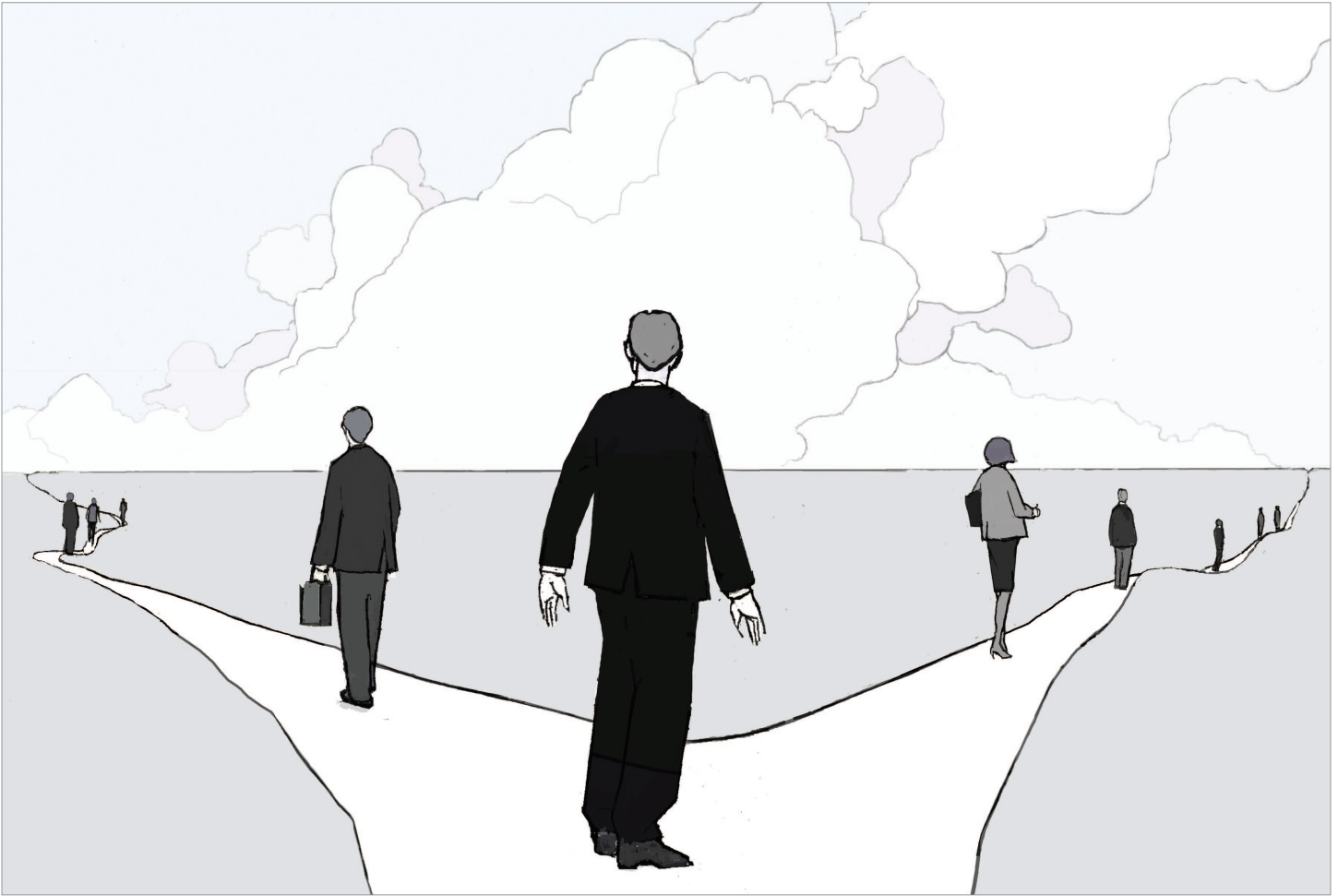


2015 Annual Outlook

Divergent



For the last six years, we have lived in a synchronized global economy in which central banks were all pulling in the same direction through unprecedented stimulus programs. As the U.S. Federal Reserve begins to normalize its policies, the European Central Bank and other central banks around the globe are embarking on new stimulus measures creating diverging paths. While some have feared the consequences of the Fed unwinding its stimulus, these changes appear to be gradual and well telegraphed so as not to cause significant disruption. However, a desynchronized world will likely lead to more volatility and investment opportunity, even as some markets around the world have reached new highs. Investors in this divergent world need to remain balanced, using caution where greed has lifted markets beyond rationality and being opportunistic when fear depresses values.

Summary

2014 was generally a good year for U.S.–focused investments, except in the energy sector. The S&P 500 led most major equity markets, increasing 13.7% for the year, while international equity markets actually declined during the year. This continues a multi-year trend in which U.S. equity markets have outperformed their international counterparts.

Global growth remains muted, as deleveraging following the over-indebtedness of the developed world economies has created persistent headwinds. The U.S. appears to be the strongest of the major developed economies, with GDP growing and employment recovering. On the other hand, Europe remains mired in economic stagnation so severe as to prompt the ECB to begin its own quantitative easing program to stave off deflation and possibly yet another recession. As a result, we see the signs of significant economic and central bank policy divergence developing. We believe these desynchronized policies will lead to increased volatility in capital markets and currencies, but also attractive investment opportunities around the globe.

The accommodative central bank policies of the last few years have created elevated valuations in many markets. However, it is nearly impossible to predict the timing of market corrections, so we recommend investors never attempt to time markets. We do believe investors should be reducing their exposures to the most overvalued areas of the capital markets in favor of more attractively priced investment opportunities elsewhere. In many cases, this rotation will take investors away from traditional U.S. stock and bond investments into a broader, more diversified array of investments. More specifically, our investment themes include:

- For several years, we have recommended that clients reduce their fixed income allocations based on the unattractive risk/reward proposition facing debt investors. This shift to different volatility reducing strategies and equity strategies has been a very productive reallocation for clients. We continue to recommend that investors underweight fixed income exposure.

- In 2014, U.S. equity market performance outpaced earnings growth, leaving these markets in a more overvalued position. Valuation metrics are above long-term averages, but remain below the peak reached during the tech bubble. At a minimum, investors should ensure that they have rebalanced their portfolio to account for recent U.S. equity market gains. More cautious investors may look to increase their non-directional exposure.
- Emerging market equity has become relatively more attractive yet again. By the end of 2014, we succeeded in gaining access to a handful of nimble, non-benchmark oriented managers in these markets to build our exposure to a significant overweight relative to many traditional benchmarks and reference points. Implementation using unconstrained, active management, is particularly important given the inefficiencies, high dispersion of returns and significant risks in these markets.
- Private equity remains an important allocation for clients and strong returns generated in 2014 were a powerful illustration of this for our long-standing clients. As valuations in these markets increase, we remain focused on implementing in less efficient areas, such as smaller companies and non-U.S. investments.
- The energy sector, particularly in the form of private investments, has become increasingly interesting as the sharp decline in crude oil prices has begun to create distress and dislocation. Our investments in private real assets over the last several years have shifted methodically away from real estate investments to value-oriented energy and mining and other more favorably priced areas.

2014 Capital Markets in Review

In 2014, some markets continued their impressive climb, while others began to feel the weight of high valuations and uncertainty. The U.S. remained the preferred destination for investors, as its aggressive monetary and fiscal policy measures and bank clean-up efforts coming out of the global financial crisis have

been far more successful than those of other countries around the world. As a result, the relative performance of the U.S. markets have been quite strong. As shown in Chart 1, the S&P 500 Index increased 13.7% during 2014, reaching all-time highs and continuing its dominant performance trend of the last several years.

Over the last five years, U.S. markets have increased at an annualized 15.5% rate, whereas international equity markets have increased at a rather modest annualized 5.3%. This follows a multi-year period during which international equity markets were the stronger performer, as shown in Chart 2. Worse yet, emerging market equities over this same five year period have increased at only a 1.8% annualized rate. We witnessed a similar pattern in 2014, with world equity markets increasing a modest 4.2%. Offsetting the surprisingly strong performance of U.S. markets was the performance of developed economy international equity markets, which declined 4.9%, and emerging market equities, which declined 2.2%.

Increasingly, we are seeing these wide divergences in economies and markets around the world. For example, in emerging markets, China and India were among the world leaders, increasing 53.8% and 29.2%, respectively, as the promise of market reforms buoyed investor confidence. On the other hand, Russia declined 42.7% and Brazil declined 13.8%. These

extremes are emblematic of the increasing economic and policy divergences we see around the globe.

The poor performance of international equity markets requires a bit more context. Much of the relative underperformance of non-U.S. equity markets was due to currency fluctuations. The performance of the U.S. dollar was quite impressive in 2014, as investors viewed the Fed's decision to end bond purchases as a sign of strength (or at least less weakness). And while the U.S. central bank policy of artificially repressing interest rates is likely to continue for some time, it looks relatively frugal compared to other central banks. As a result, in the developed world, the euro and the yen both declined approximately 12% during the year. Currency declines were even more severe in some emerging economies, including Russia (-43%), Brazil (-11%) and Argentina (-24%), in some cases accounting for nearly 100% of the equity markets' declines we witnessed in these markets last year. We expect increased volatility and wide divergences among currencies to continue over the next few years.

As we will discuss in detail later, central bank policy came to the forefront again in 2014. The U.S. Federal Reserve began to taper its support for bond markets, but remained steadfast in its commitment to keeping interest rates low. As a result, U.S. Treasury bonds performed well, despite beginning the year at already

Chart 1. Performance and Valuation

		Performance			Valuations	
Market	Index	2014	Annualized 3 Year	5 Year	Price/Earnings Dec. 2014	Dec. 2013
U.S. Equity	S&P 500	13.7%	20.4%	15.5%	16.2x	15.9x
International Equity	MSCI AC World ex U.S.	-3.9%	9.0%	4.4%	13.2x	14.1x
Emerging Market Equity	MSCI Emerging Markets	-2.2%	4.0%	1.8%	10.6x	10.2x
Spread vs. Treasuries						
Municipal Bonds	Barclays Mgd Money Short/Int	4.2%	2.2%	3.6%	72 bps	81 bps
U.S. High Yield Bonds	Barclays High Yield Corporate Bond	2.5%	8.4%	9.0%	477 bps	396 bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	5.5%	5.3%	7.3%	388 bps	318 bps
Hedge Funds	HFRI Fund Weighted	3.3%	6.2%	4.6%		
Conservative Hedge Funds	HFRI FOF Conservative	3.4%	5.1%	3.3%		
Commodities	Bloomberg Commodity Index	-15.6%	-8.9%	-5.2%		
Gold	Spot Price of Gold	-1.7%	-8.9%	0.7%		

Source: Bloomberg, MSCI, JP Morgan

low levels. Intermediate Treasuries returned 8.6% with the 10-year bond yield ending the year at 2% after beginning the year close to 3%. Similarly, other sovereign debt markets viewed as safe by investors achieved even more impressive results. The German 10-year Bund began the year at 2% and ended the year at 0.50%, as sentiment on the European continent became even gloomier and the prospects for growth and inflation declined further.

High grade corporate bonds followed the trend of declining interest rates and performed well. Importantly to many of our clients, municipal bonds performed well, with intermediate bonds increasing 9%, as a dearth of supply compounded the positive performance generated by declining interest rates. On the other hand, high yield bonds began to show some cracks late in the year. We have cautioned for some time that very tight spreads, which have led to record low yields on high-yield debt, presented investors with a particularly poor investment proposition. Only time will tell whether the year-end declines are the beginning of a broader unwinding or simply a temporary reversal.

Hedge funds, as measured by the HFRI Fund Weighted Index, produced another underwhelming year, returning 3.3%. We would have expected hedge fund performance to be better this past year, given the dispersion we have begun to see across

capital markets. This remains an area where manager selection is critical to investment success, but unfortunately, most investors don't have the access Gresham provides to managers that can effectively exploit these opportunities.

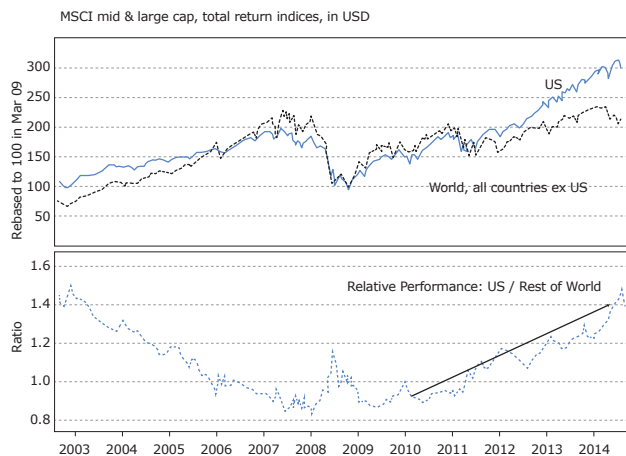
While 2014 private equity performance numbers are still months away from being finalized, a significant number of IPOs and highly valued follow-on funding rounds, particularly for later stage venture capital backed companies, are likely to translate into very good returns in 2014.

Diverging Global Economy

Seven years after the financial crisis, we continue to see weakness in the global economy. Many countries are still wrestling with the legacies of the crisis, including stubbornly slow recoveries in labor markets, high debt burdens and still fragile banks. Worse yet, there are few indications that things will improve in the near future. Recent estimates from the IMF indicate that the global economy is actually weaker than anticipated as recently as six months ago. Christine Lagarde, managing director of the International Monetary Fund, remarked in a recent speech that the global economic recovery is "brittle, uneven and beset by risks."

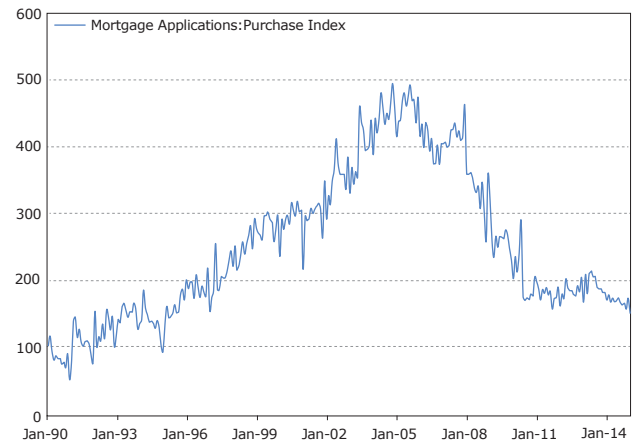
In a sense, the credit-fueled expansion of growth

Chart 2. U.S. Equities Have Outperformed for Four Straight Years



Source: Gavekal Data / Macrobond

Chart 3. Mortgage Applications Have Fallen to Late 90's Levels



Source: Gavekal Data / Macrobond

in the prior decades borrowed growth from the future and now it's payback time. As a result, there is only limited appetite for increased borrowing in many segments of the economy. Chart 3 shows the lack of recovery in U.S. mortgage applications. This is particularly important in the U.S. economy, as consumers account for roughly 70% of GDP. This unwillingness or inability to borrow is arguably even worse in many other countries around the world.

While global economic growth in aggregate is muted, this is hiding wide divergence among various countries and regions. Among advanced economies, the U.S. is expected to be the strongest, while most of Europe is unlikely to grow much at all. The emerging economies are likely to remain the main driver of global economic growth, albeit at a slower pace than in the past. Additionally, these emerging economies are themselves also likely to exhibit highly differing growth patterns, furthering our view that the world economy is becoming a highly divergent place after many years of largely synchronized policies as shown in Chart 4.

U.S. Economy

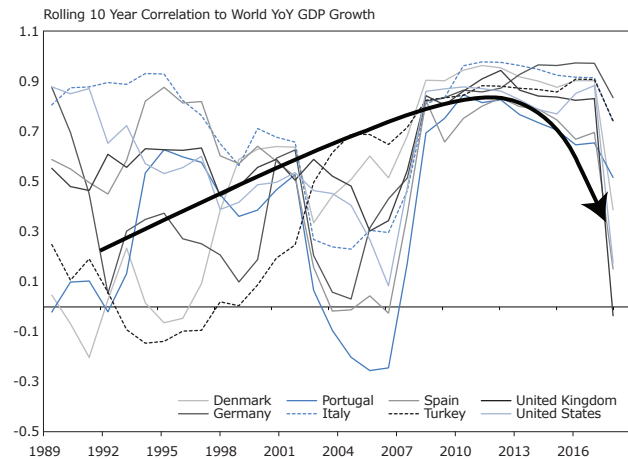
In contrast to our somewhat gloomy outlook for the global economy, the U.S. economy will likely continue to be the best among the developed economies. While the economic recovery post-financial crisis has been the slowest on record, it is progressing. On a positive note, we continue to believe that the U.S. will benefit

from several tailwinds over the coming years. First among these is the relatively low cost of energy. What was once a relative cost advantage based on improving drilling technologies that led to very low natural gas prices has now become more pervasive among the oil importing nations given global excess supply and rising inventories. While the U.S.' relative advantage will be diminished by more pervasive declines in oil prices, we still expect that the U.S.' economy will benefit alongside other oil importing countries.

The second benefit is in the form of an end to the structural deleveraging of the U.S. economy. For several years we have cautioned that the U.S. economic recovery would likely be hampered by the effects of this deleveraging. The U.S. consumer deleveraging has come a long way, as shown in Chart 5. And while we haven't seen significant evidence of increased consumer borrowing activity, the cessation of a negative influence will likely be positive.

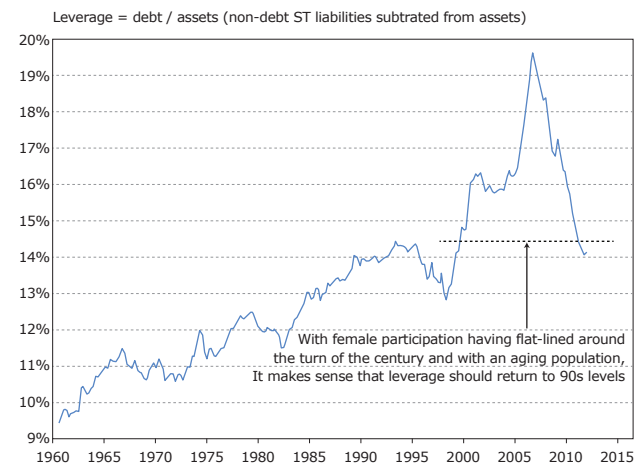
GDP growth in the U.S. over the last three quarters has been relatively strong, expanding at an annualized rate of 4.6%, 3.9% and 2.6%, respectively. Similarly, unemployment continues to decline, reaching 5.6% in December. We are somewhat skeptical of these government-produced numbers, as a significant portion of U.S. workers have stopped looking for a job and, as a result, are simply no longer counted as unemployed. Despite our skepticism,

Chart 4. Economic Performance for Individual Economies is Diverging



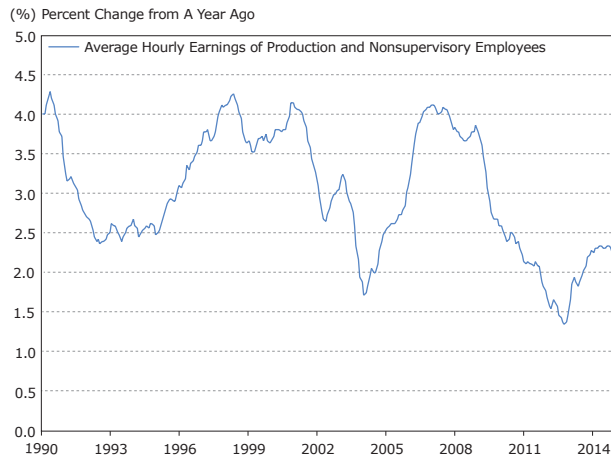
Date from 2014-2019 based on IMF Projections
Source: International Monetary Fund

Chart 5. Is U.S. Household Deleveraging Over?



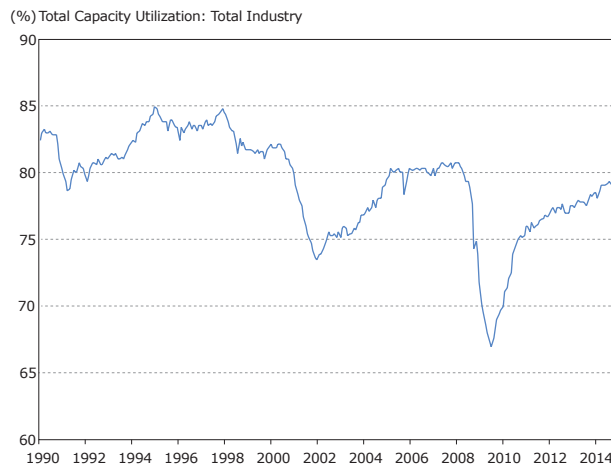
Source: Gavekal Data / Macrobond

Chart 6. Strong Employment Leading to Uptick in Wages



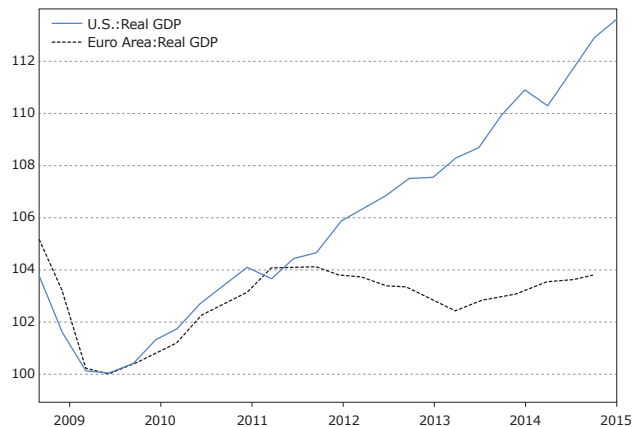
Source: St Louis Federal Reserve

Chart 7. Higher Capacity Utilization Leads to Stronger Cap-Ex Spending



Source: St Louis Federal Reserve

Chart 8. European Economies Still Stagnating



All series rebased to 100 in Q2 2009
 Source: BCA Research Inc.

the U.S. just posted its strongest year of job growth in 15 years with nearly three million jobs added during 2014. Stronger employment is finally beginning to translate into increases in real wage growth as shown in Chart 6, which has been largely absent from the current recovery and is critical to further economic growth.

Further, as shown in Chart 7, capacity utilization has now climbed back to 80% signaling that corporations may be on the verge of increasing capital spending, as it has in past recoveries. Corporate cap-ex spending has also been absent from the U.S.' anemic recovery and is an important factor in sustaining economic growth.

Overall, in the U.S. we feel the potential for upside surprises outweighs the possibility of negative surprises. Unfortunately, the same cannot be said for other parts of the world.

International Economies

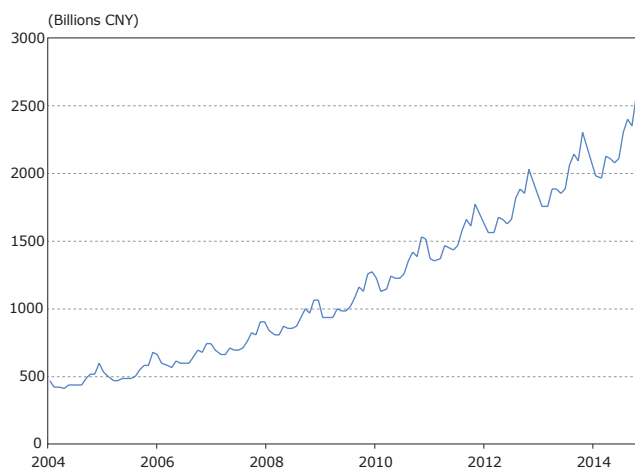
Since the trough of the financial crisis in 2009, U.S. economic growth has averaged 2.3%, while the euro area has averaged only 0.7%. Worse, as shown in Chart 8, very little of the European growth has come in the last three years, as the eurozone economies are stagnating. Many of the earlier problems in the peripheral countries, such as Greece and Spain, have now spread, as even German economic growth has slowed.

Going forward, economic growth on the European continent will remain challenged without significant structural reform and further clean-up in the banking system. On a positive note, the recently announced European Central Bank ("ECB") quantitative easing program may provide some lift, albeit mostly psychological. Many analysts believe that a program designed to lower interest rates in regions where they are already equal to or well below those in the U.S. will not be effective in stimulating growth. While we may not see a direct linkage, one clear effect has been to debase the value of the euro against most other major currencies, particularly the U.S. dollar. This should help these economies to become more competitive globally and could eventually provide a boost to economic growth and corporate profitability.

While economic growth in Europe is likely to remain subdued, growth in many emerging markets, particularly China and India, will continue to be the primary driver of global growth. Most experts believe that China will continue to slow, but even at the reported rate of 7%, its growth will remain the envy of most of the world. Similarly, economic activity in India, with its promising newly-elected reform oriented government, appears poised to grow at a healthy rate. We are not unaware of, or complacent about, the challenges that both these countries face, including significant concerns about debt levels and the pace of financial reforms, but most analysts agree that the known problems are surmountable. We remain optimistic about the emerging middle class and the corresponding increase in discretionary spending that will tilt these economies toward a more internal consumption driven model. Over the last decade, as shown in Chart 9, these trends have been unwavering, albeit from a low base, and have produced good investment results for our clients, first through private investments and more recently through marketable investments.

We note with caution that, in a world of increasing economic and policy divergence, it is particularly dangerous to generalize across emerging market economies and markets. China and India may perform well, but a number of other emerging country economies will struggle. We are particularly concerned about commodity-dependent countries such as Brazil and Russia. Each

Chart 9. China Consumption Continues to Grow



Source: Bloomberg

likely faces a deep recession, if they are not already there. While these divergences make analysis more complicated, they also create opportunities as these cross-currents and desynchronized cycles will cause misunderstanding and mispricing.

The Impact of Declining Oil Prices

The impact on the global economy of oil's near 50% price decline should not be underestimated. We believe this will have a significant impact on inflation, which may alter central bank behavior, and will add to the divergences among global economies, as the benefits felt by oil importing nations largely will be offset by comparable losses for oil exporting nations. Further, we believe these price declines will also have an impact on capital markets, particularly debt markets, as energy companies had become significant borrowers over the last few years. We expect defaults in the energy sector to increase significantly if oil prices remain low.

We agree with analysts who believe the current price of oil is a result of cyclical oversupply, which on the margin has been driven by the enormous growth in shale-related production in the U.S. However, cyclical does not mean short-lived. Most shale extraction projects, once past the fixed cost of drilling, have a marginal cost of \$20 to \$30 per barrel, which means that existing production will continue to be economic. On the other hand, these wells, particularly newer, marginally productive wells have output declines of 50% or more after the first year of operation. This means that without costly, ongoing drilling, production will naturally begin to decline in late 2014 and into 2015. Much of the incremental capital expenditures planned for new wells appear to have been cancelled as a result of lower crude oil prices. Based on this analysis, we believe that oil prices will begin to find a longer-term equilibrium at some higher price after several more quarters of supply and inventory rationalization.

While we are not commodity experts, a case can be made that longer-term equilibrium pricing should be above \$65/bbl. or \$70/bbl. based on full-cycle crude oil production costs and global demand. Chart 11 shows that a good portion of the world's production becomes

uneconomic below this level. Our goal is not to predict oil prices, but to understand the potential impact of these short-term and long-term price movements.

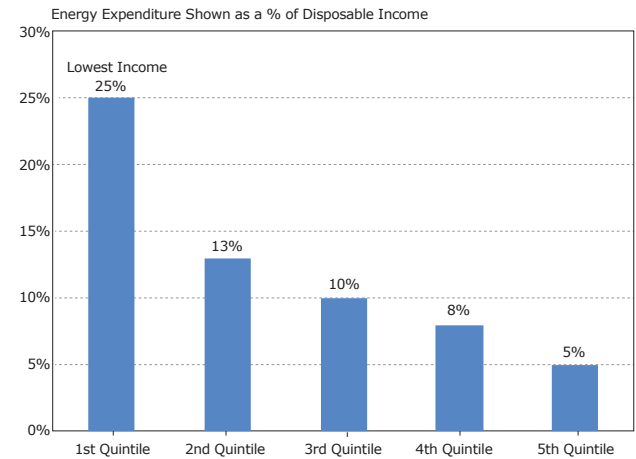
Globally, the impact of declining oil prices is not a simple story. As we mentioned before, various countries will feel different impacts. We expect the biggest beneficiaries to be the large oil importing nations, such as the U.S., Japan, China and India. On the flip side, many Middle Eastern countries and Russia, whose net exports of energy constitute nearly 20% of GDP, will feel the largest negative impact.

In the U.S., most analysts feel the impact is a net positive, as the biggest beneficiaries will be those for whom energy expenditures constitutes the largest percentage of disposable income. Chart 10 shows the significant impact on lower income families who will have the highest marginal propensity to spend the savings generated by lower energy prices, thus resulting in a net overall positive impact to the consumer-driven U.S. economy.

However, the news will not be all positive. We expect to see significant layoffs and possibly bankruptcies in the energy sector. While the shale boom has certainly been a net positive to the U.S. economy over the last few years, we believe the impact, while painful for those directly affected, will be modest in the context of the overall U.S. economy. According to the Bureau of Labor Statistics, oil and gas drilling, extraction and support accounts for only 0.5% of direct private sector payrolls. This clearly understates the potential impact due to all the secondary beneficiaries of the boom over the last few years, but the magnitude is likely directionally correct. Perhaps another way to examine this question is through capital expenditures. While the growth in cap-ex spending in this sector exploded over the last few years, BCA, a well-respected research firm, estimates that it still only represents 7% of total capital expenditures in the U.S.

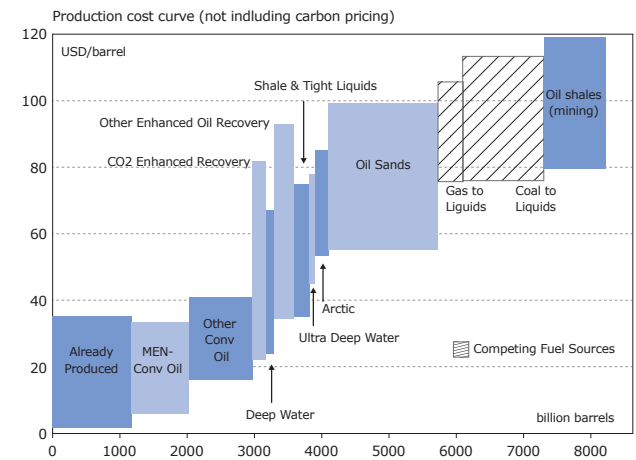
Further, Gavekal, a highly respected source of independent research, recently examined information from the Office of the Comptroller of the Currency suggesting that U.S. banks' energy sector exposure

Chart 10. Lower Energy Prices Help Those Most in Need



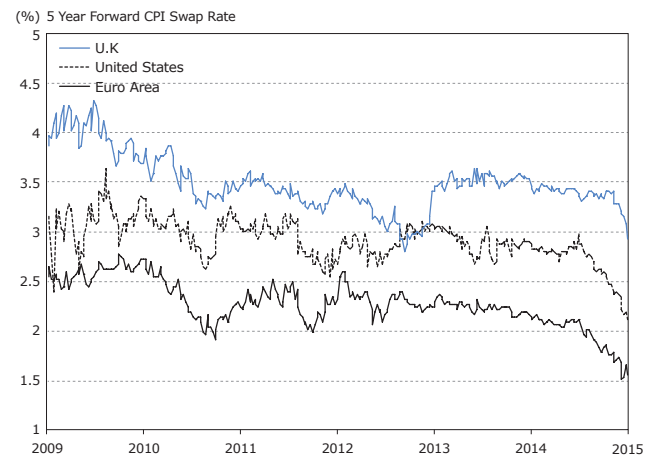
Source: BCA Research. Bureau of Labor Statistics, Consumer Expenditure Survey

Chart 11. Much of the World's Crude Oil Production is Economically Challenged below \$70/bbl



Source: BofA Merrill Lynch Global Commodity Research

Chart 12. Investors Are Worried about Deflation



Source: Bloomberg

has grown significantly over the last few years, but still represents less than 6% of total commercial loans, compared to 18% for financial and 16% for real estate exposures. Most of the risk to lenders appears to be in the relatively more transparent bond market. As a result, we feel the risk of contagion or a systemic banking problem due to declining oil prices is unlikely.

Over the coming quarters, we believe that some oil production and infrastructure assets may become available at attractive or even distressed prices. These assets could produce attractive returns in a normalized production and price environment. Further, we believe our current investments will likely weather the storm well.

Inflation

Despite years of central bank intervention to support growth and generate inflation, inflation expectations are falling most everywhere around the world as shown in Chart 12. Why do we worry about inflation so much? First, expectations of future deflation cause consumers to spend less in anticipation of falling prices, thereby reinforcing the deflationary trend. Secondly, falling prices exacerbate existing debt burdens as liabilities effectively increase at the rate of deflation. This is particularly worrisome in a world already loaded with excessive debt burdens. Finally, inflation is a key metric for global central banks. Since the global financial crisis, expansive central bank policy to avoid deflation has had a disproportionately large impact on economic growth and capital markets. Understanding the path of future inflation can provide some indication of future central bank policy.

The declining price of oil appears to be exacerbating global deflationary concerns, but it is important to distinguish between broad-based deflationary pressures and non-recurring price declines like the fall of oil prices. In fact, the opposite effect may be true as early indications are that declining oil prices have already begun to trigger increased gasoline consumption in the U.S. Further, as these lower prices work their way into other goods where oil is an input, this may trigger a future tailwind for growth and possibly

even future broad-based inflation.

While we believe global inflation is likely to remain subdued, this is also an area where generalization can be dangerous. For example, with labor markets and capacity utilization tightening in the U.S., deflationary pressures may be ending. On the other hand, eurozone deflation appears to be well entrenched, with consumer prices falling 0.2% over the last twelve months. These diverging outcomes will influence local central bank policies in different manners, creating risks and opportunities.

Central Bank Policy

The increasing divergence of economic growth and inflation provide the foundation for desynchronized central bank policies for the first time since the global financial crisis. In the U.S., the Fed will focus on beginning a path toward renormalizing monetary policy. In Japan, aggressive measures will continue with a goal of reflating their economy. In Europe, the ECB has just begun an aggressive quantitative easing program in an attempt to stave off deflation. In emerging markets, we see policy at all ends of the spectrum, with goals of fighting deflation to dampening wage inflation and housing price bubbles.

Janet Yellen, Chair of the Board of Governors of the U.S. Federal Reserve, recently stated that rate increases, when they materialize in advanced economies, “could lead to some heightened financial volatility.” While rate increases in the U.S. are still likely several quarters away, the Fed is proactively discussing normalizing interest rates well in advance of the actual event to minimize investor shock and market upheaval.

On the other hand, the ECB recently undertook its own quantitative easing program five years after the U.S. began its program and as the Fed is considering a measured exit. The ECB plans an asset purchase program with an ultimate goal of purchasing \$1.25 trillion of bonds over the next 18 months at a rate of nearly \$70 billion per month. Governmental authorities are desperate to stave off deflation and provide the basis for future growth, which is not surprising when euro area unemployment is still above 11% and peripheral

countries, such as Spain and Greece, are still at more than double that rate.

Most analysts are skeptical this policy will create meaningful economic benefit, as interest rates are already at or below zero in some European countries, as shown in Chart 13. It is reasonable to question the potential effectiveness of a policy designed to push interest rates further into negative territory. We live in a remarkable world when, as one analyst recently put it, the zero yield of gold is beginning to look like a high-yielding asset!

In our view, the biggest risk in Europe is that without real fiscal and structural economic reform to accompany this last ditch effort by the ECB, faith in the centralized European government experiment will again be tested. As a result, we could see the return of concerns about a European Union break-up similar to what we witnessed several years ago, leading us to ask: "Are the recent Greek elections of an extreme left-wing government the proverbial canary in the coal mine?"

Capital Markets and Valuations

Similar to the divergent trends in global economies and currencies, we expect capital markets to mirror this behavior with wide extremes in performance, providing volatility and opportunity. As Howard Marks of Oaktree Capital, who is one of our favorite market commentators, recently said, "Asset prices are often set to allow

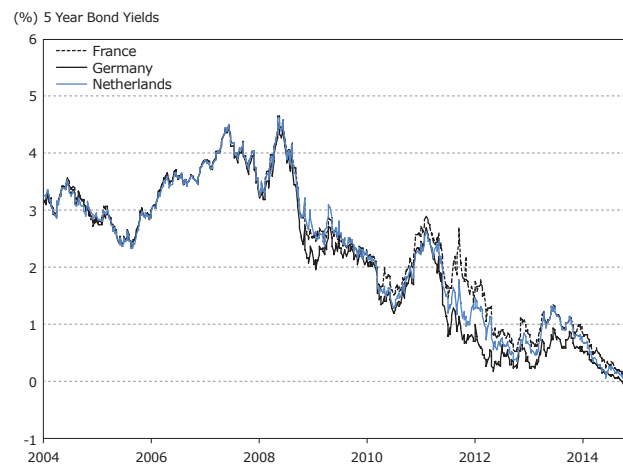
for the risks people are aware of. It's the ones they haven't thought of that can knock the market for a loop." So, what's embedded in current valuations?

Fixed Income Markets

Accommodative central bank policies over the last few years have elevated valuations in many markets and a discussion of distorted valuations should begin in the fixed income markets. Interest rates in the developed economies have been the primary victim of central bank intervention. For several years, we have lamented the poor risk/reward trade-off presented to investors by artificially repressed interest rates. Today, interest rates are near all-time lows in both nominal and real terms. As shown earlier, some European rates are already at or below zero. Think about that. Why would any creditor pay Germany or Switzerland for the privilege of owning their bonds?

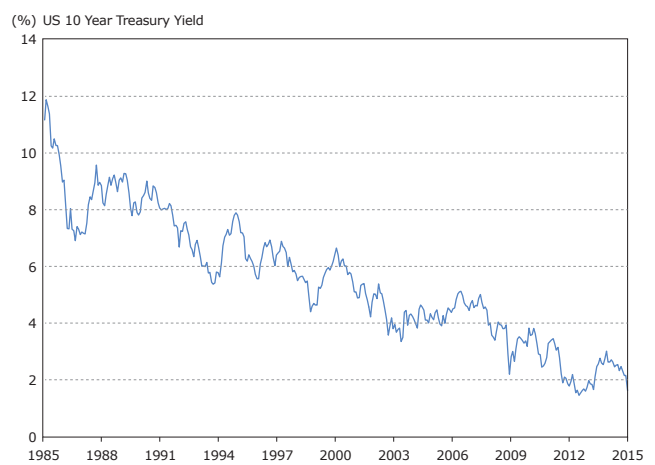
Similarly, as shown in Chart 14, U.S. Treasury rates are approaching record lows. Importantly, these rates in real (i.e., inflation-adjusted) terms appear even worse as they are at or below zero, which is well below their long-term average. Municipal bonds have followed a similar path. Interest rates in the tax-free market fell even further in 2014, as reduced borrowing needs for municipalities led to a relative supply shortage and lower borrowing rates. As shown in Chart 15, the municipal bond market is near fair value, only when compared to a highly inflated Treasury market.

Chart 13. Core European Government Debt is Trading Near Zero



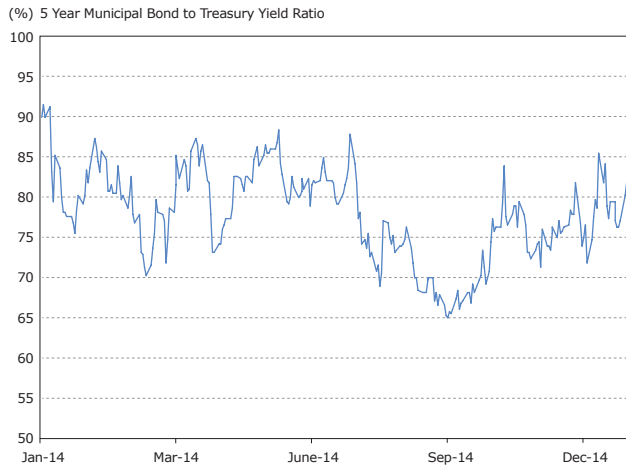
Source: Bloomberg

Chart 14. U.S. Treasury Rates Near Historic Lows



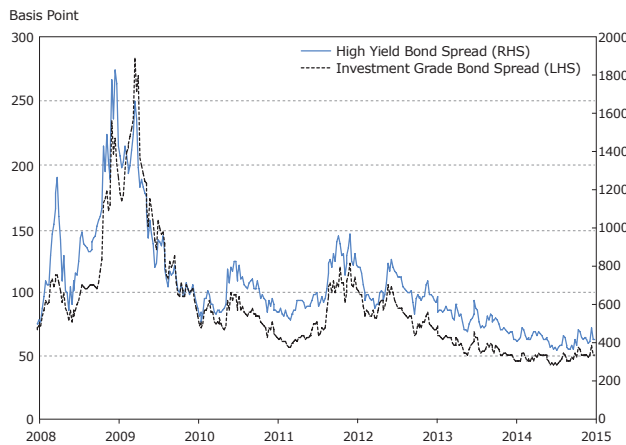
Source: Bloomberg

Chart 15. Muni Bonds Near Fair Value Compared to Treasuries



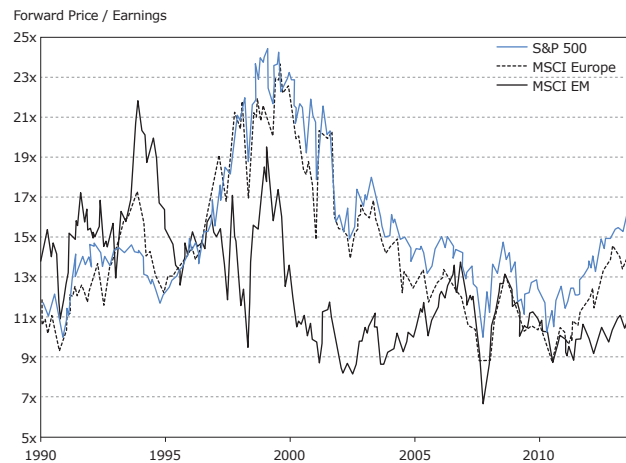
Source: Bloomberg

Chart 16. Corporate Bond Spreads at Very Low Levels



Source: Bloomberg

Chart 17. Developed Market Valuations Have Crept Up



Source: Bloomberg, Morgan Stanley Research

In the spread sectors of the fixed income market, such as high-yield bonds, we have seen a modest widening of spreads over the last few months even as equity markets reached new highs. However, credit spreads are still near record lows as shown in Chart 16. Some of this back-up is related to concerns about debt issuance in the energy sector and the rapid decline of oil prices. Of more concern to us is that investor protection in the form of protective covenants within these issues recently reached an all-time low. According to Moody's, covenant-lite loan issuance reached nearly 50% during the fall of 2014. In short, the credit markets continue to price risk in a manner that defies common sense.

Equity Market Valuations

With the strong performance of U.S. stocks over the last several years, including last year's run, we are often asked if U.S. stocks are in a bubble. The answer remains "Probably not", but valuations of U.S. markets are elevated by historical standards and became more so over the course of 2014. Chart 17 shows the price/earnings ratio based on consensus estimates of forward earnings. U.S. markets reached 16.5x in early January and are now trading at levels we have not seen since the bursting of the tech bubble in the early portion of the last decade. This is well above the long-term average of 14x, but not near the peak of 2000.

While U.S. market valuations are not at record levels, other concerns exist. Top line revenue growth continues to be underwhelming, estimated at just over 3% in 2014. Relatedly, earnings growth, while modest at 5% in 2014, has been driven primarily by margin expansion as shown in Chart 18. We believe further margin expansion will be challenging, but not impossible, as labor markets and capacity utilization are tightening. Additionally, earnings estimates continue to disappoint analysts year after year, as shown in Chart 19. This is particularly important as the price/earnings measure we discussed previously is based on future earnings estimates, so that a reduction in future earnings growth will effectively make the market more expensive.

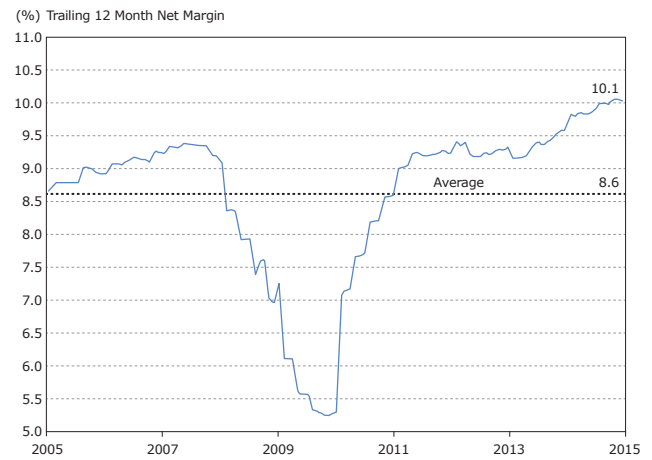
In Europe, the equity market rebound has lagged the U.S. and these markets continue to trade at a discount to U.S. markets, as seen earlier in Chart 17. Some of the recent underperformance can be attributed to currency declines, some to slower earnings growth, and some perhaps to the ECB being slower to stimulate growth after the financial crisis. However, with the recently announced ECB quantitative easing program, the euro has declined further, which should make these economies more competitive and lead to higher earnings over time. As expected, equity markets have reacted favorably to the recent stimulus measures. One additional note of caution that inhibits our interest is the ongoing structural friction that exists within the Eurozone. This is particularly true in the peripheral countries that still struggle under high debt burdens, high unemployment and stagnant growth.

Also seen in Chart 17 is the apparent relative attractiveness of emerging market equities. EM equities have underperformed U.S. markets over the last few years, creating a significant valuation gap. However, it is very important to avoid generalizations about countries and sectors, particularly within the emerging market economies. For example, valuations by sector or market capitalization can lead one to very different conclusions regarding absolute and relative attractiveness within these markets. Chart 20 shows the wide and growing dispersion in valuation between a standard market-cap weighted benchmark and one evenly weighted across sectors. As we discuss in our investment themes section below, this is the foundation for our assertion regarding the importance of active management in markets such as these.

Hedge Funds

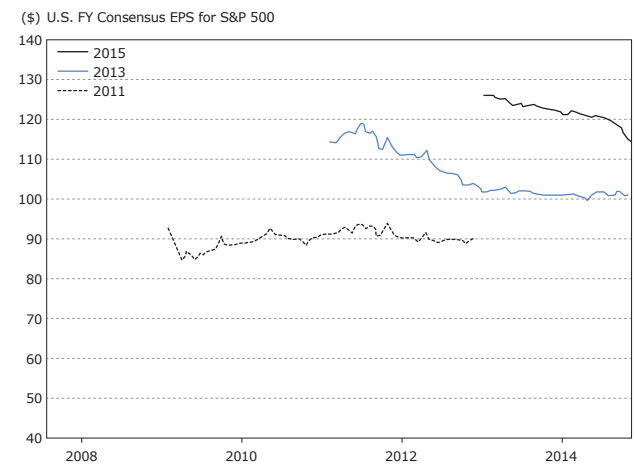
Hedge funds, while not an asset class per se, on average continue to produce underwhelming performance for investors. While the S&P 500 produced an annualized return over the last five years of 15.5%, broad hedge fund indices have generated under 5%. However, equity market indices

Chart 18. Earnings Growth Has Been Driven by Corporate Margin Expansion



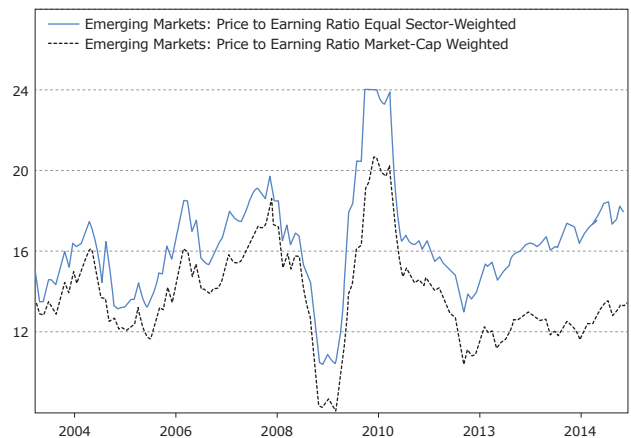
Source: FactSet

Chart 19. Analysts Continue to Revise Down Their Earnings Estimates



Source: MSCI, Datestream, Morgan Stanley Research

Chart 20. Not all Emerging Market Companies are Cheap



Source: BCA Research Inc.

are not usually the best measure for hedge fund performance over shorter periods given the lower net equity market exposure of these strategies. This is particularly true over this five-year period, which has delivered nearly uninterrupted gains to record levels. Hedging has been a costly endeavor over the last few years, but this may not be the case going forward.

Further, market volatility over the last few years, until recently, has generally been low and the dispersion of returns across asset classes has been similarly subdued. Most hedge funds generate returns by capitalizing on the dispersion of returns between securities. It should not be surprising then that, even on a risk-adjusted basis, hedge fund performance on average has been poor. This performance pattern has led some investors, including CALPERS, the largest public pension plan in the U.S., to exit their investments in the area.

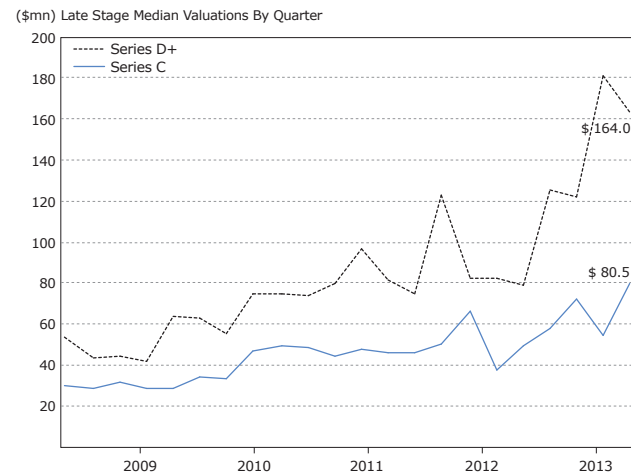
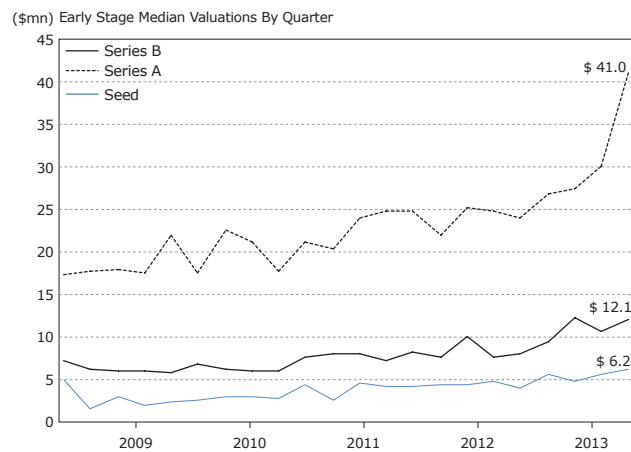
Manager selection in hedge funds continues to matter more than in any other marketable securities strategy area. It is our belief that investors who only have access to “average” hedge fund managers are bound to be disappointed by the investment results and the high fees that they pay. These investors would be better off investing in a mix of low cost stock and bond strategies, even at today’s elevated valuations.

Private Investments

It should not come as a surprise, given the change in public market prices, that valuations in the private equity and venture capital markets are also increasing. Chart 21 shows the change in price for venture capital funding at various stages over the last six years. This trend has been very productive for investors, as businesses are valued and sold at higher prices. However, this trend also creates more challenging conditions for the acquisition of businesses at attractive prices. We have always believed that manager selection in private equity is critical to success. Several elements of our manager evaluation process, especially patience and price discipline, are now more important than ever.

While transaction prices are generally higher in private equity, many private real asset investment prices have been moving in the opposite direction, creating some interesting opportunities. As mentioned earlier, we believe that declining oil prices over the last few months will create opportunities to purchase valuable assets at distressed prices over the coming quarters in anticipation of a cyclical recovery over the next few years. While existing investments in the area have clearly been impacted, those investors who were prudent in their use of leverage and who focused on developing lower-cost production assets will likely survive the downturn and generate attractive returns.

Chart 21. Late Stage Venture Valuations are Becoming Expensive



Source: BCA Research

What Should Investors Do?

Human nature never changes. While every investment cycle presents different opportunities and risks, the patterns remain the same. The pendulum swings from fear to greed and back again, creating excesses in both directions. Today, we are moving into the later part of an investment cycle. The current bull market is now 69 months old, making it one of the longest rallies on record. We have not seen a healthy 10% correction since August of 2011 (although October presented a few moments of concern). According to Nautilus Capital Research, this is longer than 97% of all uninterrupted rallies in the last 114 years. Of course none of these indicators means anything, except as to how it plays into investor psychology. When the world is greedy, be cautious, but when the world is fearful, be aggressive. This is easy to say, but hard to do.

In the later part of a cycle, one of the keys to investment success is to find those areas of the capital markets that are most egregiously over valued and simply minimize exposure to them. If one can still build a diversified portfolio among the remaining areas of the capital markets and participate in further appreciation, investment success over time will likely follow. Reviewing your portfolio in this context after so many assets have appreciated, some to extreme valuations, is particularly important at this juncture. While we are counseling caution, we are still finding attractive investment opportunities.

Fixed Income

Over the last few years, we have advised clients to reduce or eliminate exposure to fixed income markets, as we believed the risk/reward proposition was unappealing. Over the last three years, municipal bonds returned 4.3% annualized, which is well below the returns generated by other risk reduction strategies we employ for clients. While not a fair comparison, over this same time period, world and U.S. equity markets generated returns of 14.1% and 20.4%, respectively. This has been a very productive asset allocation shift.

As we look forward, the risk/reward proposition for fixed income remains uninspiring. First, interest rates are even lower than they were three years ago. While we do not have a strong view that interest rates will rise rapidly, we believe that a positive outlook for bond returns, given our starting point, would require a belief that interest rates are going to continue falling to create attractive enough returns for investors. In absolute terms, real interest rates are at or near 0%, providing investors with a relatedly unattractive proposition well below their normalized range of 2% to 3%. We continue to recommend that investors maintain their underweight position to fixed income until the Fed and other central banks normalize their interest rate policies.

Relatedly, we continue to recommend the elimination of credit and other spread-based fixed income securities given compressed spreads. As we mentioned earlier, the credit markets continue to price risk in a manner that defies common sense.

Equity

U.S. equity market valuations have become elevated, but not egregiously so. The 13.7% return of the S&P 500 in 2014 outpaced the estimated 5% growth of underlying company earnings, pushing valuations to slightly higher levels. There is no denying that the market is expensive, but the conditions that created these circumstances will likely remain for some time, which may allow the U.S. markets to climb even higher. Investors should be mindful of corporate earnings growth as a key to further advances in the future. We expect that further progress, if it indeed comes to pass, will be more volatile and interspersed with drawdowns.

Investors may feel more comfortable modestly reducing their U.S. equity exposure in favor of non-U.S. markets, particularly emerging markets, or less-directional market exposure in select hedge funds that will benefit from increased market volatility and dispersion.

International equity markets are modestly more attractive from a valuation perspective, but economic

growth, corporate profitability and the effectiveness of central bank policies remain an even greater question in these markets. While many analysts believe that European equities are poised to perform well, we do not view the valuation gap is compelling enough to warrant a significant additional emphasis. Gresham clients begin with a globally diversified equity portfolio that has significant exposure to these equity markets. Investors who do not have adequate representation in these markets may wish to rotate some exposure into them. For our clients, we are comfortable with current exposures.

Emerging market equities are the more interesting area of non-U.S. equity investing at the moment. For some time, we have been monitoring the growing valuations gap created by several years of under-performance as discussed earlier. Further, growing dispersion among sectors and countries within these markets is creating a robust opportunity for active management with flexible mandates that allow for investment outside of the major companies and indices, as shown in Chart 22.

From a risk perspective, when we couple this dispersion with increasing currency volatility, these investments could provide short-term results that will be uncomfortable for some investors. If investors have both access to superior active management solutions and have a longer investment horizon with the ability

to withstand volatility along the way, we recommend increasing allocations to these markets. As of the end of the year, our baseline investment represents an allocation that is nearly double relevant benchmarks and reference points. Some clients, at their discretion, have increased their allocation beyond this mark. Remember that implementation in these markets is particularly important.

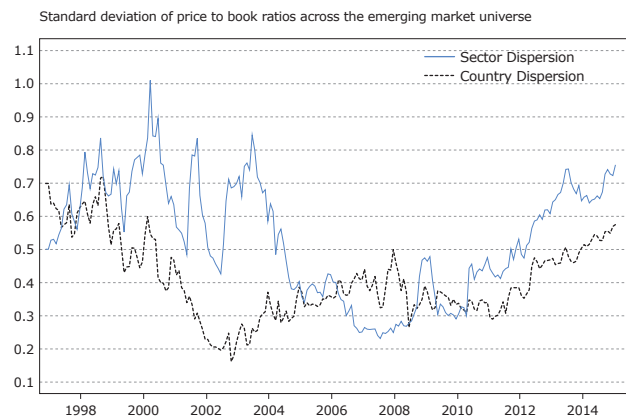
Hedge Funds

As we move into a more desynchronized world, we expect the correlations among stocks to continue declining. Chart 23 shows that pairwise correlations between stocks have been elevated during the last few years when macro factors dominated the market. As a result, we expect hedge fund returns to improve. While we believe manager selection is critical in this area, overall returns for the category should improve as well. We continue to recommend exposure to this area and to the extent investors are concerned about increased valuations in U.S. equity markets, this may be an area to overweight if access to exceptional hedge fund managers exists.

Private Equity

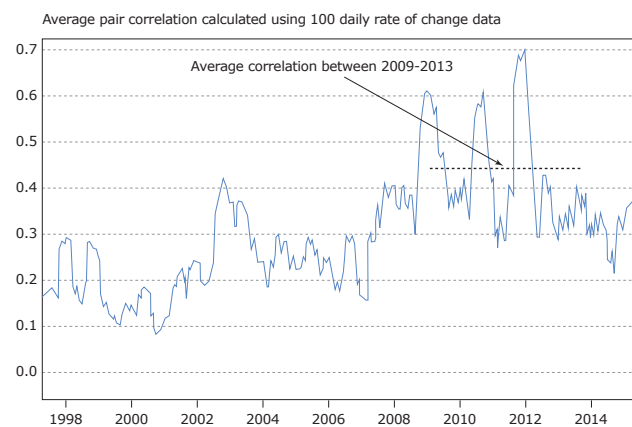
Private equity remains an important driver of long-term performance. While we don't have the final performance numbers for 2014, even the performance of the first three quarters of the year was an important illustration of how powerful this asset class can be for

Chart 22. Wider Dispersion in Country and Sector Performance in Emerging Markets



Source: Gavekal Research

Chart 23. Macro Dominance Easing, Stock Correlations Are Down



Source: Gavekal Research

our clients. The performance generated from private equity investments for our long-standing clients was substantial. For clients with moderate-to-large private equity allocations, it doubled overall portfolio returns relative to their marketable-only performance.

As we discussed earlier, strong performance has come in tandem with increased valuations for private companies. As a result, we continue to emphasize investments in less efficient areas. In the U.S., this means investing with managers who target smaller companies. Additionally, we will remain active in venture capital if we continue to have access to the top managers. However, we are increasingly concerned about valuations in later stage investments and we have shaped our allocation accordingly. Additionally, we believe our investments in Chinese venture capital and growth managers, which were a significant contributor to the strong private equity performance our clients have experienced, will continue given the opportunities we see and the access to managers that we have created.

Real Assets

Inflation appears benign in most parts of the world and, as a result, the performance of many assets within the real assets area has been poor. Similarly, the need for the diversification and inflation protection benefits provided by a real asset allocation in client portfolios over the last few years has been limited. However, the steep recent declines in oil prices may create more attractive opportunities in the area. We continue to prefer opportunities in the private markets where opportunities to add value are more prevalent than the public markets.

Important Disclosures

Over the past two years, performance for investments in emerging markets for Gresham clients has outperformed the MSCI Emerging Markets benchmark ("MSCI EM") by over 6% per year. The MSCI EM captures the performance of large and mid-cap companies across 23 emerging market countries. Over the past three years Gresham's risk reduction strategies have outperformed the average returns of municipal bonds by 2%. Performance for seasoned Gresham private equity strategies with vintage years 2011 and earlier all have IRR's over 30% for the trailing twelve month period as of 9/30/2014. 12/31/2014 valuations are not yet available. Contribution to client performance from private equity refers to a sampling of clients with assets under management in excess of \$50,000,000 and for whom 20% or more is allocated to private investments. Client performance and allocations vary based on each client's individual circumstance. A portion of private equity performance is unrealized and subject to change. Past performance is no guarantee of future results. Gresham's performance referenced is after all management fees and incentive fees of the underlying managers, but gross of Gresham's advisory fees, for which no fee is higher than 1% of total assets under management.

About Gresham

Gresham Partners, LLC is a nationally recognized, independent investment and wealth management firm that has been serving select families, family offices and endowments since 1997. Committed to delivering superior investment performance and highly personalized wealth planning, Gresham's client-focused solutions feature hard-to-access managers without the conflicts typical of other firms. With over \$4 billion under management, Gresham's Risk Conscious® investment approach and holistic planning are focused on preserving and growing clients' assets. The firm's team of highly skilled professional advisors allows families greater freedom to pursue career and personal interests.

Concluding Thoughts

The long period of uninterrupted positive performance by U.S. stocks and bonds has been productive for most investors, but it may be coming to an end. Investors need to think about asset allocation in the broadest context to ensure that their investment portfolio returns are driven by a wide variety of sources to promote more consistent compounding of returns. This is particularly important in the current market when it appears that more attractive investment opportunities can be found outside traditional U.S. stock and bond investments. To be clear, we are not advocating abandoning the U.S. markets, but rather encouraging investors to review their portfolio allocations with their advisor and ensure the appropriate balance is achieved.

In a divergent world, asset mispricing and investment opportunities are more prevalent. Over the last few years, the relative importance of asset allocation decisions increased, as being in the right market was more important than being in the right securities. Going forward, this is likely to change, particularly in less efficient areas where the potential for value-added active management is greatest, such as international and emerging market equities, hedge funds, private equity and private real assets investments. In some of these markets, the benefit of active management is high enough that without access to top managers, investors should consider avoiding the allocation entirely.