Market Review

The US equity markets continued to climb higher during the first quarter of 2013 with some of the broad market indices reaching record highs. In the first three months, the S&P 500 Index gained 10.61%[1] on a total return basis, while the price index closed at the 1569 level, eclipsing its previous "best" level set back in October 2007. Small cap equities fared even better with the Russell 2000 Index returning 12.39%, aided by investor risk-taking in belief of the market's resiliency.

International equities as represented by the MSCI EAFE Index posted a 5.23% return which broadly lagged the US market. This relative underperformance was caused in part due to the strengthening of the US Dollar against the broad basket of international currencies. The euro declined with uncertainty surrounding the bailout of Cyprus. Japan offered a somewhat brighter picture as continued monetary action to stimulate Japan's economy contributed to a lower yen and stronger market returns: the Japan Nikkei average increased nearly 20% during the quarter. The MSCI Emerging Markets Index declined (-1.57%) with policy makers considering inflation-fighting moves in Brazil and efforts to cool the property market in China. Real estate continued to post positive results but lagged broad US equity indices as the domestic-oriented FTSE NAREIT Equity Index returned 8.19%. Commodities were broadly lower, impacted by increasing supplies of industrial metals and agricultural commodities combined with uncertain global growth prospects. Gold also declined as demand for "safe haven" assets was challenged by the strong equity markets.

The Barclays Aggregate Bond Index posted a negative -0.12% for the first quarter. Intermediate and longer-term Treasuries were impacted from the rise in yields. It is important to note that the 10-year Treasury bond at 1.87% yields less than the S&P 500 Index's equity dividend yield of 2.14%.[2] Analysts highlighted that the duration of the broad bond index, at 5.26 years, was at a historic high[3], meaning that broad bond exposure was more sensitive to interest rate changes than in the past. Conversely, the more credit-sensitive fixed income sectors posted positive returns, with notable strength in high yield, which typically has more sensitivity to equity market moves. International fixed income broadly lagged the US.

Economic Highlights

The US economy continued to make slow and steady progress even in view of the $85 billion in government spending cuts. Analysts estimated that these cuts will likely reduce economic growth by 0.5% during 2013.[4] Despite the negative impacts, the continued accommodative policy by the Federal Reserve is expected to support the economy and provide continued support for the stock market. The housing market has been a bright spot as low interest rates, low supply and pent-up demand have helped further the housing market recovery. Consumer spending has also been resilient despite the

[1] Index returns from Morningstar Direct
[2] Source: Federal Reserve and Standard & Poor's
[3] Record Interest Rate Sensitivity – Joseph Kalish and Veneta Dimitrova, Ned Davis Research Group 3/20/2013
[4] U.S. Economic Comment – Joseph Kalish, V. Dimitrova, A. Grindal, Ned Davis Research Group 3/28/2013

payroll tax increase at the beginning of January. Economic forecasters, as reported in the Bloomberg survey, expect that the economy will grow 2.7% during the first quarter and 1.9% for all of 2013.[5]

Even with the positives, there are still potential risks. Many believe that the Fed's accommodative stance will trigger future inflation. Still, for the moment, with inflation rates running at or below its 2% long-term objective[6], the Fed remains committed to improving the employment picture. The unemployment rate declined from 7.9% to 7.7% in February[7], but both the participation rate and employment-to-population ratio remained at discouraging low levels. It is apparent that companies have benefited from the improving economy, but elevated profit margins lead to concern over a potential pullback in earnings growth targets. Outside the US, developed markets continue to struggle with slow economic growth, while emerging areas are feeling the impact of weaker global demand.

Outlook

Lower long-term growth projections and elevated valuations as measured by the cyclically-adjusted Shiller P/E ratio suggest more muted returns ahead for stocks. Nonetheless, these data points have less predictive ability for shorter-term market moves. The equity market has responded favorably to the Fed, although at diminishing levels with each new action, while inflation pressures have remained contained. Moreover, continued strength in company earnings reports could drive stocks even higher. Many have pointed to a so-called "Great Rotation," with investors reducing allocations to bonds in favor of stocks. Interestingly, to date, while flows into equity mutual funds and ETFs have increased, investors seek fixed income investments as well. Given the still uncertain economic climate, confidence among consumers and investors remains fragile. Retaining a diversified investment approach with exposure across multiple asset classes and strategies may help counter the uncertain range of outcomes.

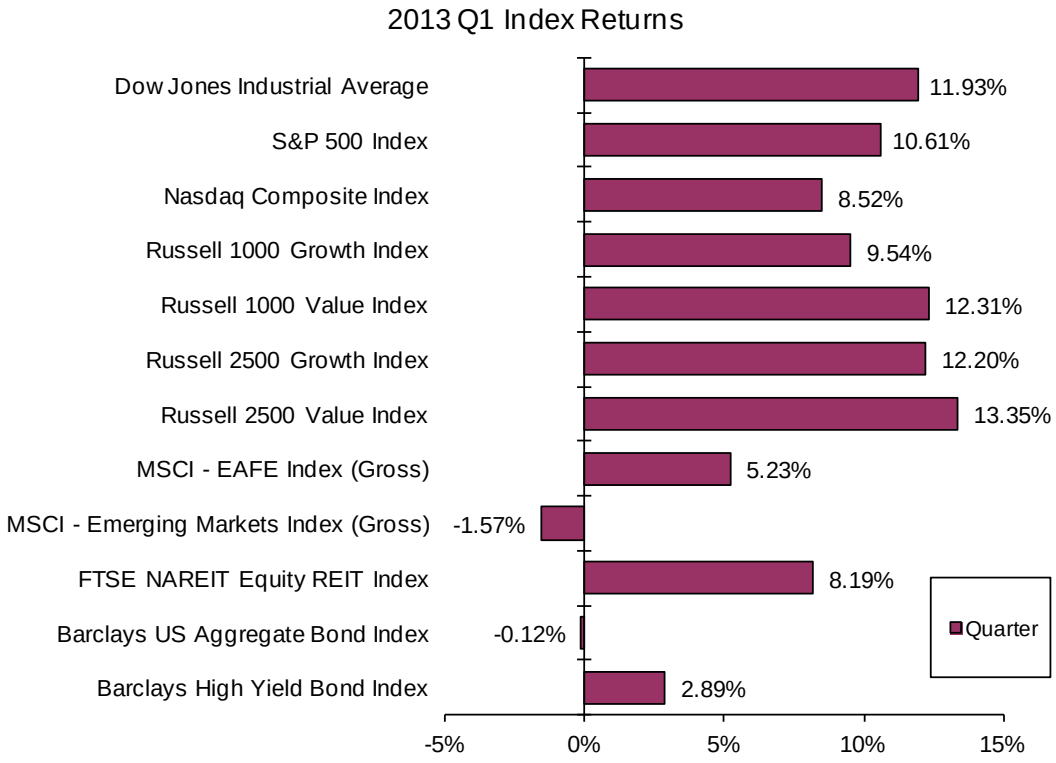
Please contact us with any questions, whatsoever, and to discuss your specific situation and objectives in detail.

[5] Source: Bloomberg
[6] Source: Bureau of Labor Statistics, Consumer Price Index - February 2013
[7] Source: Bureau of Labor Statistics, The Employment Situation - February 2013

Market Statistics

At the end of the first quarter of 2013 the Dow Jones Industrial Average closed up 11.93%. The S&P 500 Index finished with a gain of 10.61%. Within US equity markets, small cap stocks generally fared better than large cap stocks and among value/growth styles, value led growth in both large and small to mid caps. In the international arena, the MSCI EAFE Index (developed international markets) recorded a gain of 5.23%. while the MSCI Emerging Markets Index lost 1.57%. The FTSE NAREIT increased 8.19%. In the bond markets, the Barclays US Aggregate Bond Index lost 0.12%.

The US economy grew 0.40% during the fourth quarter of 2012, slowing relative to the 3.10% expansion experienced during the third quarter of 2012. The Federal Reserve (the Fed) continued to keep the Fed Funds target rate within the 0.00% - 0.25% range. Measured by the Consumer Price Index, inflation for the month of February was 2.00% on a year-over-year basis. Unemployment, as measured by the jobless rate released by the Bureau of Labor Statistics in February was 7.70%. Oil futures closed at $97.23 per barrel in March, a price increase of 5.89% from their close in December. The US dollar strengthened 2.91% against the euro and appreciated 9.28% versus the Japanese yen for the quarter.



Benchmark Definitions

Barclays US Aggregate Bond Index: an index covering the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pas throughs), ABS, and CMBS sectors. US Agency Hybrid Adjustable Rate Mortgage (ARM) securities were added to the US Aggregate Index on April 1, 2007.

Barclays High Yield Bond Index: an index measuring the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

Dow Jones Industrial Average: an unmanaged price-weighted index of large and well-known US companies, consisting of thirty companies that produce non-transportation and non-utility goods and services.

S&P 500® Index: an unmanaged index that is generally considered representative of the US equity market, consisting of 500 leading companies in leading industries of the US economy (typically large-cap companies) representing approximately 75% of the investable US equity market.

NASDAQ Composite Index: a broad-based index that measures all NASDAQ domestic and international common stocks listed on the NASDAQ stock market.

Russell 1000 Growth Index: an index that measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth rates.

Russell 1000 Value Index: an index that measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth rates.

Russell 2500 Growth Index: an index that measures the performance of the small to mid cap growth segment of the US equity universe. It includes those Russell 2500 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 2500 Value Index: an index that measures the performance of the small to mid cap value segment of the US equity universe. It includes those Russell 2500 companies with lower price-to-book ratios and lower forecasted growth values.

MSCI EAFE Index (Europe, Australasia, Far East): a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of countries considered to represent developed markets, excluding the US and Canada.

MSCI Emerging Markets Index: a free float-adjusted market capitalization index that is designed to measure the equity market performance of countries considered to represent emerging markets.

FTSE NAREIT Equity REIT Index: a broad measure of the performance of publicly traded real estate securities, such as real estate investment trusts (REITs) and real estate operating companies.