

GRESHAM

2014 Annual Outlook

Surf's Up



Unprecedented central bank policies over the last few years have allowed investors to ride waves of liquidity to impressive returns. However, global economic growth and employment growth remain underwhelming. As a result, central banks are likely to remain engaged and the policies that created these great surfing conditions are likely to persist. Surfers beware as warning signs are beginning to appear. Price and risk levels have increased, so investors must strike the right balance between continuing to participate in ongoing appreciation and rebalancing back toward portfolio constructions that allow them to withstand the inevitable market correction without engaging in the losing proposition of timing markets.

Summary

2013 was a good year for investors as they rode a wave of central bank liquidity to strong returns. U.S. equities were particularly productive, as the S&P 500 reached a record high and returned 32%—its strongest performance in over 15 years. International equity markets lagged their U.S. counterpart, but generated attractive returns by historical standards, providing investors with a 23% return. The notable exception was in emerging market equities, which disappointed investors with a 2% decline.

Global growth is likely to remain muted in the face of headwinds created by the deleveraging of over-indebted developed world economies. While U.S. growth is slow relative to past economic recoveries, it remains the key contributor to global growth. Further, we believe U.S. growth may modestly accelerate due to several positive developments, including the stabilization and rebound of the housing sector, the healing of the banking system and the diminution of the threat of a government shutdown. On the other hand, Europe will likely remain mired in an economic malaise as they have yet to deal with their troubled banking system and the inflexibility of their common currency that hinders global competitiveness. The real unknown will be in emerging market countries, which will reveal themselves to be anything but homogeneous. Some countries will perform well and others will suffer the consequences of trade imbalances and poorly managed currency regimes.

With global growth prospects remaining uninspiring, we believe developed country central banks will retain their accommodative policies, even as the U.S. Federal Reserve has begun to taper their bond buying program. Surprisingly, despite these policies, the threat of inflation appears remote. In most developed economies, with the notable exception of the U.S. and the UK, inflation remains non-existent and the risk of deflation has become a real possibility. As a result, central banks are more likely to leave their supportive policies, which partially led to robust returns in capital markets, in place for the foreseeable future.

However, warning signs are beginning to appear in many markets. Valuations in the U.S. equity market have become elevated. While not to the extreme level we witnessed before the technology bubble burst, we have surpassed the levels attained prior to the 1987 crash. Additionally, bad behavior in credit markets has returned in the form of covenant-lite loans and other undisciplined practices that we have not seen since before the financial crisis nearly seven years ago.

In this environment of elevating prices, risks to investors are increasing. While it is impossible to predict when a correction will occur, we believe it is time for investors to revisit their long-term asset allocation guidelines. First, investors should determine if they are comfortable weathering the inevitable downturn with their current portfolio structure so they can avoid the temptation to sell after declines. Second, should they be comfortable with their long-term allocation policy, they must take active steps to rebalance their portfolios to these targets, as strong performance in equity markets have likely tilted their portfolios toward riskier assets.

Within this environment of increasing prices and risks, we see opportunities to enhance returns and control risks:

- Several years ago, we recommended that investors reduce or eliminate exposure to high-quality fixed income, as the rewards relative to the risks were unattractive. Today, yields have begun to normalize and, while we still recommend underweighting this area, the investment proposition is not as poor as it was several years ago. Some investors, particularly more conservative investors and those most concerned about equity market valuations, should consider steps toward normalizing their portfolio allocations in this area.
- Equity markets, despite warning signs, may continue to perform well given the ongoing accommodative policies of central banks. Investors should continue to participate in these markets as it may be years before a serious correction occurs. How-

ever, investors must ensure that their exposure is consistent with their long-term policy guidelines and that they can withstand the inevitable drawdown that will occur in these markets.

- Emerging market equity valuations remain cheap and for some countries deservedly so. However, we continue to recommend building exposures to these markets in companies that can benefit from the secular tailwinds provided by middle class consumption that is beginning to accelerate in many of these countries. Passive or index-oriented solutions in these markets are less likely to produce attractive long-term results for investors.
- Private equity remains a powerful driver of long-term portfolio returns. We continue to believe consumer-oriented growth companies in China, many of which are only available through private investment, will remain a productive opportunity. We also continue to find opportunities in smaller U.S. private investments.
- The risk of inflation remains low in the near-term, which will provide an unsupportive environment for real assets investments. We continue to recommend that clients keep their exposure to liquid investments in this area, such as commodities-based investments, at a minimum level. On the

other hand, we are finding attractive non-marketable investment opportunities in natural resource areas such as mining and energy.

2013 Capital Market Review

There are strong and varied opinions about the effectiveness of the policies the U.S. Federal Reserve and other central banks around the world have implemented since 2009. However, it is difficult to argue with their levitating influence on both asset prices and investor psychology. As a result of these policies, risk taking is back in vogue.

The primary questions now facing investors are: How long will the levitation last? How far will it go? How do I protect myself against the impact of the inevitable correction?

It took nearly 13 years following a circuitous path for the S&P 500 index to climb from 1,500 to 1,600. However, just three months later the index passed 1,700 and just over one month after that 1,800 was in the rear view mirror. Since its low in March of 2009, the index has provided investors with a return of nearly 200%, ranking it among the strongest equity market rallies in history. Not a bad result considering the problems the world economy navigated during this five-year period.

Table 1. Performance and Valuation

Market	Index	2013	Performance		Valuations	
			Annualized 3 Year	5 Year	Price/Earnings Dec. 2013	Dec. 2012
U.S. Equity	S&P 500	32.4%	16.2%	17.9%	15.5x	12.7x
International Equity	MSCI AC World ex U.S.	15.3%	5.1%	12.8%	13.1x	14.8x
Emerging Market Equity	MSCI Emerging Markets	-2.6%	-2.1%	15.1%	10.2x	10.6x
Spread vs. Treasuries						
Municipal Bonds	Barclays Mgd Money Short/Int	-0.6%	3.6%	4.1%	92 bps	73 bps
U.S. High Yield Bonds	Barclays High Yield Corporate Bond	7.4%	9.3%	18.9%	397 bps	549 bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	-6.6%	6.3%	11.5%	290 bps	271 bps
Hedge Funds	HFRI Fund Weighted	9.3%	3.3%	7.8%		
Conservative Hedge Funds	HFRI FOF Conservative	6.7%	2.3%	4.3%		
Commodities	Dow Jones UBS Commodity	-9.5%	-8.1%	1.5%		
Gold	Spot Price of Gold	-28.0%	-6.7%	5.5%		

Source: Bloomberg, MSCI, JP Morgan

In 2013, the S&P 500 returned over 32%, marking the strongest year for U.S. equity performance since 1997. Additionally, 2013 also boasted the smallest intra-year drawdown in nearly 20 years, a very modest 6%, as enthusiastic investors viewed every small decline as a buying opportunity. Riskier U.S. small-cap stocks increased even more, rising nearly 39% over the year, eclipsing all but one year since 1991. Did we mention that risk taking was back in vogue?

Consistent with this behavior, traditional safe-haven investments performed relatively poorly, as investors reallocated away from these areas. Treasury bond yields increased during the year, as the Federal Reserve followed through on its well foreshadowed promise to begin tapering support of markets, causing higher-quality fixed income investments to retreat. The lone bright spot in fixed income markets was high-yield debt, which returned over 7%. Further, the junkier the bond, the better it performed, with CCC-rated bonds increasing more than 13% during the year.

Risk seeking investment behavior did have some limits in 2013, as investors preferred U.S. equity markets over international and emerging country markets. While developed international markets increased a healthy 23% for the year, emerging market equities actually declined 2%, which included a loss of 5% attributable to the effects of declining currencies. The outlier in the international markets was Japan, where Prime Minister Abe's aggressive "Three Arrows" reform program laid the foundation for strong returns on the back of a declining yen. Japanese equity markets increased nearly 55%, far offsetting the nearly 30% decline in its currency, leaving dollar-based investors with a very healthy 27% return for the year.

Hedge funds, as measured by the HFR Fund Weighted Index, returned just over 9% for 2013, which was the fourth highest return since 2000. However, it was also the worst year since 1998 relative to equity markets, when this index was up 2.6% and equity markets rose 28.6%. 2013 was a difficult year for shorting securities, which was a key contributor to

lackluster hedge fund performance. Additionally, it seems the pool of talented managers gets further diluted every year with larger numbers of new funds being launched. Getting access to the best hedge funds has never been more important in this increasingly crowded market. On the flip side, investors who invested in more conservative, lower-volatility hedge funds as an alternative to over-valued fixed income exposure performed relatively well, returning nearly 7%, well in excess of all but the lowest quality fixed income.

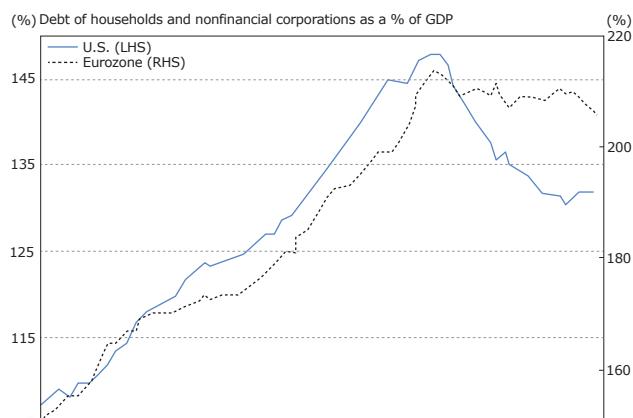
With global growth still mired in the slowest recovery on record, concerns about inflation faded even further. As a result, commodity prices generally declined and investors suffered losses in most commodity sectors. The energy sector was the only area to post gains, led by a recovery in natural gas prices and relatively flat oil prices. Relatedly, gold declined nearly 30%, as Fed tapering reduced concerns about the debasement of the dollar and the perceived probability of extreme shocks, or "tail risk", declined.

Global Economic Environment

Six years after the financial crisis, global economic growth remains muted and continues to consistently underperform analysts' estimates. The headwinds of deleveraging, on the heels of the largest credit bust of all time, continue to stymie the effectiveness of fiscal and monetary policies designed to stimulate growth. On a positive note, a good deal of deleveraging has already been accomplished in the U.S. household sector as shown in Chart 2. The combination of these reduced debt levels and low interest rates has caused debt service burdens in the U.S. to decline dramatically as shown in Chart 3. This has served to partially mitigate the lack of real wage growth and low employment level in the U.S. economy, providing a modest boost to economic growth relative to most other developed nations.

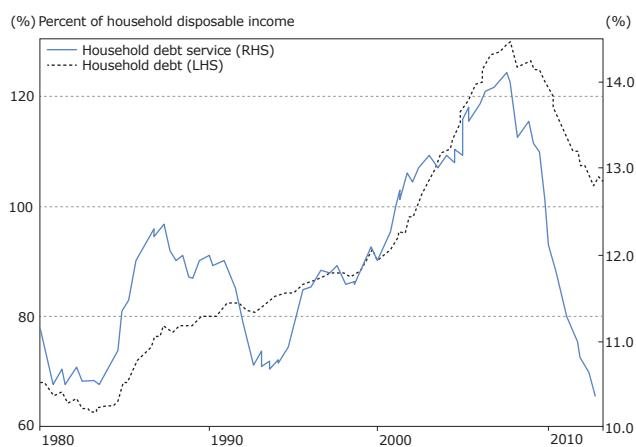
There are additional reasons to be somewhat optimistic about near-term U.S. growth prospects. 2013 was a year of enormous fiscal drag on a year-over-year basis, including the threat of a government

Chart 2. U.S. Consumers Have Deleveraged...



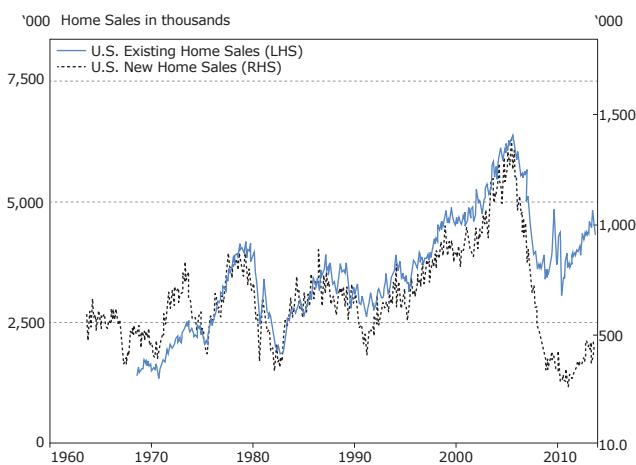
Source: JP Morgan, U.S. Bureau of Economic Analysis, Eurostat

Chart 3. ...Aided by Lower Interest Rates



Source: JP Morgan, Federal Reserve, U.S. Bureau of Economic Analysis

Chart 4. A Revival in U.S. Housing



Source: BCA Research

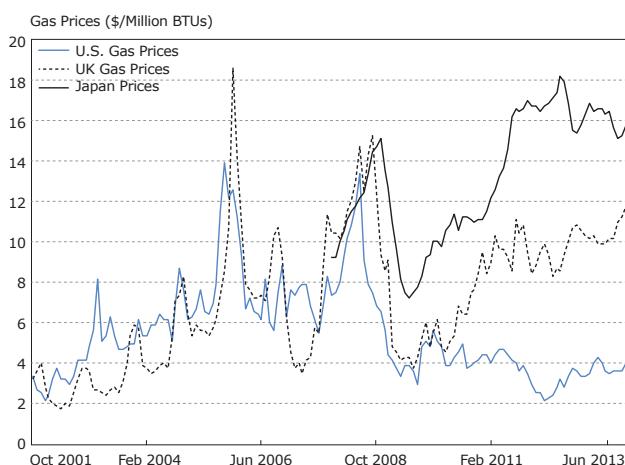
shutdown, the federal government "sequestration" that indiscriminately cut federal spending, massive hikes in payroll taxes and income taxes, and new "Obamacare" taxes. The mere removal of some of these "brakes" will result in improvement in economic activity.

Additionally, two other structural forces are likely to create modest tailwinds for the U.S. economy. First, the housing market has bottomed and is showing signs of rebounding as shown in Chart 4. Simply stopping the decline will remove a significant source of drag that has hampered growth over the last five years. Secondly, the U.S. continues to enjoy an energy cost advantage in both electricity and natural gas prices relative to other nations as shown in Chart 5. We have already begun to see the impact of this competitive advantage as many global businesses are now choosing to locate new plants within the U.S., contributing to a modest manufacturing renaissance.

International Growth Shows Improvement

Economic growth in Europe appears to be improving, largely because it couldn't get much worse. European countries that do not use the Euro, including the UK, Switzerland and Sweden, appear to be benefitting from the more flexible policy options they possess. Manufacturing and consumer confidence indicators are improving and fiscal austerity programs should

Chart 5. U.S. Has a Competitive Advantage in Energy



Source: Bloomberg

be less of a drag in many countries as their budget deficits have closed dramatically over the last few years. While these are optimistic signs, the level of improvement is likely to be modest, as many long-term structural challenges remain, including:

- Unemployment remains high and modest economic growth will not significantly improve the employment outlook, disposable income or the top-line revenue growth of European companies.
- Both household and corporate deleveraging in Europe has not progressed to the same degree they have in the U.S. as shown earlier in Chart 2. This situation will continue to provide headwinds to growth in Europe for the foreseeable future, as limited capacity to increase borrowing exists despite lower interest rates.
- European bank balance sheets have lagged far behind those of the U.S. banks both in terms of bad loan clean-up and overall deleveraging. While the ECB has been aggressive in stabilizing banks through low-cost lending and pledges to do “whatever it takes”, the healing process has been slow and the banking system throughout Europe still represents a source of risk to its recovery.

In China, we see the story as being more positive. While many analysts are concerned about slowing growth in China or high levels of debt resulting from the stimulus programs implemented after the financial crisis, the reforms proposed by President Xi Jinping and the new government are ambitious and needed. More importantly, most knowledgeable China observers are quite surprised by how quickly and effectively power has been consolidated and reforms have been pushed through. Financial reform, both to the banking system and the move towards convertibility of China’s currency, are among the most important changes being implemented.

We expect these reforms will create negative headlines and some debt defaults in the near term, but in the long-run they should provide meaningful

improvement in China’s continued ability to grow and lift large portions of its rural population from poverty. Although China’s public equity market has been one of the worst performing markets in the world over the last six years, we expect that these reforms will begin the process of recovery. However, we recommend caution, as the road to recovery will be quite volatile and investors should be prepared for a bumpy ride.

Inflation

Over the last few years, many analysts and market commentators have been concerned that the seeds of inflation were being sown by the quantitative easing policies of central banks around the world. This massive wave of liquidity would be difficult to unwind and the glut of liquidity would eventually lead to inflation...or so the theory went.

We held a similar view that these policies, while not posing an immediate inflationary threat, would eventually lead to inflation. Or at least we hoped that it would, as deflation would be a much more difficult environment to navigate. One needs only look at the Japanese economy and capital markets over the last 30 years as an example of the challenges produced by a deflationary spiral. However, five years after the financial crisis and the start of massive central bank policy experiments, the threat of inflation is nowhere to be seen today.

For the first time in decades, most countries in the industrialized world have seen their inflation rate fall below 1%, despite the multi-year experimental policies of central banks. The U.S. and UK are the notable exceptions in the G7 with slightly higher inflation rates, but the U.S. inflation rate was running at a mere 1.2% as of November as shown in Chart 6. We believe the low inflation rates are related to weak economic growth and limited employment growth that have led to real wage growth stagnation and limited demand for credit. Additionally, these factors are likely to persist into the future.

Does this mean the world is headed into a deflationary

spiral? In our opinion this is not a likely outcome, as economic growth is still positive with a chance of modest acceleration in the coming year and employment is slowly improving. However, it seems that the risk of deflation remains a non-trivial possibility despite five years of essentially 0% interest rate policies from central banks around the world.

Our primary concern with regard to deflation is not whether central banks would move to become more accommodative, but whether they would have any impact even if they tried. It's possible, should we move closer to deflation, that the Fed has used up all of its effective tools and has nothing left in its bag of tricks. Consequently, we believe the possibility of extreme outcomes for inflation in either direction remains elevated relative to more normal economic environments.

Central Bank Involvement

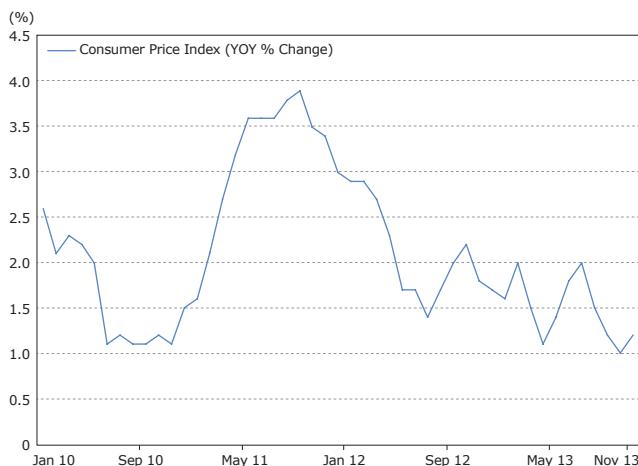
Any discussion of recent central bank activity should acknowledge the masterful foreshadowing work accomplished by Fed officials. For years, investors have been concerned about the Fed's ability to normalize or exit its accommodative policies without causing significant damage to capital markets. The clearest evidence of this concern was in May of last year when Fed Chairman Bernanke first uttered the word "taper", creating a panicked sell-off in markets

as 10-year Treasury bond yields rose nearly 1.5% and U.S. equity markets fell 6%. In December, when the Fed officially announced that it would taper asset purchases after months of discussion, the stock market rallied along with other risk assets, proving that investors can eventually adjust to most realities given enough warning.

Despite the recent tapering by the Fed, we believe central banks around the world are likely to remain engaged in their accommodative policies for years to come. Beyond simply believing their recent statements about their intent to keep interest rates low well into the future, it also appears they have good reason to continue their accommodative ways. We believe that global growth will remain muted despite the possibility for near-term improvement in the U.S. As we discussed earlier, we also believe that employment and inflation, the Fed's primary target variables, are likely to remain restrained for some time.

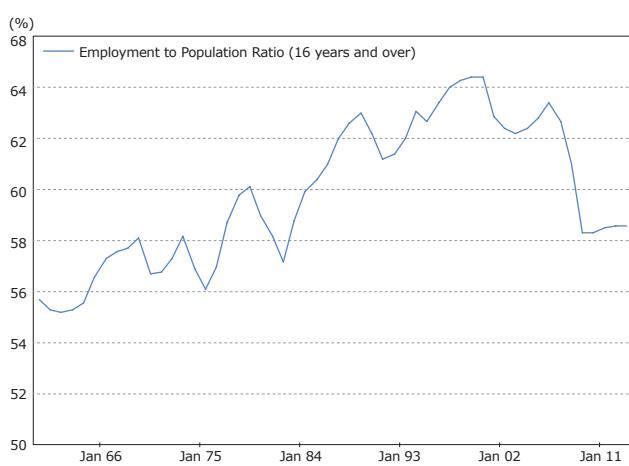
Superficially, the U.S. unemployment rate appears to be declining. However, actual employment remains stubbornly low because many potential workers have simply stopped looking for a job and are now excluded from the statistics as shown in Chart 7. As a result, real wage growth and disposable income growth as shown in Chart 8 remain quite weak. Since consumers account for roughly 70% of U.S. GDP, the

Chart 6. Inflation Running at Low Levels



Source: Bloomberg

Chart 7. Total Employment Has Not Recovered



prospects for accelerating inflation in the near term seem limited. With global growth remaining subdued, employment not growing and inflation remaining low, the Federal Reserve is quite believable when it states interest rates will remain low for a long time into the future.

Capital Market Implications

Since the beginning of “Quantitative Easing” and other accommodative policies by the Fed, little policy driven liquidity has been absorbed by the economy. Instead, these policies have been highly supportive of capital markets and asset prices over the last few years. In fact, it has been nearly impossible to avoid making money in financial markets, as the price of almost every asset has gone up. Investors who rode this liquidity wave have profited handsomely. However, as our clients remember, we believe one of the most important drivers of risk is the price one pays for an asset. Consequently, risk has certainly increased in most segments of the capital market over the past year.

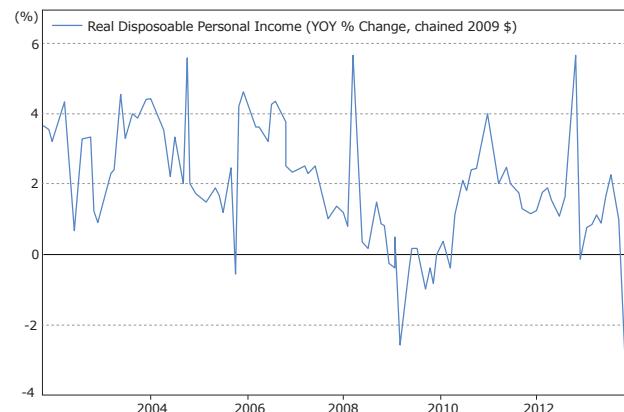
History Rhymes

Mark Twain famously once said that “History does not repeat itself, but it does rhyme.” As asset valuations increase, the investment environment has begun to feel oddly similar to the pre-crisis years of 2006 and 2007. During that period, investment volatility reached all-time lows, the prices of many assets reached all-time highs, and the appetite for leverage and risk appeared insatiable. Investors were nearly oblivious to the risks they were taking. As we now know, that period did not end well.

Many thought the lessons of the financial crisis would be well learned and not soon forgotten, but a few short years later some of the same problems that contributed to the crisis have reappeared:

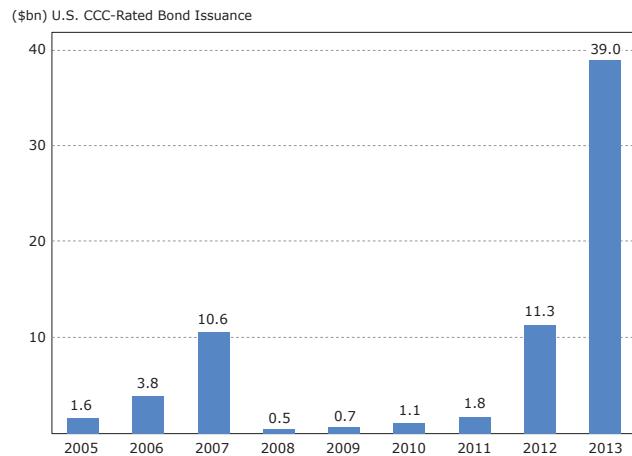
- Junk bond issuance in 2013 was nearly 2.5 times larger than in 2006. Further, within junk bonds, the junkiest of junk bonds, “CCC-rated” bonds, reached record issuance levels that were almost four times higher than in 2007 as shown in Chart 9.

Chart 8. Weak Employment Has Pressured Wages



Source: Bureau of Economic Analysis

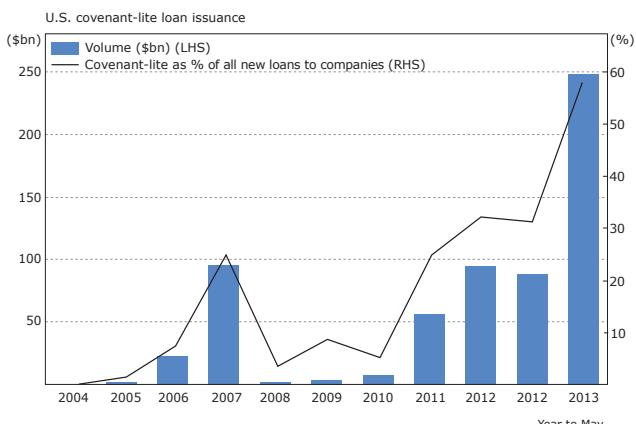
Chart 9. Junk Bond Issues Eclipse Pre-Crises Levels



Source: S&P Capital IQ

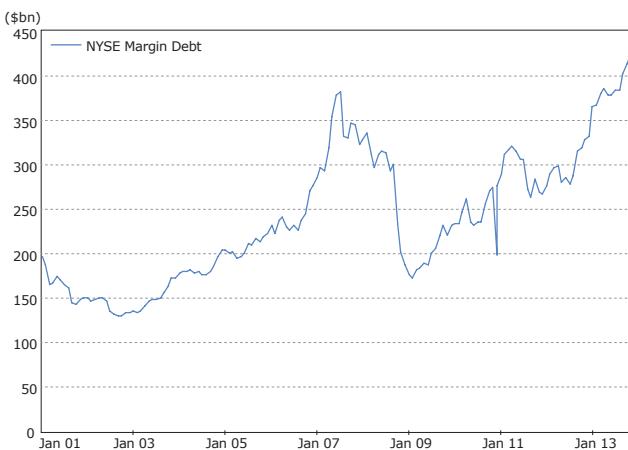
- PIK-toggle bonds (“When I can’t pay my debt, I am allowed to pay you with more debt.”) are approaching record issuance levels.
- Covenant-lite loans (“I don’t need to pay my debt and there is little you can do to make me.”) are back. In fact, nearly \$250 billion of covenant-lite loans were sold for the year through May 2013, more than doubling the record issuance in 2007. Further, nearly 60% of all loans made to companies during this period were covenant-lite loans as shown in Chart 10.
- Collateralized Loan Obligations (“CLOs”) in 2013

Chart 10. Banks Lowering Their Credit Standards



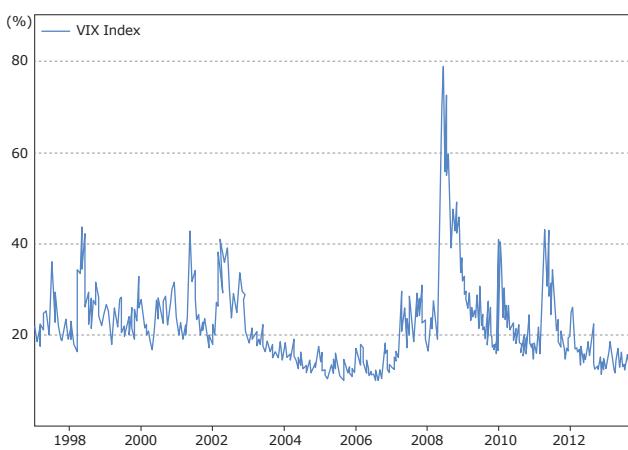
Source: S&P Capital IQ

Chart 11. Investors Adding Leverage (and Risk) to Portfolios



Source: Bloomberg

Chart 12. Signs of Investor Complacency



Source: Bloomberg

approached 2007 issuance levels and subprime loans made a comeback. This was ground zero for the financial crisis only six-years ago.

- Bad behavior is not isolated to the debt markets. Margin debt, primarily for equity investments, exceeded the prior record levels set in 2007 as shown in Chart 11.

History is rhyming pretty well at this point.

"A Near Rational Bubble"

Investor sentiment appears to be reaching very high levels fueled by positive investment returns in a dangerous self-reinforcing cycle. What is strange and perhaps sets this market environment apart from earlier periods is that this enthusiasm is accompanied by uncertainty everywhere in the world. Massive central bank experiments, intractable structural and economic problems in Europe, limited revenue growth and diminishing profit growth for corporations globally, and potential problems in certain emerging market economies headline a long list of investor concerns. Why are investors seeking risk in these uncertain times? We believe it is because most investors have become numb to these well-known concerns and the returns they can receive on low-risk and income-oriented assets have been repressed, encouraging or essentially forcing them to take more risk.

In an odd way, investor behavior might be considered rational in response to an orchestrated repression of interest rates to essentially 0%. If investors can't earn anything on their assets, the rational response is to "reach for more yield" by investing in riskier, longer-maturity bonds and lower-rated bonds. As demand increases, these securities become pricier and yields decline, forcing investors further afield. Many investors then turn to income-paying stocks and finally they rotated into broader equity markets, creating a cascade of liquidity and increasing valuations in each market successively. Ben Inker, of the global investment firm GMO, describes this as a "near rational bubble" with investors' behavior being a direct and logical - albeit artificially induced - response to the investment choices they face.

As we enter 2014, the investor sentiment pendulum has clearly swung from fear to greed and, to restate the obvious, risk seeking behavior is back in vogue. In the equity markets, implied volatility indices, what some investors often refer to as the “fear gauge” have declined to levels not seen since just before the financial crisis as shown in Chart 12. Unfortunately, these periods of euphoric investor sentiment, low implied volatility and elevated valuation rarely end well for investors.

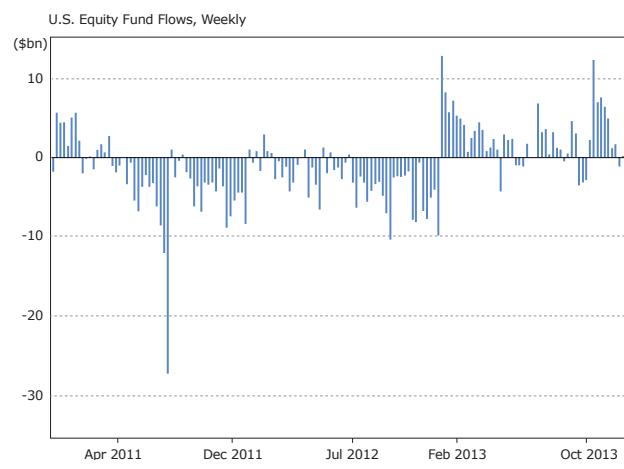
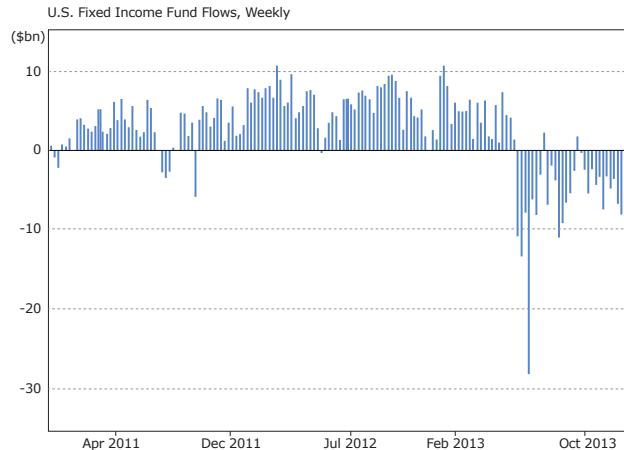
U.S. Equity Market Bubble?

How far along are we in this process of riding the waves of liquidity to higher valuations? The truth is that we really don’t know and we don’t know when or how rapidly elevated markets might unwind. While that may not be particularly helpful, there are indicators that provide some clues. Some observers have argued that we are still in the early innings of a “great rotation” out of bonds and into equities and that this trend has the potential to last well into the future as shown by mutual funds flows in Chart 13. However, margin balances, as shown earlier in Chart 10, are already at record highs, implying that many investors are already leveraged into the equity market.

Is the equity market currently a bubble? Probably not. The equity market in the developed world is not trading at extremely high levels by historical standards, but the forward looking P/E ratio should no longer be considered attractive as shown by Chart 14. Many will remember that the equity bubble of the late 1990s inflated P/E ratios well into the low 20X range. However, investors should proceed with caution as market corrections, such as the 1987 crash, occurred from valuations levels that were well below current levels.

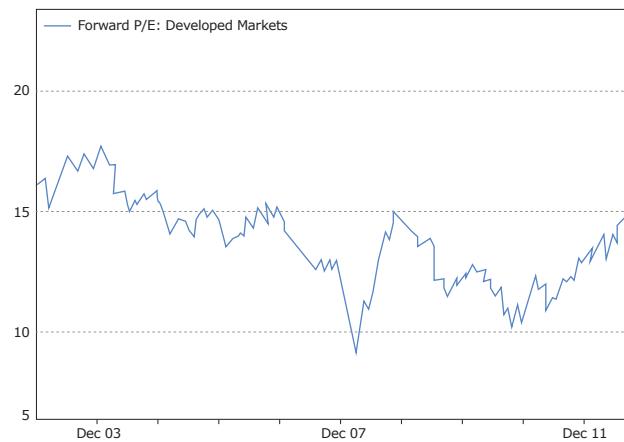
While U.S. equity market valuations are not extremely high, other concerns exist. Corporate earnings growth has slowed over the last several quarters and, as shown in Chart 15, the first few years of the current market rally were driven by earnings growth as the U.S. economy recovered from the financial crisis. The second half of the rally has been driven by multiple expansion, as earnings growth has slowed. Chart 16 more clearly shows the direct linkage over

Chart 13. Rotation from Bonds to Stocks



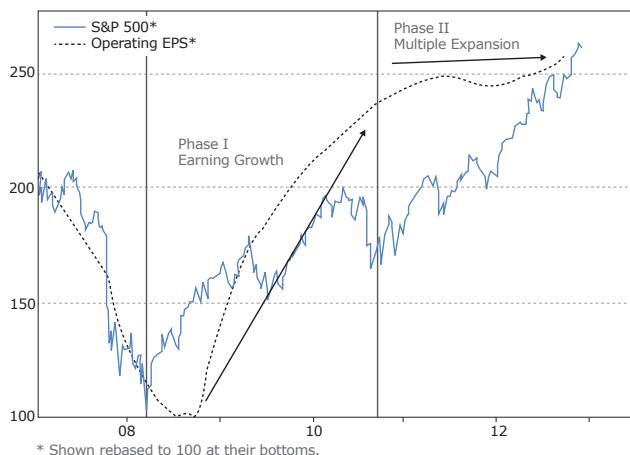
Source: ICI, Morgan Stanley Research

Chart 14. Developed Markets Are No Longer Cheap



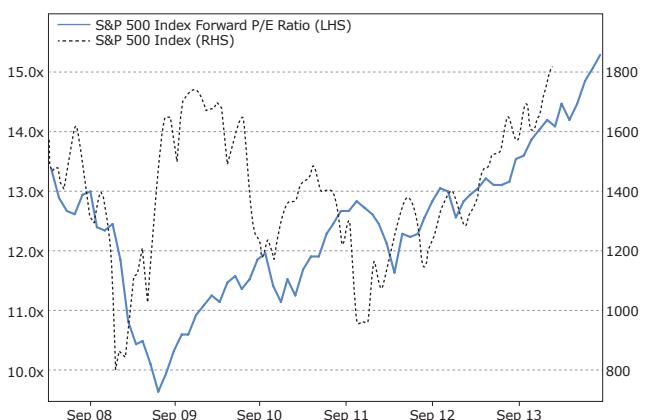
Source: IBES, MSCI, Datastream, Morgan Stanley Research

Chart 15. Two Phases to Stock Gains



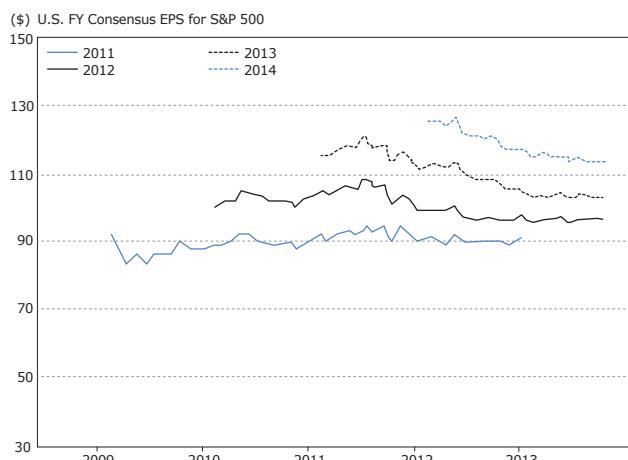
Source: BCA Research

Chart 16. Recent S&P 500 Performance Driven by Multiple Expansion



Source: BCA Research

Chart 17. Analysts Cutting Earnings Estimates



Source: Thomson Reuters IBES, Morgan Stanley Research, Datastream

the last two years between market performance and increasing P/E ratios.

Over the last year, top-line revenue growth for U.S. publicly traded companies has been disappointing at only 2% and corporate earnings have been essentially flat, but the S&P 500 increased from just over 1426 to 1848, causing its forward looking P/E ratio to increase from 12.7 to 15.5. A year ago, 2013 earnings were expected to grow over 15%. In actuality, earnings growth came in well below 5%, a number that was boosted by share repurchases. The lines on the right side of Chart 17 show the ongoing downward adjustments for corporate earnings over the last few years. It is a bit unusual to have persistent downward earnings revisions outside of a recessionary period.

Today's not-overly-inflated valuations are predicated on corporate earnings growing at a healthy rate of over 10% in 2014. We believe that earnings have the potential to disappoint investors once again, making markets more expensive than investors currently believe.

Where will equity markets go from here? Obviously, there is no clear answer to this very important question, but history has shown that liquidity driven bull markets can continue for a long time and prices can rise to very high levels. Corrections historically have not occurred without Fed tightening. The current tapering probably doesn't qualify as tightening since the Fed has signaled a commitment to keep rates low for years to come. So, while warning signs are beginning to appear, the support mechanisms remain in place for prices to continue to rise. Investors should proceed with caution.

Emerging Market Equity

While U.S. market valuations have increased and are beginning to signal warnings, emerging market equities valuations remain near historically low levels. During the year, emerging markets declined, while earnings grew at a reasonable pace. This combination caused valuations to remain relatively attractive as shown in Chart 18. As we enter 2014, emerging market equities continue to be under intense selling

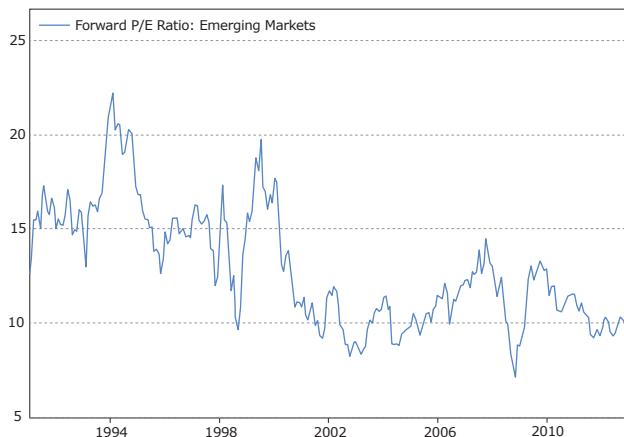
pressure and volatility remains elevated. However, we continue to believe current levels represent an attractive entry point for investors that have a long-term orientation and can withstand peaks and troughs along the way.

Fixed Income

Interest rates, at least in the U.S., have responded rationally to Fed tapering. The 10-year Treasury yield increased from its low of around 1.5% in mid-2012 to nearly 3.0% at the end of 2013. Similarly, 30-year Treasury yields have increased to nearly 4.0%. Some analysts have even begun to make the argument that the 30-year Treasury is fairly priced given their muted expectation for future inflation as real yields (after-inflation) approach 2% as shown in Chart 19.

Credit markets seem to once again be at the center of undisciplined behavior and extreme valuations. Absolute yield levels and spreads for corporate and high yield bonds have reached levels well below those of even the pre-financial crises era as shown in Chart 20. Whether this is a consequence of financial repression brought about by the zero interest rate policies of the Fed or simply a natural response by investors, the result is the same; valuations in these markets are rich relative to historical norms, increasing risk for investors.

Chart 18. Emerging Markets Trading at Attractive Valuation



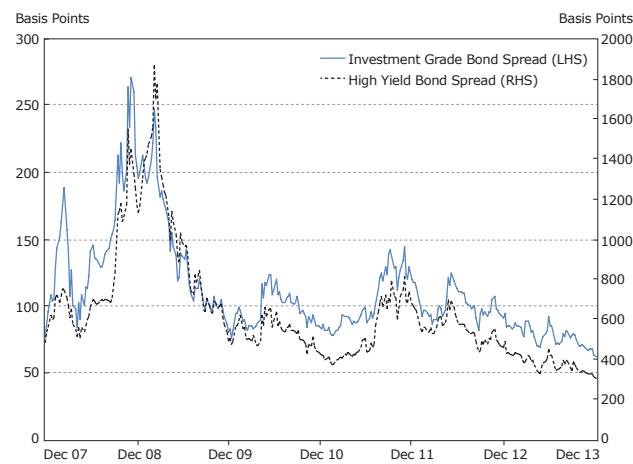
Source: BCA Research

Chart 19. Treasury Yields Rise Above Inflation



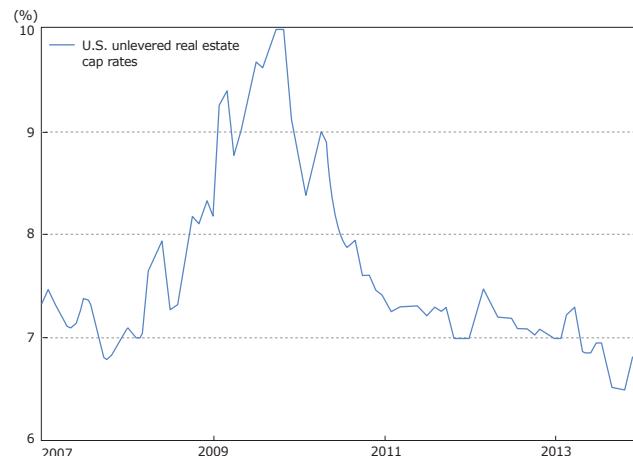
Source: Bloomberg, Morgan Stanley Research

Chart 20. Credit Spreads Are Extremely Low



Source: Bloomberg

Chart 21. Property Valuations Are at Pre-Crisis Levels



Source: JP Morgan Asset Management

Real Estate Markets

Similar dynamics have emerged in commercial real estate as investors continue to search for income even in less traditional markets. Cap rates, or the current operating income yield on real estate transactions, have dipped back below 7% to levels that are even below those of the pre-crisis era that precipitated a housing market crisis as shown in Chart 21. Further, yields on transactions in prime locations, such as the central business districts of major metropolitan areas like New York, San Francisco and London have fallen below 4%, which is also nearing pre-crisis lows.

What Should Investors Do?

Valuations in certain markets are elevated and some warning signs are beginning to appear. Does this mean we are on the precipice of a bubble bursting and that investors should retreat to cash? It is impossible to accurately forecast the timing of a market correction, but major market disruptions are an inevitable part of investing. The timing of events is always uncertain and decisions to exit the market are risky, as investors may be foregoing years of productive returns as they wait for an event. Further, the decision to re-enter the market is equally difficult, posing the very real possibility of missing returns on the upside. We simply don't believe that effective market timing is possible.

Charley Ellis recently wrote an essay in the Financial Analyst Journal drawing upon some of history's master strategists, including Sun Tzu, the famed Chinese military general, strategist and philosopher. Sun Tzu stated that "the skillful commander takes up positions so he cannot be defeated. Thus, a victorious army wins its victories before the battle." Mr. Ellis drew an interesting parallel for investors in saying that "today's best investment strategists deploy their portfolios in ways that will achieve superior results and withstand the severe interim tests of disruptive markets without the need to depend on clever portfolio tactics." In other words, well prepared investors, whose portfolio structure allows them to withstand the inevitable difficult market, will be more likely to achieve their long-term goals.

Sage advice indeed. We believe it is a particularly important time to review portfolio construction and asset allocation decisions to ensure that negative market performance will not produce impulsive selling, resulting in the permanent impairment of capital. Human nature is such that we want to chase winners. Markets over the last few years have certainly given us plenty to chase. The challenge for investors is that when they chase performance, they are adding risk to their portfolio and slowly eroding their defensive position. Consequently, when the inevitable market disruption occurs, the damage to their portfolio is far greater than expected. As prices increase, it is critically important for investors to make sure they rebalance their portfolios and even revisit their strategic asset allocation decisions to ensure they can remain invested during difficult periods.

Investment Themes

In our 2013 Annual Outlook, we cautioned that investors should not "fight the Fed" and that "if the Fed continues its zero interest rate policies, asset prices will likely continue to increase." Yet even we were surprised by the strength of the equity rally in 2013. Last year, we also cautioned investors to be mindful of increasing valuations, particularly in fixed income markets. At the risk of sounding like a broken record, the proverbial rubber band is stretched just a bit further as we enter 2014. Investors must be particularly careful to ensure they are being rewarded for the risks they take.

Fixed Income

Over the last few years, we have advised clients to reduce or eliminate their exposure to high-quality fixed income markets. Quite simply, we believed the risk reward proposition was unappealing. This positioning of client portfolios has been very beneficial, as most fixed income markets have underperformed other markets, and so called "safe haven bonds" have actually produced negative returns over the last two years. One of the benefits of poor performance is that the asset class often becomes more attractively priced, as we have seen recently with Treasury bonds.

In mid-2012, the 10-year Treasury yield reached a historic low of 1.6%. Since that time, 10-year yields have nearly doubled to roughly 3.0%.

Despite some analysts warning about systemic credit problems in municipal bond markets, we continue to believe that most municipal bond credits should hold-up well. Last year, we witnessed two very visible credit problems with the city of Detroit and the Commonwealth of Puerto Rico. While these isolated cases caused losses for investors, most municipal issuers remain relatively sound. State income taxes have rebounded quite sharply after the financial crisis and continue to grow. Additionally, property tax revenue, which tends to fund local municipalities, has begun to rebound in sympathy with healing real estate markets. The most troublesome liabilities remain long-term pension and healthcare liabilities, which provides some time for restructuring with limited near-term risk of distress or default.

While the absolute levels of interest rates are not highly attractive, investors should consider taking modest steps toward normalizing their fixed income allocations, particularly as the risk in other asset classes has increased.

Equity Markets

At the beginning of 2013, we stated that "unlike the shrinking risk premiums we see in fixed income markets, equities remain reasonably valued by historical standards." That story changed a bit during 2013, as equity markets far outpaced underlying earnings growth and rallied primarily through multiple expansion. While equities are not egregiously overvalued today, they do pose more risk to investors. As we mentioned earlier, despite some warning signs with slow corporate revenue and earnings growth, accommodative central bank policies that have supported asset price increases will likely remain in place for the foreseeable future. We believe investors should remain committed to (or rebalance to) their long-term investment plan, including maintaining some exposure to equity markets rather than attempt to guess at the timing of a future market correction.

Chart 22. Macro Dominance Easing, Stock Correlations Are Down

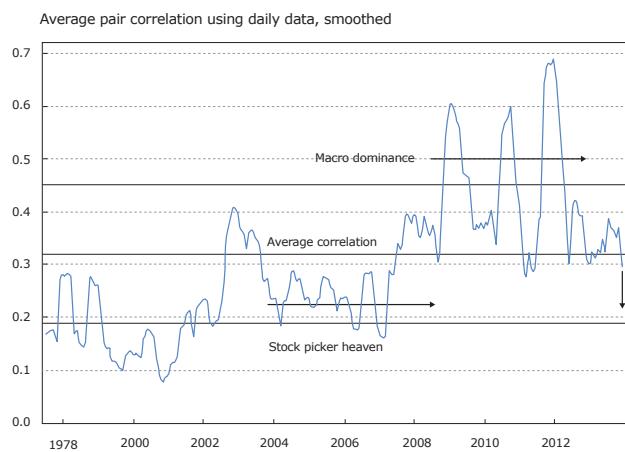


Chart 23. Wider Dispersion in Country and Sector Performance in EM

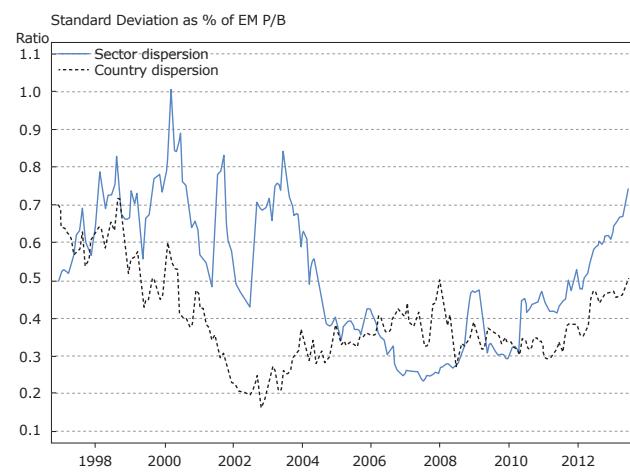
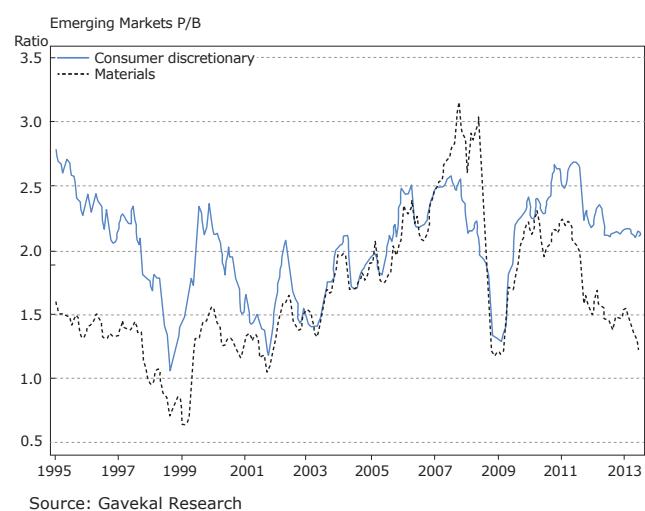


Chart 24. Widening Valuation Differences Among EM Sectors



Over the last few years, U.S. equity markets have been macro-dominated, which has led to higher correlation among stocks as shown in Chart 22. Many active management strategies are less effective during these periods because the decision to be in or out of these markets becomes relatively more important than how to access the markets. As macro concerns wane, active management should become relatively more effective. This is particularly true for hedge funds, where a large portion of the expected returns comes from stock picking and the relative performance among stocks.

Emerging market equities are an entirely different story. We continue to believe that the long-run story for emerging markets is undeniably positive, particularly if we can access the powerful tailwinds of the growing middle class and its burgeoning consumption. For the last several years, we have advocated increasing exposure to emerging market equities. While 2012 was a good year, as emerging markets outperformed most developed markets, 2013 was a poor year in the aggregate with emerging markets actually declining for the year. Fortunately, our focus on finding the right managers in these markets significantly benefitted our clients through strong relative performance.

In emerging markets, it is always dangerous to generalize, as the diversity among countries and even sectors within these countries can be quite wide. Chart 23 shows the significant dispersion between the performance of various emerging market countries and among sectors within these markets. This level of divergence provides fertile ground for active management decisions rather than investing through an index-based strategy. Further, the dispersion has been increasing over the last few years, resulting in widening valuation differences among sectors as shown in Chart 24. Despite our interest in emerging markets consumers, this means that investing in narrow sector funds in these markets can be risky, as valuations can become quite elevated.

Going forward, we continue to advocate overweighting specific opportunities in emerging markets.

Valuations in these markets remain attractive in absolute terms and have become more attractive relative to developed markets as previously shown in Charts 14 and 18. However, we believe volatility will remain elevated and investors must take a long-term perspective and be able to withstand higher volatility and sometimes unsettling headlines. We believe as strongly as ever that how we invest in these markets, primarily the managers we choose, is more important than the decision to invest in these markets.

Private Equity

Private equity remains an important driver of long-term performance for our clients. Like other highly inefficient markets, such as emerging market equity mentioned above, manager selection remains just as important as or possibly more important than the decision to invest in the asset class.

We continue to focus on investment activity in less efficient areas. In the U.S. this means emphasizing smaller managers who invest in smaller companies. Additionally, Chinese private equity continues to be an emphasis for us, albeit somewhat less so than several years ago. We continue to believe that the emerging middle class and the acceleration of consumption will be a driver of growth and create attractive opportunities. However, one of the challenges we recognized years ago in China is that many of the companies able to capture these emerging consumption patterns are still relatively small and not listed on public exchanges. As a result, much of our early investments in China were in the growth and venture capital area, which have generated good results for our clients.

Our interest in Chinese private equity has been productive in building a strong underlying portfolio of companies. This has been particularly true of our investments in the venture capital and earlier stage growth capital areas. One frustration has been limited liquidity from this portfolio, as the Chinese regulators halted IPOs since the end of 2012 to clean up fraud and misconduct. Recently, the Chinese IPO window reopened. It will take up to a year to clear the backlog of IPOs, but many predict

that the Chinese market will regain its past issuance activity, which made China the world's largest IPO market in 2010 with \$71 billion issued. Going forward, we plan to continue to selectively invest in Chinese private equity, but the emphasis will be reduced. As a secondary benefit of this IPO activity, many of the companies in the IPO backlog are consumer oriented companies, whose listing will deepen the investment opportunities in the public equity markets.

Real Assets

Inflation continues to be quite benign despite concerns that we and others have had about the impact of accommodative central bank policies. While it is possible that the liquidity created by these policies may sow the seeds of future inflation, economic growth in most of the developed world economies continues to be moribund. In this environment, it is not surprising that most inflation-sensitive assets, such as commodities and gold, have performed poorly. Until we see nearer-term prospects for change, we continue to recommend that allocations to liquid real assets remain at the lower end of asset allocation ranges.

However, we continue to find attractive opportunities in illiquid real assets investments, such as mining and drilling for natural gas and oil. Real estate

investments have produced good results from the bottom of the financial crisis, but valuations in many areas are back at pre-crisis levels and provide investors with a poor risk/reward proposition. Investors must be quite selective in their real estate activity.

Concluding Thoughts

While the identification of attractive investment opportunities and effective implementation through some of the world's best investment managers can produce materially better outcomes, we should remember that asset allocation is critical to the successful attainment on one's long-term investment objectives. Sound asset allocation and the proper calibration of a portfolio's risk profile to match an investor's tolerance lay the foundation for success by creating the ability to remain invested through volatile markets. Today, after one of the strongest multi-year equity market rallies in history, investors are likely to be over allocated to riskier assets, such as equities and high-yield debt, simply because they have performed quite well in absolute and relative terms. Some of these markets are exhibiting warnings signs that investors should heed. While it is nearly impossible to accurately time markets, investors should make sure to rebalance their portfolios back to their allocation targets to ensure they can withstand the inevitable market corrections ahead.

About Gresham

Gresham Partners, LLC is a nationally recognized, independent investment and wealth management firm that has been serving select families, family offices and endowments since 1997. Known for its commitment to delivering superior investment performance and highly personalized wealth planning, Gresham's client-focused solutions feature hard-to-access managers without the conflicts typical of other firms. With over \$4 billion under management, Gresham's Risk Conscious® investment approach and holistic planning are focused on preserving and growing clients' assets. The firm's team of highly skilled professional advisors allows families greater freedom to pursue career and personal interests.