December 31, 2013

Dear clients and colleagues,

This will be our closing comment for 2013. We will come back to some of our predictions for 2013, which we highlighted in our comment on December 27th last year. We shall also give you our forecast for 2014.

Developed markets had their strongest year in more than a decade in 2013. With one day before year end, the S&P500 with a performance of 29% is having its best year since 1997. The Nikkei at 57% (39% in C$) is having its best annual return in 41 years. European markets, despite a lot of negative news, ended the year at 18%, with the Euro at a multi-year high. Canada for a third year was a laggard, despite strong performance by the Banks. Emerging markets were laggards with a negative performance of Brazil, China and Russia.

Our Global Small Cap fund slightly underperformed the index while our International Small Cap Fund (EAFE) outperformed a bit. Both funds had a similar performance, but US small cap outperformed EAFE small cap by about 10% this year. Our overweight in Hong Kong hurt the performance in 2013. However, when markets are up 40%, technical factors such as momentum become important drivers of outperformance.

So, about our forecast for 2013.

We thought growth would be somewhat stronger in 2013 than it was in 2012. We were expecting World GDP growth of around 3.5%. Actual growth was closer to 3%, weighed down by a slow recovery in Europe and much slower growth in emerging markets.

We were very optimistic on stock markets. Sentiment was still very negative. But with record low interest rates, equities might very well be the New Bonds. We were right about this one.

So, what about 2014?

The markets have now been up for 5 years in a row. Since the S&P bottomed in March of 2009, it is up 170%, or an annual equivalent of 23%. Can we expect the markets to continue?

In the 90's, markets went up 9 years in a row until 1999 and returned 432% or an annual equivalent of >20%.

We are not suggesting that markets can't have a correction, let us have a look at the fundamentals.

The US is still in a recovery mode. 2014 should continue to see a slow recovery. We will not see the kind of growth we saw in 2005, 2006, why? That growth was driven by a twin bubble, a consumer bubble as well as a housing bubble. Nevertheless, the US should grow at 2.5% in 2014. The US$ should continue to gain strength against other currencies.

Europe has bottomed this year. Most economic indicators are now pointing to a slow recovery. The one negative is the Euro strength. However, following the US and then Japan, a potential surprise for 2014 would be to see the ECB embark on a quantitative easing strategy to weaken the euro and stimulate the economy.

Japan in 2014 should see inflation from rising wages and an increase in the sales tax. We continue to be positive on Japan.

Emerging markets still have structural problems caused by a deteriorating fiscal situation and high inflation. China will continue to grow at around 7-7.5%, Brazil should resume growth. Mexico will be a beneficiary of US growth. India and Russia will continue to face structural problems.

In terms of markets, we think equity markets will have a more normal year in 2014, 10-15% would be reasonable assuming little multiple expansion and driven by profit growth.

We forecast that Japan and Europe will outperform the US, driven by more favorable valuations and positive fund flows. Hong Kong and Asia have very attractive valuations and could also surprise on the upside.

In terms of sectors, Industrials should lead the way in 2014 with real estate trailing the markets. Although materials have corrected, we do not see a recovery in stock prices in 2014. So we believe non-resource cyclicals will outperform the resource and the defensive in 2014.

Our investment strategy remains the same. We want to add value through security selection and manage the other sources of risk which are Country/Region/Currency and Sector/Industry to neutralize their impact on the portfolio.

As a result, we have a diversified portfolio of 59 companies in 14 countries and 37 different industries. Our favored investment themes are the consumer, especially the emerging market consumer, the environment and alternative energy, high-tech, outsourcing, and infrastructure. In stock picking, we emphasize companies with better sales growth vs. industry, better operating margins, lower debt, high insider ownership and a discounted valuation. This should allow us to deliver better returns in both up and down markets.

We wish you all another successful and prosperous year!

Regards,

The Global Alpha Team