CORAL GABLES
TRUST

"ON MY WHITE BOARD" – A QUARTERLY DISCUSSION WITH CHIEF INVESTMENT OFFICER AL BHATT Q4 2012

HOSTED BY MANAGING DIRECTOR, CHIEF WEALTH OFFICER JOHN HARRIS

John Harris ("JH"): The New Year has certainly started with a positive tone across asset classes. How does the Investment Committee view current market environs and have there been any changes to asset allocation since our Q3 2012 conversation?

Al Bhatt ("AB"): Yes, indeed the markets in a broad context are off to a nice start in the New Year, John. Underpinning this rally is the fact that a major uncertainty is now off the table: Congress and the President reached a "Fiscal Cliff Agreement" at the turn of the calendar year. This, in our opinion, eliminated the possibility of a US recession induced by the full potential impact of the Fiscal Cliff. As a result, this month the Investment Committee approved an increase in the equity allocation within our Balanced Model to 55% from 50% at year end. While the recession scenario has been removed, the remaining drag from the aforementioned agreement is likely in the range of 1.0%-1.5%, so US growth in the New Year will still face material headwinds, as outlined in both our Q3 2012 discussion and note on the Fiscal Cliff. Moreover, given that several issues remain unresolved, including but not limited to, the debt ceiling, entitlement reform and the sequester, we expect continued policy-related uncertainty to drive market volatility in months ahead.

JH: There has been much discussion in the financial press regarding improvements in housing. Have we finally reached an inflection point in housing such that it can be a sustained tailwind for the US economy and the broader equity markets?

AB: In general, the housing market is improving and should be expected to be a positive contributor to the ongoing recovery; however, again our expectations are cautious if not muted. Increased residential investment did account for 16% of the growth in real US GDP in the first three quarters of 2012. Moreover, the inventory of unsold new homes is currently at a historic low. Lastly, housing prices appear to have finally bottomed in most of the major cities across the US. What tempers our forward looking expectations are the following: (1) large overhang of vacant properties; (2) resale activity has been driven by speculators, offshore residents and investors and (3) the mortgage application purchase index has not moved materially higher from its lows.

JH: More broadly, what is the state of the US economic recovery and what drivers are the Investment Committee members following most closely in assessing both the recovery and markets?

AB: As we stated above, the "stroke of midnight" agreement on the Fiscal Cliff package does take the US recession scenario off the table in our opinion. Moreover, despite the residual drag that will likely be a result of this agreement, we do see positive return drivers for the economic recovery:

- US consumer confidence continues to be surprisingly supportive of the recovery as the household savings rate has decreased concurrently with the improving labor market. For example, recent trends in retail sales and household net worth indicate that private consumption may increase to a 4% annual rate during 2013. Given the US consumer is approximately 70% of the economy, this would translate to 2.8% GDP growth during the year. Though this is not our base case scenario, it does provide some basis for upside.
- Auto sales in the US continue to improve since the 2009 recession lows, despite the fact that population-adjusted car sales remain well below historical norms. Moreover, the median age of the US car on the road is significantly higher than longer term averages; hence, we believe that there remains considerable pent up demand for new car purchases in 2013.
- Corporate spending should be expected to improve in 2013, given that the Fiscal Cliff agreement has been realized and some policy uncertainty removed. Moreover, the anemic pace of capital expenditures since the 2009 lows has barely equaled the rate of capital depreciation during this time period. Thus, the capital stock may be best characterized as relatively depleted and in need of new investment. Without such investment, medium and longer term profitability would be expected to be reduced dramatically.

JH: During our Q3 2012 discussion, you outlined the positive effects of the European Central Bank's Outright Monetary Transactions ("OMT"); however, at the same time, you outlined the continued headwinds arising out of the Euro zone crisis. What is the current assessment of this region's financial woes, and how does it impact your current macroeconomic viewpoint and portfolio construction?

AB: Clearly, there has been progress in reducing, if not eliminating, the probability of a dramatic market drawdown arising from a failure in the region's banking system, given the announcement of the OMT (or, what may be best characterized as essentially unlimited potential financing of the region's banks). Nonetheless, we are very cognizant of the fact that the banking system in the region remains seriously under-capitalized. As a result, credit expansion for the foreseeable future should be expected to be very restrained thereby continuing to dampen near to medium term growth prospects within the region.

In addition, the sovereign debt crisis in the Euro zone is far from resolved in our opinion, and there is no clear pathway linking the unified monetary union of these 17 nations to that of a single fiscal authority. At the same time, we acknowledge that significant fiscal adjustment has already taken place in the periphery. Moreover, while there is much more required in this regard, there is clear commitment across the region to prevent any more defaults. Perhaps most constructive to us is that the divergence in competitiveness across the region is beginning to somewhat dissipate. Specifically, the unit labor cost gap of member countries relative to Germany is, in general, beginning to close. We do believe that there is a bottoming process in terms of equity prices and recent leading economic indicators do, in fact, point to broader, economic stabilization for the region beginning in

2013. The bottom line key metric is longer term growth and that remains the largest issue in our mind as we consider the attractiveness of risk exposures of investments.

Importantly, equity prices already reflect the challenging state of the region, and we believe that the outlook demands exceptionally strong stock picking skills to identify sources of strong, long term returns. With such equity management skills, a well constructed portfolio of European equities may produce compelling risk-adjusted returns relative to US equities given the following drivers:

- As we have already stated, the ECB's OMT has removed "tail risk" from the region; moreover we do expect that the contractionary environment will moderate during the year ahead. The region may actually see a modest recovery beginning as early as 2014.
- We view the continued negative investor sentiment for the region as a clear bullish, contrarian signal. Sentiment is likely to remain bearish and the institutional ownership of European equities will continue to be well below historical averages.
- As we discussed during our Q3 2012 letter, US earnings are undergoing a deceleration; however, we expect that Euro zone equities may actually accelerate as the region emerges from its recessionary state, and the ECB maintains a very accommodative posture.
- Lastly, it is clear that European governments have loosened the fiscal austerity reins as fiscal deficits are now the benchmarks for most countries in the region.

Given the above, we have increased our international equity exposure from 3.0% to 12.0% in our Balanced Model. Below, we will detail some of the new active managers that we believe will be able to benefit from the investment landscape in the region given their proven stock picking skills.

JH: Similar to Europe being a source of macro headwind, during our Q3 2012 discussion you addressed growth concerns in China and the resulting effects on global growth. Any update there?

AB: We have never been in the "hard landing" camp regarding China's growth prospects. Moreover, it should not have surprised market participants of the slowing in the growth rate of China of late given the policy tightening during 2010-2011 along with the torrid housing market cooling down. Despite the observed slowing in China, it is clear that the economy will not be subject to either a hard landing or even a material step down in growth given our review of recent measures of economic activity. For example, the purchasing managers' index has moved higher recently. This, and the recent positive change in leadership, provides us with evidence that growth in China should be in the range of 7%-8% and be a positive factor within global capital markets.

JH: It seems that the Investment Committee may be more constructive on risk assets as the various markets around the world continue to benefit not only from Central Bank postures but also improving economic growth prospects. Does this imply you are reducing duration (interest rate risk) in the New Year? Should we expect some major changes within fixed income portfolios?

AB: In our Q3 2012 conversation, we pointed to the key points underpinning our stance on fixed income positioning and managing interest rate risk:

- Given continued high unemployment and a persistently low capacity utilization rate, we expect very little upward wage pressure thus overall inflation pressure will be quite benign.
- We will remain in a zero-low interest rate environment for some time given the stated and actual policy measures taken by the FED as well as Central Banks globally.

There has been no material change in either guidepost; hence, there is no material change in our overall fixed income view in regards to managing duration (interest rate risk) within our fixed income portfolios. We are very well aware that ultimately interest rates will rise, but at the same time we do not believe that they will rise unexpectedly in the near to medium term.

It is important to note some very interesting historical market performance data as well: During the last period of sustained interest rate increases from April 30, 2004 – June 30, 2006, there were a total of 17 interest rate hikes of 25 basis points (or, 0.25%) each by the FED. Perhaps many investors would be surprised – no shocked – to learn that the major bond indices produced **POSITIVE** returns over this period: the US 5-10 year Treasury Index produced a 4.5% return, and the Barclays Aggregate Bond Index returned 6.1% over this time period. Assuming an active manager who demonstrated measurable skill over this time period (that is, such a manager produced returns in excess of these common fixed income benchmarks by successfully trading and re-investing the portfolio in higher interest rate instruments over the period), an investor's actual return could have been potentially higher! And, this was in the face of a *considerable rising rate environment!*

Lastly, we have introduced two new sub-strategy allocations within fixed income and added new active managers within these mandates given our research, which we will discuss below.

JH: Before we conclude Al, you have mentioned an increase in the international equity exposure within the Balanced Model and have now just indicated new sub-strategy allocations within fixed income. Perhaps, you could briefly characterize a few of the new active managers that clients will be seeing in their portfolio accounts in the New Year.

AB: Sure, John. Within our increased international equity exposure, we are quite enthusiastic about the active managers that we are currently adding to Balanced Model portfolios. Each has a long term, successful track record investing in international equities. Moreover, we believe each not only is well positioned given our top down views on global equity markets but also complements one another within a portfolio construction setting. In brief, we have added:

BMO Pyrford International Stock Fund: Pyrford's investment philosophy is based on a value-driven, absolute return approach. At the stock level, the investment manager identifies companies that are fairly valued or undervalued in relation to their potential long-term earnings growth, while at the country level the investment manager seeks to heavily overweight countries that provide good value relative to their long-term prospects and underweight or avoid countries that do not.

Harbor International Fund: The investment manager typically invests in a minimum of ten countries throughout the world at a time, and focuses on companies located in Europe, the Pacific Basin, and emerging industrialized nations whose economies and political regimes appear stable. Harbor invests primarily (no less than 65% of its total assets) in common and preferred stocks of foreign companies, including those located in emerging market countries.

IVA International Fund: IVA seeks long-term growth of capital by investing in a range of securities and asset classes from markets around the world. Over the short-term (12-18 months), the Fund's attempt is to preserve capital while over the longer-term (5-10 years, i.e., over a full economic cycle), the investment manager seeks to outperform the Fund's benchmark. IVA employs a value oriented approach and will seek investments in companies of any size that typically have one or more of the following characteristics: financial strength, temporarily depressed earnings or entrenched franchises. IVA pays particular attention to their emphasis on establishing an "intrinsic value" and a "margin of safety."

During our Q3 2012 conversation, we discussed both bank loans and Emerging Market debt. We believe both sub-strategies will be additive to the overall portfolio construction of the Balanced Model. At year end 2012, the Investment Committee approved an allocation of 5% to bank loans and 7.5% to Global Bonds/Emerging Markets. Below is a brief summary of the active managers that we have chosen based upon proven track records in their respective fixed income mandates:

Bank Loans

Eaton Vance Floating Rate Advantage Fund: The investment manager invests broadly across the floating rate loan market, providing diversified exposure to the asset class. The Fund is expected to provide exposure to the loan market's many sectors, credit tiers and issuers. The Fund may employ leverage for the purpose of acquiring additional income-producing investments, which may increase risk and return potential.

Ridgeworth Seix Floating Rate Fund: The Seix Floating Rate strategy seeks to provide a high level of current income by investing primarily in first and second lien senior floating rate loans and other floating rate debt securities.

Global Bonds/Emerging Markets

Doubleline EM Fixed Income: The Emerging Markets Fixed Income team has been investing in the asset class since 1994. The team successfully provided a broad spectrum of customized strategies constructed from the Investment Grade to Below-Investment Grade offerings of the asset class. The EM investable universe includes Sovereign bonds, Corporate bonds, Local Currency bonds, Distressed debt, Convertible bonds, and Structured Finance. The team's bottom-up research process emphasizes global and multi-sector diversification to generate attractive risk-adjusted returns from income and capital appreciation.

TCW EM Local Currency Income Fund: The Fund's investment objective is to seek to provide high total return from current income and capital appreciation, through investment in debt securities denominated in the local currency of various Emerging Market countries. The Fund will invest (except when maintaining a temporary defensive position) at least 80% of the value of its net assets in debt securities issued or guaranteed by non-financial companies, financial institutions and government entities in Emerging Market countries denominated in the local currency of the issuer, and in derivative instruments that provide investment exposure to such securities.

Templeton Global Bond Fund: The investment manager seeks current income with capital appreciation and growth of income. The Fund normally invests at least 80% of net assets in bonds, including debt securities of any maturity, such as bonds, notes, bills and debentures. It may invest up to 25% of total assets in bonds that are rated below investment grade. It invests predominantly in bonds issued by governments and government agencies located around the world, including inflation-indexed securities. The Fund is non-diversified.

JH: Thanks, Al. I realize that there have been various manager redemptions as well this month. The rationale for these manager changes, as well as some of the other new active managers that we have been introducing into client portfolios, will be further detailed as we meet in person with each client over the coming weeks. We certainly look forward to further detailing our recent portfolio changes in the context of your particular trust and investment objectives.

Well, this serves to conclude our year end 2012 Quarterly Letter, and our kick off of the New Year. As always, we look forward to further discussing your portfolio with you. We thank you for the opportunity to be a steward of your capital and look forward to reviewing your portfolio soon.

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