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Investment
REVIEW & OUTLOOK

MARCH 31, 2013

Economic Backdrop

p.2

- Global economic growth is beginning to stabilize, but at a subdued rate and there are key regional differences:
  - Conditions in the United States were surprisingly strong in the first quarter and were a major factor behind the recent improvement in global activity; however, fiscal tightening of around 1¾% of GDP is likely to limit growth this year in spite of positives from better job growth and rebounding auto and housing markets
  - In Europe, the European Central Bank (ECB) made significant progress in alleviating strains in the financial system in the second half of 2012; however, economic activity remains very weak and high levels of debt, imbalances in competitiveness, political risks, and ongoing fiscal austerity will continue to present challenges
  - Activity in Japan is picking up as a result of the weaker currency and optimism around reforms from the new Prime Minister and Central Bank Governor
  - China appears to have bottomed but growth is sluggish by historical standards, particularly in the industrial sectors; high levels of credit and investment in relation to GDP pose a risk
  - Other emerging economies like South Korea and India are showing signs of stabilization after growth slowed last year, but activity does not yet appear to be accelerating
- Inflation has slowed in general as commodity price increases have moderated, but we remain concerned about the potential for geopolitical instability in the Middle East to push energy prices higher
- Overall, we continue to believe that the global economy will expand at a relatively slow pace in 2013, though the potential range of outcomes is quite wide

Financial Market Outlook

p.12

- Consensus profit expectations could still be too optimistic in the context of a slow growth outlook
- Stock market valuations have expanded in absolute terms but still appear attractive relative to fixed-income alternatives
- Fed policies to hold down interest rates are gradually forcing investors to move out on the risk curve—away from fixed-income assets and toward equities; it remains to be seen how far and how long these trends can continue

Portfolio Strategy

p.17

We believe the following themes are timely in an environment of below-average economic growth:

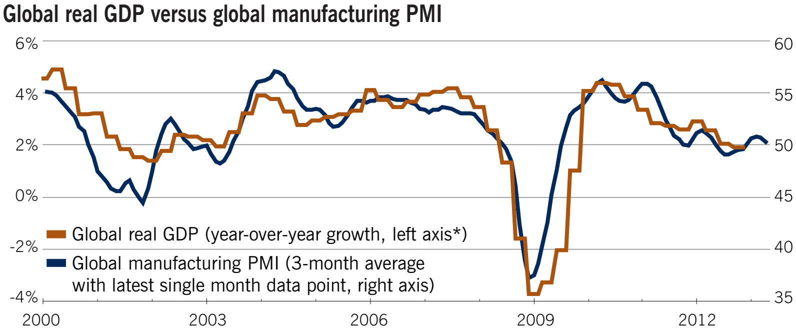
- The "strong will get stronger"— the portfolio emphasizes companies with strong operational and financial characteristics; we believe these companies can gain share from weaker competitors and thus improve their earnings
- "Earn and return cash" — stocks of companies that can both grow earnings and provide significant cash returns to shareholders through dividends and share repurchases should be attractive to many investors
- "Developed market stocks - emerging market growth" — stocks of certain companies domiciled in the developed markets appear particularly well positioned to benefit from what we anticipate will be above-average growth in the emerging markets over the next several years

Global Growth Stabilizing, But Likely to Remain Subdued With Key Regional Differences

After slowing in the latter part of 2012, global economic activity has started to improve, as evidenced by the rise in the global manufacturing Purchasing Managers Index (PMI) since the end of last year. Historically, this index has provided a timely indicator of the pace of overall global economic growth as measured by global real gross domestic product (GDP). (See Figure 1.)

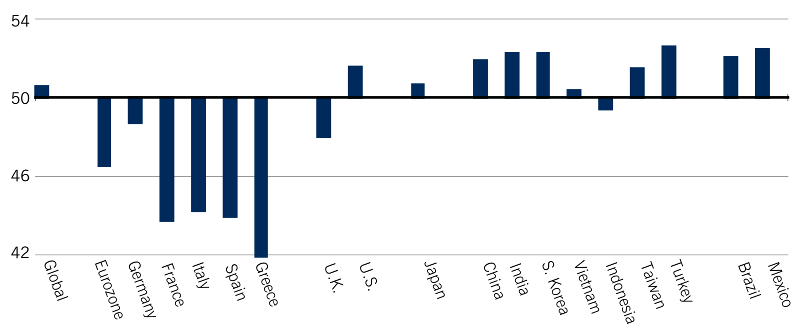
Despite the recent uplift in activity, we have two key concerns. First, conditions are still relatively sluggish; the global PMI is only slightly above 50. Second, recent growth is attributable mostly to the United States where we are worried that activity could moderate after a strong start to the year. Economic growth in the first quarter in United States has been surprisingly resilient in spite of a large headwind from government spending. Though we are optimistic that a number of the positive tailwinds that have helped activity so far will remain in place, we expect that fiscal tightening of around 1¾% of GDP will nonetheless restrain the pace of activity to around 2% for the full-year. While this rate of growth is fairly impressive given the substantial government drag on the economy, in a global context it is unlikely to be strong enough to offset sluggishness elsewhere.

FIGURE 1
Global real GDP versus global manufacturing PMI



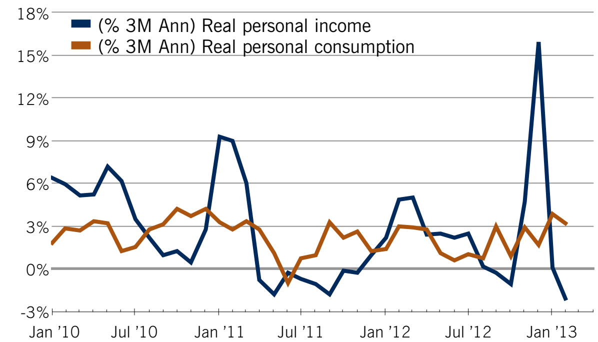
*World GDP based on exchange rate weighted average of U.S., Euro Area, China, Japan, U.K., Brazil, Russia, Canada, India, Australia, Mexico and South Korea quarterly real GDP growth
Source: ICAP, IMF World Economic Outlook, Credit Suisse, FactSet, Bloomberg; data provided from 2/2000 estimated through 5/2013

FIGURE 2
Latest manufacturing PMIs (March 2013)



Source: Markit, Bloomberg

FIGURE 3
U.S. real personal income versus spending

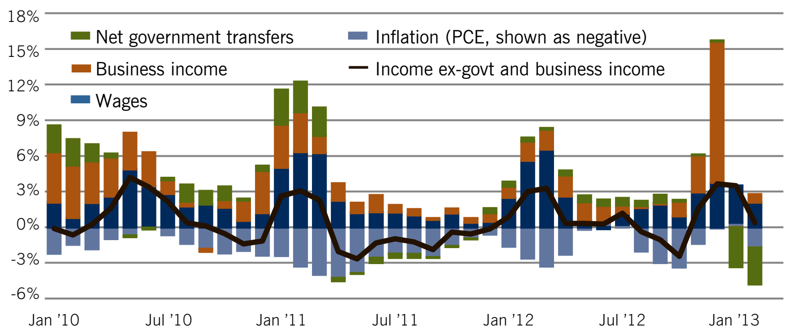


Source: Bureau of Economic Analysis, FactSet; data provided from 1/2010 through 2/2013

Regionally, economic conditions are diverging. European activity remains depressed, and we are not optimistic that things will soon improve. Japan is beginning to show early signs of better growth, though demographic trends and high levels of government debt will remain structural headwinds and sources of risk. Growth in China also appears to have picked up some from last fall, but remains slow by historical standards. Lastly, other emerging economies like South Korea and Brazil are also performing better, but are still fairly muted. These differing trends and the strength of the U.S. economy in the first quarter are evident in the latest individual country manufacturing PMI indexes. (See Figure 2.)

We expect these diverging growth trends around the world to produce a roughly 2% increase in global growth for the full year. The range of outcomes around this estimate, however, remains quite wide given divergent trends in monetary and fiscal policy around the globe, as well as a high degree of political uncertainty in a number of countries.

FIGURE 4
Contributions to real personal income growth
3-month annualized change



Source: Bureau of Economic Analysis, FactSet, ICAP; data provided from 1/2010 through 2/2013

United States

Economy Showing Resilience in the Face of Large Fiscal Headwind

Economic growth in the United States has been remarkably good so far this year given the drag from fiscal tightening. Early indicators suggest that real GDP grew by over 3% on an annualized basis in the first quarter. This resulted from a bounce back in several sectors that were weak in the fourth quarter of last year, strong consumption growth, and the recovery in the housing and auto markets.

Consumer Sector Positives Offsetting Increased Taxes

The consumer sector has been a key strength in the U.S. economy so far this year. Consumer spending has benefitted from better employment growth, rising wealth due to higher financial asset and home prices, continued low levels of debt servicing costs, and a moderation in gas prices from very elevated levels at the beginning of the year. These positives have helped to offset the headwind from increased taxes. We can see evidence of this in the fact that real personal consumption spending has remained healthy even as changing tax rates have caused personal income to fluctuate. (See Figure 3.)

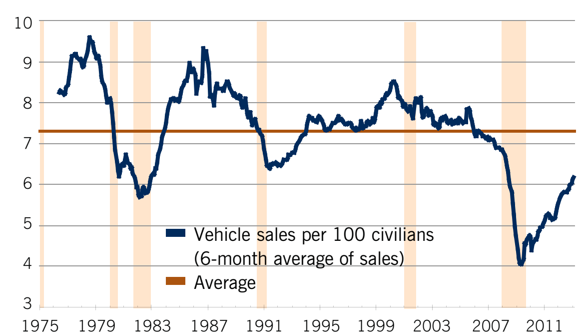
Looking forward, we think this strong rate of consumption could moderate. The savings rate is already quite low and is therefore unlikely to provide much of an additional tailwind over the remainder of the year. Income growth also appears to be only moderate after excluding the tax-related pull forward of business income in December '12 and the recent headwind from higher government taxes. (See Figure 4.) With some headwinds from fiscal tightening likely to persist and with more normal business income growth, overall income growth is likely to remain relatively modest unless employment gains strengthen materially and cause wage growth to pick up, which we do not anticipate. Without further declines in the saving rate, consumption should grow in line with this more modest rate of income growth and may decelerate from its pace in the first quarter.

Auto and Housing Sectors to Remain Key Supports for U.S. Economy

The auto and housing markets are providing key supports to the U.S. economy. In spite of the sharp increase in auto sales from the low in '09, sales remain well below their recent average on a per person basis. (See Figure 5.) Since there was no apparent bubble in auto sales prior to the recession, the market is unlikely to be oversaturated. As a result, the recovery in auto sales has room to rise further.

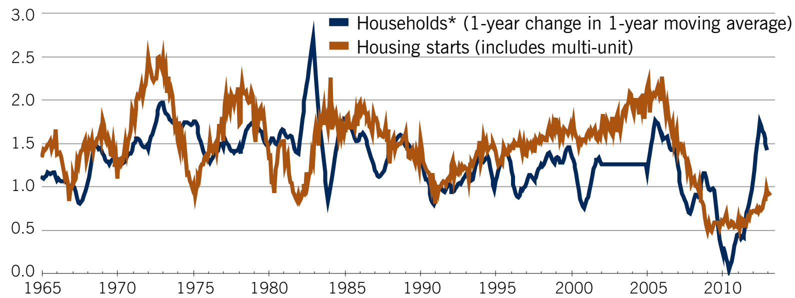
The housing market is also still recovering. After hitting its 2005 high, starts fell by around 80% from peak to trough, but they have finally begun rebounding. Since the number of scrapped homes is generally very small, total housing starts tend to track household formation, which is the key driver of demand. For several years before the crisis, starts exceeded household formation and created a buildup of excess inventories that needed to be absorbed. Currently, even after the roughly 100% increase in

FIGURE 5
U.S. vehicle sales per 100 civilians



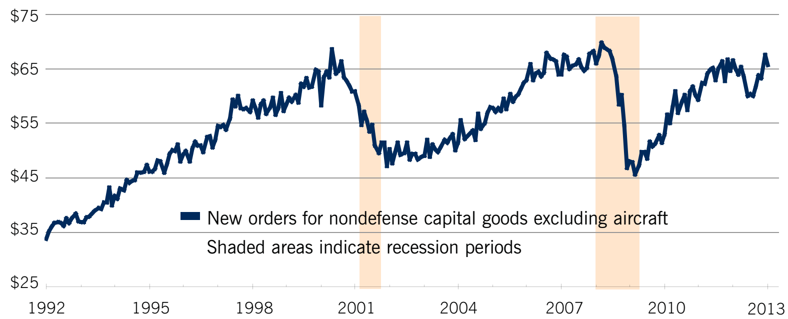
Source: Bureau of Economic Analysis, FactSet; data provided from 1/1975 through 3/2013

FIGURE 6
Household growth versus housing starts
Millions



*'02 through '04 use annual census data on household growth as the quarterly data includes substantial revisions
Source: U.S. Census Bureau, FactSet; data provided from 1/1965 through 2/2013

FIGURE 7
Durable goods orders
$ billions



Source: U.S. Census Bureau; data provided from 2/1992 through 2/2013

starts from the crisis low, starts are still lagging behind formation and this absorption is still taking place. (See Figure 6.) With excess inventories now substantially reduced (and many of the remaining inventories not ideally located geographically relative to demand), housing starts have plenty of room to increase further as they are still below household formation. That said, since the housing sector comprises less than 3% of GDP, housing construction's direct impact on the economy is relatively small. However, the benefit to the economy from a recovery in housing is likely somewhat larger once incorporating indirect effects. For example, rising prices tend to support greater consumer spending and increased sales tend to lead to stronger remodeling and home furnishing spending.

Capital Spending Recovering

Another positive for the U.S. economy is that capital spending is now rebounding after slowing sharply last fall. Orders for non-defense non-aircraft capital goods tend to be a good indicator of overall capital spending and have recently picked up after having fallen due to the uncertainty surrounding the fiscal cliff at the end of last year. (See Figure 7.) Other indicators of capital spending like the Philadelphia Federal Reserve's survey of capital expenditure plans six months forward also point to continued spending growth. While positive, these indicators do point to a more moderate pace of growth than the rapid gains experienced immediately following the recession.

Monetary Policy Likely to Remain Accommodative

Monetary policy is in an extremely accommodative position as a result of near-zero interest rates and ongoing quantitative easing (QE) that is designed to reduce longer term yields. Through its QE program, the Federal Reserve (Fed) is purchasing agency-guaranteed mortgage backed securities (MBS) at a pace of $40 billion per month and longer term Treasury securities at a pace of $45 billion per month. The result is that the yield on 10-year treasuries after adjusting for the market-expected inflation rate over the next decade remains well below zero, as measured by the Treasury Inflation Protected Security (TIPS) 10-year yield. (See Figure 8.) The Fed hopes that this negative yield will support the economy by encouraging borrowing and by increasing asset prices

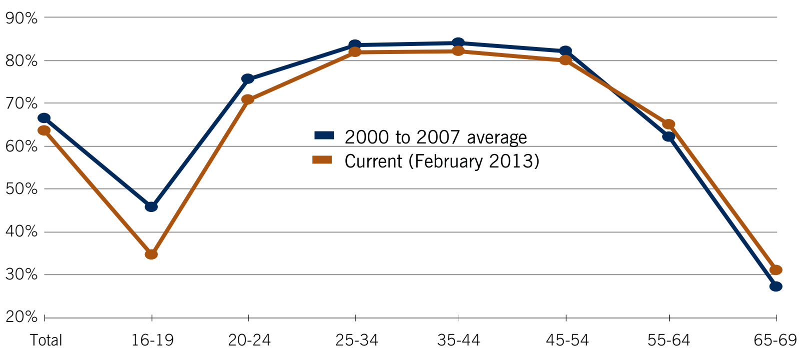
Going forward, we expect monetary policy to remain highly accommodative and think that low rates will continue to support the economy. A key issue for monetary policy in the coming quarters will be the rate of unemployment. The Fed has explicitly said that it will not raise interest rates until the unemployment rate falls below 6.5%, provided inflation remains anchored. Several members of the Federal Open Market Committee (FOMC) that sets monetary policy have said that the unemployment rate will also affect the future of QE. For example, Boston Fed president Eric Rosengren has suggested that QE purchases should continue until unemployment reaches 7¼%. Chicago Fed President Charles Evans has said that QE should continue until payroll gains average 200,000 a month for six months. FOMC Vice Chairman Janet Yellen, who may succeed current Chairman Ben Bernanke, has also emphasized the unemployment rate as guide for QE, though she has not laid out as specific a target as other policymakers.

With the unemployment rate likely to be the key indicator for monetary policy going forward, it is important to understand its components. The unemployment rate does not merely represent job gains, it is also a function of the participation rate, or

FIGURE 8
Treasury inflation protected security (TIPS) 10-year yield

Source: Bloomberg; data provided from 12/2004 through 4/2013

FIGURE 9
U.S. labor force participation rate by age cohort



Source: Bureau of Labor Statistics, U.S. Census Bureau

the percentage of the population that is either employed or actively looking for work relative to the total population during the four-week employment survey period. The participation rate varies by age group, and it is also influenced by economic cycles because some workers may still want a job but do not actively search during the survey period. These effects can be seen in a plot of the current participation rate by age cohort compared to the pre-crisis averages for each cohort. (See Figure 9.)

Several aspects of the participation rate are notable. First, the participation rate among all of the cohorts below 55 has declined. We think this is largely for cyclical reasons and expect participation rates to generally recover in these groups. Second, participation rates decline as workers get closer to retirement. As the population ages, this will tend to pull down the participation rate. In combination, when we use demographic projections by cohort, we think the participation rate will rise slightly by 2015 as a return to more normal participation rates among the younger cohorts will be somewhat offset by the overall aging of the workforce.

Based on our forecast for a modest rise in participation and demographic projections for overall population growth, we estimate that the labor force will increase by around 140,000 per month through 2015. Any job growth above this figure is thus likely to reduce the unemployment rate while any below it would lead to an increase. If payroll growth averages 200,000 per month for a year, or grows 60,000 more than the labor force increases, unemployment would fall by about 0.5% over the course of the year. This is roughly where we think employment growth may average for the year since we think positive forces for job gains will be somewhat offset by issues of long-term unemployment and skills mismatches. Given this projection for the unemployment rate, we do not anticipate an interest rate hike until the beginning of 2015, and we think QE may continue through at least the remainder of the calendar year.

In Spite of Positives for U.S. Economy, Fiscal Headwind Likely to Keep Overall Growth Somewhat Restrained

Overall, in spite of a large number of positive forces, the economy is facing a substantial headwind from fiscal tightening of around 1¾% of GDP. As increased taxes and reduced government spending work their way through the economy, we expect activity to moderate from the first quarter's very strong levels. There are already some signals that growth is beginning to ease as early indicators for activity in March were substantially weaker than those in January and February. Solid structural growth in housing and autos and a rebound in capital spending after a lull in 2012 should help to cushion the downside from this fiscal drag. This means that real 2013 GDP growth that might otherwise have been as strong as 3½% or so is instead likely to be around 2%. While this is still fairly modest and would require a deceleration after the first quarter, it is nonetheless quite positive in light of the large fiscal headwind and bodes well for growth next year when we anticipate a smaller government drag.

Europe

Economic Activity Remains Very Weak With Structural Problems Still Unresolved

The Euro Area continues to threaten the global economic outlook. Economic activity remains depressed by fiscal austerity, economic uncertainty, and a contraction in lending. We are also concerned that the core problems that led to the crisis remain unresolved. In addition, the bailout of Cyprus provides a worrying indication that the Euro Area is fracturing rather than integrating the financial system. Lastly, increasingly dissatisfied voters are causing political risk to rise.

Economic Conditions Depressed

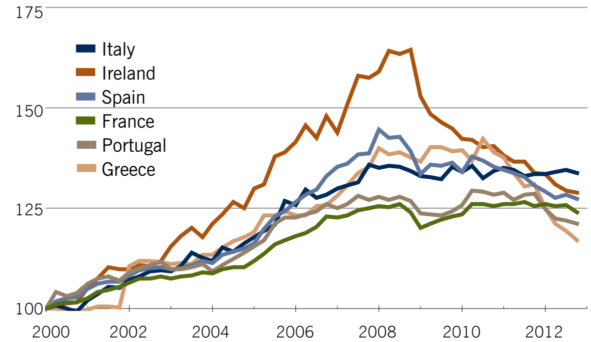
Fiscal austerity, economic uncertainty, and a general lack of financial lending are weighing heavily on economic activity throughout Europe. In the Euro Area, real GDP is below the year-end 2007 level in every major economy other than Germany and is down nearly 25% in Greece. (See Figure 10.) For comparison, the level of real GDP in the U.S. dropped 5% from the year-end 2007 level before recovering, and that was the worst recession in the United States since the Great Depression. In addition to the depth of the economic weakness in Europe, the trend of activity is not encouraging as real GDP declines do not appear to be moderating.

Competitiveness Only Improving Due to Economic Weakness, Which is Creating Additional Problems

In our view, a core problem in the Euro Area is that the adoption of the euro locked in and widened individual countries' competitive differences and this eventually led to the buildup of significant debt through the accumulation of large current account deficits. One factor that contributed to the widening of the competitiveness gap between Euro Area countries were the low interest rates put in place after the adoption of the euro. These rates were appropriate for Germany but not for many of the other countries that had very different economic conditions. This led to higher rates of inflation and reduced competitiveness in those economies. These countries then ran large current account deficits and consequently built up significant amounts of foreign debt. This explains the strong relationship between the higher sovereign yields of countries that are currently more stressed, and cumulative inflation in the decade prior to the crisis. (See Figure 11.)

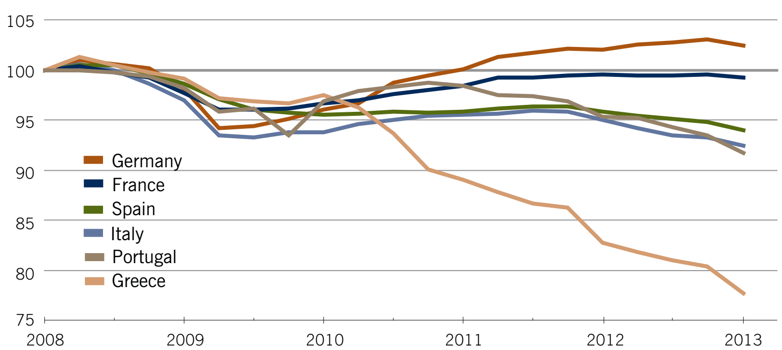
At present, some of the countries with higher rates of inflation have begun to improve their competitiveness relative to Germany. (See Figure 12.) While this is positive, the improvement appears to have resulted largely from economic weakness. This can be seen in the correlation between unit labor cost changes from the end of '08 to the end of '12 relative to nominal GDP changes over the same period. (See Figure 13.) In Greece, for example, the 20 percentage point improvement in competitiveness relative to Germany came at the cost of a 20% decline in nominal GDP. Absent the ability to improve competitiveness through currency devaluation, lower unit labor costs have had to come almost entirely from wage reductions. Such large relative wage reductions are a product of very high unemployment rates and considerable economic and societal dislocations. Thus, while it is positive that Spain has become more competitive and has experienced a modest rise in exports, these improvements have come at a great cost to the economy. In Spain, the unemployment rate is now over 25% and real GDP is nearly 10% below its 2007 level.

FIGURE 12
Total economy unit labor costs relative to Germany
Indexed to 100 in 2000



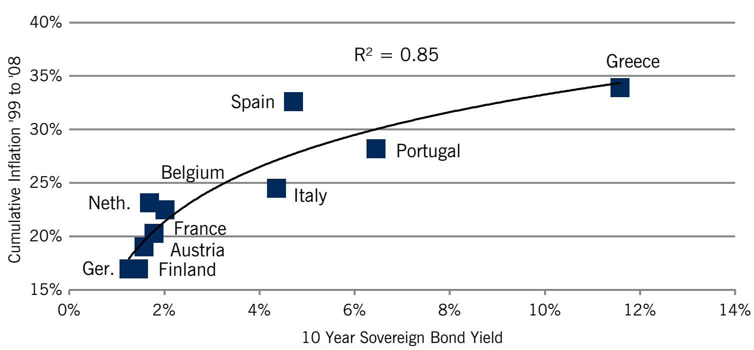
Source: OECD; data provided from 3/2000 through 12/2012

FIGURE 10
Real GDP by country indexed to 12/31/2007



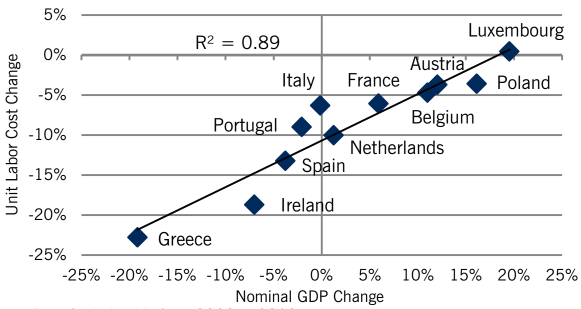
Source: Eurostat; data provided from 12/2007 through 12/2012

FIGURE 11
Euro Area 10-year yield versus cumulative inflation 1999 to 2008



Source: IMF, Bloomberg

FIGURE 13
Euro Area unit labor cost and nominal GDP changes from 4Q08 to 4Q12*



* Data for Ireland is from 3Q08 to 3Q12
Source: Eurostat, OECD

Looking forward, this relationship between competitiveness improvements and nominal GDP declines gives rise to several major worries. First, there is still a large competitiveness disparity between most countries and Germany even after the improvement that has occurred. Countries may thus need to suffer significantly greater economic weakness in order to bridge the still-wide competitiveness gaps. Second, the economic conditions that may be necessary for such an adjustment would likely worsen debt problems.

Economic weakness has been a key reason that many countries are struggling to reduce debt. It is difficult to deleverage when GDP declines are causing the denominator in the debt to GDP ratio to fall while simultaneously exacerbating government deficits by reducing revenues and increasing spending on unemployment and other social programs. This dynamic of economic weakness worsening indebtedness was a key problem in Greece. It is also an issue in Spain and Italy, where debt continues to rise relative to stagnating or declining levels of nominal GDP. (See Figure 14.) This problem would become much worse if additional competitiveness improvements came at the expense of further GDP weakness.

Cyprus Bailout Suggests Troubling Move Away From Financial Integration

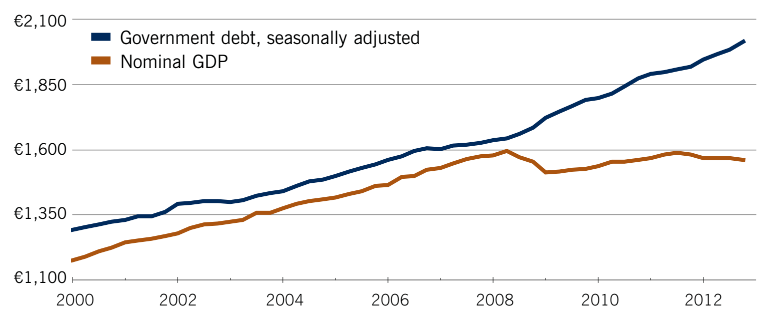
The recent Cyprus bailout is also worrisome. We have long believed that for a currency union to work and for a currency to truly be equal everywhere it is used, monetary and fiscal policies must be unified. In this regard, we believe the Euro Area needs a common deposit insurance scheme so that deposits in one country are equivalent to deposits in another country and the financial system can become more integrated. The large deposit haircut as part of the bailout in Cyprus is a move in the opposite direction and sends the message that a deposit in a bank in one country is not necessarily worth a euro deposited in another country. Without equal treatment of deposits, there is the risk of deposit flight from the less healthy countries into the more stable countries. This could ignite a banking crisis and reduce lending sharply in the country suffering from deposit flight. After the Cyprus bailout in March, it will therefore be important to watch for signs of flight. Through January, deposit trends in key Euro Area economies were already somewhat sluggish, but not pointing to a panic. (See Figure 15.)

Political Fragmentation Also a Risk in Europe

Lastly, growing voter dissatisfaction in the Euro Area is leading to increased political fragmentation. High unemployment rates (over 25% in Greece and Spain) and depressed economic conditions are stoking political unrest and increasing anti-establishment and anti-euro sentiment. These are troubling threats to political integration, which is a necessary prerequisite for a streamlined monetary policy.

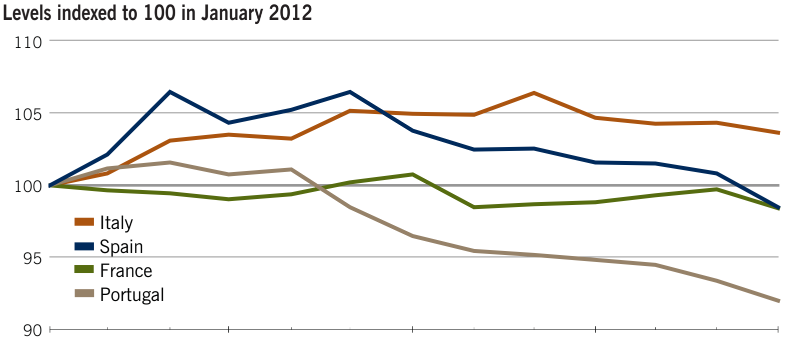
Political division in the recent elections in Italy has prevented the formation of a government. Comedian Beppe Grillo, whose Five Star Movement promotes an anti-austerity platform and calls for a referendum on the euro, took an unexpected 26% of the seats in the Lower House and 24% in the Senate. The recently ousted former Prime Minister Silvio Berlusconi, who has pledged to undo some of Mario Monti's reforms and

FIGURE 14
Italy government debt versus GDP
Billions of Euros



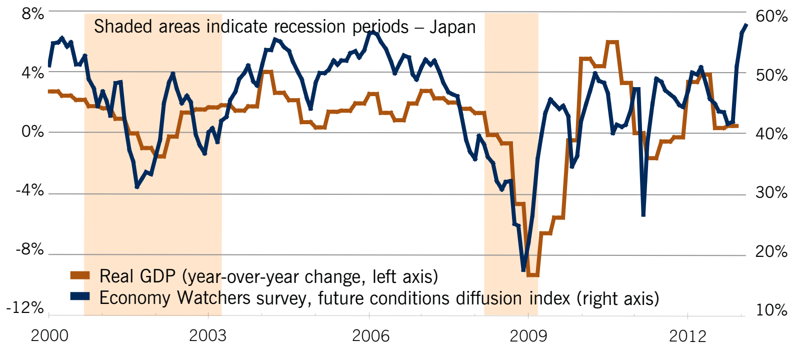
Source: Bank of Italy, Italian National Statistics Institute, FactSet; data provided from 3/2000 through 12/2012

FIGURE 15
European bank deposits by country
Levels indexed to 100 in January 2012



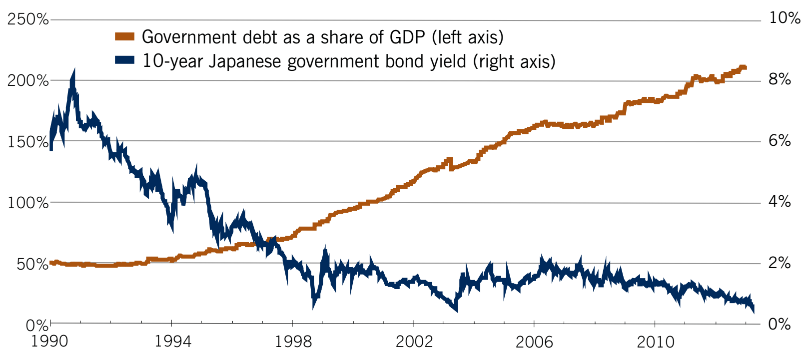
Source: European Central Bank; data provided from 1/2012 through 1/2013

FIGURE 16
Japan real GDP versus Economy Watchers future conditions survey



Source: Japanese Cabinet Office, FactSet; data provided from 1/2000 through 2/2013

FIGURE 17
Japan: government debt as a share of GDP and 10-year government bond yield



Source: Bank of Japan, FactSet; data provided from 1/1990 through 12/2012

has also made anti-euro statements, took 29% of the seats in the Lower House and 31% in the Senate. This has blocked the formation of a coalition government and is likely to lead to new elections later this year.

Anti-establishment sentiment is rising in other countries as well. In Spain, regional elections in the Basque and Catalonia regions saw an increase in separatist sentiment. The Prime Minister Mariano Rajoy is suffering from a corruption scandal in his party and an approval rating that has now dropped to around 20%. Even Germany is experiencing a rise in anti-establishment political sentiment. A group of well-known economists in Germany has started a movement called Alternative für Deutschland, which is proposing a German withdrawal from the euro, and could run in the elections this fall.

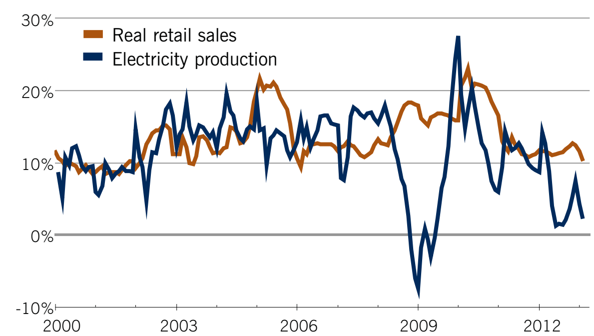
Japan

Proposed Reforms of New Prime Minister and Weaker Currency Contributing to Signs of an Upturn, But Demographic and Debt Problems Remain Concerns

Recently elected Prime Minister Shinzo Abe's goal of loosening monetary policy, expanding fiscal policy, and implementing reforms like cutting the corporate tax rate have helped to weaken the yen and improve economic sentiment in Japan. One indicator of this impact is the recent upturn in the Economy Watchers survey of future conditions, which has tended to be a good leading indicator for real GDP growth. (See Figure 16.)

Although we are encouraged by Japan's near-term growth prospects, two longer term risks continue to concern us. First, the demographic situation poses a significant challenge. The aging population will cause the workforce to decline. This will weigh on GDP since it is a function of output per worker and will be difficult to increase when the number of workers is shrinking. Second, Japan's government debt now exceeds 200% of GDP. So far this has been manageable given very low borrowing costs as a result of deflation and high domestic ownership of government debt that have made even a minimal positive return seem attractive. At present, government bond yields remain very low and have been moving in the opposite direction of the ratio of debt to GDP. (See Figure 17.) Most recently, yields dropped even further amid commentary that the Bank of Japan (BOJ) might purchase longer term bonds. Despite this recent drop in yields, there is a risk that without purchases from the BOJ, if inflation accelerates significantly, or if domestic ownership recedes, interest rates could rise. Given the high debt load of the government, this would dramatically increase spending, exacerbate the fiscal situation, and potentially worsen the economy. Borrowing costs should thus be watched closely.

FIGURE 18
China real retail sales and electricity production
Year-over-year change in 3-month average



Source: National Bureau of Statistics China, FactSet; data provided from 1/2000 through 2/2013

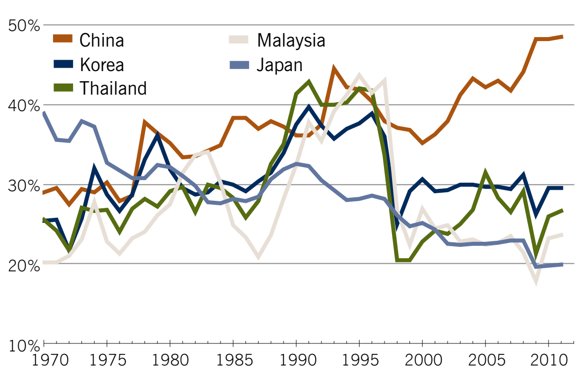
Growth Appears to Be Moderating as the Economy Struggles With the Need to Transition Away From its Heavy Reliance on Investment Spending

After picking up towards the end of last year, there are some indications that growth in China is once again decelerating. Both electricity production and real retail sales slowed in the first two months of the year. (See Figure 18.) In addition to the potential for slower growth this year relative to the rapid pace of growth achieved in the prior decade, we see a number of even larger risks for the Chinese economy.

Economy at Risk from Overdependence on Investment and Lending

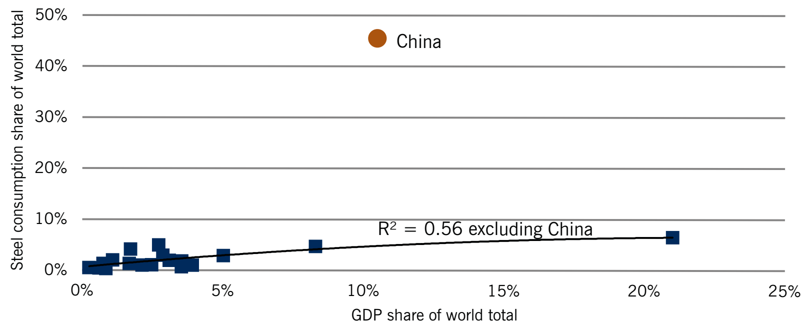
A key feature of China's rapid economic growth is that much of it has come from investment in infrastructure and real estate. As a result, the investment portion of China's GDP is nearly 50%. This is well above that of any other major economy in the world and far higher than the world average of 20%. It is also higher than the peaks reached by the Japanese and other Asian economies during their investment booms before they collapsed. (See Figure 19.) While a strong investment rate is usually very positive for economic growth, it can become counterproductive if it gets too high. In such situations in the past, returns on investment spending deteriorated and led to defaults on the debt that financed it. This then resulted in sharp slowdowns in investment spending and overall GDP growth. This appears to be a risk for China.

FIGURE 19
Investment share of GDP



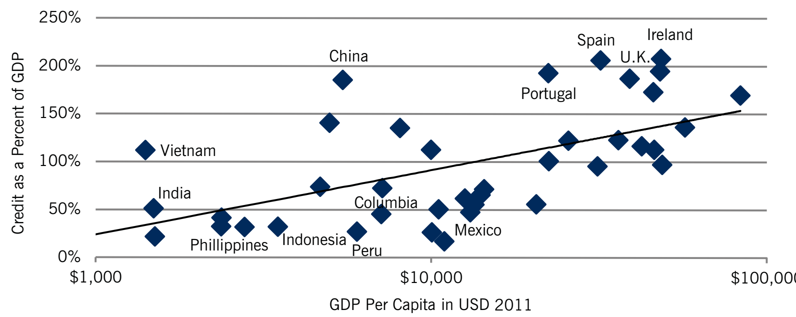
Source: The World Bank; data provided from 12/1970 through 12/2011

FIGURE 20
Steel intensity of GDP



Source: IMF, World Steel Association, FactSet; data provided for 2011 with 2012 data for China

FIGURE 21
GDP per capita versus credit as a percent of GDP*



*Note: All data is 2011 private domestic credit except China which is 2012 based on total social financing
Source: The World Bank, China Economic Information Network

One consequence of the Chinese economy's heavy reliance on investment is that its usage of certain materials is extremely skewed in a global perspective. For example, it is estimated that China emplaced more cement in the past three years than the United States did in the prior century. This is extraordinary given that China's population is only four times that of the United States and its GDP is around half as large in dollar terms. Another example is that China consumes about 45% of the world's steel. This is far out of line with its 10% share of global GDP. The relationship between GDP and steel consumption is much more consistent among other countries around the world, and China clearly is an outlier. (See Figure 20.)

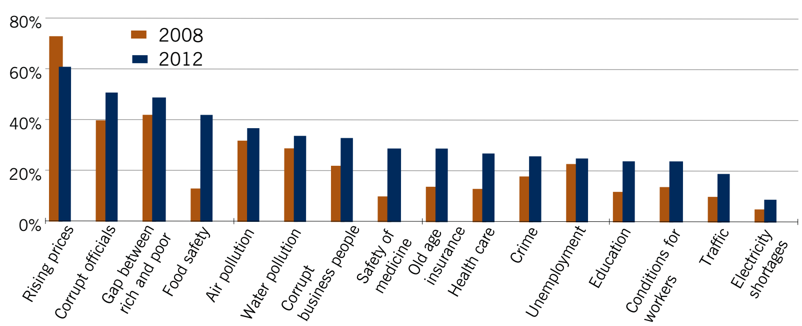
A key worry about China's high level of investment is that it has largely been funded by a massive credit expansion. Using the so-called "total social financing" measure of credit, which includes banks' off-balance sheet lending through trusts and other products, China's private credit as a percent of GDP is around 185%, well above the typical level for a country with a GDP per capita similar to China's. (See Figure 21.) This poses two key risks. First, if some of the surge in investment has funded unprofitable projects, the debt that financed these projects may not be able to be serviced. Second, future credit growth could be much slower given high existing levels and may negatively impact investment growth. With investment comprising around 50% of the economy, any significant deceleration would cause overall economic growth to slow sharply.

We think there are several risks from China's reliance on investment spending. While the need to rebalance the economy towards a healthier mix between consumption and investment spending is clear and the government has publicly stated this desire, there is a risk that this transition may not be smooth. We think this fear is one reason why the government has so far failed to fully implement policies to enable this shift. The longer this rebalancing is put off, however, the greater the risk that investment will slow on its own, which could cause a much sharper than expected adjustment.

Environmental and Other Social Concerns on the Rise

There are also some signs of growing social and environmental issues in China. A recent Pew Research study compared the responses of Chinese citizens' in 2012 and 2008 as to whether various concerns were "very big problems" in China. In general, this survey showed an increase in concerns about corruption, environmental issues like food safety and pollution, and other social issues like health care and the safety of medicine. (See Figure 22.) Inflation remained the largest worry, but had lessened since 2008, while most of the rest had become more prominent. This rise in worries about social issues may point to heightened social tensions more generally. The increase in environmental concerns may indicate a growing dissatisfaction with the investment-intensive growth model, particularly as it has encouraged expansion in more polluting sectors like steel and coal-burning energy production.

FIGURE 22
Survey of top concerns of Chinese citizens
Percent responding that issue is "a very big problem"

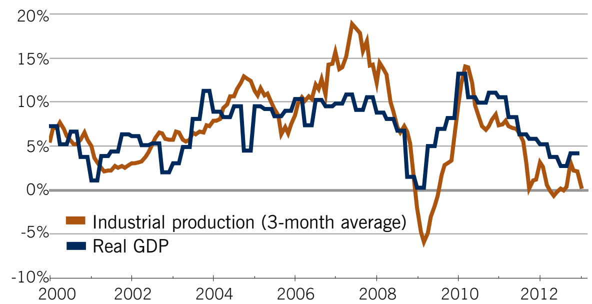


Source: Pew Research Center Global Attitudes Project; 2012 survey based on 26,210 interviews in 21 nations

FIGURE 23
South Korea exports and GDP

Source: Bank of Korea, FactSet; data provided from 1/2000 through 2/2013

FIGURE 24
India real GDP versus industrial production
Year-over-year percentage change



Source: India Ministry of Statistics, FactSet; data provided from 1/2000 through 1/2013

In the beginning of this year, pollution in China was again brought to the forefront amid the sharp rise in air pollution, as measured by fine particulate matter (PM2.5). A PM2.5 reading over 50 micrograms per cubic meter is considered unhealthy, and anything over 300 is hazardous. Sixteen airport smoking lounges in the United States registered an average PM 2.5 level of 166. In Beijing in January, the PM2.5 level shot off the scale to nearly 1,000 and averaged almost 200 for the month. The January pollution rates in China prompted calls to temporarily shut some of the most polluting steel and coal-burning energy plants. This also points to the social costs of China's investment-intensive growth model and highlights the risk of a slowdown in activity as a result of much-needed increased environmental regulation. There is also the potential that if the government fails to address some of the environmental and other concerns of citizens, there could be increased social tension.

Activity in Other Emerging Economies Appears to Be Slowing Following Recent Recovery

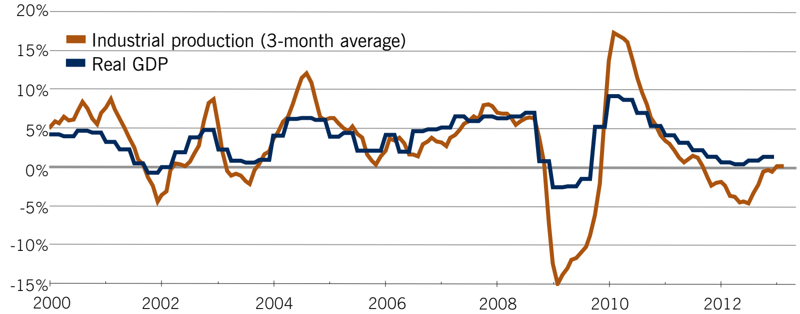
Economic growth in other emerging economies is slowing down after picking up at the end of last year. Again, however, these economies' trends and prospects vary considerably.

In South Korea, the Ministry of Finance recently lowered its 2013 real GDP forecast to 2.3% from an estimate of 3% in December. Exports usually provide a good indicator of GDP growth and recently slowed after lifting late last year. (See Figure 23.) To combat this, the government plans to introduce a stimulus package in April, and the central bank may lower interest rates. Although both actions should help restore growth, the weakness of the yen, the currency of Korea's main trading competitor, remains an obstacle.

Activity in India followed a similar trend with industrial production recently pulling back, suggesting slower near-term GDP growth. (See Figure 24.) Over the longer-term in India, however, we are encouraged by the country's growth prospects. India's demographics are very favorable. It also has a relatively low credit penetration, which gives room for further expansion. Additionally, there is movement in the way of economic reforms like reducing power subsidies and altering regulations that have limited the country's ability to provide adequate power generation. The government is also making efforts to open the economy up to greater foreign direct investment and there has been relatively little resistance to the gradual removal of costly diesel subsidies. There is some risk, however, that efforts to appease voters ahead of the upcoming election could retard progress on some of these positive reforms.

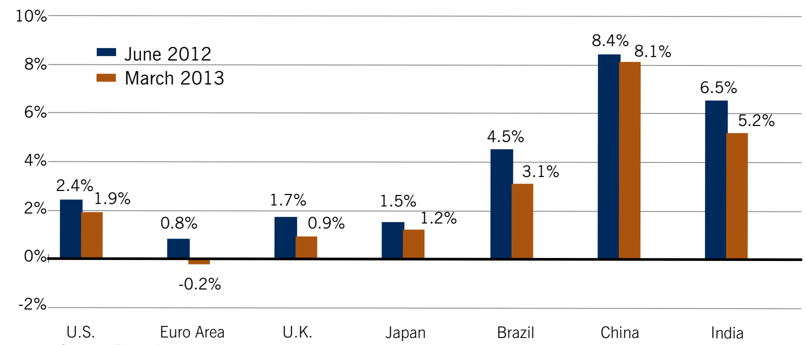
In Brazil, the near-term trends are more favorable with some indicators like industrial production picking up. (See Figure 25.) However, growth could remain somewhat sluggish due to various threats. Inflation is picking up, and the central bank may raise interest rates as a result. In addition, infrastructure continues to be a huge challenge. For example, according to industry sources, port infrastructure challenges have led to a buildup of over 200 vessels that are waiting in the Brazilian harbors to load soybeans and soybean meal. The average waiting time before loading is now 38 days and up to as many as 54 days for these ships. Similarly there are reports that the line of trucks waiting to unload soybeans and soybean meal at the Port of Santos, Brazil's biggest, has reached 15 miles long. While Brazil's government has sought to increase private investment in infrastructure, there are worries that government remains too involved, causing private entities to hold back.

FIGURE 25
Brazil industrial production and GDP
Year-over-year change



Source: IBGE, FactSet; data provided from 1/2000 through 2/2013

FIGURE 26
2013 Consensus GDP forecast by month



Source: Bloomberg

Overall, Global Economic Growth Likely to Remain Relatively Moderate

In combination, we think the increasingly divergent trends in economic activity throughout the world are likely to result in a relatively moderate expansion in real global GDP of around 2%. Consensus economic forecasts for real GDP growth in '13 have generally moved lower over the past six months and overall appear reasonably consistent with this view. (See Figure 26.) In the United States, the consensus estimate may be slightly low as some of the recent positive developments could help lessen the negative impact from fiscal tightening. In Europe, we still think estimates may be too high given fiscal tightening, the still unresolved Euro Area crisis and banking pressures that are weighing on lending. Estimates have recently moved up in Japan, which we think accurately reflects some of the near-term positives that could cause growth to rise even more than expected. Estimates in China call for growth over 8%, ahead of the government's 7.5% target. Given the country's recent economic weakness as well as the risks stemming from the economy's reliance on investment spending, we are more cautious.

One overarching theme of our economic outlook is that there remains a great deal of uncertainty and risk around the world. Thus, we believe the range of economic outcomes remains unusually wide.

Equities May Continue To Do Well In Spite of Subdued Macroeconomic Backdrop as Relative Valuations Remain Attractive

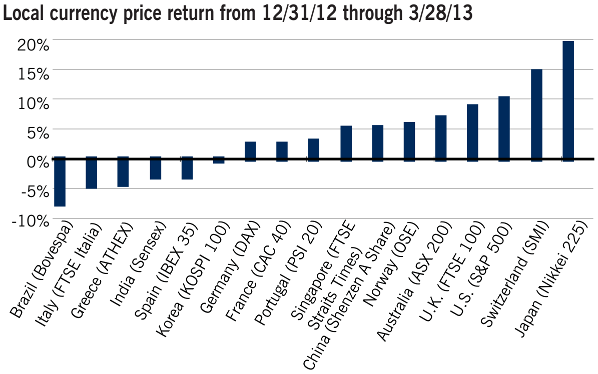
Review of equity performance by region and sector

In spite of only moderate global economic growth, equities have continued to rally. Regionally, Japan and the United States were among the best performing markets in the first quarter of the year (measured in local currency terms), while major markets in the Euro Area, Korea, India, and Brazil lagged. (See Figure 27.)

An important distinction of the recent market rally is that it has resulted from an expansion in the price-to-earnings (P/E) multiple rather than from improved expectations for earnings. P/E ratios on consensus estimated next twelve month (NTM) earnings have risen by between 20% and 50% in the United States, Europe, and Japan since July of last year, while NTM earnings estimates have fallen by between 5% and 10%. (See Figure 28.) We think this P/E expansion reflects attractive relative valuations at the start of the rally, improving expectations for economic and earnings growth, and reduced pessimism about a break-up in Europe, a sharp slowdown in China, or a fiscal crisis in the United States.

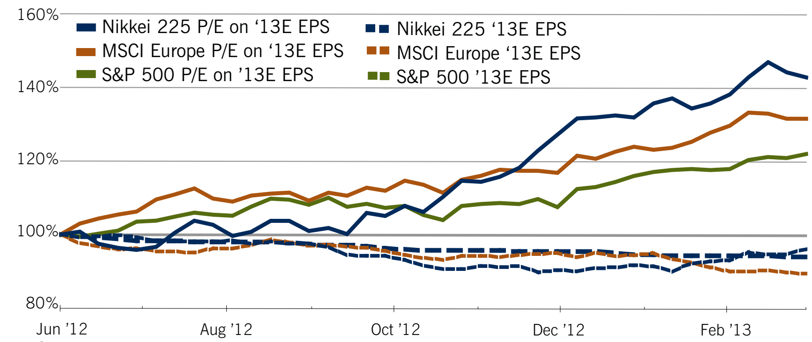
Another feature of the recent equity rally is that—similar to increased economic differentiation between the various countries of the world—country equity indices are also showing greater divergence. In the United States, for example, the S&P 500 Index showed a fairly close inverse correlation last year with the spread of the Italian 10-year sovereign bond yield versus the German 10-year yield, which indicates the amount of market stress in Italy.

FIGURE 27
Returns for major indexes in select countries
Local currency price return from 12/31/12 through 3/28/13



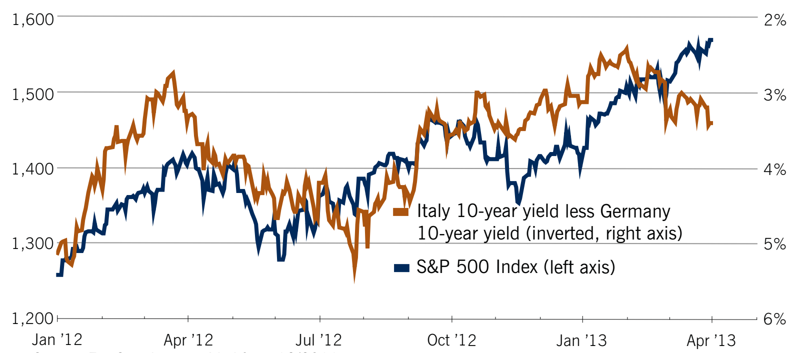
Source: FactSet

FIGURE 28
Index return composition ('13E EPS and P/E): U.S., Europe, Japan



Source: FactSet; data provided from 6/2012 through 3/2013

FIGURE 29
S&P 500 versus Italian 10-year sovereign yield spread over Germany



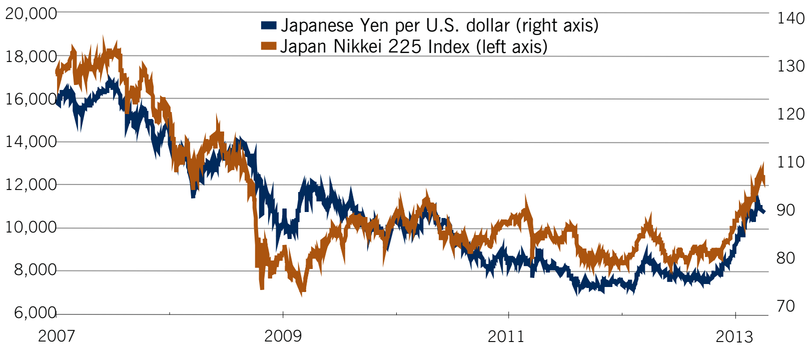
Source: FactSet; data provided from 12/2011 through 3/2013

Recently, however, the S&P 500 continued to rise even though Italian yield spreads widened in the wake of the Italian elections and the Cyprus bailout. (See Figure 29.)

The Japanese market, which was one of the other stronger performing markets in the first quarter, is also exhibiting greater independence from the rest of the global markets. Recent weakness of the yen is a key reason for this. The yen generally moves inversely to the market as the Japanese stock market is very global and companies' margins and profits are heavily influenced by the currency. (See Figure 30.)

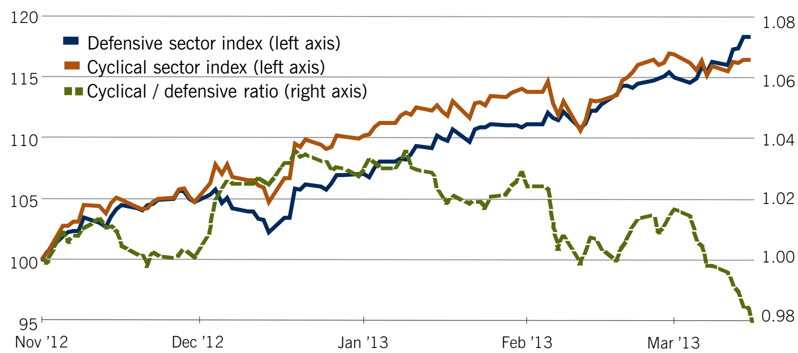
In terms of sector performance, the recent market rally has been somewhat anomalous. Sectors that are traditionally less economically sensitive and therefore considered more defensive have performed well. During most market rallies the more economically sensitive or more cyclical sectors tend to outperform, but this has not been the case in this rally. (See Figure 31.)

FIGURE 30
Nikkei 225 versus the Yen



Source: Bloomberg; data provided from 1/2007 through 3/2013

FIGURE 31
Cyclical versus defensive sectors total returns in the S&P 500 Index



Source: FactSet; data provided from 11/2012 through 3/2013

Outlook for Equity Markets Going Forward

Looking forward, equity valuations remain attractive relative to alternatives. This could continue to support gains from additional P/E expansion even if earnings estimates decline. Still, since P/E multiples increased during the recent market rally, the scope for additional expansion may be somewhat diminished.

Earnings Estimates May Still Be Too Optimistic

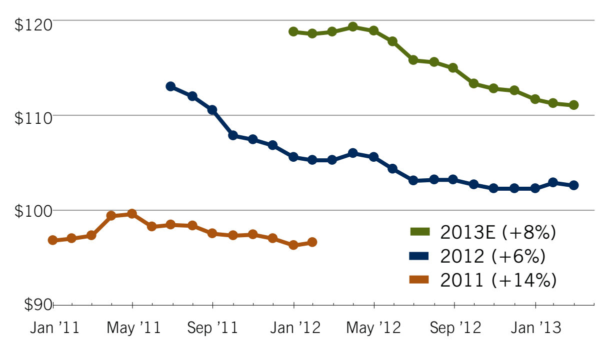
Downward earnings revisions may continue. Earnings estimates for the S&P 500 Index have generally been falling over the past several months. (See Figure 32.) But in spite of this drop, the consensus is still calling for 8% growth in 2013 for S&P 500 Index earnings per share. We think this could prove optimistic.

Earnings estimates can be split into revenue and margin forecasts. Revenues tend to track global nominal GDP in dollar terms. This makes sense because roughly half of S&P 500 sales come from abroad. Given sluggish global real GDP growth and an additional modest headwind from a stronger dollar, S&P 500 sales growth is likely to remain fairly subdued. Sales estimates for the index call for growth of around 4% and may thus be slightly optimistic.

Forecasts for additional margin expansion on top of this sales growth also look optimistic. Margins usually track the differential of sales and wage growth. When sales are growing faster than wages, margins generally rise and vice versa. This relationship can be seen in the data for all nonfinancial U.S. corporations from the Bureau of Economic Analysis (BEA), which we use as a proxy for the U.S. equity market because of its better historic availability. (See Figure 33.) Over the past decade and especially the past several years, sales growth has generally exceeded wage growth, resulting in strong margin expansion. Most recently, however, this has begun to reverse, and margins have stopped rising.

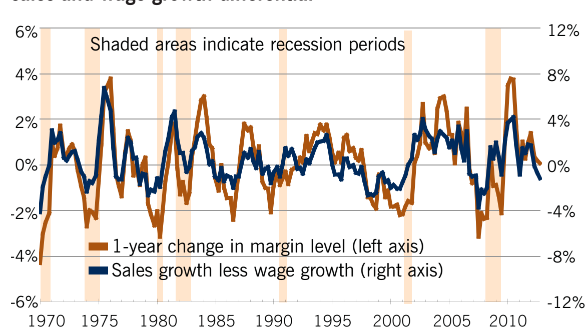
Sales cannot grow in excess of wages indefinitely because ultimately it is wages that fuel corporate sales. Over short-term periods, sales can diverge

FIGURE 32
S&P 500 consensus bottom-up operating earnings estimate
Over time: 2011, 2012 and 2013E



Source: FactSet; data provided from 1/2011 through 3/2013

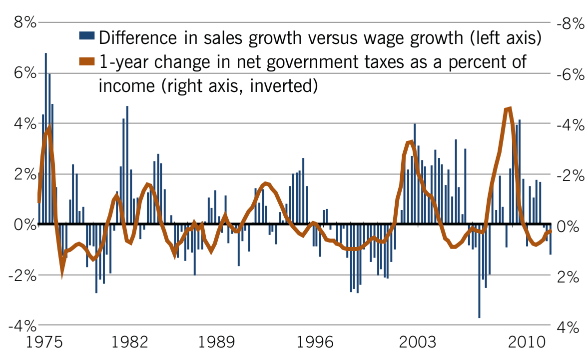
FIGURE 33
Pre-tax margin changes for U.S. nonfinancial corporations versus sales and wage growth differential



Source: FactSet, Bureau of Economic Analysis, Bureau of Labor Statistics, ICAP; data provided from 3/1970 through 12/2012 from wage growth as workers fund purchases through other means. There are two main ways that workers tend to do this. First, workers' consumption growth can surpass wage growth if they reduce their saving rate and use more of the money that they were putting aside to purchase goods. The recent downward trend in the saving rate suggests that this has contributed to the excess of consumption growth over wage growth. Given the relatively low rate of savings at present, however, this is unlikely to be a contributor in the future and may be an obstacle to further margin expansion.

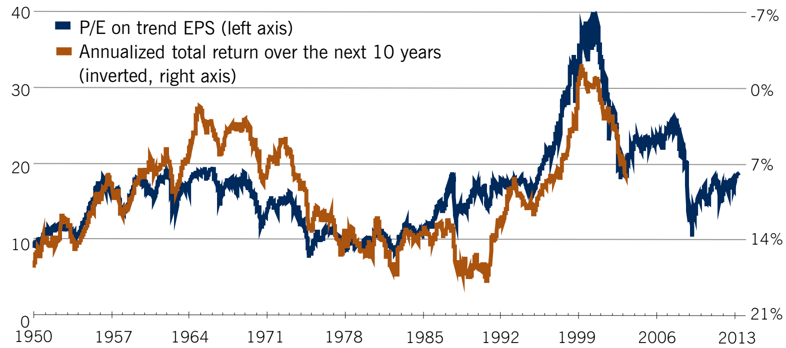
Changes in net government taxes, or the amount of income taxes less transfer payments for social security and other social programs, can also enable consumption growth to surpass wage growth. This can also be seen in the BEA data. (See Figure 34.) Recently, net government taxes have plunged as a share of personal income as the government temporarily reduced payroll and other taxes while it simultaneously increased payments for unemployment and other social programs. This helped workers increase consumption well beyond the growth in their wages, which boosted corporate margins. But the government is now beginning to increase taxes and slow transfer payments, which is causing net government taxes to rise. We think this trend will continue, and this could pressure margins in the future.

FIGURE 34
Sales less wage for U.S. nonfinancial corporations versus change in net taxes



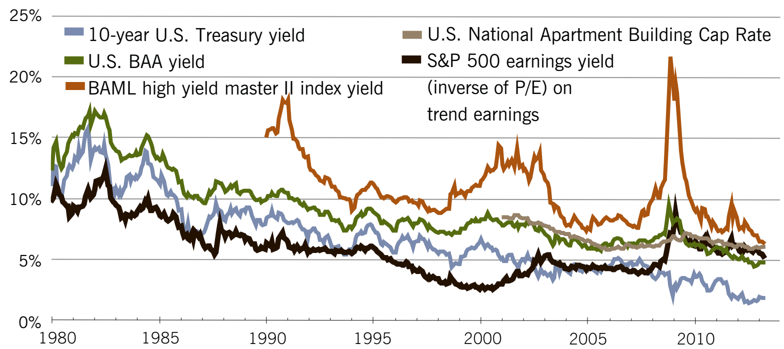
Source: Bureau of Economic Analysis, FactSet, ICAP; data provided from 3/1975 through 12/2012

FIGURE 35
S&P 500 P/E on trend EPS versus 10-year returns



Source: FactSet, ICAP; data provided from 12/1949 through 3/2013

FIGURE 36
Yields for various asset classes



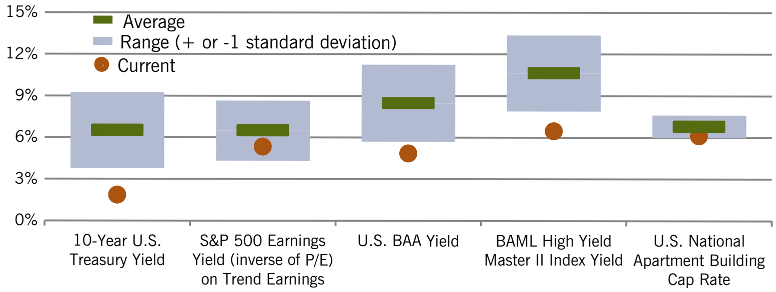
Source: ICAP, Bloomberg, Real Capital Analytics; data provided from 1/1980 through 3/2013

Equities Still Appear Attractive Versus Alternatives

If earnings are at risk from slower revenue growth and a lack of further margin improvement, additional P/E expansion will be needed to fuel continued equity increases. Given the recent P/E rise, it may seem there is little room for future price gains, but reasonably attractive equity valuations give us hope that there is still potential for additional upside. Because earnings are cyclical, we like to look at equity valuations based on our measure of trend earnings. This calculation of trend is derived from a regression of the long-term growth rate of earnings for the S&P 500 Index since 1950. Currently, the S&P 500 Index trend P/E of around 19x is starting to gain distance above the historical average of 17x. Still, equity valuations remain fairly reasonable in a historical context. We have found that the P/E on trend earnings has correlated well with the total nominal equity returns over the subsequent decade. (See Figure 35.) The average annual nominal equity returns that this relationship suggests over the next decade may be in line with their historic average, but are much higher than returns offered in fixed-income alternatives.

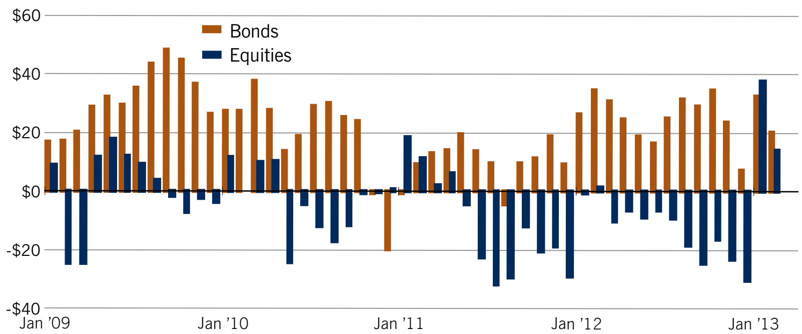
To compare equity valuations to other asset classes, we can look at the earnings yield on trend earnings (the inverse of the trend P/E ratio) in relation to yields in various fixed income categories and cap rates in real estate, which function similarly to an inverse P/E ratio for equities.

FIGURE 37
Current versus historical yields*



* Data dates back to 1960 for 10-year Treasury, S&P 500 yield, and BAA yield, 1990 for the BAML High Yield Master II, and 2001 for the Apartment Cap rate
Source: ICAP, Bloomberg, Real Capital Analytics

FIGURE 38
Monthly U.S. net mutual fund flows
Billions of dollars



Source: ICI, FactSet; data provided from 1/2009 through 2/2013

Yields on 10-year Treasuries, the index of BAA bonds, and a Bank of America Merrill Lynch index of higher yielding corporate bonds have all come down sharply in recent years and are near all-time lows. The S&P 500 yield on trend earnings, by contrast, is higher than it was before the crisis. (See Figure 36.) Cap rates for apartment buildings sold nationwide have also come down since the crisis, but not nearly as much as Treasuries and other bond yields, though we do not have data for as long a time period for this series. The trend earnings yield on equities has historically been below the 10-year yield on Treasuries since coupon payments on Treasuries are fixed while equity earnings tend to grow at a fairly healthy rate. With the trend equity yield currently well above the Treasury yield, equities appear attractively valued compared to Treasuries. The BAA and high-yield bond index yields also trade at a premium to Treasuries given their higher risk profiles and allowances for some rate of default, but the trend equity yield also looks attractive compared to these in a historical context.

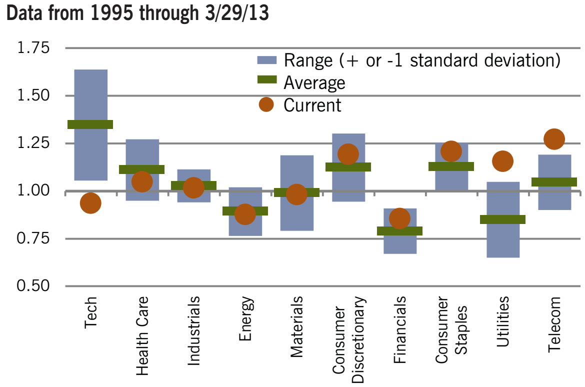
Another way to compare valuations across asset classes is to look at current yields relative to historic valuations. Due to the sharp reduction in fixed-income yields, current yields on Treasuries, BAA bonds, and high-yield bonds are more than a standard deviation below their long-term averages. The trend yield on the S&P 500 index, by contrast, is only slightly below its historic average. (See Figure 37.) The national apartment cap rate is only slightly below average, but this is based on a much shorter time period. This suggests that equities are more attractively valued in a historical context than these alternatives. This also means equities may be discounting less of the unusually low level of interest rates into valuations and could perform better if interest rates eventually normalize.

We think this disconnect between equities and alternatives suggests that while investors are less pessimistic about equities than they were, they are nonetheless still discounting a fair amount of risk into equity prices. We think this is also why mutual fund flows have only until recently heavily favored bonds over equities. (See Figure 38.)

Certain Sectors and Markets Appear More Attractive

At the same time that we think investor pessimism has rewarded certain fixed-income alternatives that are perceived as less risky than equities, we think investors have rewarded sectors that are thought to be less risky. We think this contributed to the rally in sectors that are traditionally thought of as defensive, like telecoms and utilities. Consequently, we now believe that some of these sectors currently look expensive on the basis of P/E multiples relative to the market. For example, going back to 1995, the telecom sector P/E on NTM estimates has usually been about equal to the market. Currently, however, the NTM P/E of the telecom is about 25% higher than that of the S&P 500 Index, which is well over a standard deviation above the average for this period. The current relative NTM P/E of the utilities sector is also stretched by this measure. (See Figure 39.) By contrast, the health care and tech sectors' P/E multiples are low compared to their historical ranges.

FIGURE 39
S&P 500 sector relative NTM P/E ratios: current versus historical
Data from 1995 through 3/29/13

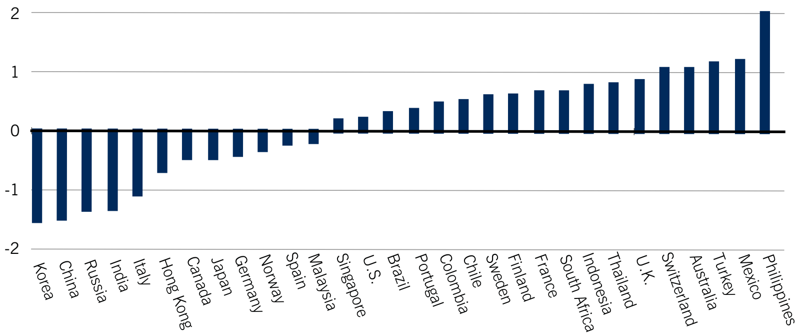


Source: FactSet, ICAP

FIGURE 40

Current NTM P/E relative to MSCI-ACWI: standard deviations from average

Based on data from 2006 through 3/13



Source: FactSet

The same analysis of relative NTM P/Es can be done on a regional level. Using data back to 2006, the Korean market appears cheap since it has a current NTM P/E relative to the market that is roughly 1½ standard deviations below its average relative NTM P/E for this period. (See Figure 40.) China also appears inexpensive on this metric, though we are more cautious about China given its macroeconomic risks. Several European countries like Italy look reasonably attractive in this measure but similarly are facing substantial risks. The U.S. equity index is trading in-line with its historic relative NTM P/E, which we think makes it somewhat attractive given our more positive economic view of the United States. The Philippines, Mexico, and Turkey, which are experiencing strong economic growth and optimism about political reform, look expensive compared to their historic NTM P/E ratios relative to the global market.

Overall, Equities May Continue to Rally if Further Reductions in Investor Pessimism Lead to Additional Multiple Expansion

Overall, given the large market rally since last fall, it would not be surprising to see some consolidation. Still, equity valuations continue to look reasonable in a historic context and very attractive compared to fixed-income alternatives. Fed policies to hold down interest rates are gradually forcing investors to move out on the risk curve—away from fixed-income assets and toward equities. It remains to be seen how far and how long these trends can continue.

Continue to Focus on Stock-Specific and Thematic Catalysts

Portfolio changes in the first quarter largely reflected company-specific developments. However, the portfolio continues to emphasize several thematic catalysts that we believe remain timely in an environment of sub-par global growth. We continue to maintain the theme that the "strong will get stronger" and believe that stocks with strong balance sheets and dominant market positions will weather difficult economic conditions and gain share over the longer term. We also continue to employ the portfolio theme called "earn and return cash." In an environment of very low interest rates and subdued economic growth, we think companies that can organically grow earnings and return significant amounts of cash to shareholders will attract investors.

We are also maintaining the theme of "developed market stocks - emerging market growth." We think that stocks of certain companies domiciled in the developed markets appear attractively valued given their exposure to what we anticipate will be above-average growth in key sectors in the emerging markets over the next several years. For example, as growth in China transitions away from investment spending and more toward the consumer sector, it should benefit the agriculture sector where there are large resource imbalances and also may boost health care spending from very low levels.

As always, ICAP continues to use a bottom-up process to determine valuation and stock-specific catalysts. These catalysts reflect factors such as a management change, a new product, a financial restructuring, a problem-fixing situation, or a change in pricing dynamics. The following examples highlight the types of stocks and stock-specific catalysts at work in the portfolio.

U.S. Portfolio

Management:

Two years into his role as CEO, Ian Read is making meaningful changes at Pfizer. During the past several years, the company has lost a significant portion of its sales to patent expirations, including that of Lipitor, which at one point sold $12 billion annually. Read has reacted to these challenges by aggressively restructuring the cost base of the company and selling assets to improve shareholder returns.

Pfizer sold its infant formula business to Nestlé in 2012, and it completed an initial public offering of Zoetis, its animal health business, early this year. Zoetis now trades at around 24x expected 2013 earnings, and Pfizer retains an 80% ownership. We expect Pfizer to divest the remainder in the next year or so. Combined, the two divested businesses accounted for about 7% of company profits but fetched around 15% of the company's market cap in the open market. Pfizer is using the proceeds of these sales to buy back its own stock. In each of the past two years, the company purchased between $8 billion and $9 billion of its own shares, and management expects to buy around $15 billion this year. In addition to share repurchases, Pfizer has raised its dividend payout ratio and currently yields almost 3.5%.

In addition to asset sales, the company has drastically reduced its spending on research and development (R&D). This comes after a decade or more of extremely low returns on this sort of investment. Prior to its 2009 merger with Wyeth, the two companies combined spent around $11 billion annually on R&D. We expect this spending to bottom at around $6.5 billion in 2013. The magnitude of this cut is unprecedented in the industry, and we see it as a sign that Read is making more disciplined investment decisions. We do not think these decisions will impair the company's future growth opportunities. In fact—and somewhat ironically in the context of the aforementioned spending cuts—the company's research pipeline is looking fuller than it has in over a decade. Anchoring this set of products is Eliquis, a blood thinner that has proven effective in preventing strokes in patients with irregular heartbeats. Eliquis was launched early this year. Pfizer is also developing Palbociclib, a breast cancer drug in the second of three stages of clinical trials. It is possible the FDA would allow an accelerated approval of this drug, based on the strength of the early data. With annual sales potential around $3 billion (or more), this would be a very positive outcome. A new drug for rheumatoid arthritis and expanded usage of its Prevnar13 vaccine in adults offer Pfizer additional significant near-term growth opportunities.

The operational and financial management decisions this management team has made suggest Pfizer is on a very strong path of earnings growth and increased shareholder returns. Trading only around 12x 2013 earnings, Pfizer shares are very attractive in our view.

Problem Fixing:

Johnson & Johnson is a global diversified health care products company with around $70 billion of annual sales, split between Medical Devices and Diagnostics (MD&D), consumer products, and pharmaceuticals. Each of these businesses is coming out of a relatively tough multi-year period. In the MD&D division, the company's once-dominant coronary stent franchise lost significant market share to new entrants. In pharmaceuticals, the patent expirations of key drugs caused a $6 billion drag on sales. And in consumer products, sales fell by about $1.5 billion from 2008 to 2011 as a series of recalls seriously impaired the company's over-the-counter medicines business. While these issues have hurt earnings growth, we believe the future looks much brighter as management has addressed the issues within its control and as patent expirations in pharmaceuticals abate.

In MD&D, management has responded to the challenges in the coronary stent business by choosing to exit the market entirely. We think this is wise, as historically this category has been characterized by short product cycles and consistently negative pricing pressure. The remainder of MD&D consists of more stable growth franchises like surgical instruments, orthopedic implants, and contact lenses. In addition, the recent $20 billion acquisition of Swiss orthopedics maker Synthes gives the company what we feel is a very attractive new set of products to sell into emerging markets.

In consumer products, it has taken much longer than expected for the company to fix its manufacturing issues and get recalled brands back into stores. U.S. Tylenol sales, for example, were nearly $700 million in 2007 and fell to just $19 million in 2011. While disappointing, the company thinks it can fully re-launch these products in 2013, and we think Tylenol will eventually regain a strong position in consumers' minds, based in part on more than 50 years of history and familiarity with the brand.

In pharmaceuticals, while no management action can offset the expiration of patents, the rest of this decade looks clear from additional significant losses. Moreover, we are encouraged that the strong pipeline of new products will contribute to sales growth during this period. Zytiga was launched in the first half of 2011 and is rapidly taking market share in the prostate cancer market. Currently selling about $1 billion annually, the drug could reach $2 billion in another few years. Projects for stroke prevention in patients with irregular heartbeats and for the treatment of HIV infection offer the company additional attractive growth opportunities. We do not think Johnson & Johnson's current valuation of around 14.5x next year's earnings per share reflects this meaningful problem fixing occurring at the company.

Restructuring:

Mosaic is one of the world's largest fertilizer companies. Roughly half of its business comes from phosphate, of which it is one of the world's biggest producers (controlling approximately 9% of the global market), as well as one of the lowest costing. The other half of its business is in potash, where it is also large (controlling approximately 13% of the global market) and low cost. Agricultural demand is rising due to a growing population, increased protein consumption that requires substantially greater agricultural production, and stronger demand for biofuels. Balanced against this, current grain supplies are tight, and arable land is limited. This means that farmers will need to boost yields in order to keep pace with demand. Greater fertilizer consumption will be a key element of this. Because a relatively small number of players tightly control phosphate and potash markets, we think pricing should remain healthy so long as crop prices continue to make it economically attractive to increase production by applying more fertilizer, which we expect will remain the case.

In addition to these strong sector characteristics, we think Mosaic is poised to benefit from a large capital restructuring. As part of Mosaic's spin off from Cargill, which is owned by the MacMillan family, around 30% of Mosaic shares (129 of 427 million shares) are currently held by the family. Roughly half of these shares are owned by a charitable trust and the remainder by several family member trusts. As part of the spin off from Cargill, these shares were not allowed to be sold until May '13. After May 26, however, the company can begin negotiations with the charitable trust and family members to buy back some or all of these shares. We think Mosaic probably has a capacity of around $6 billion (or about 100 million shares at the current price) in this manner. Mosaic is likely to end the year with somewhere in the neighborhood of $4 billion in cash against a stated need of around $1.3 billion. In addition to this excess cash, the company may issue several billion dollars in debt to further fund share repurchases. Management has described the current balance sheet, which only has around $1 billion of debt, as highly inefficient and has talked about taking on significant additional debt as a result.

Although we think that the charitable trust will likely want to sell its shares soon, some family members may not want to sell their shares or may only want to sell a portion of their holdings in the near term. If so, the company will be allowed to repurchase shares in the open market starting in November '13 and could repurchase equivalent amounts of shares in order to achieve the desired capital restructuring. With a P/E of around 13x consensus ‘13 calendar year earnings and an attractive structural story in its end markets, we think this restructuring potential makes Mosaic a compelling stock.

Pricing Flexibility:

Time Warner’s management is focused on leveraging its ability to raise pricing for its current stable of assets while being extremely disciplined with capital allocation. Cable networks (TNT, TBS, CNN, and HBO) are Time Warner's primary source of profit and in our opinion should produce strong and stable growth for several years. The cable networks have invested in original programming and sports content (e.g., MLB, NBA, NCAA), which has enabled them to command higher pricing through both affiliate fees (fees from cable or satellite operators that are paid to content owners) and advertising. Given their outlook for contract renewals, management expects affiliate fee revenues to grow at a double-digit rate over the medium term. In addition to affiliate fee increases, Time Warner's "TV Everywhere" and "HBO Go" initiatives will enable consumers to watch programming from computers and tablets, which we expect may increase viewership (which would in turn enable higher advertising rates) and improve subscriber retention (which would in turn enable higher affiliate fees). This should provide strengthen Time Warner’s pricing power. On the content production side, Warner Brothers is the leading film and TV production studio in the world. Although investors are concerned with how digital media will affect profits, much of the innovation in this sector occurs in distributing the content, not creating it. Thus, more outlets are bidding for the TV shows and movies that Warner Brothers produces. This should also increase Time Warner’s pricing power. We believe that, as the largest producer of television and film content, Time Warner has an underappreciated opportunity to benefit from this environment in which digital rights can provide an additional revenue stream. Time Warner has also shown a commitment to shareholders by repurchasing a significant amount of stock in 2012 and provided a similar commitment for 2013.

New Product:

Monsanto is the largest agricultural seed producer in the world with '12 sales of $13.5 billion. The company is extremely well positioned to benefit from the structural need to increase agricultural yields. A key element of this is the introduction of new, higher yielding seeds in both the United States and international markets. Intacta, in particular, stands out in Monsanto's new product pipeline. Intacta is a next generation soybean seed trait that is tailored to address high pest pressures in the Latin American market. Similar to the Roundup Ready I trait that is currently offered in Latin America, Monsanto will incorporate this trait into its own seeds as well as license it to other seed companies. In trials over the past several years, Intacta has offered a yield advantage of around five bushels per acre, which at current prices of around $13 a bushel, equates to a benefit of $65. In addition to this, Intacta provides additional value by reducing pesticide use, which is costly and logistically challenging on the typically large farms in Latin America. In combination, Monsanto estimates that Intacta will provide a value of $80 per bushel compared to its current Roundup Ready I product. As with other products, Monsanto hopes to charge farmers a price for this product that would allow the company to capture around one-third of this value, leaving the farmer with the remaining two-thirds.

The earnings benefit of Intacta could be substantial. In Brazil, Monsanto currently earns around $0.25 per share by selling its Roundup Ready I trait for between $3 and $4 on roughly 50 million acres. Intacta would be priced at five to six times this price and is likely to eventually replace Roundup Ready I on all of these acres. This produces potential earnings per share gain of $1 per share in just Brazil. This compares to 2012 earnings per share of $3.79. There are roughly 50 million more acres in Argentina and Ecuador that are similarly suited to benefit from Intacta and could likewise produce significant earnings growth over time. The benefit may be somewhat less, however, as pricing could be somewhat lower due to relatively less insect pressures in these markets and thus a potentially smaller yield benefit. Intacta will be launched in Brazil in the fiscal year ending August '14, and it may launch in Argentina the following year. Trading at a consensus estimated free cash yield of around 5% on the FY '14 estimate, Monsanto is attractive in our view given the significant potential for this new product.

International Portfolio

Management:

As one of the leading banks in Singapore, DBS Group enjoys access to Asia's burgeoning trade industry, which is driving secular growth in corporate and consumer banking activity. However, for many years prior to the arrival of CEO Piyush Gupta in 2009, the bank experienced high turnover in its management ranks and advanced a poorly executed acquisition program that resulted in returns on equity below the peer group. The arrival of Mr. Gupta began a transformation program at the bank whose aim was to focus the bank on capitalizing on Asia's growing commercial activity and rid the bank of its non-core business lines. Management also set out to invest in its new business model, expand headcount, invest in new technology platforms, and enter new businesses in order to grow the trade finance and wealth management areas. The expansion of DBS's product portfolio is now starting to result in higher wallet share penetration, particularly on the commercial side where new trade finance relationships are leading to more profitable business such as corporate cash management. Over time we expect these fee-based businesses to drive strong revenue growth and make DBS Group less sensitive to the interest rate environment. We believe management is doing the right things to position DBS Group as one of the key local Asia banks that will benefit from the continuing growth in these emerging markets, driving strong shareholder returns in the years to come.

Problem Fixing:

Bridgestone is the largest tire supplier in the world with approximately 17% market share, operating within a concentrated industry where the top three producers hold about 50% share. The company sells 70% of its tires to the replacement market and the rest to original equipment (OE) manufacturers. The tire industry has evolved over the past several years, from one of over-supply and competitive pricing to more of an oligopoly where the top three players have made significant, higher cost capacity cuts during the downturn. With leaner cost structures now in place, they can act much more rationally with disciplined pricing actions despite demand fluctuations. As a result, Bridgestone's profitability has benefitted from this strong pricing power. As demand for passenger car tires in several regions rebounded over the past year, the company was able to raise prices globally amid tight supply constraints. With little room for additional price increases, several other elements contribute to the company's outlook. First, a new CEO, Masaaki Tsuya, was appointed in March 2012. After the company announced in February that it would raise its 2013 dividend by an unexpected 70% year-over-year, there has been growing hope that Tsuya will announce revolutionary cost-cutting initiatives this October when the company releases its mid- to long-term target statement.

Second, Bridgestone should continue to benefit from accelerating tire volume growth in North America, where pent-up passenger car demand remains better than expected, and in Asia, where the company has increased production capacity to meet the rising auto demand. Also, replacement tire volumes in the developed markets are expected to eventually rebound around mid-2013 after several years of falling well below trend levels. Third, margin expansion opportunities remain. Bridgestone is using conservative natural rubber price assumptions. If rubber prices remain at subdued levels, the lower input costs relative to guidance could become a nice tailwind to margins. Bridgestone is also a big beneficiary of the yen weakness because of its high earnings sensitivity to foreign exchange movements, thereby providing another support to margin growth. Although the stock price has performed well year to date, the stock still trades at a large discount to its historical valuation, and we expect these drivers to lead to additional upside ahead.

Restructuring:

UK-based Lloyds Banking Group is in the midst of a significant restructuring as the bank puts its balance sheet and funding issues from the global financial crisis into the rear-view mirror. The company has already achieved a great deal by selling off non-core assets and building appropriate balance sheet reserves for the assets that remain, primarily legacy loans related to real estate in Ireland, which is undergoing a severe correction. In addition, the bank has significantly improved its funding profile by aggressively building its stable of core, low-cost deposits, which protect the bank from the ebbs and flows of market uncertainty. The bank has made enough progress to allow investors to focus now on the bank's future earnings power. In this area, management has reduced the bank's cost structure and enhanced its customer service levels, which reduces long-term regulatory and compliance costs. With an improved balance sheet and funding structure, management can more actively manage its loan and deposit pricing in an effort to drive higher net interest margins, thereby increasing revenue growth for the bank. Over the coming years we expect Lloyds Banking Group to become a more profitable and less risky bank than it was before the crisis. This should enable the bank to build capital more quickly so that it can comply with future capital standards under Basel 3, resulting in a higher share price.

Pricing Flexibility:

As one of the largest property and casualty insurers in the world, Tokio Marine is benefitting from the improvement in global P&C insurance pricing. The company is primarily a Japanese non-life insurer (70% of earnings) with 20% of earnings in international insurance and 10% of earnings from the life business. The Japanese P&C industry has historically produced low returns on equity (ROEs) given a lack of premium growth, low leverage, and excess capital. Additionally, the sector experienced price declines for five years through 2011, reducing underwriting profit significantly. Given the lack of profitability, the P&C sector is now increasing prices and causing a turn in the underwriting cycle. Evidence of the turn is emerging as the industry as a whole has been taking small rate increases of about 1% per year. Tokio Marine is well positioned to benefit from Japanese P&C rate increases due to both its position in the industry (approximately 28% market share) and its investments in technology systems. These investments have allowed them to improve pricing on new products relative to competitors. A revamped pricing system will particularly benefit their domestic auto insurance business, where a grade rating system based on number of claims filed will reduce discounts to drivers who file more claims, another form of price increase. Much of its international business is in the U.S., where P&C insurers have been achieving mid-single digit price increases for many consecutive quarters. These rate increases will be earning through Tokio Marine's book over the next year and should lead to improved underwriting profitability, higher earnings, and better ROEs. The company's leading market position enables them to take price increases, so we like Tokio Marine's business in the face of an improving P&C pricing cycle.

New Product:

SAP is one of the largest software companies in the world. Its products enable its more than 230,000 customers to make their business processes more efficient and agile. SAP recently launched new products in some of the highest growth areas in technology: Analytics, Cloud, and Mobility. These products could transform the industry, providing capabilities to the customer that vastly increase efficiency and are more technologically advanced relative to competing products. SAP's analytics solution, HANA, is an in-memory database that significantly improves the speed of analytics, predictive analysis, and business processes. Approximately 40% of HANA's deals come from outside SAP's installed base, and as a result, HANA has helped SAP grow its overall database business seven times faster than its closest competitor. Through the acquisitions of SuccessFactors, a cloud-based human capital management solution, and Ariba, a cloud-based business marketplace, SAP has become a leader in the cloud with four times more customers than its closest competitor. SAP's cloud business had a run rate of €1bn exiting 2012, which is expected to double by 2015. Overall, we believe the strong acceptance of these new technologies as well as the continued strength of SAP's core products will enable the company to continue to gain market share and achieve its 2015 goal of more than €20bn in revenue with an operating margin of 35%.

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The S&P 500, an unmanaged index consisting of 500 primarily large-capitalization stocks, is a widely published index of the large-cap equity securities which encompass most of the stocks in the universe of securities followed by ICAP. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 2000 measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Barclays Capital Government/Credit Bond Index includes securities in the Government and Corporate Indices. Specifically, the Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Barclays Capital Long Government/Credit Bond Index includes a blend of U.S. Treasury, government-sponsored, mortgage, and corporate securities limited to a maturity of more than ten years. The Corporate Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements. Information provided in this report is detailed in U.S. dollar denomination, unless indicated otherwise. Institutional Capital LLC claims compliance with the Global Investment Performance Standards (GIPS®). The firm maintains a complete list and description of composites, and the corresponding compliant presentation, which is available upon request.