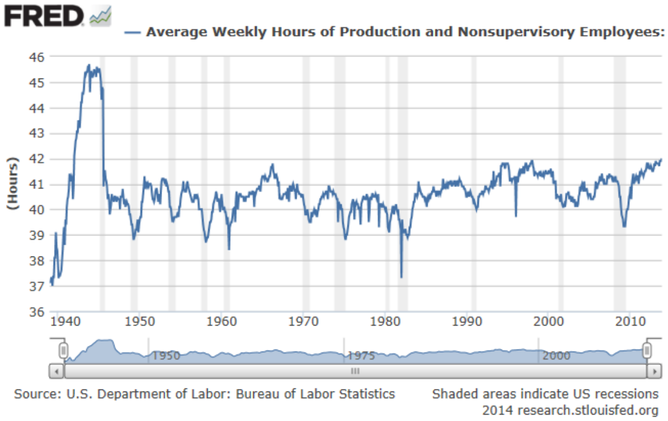
Strategy Newsletter
1st Quarter 2014

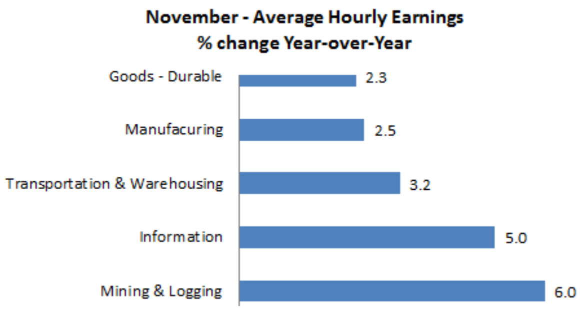
- U.S. economy glides along while wage pressures building in certain areas.
- Emerging markets equities underperformed dramatically, while Europe, Japan, and the U.S. had stellar returns.
- Interest rates were a headwind last year, but our managers see pockets of value.
- Today's environment favors long/short equity within alternative strategies.

Big Picture

Finally the worries about the US economy seem behind us. Last year around this time the talk was of sequester and debt ceilings. Today the economy is humming along quite nicely. Manufacturing employees, for example, are working more hours than any time since the war effort in the 1940s.



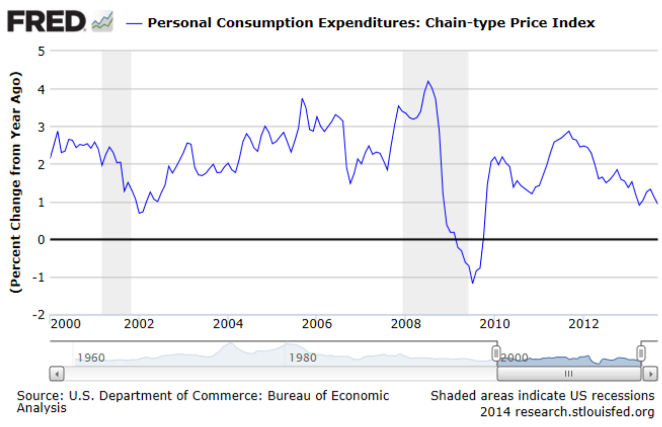
The economic strength is beginning to put wage pressure on certain industries.



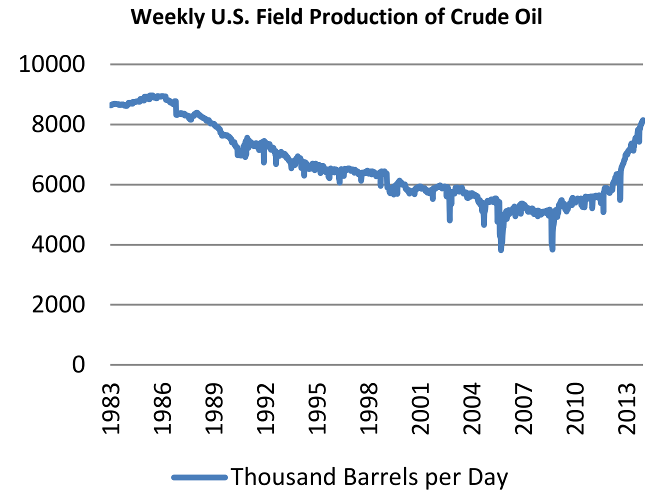
Source: Bureau of Labor Statistics

Those companies unable to pass along real wage increases to the end consumer will have difficulty maintaining the current level of profit margins. Since much has been made of record high profit margins in the United States contributing to equity market gains, this could provide a headwind to margins as the cycle matures.

The Federal Reserve is not concerned about inflation at this point as its key measure, the Personal Consumption Expenditures core index, is well below its 2% target. Should the strength of industries with wage pressure continue though, this data could rise quickly.



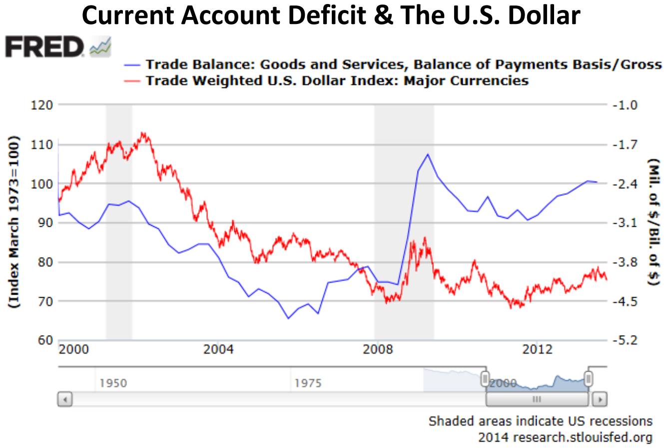
One of the best stories of this past year is the energy industry boom. Production of oil per day is now at the highest levels in 25 years.



Source: Department of Energy

This in turn is helping the current account deficit. A benefit of the improving current account deficit is an increase in value of the U.S. dollar against foreign currencies, even with the loose monetary policy.

Current Account Deficit & The U.S. Dollar



Should the European economies continue to rebound along with less bad news from emerging markets, the deficit could turn down over the next 12 months, along with the U.S. dollar. The trend is strength in the U.S. economy.

Equity

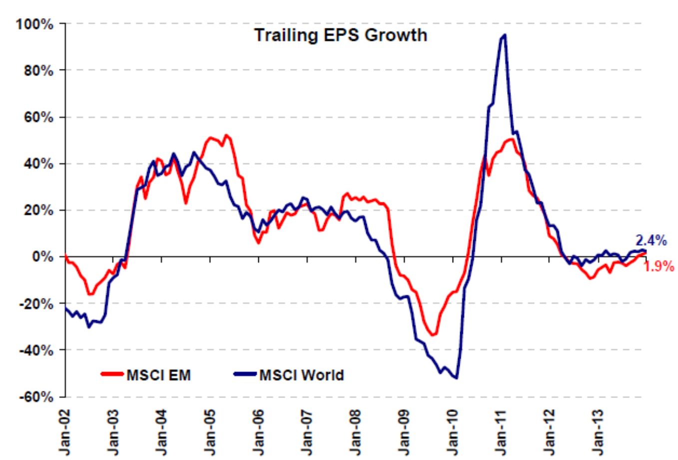
U.S. stocks outperformed all regions for the quarter and 2013. Over the past year, the broad indices were up 32% in the US, 27% in Japan, 26% in Europe, and a drop of 2% for the broader Emerging Markets.

US Equity	**4Q 2013**
Large Cap Stock	
Dow Jones Industrial Average	10.22%
S&P 500	10.51%
Small & Mid Cap Stock	
Russell Mid Cap	8.39%
Russell 2000	8.72%
Style Indices	
Russell 3000 Value	9.95%
Russell 3000 Growth	10.25%
International Equity	**4Q 2013**
MSCI EAFE	5.75%
MSCI EAFE Value	6.31%
MSCI EAFE Growth	5.17%
MSCI Europe	7.92%
MSCI Japan	2.31%
MSCI Emerging Markets	1.86%

Emerging market stocks were without doubt the dogs of the year, putting up negative performance as a group while the rest of the world produced stellar results.

It is now fashionable to discuss the negativity surrounding emerging markets, and we agree that much of it is quite deserved. The economies of the emerging markets took on too much debt over the previous cycle and now are suffering from current account deficits, while the US is actually improving its trade deficit, something few considered years ago.

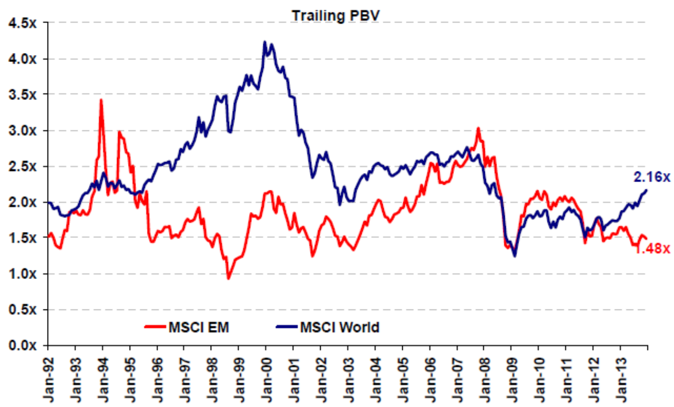
The chart below shows the last several years emerging markets had negative Earnings Per Share growth. Interestingly, this may have troughed



Source: Morgan Stanley Research

The currencies of many countries like India and Brazil are taking the brunt of the pain. In addition, many countries have inverted yield curves (the long bonds yields less than shorter duration bonds), which means slowing growth and/or recession. And with negative sentiment and poor macro outlook comes cheaper prices.

But as was seen in the U.S. in 2008-09 and Europe in 2011-12, recessions brings about attractive values and a time to consider increase allocation, even though these values can stay cheap for some time. To start the year, to purchase $1 of book value it would cost $1.48 in emerging markets. However, it is 46% more expensive to buy a share of book value in the rest of the world.



Source: Morgan Stanley Research

U.S. small caps have rich valuations and we recommend avoiding long exposure to this capitalization. U.S. large caps are more reasonably priced but still in the top quartile of valuation historically, thus making expected future returns below average. This is evident in cyclically adjusted earnings measures, replacement cost, and the above average allocation to U.S. stocks for investors. For these reasons, we recommend a modest underweight to US equities relative to strategic targets, recognizing valuations tend to far overshoot rich levels, but knowing we do not wish to wait for a 'greater fool' to come along and pay a higher price.

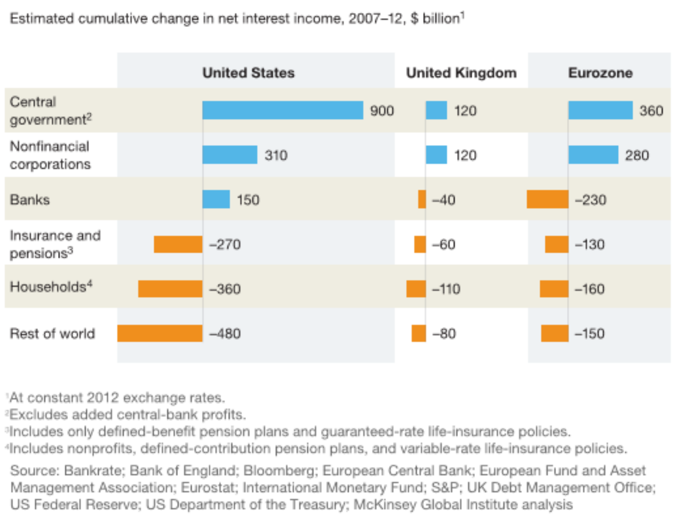
We hold an overweight to international and emerging market equities, really just rotating the profits from our outperforming U.S. stocks into the areas that underperformed over the past two years. We have a small underweight to U.S. stocks across the Aurum Asset Allocation Frameworks for the first time since 2009, as values overseas look relatively more attractive from a risk and return perspective.

Fixed Income

Corporate bonds with the highest credit risk performed best during the quarter and for the year. Municipals held steady even with the increase in Treasury yields.

Fixed Income	4Q 2013
Barclays U.S. Aggregate Bond	-0.14%
Barclays Corporate Inv. Grade	1.11%
Barclays High Yield Bond	3.58%
Barclays Global ex. U.S. Tres.	-1.39%
Barclays Municipal Bond	0.32%

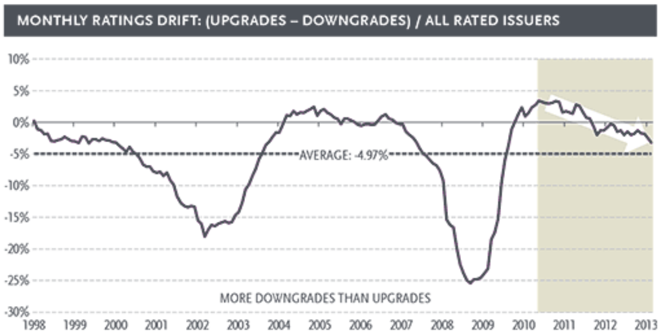
Yields rose during the quarter with the 10-year Treasury note going from 2.62% and finishing 2013 at 3.02%, and up from 1.76% at the end of 2012. The low absolute level of interest rates hurt investors while helping debtors the last few years. A great chart from McKinsey highlights the amount saved in interest by governments and corporations from 2007 to 2012.



Source: McKinsey & Co.

And since one person's debt is another person's asset, the lower interest expense resulted in lower income for households, pensions, and insurance companies. Although the interest rate rise over 2013 resulted in losses to some fixed income strategies, an increase in rates is welcome for future interest income.

A new chart we came across highlights the historical ratings upgrades minus downgrades for the corporate credit space. As can be seen, the latest numbers show deterioration in the credit quality as we enter the middle stage of this credit cycle.

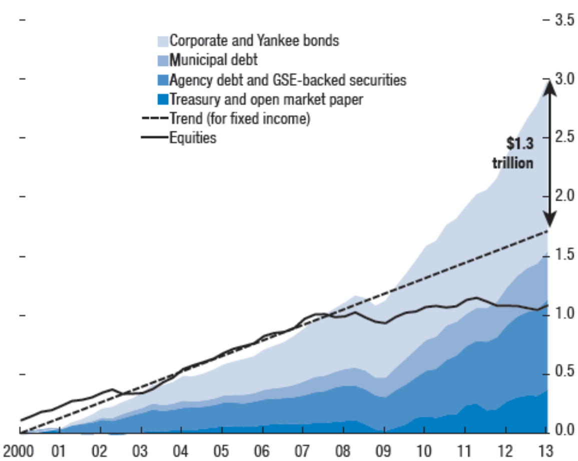


Source: Moody's, Credit Suisse, Guggenheim Investments. Data as of 12/1/13.

We highlighted that many investment grade and high yield issues reached their lowest levels ever in 2013, making the asset class less attractive to us and a reason behind our lighter exposure going into the New Year. The credit cycle is in the 54th month according to Guggenheim and spreads on *average* do not rise until the 80th month. If this is typical, then credit should continue to do well.

One item to be weary of though is the above average level of exposure investors have to bonds.

Figure 1.9. U.S. Mutual Fund Cumulative Flows
(Trillions of U.S. dollars)



Sources: Federal Reserve; and IMF staff estimates.
Note: GSE = government-sponsored enterprise.

The data shows that currently investors have $1.3 trillion more in bonds than the trend would indicate. The increase occurred following the equity drawdown of 2008 and at the lowest yields in decades.

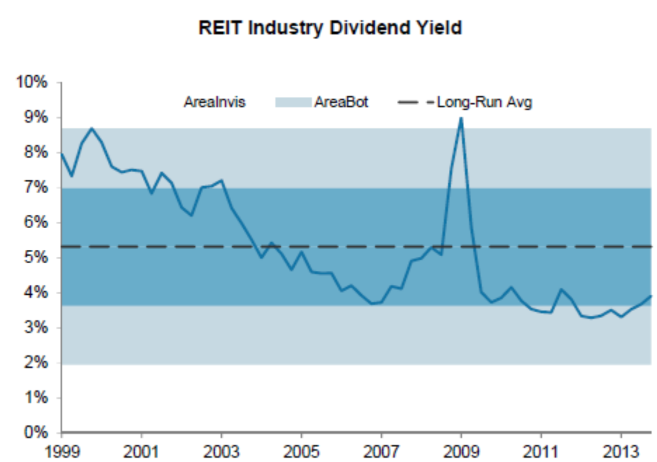
The investment committee decreased allocations to credit related strategies by 2-6% across the Frameworks. The main sectors decreased were high yield corporates and emerging markets debt. We are excited about the managers we own currently and look forward to adding to exposure from our current underweight position.

Alternative Investments

Hedge fund strategies again were the top performing alternative while REITs and TIPs both turned in results in the red. We still see the negative performance for the latter two asset classes as a product of the unwind by investors liquidating assets from the 'yield chase' the last few years, when any assets that allegedly offered inflation protection while paying a yield were bid up by investors. Also, given that REITs and TIPS at times display high interest rate sensitivity, the rise Treasury yields over the last eight months coinciding with the negative returns is unsurprising.

Alternative Assets	4Q 2013
Hedge Fund of Funds	3.48%
Wilshire REIT	-0.83%
Barclays TIPS	-1.47%

Today, REITs offer a 4% dividend yield, which is not terrible on a relative basis to other asset classes.



Source: Morgan Stanley Research

However, it is still near the lowest levels over the past 15 years and about one standard deviation rich. The best times to buy REITs were 1999-2003 and late 2008-09. If prices fell and yields rose, we would gladly look to add exposure, but not for the unattractive value being offered today. (There are plenty of other measures like Next 12 month FFO multiples and implied cap rates that also show rich valuation, lest readers think we only look at dividend yields).

In the past we showed the stock specific risk climbing to levels seen during 2003 – 2007, a time when hedge funds produced significant alpha (positive alpha indicates outperformance on a risk-adjusted basis against a benchmark). Below we see the last few years were a time when hedge funds produced negative alpha against the S&P 500, but it seems to have turned in 2013. Indeed, it was the first calendar year since 2010 that produced positive alpha, a trend we expect to continue as markets focus on company specific fundamentals versus trading macro news.

Portfolios have a 0% direct exposure to REITs and TIPS and an overweight to Diversified Alternative Strategies. This includes long/short equity, event driven, and trend followers. We added two new long/short equity strategies over the past quarter to take advantage of the dichotomy between high quality (on the long side) and low quality (on the short side) equities along with company specific catalysts our managers exploit.

Conclusion

The U.S. economy seems to be gathering strength while Europe and Japan seemed to have turned the corner. This could well turn into a positive for the struggling emerging markets at some point, and attractive valuations make them an interesting place for long-term capital to consider during its doldrums. Fixed income dealt with the rising of yields in 2013 making investors with above average allocation wonder if they are deployed correctly. We believe equity long/short strategies are set to improve upon the dismal performance since 2009.

Aurum Asset Allocation Frameworks

	Conservative Income		Conservative Balanced		Moderate Balanced		Aggressive Balanced		Aggressive Growth	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	20%	35%	36%	50%	51%	70%	73%
U.S. Equity	0%	0%	12%	10%	20%	18%	30%	27%	42%	40%
Int'l - Develop. Markets	0%	0%	6%	7%	12%	13%	16%	17%	21%	23%
Int'l - Emerg. Markets	0%	0%	2%	3%	3%	5%	4%	7%	7%	10%
Fixed Income	65%	50%	45%	33%	30%	22%	17%	10%	10%	7%
U.S. Fixed Income	56%	51%	39%	30%	26%	20%	15%	10%	7%	8%
Global Fixed Income	9%	0%	6%	0%	4%	0%	2%	0%	3%	0%
Alternative Invest.	25%	30%	28%	29%	30%	29%	30%	29%	19%	17%
Diversified Strategies	19%	30%	22%	29%	24%	29%	24%	29%	15%	17%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	20%	7%	18%	5%	14%	3%	11%	1%	3%
U.S. Dollar	10%	20%	7%	18%	5%	14%	3%	11%	1%	3%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.