Holt Capital Partners, L.P.

Fourth Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

December 31, 2013

Looking Back at 2013

- The stock market defied the skeptics last year and marched steadily and impressively higher. The S&P 500 generated a return of 32.38%, which was the best year for large cap stocks since 1997. Small cap stocks performed even better, while stocks with above average dividend yields trailed slightly.

- Corporate earnings grew at a high single digit rate and the number of companies that raised their dividends hit a twenty year high. However, the dominant driver of returns was the increase in Price-to-Earnings ratios from about 13x to 15x. The darkest days of the financial crisis were five years ago and investor confidence in the long term sustainability of earnings and dividend growth is slowly returning. As a result, P/E ratios are finally rebounding from the multi-decade lows that characterized the past few years.

- The Federal Reserve's policy of quantitative easing has resulted in short term interest rates hovering near zero. However, credit market forces drove yields on intermediate and long term government bonds higher, which pushed prices lower. As an example, yields on ten year government bonds rose from 1.76% to 3.03% during 2013. Most investors in government bonds experienced negative total returns last year, while corporate bonds, municipal bonds and high yield bonds all produced slightly better returns.

How 2014 Could Be Different

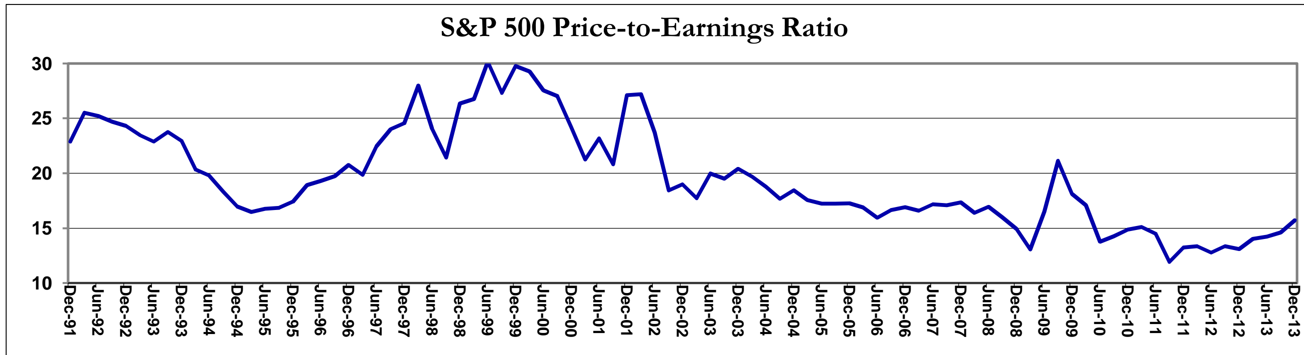
- At the Federal Reserve, the Chairman's gavel will transition from Ben Bernanke to Janet Yellen. While policy may not actually change very much, the markets may need some time to achieve the same level of confidence with Yellen that Bernanke enjoyed during his eight year tenure.

- The headlines during the past few years have generally focused on the apparent disconnect between below average economic growth and the strong advance in stock prices. This relationship could reverse in 2014 as economic growth catches up with higher stock prices.

- The new year is likely to see a return to a more normal pattern of volatility in the stock market. This is not a bearish comment, but simply the recognition that stock markets historically experience price corrections of 10+% at some point during most years.

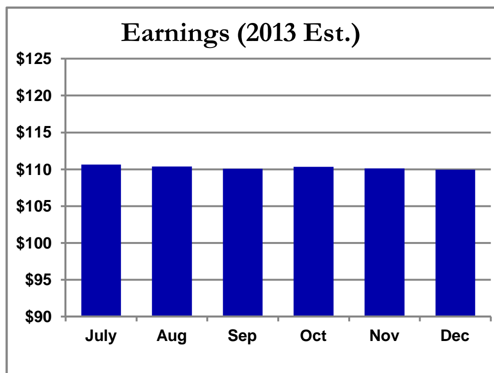
EARNINGS AND VALUATIONS

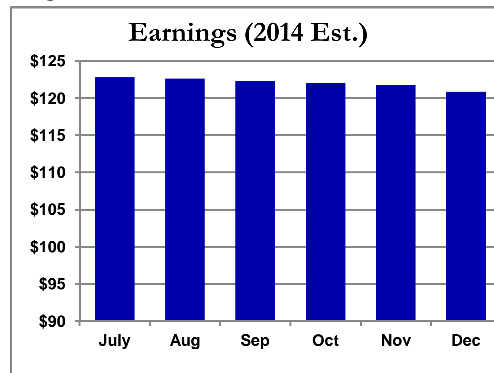
- Over the past two decades P/E ratios have ranged from 30x to 12x. Although valuations have risen during the past year, P/E ratios are still well below average when evaluated over a long period of time.



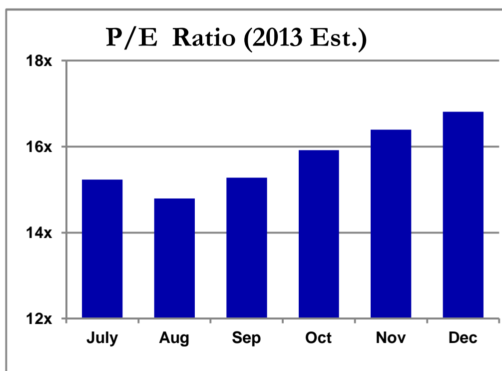
- S&P 500 earnings are poised to rise about 7% for calendar year 2013. Earnings estimates have been relatively stable since the beginning of the year and continue to hover around $110. Based on 2013 earnings estimates, P/E ratios have expanded this year from 13x to over 16x. As investors roll forward to focus on 2014 earnings, P/E ratios will begin the new year at about 15x estimated earnings.

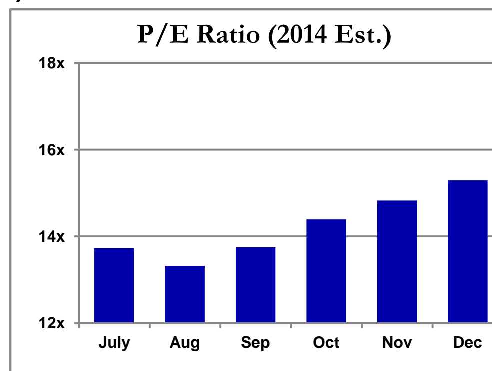
S&P 500 Earnings Estimates





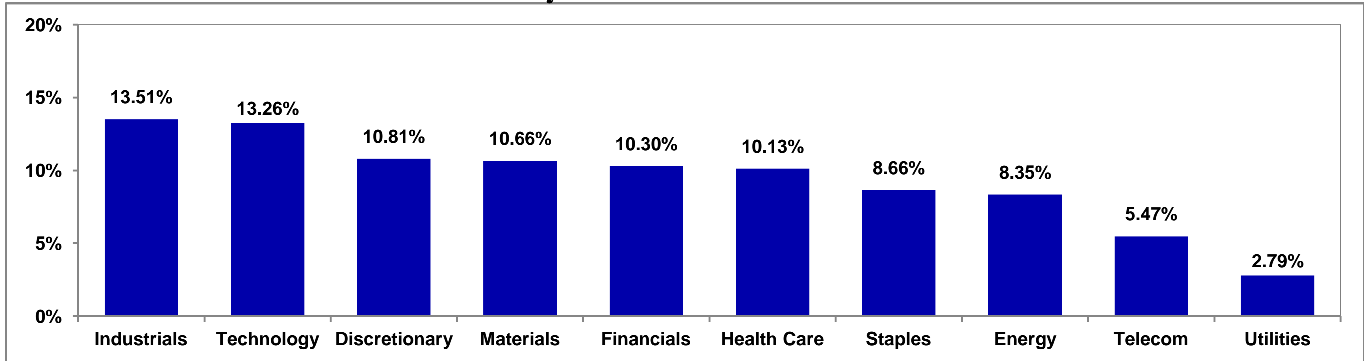
S&P 500 P/E Ratios



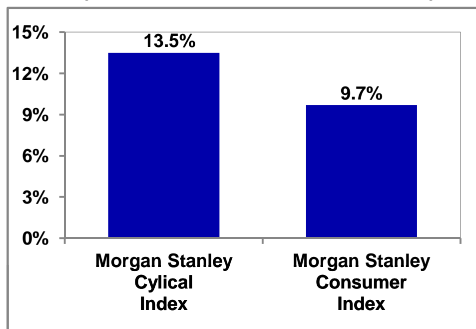


Fourth Quarter Investment Performance (including income)

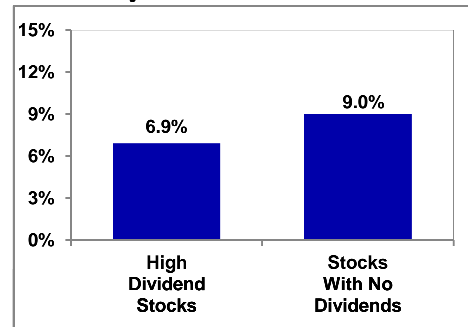
By Economic Sector



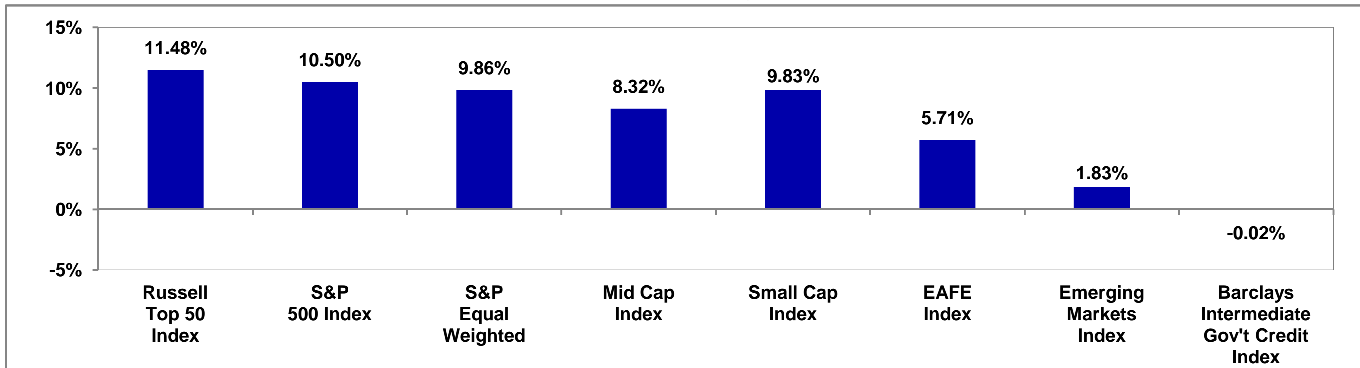
By Economic Sensitivity



By Dividend Yield



By Market Capitalization, Geography and Asset Class

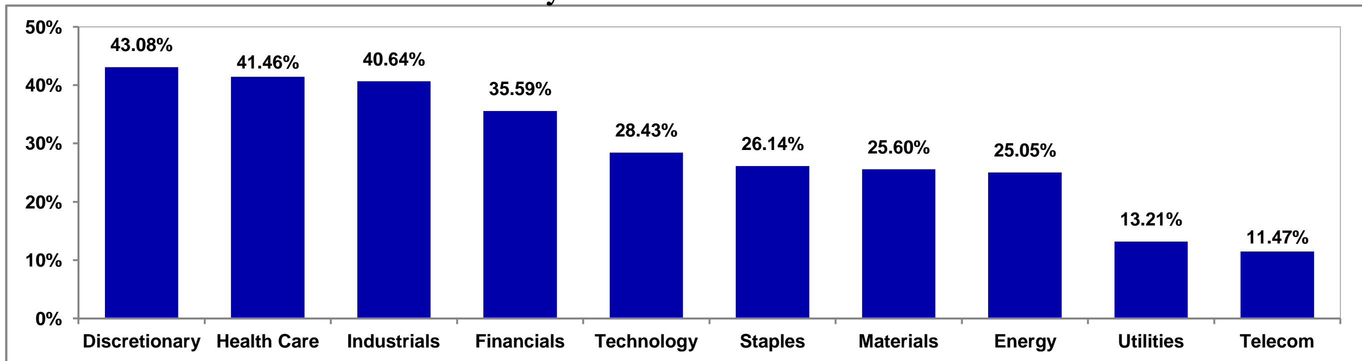


- There was clearly a cyclical bias to sector performance during the fourth quarter. Industrials and technology were the top performers, while telecommunications and utilities lagged.

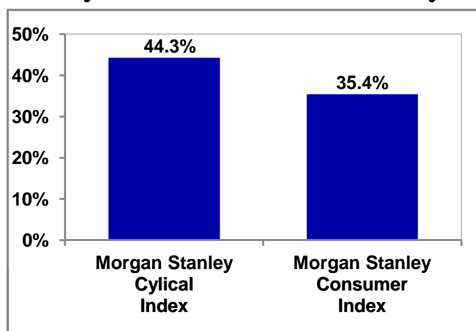
- The mega cap stocks, as represented by the Russell Top 50 Index, outperformed other size categories during the fourth quarter. This relative performance is consistent with the quarterly pattern of returns since 1926. If history continues to be a guide, small cap stocks are likely to be the best performers during the first quarter.

2013 Investment Performance (including income)

By Economic Sector



By Economic Sensitivity



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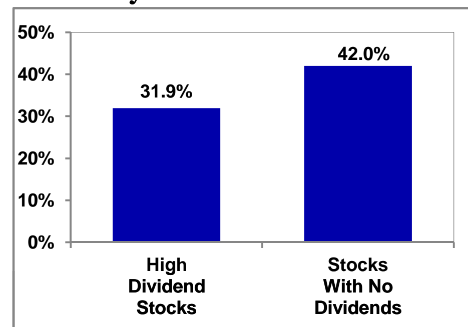

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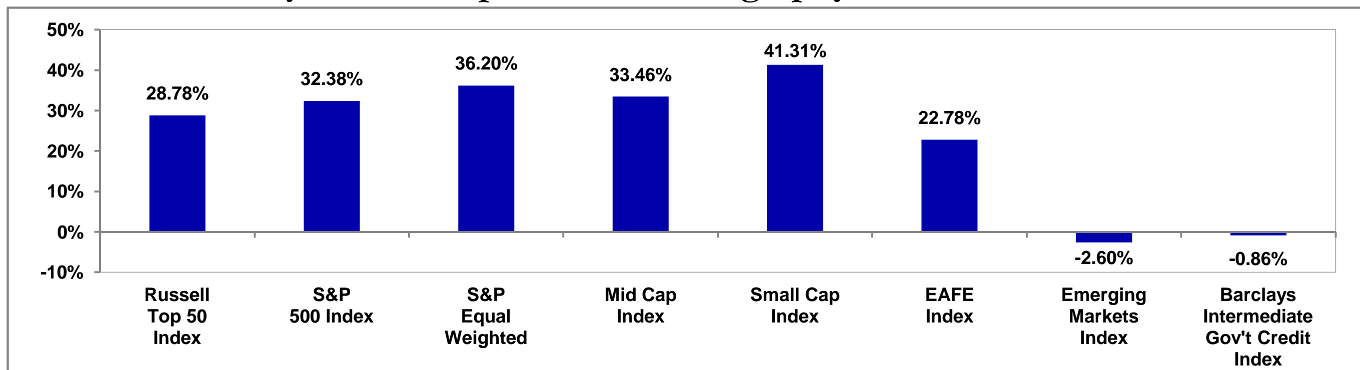

- All ten economic sectors posted double-digit total returns during the year. Economically sensitive sectors, such as consumer discretionary and industrials, posted the largest gains. The health care sector, which is generally considered to be a non-cyclical growth group, also achieved impressive results. This performance was primarily driven by outsized gains in several biotechnology stocks.

- Domestic equities were the best performing asset class by a wide margin. Although developed markets, such as Europe and Japan, generated good gains, emerging markets and fixed income indexes posted slight losses.

CORPORATE AMERICA'S FINANCIAL FLEXIBILITY

- The past two years have been all about the return **of** capital to shareholders through share buybacks and increased dividends. The emerging trend of the new year will likely be a renewed focus on the ability of corporate managements to generate a return **on** capital from strategic acquisitions and capital expenditures. Merger activity will be perceived as an attractive source of growth in a global environment of relatively slow economic activity.

- This past year's rally boosted the asset value of corporate pension funds and higher interest rates reduced the present value of future obligations. This not only puts pensions on a much healthier financial footing, but should allow many companies to cut their pension expense, thereby supplementing earnings. Individuals have experienced similar increases in their net worth as workers and retirees with 401k plans and IRAs benefited from higher stock prices.

CONCLUSION

- The fundamental backdrop for the domestic economy is likely to see further improvement in 2014. Unemployment should continue to fall, autos and housing will continue to be important economic engines, and corporate profits will rise. While this environment is likely to be supportive of higher stock prices, it should simultaneously act to minimize the downside risk. Bond investors are likely to experience another year of modest returns as interest rates continue to rise.