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Despite muted economic activity and Congress's waiting until the final hour to reach a compromise regarding the Fiscal Cliff equity markets ended the quarter largely unchanged. We continue to think an improvement in fundamentals will be required to propel equity markets meaningfully higher over the coming quarters.

Looking back on 2012, equity markets had a strong year, although there were periods of volatility. Early in the year, optimism for improved global growth prevailed. During the early summer, equity markets retreated as European macroeconomic concerns once again resurfaced. In the fall, equity markets reached new highs for the year as the prospects for increased government stimulus became a reality. Although economic growth fell short of our expectations, the generous liquidity provided by the central banks was enough to offset any economic weakness.

For the year, the S&P 500 Index gained 16.0% on a total return basis (including dividends). From a global perspective, the return for the S&P 500 was in line with that of the broader MSCI World Index. The German DAX and French CAC rebounded following a difficult 2011 and were two of the best-performing markets, gaining 32% and 23%, respectively. The Chinese Shanghai index again lagged, gaining just 5% for the year as concerns regarding slowing growth weighed on the market.

The Impact of the Fiscal Cliff

Although the total impact of going over the Fiscal Cliff was unknown, the Congressional Budget Office (CBO) estimated that U.S. economic growth would have fallen to just 0.5% in 2013 versus 2.0% GDP growth in 2012. However, the reality is that the Fiscal Cliff already had an economic impact well before the year-end deadline.

Business leaders indicated that they have been delaying hiring as well as deferring capital spending projects until they can budget and plan accordingly. From the consumer perspective (which accounts for 65%

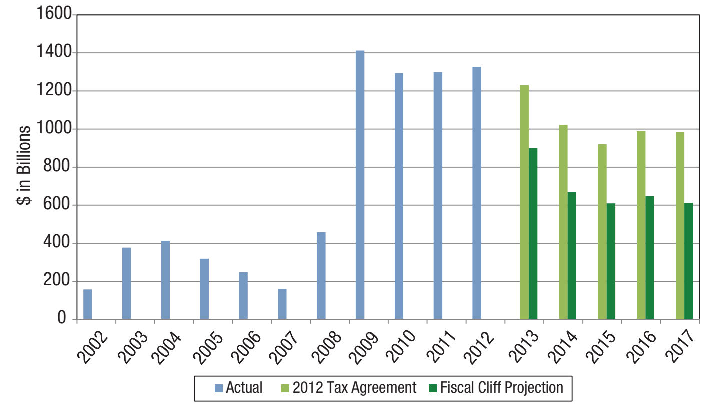
Table 1: Notable Tax Law Changes under the 2010 Affordable Care Act and the American Taxpayer Relief Act of 2012

	2012	2013
Top Income Tax Rate[1]	35%	41%[2]
Estate Tax Rate	35%	40%[3]
Capital Gains / Dividend Tax Rate	15%	23.8%[4]
Payroll Tax Rate	10.4%	12.4%
Obamacare Payroll Tax Surcharge	—	0.9%[5]

Notes: 1. Above $400,000 for single, and $450,000 for joint filers; 2. Includes effect of phase-out of various deductions; 3. Exemption of $5 million; 4. Includes 3.8% Obamacare investment income surtax on income exceeding $400,000 for single, and $450,000 for joint filers; 5. Income above $200,000 for single, and $250,000 for joint filers.

Source: U.S. Senate

Figure 1: U.S. Annual Federal Deficit (2002–2017E)



Source: Congressional Budget Office

of GDP), confidence indicators were weaker than expected in November as fear of going over the cliff increased and the top-earning consumers grappled with the prospect of higher taxes. It is interesting to note that the top 5% of income earners account for over 37% of total consumer spending. Inevitably, higher tax rates on this segment of the population will have an impact on economic growth.

While Congress and the President ultimately reached an agreement to avoid the Fiscal Cliff, mainly through increased revenues (taxation), as indicated in Table 1, the debate in Washington is far from over. The U.S. will again reach its debt ceiling limit in February, generating another round of fiscal debate in Congress.

Despite all the current political theater, the reality is that the leaders in Washington are only trying to reduce the size of the annual budget deficit rather than working towards balancing the budget. Given the outcome of the fiscal agreement, it appears unlikely that the national deficit will return to levels we experienced just five years ago. In fact, the CBO projects, as indicated in Figure 1, that under the 2012 tax agreement, the annual government budget deficit would decline to just $983 billion by 2017, still more than five times higher than the annual deficit in 2007.

Outlook for 2013

As we enter 2013, we believe that an acceleration in economic activity will be required to support further near-term equity market appreciation. We think the incremental benefit of a low interest rate environment will be more subdued going forward and that earnings growth will need to come from increased economic activity rather than further changes in a company's capital structure.

Governments around the world may attempt to strengthen their respective balance sheets next year, through a combination of revenue (tax) increases and spending reductions, negatively impacting global growth. Fiscal policy uncertainty is also likely to negatively impact business, as well as consumer spending, particularly in the first half of the year. We expect the overall economic environment to remain muted throughout the year.

On a longer-term basis, we are more optimistic and think the outlook for equities is positive. The market's forward earnings multiple is still below historical levels. Companies are sitting on record cash balances and have strengthened their balance sheets over the past several years, and many dividend yields continue to exceed corresponding bond yields.

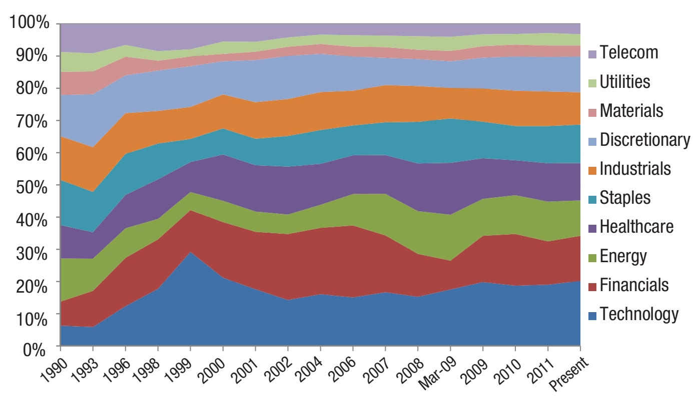
Interest rates should also remain near historic lows, as the Federal Reserve has stated that its primary goal is promoting economic activity in order to stimulate job creation. The Federal Reserve recently quantified its unemployment target, stating that it would seek to keep interest rates low until the unemployment rate reaches 6.5%, which is not expected to occur until 2015. At the same time, inflation (as measured by the CPI) could trend higher as the Federal Reserve has increased its inflation tolerance levels.

The bright spot in 2012 was clearly the rebound in the U.S. housing market. We expect further improvement in 2013, as home values have likely bottomed and should begin to rise, while housing starts return to the lower end of historical normal levels. This trend in turn should have a positive impact on consumer confidence, unemployment, discretionary spending, and could add over 0.50% GDP growth.

Focused on Fundamentals

Over the past two decades, we have experienced several boom and bust cycles that have altered the composition of equity markets. During these periods, such as the dot-com boom or the housing bubble, as indicated in Figure 2, the composition of these industries and corresponding weightings of the sectors (technology, financials) exceeded their true value as euphoria entered and ultimately exited the market. Nonetheless, during these periods, our investment approach remained constant, as we focused on the underlying fundamentals of each individual investment and were not swayed by prevailing market dynamics.

Figure 2: Historical Sector Weightings of the S&P 500



Source: BESPOKE Investment Group

We continue to focus on identifying a core group of equity investment opportunities with long-term capital appreciation potential while favoring the preservation of capital. We seek to own equities that offer attractive valuations based on the future growth profile of the company's primary business operations. As long-term investors, we seek to understand how a company will perform over the upcoming three- to five-year business cycle, not just the next quarter. Despite our extended holding period, we are proactive, and we continually monitor our existing positions for any information that may alter our investment thesis.

In terms of new investments, we look for companies that are secular growth leaders in the process of expanding their market share, companies that possess a sustainable competitive advantage that can be increasingly monetized, companies with strong management teams that have demonstrated prudent capital deployment, and companies with strong cash flow generation and solid balance sheets. We also seek to identify companies that may benefit from secular developments. Some of these which we have written about in the past, include the renaissance in American manufacturing and the impact of living in a constantly connected world.

Course of Action

As we head into 2013, we continue to position our portfolios in a somewhat defensive posture, given our cautious near-term view. We have increased our cash balances over the past two quarters, and in aggregate, we remain underweight more cyclical sectors (Industrials, Energy, Materials). However, we have selectively added high-quality names in the Technology and Consumer Discretionary sectors.

Another theme we are investigating is the lasting implications from the substantial cash balances that corporations are currently carrying on their balance sheets. Despite these record levels, merger and acquisition (M&A) activity has been dampened while companies await a decision from Washington in terms of policy changes regarding investments and taxation. Once the next fiscal debate in Washington is concluded, we think well positioned companies will begin to allocate capital to expand existing capacity and increase M&A activity to enhance their overall growth profiles. In addition, we think investors' appetite for dividends will be largely unfazed by higher tax rates and will continue to favor companies that are proactively returning capital to shareholders in the form of increased dividends and share repurchase programs.

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