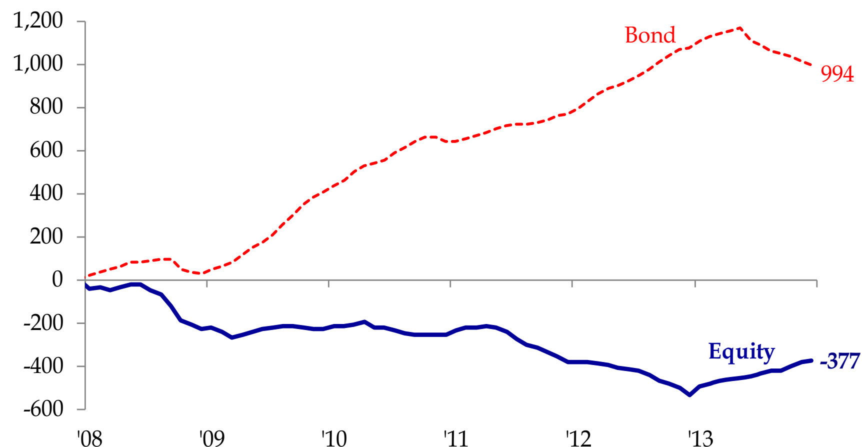
2014 Market Outlook

The Great Rotation

Between 2008 and 2013, nervous investors stashed nearly $1 trillion in bond funds and money market funds, a big portion of which came out of equity funds. Going into 2013, forecasters suggested that investors were under-allocated to equities and called for a Great Rotation out of bonds into stocks, as ultra-low interest rates forced investors to seek higher returns elsewhere.

Chart 1. Household Ownership of Equities

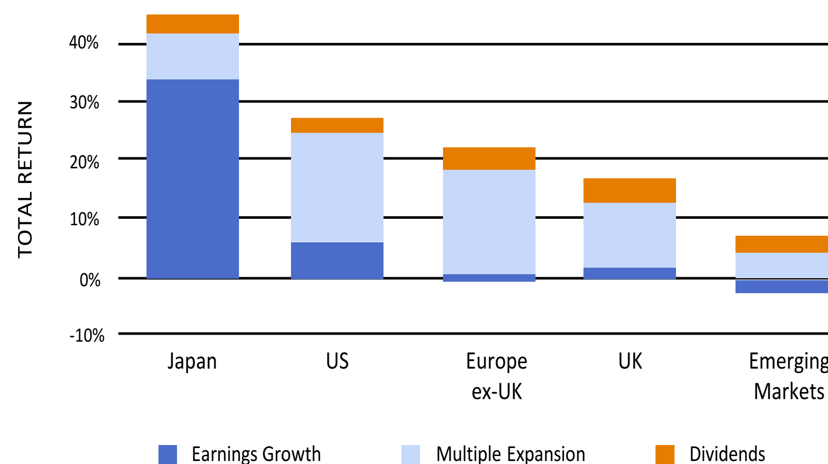


Source: Edgewood Management LLC, 4Q 2013 Update

As it happened, weak economic growth, uncertainty over tapering, market gyrations from the mid-year taper tantrum, and the third quarter government shutdown all played a role in keeping investors cautious in 2013. We did not see significant outflows from bonds into equities until the late fourth quarter, when investors finally convinced themselves that the rising stock markets reflected a real economic turnaround. As investors see further evidence of economic growth and fears of another global market crisis recede, we anticipate continuing outflows from bond funds and money market funds in 2014.

In reviewing the 2013 returns, we see that the Great Rotation became a Great Rerating, with multiple expansion a key factor in boosting stock returns in the key markets:

Chart 2. The Great Rerating - 2013 Equity Returns by Source



Source: 2014 Investment Outlook, BlackRock Investment Institute

2013 Asset Class Returns: Stocks Strong, Bonds Weak

Global Equities

Among US equity markets, the S&P 500 Index rose 32.4%, its strongest annual gain since 1997. Smaller stocks did even better, with the Russell 2000 Index up 38.8% for the year. Internationally, strong developed market returns offset weak performance by emerging markets. The MSCI EAFE Index rose 23.6%, compared to -2.4% for the MSCI Emerging Markets Index. Frontier markets also posted strong returns. The MSCI Frontier Markets Index gained 21.4% and confirmed our view that frontier markets present an opportunity distinct from mainstream emerging markets.

Global Bonds

Many categories of bonds suffered in 2013 as rates rose, with a greater impact on lower yielding or longer dated bonds. Treasurys (Barclays US Government 5-7 Year, -1.3%), suffered losses while municipal bonds (Barclays Municipal 5 Year, +0.15%) and corporate bonds (Barclays Intermediate Investment Grade, -0.11%) barely broke even.

In our 2013 mid-year outlook, we outlined the steps we were taking to buffer portfolios from rising rates. Among these, favoring high yield and floating rate bonds over Treasurys and investment-grade municipal and corporate bonds, worked out well. These were among the few categories that generated positive returns in 2013, with the Barclays High Yield Index up 8.5% for the year.

Other steps we recommended, such as diversifying into international bonds, did not pay off in 2013. The Citi World Government Bond Index lost 4.5% and the Morningstar Emerging Markets Index fell 4.4%. We believe these allocations still make sense as the bond market risks we highlighted last year are likely to resurface this year as markets adjust to rate and policy changes.

Cash

Although cash provided a near-zero return in 2013, we continue to view it as a valuable component of portfolios. It can be a buffer in volatile markets, provide liquidity when credit or other funding is unavailable, and fund unexpected liquidity needs or opportunities.

Real Return

Real return assets were among the worst performing asset classes in 2013. For each segment, we will discuss the reasons below.

Commodities: The Dow Jones UBS Commodities Index fell 9.6% in 2013. A combination of weak global demand and a supply glut for certain metals and agricultural commodities caused prices to fall for many popular commodities:

Chart 3. 2013 Commodity Returns

Commodity	Return
Natural Gas	26.23%
Cocoa	21.15%
Orange Juice	17.58%
Cotton	12.64%
Crude Oil (WTI)	7.19%
Crude Oil (Brent)	-0.28%
Tin	-4.50%
Copper	-7.01%
Sugar	-15.89%
Wheat	-22.20%
Coffee	-23.02%
Gold	-28.26%
Silver	-35.91%
Corn	-39.56%

Source: Bloomberg

Gold was among the worst performing commodities for 2013. Recall that demand skyrocketed during the financial crisis, when investors stockpiled gold in fear of a financial system meltdown, and again when successive waves of government stimulus programs stoked worries about future inflation. Now that both fears have subsided, gold prices have fallen dramatically.

According to Goldman Sachs, China accounts for 60% of iron ore and soybean imports, as well as 30+% of copper, oil and cotton imports. Hence, the slowdown in China last year affected global demand. China is expected to grow by 7.3% in 2014, marginally lower than last year's 7.6%. Thus, barring an unexpected surge in demand from other countries, commodity prices will likely remain weak this year.

REITs: The Dow Jones REIT Index lost 2.3% in 2013. Some sectors, such as hotels (+27.7%), manufactured homes (+11.1%) and self-storage (+9.4%) did well last year, while malls (-1.1%), factory outlets (-4.0%) and apartments (-6.2%) were among the worst performers.

REIT weakness can be explained by their heavy reliance on debt financing—higher interest rates mean higher interest costs. Mortgage REITs, which buy mortgage bonds and make loans to homeowners, were the worst performing REIT subsector, as rising rates increased financing costs at the same time that they depressed the value of their bond portfolios.

TIPS: The Barclays US TIPS Index lost 8.5% in 2013. Rising interest rates hurt values of longer dated bonds, while low inflation expectations reduced investor demand for inflation protection. Since inflation is expected to remain low for the foreseeable future, TIPS will remain an unattractive investment in our view.

Specialty Strategies

Hedge Funds: The HFRX Global Hedge Fund Index gained 8.72% for 2013. While hedge fund returns are low in comparison to the strong equity market returns, it is important to remember that hedge funds are not intended as a substitute for equities, although tools such as short selling and leverage can allow them to function as return enhancers. More importantly, their lower correlations to mainstream equities and bonds enable hedge funds to reduce overall portfolio risk and help preserve capital in difficult markets.

Private Equity: The S&P Listed Private Equity Index rose 37.2% in 2013. Transaction activity was strong, as strong public market comparables boosted valuations and favorable market conditions enabled PE sponsors to dispose of portfolio companies at attractive prices, whether through private sales or public offerings.

Portfolio Construction–Why Bother?

Portfolio construction and diversification are at the core of our investment process. As clients review their 2013 returns, it will be clear that diversified portfolios have generated overall returns significantly lower than the equity markets last year. This will lead you to question whether diversification delivers any value. We believe it does. History has taught us that diversified portfolios provide steadier returns and offer investors a greater chance of achieving their investment goals. Plus, as we saw in both 2001 and 2008, concentrated or undiversified portfolios can have a devastating impact on investors' wealth when markets reverse.

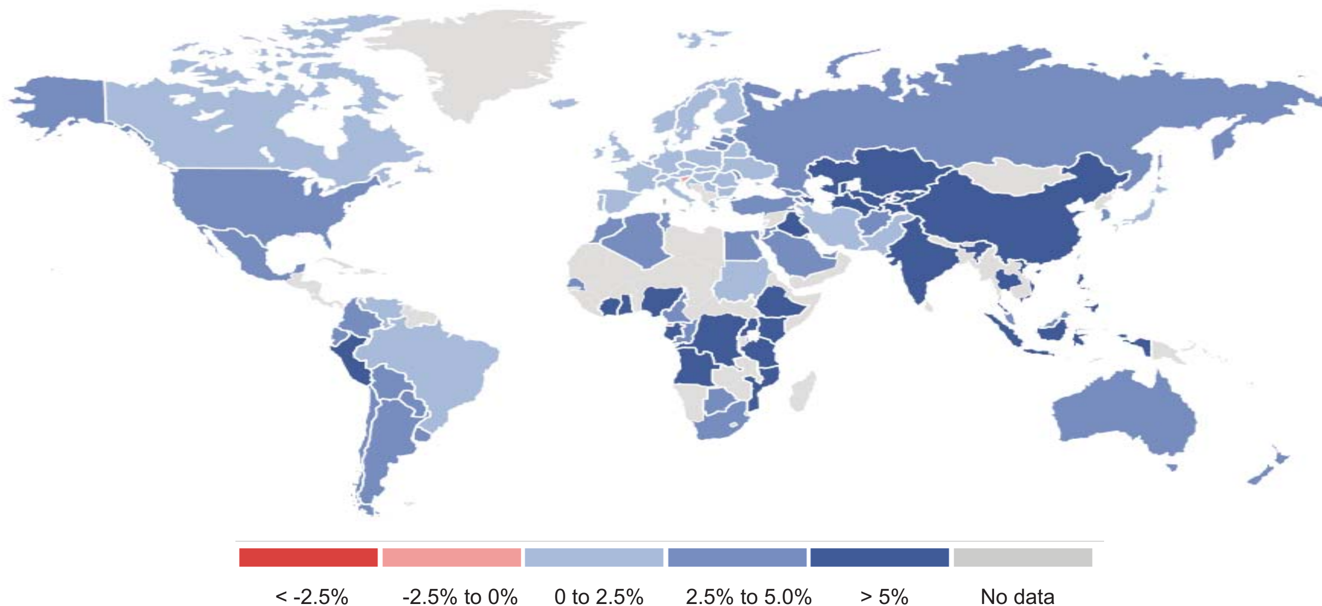
We recognize that at a given time, some assets will underperform while others outperform, but return patterns are unpredictable and time after time, mean reversion has turned last year's dogs into this year's stars. This is the core of diversification and although it did not serve investors well in 2013, it has done so in the past and will do so again in the future.

Besides diversification, another way that we try to better manage downside risk is to work with specialist managers with proven expertise in their respective asset categories. Their considerable experience makes them better equipped to deal with uncertain or unfavorable markets. Where appropriate, we will also incorporate alternative strategies that offer upside potential or reduce downside risk, thereby improving the portfolio's overall risk-return profile.

We optimize portfolio allocations over multiple time frames. We mainly base our portfolio decisions on the return and risk forecasts for each asset class over 5 to 7 year market cycles. We also review the corresponding 30-year forecasts for each asset class to ensure that portfolios are positioned to benefit from longer term cycles or themes. And finally, to be sure we do not lose sight of near-term risks and opportunities, we employ tactical asset allocation to fine-tune portfolios over 6 to 18 month time frames.

2014 Market Outlook

Chart 4. 2014 Global Economic Growth Forecasts



Source: IMF, World Economic Outlook 2013 via The Economist, October 6, 2013

2014 Outlook: Where Do We Go From Here?—Synchronized Global Growth, US Leadership, Bonds

Chart 4 summarizes the International Monetary Fund's latest global economic forecast for 2014. Overall, the IMF forecasts global GDP will grow by 3.6% in 2014, substantially higher than its latest estimate of 2.9% global GDP growth for 2013. For the first time in recent years, every country and region is forecast to contribute positive economic growth in 2014; hence our optimism over a synchronized global growth rally.

To put some perspective on the map above, see Chart 5, which shows the 2014 GDP forecasts for selected countries and regions, along with comparisons to their most recent 2013 growth estimates.

In recent years, China has been the main engine for global growth and again this year, it is forecast to generate the highest economic growth among the countries and regions shown in Chart 5. However, this year US policy actions are expected to play a key role in the global growth outlook. By some accounts, the US is viewed as the main catalyst for an upside surprise in global growth. By other accounts, it is viewed as the biggest threat to global growth.

Chart 5. IMF Global Growth Forecasts

	2013	2014	Change
World	**2.90%**	**3.60%**	**0.70%**
Advanced Economies	**1.20%**	**2.00%**	**0.80%**
USA	1.60%	2.60%	1.00%
Japan	2.00%	1.20%	-0.80%
Eurozone	-0.40%	1.00%	1.40%
Emerging Markets	**4.50%**	**5.10%**	**0.60%**
BRICs			
Brazil	2.50%	2.50%	0.00%
Russia	1.50%	3.00%	1.50%
India	3.80%	5.10%	1.30%
China	7.60%	7.30%	-0.30%
Sub-Saharan Africa	5.00%	6.00%	1.00%

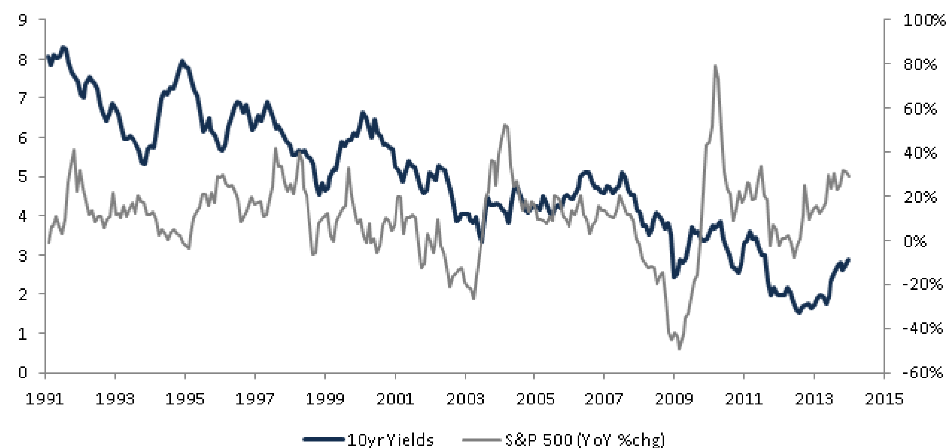
Source: IMF, World Economic Outlook, October 2013

On the plus side, investors are hopeful that if the Fed executes a successful tapering, it will remove a major cause of uncertainty over markets, set the stage for further US growth and fuel a broader global rally. On the minus side, other investors feel the US economic recovery is largely a liquidity story, driven by the extraordinary amounts of stimulus supplied by the Fed since 2008. Now that the Fed plans to start cutting back its bond purchases, they fear that US economic growth will again falter, and the repercussions will be felt globally, just as we saw in mid-2013 with the taper tantrum.

A word on tapering and interest rates. Many people equate tapering with an interest rate hike, but the two are not synonymous. Tapering is shorthand for the planned reduction in Fed bond purchases that starts in early 2014. The success or failure of this exercise will be reflected in market volatility and short-term rate movements. The Fed recognizes this is a delicate exercise and has stated its willingness to halt tapering (i.e. resume bond buying) if it sees any adverse impact on markets. The Fed has also indicated that explicit Fed action on interest rates will not happen until 2015/2016, and will be based on various factors such as inflation, the unemployment rate and the overall health of the US economy.

On the topic of interest rates, investors fear a rate hike as they believe that rising interest rates are harmful to stocks. To test this, we looked at the historical relationship between interest rates and the S&P 500 Index going back 20+ years (see Chart 6). What we see, in fact, is a fairly high positive correlation between the two. We believe this makes sense: rates and stocks fall when economic conditions are weak and they rise when economic conditions are strong. In our view, markets will view a rate rise as a positive reflection of solidly improving economic conditions.

Chart 6. Historical Relationship Between Stocks and Interest Rates



Source: ISI Group, January 10, 2014

2014 Return Expectations

Next, let us review the capital market assumptions, developed in conjunction with our research partners at NEPC. As usual, these figures assume an investment horizon over a normal market cycle of 5 to 7 years. The comparisons to last year's assumptions will help highlight how the forward-looking assumptions are impacted by strong performance, or underperformance, in the prior year. As we would expect, return expectations for the asset classes that performed best in 2013 are marginally lower for 2014, while expectations for the worst-performing asset classes are marginally higher.

Chart 7. Asset Class Return Assumptions Over 5 to 7 Year Market Cycle

	2013	2014	Change
Cash	0.75%	1.50%	0.75%
Fixed Income			
Treasurys	1.00%	2.00%	1.00%
Investment Grade	3.00%	3.50%	0.50%
High Yield	5.00%	4.50%	-0.50%
Global Bonds Hedged	0.93%	1.38%	0.45%
EM Bond Local Currency	5.00%	5.75%	0.75%
Equities			
US Large Cap	6.75%	6.25%	-0.50%
US Small/Mid Cap	7.00%	6.25%	-0.75%
Developed Non-US	7.75%	7.25%	-0.50%
Emerging Markets	9.75%	9.50%	-0.25%
Real Return			
TIPS	1.50%	2.50%	1.00%
Real Return	6.00%	6.25%	0.25%
Commodities	5.00%	5.00%	0.00%
Specialty Strategies			
Hedge Funds	5.63%	5.50%	-0.13%
Private Equity	9.00%	8.75%	-0.25%

Source: NEPC 2014 Outlook, December 2013

Some proponents of "reversion to the mean" believe that the outsized stock market returns of 2013 must be balanced by declines in the next couple of years, to bring market returns closer to their long-term averages. A well-known forecasting firm has even called for a 20% pullback in equities in Q1 on technical factors. While it would be reasonable for markets to take a breather after a banner year, we don't believe a downturn of this magnitude is likely, based on the economic forecasts we've discussed above. We are further encouraged by JP Morgan's 2014 US Equity outlook, which reviewed market returns going back to 1897 and found that when markets rose 22% to 27% in a given year, they had a 75% probability of rising the following year, and gained a further 8.1% on average. This outcome bodes well for equity markets in 2014.

US—Favorable Outlook

The IMF forecasts that the US economy will grow by 2.6% in 2014, considerably better than their last 1.6% estimate for 2013. Growth will be driven by a number of factors. Continuing recovery in the housing market is expected to lead to a rise in construction and homebuilding activity. Additionally, the US manufacturing sector expects to repatriate further jobs from overseas, to benefit from competitive US labor costs and cheap prices for domestic oil and gas.

Despite the improving economic picture, the US economy has been slow to add back jobs. The last employment report, released January 10, showed that the US economy added 74,000 jobs in December, far fewer than expectations of 200,000 jobs. The unemployment rate fell from 7.0% to 6.7%, within striking distance of the Fed's 6.5% target to step up tapering. Chart 8 shows the drop is largely due to a steep decline in the workforce, as many discouraged workers have stopped looking for work altogether. Given the cloudy employment picture and inflation expectations still low, we don't expect a further step up in tapering when the Fed policy committee meets on January 28.

Chart 8. Historical Relationship Between Stocks and Interest Rates

Source: The Wall Street Journal, January 10, 2014

2014 is expected to be a far less turbulent year in US politics, following intense public criticism of Congress over the 2013 government shutdown. As of January 15, Congress unexpectedly approved a $1.1 trillion bipartisan spending bill that keeps the US government running through the end of the fiscal year. We expect the February debate over raising the debt ceiling to be handled in a more conciliatory manner as well.

Developed Markets—Favorable Outlook

The IMF forecasts that growth in developed markets (represented by Advanced Economies in Chart 2) will rise from 1.2% in 2013 to 2.0% in 2014. Japan will grow by 1.2% and the Eurozone by 1.0%.

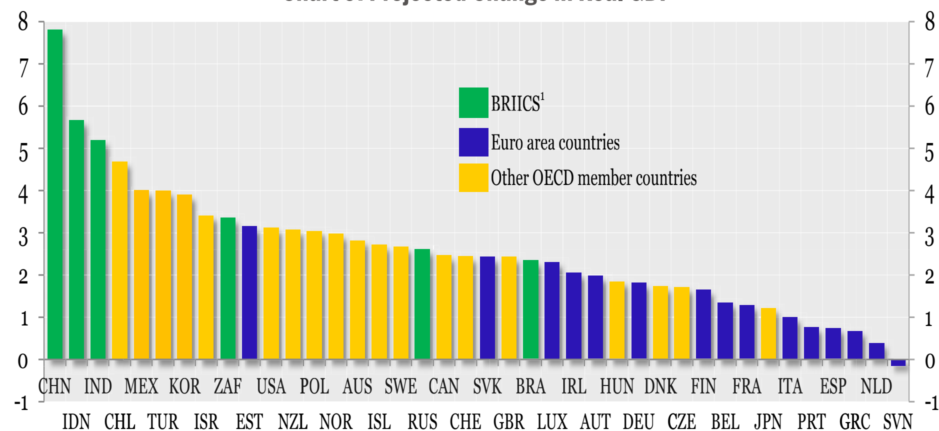
Although the Eurozone is finally emerging from recession, its recovery is painfully slow. And as we have pointed out before, the prospects for a systemic recovery are slim absent an integrated fiscal policy to accompany the single currency and unified monetary policy. Little progress has been made on structural problems such as rigid labor rules and overly generous entitlements for its rapidly aging population. As in prior years, the core northern countries are expected to grow faster than the peripheral countries.

Like Europe, Japan has been slow to tackle its structural problems, it has the highest debt burden of any developed country (250% of GDP), exacerbated by low economic growth and an aging population. To help bring down the debt, the government is raising the sales tax from 5% to 8% in 2014, one of the reasons that economic growth will slow from 2.0% in 2013 to 1.2% in 2014. In the long run, the only way to tackle these problems is by instituting tough economic reforms. The positive market reaction to Abenomics (expansionary economic policies instituted by Prime Minister Abe) in 2013 suggests that the market is hopeful that the Abe government will be able to follow through.

Emerging Markets—Uncertain? Questionable?

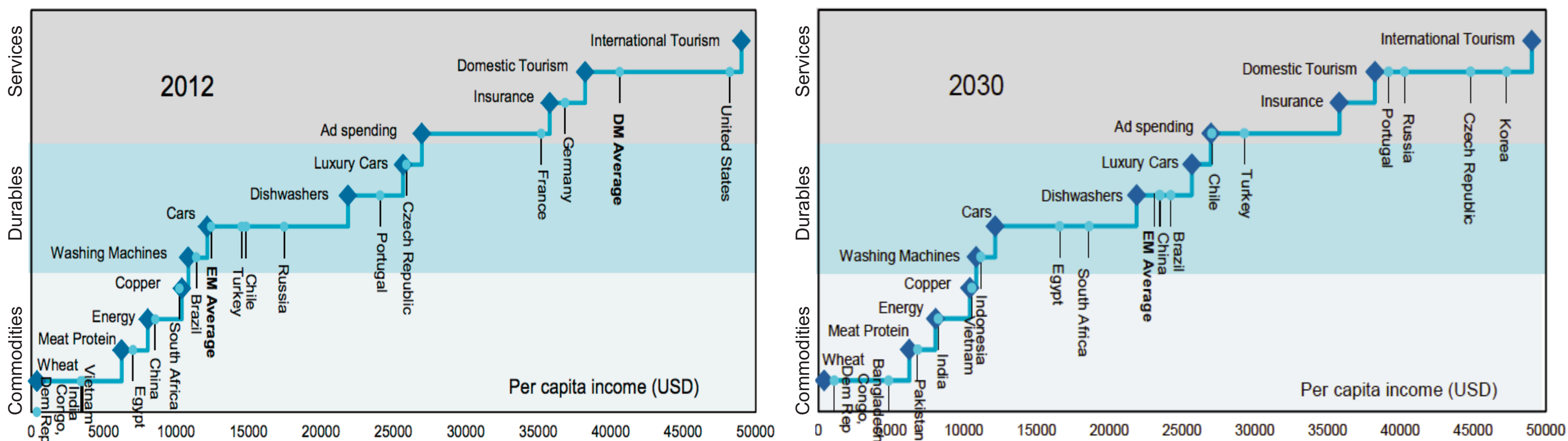
After their weak showing in 2013, it is reasonable to question whether the premise for investing in emerging markets is still valid. We believe it is premature to write off emerging markets and that they will continue to provide the greatest growth opportunities for investors in the long term. The near-term outlook is more questionable, although the chart below suggests that emerging markets will still be the main source of global growth in 2014 and 2015.

Chart 9. Projected Change in Real GDP



Source: OED Economic Outlook Database 94, November 2013

Chart 10. Ladder of Spending



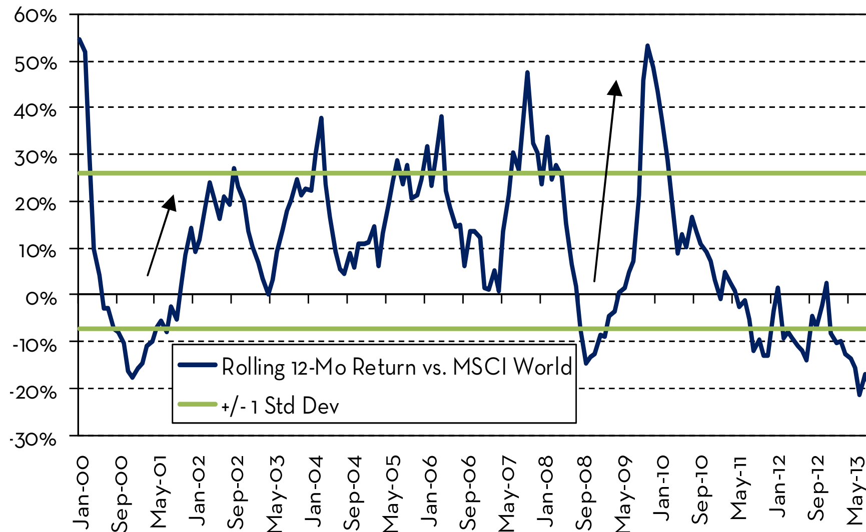
Source: EM at an Inflection, Goldman Sachs Investment Research, October 9, 2013

Many investors focus on the BRICs (Brazil, Russia, India and China) when they think of emerging markets. Chart 9 illustrates the broad diversity of countries that are part of this grouping. As we reviewed their 2014 forecasts, we saw that each of the BRICs faces specific challenges that will hurt economic growth this year, whereas prospects are decidedly brighter for the non-BRIC countries. Hence, we believe that this broader group will play an important role in offsetting weakness among the BRICs in the coming year. And we will again look to the frontier markets for further opportunities beyond emerging markets.

For a longer term perspective on the growth potential of the developing economies, Goldman Sachs has developed an interesting metric, the Ladder of Spending, which tracks historical consumption patterns over time. As the poorest countries become wealthier, they move from subsistence to rising demand for energy and other commodities. Once their basic needs are satisfied, they focus on acquiring durable goods such as appliances and automobiles to improve daily life. As they develop further, they begin to demand intangible services, such as insurance and travel. Chart 10 highlights the countries progressing up the spending ladder over the 2012 to 2030 period.

Finally, let us look at emerging markets from the standpoint of comparative valuations. Chart 11 on the following page shows the excess returns delivered by emerging markets over developed markets since 2000. Returns have

Chart 11. Excess Returns MSCI Emerging Markets vs. MSCI World (Developed Markets)

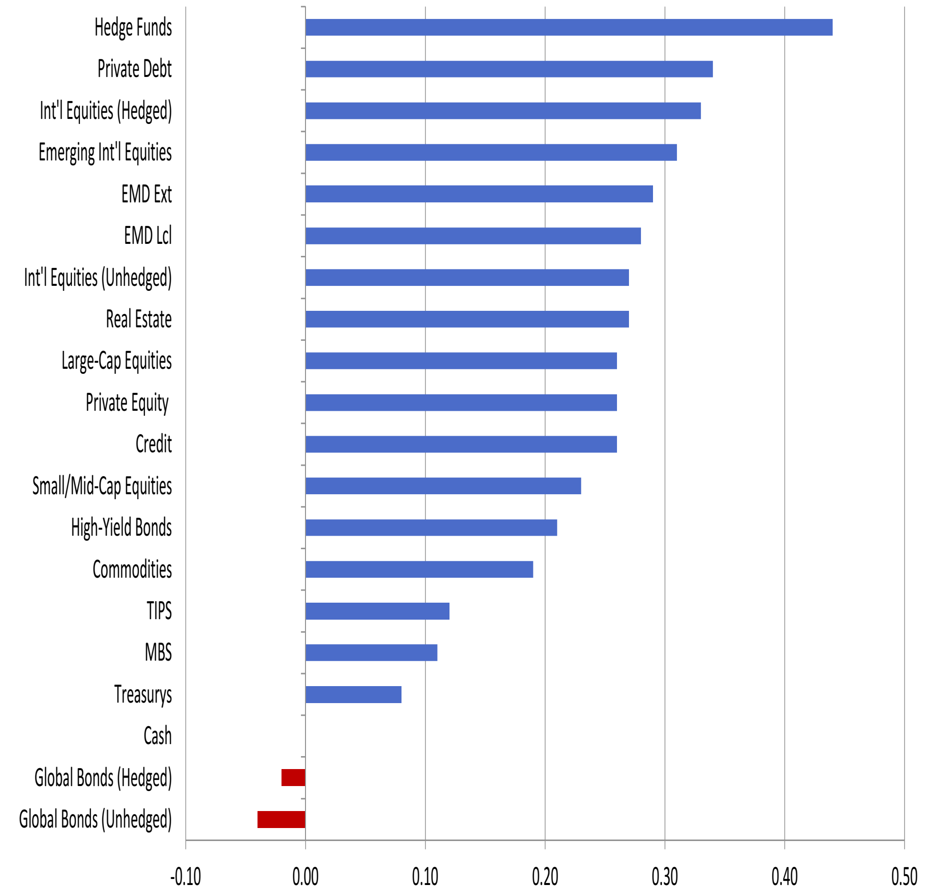


Source: NEPC, Market Thoughts, Q3 2013

diverged to the same degree as last year twice before, in 2000 and 2008. Both times, the subsequent period experienced an equally large rebound. This is a powerful argument for investors to hold on to their positions.

To conclude, Chart 12 is a useful road map for our 2014 expectations. Using the capital market assumptions in Chart 7, it shows the expected Sharpe Ratio (a measure of risk-adjusted return) for each asset class.

Chart 12. 2014 Sharpe Ratios



Source: NEPC 2014 Outlook, December 2013

2014 Market Outlook

Key Risks to our 2014 Outlook

1. Synchronized Global Growth Could Be a Plus

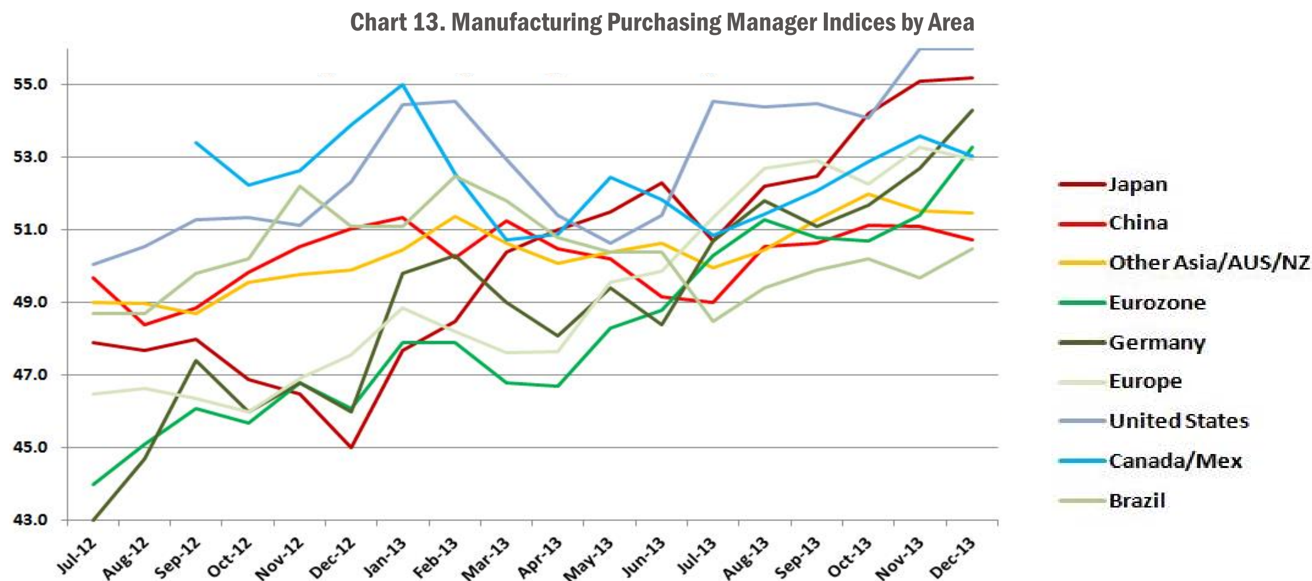
While we usually focus on downside risks, this year we highlight the potential for a positive surprise—widespread optimism for a synchronized global growth rally (see Chart 13). According to the ISI Group, 85% of global Purchasing Manager Indices are signaling an expansion, with the US at a level consistent with strong growth. Added to the US rebound, any upside in Europe and emerging markets could fuel another global rally in 2014 and boost stocks beyond our modest expectations.

2. US Disappoints

Markets are currently reconciled to the Fed trimming its bond purchase activity. If the Fed slows its plans for tapering, this could have a negative impact on markets around the world. And if the US economy does not live up to optimistic expectations for 2014, this too could have an impact on our expectations for synchronized global growth in the coming year.

3. China Slows or Disappoints in Other Ways

At its Third Plenum in November 2013, the Communist Party laid out its blueprint for key reforms including liberalization of the financial sector, reduced participation in the commercial sector by state-owned enterprises, and reform of the hukou, or household registration system. China is forecast to grow by 7.3% in 2014, down slightly from 7.6% in 2013. Any further slowing of the Chinese economy or signs that the Chinese government is unable to implement these reforms will reverberate, both globally as well as with a restive population frustrated by lack of progress on tackling official corruption, pollution and food chain contamination.



Source: SNBCHF.com

4. Geopolitical Risks

Each year, we highlight some of the flash points that could unsettle markets in the coming year. We will be watching the following in 2014:

a. Middle East: The aftermath of the Arab Spring, the ongoing insurgency in Syria and sectarian conflict in Lebanon suggest the region will again be a source of turmoil in 2014. Iran is a pivotal player in this story. It is the main sponsor of sectarian conflict and a rising nuclear threat. The new Rouhani government appears to taking a more conciliatory approach, but the situation remains fluid.

b. South East Asia: North Korea, with its nuclear capabilities and unpredictable leadership, is a perennial wild card for sowing global unrest. There are encouraging signs that China, North Korea's main benefactor, is finally tiring of the regime's erratic behavior. However, China itself is embroiled in a territorial dispute over airspace and maritime territory with neighboring South Korea and Japan, making for a volatile mix in this region.

c. Afghanistan: Pakistan, India, Iran, China and others are already jockeying for influence in Afghanistan ahead of the scheduled pullout of US troops in 2014. Given these competing interests and the continued threat of insurgency, any conflict in the region could quickly turn into a crisis with global implications.

d. Russia: In a replay of Cold War rivalries, Russia is increasingly positioning itself as a countervailing force to the US. It has blocked moves to impose sanctions on Iran and Syria, and is moving aggressively to rebuild a sphere of influence around the former Soviet Union. To prevent Ukraine from signing an economic treaty with the EU, it offered cut-rate financing and gas at below-market rates. The other former Soviet satellites are closely watching the outcome of anti-government and anti-Russia protests. The Winter Olympics in Sochi will be held under tight security following the recent bombings in Volgograd and the insurgency threat from the adjacent North Caucasus.

Asset Class Recommendations

Global Equities—Supplement US with Europe and Emerging Markets

US equities appear to be fully valued following their strong 2013 performance, while both developed markets and emerging markets equities offer attractive to compelling valuations, respectively. Accordingly, we suggest a neutral weighting to US markets and an overweight to both developed and emerging markets equities.

Global Fixed Income—Concerns Persist; Greatest Risks to Low-Yielding Bonds

Bonds play a vital role in portfolios, both as a source of income and as a diversification tool. Given our ongoing concerns about low yields on US Treasurys and investment-grade bonds, we recommend supplementing core bond holdings with other categories of bonds that carry higher yields and may therefore be less vulnerable to rising rates. Chart 14 on the following page illustrates some examples of diversification strategies to help cushion bond portfolios.

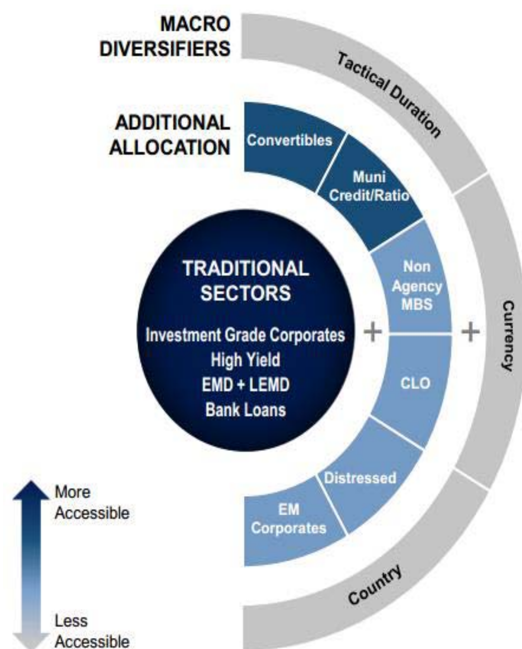
Cash—Drag on Performance, But Protection Against Volatility

Low yields make cash a drag on performance during years of strong stock market returns, but it remains an essential component of the investment mix for all the reasons we cited before. We foresee cash returns still muted but edging up in 2014.

Real Return—Underweight Commodities and TIPS

We recommend an underweight to commodities and TIPS for 2014 as we do not see these two asset categories outperforming in the current low inflation environment. We maintain a neutral weighting to REITs, which should benefit from pent-up demand for industrial, commercial and residential space as the US economy continues to improve.

Chart 14. Fixed Income Diversification Approaches



Source: Market Pulse — Implement, Goldman Sachs, October 2013

Hedge Funds—Useful for Risk Management

We recommend a neutral weighting to hedge funds. As detailed above, hedge fund strategies perform multiple roles in the portfolio. They can provide risk reduction or return enhancement opportunities that may be difficult to implement elsewhere in the portfolio.

The growing availability of hedge fund strategies in mutual fund format (liquid alternatives) makes it easier for investors to achieve these benefits without the high investment minimums, liquidity or capacity constraints typically associated with hedge funds.

Private Equity—Helpful for Maximizing Returns

We recommend a neutral weighting to private equity. Valuations are stretched in this category, in line with what we see in the public equity market. Investing in private equity allows investors to capture higher returns than are typically available in the public markets. Mindful of the multi-year time horizons for investments to come to fruition, we will continue to seek out secondary market offerings, where the investment period can be shortened considerably.

Our Key Themes for 2014

1. Emphasize stocks over bonds.

As in 2013, investors should continue to overweight stocks and underweight but not abandon, bonds. We remain positive on US stocks, but see more potential in other developed markets such as Europe and Japan. Valuations in emerging markets also look compelling, especially in relation to their growth prospects. Consider taking profits in US stocks and reallocating abroad (see items 3 and 4).

2. Complement core bond holdings with a multi-sector approach.

Core bonds are an important component of portfolios. They provide income and can help buffer the impact of unexpected downdrafts in other assets. Higher interest rates can pose a risk of lower returns or even losses on core bonds. Therefore, we suggest supplementing core bond holdings with allocations to categories such as high yield bonds, floating rate debt, emerging markets bonds, distressed debt, and perhaps even hedge funds, that can help ease the impact of higher rates.

3. Follow Europe out of the Dark Ages.

European stocks are priced attractively. Plus, Europe is poised to grow again after five years of wrenching recession. Manufacturing and employment

indicators are signaling expansion, while the ECB has lowered interest rates to help boost growth. While Southern Europe is recovering more slowly, the PIGS—Portugal, Italy, Greece and Spain—could selectively surprise to the upside and valuations there are even more compelling.

4. Emerging markets will re-emerge.

Emerging markets compare favorably with developed markets in terms of demographics, long-term growth potential and debt burdens. Growth in developed economies is constrained by aging populations and rising payments to cover retirement and health care costs, coupled with the need to trim budget deficits and pay off debt. Conversely, emerging markets benefit from rising national wealth, favorable population demographics, high capital reserves and low debt/GDP ratios. Thus, despite their recent poor showing, it is important to maintain portfolio exposure to emerging markets for the superior long-term opportunity.

5. 2014's big surprise–harmonized global growth.

In the US, consumer deleveraging appears to have bottomed, which could boost consumer spending in 2014. If politicians can agree on a debt deal, we could see a resurgence of capital spending and hiring by companies reluctant to invest under the current uncertainty. Elsewhere, we are already seeing a rebound in Europe and Japan. If China is able to maintain growth at current levels, this will have a positive impact on growth in emerging markets and resource-based economies. Under these conditions, we can foresee a domino effect on global growth, boosting markets in 2014.

6. Invest for desynchronized tapering.

Central banks will be pursuing divergent monetary policies over the coming year. In the US, the Federal Reserve will buy fewer long-term bonds. Any rise in interest rates will make core bonds less attractive. In contrast, the Bank of Japan and European Central Bank have each signaled their intention to maintain a highly accommodative monetary policy to promote economic growth.

7. Higher interest rates unlikely to derail the recovery.

As we illustrated earlier, we don't feel that higher interest rates will necessarily slow the economy or disrupt markets, nor do we believe that higher mortgage rates will hurt the housing market. Limited housing inventory and pent-up demand will help maintain the ongoing recovery.

8. Active managers poised to outperform.

Passive managers benefit from a falling rate environment, as stocks tend to rise across the board. When monetary policy becomes less accommodative and rates rise, selectivity comes into play, and good companies outperform the not-so-good companies. At that point, stock selection becomes more important for driving returns.

9. Politics will have a smaller role in 2014.

Over the past five years, central bank policy, government gridlock and geopolitical tension have all moved markets more than investment fundamental. As economic prospects improve, we expect politics and policy to recede as drivers of markets. After the drubbing they took over the 2013 government shutdown and with mid-term elections looming, US legislators are now in a more conciliatory frame of mind. As of January 15, Congress has agreed on a $1.1 trillion bipartisan measure to keep the government funded through the fiscal year. We expect the debt ceiling debate in February will be less rancorous for these reasons.

10. Diversification is key.

As we have said repeatedly, markets are inherently unpredictable. While we are bullish on the prospects for 2014, we see some uncertainties ahead, most

notably the extent and success of tapering by the Federal Reserve and the effect of Fed action on the emerging markets countries. As usual, unexpected geopolitical events can also have a big impact on markets. Given all of these uncertainties, we believe that a well-constructed, broadly diversified portfolio will give investors access to a full range of opportunities on the upside, while helping to limit risk on the downside.

Conclusion

We believe that 2014 will be marked by a continuation of the global economic recovery that took hold in 2013. We have identified some key investment themes that are likely to benefit under these conditions. As conditions evolve, we will continue to seek out opportunities to give our clients access to the best investment thinking and best managers in the marketplace.

We cannot predict how markets will behave, or how some of these themes will play out, over the coming year. However, we are confident that our prudent investment style, our focus on diversification and attention to risk management, will allow our clients to take advantage of opportunities on the upside, while benefiting from protection on the downside.

As we do each year, we have prepared a scorecard on the quality and accuracy of our 2013 investment predictions. We look forward to sharing the results of our 2014 predictions with you next year. Until then, we thank you for your continued trust and confidence in our firm.

Source: Joe Heller, Green Bay Press-Gazette. Reprinted with permission

2013 Scorecard

Our 2013 Outlook presented our "Baker's Dozen–Our Key Investment Themes for 2013" on everything from asset class performance to expected policy actions. Here is our tally on the accuracy of the predictions we made for 2013. -**The HPM Partners Investment Committee**

Key Issue: Cash	**Key Issue:** Credit Risk vs. Interest Rate/Duration Risk
What we said: Invest idle cash. With markets normalizing and attractive investment opportunities in many areas, there will be an open opportunity cost to holding cash at near-zero yields.	**What we said:** If pressed to make a choice, choose credit risk over duration risk. As financial risks reduce and growth resumes, fears of deflation risk will be superseded by inflation worries.
Were we right? Yes	**Were we right?** Yes
What really happened: 2013 turned out be a banner year for investing in equities. Selectively, other asset categories such as high-yield bonds, floating rate debt and hedge funds provided good opportunities for putting cash to work.	**What really happened:** Investors in high-yield bonds and credit strategies were rewarded in 2013 as these sectors benefited from strong equity markets. Conversely, investors in high-quality bonds with low yields or longer durations were punished.
Key Issue: Interest Rate Risk	**Key Issue:** Municipal Bonds
What we said: Reduce exposure to high quality, low yielding bonds, particularly US Treasurys. While these provided an element of safety during distressed markets, these categories of bonds are subject to considerable downside risk when interest rates begin to rise.	**What we said:** Focus on municipal bonds, both for attractive yield and tax benefits. Essential service revenue bonds may offer superior covenant protection compared to general obligation bonds.
Were we right? Yes	**Were we right?** Partly
What really happened: Treasurys, corporate and municipal bonds, particularly longer duration bonds, suffered steep losses in 2013. Short and intermediate bonds fared slightly better, but overall 2013 was a bad year for bond investors.	**What really happened:** The Puerto Rico downgrade, Detroit bankruptcy filing and concerns over Chicago and other large issuers, all weighed heavily on municipal bond returns in 2013. The Detroit filing confirmed our view that revenue bonds could offer superior covenant protection to General Obligation bonds.
Key Issue: Great Rotation	**Key Issue:** Cap Weightings
What we said: Rotate out of bonds into equities. Equities valuations still reflect uncertainty about future prospects. Conversely, bonds are fully valued and offer more downside than upside at current rates.	**What we said:** Favor large-cap and globally-oriented equities in portfolios. Small-cap stocks and domestically focused businesses will be less able to participate in the global recovery than companies with significant international exposure.
Were we right? Yes	**Were we right?** Partly
What really happened: Investors were richly rewarded for going into equities last year. Equity markets had a banner year and investors also avoided the pain inflicted on bondholders in 2013.	**What really happened:** We were correct that large-cap and mega-cap stocks participated in the 2013 global recovery. However, small- and mid-cap stocks performed even better.

2013 Scorecard (Continued)

MSCI ACWI All Countries World +23.44%	S&P 500 +32.4%	Russell 2000 +38.8%	MSCI EAFE +23.6%	MSCI EM -2.4%	BC Aggregate -2.0%	BC US Govt 5-7 Yr -1.3%	BC Municipal 5 Yr 0.15%

Key Issue: Emerging vs. Developed	**Key Issue:** Cyclical vs. Defensive Stocks
What we said: Emphasize emerging markets over developed markets, both for equities and fixed income. Long term, emerging markets offer superior growth opportunities. Near term, developed market equities are subject to headline risk while developed market bonds may be subject to currency risk.	**What we said:** Focus on exposure to cyclical stocks. Defensive stocks are liable to underperform cyclical stocks under recovery conditions.
Were we right? Mostly no	**Were we right?** Yes
What really happened: We were wrong on emerging markets as both EM equities and EM debt saw negative returns. While developed market equities were subject to headline risk, investors benefited from the rise of Europe and Japan. We were correct about developed market bonds, which posted negative returns due to the strong dollar.	**What really happened:** S&P returns show that industrial stocks rose 40.7% and Consumer Discretionary gained 43.1%. Conversely, Consumer Staples stocks rose 26.1% and Utilities returned 13.2%.
Key Issue: Dividends	**Key Issue:** FX and Hedging
What we said: Capture rising dividend yields. Companies are expected to raise payouts in 2013. Also, growth may give way to value as the preferred investment style for 2013.	**What we said:** Hedge exposure to developed currencies such as the euro and yen that are expected to weaken in 2013. Maintain exposure to emerging currencies that are expected to strengthen.
Were we right? Partly	**Were we right?** Partly
What really happened: Stocks with high dividend growth patterns outperformed those with high payouts. However, Growth stocks modestly outperformed Value stocks in large and mid caps. In small caps, Growth trounced Value.	**What really happened:** We were correct that both the euro and yen would weaken in 2013. However, we were wrong that EM currencies would appreciate.

2013 Scorecard (Continued)

BC High Yield +8.48%	Citi WGBI -4.5%	Morningstar EM Composite -4.4%	DJ REIT Composite -2.3%	DJ UBS Commodities -9.6%	Gold -28.3%	HFRX +6.7%

Key Issue: Real Estate	**Key Issue:** Commodities
What we said: Invest in real estate and infrastructure while the cost of borrowing is still low.	**What we said:** Exposure to commodities will enable you to participate in the global recovery and also provide inflation protection in the longer term. Focus on agricultural commodities and base metals rather than energy or precious metals.
Were we right? Yes	**Were we right?** No
What really happened: Following the mid-year taper tantrum, interest rates shifted markedly. Investors who locked in low rates earlier in the year did well for themselves. Also asset prices rose as the year progressed and investors saw clear signs of the recovery taking hold.	**What really happened:** Exposure to commodities was a major detractor in 2013, and equities were the best way to participate in the global recovery. We were correct about precious metals, but wrong on the others–other than cocoa, agricultural commodities slumped, while oil was up modestly and natural gas was the best performing commodity of 2013.

Key Issue: Portfolio Diversification
What we said: Last but not least, remember that diversification is vital to managing risk. With markets at multi-year highs and volatility at multi-year lows, beware of complacency. A well-diversified portfolio can provide access to upside opportunities while helping to limit downside risk.
Were we right? Partly
What really happened: Being well-diversified meant that we participated on the upside in equities and high yield, and managed to avoid some of the downside in fixed income, commodities and emerging markets. However, diversified portfolios lagged the strong equity market returns so we marked ourselves down on this point.

Fourth Quarter Performance Summary

Asset Class	Benchmark	4Q13 Return	YTD Return	Performance Summary
Cash	*Citi 3-month T-bill*	0.01%	0.05%	Expect cash yields to remain low for the foreseeable future.
Domestic Gov't / Agency	*BC U.S. Gov't & Related 5-7*	-0.42%	-1.31%	As expected, interest rate gyrations had a big impact on returns. Shorter dated bonds avoided the losses suffered by longer maturity bonds as 10-year Treasury yields jumped from a low of 1.66% in May to 3.04% by December.
Domestic Tax-Exempt	*BC Municipal Bond 5-Year*	0.84%	0.15%	2013 was the worst year for municipal bonds since 1994. Returns were hurt by both rising interest rates and selling pressure, as investors pulled out of municipal bonds in the wake of the Puerto Rico downgrade, Detroit bankruptcy filing and concerns over the finances of Illinois and other large issuers.
TIPS	*BC TIPS*	-2.00%	-8.52%	2013 was the worst year for TIPS since their 1997 inception. Rising interest rates had the biggest impact on longer dated maturities.
Investment-Grade Debt	*BC Inv. Grade Intermediate*	0.68%	-0.11%	The Barclays Aggregate index posted its first loss since 1999. Bonds with the highest sensitivity to interest rates and the longest durations fared the worst in 2013. New issuance exceeded $1 trillion for the second year as investors took advantage of refinancing ahead of rising interest rates.
High-Yield Debt	*BC High-Yield Intermediate*	3.53%	8.48%	High-yield bonds and bank loans were among the only bond categories that did well in 2013, helped by a combination of an improving economy, accommodative Fed, low default rates and their higher sensitivity to equity market movements than to interest rate changes.
Global Bonds	*Citi World Gov't Bond Index (Hedged)*	-1.09%	-4.52%	Global bond markets finished the year essentially flat in local currency terms; however, US investors incurred losses as foreign currencies depreciated against the dollar.
Emerging-Markets Debt	*Morningstar EM Composite Bond Index*	1.06%	-4.39%	Returns were hurt by a combination of rising local interest rates that caused bond values to drop and selling pressures as higher US rates caused outflows from emerging markets to the US. Local currency debt was hit harder than dollar-denominated debt.

Source: Bloomberg; Data as of 12/31/13

Fourth Quarter Performance Summary (Continued)

Asset Class	Benchmark	4Q13 Return	YTD Return	Performance Summary
Large-Cap Equity	*S&P 500*	10.50%	32.38%	US large-cap stocks posted their best returns since 1997. The improving US economy, strong corporate profits and accommodative monetary policy encouraged investors to move out of bonds into equities.
Small/Mid-Cap Equity	*Russell 2000*	8.73%	38.82%	Encouraging economic growth, strong corporate earnings and accommodative monetary policy helped drive mid-cap and small-cap stocks to new highs in 2013.
International Equity	*MSCI EAFE*	5.79%	23.57%	European stocks rose as the Eurozone emerged from recession, while Japanese markets received a boost from the implementation of Abenomics. Small-cap international stocks outperformed large-cap stocks, 29.3% to 22.78%.
Emerging-Markets Equity	*MSCI EM*	1.87%	-2.41%	Emerging markets equities sat out the 2013 global rally as countries grappled with low exports, falling currencies, rising inflation and capital outflows.
Real Estate	*DJ Composite REIT Index*	-1.28%	-2.30%	Overall REIT returns were hurt by rising interests rates, although returns varied greatly by sector. Hotels, manufactured homes and self storage REITs enjoyed stronger returns, while industrial, factory outlets and apartment REITs saw the worst returns.
Commodities	*DJ UBS Commodity Index*	-1.07%	-9.58%	Commodities suffered dismal returns in 2013 from the combined impact of falling demand, increased supply and low inflation worldwide. Gold fell 28.3%, its worst showing in 30 years, as low inflation and receding fears of another financial crisis lessened demand.
Private Equity	*S&P Listed Private Equity*	6.44%	37.19%	Private equity had another banner year in 2013. Strong equity markets boosted valuations based on market comparables, while favorable market conditions encouraged sponsor firms to step up transaction activity.
Hedge Funds	*HFRX Global Hedge Fund Index*	2.33%	6.72%	Hedge funds posted their best performance since 2010. Equity and credit-oriented strategies did particularly well in 2013. Distressed and event-driven strategies delivered good returns. Despite the resurgent stock markets, equity hedged strategies also delivered strong returns for the year.

Source: Bloomberg; Data as of 12/31/13

Fourth Quarter Market Summary

		1Q13	2Q13	3Q13	4Q13	YTD	Annualized 1-Year	3-Year	5-Year	10-Year
US Equity Benchmarks	**Price**									
Dow Jones Industrial	16,576.66	11.93%	2.91%	1.66%	10.22%	29.65%	29.65%	15.71%	16.73%	7.44%
Nasdaq Index Composite	4,176.59	8.53%	4.52%	10.16%	11.13%	40.17%	40.17%	17.87%	22.97%	8.84%
S&P 500	1,848.36	10.60%	2.91%	4.67%	10.50%	32.38%	32.38%	16.17%	17.93%	7.41%
Russell 1000 (Large Cap)	1,030.36	10.96%	2.67%	5.36%	10.23%	33.13%	33.13%	16.30%	18.58%	7.77%
Russell 1000 Growth	863.81	9.55%	2.06%	7.28%	10.44%	33.49%	33.49%	16.45%	20.38%	7.82%
Russell 1000 Value	927.61	12.31%	3.23%	3.44%	10.01%	32.56%	32.56%	16.07%	16.66%	7.57%
Russell Mid Cap	1,491.75	12.96%	2.26%	6.76%	8.38%	34.82%	34.82%	15.90%	22.34%	10.18%
Russell Mid Cap Growth	675.52	11.51%	2.87%	8.08%	8.23%	35.73%	35.73%	15.63%	23.35%	9.73%
Russell Mid Cap Value	1,510.12	14.21%	1.74%	5.32%	8.55%	33.57%	33.57%	16.02%	21.16%	10.22%
Russell 2000 (Small Cap)	1,163.64	12.39%	3.08%	8.83%	8.73%	38.82%	38.82%	15.69%	20.07%	9.05%
Russell 2000 Growth	688.14	13.21%	3.73%	11.16%	8.17%	43.30%	43.30%	16.84%	22.56%	9.38%
Russell 2000 Value	1,491.42	11.63%	2.47%	6.47%	9.31%	34.53%	34.53%	14.49%	17.62%	8.57%
S&P GICS Sectors	**Weight**									
Consumer Discretionary	9.6%	12.15%	6.81%	7.06%	10.81%	43.08%	43.08%	23.46%	27.69%	9.44%
Consumer Staple	11.5%	14.58%	0.50%	0.07%	8.67%	26.14%	26.14%	16.78%	15.86%	9.95%
Energy Sector	11.4%	10.17%	-0.37%	4.57%	8.35%	25.07%	25.07%	11.07%	13.44%	13.44%
Financials	14.6%	11.42%	7.25%	2.37%	10.33%	35.63%	35.63%	13.16%	13.75%	-0.26%
Health Care	13.0%	15.81%	3.84%	6.35%	10.12%	41.46%	41.46%	23.42%	18.29%	8.35%
Industrials	10.5%	10.67%	2.81%	7.93%	13.53%	40.68%	40.68%	17.28%	19.84%	8.57%
Information Technology	19.4%	4.59%	1.68%	5.87%	13.26%	28.43%	28.43%	14.73%	21.90%	7.17%
Materials	3.5%	4.79%	-1.80%	9.47%	10.66%	25.60%	25.60%	9.23%	18.80%	8.25%
Telecommunication Services	3.0%	9.46%	1.00%	-4.28%	5.47%	11.47%	11.47%	11.91%	12.67%	8.14%
Utilities	3.6%	13.02%	-2.73%	1.51%	2.79%	13.21%	13.21%	11.20%	10.17%	9.23%
Global Equity Benchmarks	**Price**									
MSCI World Index	1,661.07	7.92%	0.83%	7.53%	8.13%	27.49%	27.49%	12.26%	15.82%	7.72%
MSCI AC World x-USA	408.55	6.62%	-0.22%	7.33%	7.43%	23.52%	23.52%	10.43%	15.66%	7.88%
MSCI EAFE	1,915.60	5.34%	-0.77%	10.58%	5.79%	23.57%	23.57%	8.88%	13.19%	7.66%
MSCI EAFE Growth	1,454.70	6.88%	-1.02%	9.43%	5.15%	23.10%	23.10%	8.48%	13.38%	7.59%
MSCI EAFE Value	3,086.55	3.78%	-0.49%	11.76%	6.41%	23.99%	23.99%	9.24%	12.93%	7.65%
MSCI Emerging Markets	1,002.69	-1.90%	-7.76%	5.68%	1.87%	-2.41%	-2.41%	-1.77%	15.16%	11.55%
MSCI BRIC	278.43	-3.01%	-9.74%	8.58%	1.69%	-3.28%	-3.28%	-4.94%	12.41%	10.46%
Nikkei 225	16,291.31	19.67%	10.98%	5.01%	12.76%	59.28%	59.28%	19.10%	15.09%	5.95%

Global Equity Valuation Summary

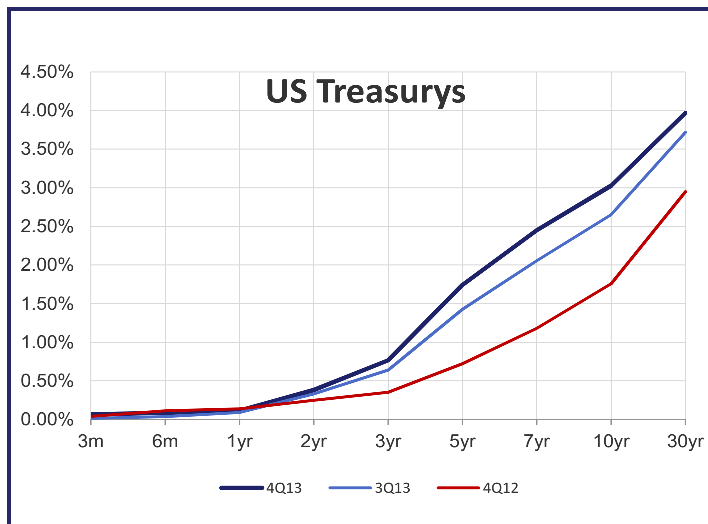
Benchmarks	3Q13	4Q13	QoQ
S&P 500			
Price	1,681.6	1,848.4	166.8
Trailing P/E	15.9	17.4	1.5
Est P/E	15.3	16.7	1.5
Trailing 12m Earnings	105.9	106.4	0.5
Est Forward 12m Earnings	110.2	110.5	0.3
Implied 1yr Earnings Growth	4.1%	3.8%	-0.3%
Russell Mid Cap			
Price	1,381.8	1,491.8	109.9
Trailing P/E	20.2	21.4	1.2
Est P/E	18.3	19.5	1.2
Trailing 12m Earnings	68.4	69.6	1.3
Est Forward 12m Earnings	75.4	76.3	1.0
Implied 1yr Earnings Growth	10.2%	9.6%	-0.6%
Russell 2000			
Price	1,073.8	1,163.6	89.9
Trailing P/E	39.6	51.5	12.0
Est P/E	26.7	30.0	3.3
Trailing 12m Earnings	27.1	22.6	(4.6)
Est Forward 12m Earnings	40.2	38.7	(1.5)
Implied 1yr Earnings Growth	48.2%	71.5%	23.3%
MSCI EAFE			
Price	1,818.2	1,915.6	97.4
Trailing P/E	16.4	17.1	0.7
Est P/E	13.1	13.9	0.7
Trailing 12m Earnings	111.1	112.4	1.3
Est Forward 12m Earnings	138.5	138.2	(0.3)
Implied 1yr Earnings Growth	24.7%	23.0%	-1.7%
MSCI Emerging Markets			
Price	987.5	1,002.7	15.2
Trailing P/E	12.0	12.1	0.1
Est P/E	10.0	10.1	0.1
Trailing 12m Earnings	82.5	82.9	0.4
Est Forward 12m Earnings	98.6	99.0	0.4
Implied 1yr Earnings Growth	19.6%	19.4%	-0.2%

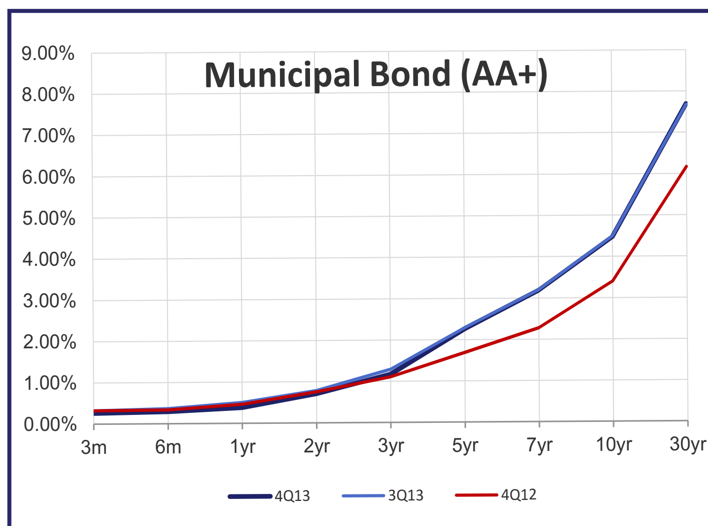
Source: Bloomberg; Data as of 12/31/13

Fourth Quarter Market Summary (Continued)

		1Q13	2Q13	3Q13	4Q13	YTD	Annualized 1-Year	3-Year	5-Year	10-Year
Interest Rates	**Yield**									
Prime Rate	3.25	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-0.75
3m Treasury Bill	0.07	0.06	0.06	0.06	0.06	0.03	0.03	-0.05	-0.01	-0.85
US LIBOR 3m	0.25	0.00	0.00	0.00	0.00	-0.06	-0.06	-0.06	-1.18	-0.91
US Treasury 3m	0.07	0.05	0.05	0.05	0.05	0.02	0.02	-0.05	-0.04	-0.88
US Treasury 10yr	3.04	0.40	0.40	0.40	0.40	1.26	1.26	-0.26	0.79	-1.23
US Treasury 30yr	3.97	0.28	0.28	0.28	0.28	1.02	1.02	-0.37	1.29	-1.10
Fixed Income										
Citi 3-month T-bill		0.02%	0.02%	0.01%	0.01%	0.05%	0.05%	0.07%	0.10%	1.59%
BC U.S. Gov't & Related 5-7		0.14%	-1.37%	0.40%	-0.42%	-1.31%	-1.31%	2.14%	2.20%	3.74%
BC Municipal Bond 5-Year		0.84%	-1.71%	0.87%	0.84%	0.15%	0.15%	3.54%	4.27%	3.92%
BC TIPS		-0.36%	-7.05%	0.70%	-2.00%	-8.52%	-8.52%	3.55%	5.63%	4.85%
BC Investment Grade Intermediate		-0.12%	-2.32%	0.57%	0.68%	-0.11%	-0.11%	4.38%	7.27%	4.87%
BC High Yield Intermediate		2.90%	-1.43%	2.44%	3.53%	8.48%	8.48%	9.10%	18.28%	8.34%
Citi World Gov't Bond Index		-2.78%	-2.97%	2.84%	-1.09%	-4.52%	-4.52%	1.25%	2.28%	4.15%
Morningstar EM Composite Bond Index		-1.23%	-5.28%	0.87%	1.06%	-4.39%	-4.39%	4.49%	11.68%	7.87%
Real Estate	**Price**									
Dow Jones Composite REIT Index	200.36	7.84%	-4.73%	-3.26%	-1.28%	-2.30%	-2.30%	4.32%	10.58%	2.00%
FTSE EPRA/NAREIT Europe	1,594.90	0.09%	0.60%	6.21%	4.05%	10.77%	10.77%	8.87%	15.45%	6.90%
Commodities	**Weight**									
DJ UBS Commodity Index		-1.15%	-9.46%	1.37%	-1.07%	-9.58%	-9.58%	-8.17%	1.41%	-0.73%
Energy	21.0%	7.09%	-8.51%	1.96%	4.37%	5.13%	5.13%	-7.18%	-7.55%	-9.59%
Agriculturals	33.0%	-3.18%	-4.49%	-1.80%	-4.88%	-14.33%	-14.33%	-8.67%	3.65%	-0.28%
Livestock	6.7%	-6.45%	2.18%	2.75%	-1.74%	-3.60%	-3.60%	-3.20%	-3.44%	-5.84%
Softs	8.3%	-3.22%	-8.44%	0.83%	-7.10%	-16.91%	-16.91%	-17.87%	4.96%	-2.80%
Industrial Metals	20.2%	-7.86%	-10.40%	1.44%	0.27%	-13.68%	-13.68%	-13.05%	6.52%	4.68%
Precious Metals	10.8%	-5.48%	-25.51%	6.70%	-9.85%	-30.84%	-30.84%	-8.45%	7.12%	9.16%
Private Equity / Hedge Funds	**Price**									
S&P Listed Private Equity Index	203.18	13.63%	0.60%	11.83%	6.44%	37.19%	37.19%	13.50%	25.46%	6.67%
HFRX Global Hedge Fund Index	1225.49	3.13%	0.03%	0.86%	2.33%	6.72%	6.72%	0.22%	3.73%	1.02%
Currencies	**Price**									
ICE Dollar Index	80.04	4.05%	0.17%	-3.41%	-0.23%	0.33%	0.33%	0.42%	-0.32%	-0.82%
Euro / US Dollar	1.37	-2.86%	1.51%	3.54%	1.60%	4.17%	4.17%	0.89%	-0.33%	0.88%
Pound / US Dollar	1.66	-6.53%	0.13%	6.37%	2.29%	1.86%	1.86%	1.98%	2.56%	-0.75%
US Dollar / Yen	105.31	8.53%	5.30%	-1.39%	7.16%	21.39%	21.39%	9.09%	3.05%	-0.18%

Source: Bloomberg; Data as of 12/31/13





Municipal bond yields are shown on a comparable, adjusted basis using a 35% tax rate.

Important Information

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