



QUARTERLY REVIEW AND OUTLOOK

During the fourth quarter of 2013, the S&P 500 continued its march toward new highs. For the period, the S&P 500 returned ~10.50% or almost 1/3 of the total return for the year. One could argue that this is an aberrational quarter and year given corporate profit growth averaged 5.8% for 2013. What drove the return in 2013 was an expansion in valuation (increase in the price/earnings multiple). We have long believed that “changes in valuation” have a greater impact on equity prices than earnings growth. The expansion in equity valuation, both real and relative to benchmarks, was the driving force behind the equity returns last year.

Chart I



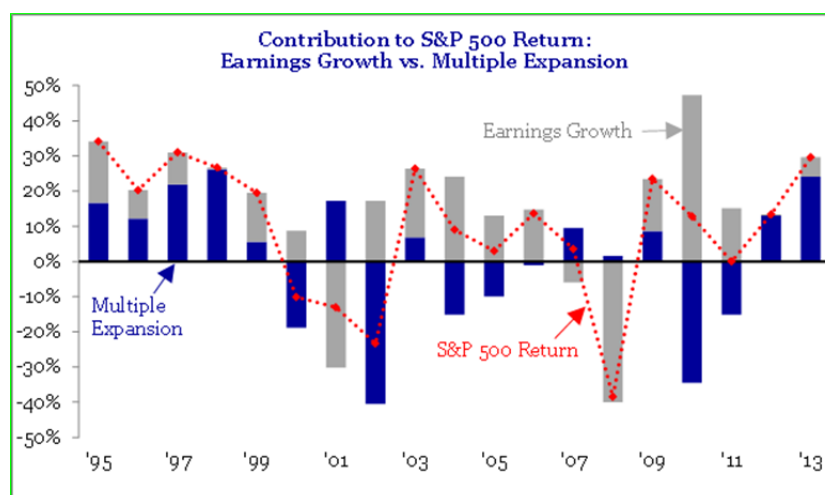
There are a number of factors that drove the expansion of P/E ratios from 12 – 13 earnings to 15 - 16 times earnings at the end of the year:

- First and most important was the belief that the U.S. economy had finally stabilized and job growth was improving.
- Second, many businesses were indicating that overall product demand was modestly accelerating. This was a substantial change in view from what companies were reporting only six months ago.

- Third, overall demand for housing and autos continued to accelerate and, as such, had a positive economic impact as seen in reported GDP figures (3.5 – 4.2% growth).
- Fourth, in the overseas markets, European economic trends stabilized and Japan began to see accelerating growth in their domestic markets after almost 2 decades of little economic expansion.

Finally, the U.S. investor base has been unusually bearish since the near depression scenario that was avoided in 2008-09. Once it became clearer that the U.S economy was recovering, and that interest rates would stay relatively low for the next few years, investors aggressively rotated out of low return cash and fixed income alternatives and into equities. As such, the period of the low P/E valuations reversed and jumped to near normal levels by the end of 2013.

Chart II

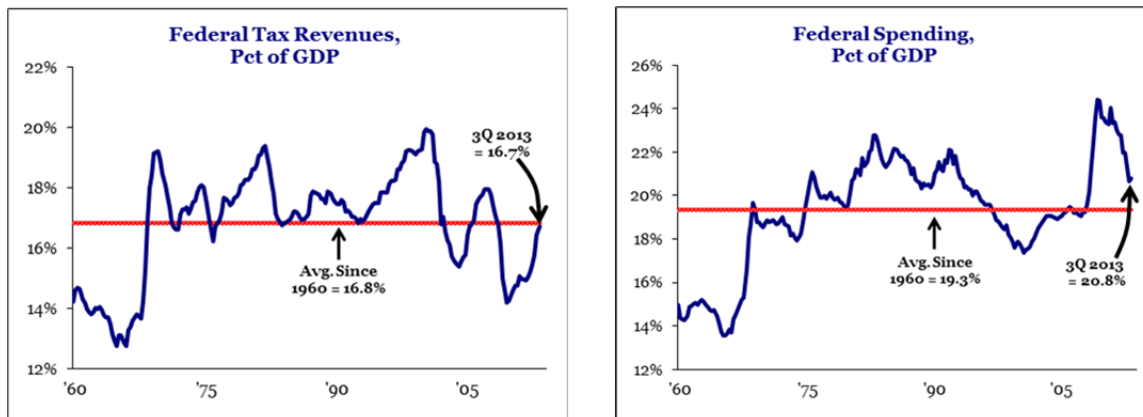


Source: Strategas

As a result, we believe that the equity market is fairly valued at current levels. Between 2008 and 2012, a recovery in earnings drove the increase in equity appreciation. However, in 2013, the large increase in the P/E ratio moved the market to a more normal valuation level given the current outlook for 3.0 – 3.5 GDP growth in 2014 and an estimated 8 - 10% growth in corporate profits. With interest rates on the 10 year government bond fluctuating between 2.75% and 3.00% and inflation remaining relatively benign, the U.S. equity markets seem to be adjusting to historical normal valuation levels.

The fixed income markets are also likely to behave more rationally in 2014. Despite the emotional rhetoric encompassing the timing and amount of Fed tapering, the initial decrease in the overall amount of monthly bond purchasing was met with little impact. More importantly as the U.S. economy continues to gain momentum, interest rates will be more reflective of current economic activity rather than Fed tapering. Thus, we expect a well-behaved bond market in 2014. There is little likelihood that the Federal Funds rate will increase until 2015; with inflation well contained, we do not expect that long term rates will move dramatically higher this year.

Chart III & IV



Source: Strategas

As the above charts indicate, GDP growth, a rise in taxation and the sequester cuts in the Federal budget have all combined to return our economy to historical averages. Thus, we see little change likely by the Federal government to materially alter the status quo.

One concern that should briefly be mentioned relates to the emerging market economies and the impact from a rising U.S. dollar. Over the last few years, many emerging market economies have engaged in various monetary policies and programs in order to stimulate economic recoveries in their home countries. One of the typical policies is accomplished by leveraging up the balance sheet (aka: Quantitative Easing) to drive growth. While far more emerging market debt is denominated in local currency than in the past, a substantial portion remains pegged to the U.S. dollar. As the U.S. economy improves and the Fed continues to ease back on its QE program, the dollar tends to appreciate against most currencies. Thus, it is more difficult for emerging market economies to pay off their debt. Many of us recall the currency induced market panics in 1994 (Mexico), 1998 (Russia), ... Debt markets in emerging economies are "thin" and volatile in comparison to the more established debt markets in the US and Europe. As such, this issue is something to closely monitor during 2014.

PORTFOLIO POSITIONING FOR 2014

As many of you know, our efforts are focused on identifying long term, tax efficient investment opportunities. We seek out investments that can generate superior returns over a 2 - 5 year basis, and tend to orient our positions toward companies that are near monopolies and/or category leaders. Two recent additions fitting our criteria were Nielsen Holdings and CBS Corp.; the former is the well-known TV audience measurement company. Nielsen is also the largest supplier of market share data to consumer product companies in all major food and warehouse retail channels. Moreover, it is rapidly building out its ability to measure consumer interests and purchases in the all-important mobile and online markets. We expect the company to generate earnings growth of at least 10 - 15% annually in the next few years. Additionally, its position as a must-have service should make them less sensitive to future economic cycles.

CBS Corp is the well-known TV broadcaster. The company is enjoying a major growth spurt from its efforts to raise prices to cable companies for the retransmission of its content. Content has become significantly more valuable as cable systems compete for subscribers. CBS is also home to a substantial list of top rated shows which generate significant profits in syndication. Management is shareholder focused and has initiated a number of shareholder friendly programs such as share buybacks, spin offs of non-essential assets, and dividend increases. Given the significant free cash flow expected in the next few years, the company meets our criteria for long-term appreciation potential.

Finally, our Master Limited Partnership portfolio continues to generate excellent returns. The growth in energy independence in the U.S. makes this asset class a very attractive long-term holding.

As always, please contact us to discuss any of your positions.

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