2013 Review

In 2013, our US Value Equity-EQ and US Value Equity-CS returned +54.4% and +50.9%, respectively, compared to the +32.4% for the S&P 500 Index and +32.5% for the Russell 1000 Value.

	2009	2010	2011	2012	2013	ITD
U.S. Value Equity - EQ (Gross)	+80.0%	+25.2%	-0.2%	+19.7%	+60.7%	+332.6%
U.S. Value Equity - EQ (Net)	+68.3%	+22.4%	-1.0%	+18.8%	+54.4%	+274.4%
EQ Relative Performance (Net)	+4,180 bp	+730 bp	-310 bp	+280 bp	+2,200 bp	+14,620 bp
U.S. Value Equity - CS (Gross)	+63.7%	+22.7%	-2.0%	+19.4%	+52.8%	+259.3%
U.S. Value Equity - CS (Net)	+61.7%	+21.2%	-3.2%	+18.0%	+50.9%	+237.9%
CS Relative Performance (Net)	+3,520 bp	+610 bp	-530 bp	+200 bp	+1,850 bp	+10,970 bp
S&P 500 (Total Return)	+26.5%	+15.1%	+2.1%	+16.0%	+32.4%	+128.2%

We had a fantastic year in 2013. Just about everything went right, and we demonstrated again we are capable of producing remarkable returns. Not every year will be this good, and some will inevitably be disappointing. Even when we make the right investment decisions, the market does not necessarily reward such decisions in an orderly fashion. In fact, the same stocks that drove our returns in 2012 and 2013 gave rise to modest underperformance in 2011. Over the course of a full investment cycle, we aim to outperform the S&P 500 by 500 to 1,000 basis points per year, but we expect the return pattern to be lumpy from year to year, with years well above and well below our performance objective.

In analyzing our portfolio's performance attribution, we find it helpful to examine both investment success rate and skew in the distribution of returns. Our success rate was extremely high in 2013, as 98% of our investments posted gains and 83% outperformed the S&P 500. Skew was also a positive factor for the year, as outperformers outperformed by 29% while underperformers underperformed by 13%.

Portfolio turnover in 2013 was 24.7%, compared to our average turnover of 18.2% per annum over the past five years. In total, we sold eight stocks, as five approached fair value, two were acquired and one was eliminated because we lost conviction in the company. For each stock sold, we added a compelling replacement from our inventory of researched investments.

We believe the value opportunity in the portfolio remains attractive, although certainly not as attractive as it has been over the past five years, an exceptional period for value opportunities. As certain of our existing positions approach our estimates of fair value, we still are finding attractive new stocks to add to the portfolio. It is getting harder to find such opportunities, but we believe the ones we are finding offer sufficiently attractive upside to sustain our ambitious performance goals.

#1 IN eVESTMENT

We used eVestment's database and examined the returns of all Large Cap, Mid Cap and All Cap Value products. While not all of these products are true peers of ours, we wanted to cast a wide net in capturing the performance data. In total, as of January 21, 2014 there are 556 products in those three categories that reported five year returns. Lyrical Asset Management's U.S. Value Equity - EQ ranks as the product with the highest return in that assembled, superset universe. *(Note that eVestment uses gross performance for such rankings).*

LOOKING BACK

This past year, S&P 500 earnings growth was fairly normal compared to history. Specifically, 2013 S&P 500 estimated earnings growth was 8.3% based on FactSet data. Notwithstanding such a pedestrian figure, the

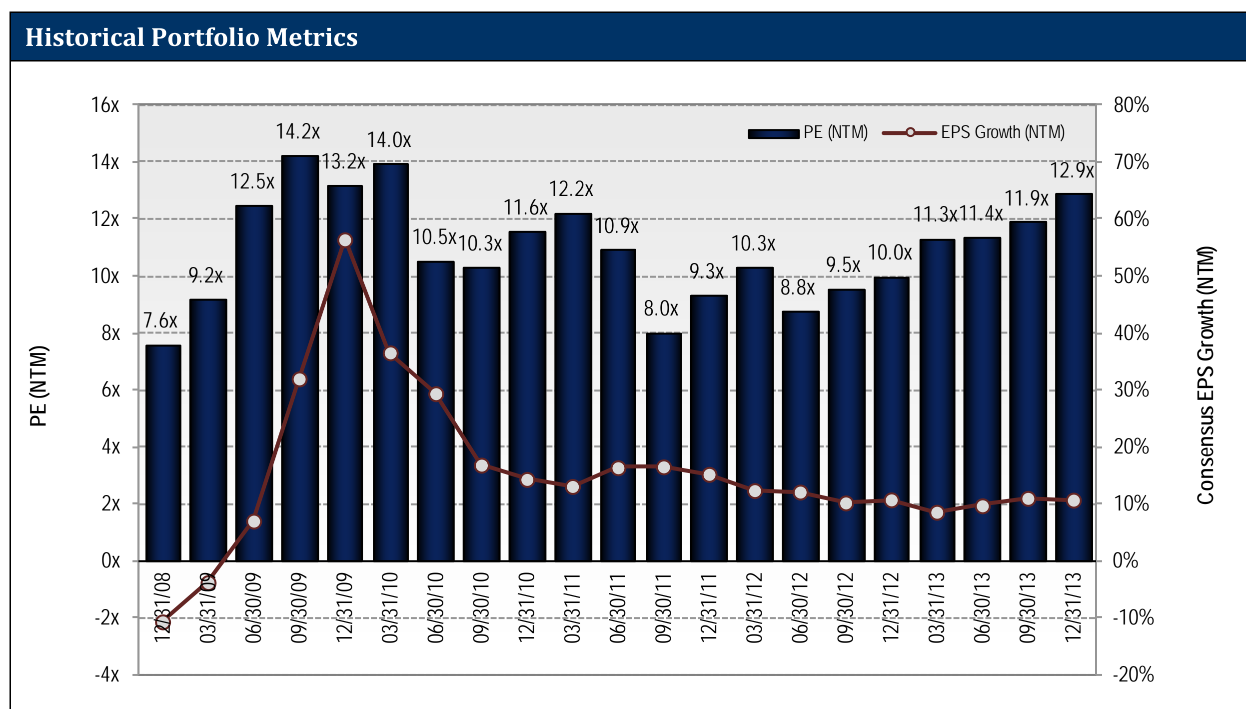
S&P 500 total return of 32.4% stands as the fourth best year on record since 1960, eclipsed only by 1975, 1995 and 1997.

LOOKING FORWARD

Even after our strong absolute and relative returns this year, our portfolio remains attractively valued, both in absolute terms and relative to the S&P 500. The P/E ratio for our portfolio on forward consensus earnings estimates was 12.9x at the end 2013. While this is not as low a multiple as at the start of 2013, it still remains very attractive in comparison to the S&P 500, which, at 15.5x, is 20% higher. In fact, at 12.9x our portfolio is still cheaper than the 13.2x multiple the S&P 500 had at the start of 2013.

Furthermore, the consensus estimates for 2013 earnings growth for our portfolio is 10.7%, higher than the 9.3% expected for the S&P 500. Given the combination of lower multiple and higher expected growth, we are optimistic about our prospects for continuing to outperform the U.S. markets in the coming year.

Historical Portfolio Metrics



Source: FactSet; Lyrical analytics

WHAT ABOUT 2014?

Before offering some straightforward observations of available data, let us assert unequivocally that we neither now nor ever expect to have a market view that will impact how we invest. Our investment approach is based entirely on bottom up stock selection. We do not have a market view, macro view, or sector view. However, given the standout performance of the S&P 500 last year, we are being asked more than ever for some commentary on what to expect in 2014.

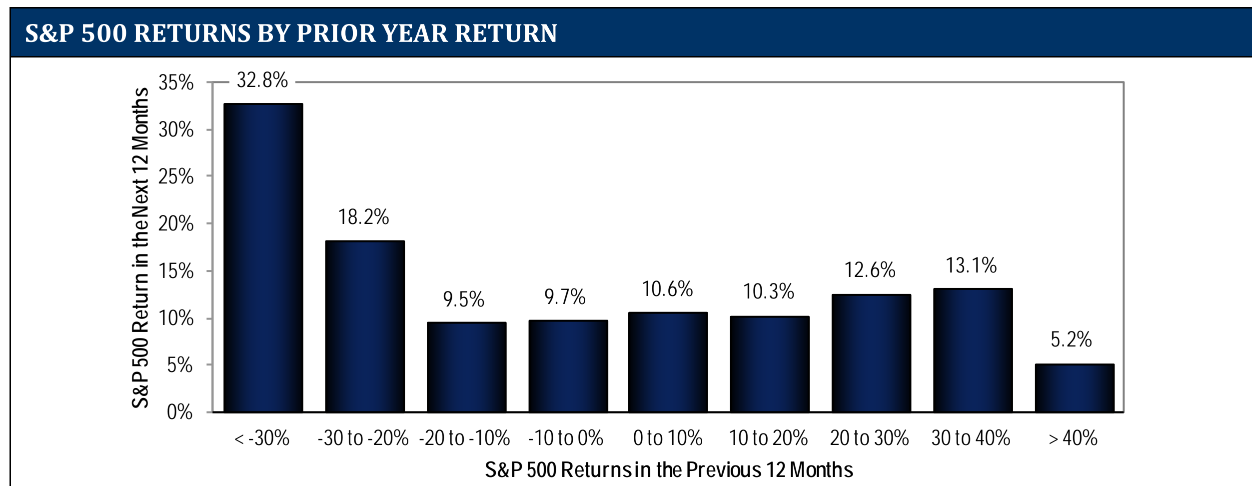
We have analyzed the long-term return data of the S&P 500 and have gleaned some insights. The most obvious insight is that one should expect the market to rise next year because, since 1960, for any twelve month period, the S&P 500 has produced a positive return more than 77% of the time. In the absence of any other information, probability suggests that the market is likely to be up.

LAST YEAR'S RETURN DOESN'T REALLY MATTER

The S&P 500 had one of its best years ever in 2013, producing a total return of 32.4%. It seems like common sense that, after a strong up year for the market, one should expect a disappointing year to follow. History, however, seems to indicate otherwise. In most cases, returns in one twelve month period do not impact returns in the next twelve months, except in the extremes.

Since 1960, the average twelve month return for the S&P 500 has been 11.5%. And, since 1960 there have been 19 such periods where the S&P 500 produced returns in the 30% to 40% range, as it did in 2013. On average, the twelve months following those periods actually produced above average returns of 13.1%. In fact, when you analyze buckets of prior year return ranges, we find that for the span of -20% to +40%, the market return over the following twelve months seems to be in line with the long-term average of 11.5% for the full data set. In the nine periods where the S&P 500 was up 40% or more, we did see muted returns in the following twelve months of only 5.2%, on average. Likewise, we see that, in periods following S&P 500 declines of 20% or more, the following year has above average returns. But it seems clear that in the wide span from -20% all the way to +40%, the returns in one twelve month period have little noticeable impact on the following period.

S&P 500 RETURNS BY PRIOR YEAR RETURN

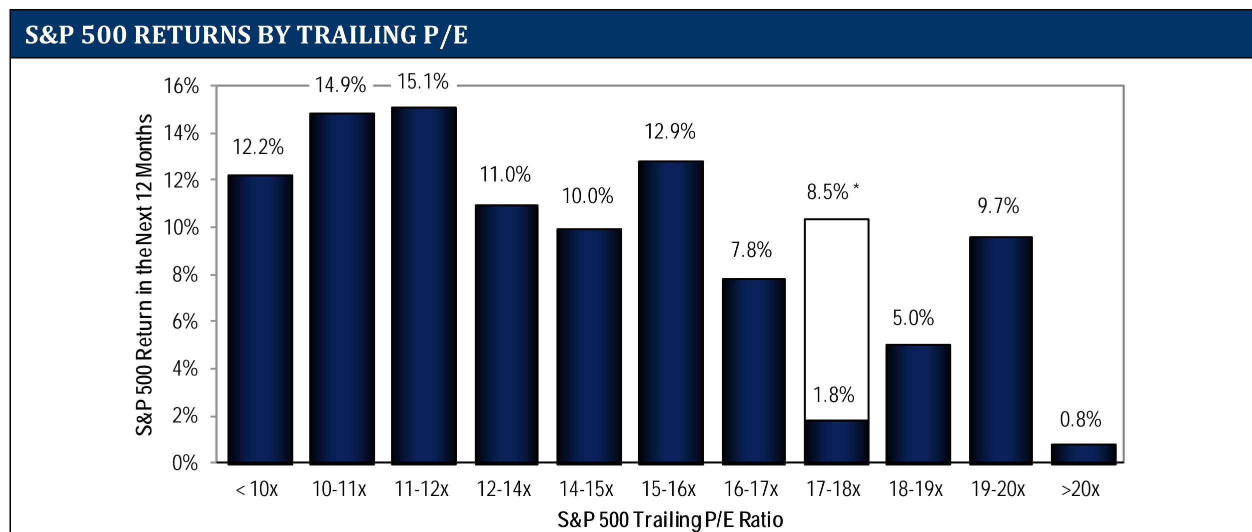


Source: FactSet

P/E MATTERS, BUT NOT MUCH

Perhaps the P/E ratio of the S&P 500 is a better metric to indicate what return to expect for the next twelve months. We have quarterly data on the S&P 500 P/E and returns going back to 1960. When we parse the data, there does seem to be some correlation between P/E and returns over the following twelve months. We generally see the highest returns when the market P/E is below 12x. When the S&P 500 starts with a P/E of 12x or less, the following year averaged a 13.4% return. When the S&P 500 P/E was between 12x and 16x, the returns were lower, but still average 11.2%. When the P/E is in the range of 16x to 20x, returns were lower still, but quite acceptable at 5.0% (or 7.6% excluding the significant impact of 2008). However, once the P/E ratio rises above 20x, the returns for the S&P 500 on average are just 0.8%.

S&P 500 RETURNS BY TRAILING P/E



Source: ISI; Lyrical analysis
* Adjusted to exclude 3Q07, 4Q07 and 1Q08

EXPECT 7-8%, BUT IT PROBABLY WON'T HAPPEN

The trailing P/E for the S&P 500 started the year at 17x. Given what we have observed in the past, an "average" return over the next year would be in the 7% to 8% range. However, it is highly unlikely we actually see a return in that range. Since 1960 we have seen the S&P 500 produce a 7-8% return only 2% of the time. Furthermore, we have observed a vast range of returns when the S&P 500 P/E is in the 16x to 20x P/E range that includes periods with returns greater than 45%, worse than -35%, and everything in between. The historical average may serve as a guide for setting expectations, but it is not a good forecasting tool.

CONCLUSION

To repeat: Our investment approach is based entirely on bottom up stock selection. We do not have a market view or macro view. In spite of this (or, as we believe, because of this), over the last five years we have produced investment results superior to all of our Large Cap, Mid Cap and All Cap Value peers. We have achieved this success with a disciplined, systematic, repeatable process. Furthermore, we achieve returns by investing, not trading. Cumulatively, we have turned over 91% of our portfolio over the past five years, while the average mutual fund turns over theirs 80-90% every single year. We believe we offer an investment proposition designed to endure for years and years to come.

Andrew Wellington,
Managing Partner
Chief Investment Officer

THIS IS NOT AN OFFERING OR THE SOLICITATION OF AN OFFER TO INVEST IN THE STRATEGY PRESENTED. ANY SUCH OFFERING CAN ONLY BE MADE FOLLOWING A ONE-ON-ONE PRESENTATION, AND ONLY TO QUALIFIED INVESTORS IN THOSE JURISDICTIONS WHERE PERMITTED BY LAW.

THERE IS NO GUARANTEE THAT THE INVESTMENT OBJECTIVE OF THE STRATEGY WILL BE ACHIEVED. RISKS OF AN INVESTMENT IN THIS STRATEGY INCLUDE, BUT ARE NOT LIMITED TO, THE RISKS OF INVESTING IN EQUITY SECURITIES GENERALLY, AND IN A VALUE INVESTING APPROACH, MORE SPECIFICALLY. MOREOVER, PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS AN INDICATOR OF FUTURE PERFORMANCE.

THE S&P 500 INDEX IS A MARKET CAPITALIZATION WEIGHTED INDEX COMPRISED OF 500 WIDELY-HELD COMMON STOCKS.

THE RUSSELL 1000 VALUE INDEX MEASURES THE PERFORMANCE OF THE LARGE-CAP VALUE SEGMENT OF THE U.S. EQUITY UNIVERSE. IT INCLUDES THOSE RUSSELL 1000 COMPANIES WITH LOWER PRICE-TO-BOOK RATIOS AND LOWER EXPECTED GROWTH VALUES. THE RUSSELL 1000 VALUE INDEX IS CONSTRUCTED TO PROVIDE A COMPREHENSIVE AND UNBIASED BAROMETER FOR THE LARGE-CAP VALUE SEGMENT. THE INDEX IS COMPLETELY RECONSTITUTED ANNUALLY TO ENSURE NEW AND GROWING EQUITIES ARE INCLUDED AND THAT THE REPRESENTED COMPANIES CONTINUE TO REFLECT VALUE CHARACTERISTICS.

ADDITIONAL INFORMATION REGARDING LAM –US VALUE EQUITY-CS:

PERFORMANCE FIGURES PRIOR TO AUGUST 2013 REFLECT THE MODEL, HYPOTHETICAL RESULTS FOR A HYPOTHETICAL PORTFOLIO PURSUING THE MARKET CAPITALIZATION WEIGHTED INVESTMENT GUIDELINES (THE "GUIDELINES") DESCRIBED BELOW, AND DO NOT REPRESENT RETURNS OF ACTUAL INVESTMENTS MADE. THERE ARE A VARIETY OF LIMITATIONS INHERENT IN MODEL RESULTS. TRANSACTION EXPENSES HAVE BEEN INCLUDED AT FIVE CENTS PER SHARE, TO REFLECT COMMISSIONS AND EXPECTED MARKET IMPACT. DIVIDENDS HAVE BEEN INCLUDED IN THE RETURNS. LAM'S CLIENTS HAD RESULTS THAT WERE MATERIALLY DIFFERENT FROM THOSE PORTRAYED IN THE MODEL.

MARKET CAPITALIZATION WEIGHTED INVESTMENT GUIDELINES

LAM'S ORIGINAL, U.S. VALUE EQUITY - EQ IS AN APPROXIMATELY 34 STOCK PORTFOLIO THAT IS EQUAL WEIGHTED AT COST TO TARGET 99% INVESTED WITH 1% CASH, HENCE APPROXIMATELY 2.9% PER POSITION. WE HAVE PICKED A BENCHMARK CAPITALIZATION LEVEL (THE "CAPITALIZATION BENCHMARK") EQUAL TO $11.2BN AS OF DECEMBER 31, 2013 AND EQUAL TO $11.2BN MULTIPLIED BY THE QUOTIENT DERIVED BY DIVIDING THE LEVEL OF THE S&P 500 INDEX® AT ALL OTHER TIMES BY 1,848.36 (THE CLOSING PRICE OF THAT INDEX ON DECEMBER 31, 2013).

TO REFLECT A PORTFOLIO THAT HAS GREATER LIQUIDITY, WE CREATED A MODEL PORTFOLIO WITH MODIFIED PORTFOLIO POSITION WEIGHTS.

- STOCKS WITH A MARKET CAPITALIZATION GREATER THAN THE CAPITALIZATION BENCHMARK HAVE BEEN MADE EQUAL WEIGHTED FULL POSITIONS.
- STOCKS WITH A MARKET CAPITALIZATION LESS THAN THE CAPITALIZATION BENCHMARK HAVE HAD THEIR POSITION WEIGHTS SCALED IN PROPORTION TO THEIR MARKET CAP.

FOR EXAMPLE, A STOCK WITH A $5.6BN MARKET CAPITALIZATION AS OF DECEMBER 31, 2013 WOULD HAVE BEEN GIVEN AN INITIAL PORTFOLIO WEIGHT OF 0.5X A FULL POSITION. A STOCK WITH A $3.4BN MARKET CAPITALIZATION AS OF DECEMBER 31, 2013 WOULD HAVE BEEN GIVEN AN INITIAL PORTFOLIO WEIGHT OF 0.3X A FULL POSITION.

WITH LESS CAPITAL ALLOCATED TO THE LESS LIQUID STOCKS, WE HAVE GROSSED UP THE SIZE OF A FULL POSITION FROM THE CURRENT 2.9% IN THE EQUAL WEIGHTED ORIGINAL PORTFOLIO TO APPROXIMATELY 3.8% IN THE HYPOTHETICAL MARKET CAPITALIZATION WEIGHTED PORTFOLIO, TO ACHIEVE A MODEL PORTFOLIO WITH 99% INVESTED IN STOCKS AND 1% CASH.

PERFORMANCE ESTIMATION METHODOLOGY

TO ESTIMATE THE HISTORICAL PERFORMANCE OF THE US VALUE EQUITY–CS, MARKET CAPITALIZATION WEIGHTED PORTFOLIO, WE APPLIED THE METHODOLOGY DESCRIBED ABOVE TO THE STOCKS IN OUR ORIGINAL US VALUE EQUITY-EQ PORTFOLIO OF DECEMBER 31, 2008.

WE MODELED THAT ALL PURCHASES OF NEW HOLDINGS AND EXITS FROM EXISTING HOLDINGS THAT TOOK PLACE DURING A MONTH IN OUR ACTUAL PORTFOLIOS TOOK PLACE AS OF THE END OF THAT MONTH IN THE BACKTEST MODEL.

IN MONTHS WHERE CASH WAS NEEDED BECAUSE THE SIZE OF THE PURCHASED STOCK EXCEEDED THE PROCEEDS FROM THE STOCK SOLD, WE MODELED THAT WE TRIMMED THE LARGEST POSITION (AT MARKET) IN THE PORTFOLIO TO GENERATE ENOUGH CASH TO COVER THE DIFFERENCE.

IN MONTHS WHERE THE CASH POSITION ROSE TO LEVELS ABOVE 1% WE DID NOT REINVEST THE EXTRA CASH.

THESE MODEL RESULTS ARE UNAUDITED AND SUBJECT TO REVISION AND SHOW ALL PERIODS BEGINNING WITH THE FIRST FULL MONTH IN WHICH THE ADVISOR MANAGED ITS FIRST FEE-PAYING ACCOUNT. HYPOTHETICAL NET RETURNS INCLUDE A 1.25% BASE FEE.