

Knightbridge Quarterly

Overview

The second quarter can be summed up in one word, impressive! After a choppy Q1, financial markets responded in a positive fashion posting an outstanding quarter. Equities which had looked tired during Q1 after posting a standout 2013, sprang back to life delivering a strong quarter as sentiment improved with modestly better economic data, continued global monetary policy accommodation and receding geopolitical concerns. Fixed income markets continued to grind higher post a strong first quarter and at mid-year have provided decent returns despite an outlook still less favorable than equities. A good bit of the damage done in 2013 across the fixed income complex has been reversed, but the one caveat remaining is how to avoid asset price declines when interest rates finally do rise meaningfully. From a macroeconomic perspective, while mixed data continues to be the new norm and this looks to have actually benefited risk markets over the past couple of years evidence of a stronger economy is likely needed to push equities further against the backdrop of a potentially higher interest rate environment in the coming years. With the Federal Reserve set to complete the unwinding of its massive asset purchasing program later this year and likely hike interest rates sometime in 2015, the underlying narrative will shift accordingly. That said, with continued sluggishness likely across the global economy and the potential for staged monetary policy retracement equities still look favorable, despite their continued move higher, versus fixed income and cash. Moving forward stock picking will be of greater importance and we continue to see plenty of opportunity in finding companies possessing a high-quality capital structure, a solid top-line and strong earnings growth while still being able to address both the investment needs of the business while at the same time rewarding shareholders. When these opportunities become scarce our relative bias towards equities will lessen, though this may be a ways out given current market conditions.

Index	Qtr	YTD	One-Year	Five-Years (annualized)	Ten-Years (annualized)
S&P 500	5.23%	7.13%	24.61%	18.83%	7.78%
Dow Jones Industrial Average	2.83%	2.68%	15.56%	17.83%	7.63%
Nasdaq Composite	5.31%	5.88%	31.17%	20.50%	8.99%
Russell 2000	2.05%	3.19%	23.64%	20.21%	8.70%
MSCI EAFE	4.09%	4.78%	23.57%	11.77%	6.93%
Barclays US Aggregate Bond	2.04%	3.92%	4.37%	4.85%	4.93%

Source: Morningstar

Equity

Domestic equity markets delivered strong results during Q2, reversing much of the disappointment experienced early in the year. Despite a modest market selloff during the second week of April, a sharp reversal began mid-month providing equities a significant lift that continued through the remainder of Q2. After a down-up-down Q1, the trajectory of equities in Q2 steadily rose from mid-April resulting in mid-year returns of positive ~5% for broader indices. While we continue to expect a choppy back half of the year the trend heading into Q3 is upward and despite a lack of direction at times during the late summer months we believe that domestic equities will end the year higher though probably only a couple of percentage points above early July's highs. This outcome would yield full-year returns in the positive high single digit percentage range, which would be viewed as strong year on the heels of an outstanding 2013.

During the quarter, large caps outperformed both mid-caps and small caps while value outperformed growth slightly among large caps and more significantly as cap size became smaller (by a ratio of ~2:1 for mid-caps and better than 5:1 for small caps). All ten sectors saw positive results with Energy, Utilities and Technology performing best along with Materials and Health Care while Consumer Staples, Industrials, Consumer Discretionary, Financials and Telecom lagged behind. On a year-to-date basis, Utilities, Energy and Health Care have performed best with each sector posting double-digit percentage gains. Based on a possible reversion to the mean and given elevated valuations for all three sectors we would expect some profit-taking during the second half and the potential for rotation to drive outperformance in some of the lagging sectors.

International equities at the broad category level returned +4.63% in Q2, nearly keeping pace with domestic equities. In contrast to Q1 where performance in developed markets outpaced that of emerging markets, Q2 experienced a reversal with the emerging markets category modestly outperforming the developed markets category (+5.06% vs. +4.40%). Large caps outperformed small- and mid-caps by ~120 bps on average, fully reversing a two quarter trend where the gap had widened to ~280 bps as there seems to have been a flight to higher quality underway in many international markets. By region, standouts included India (+17.75%; on the heels of Q1's +9.28%) and Latin America (+7.98%) while laggards included Europe (+1.32%) and China (+2.63%). Unfortunately, after a couple quarters of both macroeconomic and market performance improvement Europe seems to have slipped some and as evidenced by renewed accommodation from the ECB may not be rebounding as thought. This bears continued watching given the continent's importance to the broader global economy.

Fixed Income

Performance was again solid across the fixed income complex during Q2 as every sub-category achieved positive returns. Treasuries continued to rally throughout the quarter as evidenced by the ~20 bp drop in yield on the 10-year U.S. Treasury note (on the heels of Q1's ~30 bp drop; at quarter-end the yield stood

at 2.52% down from 3.03% on 12/31/13). Continued to flight to quality, especially early in the quarter post the release of Q1's weak GDP figures drove much of the move lower in yields as investors allocated away from equities (only to reverse this later in the quarter). Expectations of a higher 10-year U.S. Treasury yield during 2014 have not come to fruition and at current there is building sentiment that the benchmark yield might see 2.0% sometime later this year (a stark contrast from earlier consensus that saw a 3.25% - 3.75% level as most likely during 2014). While this will benefit holders of many bonds funds and dividend-paying strategies this would not be a welcomed sight from a macroeconomic perspective as it would likely point to an economy unable to grow at a sustainable 3%-GDP level.

The taxable bond category returned 2.01% for the quarter, while municipals again outperformed rising 2.26% as a category. Within the taxable category Long Government (+4.62%), Preferred Stock (+3.72%), Long-Term Bond (+3.32%) and Inflation-Protected Bond (+3.09%) performed best while the shorter-duration categories (Ultrashort Bond, Short Government and Short-Term Bond) lagged though still providing modest increases during Q2. Within municipals, leading sub-categories included High Yield (+3.55%), California Long (+3.06%), New York Long (+2.76%) and Single State Long (+2.57%); lagging categories again on the shorter-end of the curve included National Short (+0.61%) and Single State Short (+0.80%). On the international front the Emerging Markets and World Bond categories led the way, increasing 4.28% and 2.47%, respectively.

Performance of selected Knightbridge portfolios

While keeping up with a "red hot" market is usually challenging when managing Core and Value strategies, our six portfolios actually performed quite well during Q2 generating 304 bps of aggregate alpha. Post a challenging Q1 this reversal of performance was welcomed and the better performance has continued thus far in Q3 as value has outperformed growth and larger caps have outdistanced their smaller cap counterparts. All six of our managed portfolios generated alpha during Q2 with the two dividend strategies, **Alpha Dividend** and **Select Dividend** generating 75 bps and 90 bps, respectively. ConocoPhillips (COP) 20%+ increase during the quarter was a highlight in both portfolios and while the position was pared back some as a result of the outsized performance, it remains one of our favorite holdings given its domestic energy exposure and significant natural gas assets. Additionally, Principal Financial Group (PFG), which we have dubbed our baby Ameriprise (AMP; +52% since purchase) performed admirably during the quarter with a 10.5% increase and still provides 25%+ upside to our 12-month blended upside target price of \$66. Our remaining four portfolios (**Alpha Core**, **Alpha Market**, **Select Core** and **Select Mid Cap**) generated between 14 bps and 61 bps of alpha during Q2.

While Q2's strong equity market performance is not likely to repeat itself and the potential for a correction of mild (down 3-7%) to major (down 10% or more) size continues to increase, we feel this benefits strategies where stock-picking is employed over straight market exposure. As we have mentioned before, 2014 continues to feel like an environment where mixed economic signals and geopolitical uncertainty

will lead to up and down equity market performance until a clearer direction is realized. This is normal for periods post significant up-years and is usually just the market digesting its recent outperformance. A recent spike in volatility, albeit short-lived is common and given the Federal Reserve's lessening of its accommodative stance combined with a choppy macro-environment likely points to periods of increased volatility presenting itself again during the second half of the year and into 2015.

Performance for all six Knightbridge portfolios can be seen in the table below.

Knightbridge Capital Equity Portfolios Quarterly Performance			
Strategy	Q2	YTD	Since Inception
Alpha Beta Core	5.35	6.15	6.15
SPDR S&P 500 (SPY)	5.16	6.93	6.93
+/- Benchmark	0.19	-0.78	-0.78
Alpha Beta Dividend	4.91	6.01	6.01
Vanguard Dividend Appreciation ETF (VIG)	4.16	4.58	4.58
+/- Benchmark	0.75	1.43	1.43
Alpha Beta Market	5.45	6.67	54.67
Vanguard Total Market Index ETF (VTI)	4.84	6.98	42.48
+/- Benchmark	0.61	-0.31	12.20
Select Core	5.61	4.90	46.00
SPDR S&P 500 (SPY)	5.16	6.93	41.19
+/- Benchmark	0.45	-2.03	4.81
Select Dividend	5.06	6.73	38.87
Vanguard Dividend Appreciation ETF (VIG)	4.16	4.58	34.53
+/- Benchmark	0.90	2.15	4.33
Select Mid Cap	4.44	-0.33	48.66
SPDR S&P Mid Cap 400 (MDY)	4.30	7.30	42.60
+/- Benchmark	0.14	-7.63	6.06

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