EDGE

# Q4 2013 Outlook

Fall/Winter 2013

CONFIDENTIAL

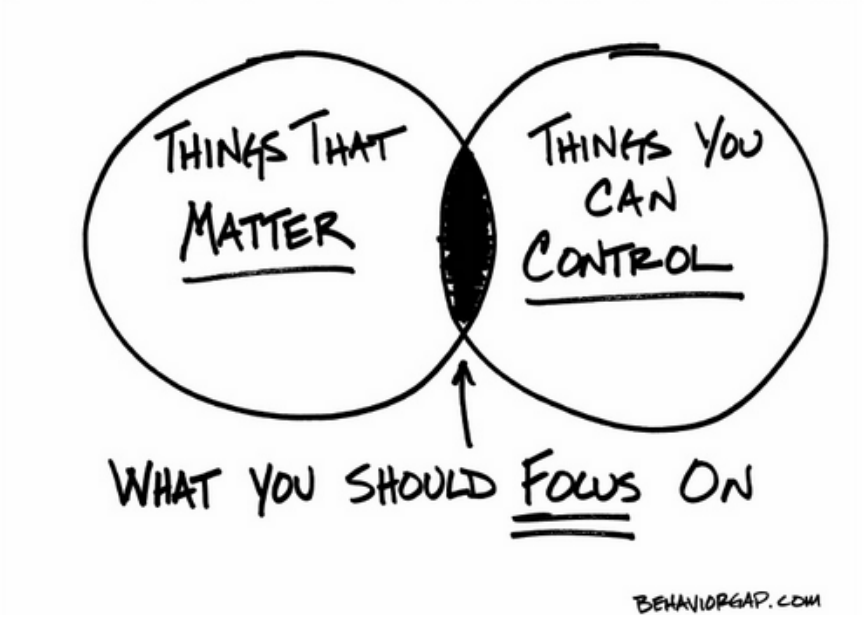
# FOCUS ON WHAT YOU CAN CONTROL

The financial markets are not so unlike many other aspects of life. There are events that you can control and those you cannot. News headlines in the most recent quarter once again make this humbling point. Geopolitical risk demonstrated through the violence in Syria, gridlock politics hampering the legislative process seen during the US government shutdown, or monetary policy impacts on financial markets evidenced by the Federal Reserve decision not to taper are all illustrations of forces beyond an investor's influence that must still be incorporated into portfolio construction and decision making.

Clichés are often used because they have the ring of truth. An example is that investing draws many parallels to sports. In both activities, there are talented participants, seasoned commentators, and statistics that shape a team's game plan. On game day, the players take the field and become subject to the pressures put forth by the other team, the field conditions, the referees, and even themselves. The team that consistently rises above is the one that focuses within and filters out the noise. It is the team that best adapts their strengths to the many influences outside their control that sees success.

In today's investing world, we find ourselves again at the turning point of so many economic situations, many of which are out of our control. It is likely that the US Federal Reserve will be the first central bank to start withdrawing its extraordinary support in the coming years and we are likely to see rising interest rates in the long term. Japan continues to push forward on its own policies and has seen a tremendous shift in the value of its currency relative to those of its neighbors. Europe has reduced the stress on its most vulnerable members, but still seeks resolution of its economic unity and long-term structural issues. Emerging markets are coping with the need for a more self-sustaining and self-funding growth path. Future news headlines will certainly continue to redirect our short-term focus.

**In the face of these outside influences, we must focus on what we know – that valuation is the guide to good returns. As investors, we can exert our control by being selective in the assets we own. By having a plan yet staying flexible, we will be able to find the path to our long-term investment goals.**




*As we are often reminded, events out of our control distract us from what is most important. A simple picture draws our focus back to what we know will help reach our goals.*

*Source: Behavior Gap*

| | | Changes |
|---|---|---|
| **FIXED INCOME** | | |
| **DEFENSE** | | |
| **INVESTMENT GRADE** | | |
| Municipals | NEUTRAL | |
| Treasuries/Gov't Agencies | UNDERWEIGHT | |
| Corporates | NEUTRAL | |
| **OFFENSE** | | |
| **HIGH YIELD (CORPORATE)** | UNDERWEIGHT | |
| **OPPORTUNISTIC** | NEUTRAL | |
| **PRIVATE** | OVERWEIGHT | |
| **EQUITIES** | | |
| **US EQUITY** | | |
| Large Cap Equity | OVERWEIGHT | |
| Small Cap Equity | NEUTRAL | |
| **INTERNATIONAL EQUITY** | | |
| Developed Markets Equity | NEUTRAL | increase |
| Emerging Markets Equity | OVERWEIGHT | |
| **LONG/SHORT EQUITY** | NEUTRAL | |
| **PRIVATE** | NEUTRAL | |
| **REAL ASSETS** | | |
| **REAL ESTATE (REITS)** | UNDERWEIGHT | |
| **MLP/INFRASTRUCTURE** | NEUTRAL | |
| **COMMODITIES** | NEUTRAL | |

## Macro

- While the market was surprised by the decision to maintain current stimulus, the nomination of Janet Yellen to succeed Ben Bernanke in 2014 came as expected. Despite the Fed's acknowledgment that economic improvement warrants less monetary support in the future, we continue to believe the Fed under Yellen will maintain a low Federal Funds rate through 2015. **In the intermediate term, we fully expect the cost of money to increase, thus impacting all asset classes from a valuation and expected return perspective.**
- Leaders in Europe are quick to speak of action; however, they continue to allow the size of the ECB Balance Sheet to shrink by nearly 25% from its peak. **A time may come when additional monetary support or a weaker euro is needed in order to sustain the economic recovery in Europe.**
- Looking forward, as the cost of capital is expected to increase, the impact to emerging economies must be considered, especially those largely dependent on foreign capital for investment. Throughout the past 16 years, **Developing Asia has reduced external debt over 50%, thus providing additional margin for safety for sustained growth** as the US is likely hitting its "high-water mark" for monetary support from the Federal Reserve.

## Fixed Income

- With the unanticipated move by the Federal Reserve to maintain asset purchases, credit markets once again returned to the status quo of near-term low rates with spreads normalizing towards 12-month averages and volatility dampening over the prior quarter. We continue to **favor high-quality, low-duration credit allocations** to serve a defensive role in portfolios.

## Equities

- Multiple expansion continues to be the story of 2013 for investors in the US equity markets. Despite earnings revisions downward, the 2013 S&P 500 multiple has moved to 15.1x, handsomely rewarding investors. Looking forward to 2014, revenue growth and operating leverage must improve to meet estimated operating EPS growth of 13%. **Selection of companies able to deliver top-line growth will continue to earn multiple premiums to a broader market, which continues to become more fairly valued.**
- As fundamental investors, we continue to look globally for opportunities. For the first time since 2007, we recommend an upgrade to International Developed equities, particularly in Europe. While European equities continue to trade at a statistically significant, multi-decade discount to the US, **we now see stronger economic activity to support the sustained recovery that should directly impact European domestic companies over their multinational counterparts.** Similar to the past few years in the US, we also see the ability for multiple expansion to contribute to increased total return in the region.
- Continued price underperformance of emerging market (EM) equities (despite continued earnings growth) has led to valuations falling to multi-year lows relative to developed equities. **We believe that EM equities warrant an overweight allocation based on the combination of discounted valuation, sustained profit growth, and attractive dividend yields.**
- As we continue to recommend allocations outside the US for our dollar-denominated investors, currencies can greatly impact investment performance in the short run; however, with a longer investment horizon, we believe the selective fundamental value we are now seeing outside the US warrants potential near-term volatility.

## Real Assets

- **After years of declining production, US energy output is experiencing a renaissance.** The boom in production will provide a tailwind across the energy "food chain," benefitting subsectors such as infrastructure, transportation, engineering, chemicals, as well as some utilities. As "toll road" businesses, master limited partnerships (MLPs) should also benefit from the increased production; however, we advise that active management is as important as ever not only due to valuation considerations after a standout performance year up over 21%, but also due to increased transportation competition in certain geographies.

OUTLOOK

# Realize MORE

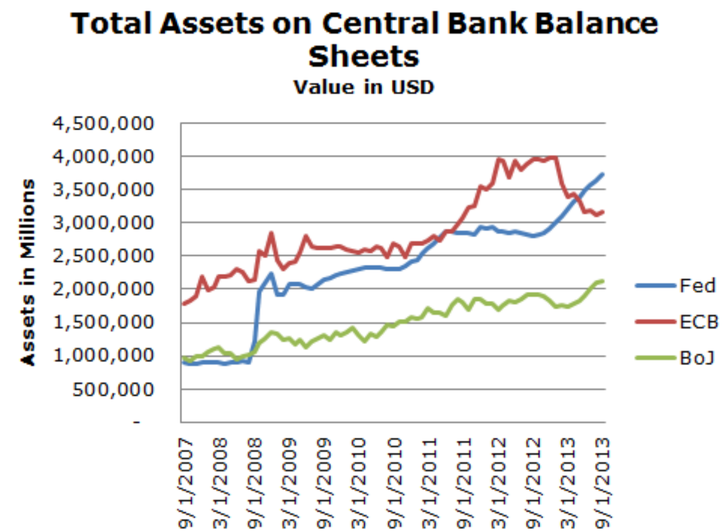
# HIGH-WATER MARK IN US FEDERAL RESERVE SUPPORT

The third quarter of 2013 demonstrated again the interaction of policy, economy, and financial markets as the highly telegraphed policy move in reducing the pace of bond purchases by the US Federal Reserve ended up with a surprising non-action in September. The Fed minutes showed a range of reasons for the decision but also showed consensus that economic conditions broadly warranted a reduction in the pace of bond purchases in the near future.

The official nomination of Janet Yellen as the successor to Ben Bernanke in January is consistent with our expectations. As current vice chair of the Federal Reserve (as well as prior Fed president in San Francisco, former chair of the Council of Economic Advisers to Clinton, and a labor economist), she is a qualified candidate and a supporter of recent extraordinary policies. **While easy monetary policy will linger under Yellen (e.g. previous guidance that the Fed Funds rate will stay low until 2015), it is likely that we have seen the high-water mark of monetary support in the US, barring an unforeseen challenge. In the next three to five years, the cost of money is likely to rise, which has an impact on both equity valuation and bond returns.** It is now left to the politicians to get the fiscal house in order.

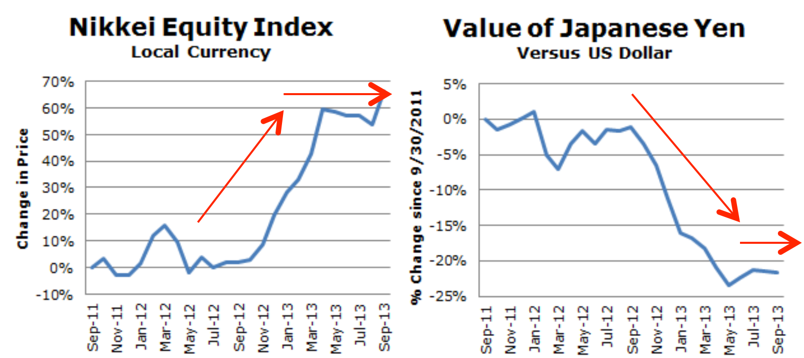
In Europe, the monetary policy tool of choice these days seems to be the cheapest: words. Styled as "forward guidance," both the Bank of England (BoE, now under the leadership of Canadian Mark Carney) and the European Central Bank (ECB) availed themselves of this strategy partly in response to US interest rates rising so quickly, to prevent the contagion from spreading to their own sovereign yields. Were we making policy, we would seek a path that allowed the euro to lessen in value to improve competitiveness and support growth. Alas, we are policy takers and it appears that ECB President Draghi has no appetite for it at the moment. In order for Europe to further the recent shift into economic expansion, the banking system still needs to be more fully repaired.

The need for structural reform and the limitations of money printing are not solely a US phenomenon. The oft-discussed policies of Abe-nomics in Japan (so-called Three Arrows) is facing its true first challenge on the reform front. Japan has experienced strong economic expansion and positive inflation by undertaking a massive expansion of the central bank balance sheet (First Arrow) combined with sizable stimulus (Second Arrow). On the Third Arrow of reform, the plan to increase the sales tax in Japan from 5% to 8% has many people nervous. Investors recall the last time this critical tax was increased in 1997. It is cited as a reason for the subsequent recession and part of the cause for the Asian financial crisis. Looking toward next year, the BoJ may be called upon again as the massive fiscal stimulus from early 2013 is likely to roll off in mid-2014. Japan needs all three arrows to hit the bulls-eye because, judging by the pace of the financial market reaction, it would not take much for policy makers to lose their control.




Source: Bloomberg

**Market Reaction to Japanese Policy**




Source: Bloomberg as of 9/30/2013

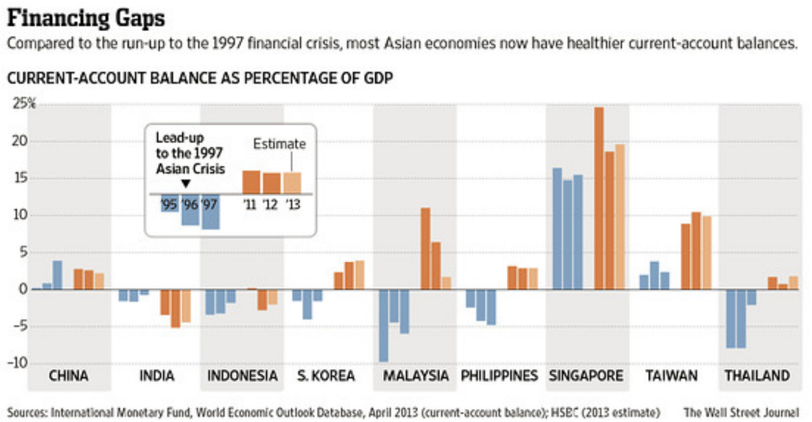
# EMERGING ASIA IS MORE RESILIENT TO FUND FLOWS

There is a basic economic equation called the "balance of payments." The balance of payments records all transactions between those inside a country and those outside that country. There are two primary components – the current account (recent transactions like exports/imports) and the capital account (long-term transactions like investment). The sum of the current account and the capital account is zero. Simply stated, if I spend more than I earn today, then someone had to lend me the money (or vice versa).

The emerging markets are why we are focused on this relationship, particularly in Asia. Many remember the Asian financial crisis in 1997, which coincided with the US Federal Reserve tightening monetary policy (raising the Fed Funds rate), a sales tax hike in Japan, and a resulting outflow of capital from the region. Interestingly, this rhymes with investor concerns today. In 1997, many of these economies had current account deficits, meaning they needed foreign investment to plug the gap in spending. This foreign investment (called external debt) was primarily denominated in US dollars which, when most of the emerging Asian central banks had insufficient foreign currency reserves to defend the then-prevalent currency pegs, left the debtors unable to make good on their obligations. Currency devaluations ensued, and the loss of confidence left the region stunted for several years.

Recently, we have seen outflows from the region again as rising US rates have increased the cost of capital. In our opinion, the emerging Asia region as a whole is far better positioned for the outflow of capital today versus then. Most currency exchange rates are now floating rather than fixed, providing a more orderly release valve. Many of these countries now have current account surpluses, which reduce their dependence on foreign capital. Foreign currency reserves have built up over the past several years. There is more use of local currency debt, and there is greater transparency into the economic data and policies of these countries. **Taken as a whole, the emerging Asia region is far less vulnerable today than 16 years ago.**

There are still some areas of weakness. In particular, India and Indonesia (which along with Turkey, South Africa, and Brazil in the broader emerging markets have been dubbed the Fragile Five) remain in the spotlight. While we do not expect the capital outflows to disrupt general stability in the near term, we are also not expecting a massive reversal of capital back to the emerging markets in the medium term. Thus, there is tightening in financial conditions, which understandably reduces economic growth expectations. The next three to five years will see whether this cycle's investments are productive. It is likely that a natural shakeout of successful business models will occur with some impact on the traditional banking system. **We continue to reiterate that selective active management is key to taking advantage of the long-term valuation opportunity existing in emerging Asian equity.**




Source: The Wall Street Journal


Source: Bloomberg, IMF

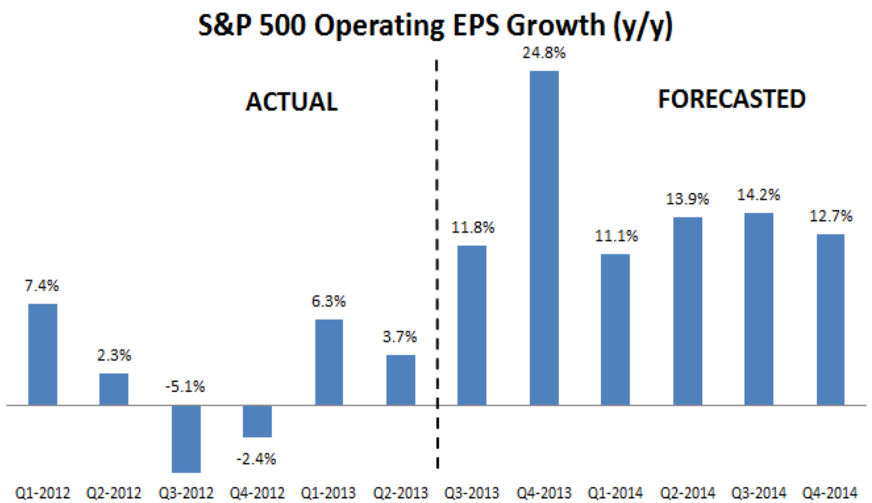
# US EARNINGS EXPECTATIONS OPTIMISTIC AGAIN

Looking back through the year, equities have proven to be one of the more resilient assets as investors have demonstrated a willingness to look through much of the "noise" that in prior years would have forced a sale. For example, despite a few market shocks year to date, the worst drawdown in the S&P 500 is slightly above 5% (from mid-May to June-end). Typically, changes in earnings expectations have a strong influence on market valuations; however, this hasn't been the case this year. Earnings expectations have continually declined; however, investors have decided instead to pay more for earnings, pushing the 2013 PE multiple from 12.5x to 15.1x.

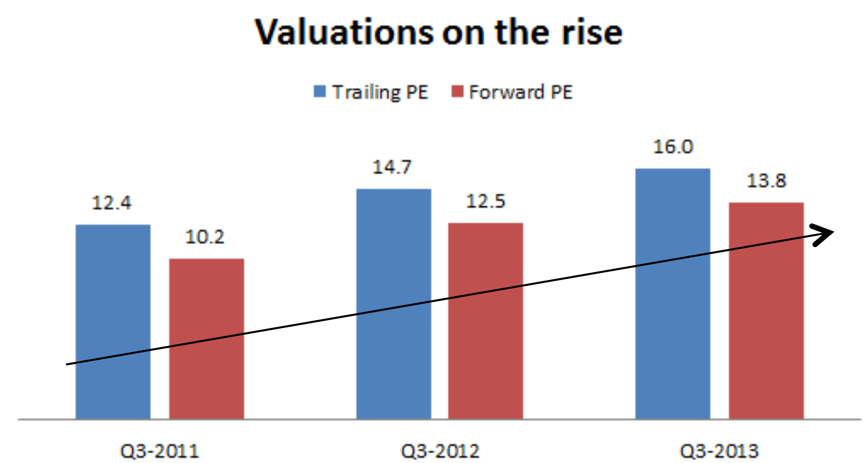
Let's peel back the layers further and look at the individual quarters of the year. Through the first half of 2013, operating earnings per share have increased roughly 5% year over year; however, expectations are back-end loaded (again). Investors are expecting a lofty 18% year-over-year growth in earnings during the second half of 2013. A pretty strong acceleration, especially considering the recent trend. Our experience would lead us to be concerned but should we be? A year ago, investors were expecting 8% year-over-year growth for the second half of 2012, but instead earnings fell 4%, a difference of 12%. Investors shrugged and  the S&P 500 returned +6% during the second half of 2012 (although the market was flat in Q4). Perhaps investors' need for a growing source of current cash flow coupled with lower inflationary expectations is driving continued equity support currently.

Nothing happens in a vacuum, and it's important to remember that stocks are forward discounting – what happened today matters less than what you believe will happen tomorrow. It is about the time of year when investor focus turns toward 2014. From a valuation perspective, the market is trading at 13.8x 2014 earnings, a fair multiple at face value. **Assuming no future revisions to 2013 estimates (not our base case as discussed above), the market is forecasting a robust 13% EPS growth for 2014. Based on our assumptions for earnings growth next year (6%-8%), we believe the market is valued closer to 15x earnings.**

We continue to believe earnings expectations remain too high – for both the second half of 2013 and "full year" 2014. As discussed above, the tougher question to answer is whether investors again look through negative revisions and continue to assign a higher multiple to stocks. We think it is possible, even with the recent expansion; stocks are valued near historical averages, which leaves room for upside. An uptick in economic data would support higher multiples, but given where we sit today, markets are already pricing in stronger growth. **In the current environment, we recommend investors focus more on individual sectors and companies capable of delivering on those higher expectations.**




Source: Standard & Poor's, Edge Capital




This chart examines trailing and forward consensus earnings multiples at the end of the third quarter (prior three years)

Source: Standard & Poor's, Edge Capital

# FOCUS ON TOP-LINE GROWTH AND INNOVATION

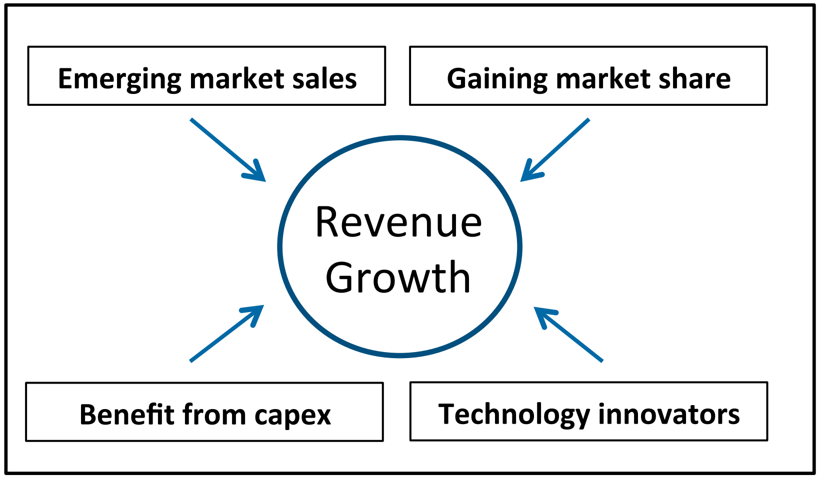
Looking through the lens of higher multiples and declining earnings expectations for next year, we emphasize that the margin of error for equity investors has declined and that selectivity will be more important in 2014. In recent years, US companies have done an outstanding job of improving internal efficiencies (resulting in higher margins) and strengthening balance sheets (lowering interest costs). These above factors, not to mention share buybacks, have been incredibly helpful for earnings growth. Moving forward, some of these tailwinds will dissipate and we believe investors will reward companies capable of delivering old-fashion revenue growth. **Revenue growth and operating leverage (improved by the factors above) is the best recipe for earnings growth and we believe companies capable of delivering topline growth will continue to deserve premium multiples.**

One sector we believe will deliver revenue growth is technology and more specifically, companies that are on the leading edge of innovation. We have been recommending technology for several quarters – specifically legacy technology with great balance sheets, strong cash flow, and "shareholder friendly" management. These companies have been trading at steep discounts to the broader market. There is, however, another group of companies within technology that are capable of delivering revenue growth for the foreseeable future.

Disruptive technologies do not come around very often; in fact ,over the past decade there are probably only a handful of breakthroughs that are worthy of the label. A few that come to mind immediately are mobile technology (iPhone), cloud computing, and shale fracing (innovation can occur in many sectors). These technologies have transformed the way consumers and business interact and have created (and bankrupted) billion-dollar businesses along the way. It is difficult to predict which technology will truly become "disruptive" but there are several worth exploring. Two that are attracting increasing attention are electric/hybrid vehicles and 3-D printing. **Our sense in speaking to technologists is that the entrepreneurial spirit is alive and well and the next decade could be an exceptionally strong one for innovation.**

As fundamental, value-conscious investors, we are always aware of the price paid for growth and it is possible to pay too much for even the best technology. What appears to be a disruptive technology today may not prove sustainable over the long run as highly competitive industries continually evolve and customer preferences change rapidly. Taking all into consideration, we believe that technological innovation is rapidly advancing and there will be big winners that get the combination right and big losers that didn't see it coming. **Finding new ideas early and understanding the broader impacts on the business environment will be key to the success of a flexible and active approach.**

## Drivers of revenue growth...




Source: Edge Capital

## Disruptive technology – Electric vehicles

Sales of hybrid and electric vehicles continue to gain strength, year-to-date sales through Sept.

| | |
|---|---|
| Full EV: | up 448% |
| Hybrid/EV mix: | up 36% |
| True Hybrid: | up 21% |

**Total EV / Hybrid sales up 30% YTD**

**Despite the gaudy increase, total EV / Hybrid sales account for only 4% of total US light-vehicle sales YTD.**

Further supporting the trend, battery development costs continue to fall, increasing the affordability of hybrid vehicles for the masses.

Source: EVobsession.com

# THE BEST VALUE IN EQUITIES IS OUTSIDE THE US

Looking back over the last three years, the US equity markets have performed exceptionally well – the S&P 500 has annualized at 16%. With forward multiples at multiyear highs and uncertainty over earnings expectations, we expect future returns within the US to be lower than in the recent past but still attractive. As "value conscious", fundamental investors, we continually scan the globe for attractive opportunities.

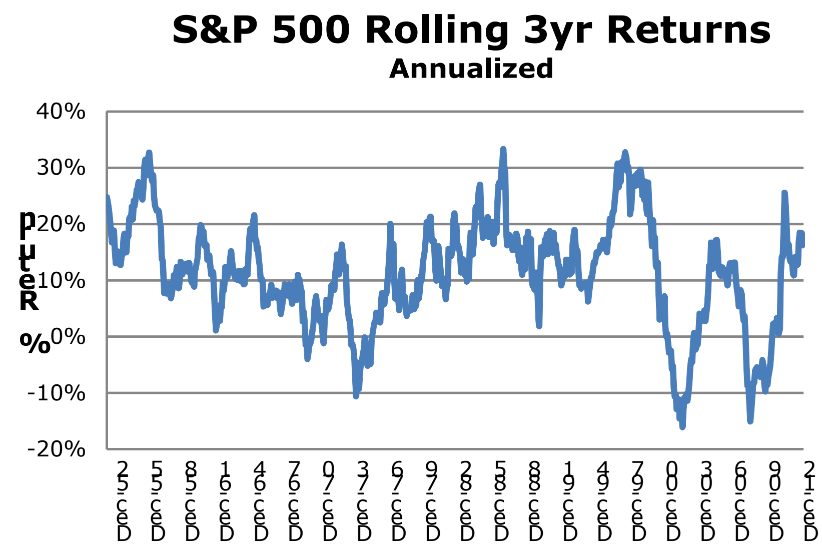
**The future return for an equity market is derived from three parts (excluding the effect of currencies). The three factors are 1) current valuations and the ability for them to expand, 2) the expected level of earnings growth, and 3) the dividend yield.**

Examining factors 1 and 2 from above, emerging markets potentially present the most compelling combination. Take MSCI Asia ex-Japan as an example; the current PE multiple is 12x, an attractive level, especially on a relative comparison. This compares to a 15.1x multiple for the S&P 500. Emerging markets (EM) typically trade at a discount to their developed market peers, but the discount is wider than average today. Part of the discrepancy can be explained by reasons addressed earlier in this Outlook. The cost of capital is increasing around the globe; however, for EM countries this can be a difficult adjustment period, as external financing can be vital. As previously stated, this adjustment period is likely transitory and not likely to create systemic problems for reasons also explained.

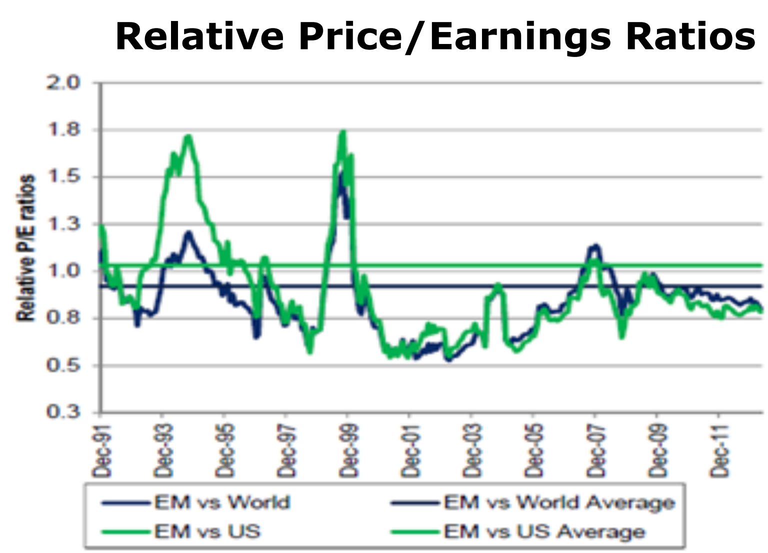
The earnings growth rate is also expected to be higher over the next 5 years (as compared to that of the US) for several reasons: economic growth is stronger, income growth is higher, living standards are improving rapidly, and employment trends are favorable. We estimate an earnings growth rate of around 11% in emerging markets (broadly). It is important to note that our views and expectations for EM are more focused on the consumer-related storylines, not the cyclical or financial sectors.

The third component to returns, dividend yield, is also available for investors in emerging markets. Many companies within the emerging markets have strong dividend policies and many active managers also focus on dividend payers.

**Net the three factors above, and we expect EM investors to earn a total return (including dividends) north of 13% per year over the next five years. This excludes the impact of FX, which can be significant in the short run. Aside from EM, we also see improving return potential in Europe because of the potential for expanding multiples and attractive dividends.**




Source: Bloomberg as of 9/30/2013




Source: Henderson Global

# UPGRADING EUROPEAN EQUITY

In the Edge Capital Q2 2008 Outlook we downgraded our view on developed international equity to underweight and wrote: "We strongly favor US equity over European equity." **The S&P outperformed the DJ Euro Stoxx by 55% (8.9% annually) from March 31, 2008 through September 30, 2013.**

The stark divergence in performance is a reflection of the structural challenges facing Europe and the relative success (at least so far) by US policy makers in promoting growth and liquidity over the austerity measures imposed in much of Europe.

Looking forward, however, the last five years of European underperformance has resulted in a meaningful discount to US equities. The cycle-adjusted price-to-earnings ratio (which is calculated using the average earnings over the last 10 years to adjust for the ebb and flow of the business cycle) shows that European equities currently trade at a multi-decade discount to US equities.

There are several catalysts that cause us to upgrade our view on European equities, but the most significant is a return to economic growth. Both Europe and the US experienced a sharp recovery after the 2008 financial crisis. Europe, however, experienced a "double dip" recession beginning in 2011 as its sovereign debt crisis and self-imposed austerity hurt growth. After moving sideways for nearly two years, we have recently seen a reacceleration of growth. We would caution that growth could remain below average (constrained by overlevered banks and structural headwinds), but even slow growth creates upside opportunity for stocks.

**With valuation as a support and a reacceleration in economic activity occurring, we believe that investors should begin to increase their European equity exposure. European domestic firms are more attractively positioned to benefit from this growth relative to European-based multinationals.**

**European Equities: Multi-Decade Discount**
**Comparing European and US cycle-adjusted P/Es**


Source: Datastream, MSCI, Henderson

**Measuring Economic Activity in the US and Europe**
**Purchasing Managers Index (PMI)**


Source: Bloomberg

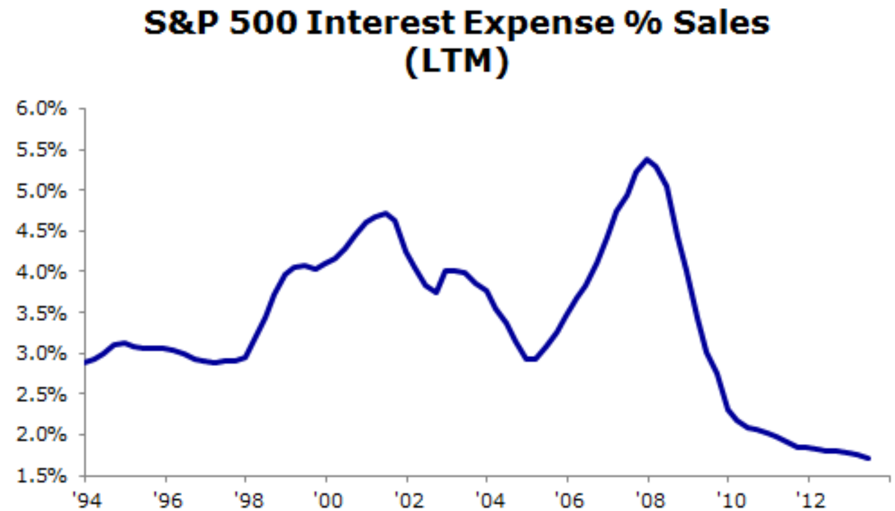
# RISING INTEREST RATES AFFECT VALUATION ACROSS ASSETS

Companies have continued to benefit from the extraordinary policies of central banks by accessing cheap capital. Examples include Apple, which issued a $17bln bond deal to pay an equity dividend or Verizon's $49bln new issuance, which was used to buy the outstanding ownership of Verizon Wireless from Vodafone. In addition to the opportunity to deploy capital for the benefit of shareholders, companies have also been able to reduce their interest cost (as a percent of sales), which improved their profit margins. According to analysis by brokerage firm Newedge, almost 35% of the growth in quarterly earnings of the S&P 500 is a result of "lower cost" issuance ($18 per share quarterly earnings and $4 per share interest cost at the end of 2009 versus $25 in quarterly earnings and $1.50 per share in interest cost in Q2 2013).

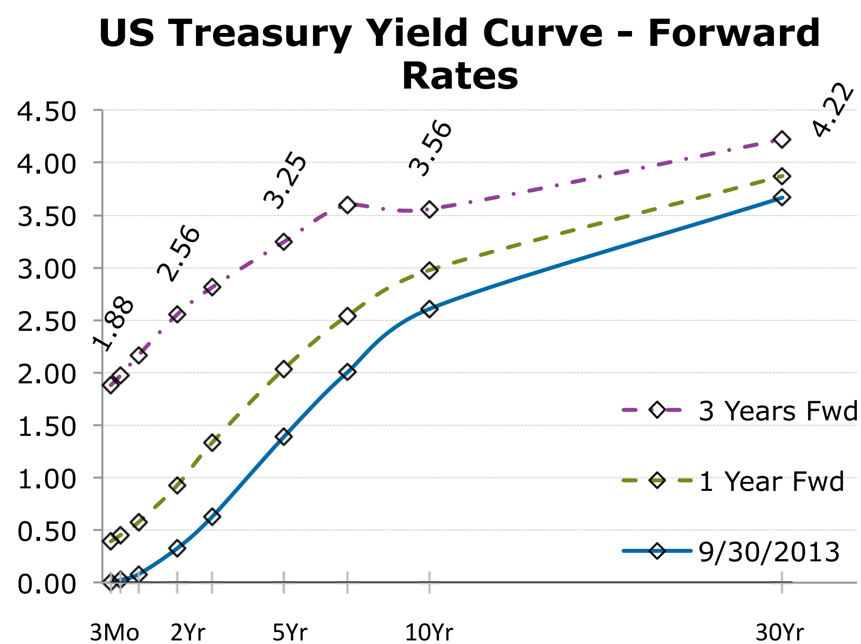
As previously discussed, it seems likely that we have seen the high-water mark of monetary policy support in the United States (barring an unforeseen concern). While low rates are likely to remain for some time (the Fed pledge of low Fed Funds rates until 2015 is still outstanding), fixed income markets have already begun to react. The uncertainty around Fed policy in the near term combined with bungled fiscal management by the US Congress has impacted investor confidence and liquidity in the fixed income markets has been affected. We estimate that the average daily trading volume of investment grade debt is down 13% so far this half of 2013 as compared to the first half, and down 18% for non-investment grade debt.

Looking forward to the long term, it seems clear that rates will be on the rise. The three-year Treasury forward curve (looking beyond 2015) is already suggesting that this is the market consensus. While the Fed may intervene should rates rise too quickly (they likely desire interest rates below nominal GDP growth), we must use this assumption as a base case while assessing investment opportunities. **In the long term, a rising rate environment will impact not only bond returns and corporate fundamentals but also equity valuations and fund flows.** As conditions evolve, it will require adaptation within portfolio strategy.

In prior Outlooks, we have discussed the attractiveness of private investments across the fixed income spectrum. **We continue to see talented portfolio management teams sourcing high current cash flow investments by targeting small and medium-size businesses that do not have access to the public markets.**




Source: Strategas




Source: Bloomberg

# ROLE OF FIXED INCOME IN A DIVERSIFIED PORTFOLIO

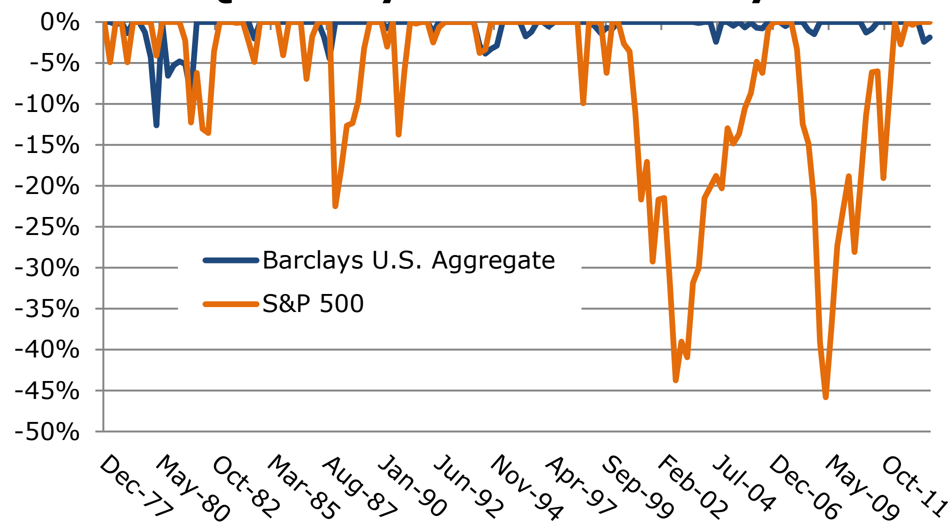
With the prospect of the end of Fed quantitative easing in the future, it is important to remember the role of a predictable cash flow stream provided by fixed income securities. This steady stream of income can be used as a shock absorber against equity market volatility and as a store of dry powder for opportunistic purchases. While we know that rates will eventually rise in the future, we do not know the path or timeline on how this saga will play out. We do anticipate the Fed will drag the government deleveraging out as long as possible to reduce the pain of rising interest costs.

The Barclays Aggregate bond index has experienced 32 down quarters since 1978, with an average down return of -1.6%. Contrast this to the S&P 500, which has experienced 42 down quarters with an average down return of -6.55%. The returns of the two indices have a correlation of 0.14, so while not exactly inversely related, it is rare for both indices to be down in the same quarter, as illustrated at the top-right chart.

While recognizing that a large portion of this analysis took place during a secular bond bull market, it is important to remember that in 1978 the yield on the 10-year Treasury was 7.8% and rose continuously until topping out at 15.8% in August 1981. This period was the Barclays Aggregate's worst-performing period of -12.6%, much less severe than the S&P's of -45.8% from 2007Q4 through 2009Q1.

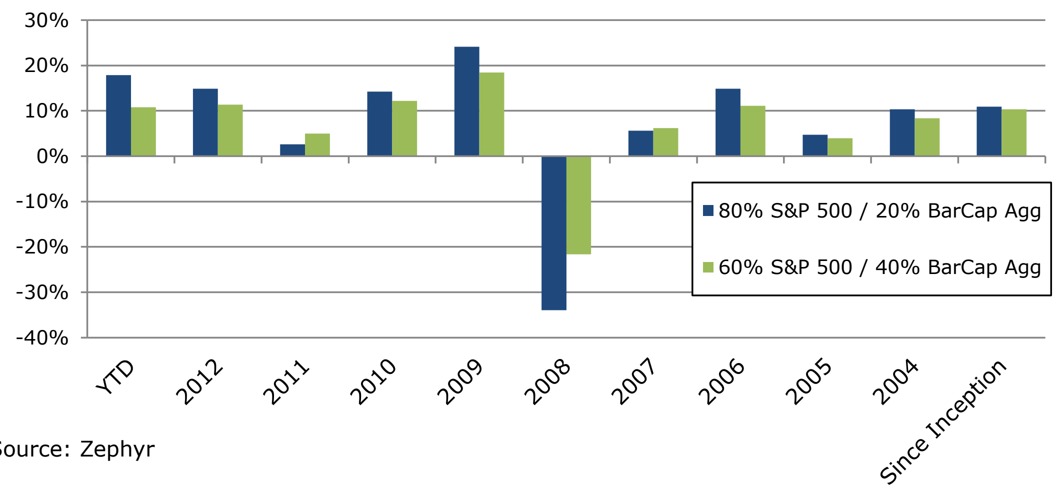
To further help illustrate this we track the historical performance of two blended portfolios comprising the S&P 500 and the Barclays Aggregate bond indices rebalanced quarterly since January 1978. While the 80/20 is the best-performing blend during periods of stock market performance, it is also the worst performer during down markets, with 155 down months, average down return of -3.07%, and maximum drawdown of -47%. The interesting observation is that from 1978 to today the 80/20 blend has an annualized return of 11.1% while the 60/40 only lags by 0.63%, returning 10.47%. The 60/40 volatility of returns is also significantly lower than that of the 80/20, 9.89% and 13.8% respectively. Again, because of a long bull market for the Aggregate Bond index, past returns might not be repeated going forward, but nonetheless fixed income does provide a role dampening volatility. **In summary, remember the effects of reduced volatility bonds can add in a diversified portfolio. Protecting against the downside is as important as participating to the upside.**

**Quarterly Drawdown Analysis**




Source: Zephyr

**Blended Portfolio Performance**




Source: Zephyr

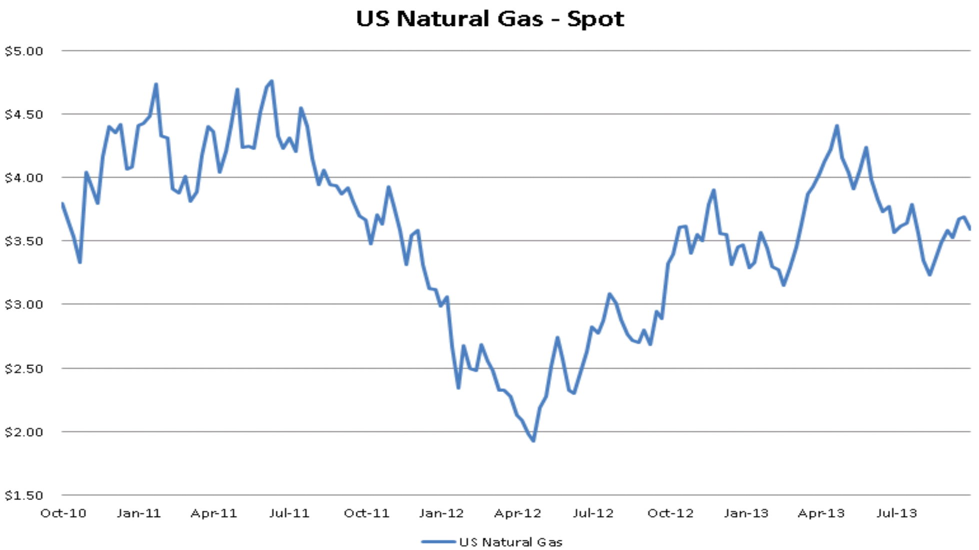
# ENERGY OPPORTUNITY SET IS CHANGING

**Hydraulic fracturing (aka "fracing") is a classic example of how the introduction of a new, disruptive technology into an industry can radically change the investment landscape.** One result was that US natural gas prices were driven to unsustainably low levels in 2012 on the heels of the dramatic production increase caused by the innovation. At the beginning of 2013, we recommended that investors increase exposure to US small and mid cap gas producers based on their valuation. While we believe there is a limit to how high natural gas prices can go in the near term, the equity market was valuing producers as if the commodity price in the US was going to linger around the $2 mark in perpetuity. We did not see this circumstance existing forever, since enterprising businesses always look to make substitutions to support profitability and growth. We highlighted catalysts such as coal-to-gas switching for power production, a drop in the rig count, and demand from manufacturers that would increase demand – leading to both higher gas prices and gains for gas-related companies.

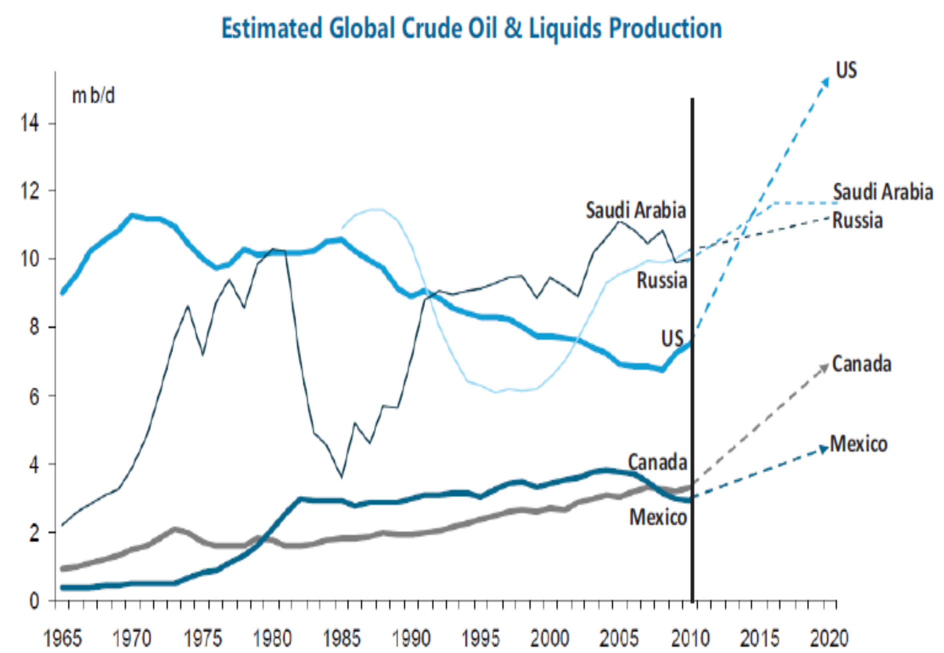
Subsequently, there has been some recovery in gas prices and in sentiment around producers, which has led to strong performance of gas-related E&P companies. At this point, there is a less compelling valuation case for these names.

We continue to believe that the US is in a new chapter in energy production and there will be numerous opportunities to profit as US energy volume surpasses that of both Russia and Saudi Arabia over the coming years. Continued production increases could cause commodity prices to fall over time. **It is important to take a broad perspective in thinking about how best to remain invested in this theme.** As discussed in prior outlooks, mid-stream master limited partnerships (MLPs) are an implementation option focused on volumes, but there are other areas of growth across the energy value chain.

**Within the public equity markets, investors will benefit by taking a selective approach conscious of the shifting dynamics of how to support this production growth and its effect across many industries.** Companies operating in sectors such as energy infrastructure, transportation, chemicals, industrials, engineering/construction, oil/gas services, and utilities are among the best-positioned.




Source: Bloomberg




Source: Citi Investment Research, Cushing Asset Management

# APPENDIX

## Market Performance

| Index | July | August | Sept | Q3-13 | 2013 | 2012 | 2011 | 2010 | 2009 | 2008 | 3yr | 5yr | 10yr | 15yr |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total Return | | | | | | | | | | Trailing (annualized) | | | |
| **DOMESTIC EQUITY** | | | | | | | | | | | | | | |
| S&P 500 | 5.1% | -2.9% | 3.1% | 5.2% | 19.8% | 16.1% | 2.1% | 15.1% | 26.5% | -37.0% | 16.2% | 10.0% | 7.6% | 5.3% |
| DOW JONES INDUSTRIAL | 4.1% | -4.1% | 2.3% | 2.1% | 17.6% | 10.2% | 8.4% | 14.1% | 22.7% | -31.9% | 14.9% | 9.9% | 7.7% | 6.9% |
| NASDAQ | 6.6% | -0.8% | 5.1% | 11.2% | 26.1% | 17.7% | -0.8% | 18.1% | 45.3% | -40.0% | 18.3% | 13.8% | 8.9% | 6.4% |
| S&P 400 Midcap | 6.2% | -3.8% | 5.2% | 7.5% | 23.2% | 18.3% | -1.7% | 26.7% | 37.5% | -36.2% | 17.4% | 13.0% | 10.8% | 11.2% |
| RUSSELL 2000 INDEX | 7.0% | -3.2% | 6.4% | 10.2% | 27.7% | 16.4% | -4.2% | 26.8% | 27.1% | -33.8% | 18.3% | 11.1% | 9.6% | 8.9% |
| RUSSELL 3000 INDEX | 5.5% | -2.8% | 3.7% | 6.3% | 21.3% | 16.4% | 1.1% | 17.0% | 28.4% | -37.3% | 16.8% | 10.6% | 8.1% | 6.0% |
| ALERIAN INDEX | -0.5% | -2.5% | 2.3% | -0.7% | 21.2% | 4.8% | 13.9% | 35.6% | 75.7% | -37.0% | 16.5% | 22.4% | 15.6% | 16.5% |
| **INTERNATIONAL EQUITY** | | | | | | | | | | | | | | |
| MSCI AC World (ACWI) | 4.8% | -2.0% | 5.2% | 8.1% | 15.0% | 17.0% | -6.8% | 13.4% | 35.6% | -41.7% | 10.9% | 8.4% | 8.6% | 6.1% |
| MSCI EAFE | 5.3% | -1.3% | 7.4% | 11.7% | 16.8% | 18.1% | -11.6% | 8.4% | 32.7% | -42.9% | 9.2% | 7.1% | 8.8% | 6.1% |
| MSCI EM | 1.1% | -1.7% | 6.5% | 5.9% | -4.2% | 18.7% | -18.2% | 19.4% | 79.0% | -53.1% | 0.0% | 7.6% | 13.2% | 12.3% |
| MSCI EMEA | 2.6% | -1.9% | 8.8% | 9.4% | -5.0% | 22.5% | -20.2% | 23.9% | 68.2% | -55.3% | 0.8% | 5.1% | 12.0% | 12.2% |
| DJ Stoxx 50 | 8.8% | -2.2% | 9.1% | 16.1% | 16.6% | 21.8% | -15.7% | -8.4% | 30.5% | -44.3% | 6.3% | 2.8% | 7.6% | 5.0% |
| FTSE 100 INDEX | 6.6% | -0.4% | 5.5% | 11.9% | 12.9% | 15.8% | -2.1% | 9.1% | 41.7% | -47.0% | 10.7% | 8.2% | 8.8% | 5.2% |
| NIKKEI 225 | 1.0% | -1.9% | 8.5% | 7.5% | 23.7% | 12.4% | -10.4% | 11.5% | 18.4% | -26.4% | 11.6% | 8.8% | 6.5% | 4.1% |
| HANG SENG INDEX | 5.2% | -0.4% | 5.7% | 10.7% | 4.2% | 27.7% | -17.3% | 8.3% | 56.7% | -46.0% | 4.3% | 8.5% | 11.0% | 11.0% |
| SHANGHAI SE COMPOSITE | 1.6% | 5.5% | 3.9% | 11.4% | 0.6% | 6.9% | -16.5% | -9.7% | 82.6% | -62.4% | -1.2% | 3.4% | 10.0% | 7.6% |
| BRAZIL BOVESPA INDEX | -1.6% | -0.1% | 11.9% | 10.1% | -21.2% | -2.0% | -27.1% | 5.9% | 144.9% | -55.3% | -16.9% | -1.8% | 15.7% | 10.1% |
| MSCI BRAZIL SMALLCAP | -3.9% | -4.7% | 12.0% | 2.6% | -18.2% | 29.5% | -24.0% | 43.1% | 250.3% | -66.9% | -2.0% | 20.9% | - | - |
| **S&P SECTOR BREAKDOWN** | | | | | | | | | | | | | | |
| S&P 500 ENERGY INDEX | 5.1% | -1.7% | 1.8% | 5.2% | 15.4% | 4.6% | 4.7% | 20.5% | 13.9% | -34.9% | 15.3% | 6.6% | 14.2% | 10.6% |
| S&P 500 MATERIALS INDEX | 5.6% | 0.0% | 4.4% | 10.3% | 13.5% | 15.2% | -9.7% | 22.5% | 48.6% | -45.7% | 11.9% | 8.2% | 9.3% | 7.4% |
| S&P 500 INDUSTRIALS IDX | 5.7% | -2.5% | 5.7% | 8.9% | 23.9% | 15.4% | -0.6% | 26.8% | 20.9% | -39.9% | 16.7% | 10.6% | 8.7% | 7.1% |
| S&P 500 CONS DISCRET IDX | 5.2% | -2.8% | 5.4% | 7.8% | 29.1% | 24.1% | 6.2% | 27.8% | 41.3% | -33.5% | 24.1% | 18.8% | 9.8% | 7.8% |
| S&P 500 CONS STAPLES IDX | 4.1% | -4.4% | 1.3% | 0.8% | 16.1% | 11.1% | 14.0% | 14.4% | 14.9% | -15.4% | 15.8% | 10.9% | 9.9% | 7.3% |
| S&P 500 FINANCIALS INDEX | 5.4% | -5.0% | 2.8% | 2.9% | 22.9% | 28.9% | -17.0% | 12.2% | 17.2% | -55.3% | 13.5% | 1.7% | -0.1% | 2.4% |
| S&P 500 HEALTH CARE IDX | 7.3% | -3.5% | 3.2% | 6.8% | 28.5% | 17.9% | 12.7% | 2.9% | 19.7% | -22.8% | 20.9% | 13.1% | 8.2% | 5.8% |
| S&P 500 INFO TECH INDEX | 4.2% | -0.5% | 2.9% | 6.6% | 13.4% | 14.8% | 2.4% | 10.2% | 61.7% | -43.1% | 13.7% | 12.0% | 7.1% | 3.7% |
| S&P 500 TELECOMM SVCS IX | 0.2% | -4.1% | -0.5% | -4.4% | 5.7% | 18.3% | 6.3% | 19.0% | 8.9% | -30.5% | 12.6% | 11.2% | 8.9% | 1.2% |
| S&P 500 UTILITIES INDEX | 4.3% | -5.0% | 1.1% | 0.2% | 10.1% | 1.3% | 19.9% | 5.5% | 11.9% | -29.0% | 10.6% | 7.1% | 9.8% | 5.1% |
| **FIXED INCOME** | | | | | | | | | | | | | | |
| US TREASURY BILLS | 0.0% | 0.0% | 0.0% | 0.0% | 0.1% | 0.1% | 0.1% | 0.2% | 0.3% | 2.4% | 0.1% | 0.3% | 1.8% | 2.4% |
| US TREASURY MASTER | -0.2% | -0.5% | 0.8% | 0.0% | -2.5% | 2.2% | 9.8% | 5.9% | -3.7% | 14.0% | 2.1% | 4.0% | 4.2% | 4.9% |
| US MUNICIPAL 3-5 YEAR | 0.5% | -0.3% | 0.7% | 0.9% | 0.6% | 2.4% | 5.4% | 2.5% | 7.0% | 6.1% | 2.3% | 4.3% | 3.6% | 4.2% |
| US CORP, GOVT, MTG INDEX | 0.1% | -0.5% | 1.0% | 0.5% | -2.1% | 4.4% | 7.9% | 6.4% | 5.2% | 6.2% | 2.8% | 5.4% | 4.6% | 5.3% |
| US CORP & GOVT A RATED | 0.0% | -0.5% | 0.7% | 0.2% | -2.4% | 3.9% | 8.6% | 6.2% | 1.4% | 7.4% | 2.5% | 5.0% | 4.2% | 5.0% |
| US BROAD CORPORATE | 0.7% | -0.7% | 0.8% | 0.9% | -2.5% | 10.4% | 7.5% | 9.5% | 19.8% | -6.8% | 4.4% | 9.0% | 5.3% | 5.9% |
| GLOBAL BROAD MKT CORP | 1.5% | -0.7% | 1.9% | 2.8% | -1.0% | 11.0% | 4.5% | 6.0% | 19.2% | -8.3% | 4.1% | 7.6% | 5.4% | 6.0% |
| US HIGH YIELD | 1.9% | -0.6% | 1.0% | 2.3% | 3.8% | 15.6% | 4.4% | 15.2% | 57.5% | -26.4% | 8.9% | 13.4% | 8.7% | 7.2% |

All performance data quoted in USD and includes dividends

Source: Bloomberg

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