2013 Fourth Quarter ReView of the Markets

Index	4th Qtr Return	2013 Return
MSCI World	7.4%	23.4%
S&P 500	10.5%	32.4%
Barclay’s Bond Index	-0.1%	-2.0%
Consumer Price Index	0.3%	1.5%

Investment Commentary

Equity markets turned in a remarkably strong year in 2013. For the year the MSCI World Index returned 23.4 % while domestically, the S&P 500 was up 32.4%. To put that in context, annual returns rank 12th highest out of 64 years since 1950. The S&P 500 was not down on a year-to-date basis on any day of the year. Also, the daily volatility was extremely low with the market suffering only one correction of at least 5% which was the lowest volatility over the last 20 years. Foreign markets underperformed the U.S. market where emerging markets exhibited the worst return with a 5% loss. Doubtful market views on economic growth did not improve over the year, but the downside fears that were present early in the year – European implosions, Chinese hard landing and U.S. fiscal crisis – did not materialize. The stock markets were also boosted by an accommodative monetary policy and economic improvement especially in the U.S. Finally, one aspect of the strong equity performance that is often overlooked is that of supply and demand. Non-equity asset classes such as fixed income have provided poor to negative returns in the recent past and are generally expected to preform similarly going forward. Thus, investors including large institutions are allocating to equities as the most favorable of the less than perfect options. This increase in demand for equities increased their valuations.

In the fixed income area, the threat of rising interest rates, which had been lurking in the ether for years, finally materialized in 2013 pushing bond prices lower. This was caused by the continued economic recovery and by the Federal Reserve coming off of its easy money strategy (known as “quantitative easing”). As a result, the bond market (as measured by the Barclay’s Aggregate Index) had its worst loss since 1998 and was down for only the third time in 28 years.

Economic Outlook

U.S. and global economic fundamentals continued to gradually improve over the past year across a number of dimensions. For 2014 we expect continued slow economic growth led by strength in housing and a pick-up in business capital spending (which correlates well with job growth). The drag on the economy due to last year's federal budget cuts should be more muted going forward while political and Federal Reserve uncertainty will fade this year thereby aiding economic growth. Overall we expect a growth rate of 2% with a slight increase in inflation. If the unemployment rate were to decline more rapidly than expected alongside stronger than expected economic growth, it could have negative implications for inflation and interest rates which would have negative implications for both the stock and bond markets.

Investment Strategy

As a reminder, no one really knows how investors will value securities 12 months hence. For example, last year's forecasts from Wall Street's most respected firms were for an average gain of 8%, and we know how incorrect that was (albeit for the better). However, last year's performance was not all that *shocking* to us, albeit a pleasant *surprise*, since some of the most respected investment strategists we follow were calling for "***multiple expansion***" of the S&P 500 during this part of the economic cycle and recovery. Having said this, we *do* know that economic growth drives corporate profits which, in turn, impact stock prices in the long run. We believe that corporate profits will improve in 2014 in line with economic growth and this *should* promote stock market growth. However, a growing economy does not always predict positive stock market growth. Indeed, momentum (through multiple expansion) drove most of 2013's total return. If price-earnings multiples enjoy no expansion, or even a minor contraction, it could have an adverse effect on equity prices, even assuming positive economic growth in 2014.

We continue to emphasize U.S. markets as the U.S. has seen a more broad-based economic improvement than the rest of the world in general. For our bond exposure, we are keeping very conservative interest rate exposure as we believe that interest rates will continue to exhibit an upward bias due to economic growth and a tapering of the Fed's easy monetary policy. By keeping bond maturities short, our clients should be less exposed to decreasing bond prices as rates rise. Although not yet overly troubling, valuations are not as compelling as in recent years but remain far below where they typically top out at the end of bull markets. Finally, while there have been fundamental improvements in the macro environment over the past year, many big-picture risks such a global debt and subpar growth remain. We are not confident in predicting that any of these risks will actually play out, but if they do the negative consequences for financial markets and asset prices would likely be meaningful. Although there doesn't appear to be any near-term catalysts, we believe it remains prudent to manage portfolios with these risks and their potential market impacts firmly in mind.

At a high level, our goal is to identify the appropriate asset allocation and individual investments that will create consistent long-term returns commensurate with our clients' individual risk profiles. We remain confident in the philosophy and process that underpins our investment management process.