The Colony Group

March 31, 2014

The effects of weather may linger for a couple more months, but the economy appears set to reaccelerate in the coming quarters.

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Q1 2014 Market Update and Economic Review

Introduction: In the first quarter of 2014, the U.S. economy's momentum slipped as bad weather and volatility overseas restrained consumers and businesses, diminishing hopes for an early-2014 breakout in growth. Gross domestic product (GDP), the broadest measure of goods and services produced across the economy, decelerated in the final quarter of 2013, growing at a seasonally adjusted annual rate of 2.6%. This was down from the third quarter's 4.1% growth rate, which had sparked enthusiasm across financial markets and corporate America.

Other recent economic gauges also have flashed warning signs. Measures of consumer spending, job creation, factory output, and the housing market have come in below expectations. Heavy winter storms and frigid weather in many parts of the country may have depressed or delayed some activity, which raised fresh concerns about the underlying strength of the economy.

Business spending was a bright spot late last year, with companies investing more in equipment, software, and buildings. The gain in non-residential fixed investment may be interpreted as a sign of optimism for future growth.

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We generally expect the economy to strengthen from current levels over the remainder of the year. With a budget agreement now in place for the federal government, visibility into fiscal spending has improved. As such, we expect that government spending will be less of a headwind this year versus last. In addition, consumer spending continues to hold up well, notwithstanding the recent weather-induced slowdown. The effects of weather may linger for a couple more months, but the economy appears set to reaccelerate in the coming quarters.

Capital Markets Update

Global equity and fixed-income markets advanced modestly during the first quarter. The path to achieving those gains was not a smooth one, however. Equity markets stumbled out of the gate in January, with widespread losses followed by advances in February and March that generally offset January's declines. Developed markets, such as the U.S. and Europe, generally outpaced emerging markets, which subtly declined in aggregate but fell more sharply in Russia and China. Emerging market equities continue to be under pressure, with investors concerned about the fallout from the continued slowdown in Chinese growth, the likelihood of rising interest rates in the U.S., and the uncertainty that accompanied the geopolitical repercussions from the crisis in the Ukraine. Emerging market countries running large deficits and requiring foreign capital inflows were hurt the most (*e.g.*, Turkey).

Within the U.S., the more defensive equity sectors, such as healthcare and utilities, were up sharply while consumer discretionary stocks lagged. The consumer discretionary sector was the only one to post a negative return for the period. As a result, value-style stocks outpaced growth stocks.

In the bond markets, a main headline for the quarter was the rally in U.S. Treasury bonds, which erased much of 2013's losses. Fixed-income markets across the globe turned in positive total returns as investors responded with caution to rising geopolitical uncertainty and economic softness. Of particular note was the rally in municipal bonds, which turned in positive results, advancing over 3% as selling pressure from last year's rout reversed course. We believed that this bond sector was oversold heading into the year, and state and local government finances have continued to show improvement. Investment-grade and high-yield bonds also posted sizable positive returns.

Within non-traditional (alternative and real asset) investments, returns were largely positive. The REIT sector posted near double-digit gains, largely a result of falling interest rates and expectations that this drop is sustainable. Commodity prices also advanced sharply in the period, led by agricultural goods, livestock, and natural gas. Hedge fund strategies performed relatively well, which was not surprising given the uneven performance of the equity and fixed-income markets.

Economic Review

Federal Reserve: The Federal Open Markets Committee (FOMC) made changes to its forward guidance, putting less weight on the unemployment rate as a signpost for when to start raising short-term interest rates, while affirming its plan to keep borrowing costs low in the future. Since late 2012, the Fed has said it would not consider raising interest rates until the jobless rate fell to 6.5%, provided inflation expectations remained below 2.5%. The Fed has now dropped its reference to the 6.5% jobless rate, which it considered to be too narrow an indicator of the labor market's health. Judging that there is sufficient underlying strength in the

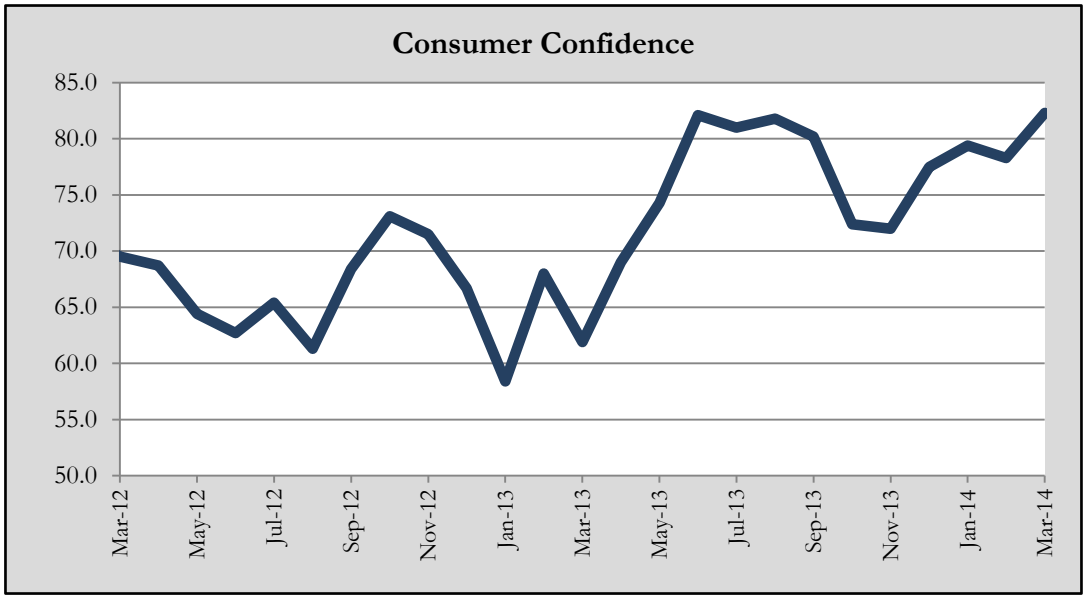
broader economy, the Fed also reduced its pace of monthly asset purchases to $55 billion, down from $65 billion.

Inflation, the other half of the FOMC's dual mandate of maintaining maximum employment and stable prices, is still running well below its target. Tightening labor markets are likely to put some upward pressure on inflation over the next few years, but not so much that it should pose a threat to the FOMC's current forecasts. Therefore, we currently expect that the Fed will likely end its asset purchase program in 2014 but not increase the federal funds target rate before mid-2015.

GDP: GDP in the fourth quarter of 2013 grew by 2.6%. Declines in housing investment and government outlays were the two biggest drags on growth in the fourth quarter. Housing investment fell by 7.9%, the first annual decline in three years, triggered in part by rising mortgage rates. Consumer spending, which accounts for roughly two-thirds of economic output, was the chief growth driver in the fourth quarter. Spending rose 3.3% in the fourth quarter, the fastest pace in three years, and was up from 2% in the third quarter of 2013. Rising consumer spending should underpin expectations for economic growth in 2014, despite weather-related disruptions during the first two months of the year. Also, the fading effect of last year's tax increases, coupled with fast-rising stock and home values (a/k/a the wealth effect), have augmented consumers' ability to spend.

Consumer Confidence: Consumer confidence surged in March to 82.3, its highest level since January, 2008. An improvement in confidence for the economy bodes well for a housing market that has underperformed over the last few months. In addition, increased confidence could contribute to growing consumer expenditures, and thus GDP growth, in the coming months.

Retail sales: U.S. retail sales increased by 0.3% in February following downward revisions in the January and December figures. The details of the



Source: The Conference Board

most recent report were encouraging, with gains in all major sectors. Despite February's inclement weather, the data was better than expected. Core retail sales also posted a 0.3% gain, the largest move since October, 2013. A continued rebound in sales is expected as the weather improves. First quarter consumer spending growth should remain at approximately the same pace set in the fourth quarter of last year. We look for acceleration in the second quarter, as the warmer months help to thaw demand previously frozen by the frigid winter weather.

ISM Manufacturing Index: January's ISM Manufacturing Index reading was reported at 53.2, up from 51.3 in December. Levels above 50 indicate expansion in the manufacturing sector. The index has averaged 55.1 over the past six months, which supports a positive growth outlook for the sector in 2014.

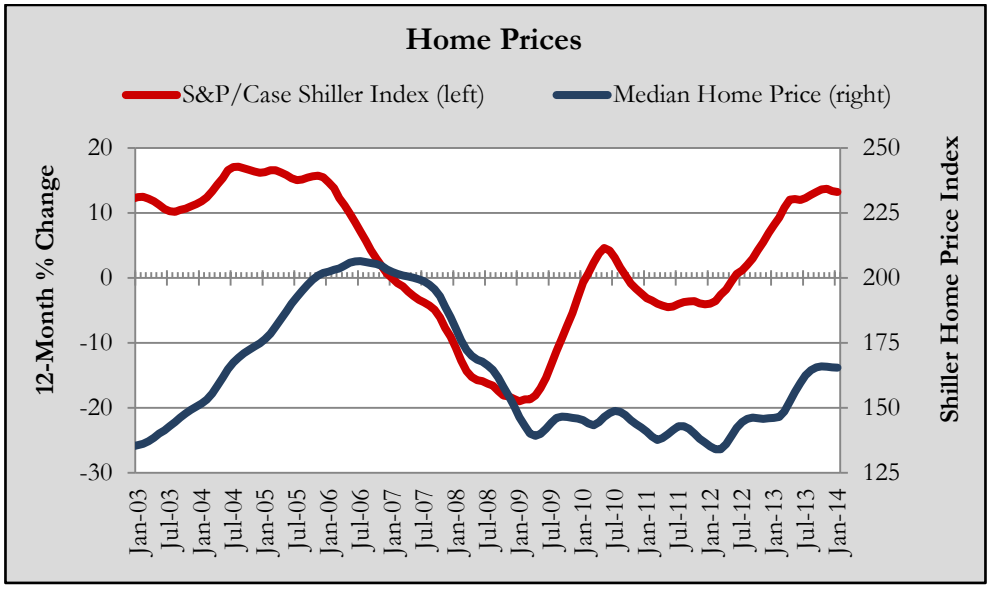
Inflation: Consumer prices increased by 0.1% in February compared to January. On a year-over-year basis, headline inflation slipped to 1.1% from 1.6% posted in January. Core inflation – a measure that excludes the more volatile items such as food and energy – rose by 1.6% year-over-year. Gains in housing, medical care, and recreation helped offset declines in transportation, apparel, and energy.

Recent inflation data has been positive, with both headline and core inflation measures posting only modest gains. While inflationary pressures should continue to drift higher over the course of this year, annual core CPI is not expected to hit 2% until at least the middle of next year.

Housing: Both new home sales and pending home sales declined in February relative to January as a result of the severe weather and rising mortgage rates. The drop in pending home sales would suggest the recovery in the housing market may have to wait another month or two. Nonetheless, home prices accelerated month over month in January according to the S&P Case-Shiller home index. With building permits rising strongly in the preceding week, a rebound in the housing market could be just around the corner.

Global Economy: If the Ukraine-Crimea-Russia stand-off continues to escalate, global economic growth could be negatively impacted. For instance, Europe depends on Russia for a significant portion of its supply of natural gas. Should Russia decide to limit this supply, it could impede the nascent European economic recovery. In addition, this conflict has added to concerns regarding emerging market economies following currency devaluations in Turkey and Argentina earlier this year.

There were multiple factors influencing commodity prices during the first quarter. Surprisingly, energy prices have not shown much reaction thus far to the Ukraine-Russia situation, despite Russia's prominence as one of the top energy producers in the world. The largest movement in energy prices has been in natural gas, which saw a sizeable spike in February as a result of colder weather. Copper prices, which are tied to Chinese economic growth, have seen a strong pullback as economic news out of China has not been encouraging. Agricultural commodities' pricing has spiked due to inclement weather across the world. At this time, it is too early to determine the net effect on the global economy coming from the current environment. The only certainty is that global economic risks have increased.



Source: S&P Dow Jones Indices

Outlook: Expectations around economic growth were high heading into this year. Abnormally cold weather has put a damper on these expectations. It will be important for economic growth to reaccelerate from here now that winter is over.

We believe that diminishing fiscal drag, improved household finances, and rebounding investment auger for better growth over the remainder of the year. Government spending (federal, state, and local) subtracted 0.4 percentage points from real GDP growth in 2013. With budgets improving at the state and local levels and a bipartisan federal budget agreement in place that reduces sequestration, the contribution from government spending is expected to turn modestly positive in 2014.

Finally, the outlook for investment spending is as positive as it has been since the recovery began. Investment in residential structures likely will lead the way as housing starts move higher towards their long-term trend. Even outside of the residential sector, the outlook appears increasingly optimistic. The detente in Washington has removed some of the uncertainty that was weighing on corporate decision makers. All told, despite recent setbacks, a modestly stronger U.S. economy is forecasted for 2014.

Sources: Capital Market Consultants, Department of Commerce, U.S. Census Bureau, The Conference Board, Department of Labor, Federal Reserve, Institute for Supply Management, Bureau of Labor Statistics, Standard and Poors

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Index Performance as of: 3/31/2014								
	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	1.20	2.30	2.92	2.92	2.92	21.67	14.63	21.88
3000	0.72	0.53	1.97	1.97	1.97	22.63	14.61	21.93
3000 Growth	0.25	-1.13	1.07	1.07	1.07	23.55	14.53	21.95
1000 Value	1.30	2.39	3.02	3.02	3.02	21.58	14.80	21.75
1000	0.81	0.64	2.05	2.05	2.05	22.43	14.74	21.73
1000 Growth	0.34	-1.01	1.12	1.12	1.12	23.24	14.62	21.68
Mid Cap Value	1.26	1.54	5.22	5.22	5.22	22.97	15.17	26.35
Mid Cap	0.72	-0.27	3.53	3.53	3.53	23.53	14.39	25.55
Mid Cap Growth	0.24	-1.85	2.04	2.04	2.04	24.24	13.51	24.73
2000 Value	0.01	1.24	1.78	1.78	1.78	22.66	12.73	23.33
2000	-0.38	-0.68	1.12	1.12	1.12	24.92	13.18	24.32
2000 Growth	-0.75	-2.46	0.48	0.48	0.48	27.21	13.61	25.24
Standard & Poors								
S&P 500	0.84	0.84	1.81	1.81	1.81	21.87	14.65	21.16
Consumer Disc	-0.44	-2.76	-2.80	-2.80	-2.80	24.02	20.42	29.13
Consumer Staples	1.36	2.29	0.50	0.50	0.50	10.65	16.00	18.60
Energy	2.62	2.37	0.79	0.79	0.79	14.42	5.74	16.45
Financials	-0.14	3.22	2.61	2.61	2.61	24.93	13.00	22.39
Health Care	1.64	-1.27	5.81	5.81	5.81	29.26	23.49	21.64
Industrials	1.58	0.88	0.14	0.14	0.14	27.31	14.09	25.63
Information Technology	0.09	0.27	2.28	2.28	2.28	25.61	14.28	21.42
Materials	0.57	0.81	2.86	2.86	2.86	23.30	8.64	19.97
Telecom Services	1.64	4.82	0.47	0.47	0.47	2.32	10.32	14.46
Utilities	2.08	3.38	10.09	10.09	10.09	10.29	13.79	14.90
Other U.S. Equity								
Dow Jones Industrial Avg.	1.11	0.93	-0.15	-0.15	-0.15	15.67	13.04	19.86
MSCI USA	0.84	0.69	1.84	1.84	1.84	22.06	14.71	21.28
Wilshire 5000 (Full Cap)	0.63	0.39	1.94	1.94	1.94	22.84	14.61	22.05
International Equity - Broad Market								
MSCI EAFE	3.11	-0.57	0.77	0.77	0.77	18.08	7.71	16.56
MSCI Emerging Markets	4.30	3.09	-0.37	-0.37	-0.37	-1.07	-2.54	14.83
MSCI Frontier Markets	2.42	3.02	7.53	7.53	7.53	25.51	8.59	15.29
MSCI AC World	2.07	0.50	1.21	1.21	1.21	17.18	9.14	18.43
MSCI AC World ex USA	3.28	0.32	0.61	0.61	0.61	12.81	4.62	16.04
MSCI AC Asia ex Japan	2.83	1.01	-0.68	-0.68	-0.68	3.07	1.05	16.51
International Equity - Country Region								
MSCI Brazil	8.02	11.01	2.86	2.86	2.86	-12.71	-12.76	8.15
MSCI BRIC	4.72	2.88	-2.89	-2.89	-2.89	-3.17	-6.85	11.08
MSCI China	2.11	-1.69	-5.86	-5.86	-5.86	2.52	-1.44	10.63
MSCI Europe	3.10	-0.96	2.21	2.21	2.21	25.22	9.05	18.22
MSCI India	3.93	8.71	8.16	8.16	8.16	6.75	-4.62	15.44
MSCI Japan	3.59	-1.15	-5.47	-5.47	-5.47	7.77	5.57	10.54
MSCI EM Latin America	6.26	8.84	0.39	0.39	0.39	-13.62	-8.72	11.41
MSCI Russia	8.87	-2.46	-14.45	-14.45	-14.45	-10.46	-11.71	13.08
Fixed Income								
Barclays U.S. Aggregate	0.17	-0.17	1.84	1.84	1.84	-0.10	3.75	4.80
BofA Merrill Lynch 3-Month T-Bill	0.00	0.00	0.01	0.01	0.01	0.07	0.08	0.12
Barclays U.S. Government	0.13	-0.27	1.31	1.31	1.31	-1.17	3.18	2.73
Barclays U.S. Credit	0.32	0.12	2.91	2.91	2.91	1.02	5.80	8.90
Barclays High Yield Corporate Bond	0.25	0.24	2.98	2.98	2.98	7.54	9.00	18.25
Barclays Municipal	0.35	0.17	3.32	3.32	3.32	0.39	5.79	5.71
Barclays TIPS	0.11	-0.47	1.95	1.95	1.95	-6.49	3.50	4.91
Barclays Global Aggregate ex US	0.16	-0.01	2.79	2.79	2.79	3.25	2.06	5.25
Barclays Global Aggregate	0.18	-0.07	2.40	2.40	2.40	1.88	2.78	5.10
BofA Merrill Lynch Emerg. Mkt. Credit	1.08	2.85	1.93	1.93	1.93	1.61	9.98	21.10
Alternative Investments								
Alerian MLP	1.79	1.45	1.87	1.87	1.87	8.54	13.53	27.30
Dow Jones UBS Commodity	1.09	0.41	6.99	6.99	6.99	-2.10	-7.37	4.24
FTSE NAREIT Equity REIT	1.79	0.56	9.98	9.98	9.98	4.16	10.65	28.21
S&P Global Natural Resources	2.99	0.72	-0.01	-0.01	-0.01	3.07	-4.53	7.98
S&P North American Natural Resources	2.31	1.80	2.70	2.70	2.70	11.64	0.15	15.73

Sources: MPI, Morningstar, Barclays, HFR