Navigator® U.S. Small Cap

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Executive Summary

Another strong quarter for equities: Q4 and 2013 were "risk on" periods for equities. For the year, small caps outpaced large caps, growth beat value and low quality stocks bettered blue chips.

An aging bull market: Investor expectations should be tempered by the length of the current bull market, its heady gains, record levels of profit margins and high levels of investor optimism.
At current levels of interest rates and expected earnings growth rates, equities are within their historic fair value range.

Déjà Vu All Over Again

Strong equity performance in the fourth quarter mirrored the third quarter as all of our "long only" strategies closed the year at/or near new highs. 2013 was a "risk on" year as small caps outpaced large caps, growth beat value and low quality stocks bettered blue chips. For the quarter, large company stocks as represented by the S&P 500 gained 10.51%, the Russell 2000 Small Cap Index shot ahead 8.72%, and the All Country World ex-U.S. Index advanced 4.77% as anticipated strong earnings growth and more responsible monetary policy supported investor optimism to high levels. Fed policy changed during the quarter, as the five-year policy of ever growing bond buying, or Quantitative Easing, has now been tapered from $85B per month in treasury and mortgage backed securities purchases to $75B. History will likely shine brightly on Ben Bernanke and the Monetarists during this period as their unconventional approach to policy has left equity markets at new highs, real estate markets stabilized and economic growth intact (albeit at a pace slowed by increased structural impediments). As we enter 2014, I believe investor expectations would be tempered by the length of the current bull market, its heady gains, record levels of profit margins and high levels of investor optimism.

Taking Stock

While long only equity managers are typically an optimistic bunch, highlighting both the long term and short term excess returns of equities over bonds, I feel it is appropriate to highlight risk at this point in the market cycle. Don't get me wrong — I am not forecasting an imminent bear market and 20% plus declines, but rather I would like to put in perspective the possible gains of stocks over the next few years. Historically, the current bull market is aging. It has gained over 175% and is approaching its fifth anniversary since March 2009. Certainly there is no magic rule which limits the length or size of the advance, but as prices move faster than earnings, anticipated future returns should be adjusted downward. In other words, as P/E ratios rise — the inverse — or earnings yield historically has been seen to decline. If you think of the return to equity holders as the dividend yield plus earnings growth plus the change in the P/E ratio, then a rising P/E ratio helps prior period returns but potentially harms future returns. I say this because P/E ratios have historically changed — in a moderate interest rate level environment — directly and inversely to the level of intermediate term interest rates. As such, last year's expansion in P/E ratios in the face of rising interest rates, while still possible, strains the relationship between stocks and bonds. At current levels of interest rates and expected earnings growth rates, I no longer view U.S. equities as undervalued, but rather to be within their historic fair value range.

Irony and Mean Reversion

I believe a portion of stocks large gains over the last four plus years can be attributed to the anticipated advance in earnings. Stock prices, as do other financial assets, reflect the net present value of EXPECTED cash flows. Not the flows of the past but rather the flows of the future. Deep in the recession with utilization low, fixed costs high and earnings depressed, in order to invest better times must be anticipated. By 2008, after-tax corporate profits as a percent of GDP fell to just 4.5%. As such, cost cutting became rampant as companies needed to rightsize to the "new-normal" of lower revenue. As GDP rebounded, higher revenue produced a multiplier to earnings as fixed costs became spread out over a greater base. At 5% net margins, a% gain in revenue with no change in costs could produce a 100% gain in profits! Taken together, cost cutting and higher revenue has launched net profit margins to the highest level, more than doubling to over 10%. Moreover, five-year earnings growth for the S&P 500 and S&P Small Cap 600 are over 15% and 21% respectively. Focusing on the future however produces an ironic result; today's record high margins are not likely to produce high earnings growth going forward. High margins reflect the efficiency of current management in keeping fixed costs low and labor gains to a minimum. With profit margins at record highs, future earnings growth may lean on revenue gains exclusively.

Finally, investor optimism has reached high levels, leaving fewer investors to push stock prices to new highs. Just last week, optimism among individual investors as measured by the latest AAII Sentiment Survey hit a near three-year high at 55.1% and pessimism hit a two-year low. Both measures are more than one standard deviation from their historic averages. While high levels of investor optimism and high small cap P/Es cause concern, I recognize that neither value nor sentiment are perfect market timing tools. I do need to recognize that

the risk of loss must be weighed along with return in the evaluation of equity investments as we are likely closer to the end of a cyclical move then the beginning.

Small Cap Pulls Ahead!

The Navigator Small Cap strategy gained approximately 11.16% (gross) for the fourth quarter, outpacing the strong advance of the Russell 2000 small cap index (+8.72%). We believe that our focus on high quality, undervalued companies with improving business prospects continues to yield strong performance and, year to date, the strategy's performance is exceeded the gains of the Russell 2000. Growth stocks CoreLogic, G-III Apparel and Spirit Airlines each gained more than 30%. Poor performance was mostly concentrated in our health care stocks as Bio Reference Labs, Myriad Genetics and Haemonetics each declined. Bio Reference has been removed from the portfolio as reimbursement rates for services are now expected to dramatically decline. Portfolio additions for the quarter include ambulatory surgery centers provider Amsurg, sneaker retailer Finish Line and regional bank First NBC Bank. Navigator Small Cap's high quality portfolio continues to have value metrics far below that of the S&P Small Cap Index with a current P/E of just 16.6 vs 24.8 for the index. I anticipate that the long term earnings growth rate of its portfolio holdings could possibly match that of the S&P Small Cap Index.

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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 2000® Index measures the performance of U.S. small cap stocks including the bottom 2000 of the Russell 3000.

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 S&P Small Cap Index measures the performance of the small-cap segment of U.S. stocks. The index has inclusion criteria to insure included companies are liquid and financially viable.

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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