TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

April 2014

Quarterly Insights

EXECUTIVE SUMMARY

U.S. Stocks And Bonds Rise In The First Quarter

In the First Quarter, the domestic S&P 500 Index rose 1.81%, the foreign MSCI EAFE Index increased 0.66%, Japan declined 5.61%, and emerging markets fell 0.43%. There was regional disparity in emerging markets: China fell 5.87%, Brazil rose 2.80% and India was up 8.16%. Bear in mind that all of these emerging markets regions have severely lagged the U.S. over the last one, three, and five-year time intervals. The Barclay's Aggregate Bond Index rose 2.05% in the First Quarter. We await higher interest rates to reposition our bond portfolio.

Emerging Markets Exposure: Where & How Much?

Emerging stock markets appeal to investors for several reasons, the most frequently cited being their rapid economic growth. However, higher GDP growth does not translate to higher stock returns. In fact, countries with lower GDP have historically produced higher stock returns. Looking at individual country GDP data in isolation gives us zero insight into the potential merits of investing in emerging markets. Four factors help us determine where to have emerging markets exposure and how much: valuation, growth surprises, globalization, and interest rates.

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First Quarter 2014

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Emerging Markets Exposure: Where & How Much?

Emerging Markets: Higher GDP Does Not Lead To Higher Stock Returns

Emerging stock markets appeal to investors for several reasons, the most frequently cited being their rapid economic growth. The allure of emerging markets can be strong, as faster economic growth is typically associated with stronger earnings growth, which many investors associate with higher stock returns. However, this assumption is wrong. Across 16 major markets, there is zero cross-country correlation between long-run GDP growth and long-run stock returns. Higher GDP does not translate to higher stock returns. In fact, countries with slower GDP growth have historically produced higher stock returns.

Related GDP Growth To Actual Returns Using 100 Years Of Data For 19 Different Countries

Investor Action	Relative Annual Under-Performance Vs. "Slow Growers"
Invest Only In Countries With Lowest GDP Growth	N/A
Invest Only In Countries With Highest GDP Growth	**- 3%**
Invest Only In Emerging Markets	**- 5%**

Source: Study By Goldman Sachs

Emerging Markets: Why Relative Performance Varies From Relative GDP Growth

Looking at individual country GDP data in isolation gives us zero insight into the potential merits of investing in emerging markets. Our investment decision process must be driven through other considerations. We believe there are four key factors that provide insights as to why relative stock performance between emerging markets and developed markets varies from their relative GDP growth. Understanding these factors help us determine where to have emerging markets exposure and how much.

Why Relative Stock Performance Between Emerging And Developed Markets Varies From Their Relative GDP Growth
Four Key Factors

1. Valuation: What Is The Relative Discount For Emerging Markets Stocks?

2. Growth Surprises: How Much Does A Country's Actual GDP Compare To Its Prior Market Expectations?

3. Globalization: How Much Is The Emerging Markets GDP Growth Fueled By Foreign Investment?

4. Interest Rates: Are There Current Or Anticipated Future Adjustments To Interest Rates?

Four Key Factors That Help Us Determine Emerging Markets Exposure

1. Valuation

We pay attention to valuation metrics such as price/earnings (P/E) ratios. Expected economic growth is built into current prices. Disappointments hurt. Upside surprises help. For example, when Japan's Nikkei 225 soared to almost 39,000 in December, 1989, investors were overly bullish about Japan's economic prospects and the valuations for Japanese stocks were extremely high. When that growth did not materialize, the Japanese stock market collapsed. A recent stock out-performance happened here. The U.S. was a "bad story with a good price" in 2008-2009, and turned out to be by far the best investment over the last three years.

2. Growth Surprises

The correlation of unexpected changes in annual GDP growth with annual emerging market returns is a statistically significant 53%. For example, in 1993 Brazil's stocks were relatively cheap because its economy had high debt, hyperinflation, and political instability. Brazil's government managed to turn it around, much to the surprise of most, and its stock market took off. To be a lucrative investment at this time, China would need to grow even more than the 7.7% GDP that is already priced in to its stocks.

CASE STUDY - EMERGING MARKETS: "LEAD AND SUBSEQUENT LAG" OVER THE LAST DECADE

Emerging markets out-performed in 2005-2009, not from high economic (GDP) growth, but for two reasons:

- Equity valuations were low in the 2000s as compared to developed markets (valuations were attractive)
- There was higher-than-expected growth during much of this period (there was a growth surprise to the upside)

Emerging markets under-performed in 2009-2013, not from high economic (GDP) growth, but for two reasons:

- Equity valuations became high (identical to the U.S., which eliminated the risk premium for investing overseas)
- There were no "surprises" regarding economic growth (it was expected, or "priced in", to be high)

MSCI Index (as of 03/31/14)	YTD*	1 Year*	3 Year*	5 Year*	10 Year*	Current Forward P/E**
USA	1.69%	**21.30%**	**13.98%**	20.51%	**6.96%**	15.4
EAFE (Europe, Australia, Far East)	0.66%	17.56%	7.21%	16.02%	6.53%	13.3
Japan	(5.61%)	7.53%	5.38%	10.35%	2.19%	14.1
Emerging Markets	(0.43%)	(1.43%)	**(2.86%)**	14.48%	**10.11%**	10.2
China	(5.87%)	**2.20%**	(1.70%)	10.36%	12.09%	9.0
Brazil	2.80%	**(13.00%)**	(13.03%)	7.84%	14.88%	10.0
India	8.16%	6.74%	(4.62%)	15.44%	11.99%	14.1

* Annualized Performance **Source: JP Morgan

3. Globalization

GDP growth in emerging markets is significantly financed from abroad. U.S. corporate profits derived from direct foreign investment income doubled from 20% in 1999 to 40% in 2008. Historically, one third of foreign earnings have come from direct U.S. investment in emerging markets (source: Bureau of Economic Analysis). Developed markets contribute to emerging market GDP growth but receive no GDP credit themselves. A U.S. company building a factory in China and selling to Chinese consumers will add to China's GDP, won't add to U.S. GDP, but can increase the U.S. company profits. This shows how the one-year stock performance between "developed U.S." and "emerging China" (21.3% versus 2.2%) can inversely vary from relative GDP growth (2.5% versus 7.7%).

4. Interest Rates

Capital flows from developed markets to emerging markets can easily be reversed given sufficient interest rate enticement. For example, the 10-Year U.S. Treasury rose 128 basis points (1.76% to 3.04%) in 2013. U.S. investments got pulled from projects in Brazil and economic development in Brazil was negatively impacted. Over the last 12 months, the U.S. stock market was up 21.3% and the Brazilian stock market was down 13.0%.

Right Now, We Want Indirect (Versus Direct) Emerging Markets Exposure

We have two ways to gain emerging markets exposure in the portfolio:

1. Direct Exposure - we can purchase individual stocks by country (China, Brazil, India) or region (an ETF)
2. Indirect Exposure - a well-diversified position can be achieved through U.S. multinational companies

The four factors we just discussed guide our current decision to have indirect exposure. Here is our rationale.

1. Valuation ⟶ DECISION: Indirect Emerging Markets Exposure

The U.S. has tremendous competitive advantages - property rights, legal protection, resources, infrastructure, educated labor, and entrepreneurial spirit. Therefore the risk premium to invest directly must be adequate. We don't think it is. Let's consider forward P/Es. The U.S. is 15.4. Emerging markets is 10.2. The gap appears promising from a risk-premium standpoint but bear in mind that emerging markets data is highly skewed. While the forward P/E in China is 9.0, the P/Es in most other areas are much closer to that of the U.S. (offering little or no risk premium). While China may appear attractive from a valuation standpoint, its high GDP expectations are already "priced in" to the market. Brazil may appear attractive, but it is highly susceptible to investment outflows should U.S. interest rates rise (see Interest Rates). India now offers little risk premium.

2. Growth Surprises ⟶ DECISION: Indirect Emerging Markets Exposure

Let's look at current GDP (source: The Economist) for the main emerging markets countries: China (7.7%), India (4.7%), Indonesia (5.7%), Malaysia (5.1%), Singapore (5.5%), South Korea (4.0%), and Brazil (1.9%). We don't see potential positive growth surprises with any of these countries right now. No one stands out.

3. Globalization ⟶ DECISION: Indirect Emerging Markets Exposure

There is a lot more foreign and emerging markets exposure in our portfolio than meets the eye. Our current emphasis is on large multinational U.S. companies. As mentioned earlier, these companies average 40% of their earnings from outside the U.S. Consequently, the portfolio will benefit should emerging markets out-perform, albeit indirectly. If we had a current emphasis on smaller U.S. companies, their internationally-based revenues would be less than 20% and we would be less positioned to benefit from a bump in emerging markets. Taking globalization into consideration, we can achieve better emerging markets diversification and portfolio risk control indirectly versus directly.

4. Interest Rates ⟶ DECISION: Indirect Emerging Markets Exposure

We believe U.S. interest rates will rise by 2015. Coupled with Fed tapering, this could trigger an outflow of investment capital from emerging markets. We are better protected with indirect emerging markets exposure.

We Have A Lot More Emerging Markets Exposure Than Meets The Eye

We recently reached our 10 year anniversary. During the first five years, we had a much heavier component of foreign/emerging markets exposure in our stock portfolio than over the subsequent five years. Effectively we operate in a range of 10%-30% foreign weighting as defined by Morningstar. At the moment, Morningstar weights our portfolio at 88% U.S., 12% developed foreign, and 0% emerging markets. This data is misleading in that our U.S. multinational stocks, while headquartered here, have significant emerging markets exposure.

We believe we are in the mature phase of the business cycle; hence we have a heavy emphasis on large high-quality-earnings U.S. stocks. We advocate style rotation. As conditions change, we will adjust. For now, we think it is best to gain our emerging markets exposure from U.S. multinational companies versus direct security purchases. We acknowledge that certain "pockets" of emerging markets may out-perform intermittently - this will always be the case. Our bigger concern is risk control: emerging markets are volatile.

Incumbent (Local) Firms Lose Their Competitive Advantage In A Growing Market

The business development stage of an emerging market country/region also helps us decide whether direct versus indirect investment is best. Companies with the best competitive advantage will prevail in the long-run. The strongest indicator of competitive advantage is economies of scale, which allows a company greater ability to lower prices to gain market share. An indicator of economies of scale is the measure of fixed costs as a percentage of sales.

Imagine an emerging market with three stages of economic development - Stage 2 has triple the sales of Stage 1 and Stage 3 has ten times the sales of Stage 1. Assume there is an incumbent (local) company and a new market entrant (multinational) company. Incumbent firms lose their competitive advantage in a growing market (in this case measured by fixed costs as a percentage of sales).

STAGE 1 ECONOMY	Entrant	Incumbent	Incumbent's Advantage
Sales	500	2500	2000
Fixed Costs	100	100	
FC/Sales	20%	4%	**16%**

STAGE 2 ECONOMY	Entrant	Incumbent	Incumbent's Advantage
Sales	1500	7500	6000
Fixed Costs	100	100	
FC/Sales	6.7%	1.3%	**5.4%**

STAGE 3 ECONOMY	Entrant	Incumbent	Incumbent's Advantage
Sales	5000	25000	20000
Fixed Costs	100	100	
FC/Sales	2%	0.4%	**1.6%**

Multinational (Indirect) Exposure Is Better Once An Emerging Economy Starts To Mature

Let's continue with our example. At any three stages, the incumbent (local) company and/or its government may deter multinational competition through tariffs, taxes, product dumping, or unfavorable legislation. The multinational company can fail if it lacks a cultural understanding of the region. Let's assume there are no barriers to entry and market growth is enough (4%+) to attract a multinational. As the market expands, there is an evolution from accelerating to slowing to stable growth. The market matures over time as economic profits go from "abnormally high" to "above normal" to "normal". Stock selection is tougher in the Stage 2 economy because it is unclear which company will prevail. In Stage 3 (intense competition), the multinational company usually prevails due to superior economies of scale coupled with better management, operational, marketing and distribution capabilities. Therefore multinational (indirect) exposure is usually better in a mature market. Stock selection is easier in Stage 3 as there is greater clarity regarding market share and profit.

Our 10-Point Decision Framework: Direct Versus Indirect Emerging Markets Exposure

	Stage 1 Economy	Stage 2 Economy	Stage 3 Economy
Defensive Mechanisms To Multinational Entry	Tariffs, Taxes, Dumping, Political	Tariffs, Taxes, Dumping, Political	Tariffs, Taxes, Dumping, Political
Other Impediments	Cultural Understanding	Cultural Understanding	Cultural Understanding
Market Growth Unattractive	Stagnant (No Advance)	N/A	N/A
Market Growth Attractive (greater than 4%)	Accelerating Growth	Accelerating Growth (Start) to Slowing Growth (Mid to Late)	Stable Growth (Mature Market)
Market Participants	Incumbents (Local)	Incumbents (Local) Multinationals (Foreign)	Incumbents (Local) Multinationals (Foreign)
Competitive Advantage	Incumbents (Local)	Incumbents Lose Ground Multinationals Gain Ground	Multinationals
Competition/Price Pressure	Limited	Growing	Intense
Economic Profits	Abnormally High	Above Normal	Normal
Stock Selection	**EASIER** (May Be Limited Choice)	**TOUGHER**	**EASIER**
Choice Of Exposure	**DIRECT**	**DIRECT (Start) to INDIRECT (Mid to Late)**	**INDIRECT**

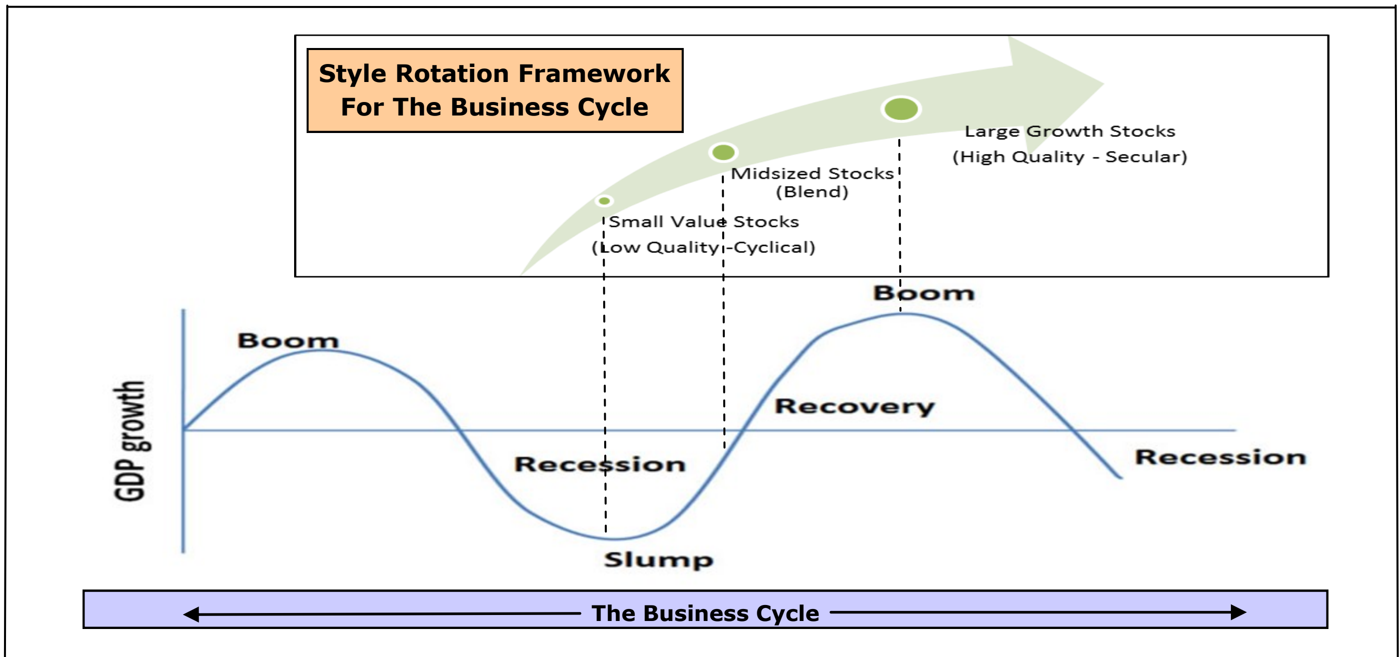
Stock Market Spotlight

The U.S. Market Led In The First Quarter, But Not By Much

In the First Quarter, the domestic S&P 500 Index rose 1.81%, the foreign developed MSCI EAFE Index increased 0.66%, Japan declined 5.61%, and the MSCI Emerging Markets fell by 0.43%. There was regional disparity in emerging markets: China fell 5.87%, Brazil rose 2.80%, and India was up 8.16%. Bear in mind that all of these emerging markets regions have severely lagged the U.S. over the last one, three, and five-year time intervals (see page 3).

Our Style Rotation Framework Still Favors Large Growth Stocks

Styles go in and out of favor as the business cycle evolves. Smaller companies do very well off the bottom of a business cycle because their businesses (and hence their earnings) are more cyclical. We deem small companies' earnings as "low quality" (cyclical) because their earnings are closely aligned with the economy (they move up and down in cycles). As the market cycle matures, the large companies with "secular" (high quality) earnings find favor as their earnings are less dependent on an improving economy. Right now, we continue to favor large growth stocks because we are at the mature phase of the business cycle.



Large Growth Stocks Are In The Sweet Spot From A Valuations Standpoint

We are five years into this bull market and we have been rotating the portfolio into higher quality blue chip stocks for the last three years. Current valuations support our conceptual framework. We are in the sweet spot from a valuations standpoint. For example, the Large Growth P/E is 85.7% of its 20 year average, so that style is trading at a 14.3% historical discount. TriVant's model portfolio has a 47% weighting in this category.

Current Market P/E vs. 20-Year Average P/E			
Mkt Cap	Value	Blend	Growth
Large	101.6%	95.1%	85.7%
Mid	110.5%	106.8%	89.4%
Small	117.3%	112.2%	102.9%

Source: JP Morgan

Current TriVant Portfolio Position			
Mkt Cap	Value	Blend	Growth
Large	19%	29%	47%
Mid	0%	1%	1%
Small	0%	3%	0%

Source: Morningstar

Bond Market Spotlight

Bond Prices Rise In The First Quarter

The Barclay's Aggregate Bond Index, a broad-based representation of fixed income performance, rose 2.05% in the First Quarter, slightly out-performing the S&P 500 Index. As we stated in our Quarterly Insights January 2014 (page 6), "there is room to make some money in bonds". The 10-year Treasury bond yield fell 40 basis points, ending the First Quarter at 3.57% after starting the year at 3.97%. We do not believe yields will continue to fall - rather, we anticipate higher yields over the next year.

Portfolio Rebalancing Can Be A Drag - Literally

Many of our clients have a target asset allocation that includes bonds. Sticking to a disciplined asset allocation strategy is crucial to portfolio success. As stock and bond markets fluctuate, relative portfolio weights of stocks and bonds also fluctuate. We generally "rebalance" portfolios whenever the actual stock weight deviates by some degree from the target. In 2013 there was a huge divergence between stock and bond performance. Strict adherence to portfolio risk control (rebalancing) led to a performance drag.

CASE STUDY - REBALANCING A PORTFOLIO IN 2013

Assume you had a portfolio worth $1,000,000 on January 1, 2013 and we have a target asset allocation of 60% stocks. Let's also assume that no funds were added to or withdrawn from your account throughout the year, and that your performance mimicked the markets. Without rebalancing, your stock weighting would have risen to 67% by year-end and your portfolio would have appreciated 18.74%. Now assume systematic rebalancing in the four out of four quarters where stocks were up a lot relative to bonds. Your target stock allocation would have remained in line (60%) but performance would have suffered. Stock exposure was reduced as stocks rose relative to bonds. Doing the right thing was a drag.

Doing The Right Thing In 2013 Was A Drag				
Interval	**Stocks (S&P 500)**	**Bonds (Barclays)**	**Wtd. Average (60% Stocks)**	**Action If Stocks Deviate From Target Weight**
Q1 2013	10.61%	(0.10%)		REBALANCE
Q2 2013	2.91%	(2.50%)		REBALANCE
Q3 2013	5.25%	0.78%		REBALANCE
Q4 2013	10.51%	0.10%		REBALANCE
2013 - Full Year	**32.39%**	**(1.74%)**	**18.74%**	**4 Rebalances = DRAG**
Beginning Portfolio Value	$600,000 **(60%)**	$400,000 **(40%)**	$1,000,000 (100%)	We estimate up to a 2% lag in 2013 had we rebalanced at the end of each quarter. **It was still right to do it!**
End Value (No Rebalance)	$794,350 **(67%)**	$393,050 **(33%)**	$1,187,400 (100%)	

We Maintain Our Bond Strategy Pending Higher Interest Rates

We continue to hold short-term maturity bonds with an overall duration of 2.75 years. This is lower than the Barclay's Aggregate Bond Index duration of 5.24 years. We are waiting for higher rates (a further normalization of bond yields) before considering a repositioned bond portfolio. For now, we hold 70% short-term corporate bonds and 30% medium-term TIPS (Treasury Inflation Protected Securities).

Your Portfolio

The stock market was fairly tame in the First Quarter. We maintain our bullish 2014 prediction (the S&P 500 Index will rise 12% - 15%) because of four factors: fiscal certainty, accelerating GDP growth, continued accommodative Fed policy, and higher capacity for corporate spending. In your portfolio, we continue to be primarily focused on holding large companies that offer secular growth. These are companies that will be able to grow their sales even without strong growth in the domestic or world economy.

We bought NXP Semiconductors NV (symbol: NXPI), a Netherlands-based global leader in providing high-performance mixed signal and standard product solutions. Its solutions are used for automotive, identification, wireless infrastructure, lighting, consumer, and computing applications. We also bought John Deere (symbol: DE), the global leader in farming equipment. It has over a 50% market share in the US and Canada, and has great potential global growth.

We sold Bank Bradesco ADR (symbol: BBD), a leading Brazilian bank which performed worse than we expected in the midst of a slowing Brazilian economy. We also sold Devon Energy Corporation (symbol: DVN) because it is getting increasingly expensive to produce energy with no signs of rising energy prices. Finally, we sold Corning Inc. (symbol: GLW), a leading glass manufacturer for LCD televisions, computer monitors, and other display applications. Corning's relationship with Apple is no longer secure.

We made no adjustments to the bond portfolio because we are waiting for higher interest rates.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

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Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.