COMMENTARY 2013 Q4

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During the quarter, equity markets continued to rally, and the S&P 500 Index reached yet another all-time high in December of 1,848. This is now the fourth quarter in a row in which the S&P 500 has set a record. Economic growth has recently accelerated, and many of the investment catalysts we have been looking for have begun to surface. The environment remains reasonably favorable for many investments, but with the Federal Reserve beginning to decrease its quantitative easing program, markets may become more volatile for a period of time.

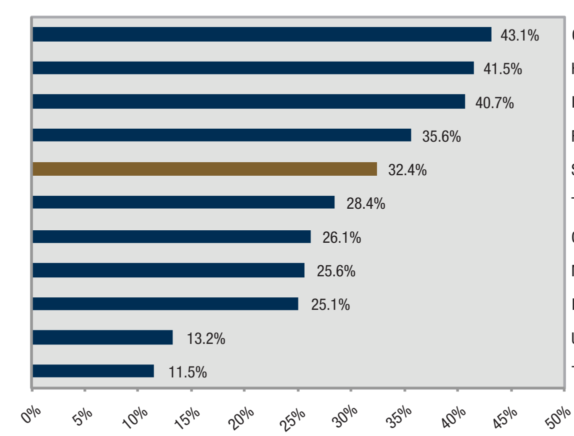
The S&P 500 gained 10.5% for the quarter and was up 32.4% for 2013. From a sector perspective, Industrials and Technology led the way this quarter, while performance for the Telecom and Utilities sectors lagged. For 2013 as a whole (See Figure 1), the Health Care and Consumer Discretionary sectors led the way all year, while the Industrials sector caught up to the leaders in the second half. The slower-growth Utilities and Telecom sectors have continued to trail during this strong rally.

From a global perspective, most European markets performed in line with the U.S. this quarter. For the year, the German DAX (up 31.0%) is the only European market that kept pace with the U.S. As you can see in Figure 2, below, European stocks in total were up 25.2% for the year. The Japanese Nikkei had a strong year when priced in yen (up 59.3%), but due to the managed depreciation of that currency, the Nikkei is up only 30.5% when priced in U.S. dollars. The MSCI Emerging Markets Index had a weak quarter and a very weak year (down 2.6%). More specifically, the Shanghai Composite was down 0.5% for the year, and the Brazilian Bovespa was down 26.8%. Gold also had a tough year, down 28.8%.

Third Time's the Charm (Revisited)

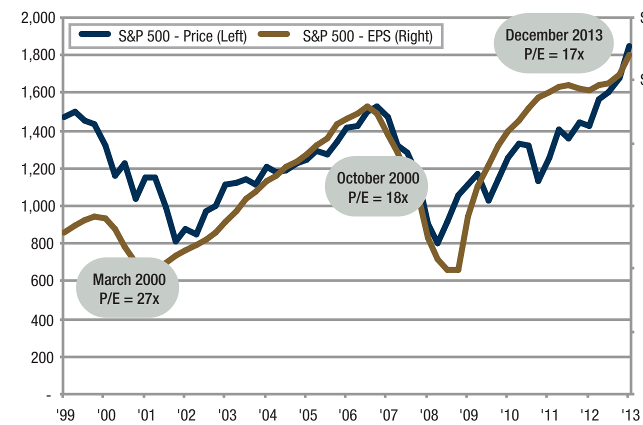
In our first-quarter commentary this year, we highlighted that this was the third time in 13 years that the S&P 500 had traded above the 1,500 level. In the prior two cases, it traded down in future months, leading to bear markets (greater than 20% losses) both times. We noted that the one big difference this time was valuation: S&P 500 companies produce twice as much profit today as they did 13 years ago, but the market was willing to pay only half as much for it.

Figure 1: 2013 Performance by Sector



Source: Bloomberg. Data as of 12/31/2013.

Figure 3: S&P 500 Price and EPS Trends



Source: Standard & Poor's and Bloomberg. Data as of 12/31/2013.

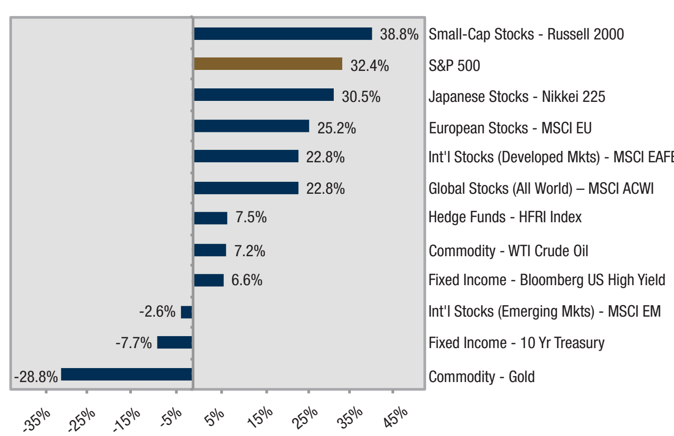
Nonetheless, we acknowledged that a large part of the stock market rally since 2009 had been driven by easy money from the Federal Reserve and that further improvement in fundamentals would be required to propel equity markets meaningfully higher in the coming quarters. We identified a number of catalysts that could drive further improvement: continued improvement in the housing market; a resurgence in U.S. manufacturing; an upturn in capital expenditures; and improved household, corporate, and bank balance sheets finally being put to work. Many of these catalysts have begun to surface.

Although we have seen some improvement in fundamentals over the year, revenue and earnings have not kept up with the rapid appreciation in the stock market (up 32.4%). Earnings for the S&P 500 have grown by 11.4% year-over-year, and revenue has grown at a slower rate. Given this divergence, valuations have risen and are now more in line with their long-term averages.

Outlook for 2014

As we head into 2014, we continue to position portfolios for modest economic growth. We believe that the economy will continue to improve and that this improvement will eventually translate into higher earnings growth for many companies. Economic growth, as defined by Gross

Figure 2: 2013 Performance by Category



Source: Bloomberg. Data as of 12/31/2013. All total returns are in U.S. dollars.

Domestic Product (GDP), was at a 4.1% annual pace in the third quarter, which is the strongest reading since the economy expanded by 4.9% in the fourth quarter of 2011. The most recent measure exceeded consensus expectations of 3.6%.

Accelerating growth in our economy would appear to be the next catalyst for financial markets, helping to offset current concerns and provide long-term investment support. So far in this recovery, economic growth has been inconsistent and well below levels experienced during other post-recession periods. For the last two years, this low-growth environment has resulted in subpar top-line revenue growth for many companies. With profit margins already at record levels, this subpar top-line growth forced many analysts to reduce their earnings estimates as the year progressed.

Many of the catalysts we identified earlier in the year are beginning to take shape, and we look for the industrial part of the economy to improve further. We continue to focus on companies with top-line revenue growth, since we think the incremental benefit of a low interest rate environment will be subdued going forward. We believe labor costs, driven by wage increases and increasing insurance premiums, may begin to pressure margins at certain companies. As we have discussed previously, we seek to invest in companies that have a strong core business that can absorb and pass on input and wage inflation.

Although we expect continued improvement in 2014, we also will not be surprised if market volatility increases from very low levels. The S&P 500 has not experienced a 10% or higher correction since the late summer/fall of 2011, which makes this current rally one of the longest periods in history with no significant correction. The Federal Reserve has been buying $85 billion of mortgage-backed securities and long-term government bonds each month since September 2012. After much anticipation, the Fed announced the beginning of its "tapering" program, which will reduce this number to $75 billion a month in January 2014. This reduction may be followed by additional measured steps at future meetings. In addition, Janet Yellen will become the Federal Reserve chairman in early 2014. With the market facing a change in Fed policy, to be implemented by a new chairman sometime in the intermediate future, we may see markets become more volatile for a period of time.

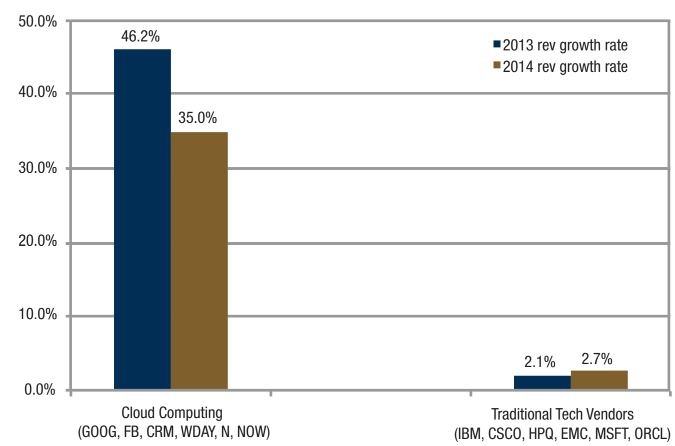
Cloud Computing

In previous commentaries, we have written about some investment themes. Areas we think could offer compelling long-term growth opportunities include the renaissance of the American manufacturing industry, the downstream implications of record cash balances, and the impact of living in a constantly connected world. As an expansion of this last theme, we believe cloud computing is a trend that is here to stay.

Cloud computing, at a basic level, means accessing data and services provided by a remote server that is owned and maintained by another party. The average person who uses a Web-based email service like Gmail, or social networking sites like Facebook and LinkedIn, is already a user of cloud computing. Corporations are also increasingly using cloud computing for its many benefits. By going to third-party providers for computing resources, a company can reduce its operating and capital costs, since it no longer has to purchase the same number of servers and systems or maintain them internally. Since the service providers handle everything, there is no need to maintain a costly staff to support a complex infrastructure. In a sense, computing becomes a utility, and you pay only for what you need. Another added benefit is scalability: as your business grows or changes, you can add additional computing resources quickly and efficiently.

This trend has already had significant implications for traditional technology vendors. A recent research report from Barclays asserts that a dollar spent on cloud infrastructure in this new computing model results in several dollars being taken out of other technology end markets due to the efficiencies gained by sharing pooled resources. The impact has affected traditional hardware vendors, who have been reporting little or no revenue growth. We have identified companies gaining market share, and we believe this shift is truly just the beginning of a long secular trend in computing. As shown in Figure 4, traditional hardware vendors (such as IBM, Cisco, Hewlett-Packard, EMC, Microsoft, and Oracle) are expected to grow revenue at a very low rate. Companies that are beneficiaries of cloud computing (such as Google, Facebook, Salesforce.com, Workday, NetSuite, and ServiceNow) are expected to grow revenues at least 10 times faster.

Figure 4: Beneficiaries of Cloud Computing



Source: Bloomberg. Data as of 12/31/2013.

Course of Action

We continue to position portfolios for modest economic growth. We believe the recent acceleration in economic growth will eventually translate into higher earnings growth for many companies, but top-line revenue growth will be key. During the second half of the year, we increased exposure to the economically sensitive Industrials and Energy sectors. We have also increased exposure in the Technology sector. We continue to have significant exposure to Consumer Discretionary companies, many of which have seen strong performance this year as consumer confidence improved from low levels.

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