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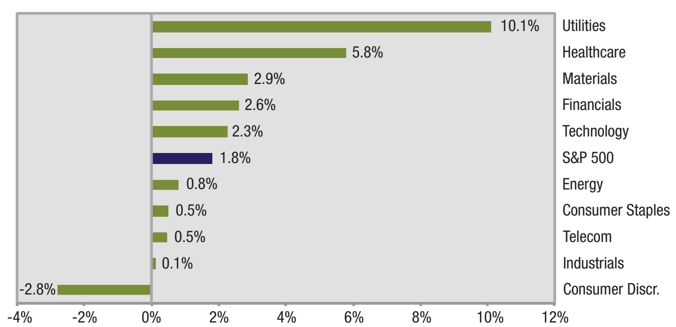
During the quarter, equity markets experienced some volatility, although the S&P 500 Index reached yet another all-time high in March of 1,878. After showing promising strength late last year, the economy seems to have hit another soft patch. Many of the investment catalysts we had been looking for began to surface in the second half of 2013 and we believe this strength will reemerge when this harsh winter ends. We continue to position portfolios for modest economic growth, although we expect higher volatility as the year progresses.

The S&P 500 gained 1.8% for the quarter. From a sector perspective, Utilities led the market higher and Healthcare continued to be a strong performer. Consumer Discretionary was the leader last year, but its performance has lagged so far this year. Many consumer companies have had disappointing results due to the weather and other issues. Performance for the Industrials has also lagged.

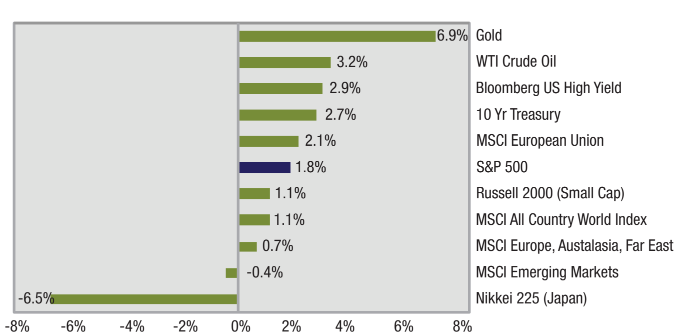
Figure 1: 2014 Performance by Sector



Source: Bloomberg. Data as of 03/31/2014.

From a global perspective, most European markets performed in-line with the S&P 500 this quarter. After a strong 2013, the Japanese Nikkei had a difficult start and is down 6.5% for the year. Many emerging markets had a tough 2013 and weakness in these markets has continued. The Shanghai Composite was down 3.9% for the quarter and the Brazilian Bovespa declined by 2.1%. Gold rebounded 6.9% during the quarter, but remains 32% below its 2011 high point.

Figure 2: 2014 Performance by Category



Source: Bloomberg. Data as of 03/31/2014. All returns in U.S. dollars.

Waiting for the Thaw

Many of the investment catalysts we identified early in 2013 were beginning to develop prior to the winter. These include: continued improvement in the housing market; a resurgence in U.S. manufacturing; improved household, corporate and bank balance sheets finally being put to work; and an upturn in capital expenditures.

Unfortunately, after showing promising strength late last year, the economy seems to have hit another soft patch. The harsh winter weather has been a common excuse, but we will find out when the snow melts whether it was the main factor.

Looking ahead, the economy, as defined by Gross Domestic Product (GDP), is expected to grow at a real rate (i.e. excluding inflation) of 2.7% in 2014. Although this figure is down from earlier forecasts of 3% or greater, it still compares favorably to the 1.9% growth rate experienced in 2013. Importantly, this growth is now weighted toward the second half of the year, and we will be watching closely for signs of acceleration. Two possible signs are the February increase in retail sales, the first time in three months, and the jump in the Institute of Supply Management (ISM) Manufacturing Index from 51.3 in January to 53.2 in February.

Economic (GDP) growth in the fourth quarter of 2013 was revised down from previous estimates, but one component that was revised up was business capital expenditures. Even with the recent economic weakness, capacity utilization has remained constant, and we believe we will continue to see an upturn in capital expenditures due to factory expansion and replacement of aging equipment.

The banking industry has also offered some encouraging data points. The balance sheets for most large U.S. banks are in excellent shape. After several years of weak or no loan growth, commercial and industrial loans grew at an annualized rate of 28.3% in February and commercial real estate loans grew at an annualized rate of 9.5%. Some of this loan growth may be due to borrowers locking in rates, but some of this growth will likely translate into higher capital expenditures and increased employment.

We continue to believe housing and manufacturing will strengthen as the year progresses. The pace of homebuilding remains well below the historical trend line, which leaves plenty of room for improvement.

Speed Bumps Ahead

We continue to think market volatility will increase from low levels. Over the last 30 years the S&P 500 has had a 14% correction once a year on average. The S&P 500 has not experienced a 10% or higher correction since the late summer/fall of 2011, which makes this one of the longest periods in history with no significant correction. We highlight below some of the possible sources of volatility.

In general, equity market valuations are now in line with or slightly above their long-term averages. In each of the last two years, this low-growth economic environment has forced many equity analysts to reduce their optimistic estimates as the year progressed. Many investors were willing to look past this weakness and continue to purchase equities given attractive valuations. If the economy disappoints in the second half of this year, the valuation buffer will no longer exist. It is also worth noting that this is now the fourth longest bull market in history – up 176% from the March 2009 low. Not surprisingly, we are seeing some signs of frothiness. Some investors note that valuation metrics for certain technology and biotech companies rival the bubble metrics of the late 1990s. Others point to the active initial public offering (IPO) market. In this low-growth environment, we have observed that investors are willing to pay a premium for companies that have growth, and in some cases, these premiums appear aggressive.

The Federal Reserve is another source of possible volatility. The Fed had been buying $85 billion of mortgage backed securities and long-term government bonds each month since September 2012. With the economy looking better, the Fed began its "tapering" program in January and has reduced its monthly purchases by $10 billion in each of its past three meetings. The Fed is on track to end the quantitative easing program (known as QE3) by the end of 2014. If the Fed decides either to accelerate this tapering or to delay it, the market could experience a period of volatility. For now, the market seems to be comfortable with the timetable.

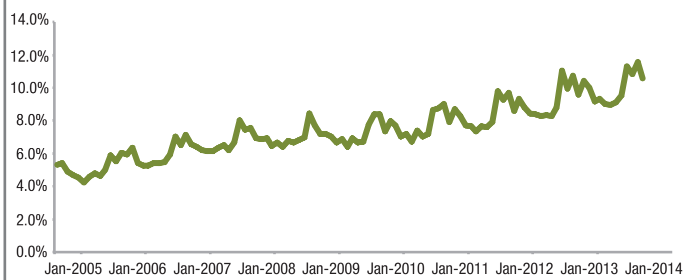
Then there are the "history certainly rhymes" items. This year is a nonpresidential election year. Over the last 50 years, the S&P 500 has seen a correction greater than 10% in 10 of the last 13 nonpresidential election years (i.e. 75% of the time.) History may not repeat itself, but given the current environment in Washington, D.C., it is not hard to imagine a lot of finger pointing as we get closer to Election Day. Such an atmosphere could weigh on consumer and investor sentiment.

At its lowest point during the first quarter of 2014, the S&P 500 was down 5.7% for the year. Concerns about Turkey and the emerging markets in general drove this period of weakness, but it was short-lived and fairly orderly. With the slowdown in China, ongoing tension in the Middle East, and the Russia-Ukraine situation, concerns about emerging markets could certainly reappear to drive another round of volatility.

The Explosion of E-Commerce

Among long-term themes and trends with significant investment implications, the rapid growth in e-commerce is certainly the most important trend in the consumer space today. E-commerce sales have been growing at a significantly faster pace than overall retail sales for several years. E-commerce sales now represent more than 10% of total retail sales and this figure is expected to rise into the mid-teens in coming years as mobile phone transactions proliferate (Figure 3).

Figure 3: E-Commerce as a Percent of Total Retail Sales



Source: ComScore and U.S. Census Bureau.

At the other end of the spectrum lie shopping malls, which saw growth peak in the late 1980s and have faced limited new construction since 2006. This change is evidenced across the country by declining foot traffic and high vacancy levels within shopping malls. Large anchor tenants like Sears and J.C. Penney are closing stores, leaving mall owners scrambling to find replacement occupants. In fact, e-commerce sales ($263 billion in 2013) have surpassed department store sales ($178 billion in 2013), according to the latest U.S. Department of Commerce data. The growth in the stores selling brand names at discount prices (off-price retail) has also played a role in the disruption of department stores: off-price retail accounted for 11% of U.S. apparel sales in 2013, up from 6% in 1999.

Nevertheless, growth opportunities still exist. While some retail segments have been under pressure, others have stepped in to fill the vacancies. According to FactSet Research Systems, nearly 10,500 new retail stores opened in 2013, compared with about 2,600 closures. The warehouse club channel, discount/dollar stores, and off-price retailers represent the majority of new store openings. Our focus has been on companies that have the ability to meaningfully grow their store base, as well as those succeeding in extracting more value from customers via more visits, higher average purchase transactions, or (ideally) a combination of the two.

Course of Action

We continue to position portfolios for modest economic growth. Many of the investment catalysts we had been looking for began to surface late last year and we believe this strength will reemerge when this harsh winter ends. At the same time, we acknowledge that volatility is likely to increase from low levels and we have spent a considerable amount of time in our investment meetings discussing this possibility and examining our exposure in portfolios. Volatility is part of investing in equities and a correction could be helpful in restoring some discipline in the market. If we do experience a correction, we are likely to view it as an opportunity to position portfolios for continued growth.

During the quarter, we reduced our exposure to Consumer Discretionary companies, although we continue to have significant exposure in this sector, which has been one of the leaders in this bull market. We have continued to increase exposure to the Technology sector.

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