VAUGHAN NELSON

fourth quarter 2013

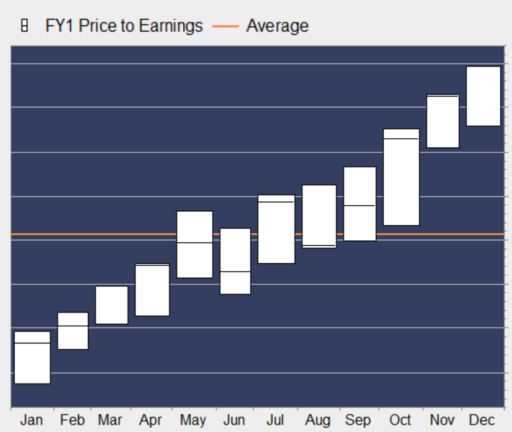
INVESTMENT *perspective*

U.S. equity markets continued to advance in the fourth quarter as investors brushed aside the Federal Reserve's ("Fed") tapering of Quantitative Easing ("QE") placing more importance on the improvement in recent economic surveys and a third quarter earnings season that met lowered earnings expectations. The S&P 500 gained 10.5% for the fourth quarter and advanced 32.4% for the full year. Fixed income investors were challenged in 2013 as a generally rising interest rate environment resulted in negative returns, with the Barclays Aggregate Index declining -0.1% for the fourth quarter and posting a return of -2.0% for 2013.

Given the significant expansion in the equity market's valuation multiples **(Figure 1)**, combined with the declining impact of further QE to enhance corporate earnings and boost real economic activity, we continue to expect the rate of return for the broader equity indices to moderate materially over the next three years relative to what was experienced over the prior three years. The fixed income market will continue to be challenged by a gradual increase in interest rates, likely leading to very modest returns for the broad fixed income indices. However, higher rates will enable fixed income investors to secure a more attractive income stream than has been the case the past five years.

FIGURE 1 **S&P 500 No Longer Materially Undervalued**

S&P 500 P/E Ratio

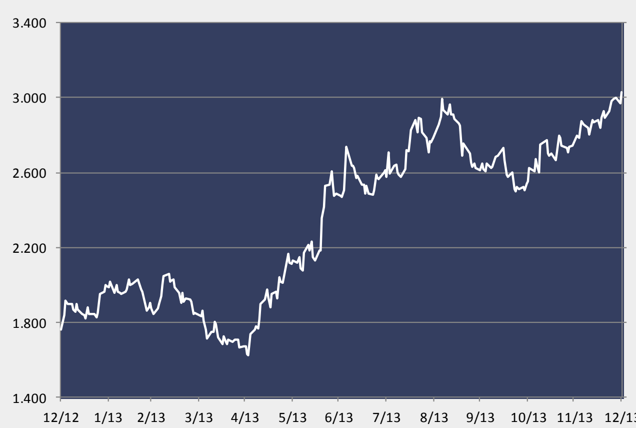


Source: FactSet

The back drop of stable earnings growth, low inflation, and easy money led to a broad revaluation of equity multiples that began in earnest in the fourth quarter of 2012. While the U.S. equity markets rallied throughout 2013, the nature of their ascent changed dramatically post the Fed's initial discussion of tapering QE in May of 2013. Prior to the tapering discussion, the equity market rally was being led by equities that were termed "bond proxies" and by cyclical sectors that were responding to ultra low interest rates and increases in liquidity and credit availability. Post the tapering discussion, the bond proxies and cyclical sectors came under pressure as the 10-year treasury yield increased from a low of approximately 1.6% to a recent high of 3.0% **(Figure 2)**. Despite the Fed saying otherwise, tapering QE represents a tightening of monetary policy and thus an increase in interest rates was experienced across the entire treasury curve; representing an increase in overall real rates within the capital markets.

FIGURE 2 **10-Year Treasury Yield Rose Steadily Throughout 2013**

10-Year U.S. Treasury Yield



Source: Bloomberg Analytical

Despite the increase in real rates, we continue to expect a modest economic growth environment as the reductions in government spending are no longer an impediment in 2014. The continued slow recovery in capital spending, residential construction, non-residential

over...

construction, and the elimination of the fiscal drags have the potential to drive real GDP growth of 2.5% to 3.5% in 2014. The primary risks to this outlook would be a flare up in the European credit markets, a significant slowdown in China's economic growth, or instability emanating out of Japanese credit markets.

Throughout 2014 the U.S. equity markets will rely less on Fed stimulus and more 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.

As was the case with equities in 2013, the fixed income market faced the hurdles of a less accommodative Fed, gradually improving economic data and a difficult geopolitical environment. Long duration Treasuries were the worst performing investment grade sector, with the Barclays Treasury Index declining -2.8%. Those investors who had extended out the maturity curve in search of higher yields were especially hurt as the 30-year Treasury declined -15% in 2013 and the 10-year Treasury fell -8%. Within the Treasury market, only the shortest of maturities were able to post positive returns. For example, the 2-year Treasury struggled to stay out of negative territory, generating a meager return of 0.3%.

Vaughan Nelson's taxable fixed income portfolios performed well in the challenged environment of 2013. Clients benefited from shorter duration portfolios and an overweight to corporate bonds, at the expense of treasury and mortgage securities. We anticipate a similar environment in 2014 and thus client portfolios will remain overweight corporate bonds, although we will look to sell overvalued holdings and redeploy the funds to positions offering better return potential.

Municipal bonds struggled in 2013 due to redemptions in the mutual fund arena and negative front-page headlines driven by a few large Chapter 9 filings, mainly Detroit and Jefferson County in Alabama. These headlines diverted attention from the fact that most states and local governments have significantly improved their revenues and have controlled expenses in order to meet their balanced budget mandates. We expect the combination of improved credit quality, reduced issuance and higher yields to attract investors to municipal bonds and thus provide a favorable backdrop for municipals throughout 2014.

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