Q4: 2014

Knightbridge Quarterly

Overview

Q4 provided a strong end to a solid 2014 that saw its share of ups and downs. Domestic equities again rallied into year-end, providing a solid sequel to 2013's spectacular performance. Another year of double-digit gains for domestic stocks may be a tall order, though despite two years of solid outperformance relative to nearly all other asset classes our bias continues to prefer stocks to bonds in the near- and medium-term. Fixed Income experienced mixed results during the quarter with intermediate- and long-dated Treasuries posting strong returns offset by weakness in High Yield Corporates. For the year, the broader taxable bond category increased just under 3%, a modest disappointment from a historical perspective but given the current rate environment about all that should be expected. From here, ahead of prospective interest rate hikes, albeit measured from the Fed sometime during 2016, the likelihood of historically lower returns from fixed income should be expected to continue while the risk to the rising interest rates should be fully understood. Volatility, not seen in some time, presented itself and will likely stick around in some form with potential headwinds around global growth, commodity price worries, the strengthening U.S. dollar, "Fed liftoff" and increased terrorism concerns. This said, our view of volatility is one that can also present opportunity and our portfolios will likely experience a modest uptick in trading as we attempt to capitalize on these opportunities. While corporate financial stability remains healthy buoyed by strong balance sheets and expanding operating margins, valuation has come up some and moving forward picking the right stocks will take on greater importance. Within our Alpha Beta construct that also allows us to shift from active (individual stocks) to passive (index ETFs) when valuations seem stretched while still remaining exposed to the market. Conversely, should equities see a broad-based correction this would allow for allocation back towards individual stocks that may have corrected more than warranted. This is where our fundamental research usually pays dividends and sets the table for alpha generation, which thankfully we have produced a decent amount of over the past two years.

Index	Q4	2014	Five-Years (annualized)	Ten-Years (annualized)
S&P 500	4.9%	13.7%	15.5%	7.7%
Dow Jones Industrial Average	5.2%	10.0%	14.2%	7.9%
Nasdaq Composite	5.7%	14.8%	20.5%	9.0%
Russell 2000	9.7%	4.9%	15.6%	7.8%
MSCI EAFE	-3.6%	-4.9%	5.3%	4.4%
Barclays US Aggregate Bond	1.8%	6.0%	4.5%	4.7%

Source: Morningstar

Equity

Domestic equity markets delivered another strong showing in Q4 returning +6% on average, capping a very successful 2014 where the average domestic equity index increased ~10%. Even more impressive may have been the strong reversal experienced from mid-October through year-end as equities rallied nearly 11% after selling off significantly in late Q3/early Q4. After a weak start to the Q3 earnings season coupled with uncertainty around Ebola and slowing global growth equities brushed off these worries and found their footing, regaining momentum and aggressively surging upwards. From a style perspective, growth outperformed value significantly in large-cap and just modestly in mid-cap while the reverse was seen in small-cap as a flight to safety mentality took hold during the second half of the year exacerbated by the significant selloff in the Russell 2000 felt in late summer. By sector, Consumer Discretionary, Technology, Health Care, Financial Services and Utilities were outperformers while Consumer Staples, Industrials, Telecommunications, Basic Materials and Energy all lagged (with the last three all posting negative returns during the quarter). Dividend paying stocks outperformed as interest rates fell during the quarter and the gap between average dividend yield and the 10-year U.S. Treasury yield widened. Eventually, bond yields will rise, though timing and magnitude may be harder to predict given a slew of mixed economic indicators and global central banks continued accommodation. That said, rising rates should be a welcomed sight for a variety of investors as it likely highlights a stronger economy finally breaking out of its prolonged slow-growth trend.

On the international front, equities struggled as heightened concerns around slowing global growth and a strengthening U.S. dollar impacted performance. The broad category averaged a decline of ~4% during Q4, pulling what had been a slight increase into negative territory for the full year with a 3% decline on average. During the quarter developed markets (-3.6%) outpaced emerging markets (-4.9%), growth outpaced value (by ~250 bps) and small- and mid-caps slightly lagged large caps (by ~25 bps). By region, the standout was India (+6% during Q4; +45% for 2014) where a new government has lifted sentiment and broad-based reforms are taking place. Additionally, China (+3%) and Europe (-3%) outperformed during Q4. With Europe, the hope for accommodation from the ECB (which was announced and is scheduled to take place over the 18 months) drove the modest outperformance on a relative basis. Conversely, weak performance was seen across Latin America (-13% as a region) where Brazil's economy continues to struggle, reflected in the country's -16% performance during the quarter.

As we look to 2015, fundamentals should continue to take on greater importance and likely carry more weight. This environment favors stock picking as was the case for our portfolios during Q4 and to a lesser extent 2014. Our bias remains to gravitate towards companies of higher quality and those with the ability to grow at above market levels as we feel the market rewards these companies with higher valuation multiples. As always, corporate willingness to buy back shares, raise dividends or invest capital back into their businesses in an effort to drive future growth remains a key focus of how we allocate capital within the portfolios. Those companies that value the dual strategy of returning capital to shareholders while positioning themselves for future growth should be afforded higher multiples yielding relative outperformance against the broader market. It is our job through stock selection to find these winners and appropriately allocate across each strategy in an effort to generate portfolio alpha.

Fixed Income

Performance within the Treasuries market dominated the fixed income complex during Q4 with yields falling significantly during the quarter as global funds flowed towards the relative safety of the U.S. government. The bellwether 10-year U.S. Treasury yield fell 35 bps during the quarter and at year-end sat nearly 90 bps lower than where it started the year. All this during a year when the betting money was squarely focused on the likelihood of rising yields. In a nutshell, these bets likely exacerbated the significant move down in yields as many positioned for rising rates had to reverse pivot and cover these out-of-the-money positions. During the quarter, the taxable bond category declined ~0.3% in contrast to municipals which increased ~1.2%. Within the taxable category anything with length performed well as evidenced by the following categories: long-term bond (+4.22%), corporate bond (+1.22%) and intermediate-term bond (+1.11%). Conversely, most categories deemed to be high risk underperformed as evidenced by high yield (-1.56%), nontraditional bond (-0.97%) and two other areas inflation-protected (-0.84%) and bank loan (-0.72%) which tend to skew higher risk in falling or sideways rate environments. Within municipals, standout areas included High Yield (+1.99%), California Long (+1.67%), National Long (+1.49%) and various other single state long strategies, while only short-dated strategies saw declines during quarter and most of these were only slightly negative. On the international front the World Bond category declined 1.15% far outdistancing the Emerging Markets Bond category which declined ~4% on average reversing what had been a solid year in the making (+3% through nine months). Tough sledding is expected for this category given global concerns, however, this may present strategy selection opportunity at some point during 2015.

Sensitivity to interest rates remains of paramount interest and should continue to be of greater importance than credit risk, absent energy-related names where heightened risk has become a recent concern giving the swoon in oil prices. While the Fed will likely raise rates sometime during 2015, it will do so with a keen eye on underlying economic data and likely takes a measured approach in doing so. Any market-related rise in interest rates will benefit new money, however, the downside pricing pressure on held securities could overwhelm. In this scenario a measured rise in interest rates would be most welcomed. Shorter-duration and floating-rate products (think bank loan securities) will likely provide a favorable risk/reward profile (safest from an interest rate risk perspective) in this scenario. International bonds which underperformed late in 2014 likely benefit also in a reversion to the mean occurring sometime during 2015 given the crowded nature that is evident in the flight to safety trade seen in U.S. Treasury and Corporate Grade instruments.

Performance of KbC equity portfolios

2014 ended on a high note with KbC equity portfolios posting both their best absolute and relative quarter ever. All six of our equity portfolios outperformed during the quarter, with the best performance realized in Select portfolios as stock selection proved meaningful. For that matter, the Select Core and Select Dividend portfolios produced twice and three times as much alpha as their Alpha Beta counterparts, respectively. Select Mid Cap, however, was the star performer generating 825 bps of alpha during Q4 (+14.56% vs. MDY's +6.31%) benefiting from broad-based stock selection across both consumer sectors as well as its healthcare and utilities exposure. For the year this strategy outperformed its benchmark by 363 bps (+12.99% vs. MDY's +9.36%) and since inception has outperformed by 2,462 bps (+69.83% vs. MDY's +45.21%). Absent the first quarter of 2014 when the strategy fell behind meaningfully (trailing by 746 bps) against it benchmark, the remainder of the year looked very similar to 2013's performance (when Select Mid Cap outperformed by 1,357 bps). Additional detail for each portfolio is below in table and text form.

Knightbridge Capital Equity Portfolios Quarterly Performance

Strategy	Q4	2014	Since Inception	Annualized Return
Alpha Beta Core	**8.40**	**17.92**	**17.92**	**17.92**
SPDR S&P 500 (SPY)	4.90	13.37	13.37	13.37
+/- Benchmark	*3.50*	*4.55*	*4.55*	*4.55*
Alpha Beta Dividend	**7.23**	**12.89**	**12.89**	**12.89**
Vanguard Dividend Appreciation ETF (VIG)	6.07	9.97	9.97	9.97
+/- Benchmark	*1.16*	*2.92*	*2.92*	*2.92*
Alpha Beta Market	**7.71**	**15.24**	**63.38**	**27.82**
Vanguard Total Market Index ETF (VTI)	5.26	12.46	49.48	22.26
+/- Benchmark	*2.45*	*2.78*	*13.90*	*5.56*
Select Core	**10.05**	**19.58**	**70.19**	**30.46**
SPDR S&P 500 (SPY)	4.90	13.37	49.38	22.22
+/- Benchmark	*5.15*	*6.21*	*20.81*	*8.24*
Select Dividend	**9.67**	**16.18**	**50.90**	**22.84**
Vanguard Dividend Appreciation ETF (VIG)	6.07	9.97	41.23	18.84
+/- Benchmark	*3.60*	*6.21*	*9.67*	*4.00*
Select Mid Cap	**14.56**	**12.99**	**69.83**	**30.32**
SPDR S&P Mid Cap 400 (MDY)	6.31	9.36	45.21	20.50
+/- Benchmark	*8.25*	*3.63*	*24.62*	*9.82*

Source: Vanguard, State Street and Knightbridge Capital

Alpha Beta Core generated 350 bps of alpha during Q4 returning +8.40% and for the year produced 455 bps of alpha with a return of +17.92%. Standout performers within the portfolio during the quarter included Whirlpool (WHR) which increased 34% as investors applauded the company's ability to continue to make opportunistic acquisitions in China and Europe while improving its overall margin profile. Within healthcare, positions in Acadia Healthcare (ACHC) and Allergan (AGN) outperformed the benchmark by factors of ~5x and ~4x, respectively. Additionally, three other positions produced double-digit returns during the quarter (VF Corp (VFC) +14%; Morgan Stanley (MS) +13%; and Simon Property Group (SPG) +12%) all benefiting the portfolio's alpha creation. In all, 9 of the portfolio's 11 active positions outperformed the benchmark in Q4.

Alpha Beta Dividend was the weakest performer of the six portfolio strategies employed at KbC during Q4, however, it was still able to generate 116 bps of alpha (+7.23% vs. +6.07% for VIG). For the full year the strategy outperformed its benchmark by 292 bps, returning +12.89%. During the fourth quarter the portfolio benefited from its exposure to Whirlpool (WHR) which increased 34% and Wisconsin Energy (WEC) which increased 24%. Additionally, the following four positions all produced double-digit gains during the quarter (Vanguard REIT ETF (VNQ) +14%; VF Corp. (VFC) +14%; Kraft Foods (KRFT) +13%; and Reynolds American (RAI) +10%). Offsetting these solid performers were two positions that significantly underperformed during Q4, Nucor (NUE) and ConocoPhillips (COP) which both declined 9%. In all, 10 of the portfolio's 14 active positions outperformed the benchmark in Q4.

Alpha Beta Market put in a solid Q4 as it outperformed its benchmark by 245 bps (+7.71% vs. +5.26% for VTI). For the full year the strategy generated 278 bps of alpha returning +15.24%. Since inception, the portfolio has produced annual outperformance of 556 bps (average annual return of +27.82% vs. VTI's +22.26%). During the quarter significant alpha was generated by holdings in the following positions: Acadia Healthcare (ACHC), the portfolio's largest holding at ~9.4% of assets which increased 26.2% in Q4 and ended the year up 51.2%; along with VF Corp. (VFC), Hain Celestial Foods (HAIN) and Crown Holdings (CCK) – all three representing ~4-6% of the portfolio and returning ~14% each or nearly triple the benchmark return. Conversely, two positions TripAdvisor (TRIP) and J.M. Smucker (SJM) underperformed meaningfully though both remain in the portfolio given their long-term appreciation potential. During Q4 and likely to continue during 2015 we increased the allocation to Vanguard Total Market Index ETF (VTI), shifting funds away from positions with less favorable risk/reward and what was a small cash position that is now even smaller. Should the broader market pullback we will be less exposed to individual stock selection and also have an opportunity to rebalance funds into positions where more favorable risk/reward exists.

Select Core outperformed its benchmark by 515 bps (+10.05% vs. +4.90% for SPY) during Q4 as it benefited from stock selection across numerous sectors including Consumer Discretionary, Health Care and Financials. For the full year the portfolio generated 621 bps of alpha (+19.58% vs. SPY's +13.37%). Whirlpool was the portfolio's top alpha contributor during the quarter as it increased 34% providing approximately 150 bps or ~30% of the strategy's total alpha generation. Other significant alpha generators included Acadia Healthcare (ACHC), VF Corp. (VFC), Morgan Stanley (MS), Cigna (CI), Allergan

(AGN) and Simon Property Group (SPG). Only two positions provided negative returns during the quarter, Principal Financial Group (PFG) which declined just 0.4% and Google (GOOG) which fell ~9%. We remain confident that the investment thesis in each position still holds and actually believe that both remain significantly undervalued at current levels.

Select Dividend generated 360 bps of alpha (+9.67% vs. VIG's +6.07%) during Q4 as stock selection significantly aided the outperformance. Additionally, the benchmark this strategy compares against outperformed the S&P 500 by more than 100 bps during the quarter. For the full year the portfolio outperformed by 621 bps (+16.18% vs. VIG's +9.97%). Dividend-paying strategies performed well during Q4 benefiting from the 33 bp decline in the 10-year U.S. Treasury yield. Historically, when the gap between the average dividend yield in a basket of income-producing stocks widens versus the 10-year U.S. Treasury yield, these stocks should outperform and during Q4 this was clearly the case as 12 of the strategy's 17 position outperformed the benchmark. Five positions underperformed relative to the benchmark during the quarter and each of these had its reasons, but all five provide solid investment rationale in continuing to hold and likely become modestly bigger positions within the portfolio as the market provides buying opportunities.

Select Mid Cap turned in a spectacular fourth quarter posting a +14.56% return, outperforming its benchmark, the SPDR S&P MidCap 400 (MDY) by 825 bps. This capped a year that had seen the strategy trail early by a significant margin only to rebound fully and end the year with alpha of 363 bps (+12.99% vs. MDY's +9.36%). Since inception, the portfolio has produced annual outperformance of 982 bps (average annual return of +30.32% vs. VTI's +20.50%). Exposure to consumer-related positions was a big driver of alpha during Q4 with Rite Aid (RAD), Whirlpool (WHR), Tractor Supply (TSCO) along with Acadia Healthcare (ACHC) each outperforming by at least 2,000 bps during the quarter. Additionally, Wisconsin Energy (WEC) and Jarden (JAH) both outperformed by at least 1,000 bps in Q4. For 2014, a big component of alpha generation was driven by the strategy's ~15% weighting in healthcare where both Acadia Healthcare (the strategy's largest position) and Universal Health Services outperformed the benchmark five-fold and four-fold, respectively. Positions in AvalonBay Communities (AVB), Wisconsin Energy (WEC) and Hain Celestial Group (HAIN) also were significant alpha generators during 2014. Finally, despite outperformance from the strategy over the past year, two positions TripAdvisor (TRIP) and J.M. Smucker (SJM) underperformed meaningfully though both remain in the portfolio given their long-term appreciation potential. The strategy exited positions in Chart Industries (GTLS), GNC Holdings (GNC) and Hanger (HGR) as the investment thesis for each of these holdings faltered during 2014.

As we move to 2015 one thing we have a lot of confidence in is that volatility, which has been muted for some time, will likely increase meaningfully. As the concerns around global growth, a strengthening U.S. dollar and prospective "Fed liftoff" move to the forefront the likelihood of a continuation of the lower volatility environment continuing lessens dramatically. While we are not active traders it is imperative that the portfolios pay close attention to both fundamentals of the underlying companies invested in as well as stay true the valuation framework in place to highlight areas of opportunity (to the upside) and risk (to the downside). During 2015 as was the case in 2014 our portfolios likely see a modest uptick in trading as we attempt to capitalize on some of the opportunity that this added volatility creates.

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