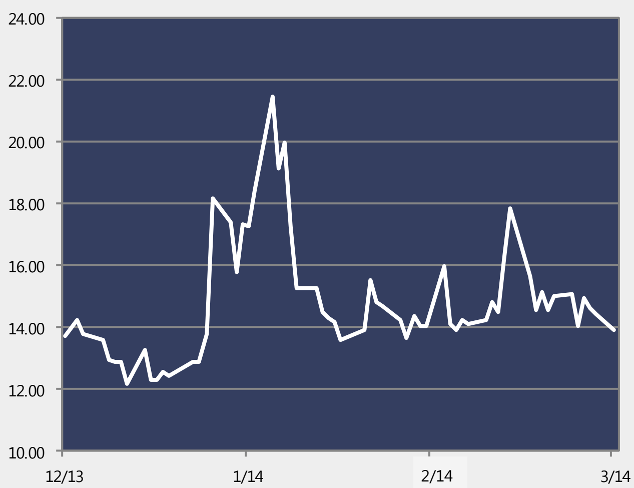
first quarter 2014

INVESTMENT *perspective*

U.S. equity markets generally rose in the first quarter but the modest advance masked increased volatility as the market consolidated the gains experienced in the second half of 2013. Prior year market leadership began to succumb to selling pressure in the back half of the quarter as last year's laggards began to outperform. We view this consolidation and tepid market increase as the beginning of a healthy equity market correction that is necessary prior to any further material advance.

Volatility Increased in First Quarter

VIX (12/31/13 to 3/31/14)



Source: Bloomberg Analytical

The fixed income markets were relatively quiet, with the 10-Year Treasury yield remaining in a fairly tight range of 2.60% to 3.00%. Janet Yellen's first Federal Open Market Committee meeting created an unexpected stir in March when her unscripted comments appeared to indicate that the Fed may look to increase short term rates sooner than expected, possibly as early as the first half of 2015. Given that the money markets had been projecting a September 2015 start date, Chair Yellen's comments effectively repriced the markets to an April 2015 rate hike. In the coming weeks we expect that the Fed will make several statements designed to recalibrate the market's expectation that rates will likely remain at current levels until late 2015, with the understanding that an increase prior to such time would be data-dependent.

The duration and measure of an equity market correction, or any further market advance, will be driven by the underlying earning fundamentals of the broader market. Despite the Federal Reserve's continued modest tapering of Quantitative Easing (the Fed's asset purchase program), and of the potential for Fed Fund rate increases in 2015, rising interest rates are not an immediate threat to equity valuations. In order for equities to move higher, we need to see a modest increase in revenue growth that translates into higher earnings per share and accelerating earnings growth for the overall market. As the economic recovery continues to advance, we anticipate increased pressure on corporate profit margins as companies are forced to increase capital expenditures as well as increase wages and benefits. However, any acceleration in capital expenditures and wage growth will only further support the economic recovery so it is not clear if margin pressure will directly translate into market weakness.

S&P 500 Operating Profit Margin (4/30/04 to 3/31/14)

Source: FactSet

Due to the harsh winter conditions, the recent economic data has been much softer than the economic growth experienced in the second half of 2013. There is no question that the harsh conditions negatively impacted economic activity, but it is not realistic to assume that all of the

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slowdown is weather related. The developed and developing economies around the world continue to face headwinds from deleveraging, economic restructuring, and declining demographic profiles. These headwinds will remain a factor for years to come and will account for the majority of the "below trend" economic growth. As such, economic accelerations should not be extrapolated into the future, but instead subsequent weakness should be expected. Likewise any weakness will likely be followed by modest acceleration. Such modest economic growth prevents the buildup of excesses in inventory, credit, and employment, which tends to dampen the overall business cycle.

As we continue through 2014, the U.S. equity markets will increasingly be less dependent on Fed stimulus and more reliant on individual company fundamentals. This will represent an incremental headwind to the broad averages, but will have varying impacts across individual securities. There are still individual stocks that will perform well despite the lowered return expectations for the general market. This positive outlook continues to be stock-specific and not reflective of opportunities in specific industries or regions of the world. Finally, we believe U.S. equities are attractively valued relative to other asset classes, including fixed income.

Within the fixed income arena, corporate bond risk premiums continue to drift lower and, with overall credit quality strong and the likelihood of the Fed maintaining a zero interest rate policy well beyond the end of Quantitative Easing, we do not expect this trend to change. This, coupled with the health of the financial sector (as evidenced by the recent Fed stress test results), should lead to continued outperformance from the corporate sector. We thus will maintain an overweight to corporate bonds at the expense of mortgage-backed securities and Treasuries. For taxable fixed income investors, the taxable equivalent yield on high quality municipal bonds remains extremely attractive when compared to similarly rated corporate bonds. Within client municipal bond portfolios we continue to find value in Texas municipals. We also anticipate a general rise in interest rates throughout 2014 and therefore we will maintain a shorter duration versus the broader market across our fixed income strategies.

Credit Spread

Source: FactSet