Navigator® Fixed Income Total Return

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Executive Summary

Looking Back to 2013: Most fixed income sectors losing ground as taper concerns and stronger economic growth drove interest rates higher.

The U.S. economy gained momentum throughout the year and allowed the equity markets to rally in the face of taper concerns.

Outlook for 2014: In 2014 we think rates on the 10-year Treasury note will end the year higher at near 3.50%, but we could see this rate fall down to 2.5% first.

Under Pressure

In 2013 the markets were fueled by Fed-driven liquidity and an improving economic landscape both in the U.S. and overseas and that helped spur the global equity markets higher. Equities experienced a year to remember with the major developed markets gaining more than 20 percent. However, it was a different story for fixed income with most fixed income sectors losing ground as taper concerns and stronger economic growth drove interest rates higher. Fixed income suffered losses with the Barclays Aggregate Bond Index down 2.02%. It was the biggest yearly loss for the bond market since 1994! Treasuries yielded losses across the yield curve with the Barclays 7-10 Year Treasury Index down 6.04% and the Barclays 20+ Year Treasury Index down 13.88%. The bright spot among the fixed income asset class was below investment grade credit, with the Barclays High Yield Index posting a 7.44% gain.

The taper concerns were not the only headwinds facing fixed income in 2013. The U.S. economy gained momentum throughout the year and allowed the equity markets to rally in the face of taper concerns. In fact, the economy accelerated in each quarter from the fourth quarter of 2012 through the third quarter of 2013. In the fourth quarter of 2012 the economy stalled and grew at just 0.1% before accelerating to 1.1%, 2.5%, and 4.1% for the next three quarters. The 4.1% growth in the third quarter of 2013 was the second highest quarterly reading since the expansion began in 2009. The improving economic outlook and strong equity gains led investors to pull assets from bonds and rotate into equities. In fact, according to the Investment Company Institute, retail investors have been selling their bond mutual funds for seven consecutive months through November. We suspect when we see the data for December that it will mark the eighth consecutive month of bond fund withdrawals.

12/31/2013 Portfolio Characteristics

Total Exposure:	1576 Holdings
Current 30 Day Yield:	6.29%
Average Duration:	3.99 Years
Average Coupon:	6.95%

48.5%	iShares iBoxx $ High Yield Corp Bond (HYG)	890 Holdings
		30 Day Yield: 6.08%
48.5%	Barclays High Yield Bond SPDR (JNK)	689 Holdings
		30 Day Yield: 6.89%
3.0%	Cash	

Source: Morningstar; iShares; State Street Global Advisors
This is not a recommendation to buy or sell a particular security.

Performance & Analysis

For the quarter, the Fixed Income Total Return composite returned 3.08% gross of fees and 2.55% net of fees[1]. The Barclays High Yield Index returned 3.58% and the Barclays Aggregate Bond Index lost 0.14% for the quarter.

In mid to late June, the Fixed Income Total Return (FITR) portfolio reduced the risk in its portfolio by paring back its high yield bond position. Our models are designed to react when raw price losses in high yield bonds exceed a certain threshold, and that threshold was exceeded on June 21st. However, distressed conditions in the credit markets did not last long. Prices recovered and, as a result, we quickly moved back into high yield bonds on July 18th. Since then, high yield bond prices have been basically flat, and investors have simply collected yield. The portfolio has remained fully allocated to the lower quality space for the duration of the quarter, extending the high yield holding period that was established in July. The FITR quantitative models continue to be near their maximum positivity on high yield bonds, particularly in comparison to Treasuries. Looking forward, interest rates appear to be on the rise over the intermediate and longer term. Taking a look at bond performance during 2013, a time of rising interest rates, quickly shows the value of adding high yield bonds to a fixed income portfolio. For the year, the Barclays High Yield Bond SPDR (JNK) was up 5.83% while the iShares Barclays 7-10 Year Treasury ETF (IEF) was down 6.08%. A nearly 12% difference

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in returns between Treasuries and High Yields is indeed startling, and indicates that Treasuries in 2013 represented risk without return.

Outlook

The Fed's balance sheet has swelled to $4 trillion and this will have to be dealt with sooner or later. We feel this will be a big influence on performance in 2014. The Fed announced last month that it will begin tapering by $10 billion. Instead of buying $85 billion of bonds per month they will buy $75 billion. The market responded positively, in large part because the market was expecting the tapering to begin. We expect that the Fed will phase-out its bond buying program by the end of the year, and as that realization sets in it could weigh on the bond market.

Philadelphia Fed President, Charles Plosser, a voting member on the FOMC and a monetary hawk, said the Fed must be ready for a rapid tightening program as the Fed unwinds its $4 trillion balance sheet. He said, "We like to believe that everything is going to be gradual, everything is going to be smooth, and everything is going to be hunky-dory. History does suggest that the Fed, as an institution, is oftentimes late when it comes to tightening." He said the Fed has the technical ability to unwind the stimulus quickly but it will need "sufficient willpower" to tackle the task of removing the $4 trillion in stimulus.

With the Fed buying 75% of the treasuries in the market they have been able to keep rates low but even with that massive buying power rates have doubled over the last year. As the Fed leaves the market, the stage is set for a disruption in the markets with a major buyer stepping away. The 10-year Treasury note yield has risen from a low of 1.4% in July 2012 and ended 2013 at 3.03%. The yield has risen by more than 100% since bottoming and almost doubled since May. Now that the Fed has finally embarked on the taper program the yields should continue to rise and most analysts believe we will see 3.5% or even 4% yields in 2014. It all depends on how quickly the Fed tapers and the path of the rise in yields may differ from the consensus.

We have been on record for the past year and a half as believing that we are in the early stages of a new long-term bear market in bonds. What that means is that we believe bonds now have secular head winds and interest rates will move higher over the long term. We have already seen rates move higher over the past year, but historically they are still very low. Interest rates are not likely to go straight up and we may have years when they fall, but we expect the general trend of higher rates will persist for years to come.

In 2014 we think rates on the 10-year Treasury note will end the year higher at near 3.50%, but we could see this rate fall down to 2.5% first. Investor sentiment in bonds is very depressed and even though we fully expect equity flows to increase over the long term, the asset flows out of bonds and into stocks have reached short-term extremes. Also, if the equity markets do experience the normal mid-term election year correction, we would expect Treasuries to be a benefactor given their risk off/flight-to-safety characteristics. Our range for Treasury yields this year is 2.4 to 3.75%. The low end of the range would come into play mid-year during an equity market correction with rates heading higher into year-end in tandem with a market recovery.

The yield curve has the potential to remain very steep. New Fed Chairman Janet Yellen is expected to maintain accommodative monetary policy and keep overnight lending rates as low as possible for as long as possible. Pricing in the risk of higher inflation along with the Fed's determination to keep short-term rates anchored close to zero may result in a steeper yield curve.

Within fixed income we continue to favor credit over duration risk as the strengthening economy offers support to lower quality fixed income. Credit spreads remain low historically, with the Barclays High Yield Index trading at a 274 bp spread over the 10-year Treasury and, given continued economic growth, they could stay low for an extended period. In addition default rates are also running very low and fell to 2.4% in November, below the 4.5% average since 1993, and well below the peak default rate of 14% at the end of 2009. Default rates have historically tracked the fed funds rate with about a two-year lag and given the anticipated desire of the Fed to keep policy rates near zero into 2016, we should not see a meaningful increase in defaults.

[1] Past performance not indicative of future results. Net returns reflect a deduction of 2.10% in advisory and other fees incurred in the management of the account. Please see attached disclosures.

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The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI Emerging Markets Index is a free float adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The CBOE Volatility Index (VIX) is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related & investment grade U.S. corporate securities that have a remaining maturity of greater than one year.

The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The B of A Merrill Lynch U.S. High Yield Index tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Barclays 7-10 Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities between seven and ten years.

The Barclays 20+ Year Treasury Index tracks the investment results of an index comprised of the U.S. Treasury bonds with remaining maturities greater than twenty years.

The Barclays Long-Term Year Treasury Index tracks the performance of the long-term U.S. government bond market.

The Barclays U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Barclays U.S. Treasury Bond Index is an issuances-weighted index measuring the performance of the U.S. Treasury bond market, one of the largest and most liquid government bond markets in the world.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

Returns are presented gross of investment advisory fees and include the reinvestment of all income.

Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. For example, a 0.50% annual fee deducted quarterly (.125%) from an account with a ten year annualized growth rate of 5% will produce a net result of 4.4%. Actual performance results will vary from this example. The Firm's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

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