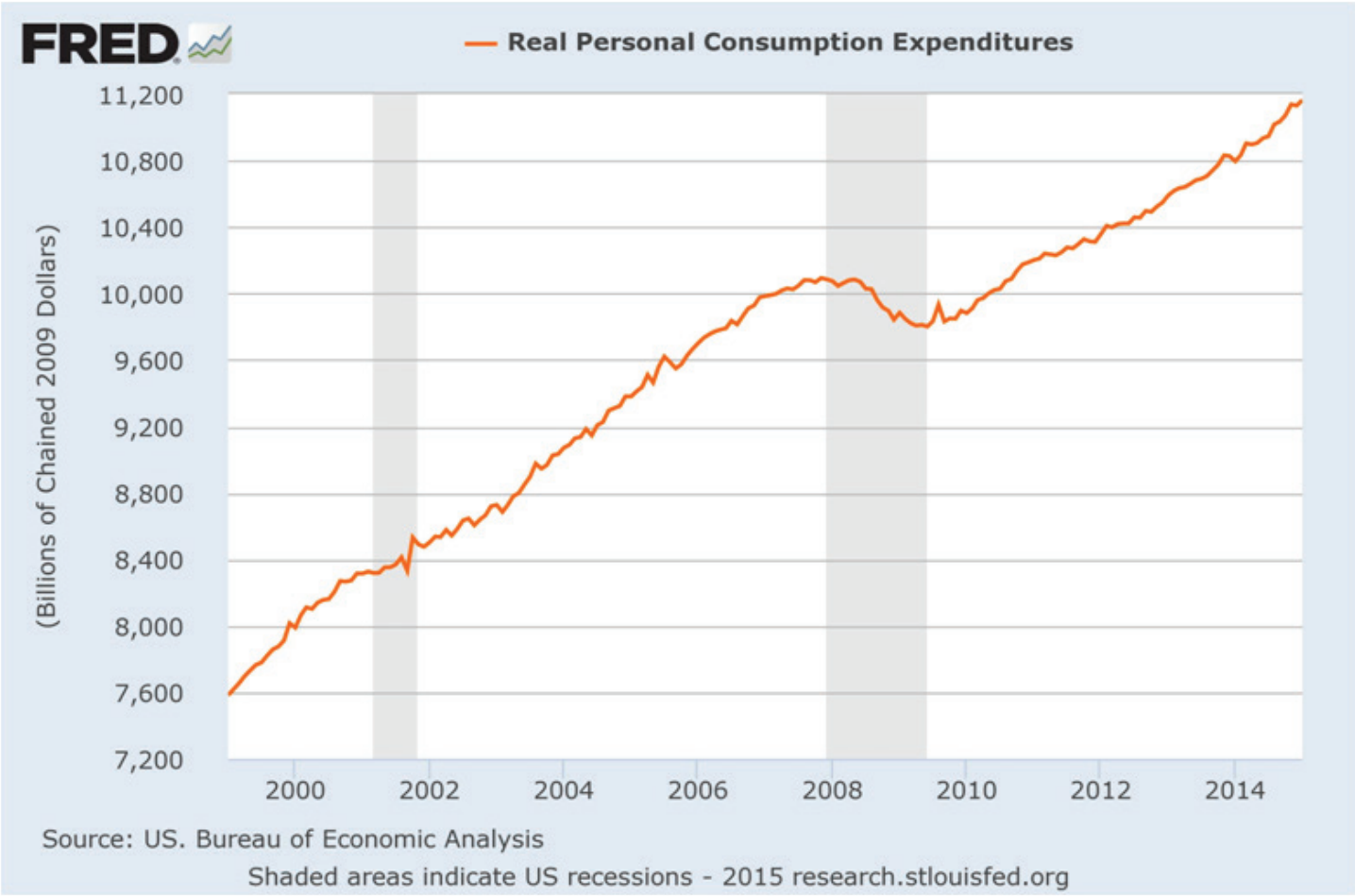
continued from page three

spurt in December 2012, which was on top of a very strong increase of 1.44 percent in November 2012. Of course, real DPI plunged by 5.9 percent in January 2013, the biggest drop in over 50 years. That is most unlikely to occur this time, as we will see when we get the data for February 2015 on March 30.

This 0.9 percent increase in real DPI in January is even more amazing, because January wages and salaries are hit every year by increases in Social Security taxes on both employees and employers. Every employed person who exceeded the $117,000 taxable maximum in 2014 before December 31 had to start paying again on January 1. This year the tax covers wages and salaries up to $118,500. That change subtracted an additional $7.9 billion in January.

Note the phenomenal growth in real DPI in the previous chart. It is now six times higher than in 1959, triple the 1973-1975 level and double where it was in 1987-1988. It's up more than 20 percent since 2009. Most countries would be delighted to have such terrific growth in DPI over comparable periods.

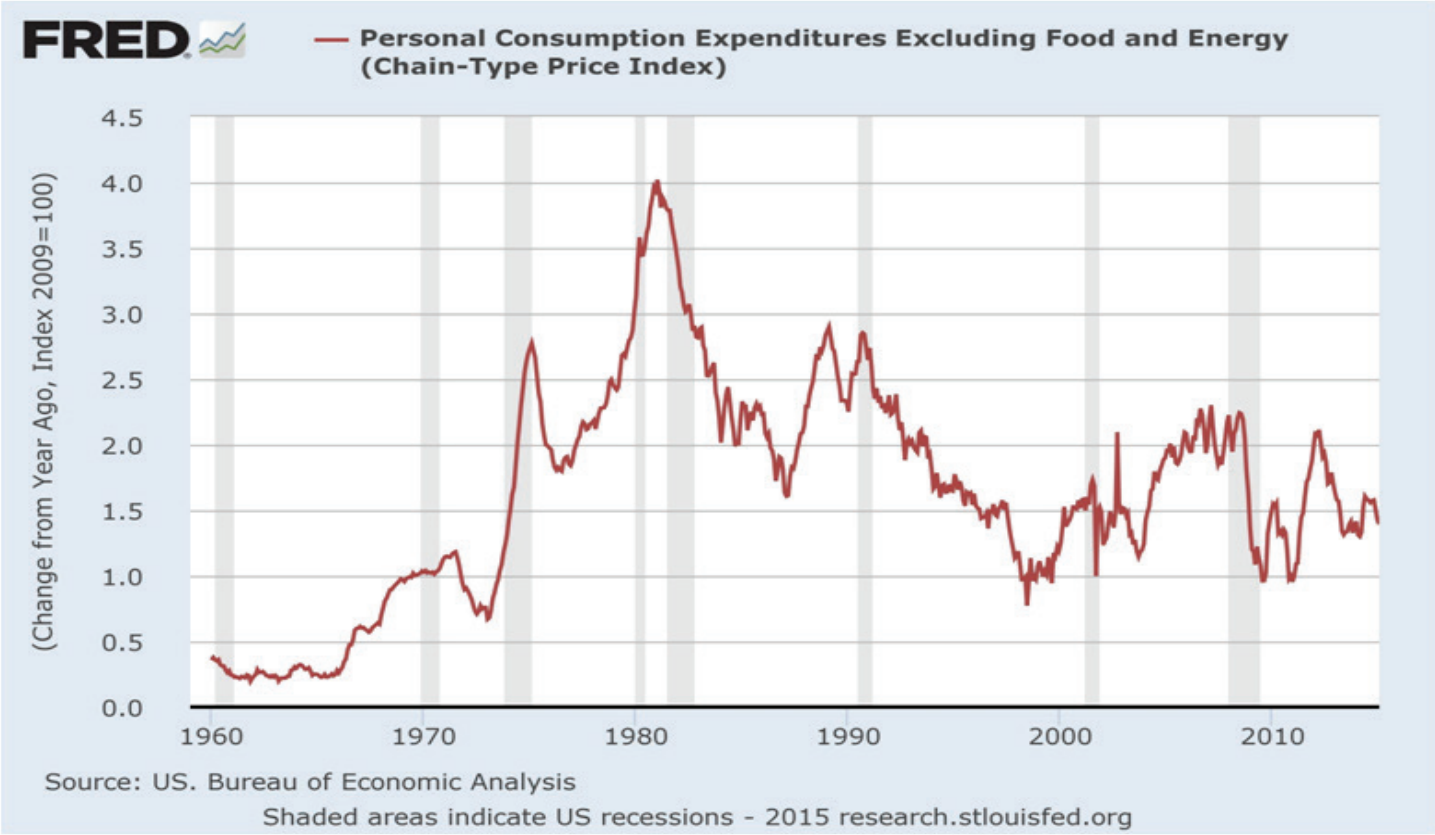
The second piece of great news in the report was the fact that real personal consumption expenditures (PCE) set a new record in January of $11.164 trillion at a seasonally adjusted annual rate, as shown in the following chart. That was up 0.3 percent from December and a very impressive 3.4 percent from January 2014. Because real PCE makes up by far the largest share of real GDP (68.2 percent in 2014), this strong beginning to 2015 reinforces the consensus forecast that this will be the first year since 2005 to see real GDP growth of 3.0 percent or more.



Great News on Incomes, Spending, and Inflation

continued from page four

The third piece of wonderful news was the continued low rate of increase of so-called "core" inflation, the implicit price deflator for PCE less food and energy. The chart below shows how this measure rose in the late 1970s and early 1980s hitting a peak of 4.02 percent in January 1981. It is probably not a coincidence that that was the month when President Reagan took office, as his first official act was to deregulate oil prices. While both energy and food are excluded from this index, the impact of that decision had far-ranging consequences in reducing inflation.



The overall PCE deflator fell 0.5 percent in January from December and was only 0.2 percent above January 2014. That was primarily because "Energy goods and services" registered price declines of 10.4 percent in January from December, and fell a whopping 21.2 percent from January 2014.

This very small increase in the overall PCE deflator made a big contribution to the 0.9 percent jump in real DPI. The rest came from the large increases in nominal income.

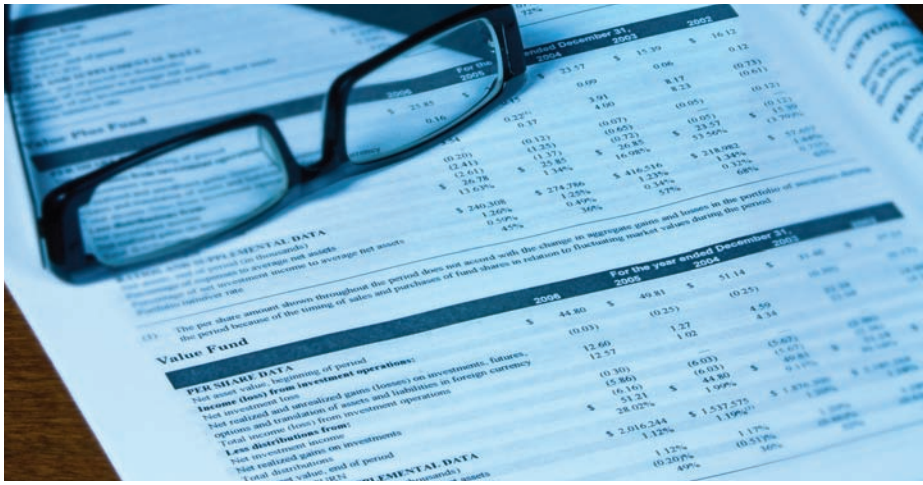
This BEA report is one of the best ones we've had in many years. It should be followed by much more good news on income and spending by consumers in coming months.

Jim Smith joined the firm in 2006 as Parsec's first chief economist. He has had an outstanding 30-year career as an economist in business, government, academic, and trade association settings. He has been an Adjunct Professor at Kenan-Flagler Business School at UNC Chapel Hill since 1988.

Fundamentals of Stock Evaluation

Are you a little fuzzy when the topic of individual stocks comes up? If so, you're not alone. While about half of Americans own equities, either directly or through a mutual fund, many aren't sure how to evaluate a stock. Is it cheap? Is it expensive? Are the fundamentals good? Hopefully, you trust your financial advisor or have confidence in your mutual fund manager, but you'd still like to understand why they recommend some stocks over others. When you can identify the basics of stock evaluation, you become a more active participant in your financial future.

For long-term investors like you, it's import to size-up four aspects of a company or stock:



1. Competitive positioning
2. Health of the financial statements
3. Long-term growth drivers
4. Valuation

Let's look at each of these in more detail.

Companies with high barriers to entry, a loyal customer base, a well-regarded brand, or some combination of these often have a strong competitive position. This is important for any stock in your portfolio because competitive threats are a regular occurrence and the better a company can withstand new competition, the higher the chances you'll receive a healthy long-term stock return.

Every investor should examine a company's financial statements before buying its stock. While your advisory firm or fund manager should be taking a hard look at the income statement, balance sheet, and cash flow statement of every company in your portfolio, as a lay investor, looking at a few key trends can give clarity. Income statements display a company's sales, expenses, and profits. Look for companies with an accelerating or stable rate of sales and earnings per share (EPS) growth. Make sure profit margins as a percent of sales are stable and preferably, expanding. On the balance sheet, cash is key. Confirm that the company has enough to pay upcoming debt payments. Check inventory growth (if the company has inventories) and make sure it's not too far ahead of sales growth. Last, but certainly not least, the statement of cash flows provides the real "bottom-line": how much cash does the company generate and how does it use that cash?

If you're a long-term investor, understanding a company's long-term growth drivers is critical. You want to invest in firms that will be around for years to come and will deliver earnings and cash flows ahead of inflation. Long-term growth drivers include expanding into new geographic markets, product innovation, and market share gains, among others. Basically, when a company has a history of delivering quality products or services and continues to invest in its people and research, it's better positioned to drive earnings growth for the long-term. I recommend reading a company's annual report or its 10-K filing with the SEC. Usually firms spell-out their long-term growth catalysts. Then it's up to you to decide if they can achieve them.

Finally, valuation may be the most important and difficult aspect of stock evaluation. A simple starting point is

Fundamentals of Stock Evaluation

continued from page six

to examine a stock's price-to-earnings or P/E ratio. This ratio measures how much the market is willing to pay for a dollar of earnings. Typically, stocks with higher P/E ratios indicate a higher growth rate, i.e. an investor is willing to pay more per dollar of earnings today because she expects the company to grow earnings rapidly tomorrow. Likewise, stocks with lower P/E multiples usually imply a slower or slowing growth rate. This is not always the case and market overreactions can present big opportunities to buy high-quality stocks on the cheap. Sizing up a stock's P/E goes hand-in-hand with assessing its growth rate. If a stock's growth accelerates, you could benefit from higher earnings per share (EPS) and a higher P/E multiple. On the downside, if a company's growth stalls, not only will EPS decline but the stock's P/E multiple is likely to contract as well. Point being, it's usually safer to buy lower P/E stocks and have a high degree of confidence that current growth levels can continue.

While picking stocks for a living can take years of study and practice, understanding the basics can be fun and straightforward. It takes a little bit of time and effort, but by starting with companies that interest you, and sticking to the four factors above, you'll become an active participant in your financial future.

Carrie A. Tallman has ten years of experience in institutional investments and served as a buy-side equity analyst in Atlanta, GA for seven years before joining Parsec in 2013. Carrie is a CFA charterholder and holds a B.S. in zoology and an M.A. in education from the University of Florida. A recent transplant to the Asheville area, Carrie loves living closer to family, exploring the great outdoors, and spending time with her Border Collie.

Parsec Prize Awarded

Recently, we announced the 2015 recipients of the Parsec Prize. This year, we have three levels - gold, silver, and bronze. Here are the recipients:

Gold: $20,000 each

- Pisgah Legal Services (Asheville)
- Arc of Buncombe County
- Urban Ministries (Charlotte)

Silver: $15,000 each

- The Cindy Platt Boys and Girls Club of Transylvania County
- Open Doors of Asheville

Bronze: $10,000 each

- Augustine Literacy Project (Charlotte)
- Go! Green Opportunities (Asheville)

The Parsec Prize is our way of supporting non-profit organizations in the communities we serve. We dedicate a portion of our revenues annually toward the endeavor. For a list of past recipients, check out our website at: http://parsecfinancial.com/parsec-prize.html.

Congratulations to the winners!

Help Us Name Our Newsletter

For the last three editions, we have experimented with new formats for our quarterly newsletter. We hope you like the changes.

We want the newsletter to be something more than another item you toss into the recycling bin. What do you like? What could we improve? Do you have a topic you would like for us to discuss in an upcoming edition?

What should we call our newsletter? We want your opinion. Please e-mail your suggestion for our name to newsletter@parsecfinancial.com. If we pick your suggestion, then we will donate $100 to the charity of your choice.

Also, please feel free to e-mail any comments or suggestions. Thank you!

Form ADV and Privacy Notice

Pursuant to SEC rules, we are required to provide you with a summary of any material changes to our ADV Part II brochure within 120 days of the close of Parsec's fiscal year. We must also provide other ongoing disclosure information about material changes as necessary. This year, we did not have any material changes to the brochure. You can still receive a copy of our current brochure, if you like. Please contact our office, and we will be happy to mail a brochure to you. You can also view our brochure on our website: www.parsecfinancial.com/ethics-and-transparency. Additional information about Parsec Financial is available on the SEC's website at http://www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx. The SEC's website provides information about any persons affiliated with Parsec who are registered, or are required to be registered, as investment advisor representatives of Parsec.

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- Information you may provide to us verbally, and
- Information about your transactions with us, our affiliates, or others.

Parsec Financial Management, Inc. shares non-public information solely to service our client accounts, and therefore we provide information only to other financial service providers, such as brokers and custodians. With client permission only, we may disclose information to insurance providers, accountants, or attorneys. We do not otherwise disclose any non-public personal information about our clients or former clients to anyone, except as permitted by law.

If Parsec's policy changes in the future, clients will be provided with a revised notice reflecting the new privacy policy.

Each employee is required to sign a confidentiality agreement. The employee understands that he or she will be terminated if he or she discloses confidential client information to an outside party, unless that party requires the information to complete a transaction for you. We require that any third-party vendor who may have indirect access to your information sign Parsec's confidentiality agreement. In addition, we will maintain physical, electronic, and procedural safeguards that meet federal and/or state standards to guard your non-public personal information. If you have any questions about the information you read in the brochure or our privacy policies, please let us know.

Parsec requires each employee to read, sign and abide by a Code of Ethics. The Code of Ethics covers topics such as our gift policy and personal trading policy. Employees are not allowed to make or receive gifts that may influence their decision making in business matters. Before trading personal or household owned securities, covered employees must receive compliance pre-approval for trades of equities and other covered securities. If the employee is trading a security that is also being traded for a large portion of clients at one time (block trade), the employee's trade is allowed to be included in the block trade with client trades, and everyone receives the same price. Otherwise, employee trades must be placed after the block trade is completed. If you would like a copy of our Code of Ethics, please contact Vicki Oxner at voxner@parsecfinancial.com.

Kit Kats, Blow Pops, and the Benefits of Diversification

"But international stocks are underperforming the S&P 500! Why are you buying international mutual funds in my account?" We hear this question a lot. People often wonder why we include various sectors and asset classes in our portfolios, but the one that tends to get the most scrutiny is international equity.

Many investors exhibit what is known as "home bias," or the tendency to invest primarily in domestic securities, whether it stems from a nationalistic desire to "buy local" or simply the belief that international investing carries additional costs and complexities. Often, investors eschew international diversification to their detriment, as many studies have shown that the inclusion of international equities lowers portfolio volatility while increasing risk-adjusted return. However, these metrics are not what investors see – they see performance. They see that the return on their international fund is lower than the return on the S&P 500 and fear that it will be a drag on their returns forever. So why don't we sell it?

Quite simply, we keep it for the diversification benefits. Perhaps an analogy will help. Let's pretend it is Halloween. When you're trick-or-treating, you knock on the door of every lighted house and collect as much candy as you can carry home. Then you dump it out on the floor and sort through it to revel in the spoils. Hopefully you'll come home with lots of chocolate candy bars, M&Ms, Milk Duds, Junior Mints, and Reese's cups. Then there might be a smattering of Smarties, Starburst, and Skittles, which are fine. Invariably there will be a few of those orange and black-wrapped peanut butter taffies, some chalky Dubble Bubble and a handful of Dum

Kit Kats, Blow Pops, and the Benefits of Diversification

continued from page ten

Dums – but that's OK. A few crummy candies won't ruin the night, since you have so much more of the good stuff. And you never know which houses are going to hand out what candy, so you have to hit them all. (And to the person handing out raisins, just stop. Don't be that guy.)

Now imagine that your portfolio is a bag of Halloween candy. Even if you love Snickers, it would be pretty disappointing if your entire haul was nothing but Snickers – that would defeat the purpose of trick-or-treating, because you could simply go to the store and buy a bag. No, you want a wide variety from which to choose, based on changing moods and cravings! In a similar way, you need to diversify your investments so that the mood of the day doesn't destroy your savings in one fell swoop. If your entire portfolio consists of the stock of one bank and the bank goes under, you lose all of your money. If you buy the stock of 5 different banks, but the entire banking industry hits a rough patch, your portfolio plummets…so you buy the stock of 40 different companies in different sectors and industries to spread the risk. But what if they're all domestic companies and the domestic economy tanks? I think you see where this is going. Different investments zig and zag, moving in opposite directions simultaneously, which dampens the overall volatility of the portfolio.

You may not be a huge fan of Blow-Pops, but what happens if you fill your bag with Kit Kats and you're suddenly in the mood for Sour Apple? What if you leave your bag in the sun and all the Kit Kats melt? It's true that if a particular sector (such as international equity) underperforms and you have it in your portfolio, you might get a lower return on your portfolio for that period. But when that sector rallies, you'll be happy you had a couple of Blow-Pops in your bag.

Sarah DerGarabedian joined Parsec in 2005. She is a CFA charterholder and a member of the CFA Institute and the CFA North Carolina Society. A native of Atlanta, Sarah graduated magna cum laude from Wellesley College with a Bachelor of Arts degree in geology. She enjoys writing for the Parsec newsletter and blog.

Interest Rate Environment: What Does It Mean to You and Your Money?

Interest rates are important factors in the global economy and capital markets. They drive asset prices and communicate investor expectations for both future economic growth and inflation. Today, interest rates in the U.S. are at historically low levels and credit spreads between risky and risk-free assets, although starting to widen, remain narrow versus long-term averages. In this article, we'll explore how we got here and what this means for your investments going forward.

Interest rates and prices move in opposite directions. For example, when investor demand for corporate bonds is high, increased buying drives up the price and pushes down the yield, or interest rate, on the bond. Thus, we can say that price and yield are inversely correlated. This is an important relationship especially in light of today's historically low interest rate environment. And it's not just important for bonds. The same relationship between prices and interest rates (inverse correlation) also applies to stocks or equities. A popular equity valuation method, the dividend discount model, projects future cash flows from a stock and then discounts them back to the present day using current interest rates. Thus, the lower the interest rate, the higher the stock value and vice versa. So if today's interest rates are historically low, we could argue that asset values are high, all things being equal. The problem is that all things aren't necessarily "equal" in today's environment.

In fact, today's environment is quite unusual. Since 1981 when interest rates peaked at just over 15%, we've seen yields steadily decline for the past three and half decades. This led to the longest bond bull market on record, with particularly robust price gains following the Great Recession in 2008. It was then that Federal Reserve (Fed) chairman Ben Bernanke embarked on massive and unorthodox monetary policy measures to try and avoid another Great Depression. He cut short-term interest rates to 0% and initiated Quantitative Easing (QE), a program designed to pump money into the US economy by buying up lots of government bonds. These actions were designed to loosen lending and stimulate demand, or at least prevent it from falling off a cliff.

Although it's not entirely clear if the Fed achieved its intended goal, it is clear that several years of unprecedented monetary stimulus has left us with a lot of excess money. Given a negative real return in savings accounts, investors have plowed that excess cash into stocks and bonds in search of better returns. In their quest for yield at any cost, investors became less discerning which led to narrow credit spreads and pockets of over-valuation in some smaller capitalization and speculative stocks.

The good news is that yield spreads are starting to narrow as investors begin to pare back on riskier bond holdings. Likewise, small cap stocks have declined year-to-date, helping reset perhaps over-inflated equity valuations. Today, falling oil prices are putting near-term pressure on energy-related stocks and are providing a wake-up call for previously complacent investors. As the Fed prepares to raise interest rates, the record-low volatility and "Goldilocks" environment we've experienced, where assets went up no matter the economic backdrop, may be coming to an end. The silver lining is that, historically, rising interest rates have signaled a healthy economy, one

Interest Rate Environment:
What Does It Mean to You and Your Money?

continued from page twelve

that can continue to grow despite tightening monetary policy. In fact, monetary policy remains incredibly lose by historical standards, and higher interest rates would be a welcome change and a step towards a more normalized environment.

What does this mean for long-term investors? While market gains have been especially robust these past several years as interest rates fell, rising rates are likely to produce more moderate gains going forward. That said, gains should be driven by real economic traction and a healthier consumer, both of which are much more sustainable than accommodative monetary policy.

Carrie A. Tallman is our Director of Research. Prior to entering the world of finance, she held interesting jobs. Did you know that she is a former high school science teacher? She also directed educational programming for a local zoo in Tampa, Florida.

A Crisis of Confidence

Self-fulfilling prophesy. You hear that term a lot regarding the stock market. It was coined by sociologist Robert K. Merton, father of economist and Nobel laureate Robert C. Merton, known for his work on options pricing models (Black-Scholes-Merton, anyone? Anyone? Bueller?). Of course, the idea of the self-fulfilling prophesy has been around for ages and is a popular plot device, from Oedipus and Macbeth to Star Wars and Harry Potter.

It is a fascinating concept; whereby, a prediction influences the behavior that indirectly leads to the fulfillment of the prediction. I spoke with some colleagues about the phenomenon as it relates to testing. A person can end up failing a test, not necessarily because they were unprepared, but because they were so worried about failing that their lack of confidence caused them to freak out and freeze up on exam day.

In fact, it's lack of confidence in the economy that sometimes weighs on the stock market. Investors hear news of a possible default or a certain country's financial crisis, and they worry that it will cause a downturn in global markets. As a result, they sell their investments, which – guess what? – causes markets to go down! A self-fulfilling prophesy. Then, the news turns positive (a possible bailout). Markets rally as confidence improves, and investors buy back into the market.

It is interesting to watch the effect of human behavior on the markets, but it can make you downright seasick when you are invested in the market and riding the waves of sociological phenomena. I know we have said it a thousand times, but the best thing to do is sit tight. If you can resist the pull of the crowd, you can dampen its effect on markets in some infinitesimal way. More importantly, resisting the urge to time the markets has been shown to improve investment returns over the long run.

Sarah DerGarabedian is a financial advisor at Parsec. She is also an avid CrossFitter, which enables her to eat all the candy she wants. She prefers bacon, though.

We Can Help with Retirement Plans

Do you have a retirement account, such as a 401(k) or 403(b), that you'd like Parsec to manage? The industry for retirement plans is evolving, and there are more options than ever. Here are a few ways we may be able to help:

For retirement plan participants (employees):

- We may advise on the existing investment options and allocations in your plan by downloading a feed to our software for 0.40% annually (lower than our regular schedule), **or**

- We may become an authorized agent on your account within the plan so that we can place trades for you and invest in a wide range of investment options to suit your objectives, just like we do for your existing Parsec-managed accounts.

For retirement plan trustees/business owners (employers):

- We may become a retirement plan consultant to your plan, and manage the selection of investments and employee education for your entire company (best for small businesses), **or**

- We may create a free plan-level benchmarking report for your plan sponsor, which will help you comply with Department of Labor fee disclosure rules.

Every plan is different and may not be open to all options. If you're interested in learning more, please contact your advisor!

Harli joined Parsec in 2003. She is a CFA charterholder as well as a CERTIFIED FINANCIAL PLANNER™ practitioner. In addition to her duties as an advisor, she is the firm's Chief Compliance Officer and the Director of Wealth Management. Harli is a member of the CFA Institute, the CFA North Carolina Society, and the Financial Planning Association. Currently, she serves on the board of OnTrack. She has a B.A. in English from Wake Forest University.

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