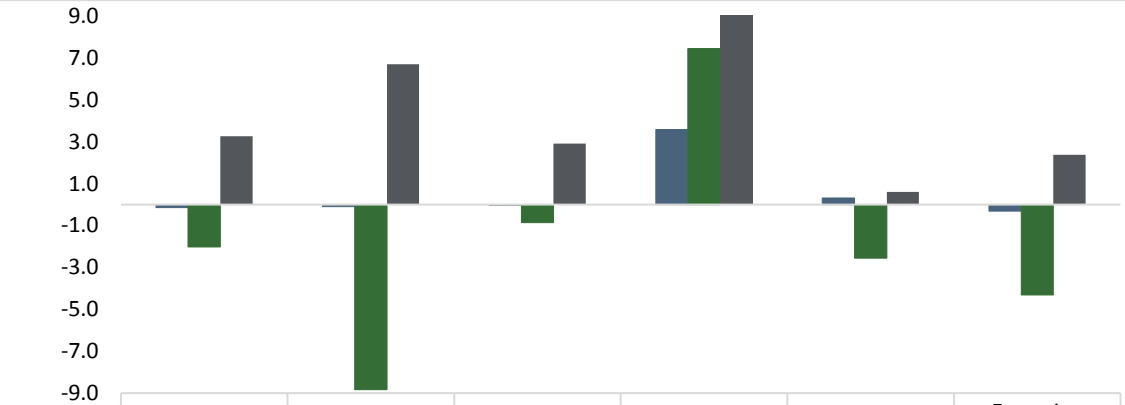
Independence | Asset Advisors

2013 Fourth Quarter Review

- The U.S. and global economies strengthened, propelling equity markets to all-time highs amid record low volatility.
- Upward pressure on interest rates pushed most fixed income instruments lower with the exception of higher yield bonds.
- In general, investors favored risky asset classes throughout the year with the exception of emerging markets where rising U.S. rates drew capital away from those markets.
- The Fed announced the commencement of tapering to begin in January 2014 at a modest pace, signaling the end to the end of Quantitative Easing, but still no end to the 0% short term Fed Funds rate environment.

Fixed Income Markets

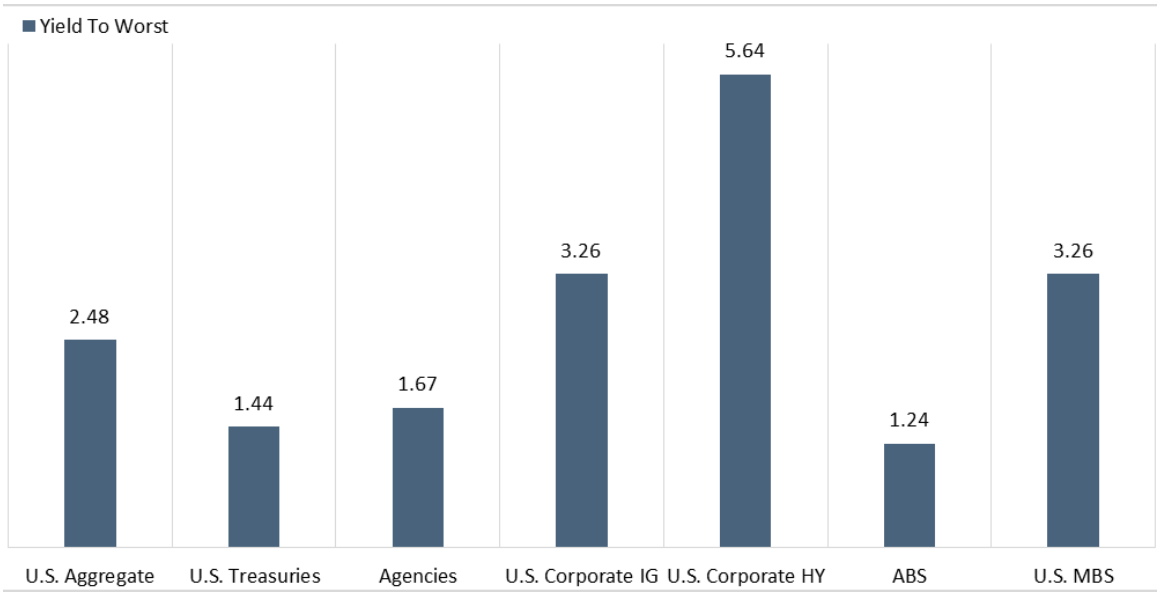


	US Aggregate Bond	US Gov/Credit Long	US Gov/Credit Intermediate	US Corporate High Yield	International Bond	Emerging Market Local Curr Govt
4th Qtr	(0.14)	(0.10)	(0.02)	3.58	0.32	(0.31)
One Yr	(2.02)	(8.83)	(0.86)	7.44	(2.55)	(4.32)
Three Yr	3.26	6.70	2.91	9.32	0.60	2.37

The fourth quarter continued the 2013 trending rise in interest rates. The 10 year U.S. treasury rose from a level of 2.12% at the beginning of the year to 3.0% at the end. Much of the rise occurred in June, dropping in September when the Fed delayed any tapering action and then rising slightly in December with the announcement of the start of gradual tapering in 2014. This rise in rates resulted in a steepening of the yield curve. It is largely anticipated that the Fed will keep short term rates set near 0% for the foreseeable future and will merely end asset purchases in intermediate and long maturity treasuries. The outcome was that the total return for most bond categories was negative for the year. The impact was most severe in long maturities and U.S. government instruments. Shorter duration strategies offered the most protection along with credit strategies where spread

tightening muted the yield curve impact. Credit spreads, and high yield bond spreads in particular, are well below long term averages. Default rates in the U.S. are currently at 0.7% compared to the 30 year average of 3.7%. Corporate health coupled with a shortage of income producing investments are drawing investors to high yield bonds in place of traditional investment grade credit.

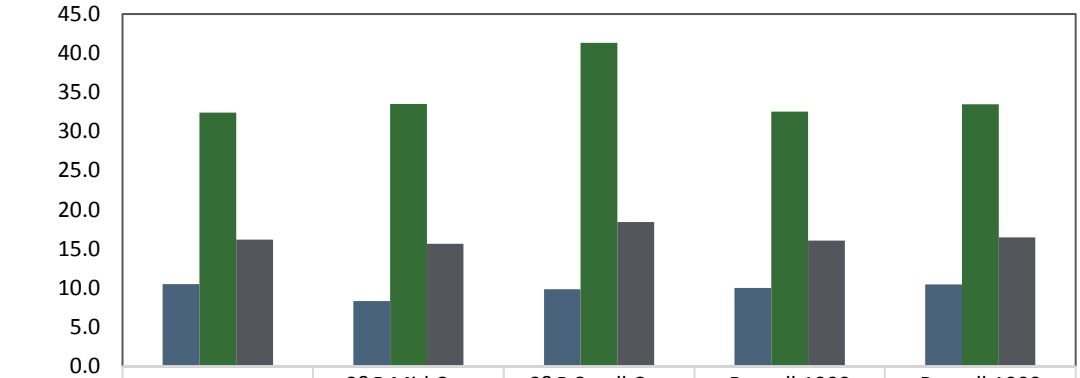
Developed market bonds largely mimicked the U.S. bond market. Emerging market bonds experienced similar local interest rate moves, but were more negatively impacted by weakening currencies relative to the U.S. dollar, leading investors to pull capital from these investments.



Duration(years)						
5.55	4.99	4.02	6.8	4.16	2.45	5.62

The chart above compares yield and duration amongst various U.S. fixed income sectors, illustrating the opportunities in picking up yield at the same time as lowering duration with a shift from either treasuries or investment grade credit to high yield bonds. Corporations have taken advantage of the recent low rate environments over the past few years to refinance to lower rate debt and push out significant maturities to 2017 and beyond. This provides a margin of safety for below investment grade credits.

U.S. Equity Market



	S&P 500	S&P Mid Cap 400	S&P Small Cap 600	Russell 1000 Value	Russell 1000 Growth
4th Qtr	10.51	8.33	9.83	10.01	10.44
One Yr	32.39	33.50	41.31	32.53	33.48
Three Yr	16.18	15.64	18.42	16.06	16.45

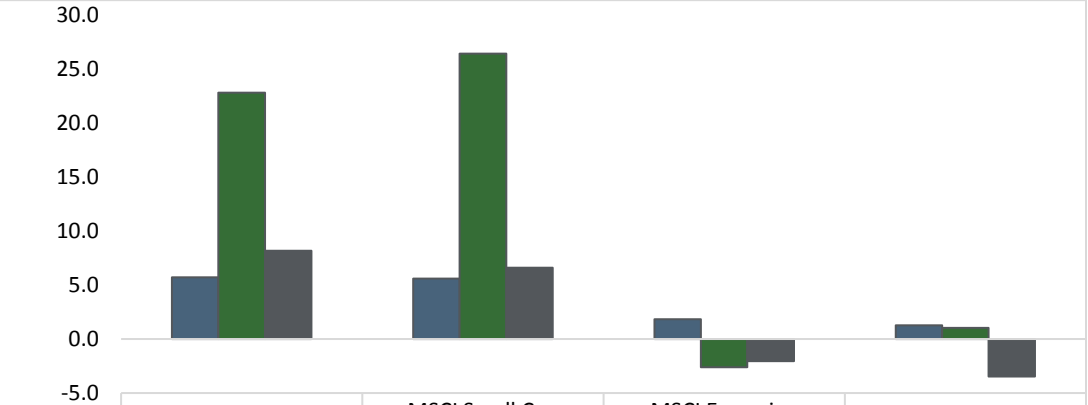
U.S. equities ended the year with across the board strength, giving the S&P 500 its best year since 1997. The U.S. equity market was by far the biggest winner of all major asset classes, outperforming bonds, developed market equities, commodities, hedge funds, real estate and decidedly emerging market equities. Within the U.S., small capitalization stocks exceeded larger and mid-capitalization issues. Smaller companies offered a more pure exposure to improving U.S. growth prospects and more exposure to the dynamics of housing market gains. Economically sensitive sectors, particularly those tied to domestic growth, showed higher returns, including consumer discretionary and financials. Sectors such as energy and materials tended to lag along with the commodity prices as emerging markets demand slowed. Defensive and dividend heavy sectors, such as utilities and telecommunications, underperformed in the face of rising interest rates. In general the lowest quality, lowest dividend paying and growth oriented companies performed the best.

Earnings for S&P 500 companies likely saw close to 7% earnings growth for 2013 on top of only about 5% revenue growth. Higher earnings per share growth over revenue gains has been achieved through conservative capital spending policies, productivity gains, low interest rates and share buybacks. Corporate margins remain at historically high levels, which is benefitting corporate profitability, but limits future earnings growth potential without better top line growth.

The valuation of the market based on the forward price to earnings ratio expanded by 3 turns throughout 2013. Where we started the year pricing earnings at 12.7 per dollar of earnings, we ended the year priced at 15.4x. The level has pushed past the 10 year average valuation of 14x, but has not reached the peaks prior to the 2000 or 2007 market corrections. The market is now priced for a good 2014 in the U.S. economy and for solid corporate earnings growth of close to 9%, higher than 2013 but likely achievable. While we

would argue against a bubble in U.S. equity prices, we would agree that equities are fairly valued and we are unlikely to see significant price appreciation this year.

Global Equity Markets



	MSCI EAFE	MSCI Small Cap EAFE	MSCI Emerging Markets	MSCI EM Small Cap
4th Qtr	5.71	5.60	1.83	1.26
One Yr	22.78	26.40	-2.60	1.04
Three Yr	8.17	6.60	-2.06	-3.48

International equity markets may have lagged the U.S., but developed markets still experienced healthy gains in the quarter and for the full year. Even within developed international markets, returns were not homogeneous. Europe pushed itself out of recession with modest growth for the year while continuing the deleveraging of its financial system. The central bank's commitment to do "whatever it takes" to provide liquidity to European economies kept volatility low. Strides in periphery nations of Spain, Greece and Portugal far exceeded expectations, leading to foreign capital flowing back into these countries. Spanish equities returned 11% for the quarter and 31% for the year, largely in line with U.S. equities. The improvement in some of the smaller countries and the continued bank restructuring contributed to smaller companies also performing better in the developed markets.

While the Euro and British Pound remained stable relative to the US dollar, the Japanese Yen fell by 18% during the year as the government reinflated a stagnant economy. These efforts buoyed Japanese stock returns to a 27% increase for the year.

Emerging markets were also widely divergent, but overall still lagged in equity returns in the quarter and year. This year's volatility in emerging market equities largely revolved around the impact of rising U.S. interest rates on EM currencies. In general, emerging market equities rose by over 3% in each country's local currency terms but fell by 2.6% for U.S. dollar investors. The concerns focused mostly on those countries with large current account deficits. These nations needed to buy more dollars with weaker currencies to pay

for imports. So while local GDP rates still remain higher than developed market economies, the weakening currencies have diminished investment returns for foreigners.

While the concern for some of the debtor country currencies is well founded, we see attractive valuations for emerging markets overall that are trading at only 10.5 times next year's earnings versus a 10 year average multiple over 11. At the same time most developed markets are at or above their long term averages. Specifically, smaller capitalization companies in these emerging economies may offer an investment opportunity as they are more exposed to local growth trends than global trade dynamics.

Investment Outlook

The following table is a summary of the most significant macro factors driving the markets in each region.

	Tailwinds	Headwinds
U.S.	Improving GDP Growth	Rising Rates
	High Corporate Cash Balances	Fair Equity Market Valuation
	Declining Unemployment	Peak Corporate Margins
	Corporate Quality	Slowing EM GDP Growth
EAFE	Accommodative Central Banks (Japan and Europe)	Slowing EM GDP Growth
	Stabilizing GDP growth	High Unemployment
	Low Inflation	Tight Lending Conditions
EM	Attractive Relative Valuation	Large Current Account Deficits (India)
	5% GDP Growth	Rising U.S. Rates
	Low Corporate & Government Debt	Slowing GDP Growth

Primarily based on market valuations, we would favor international equities over U.S. and short duration and high yield credit over treasuries and investment grade bonds. In the U.S., opportunities may be limited in traditional asset classes. However, low equity volatility and low correlations of stock returns provide improved opportunities for hedge funds in the coming year.

2014 Investment Outlook

	Max Underweight 5	4	Neutral 3	2	Max Overweight 1
Equities					
U.S. Large Cap					
U.S. Small Cap					
Developed Equities(EAFE)					
Emerging Market Equities					
Fixed Income					
Investment Grade Bonds					
Treasuries					
Municipal Bonds					
Developed Market Bonds					
High Yield Bonds					
Bank Loans					
Floating Rate					
Other					
Commodities					
Real Estate					
Absolute Returns Strategies					
Distressed Debt					
Cash					
Cash					

In our view, investors need to be prepared for negative to modest returns in U.S. equities and bonds over an intermediate term as a stabilizing economy leads to eventually rising and normalized interest rates. We project better returns in high quality large U.S., developed international and emerging market stocks based on lower valuations and attractive economic growth.