Diversified Trust

2014 INVESTMENT OUTLOOK

Top Themes from 2013

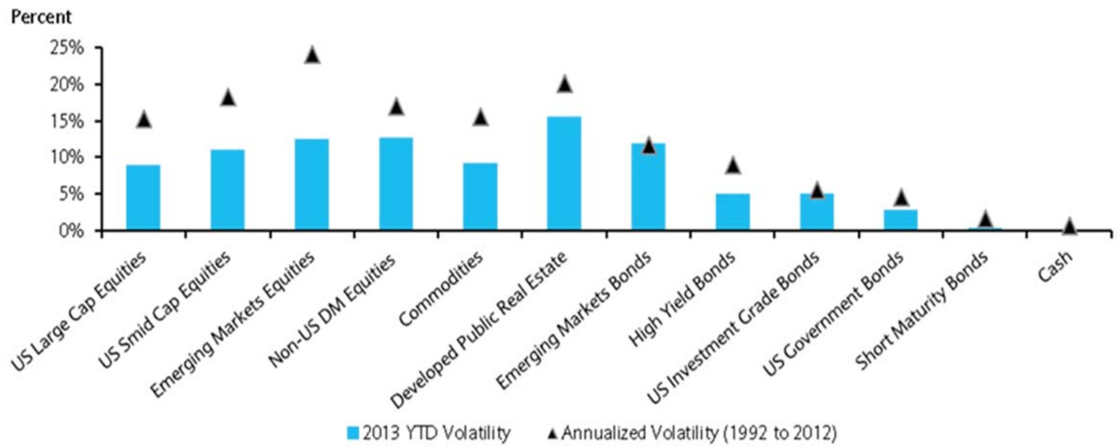
- 2013 was the best year for U.S. equities since 1997.
- Emerging markets trailed dramatically, finishing down 2.6% for the year on currency weakness and growth concerns.
- MLPs continued their strong absolute performance amidst rapid growth in North American energy production.
- With U.S. stocks being the top performers for the year, diversified portfolios lagged.

The U.S. stock market posted exceptional returns in 2013, with the S&P 500 up 32.4% and the smaller capitalization Russell 2000 up 38.8%. The beginning of Federal Reserve monetary policy normalization coupled with greater fiscal policy certainty provided an improved backdrop for the U.S. economy and equity markets.

Developed market international equities gained 22.8% as the risk of bank failures in Europe remained contained by the European Central Bank's commitment to prevent a financial collapse and fiscal policy prescriptions retreated from growth-stifling tax rate hikes to more pro-growth emphasis. The result was modest signs of Eurozone economic improvement. Japan's quantitative easing policies drove their equity markets up dramatically for the year and caused the Yen to fall. Emerging market equities suffered (-2.6%) from the impacts of falling commodity prices and slowing growth, especially in China. Emerging market economies are generally commodity-centric and therefore sensitive to prices. Investment capital repatriation to developed markets accentuated the decline.

The improving U.S. economic environment in 2013 led to much supposition regarding if, when, and to what degree the Federal Reserve would adjust its monetary policies. While the Fed hinted at tapering in May, definitive plans weren't announced until December. In anticipation of policy changes the 10-year Treasury rate rose from 1.8% to 3.0%, producing a total return of -7.8%. The Barclays Aggregate bond index returned -2.0%, its first calendar year loss since 1999 (-0.8%). Only exposure to high yield bonds and senior loans provided positive fixed income returns thanks to their higher coupons and lower rate sensitivity.

While U.S. equities outpaced all major asset classes in 2013, they did so with low volatility. This chart from Barclays shows the 2013 standard deviation for various asset classes (blue bars) compared with their previous 20-year average volatility (black triangles).



The combination of high return and low volatility rendered diversification unnecessary this year. Per Cambridge Associates, diversified portfolios (as measured by large endowments) have meaningfully lagged a 60% U.S. equity/40% fixed income blend during two periods since 1990: 1996-99 and 2008–present. In both periods U.S. equity markets performed exceedingly well.[1] It is natural for investors to question the long-term benefits of diversification during such periods. We remain believers in diversification as the only "free lunch" in investing and hope to illustrate why in our Outlook.

Outlook

"Greater certainty" may best describe the current U.S. policy and economic environment. The Fed's steps toward tapering have removed some uncertainty for future easing, initiating the process toward stabilizing and strengthening the U.S. dollar. Monetary policy stability is critical to a well-functioning market, and we look forward to interest rates being established by fundamentals rather than the central bank. Fiscal policy uncertainty has eased as tax rates were finally set at the end of 2012 and most budget issues resolved. While we are not ignoring longer-term fiscal issues, the "policy haze" of the last few years appears to have lifted. This greater fiscal and monetary certainty ultimately provides an improved backdrop for business investment and this investment should lead to growth.

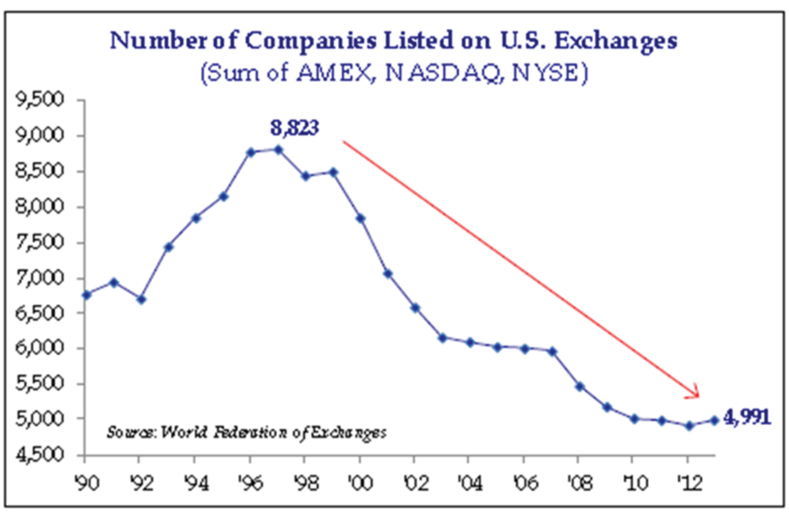
[1] Cambridge Associates, LLC paper U. S. Market Commentary, "Why did I diversify?" written by Celia Dallas and Bob Sincerbeaux.

S&P 500 Trailing 12 month PE Ratio

Last year's equity returns were driven by P/E multiple expansion, as earnings grew 8% but equities rose 32%. While 2013 was an extreme example, P/E expansion and contraction often drives market returns. U.S. equities are now fully-valued (see above chart), but we remain constructive given many favorable factors:

- An improving economy and modest, but persistent employment gains
- Strength in housing markets driven by affordability as well as a household formation supply and demand imbalance
- Gains in U.S. energy production creating many ancillary positives, the most important being an upper bound on energy costs
- Investor flows into equity mutual funds just turned positive in mid-2013, and only marginally so

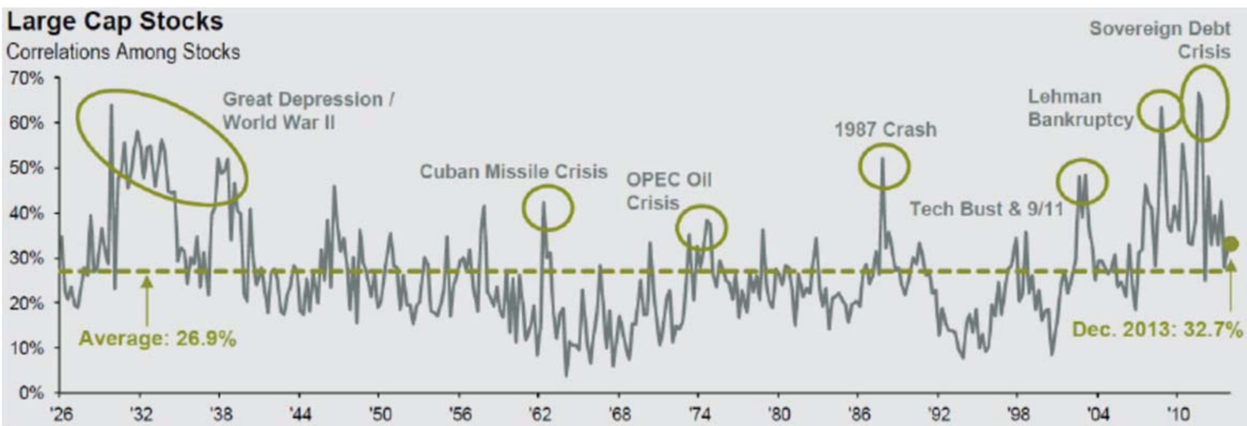
Investors, both institutional and individuals, appear underweighted to equities, possibly still feeling the pain from 2008. Interestingly, the number of listed companies on U.S. exchanges has almost halved from 8,823 in 1997 to 4,991 at the end of 2013[2]. Couple the reduced number of companies with the surge in stock buybacks over the last four years, and the basic economic dynamic of supply and demand may be underpinning equity gains.



[2]Strategas Stock supply, *Annual Review Chart Book*

All of this is not to say that a correction or moderation in returns isn't likely to occur, but it is important to note that the most painful and longer-duration market declines typically come in advance of a recession. Most recessions can be linked to poor policy decisions (monetary, fiscal, or regulatory). Both fiscal and monetary policies are trending in a positive direction rendering a recession unlikely.

With less policy intervention on the horizon, we anticipate investment fundamentals coming into focus. Equity market volatility is expected to rise from its current low levels, especially as interest rates begin to normalize. We expect intra-stock correlations to recede further towards historical levels. Typically, approximately a quarter of an individual stock's performance is explained by broad market movements rather than the 50-70% range experienced since 2009 (see below chart). As stock correlations decline, individual corporate fundamentals should become more relevant to stock prices; a positive for active management.



JP Morgan, *Guide to the Markets 1Q14*

We continue to favor larger capitalization stocks relative to smaller capitalization stocks based on their more attractive relative valuation. However, momentum has clearly been in smaller stocks' favor as smaller companies are more leveraged to the improving economics in the U.S. Within large cap, we prefer higher quality stocks as well as technology stocks. Higher quality stocks, defined as companies with a high ROE, low debt to capitalization, and a strong market share position, continue to trade at a discount to the broader market. Many technology stocks have transitioned from "growth" stocks to high quality "value" stocks, resulting in attractive valuations supported by higher dividend yields and significant financial flexibility. Master Limited Partnerships (MLPs) continue to benefit from the U.S. energy renaissance, delivering attractive and improving distribution growth in the 7% range, current yields close to 6% and reasonable valuations.

Internationally, the story is a bit different as Europe is not as far along in their recovery as the U.S., but this difference is reflected in the relative valuation. The situation in Europe appears to be improving, and the European Central Bank (ECB) has significant policy flexibility should it be needed in the future. Additionally, governments have stepped back from austerity-oriented policies, seeing the need for economic growth to improve their fiscal situations. With valuations relatively attractive, we believe that the risks and the outlook are priced in to the broader European markets. Japan is expected to continue its unorthodox monetary and fiscal policies in an attempt to end years of deflation, while an increase in consumer spending is needed to propel the economy further. A potential negative for international investments is the strengthening U.S. dollar, but we are maintaining our developed market international equity positioning seeing the positives outweigh the negatives.

Emerging markets remain a challenging area and we expect the U.S. policy normalization to continue to impact these markets. The variation in emerging market economies makes generalization difficult, but recent emerging market and currency volatility is likely to continue as investment outflows are dominating the policy responses of the individual countries. The negative impact of commodity price weakness, stemming from slower emerging market demand and a strengthening U.S. dollar, is expected to continue as about a third of emerging market capitalization is resource-related. Within Diversified Trust's strategies, the individual country and stock selection process remains with investment managers that specialize in these regions. Longer-term we remain bullish on the opportunities that the growing emerging market middle class could provide, but the timing surrounding these opportunities remains in question.

We appear to be at the beginning of the end of the Federal Reserve's financial market involvement. Given the Fed's guidance, short-term interest rates are likely to remain artificially low for some time, while longer-term rates are likely to move modestly higher commensurate with economic growth.

Historically, the spread between short and longer-term rates has not exceeded 4%. Tethered by the Fed's commitment to hold short rates low for an extended period, longer-term rates may rise another 1% or so over the next 12 months, a more muted move than in 2013.

Given this outlook, we remain modestly underweight traditional investment grade taxable bonds preferring credit risk (in high yield and senior loans) to interest rate risk. Municipal bonds appear relatively more attractive in light of higher tax rates coupled with improving municipal finances.

In the alternatives area, hedged strategies continue to play an important role in client portfolios. With low prospective fixed income returns and rising equity market volatility, these strategies are utilized as portfolio stabilizers, helping to reduce the impact of market fluctuations. This role is even more important in today's environment, where traditional fixed income is expected to be more volatile as rates rise. Alternatives offer the potential for asymmetric returns, trading tempered downside exposure for modest upside performance. The focus remains on selecting skilled investment managers that can add value above their "net" market exposures, deliver a differentiated source of alpha, and provide a meaningful degree of protection in market down turns given these strategies' flexible investment mandates. Managers can choose to be fully invested, hold significant cash allocations, or even "short" securities viewed as unattractive.

Our expectation for higher market volatility, lower stock correlations, and the rising relevance of fundamentals should provide an attractive environment for alternative strategies.

For portfolios that can diversify further into the private investment space and withstand the commensurate illiquidity, unique and persistent structural opportunities continue in private equity and private real estate. Most importantly, liquidity remains at a premium today, so less capital flowing to illiquid investments drives more selective opportunities. Private equity provides exposure to a wide range of privately-held companies that together produce a differentiated source of return vs. the public markets. Examples of this include disruptive technologies that are tapping into opportunities evolving through the internet and mobile communication, personalized medicine, and energy, as well as gaining exposure to more traditional strategies of adding value to existing business through operational improvements.

Within real estate, significant opportunities exist in the "value-added" sector, especially when compared to more traditional core real estate. Core yields remain low and pricing challenged, but properties requiring development and renovation expertise, financial re-structuring, and /or leasing challenges can offer a significant premium to core returns. For investors with patient, longer-term capital where illiquidity is not an issue, attractive opportunities are likely to provide rewards over the coming years.

Bringing It All Together

Overall, we remain constructive on the market outlook for 2014 although the coming year will almost certainly be more volatile than the last. While the U.S. market is fully valued, opportunities exist in larger capitalization stocks and sectors like quality, technology, and MLPs. Internationally, valuations are more attractive relative to the U.S. and the positives appear to outweigh the negatives. While municipal bonds' relative attractiveness has improved, we remain underweight to traditional fixed income, continuing to favor credit exposure over interest rate risk. Alternatives should prove valuable in what is anticipated to be a more volatile environment, especially in light of our underweight to traditional fixed income. For investors who can lock up capital for longer time periods, the illiquidity premium of private investments appears especially attractive.

Because it is so difficult to accurately predict market outcomes over the short-term, we remain vigilant to potential risks and fully diversified across portfolios. We continue to evaluate client allocations individually and rebalance portfolios as needed. The combination of diversification and the appropriate asset allocation will lead to more consistent, long-term results.

Thank you for your continued confidence in Diversified Trust. Please contact us with any questions and/or feedback you would like to provide.

Diversified Trust Investment Team

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