"ON MY WHITE BOARD" – A QUARTERLY DISCUSSION WITH CHIEF INVESTMENT OFFICER AL BHATT Q3 2012

HOSTED BY MANAGING DIRECTOR, CHIEF WEALTH OFFICER JOHN HARRIS

I would like to welcome you to our new quarterly letter format in which we hope to convey our thoughts and views on global capital markets, developments that may likely affect your portfolio and areas of current investment research by our team. We are launching this new format in conjunction with the arrival of our new Chief Investment Officer, Al Bhatt. I will point you to our website www.cgtrust.com for both a press release of Al joining our team as well as a summary of his professional background. If you are an existing client, then you also have received a letter from the Chairman of our Board, Jim Davidson, introducing Al as our newest team member.

The letter, as you will see below, follows a Q&A format based upon "top of mind" research areas on the white board in Al's office; moreover, what we hope to achieve is to make the dialog captured in these letters a narrative that would take place if you were actually in his office discussing markets and investment portfolios. In an era of the Internet and data overload, we hope to synthesize for you the most pressing topics and factors that may be affecting your portfolio. Thus, it seemed the best place to start would be examining the white board of our Chief Investment Officer! Let's begin.

John Harris ("JH"): Al, welcome to Coral Gables Trust and this inaugural edition of "On My White Board." Before we start discussing markets, could you summarize for us your investment philosophy and portfolio management style?

Al Bhatt ("AB"): First of all, thanks John. I am very excited to join the firm and the wonderful professionals who make up a world class team! The values of passionate client-focus, dedication to the highest level of integrity and superior transparency are essential characteristics of a successful trust and wealth management company, and the team is clearly committed to each of these. I look forward to contributing to continued success as Chief Investment Officer.

In summary, my investment philosophy is a byproduct of my training as an economist and my professional experience across direct investing and building institutional-quality, multi-manager portfolio solutions for investors. Specifically, I believe asset allocation should tightly integrate both one's top down, macroeconomic views and a particular client's investment objectives. Thus, the analysis of stocks versus bonds, for example, needs to also be viewed through the lens of an investor's needs for (1) preservation of capital; (2) growth of capital; and (3) preservation of purchasing power. Ultimately, a portfolio should meet a client's particular objectives!

These defining objectives then serve to dictate how we use manager selection to generate what I would term "meaningful risk-adjusted returns" from a portfolio. Simply, this means that we need to be cognizant of (1) client objectives; (2) the given opportunity sets as dictated by global markets; and (3) the relevant benchmarks in constructing client portfolios. Moreover, risk management is critical in this process in that portfolio construction should focus on finding well compensated risk exposures while at the same time mitigating, if not eliminating, sources of uncompensated risk. The former allows us to produce returns in excess of risk free rates while the latter has the potential to impair the value of investor principal, detracting from our efforts in meeting client objectives.

Lastly, I have focused on open architecture-based manager selection throughout my career. I believe this is required to provide clients the most compelling palette of managers. In the process, transparency, liquidity and valuation are all parameters that are weighed quite heavily in not only selecting particular managers, but also in sizing of manager allocations within a client portfolio.

JH: That is a helpful overview Al and, of course, very consistent with the investment philosophy of the Investment Committee of Coral Gables Trust chaired by Will Wheeler. Let's shift gears to the markets. Despite the sluggish global economic recovery, signs that the European recession may in fact be deepening, and heightened concerns regarding Chinese/Asian growth, broad markets performed quite well during Q3. What drove this seemingly paradoxical quarter?

AB: You are correct, John – the markets, in particular risk assets such as non-US equities, Emerging Market fixed income and commodities, enjoyed a very strong Q3. The table below summarizes returns across a variety of asset class exposures:

	Q3 2012	YTD
Gold	11.1%	16.0%
Commodities	9.7%	5.6%
Non-US Small Cap	7.9%	13.6%
EM Equities	7.9%	12.3%
Non-US Dev Equities	7.0%	10.6%
EM Bonds	6.8%	14.7%
US Large Cap	6.4%	16.4%
HY Bonds	4.6%	12.0%
US Corporate Bonds	3.5%	8.2%
IG Bonds	1.6%	4.0%
US T Bonds	0.6%	2.1%

The primary driver of market returns was continued accommodative Central Bank policy commonly referred to as Quantitative Easing ("QE"), both here in the US as well as abroad. The Federal

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Reserve Bank ("FED") extended its Operation Twist (in which it sells short term Treasuries and buys longer dated bonds) beyond its initial terminal date, and the timeline for a potential FED interest rate hike was extended into mid-2015. However, the major FED move was the new commitment to purchase $40 billion of agency mortgage backed securities every month as long as unemployment was deemed to be too high. The objectives of QE are as follows:

- Lower interest rates to spur investment and lending.
- Bolster the housing market by reducing mortgage rates and increase cash available for the consumer by stimulating refinancing.
- Increase demand for higher yielding assets in order to lower the cost of borrowing for businesses, which in turn should stimulate business investment.
- Reduce the interest expense for the US Treasury on outstanding debt.
- Weaken the dollar to boost US exports.
- Send a signal to market participants that the FED will continue to support fragile capital markets in the face of various macroeconomic headwinds and "landmines."

The actions by the FED were met by similar, significant Central Bank actions abroad. In Europe, the European Central Bank ("ECB") announced its Outright Monetary Transactions ("OMT") programs to buy government bonds with maturities of three years or less. This newest program offered by the ECB essentially transforms the institution from a *secured* lender of last resort for the *European banking system* into an *unsecured* lender of last resort for *sovereign nations*. As a result, OMT should not only bring down borrowing costs in the region, but also serve to effectively remove the "tail risk" fear that the Euro zone crisis may lead to a global markets catastrophe.

Also during Q3, the Bank of England revealed a plan to increase their bond purchases by 50 billion pounds, a figure widely believed to be open for upward adjustment in coming months. In Asia, Central Banks made similar accommodative moves: The Bank of Japan announced $126 billion of additional bond purchases in an effort to keep its fragile economy reflating. Lastly, at the end of Q3, market participants were focused on wide spread rumors that the Chinese government was contemplating various simulative measures to counter concerns that the growth rate was subject to a precipitous decrease.

JH: How do these developments affect the cautious posture on asset allocation the Investment Committee has had during most of the year?

AB: We are well aware of the continued "push/pull phenomenon" being experienced in global markets. That is, Central Bank-infused liquidity (as detailed above, for example) has served as a propellant for risk assets. At the same time, various well known macroeconomic headwinds have served to pull back (at times) broad equity markets and the global recovery continues to be anemic at best, relative to prior post-recessionary periods. Of greatest concern is the Euro zone debt crisis;

However, continued challenges for the US consumer, lingering concerns arising from the regulatory and political "overhang," and rising concerns of marked slower growth in China/Asia also combine to dampen enthusiasm for one's risk appetite. Hence, we remain cautious and have recently re-affirmed our Balanced Model's allocation of 50% equities, 45% bonds and 5% cash.

JH: Looking at the US, it does seem that economic data continues to be mixed as unemployment did finally drop below 8%, recent consumer sentiment data is somewhat promising, and there is growing consensus that housing has finally bottomed. Is there a light at the end of the tunnel?

AB: Well John, sometimes the light at the end of the tunnel is an incoming train! Not to be a cynic, but we still have several pockets of concern regarding our sluggish economy which, in turn, affects our views regarding the equity and bond markets in the US. The US consumer has been quite resilient since the "Great Recession"; however, there is still quite a bit of deleveraging to go and the negative wealth effect of the housing implosion will have long dated adverse affects on spending. Moreover, consumption has also been muted due to continued high unemployment and meager wage appreciation. Given that the US consumer is approximately 70% of our GDP, this will continue to dampen what has been anemic growth during this recovery. The economy grew at an annualized rate of only 1.3% during Q2, and a rate of 2% during Q3. It is important to note that during Q3, there was a 0.6% boost in defense procurements (a temporary increase), and while consumption grew at 2%, real disposable income increased by only 0.8% during the quarter.

Perhaps of most import, however, regarding future US GDP is the impending "Fiscal Cliff," or series of legislative measures and tax relief that may expire at year end. The outcome of the elections will likely lead to the lame duck session of Congress "kicking the can down the road" to March 2013 when the debt ceiling must be re-addressed. Failure to extend such measures may lead to a loss of US economic growth of anywhere from 1.5% to almost 4%. Given expectations for continued anemic growth of approximately 2%, such a failure by Washington, DC could push the US into a recession some time during the first half of 2013. We do not believe that equity markets currently price in such a recession in the US, and recent volatility in markets does not surprise us.

JH: US equity markets have enjoyed fairly strong returns year to date as Large Cap stocks realized 6.4% during Q3 and 16.4% year to date, Mid Cap stocks 5.6% during Q3 and 14% year to date and Small Cap stocks 5.3% during Q3 and 14.2% year to date. Why not increase equity allocations?

AB: As we discussed earlier, we believe asset prices have benefited from, in large part, Central Bank-infused liquidity into markets. This is a "technical driver" of asset prices that has indeed been quite favorable; however, from a bottom up, fundamental point of view, it is difficult to gain a high level conviction of continued double digit returns for US equities. This is based on a few observations on fundamental valuation and expectations going forward:

- Operating margins are at historical highs for US companies, and it was margin expansion that was the primary driver of equity prices not multiple expansion.
- Recent CEO guidance may best be characterized as quite tempered if not weak. Some large cap companies have already announced layoffs and deep cost costs, where possible.
- US companies are very lean such that additional cost cutting measures will be difficult to attain. Given the headwinds created by reduced demand due to the European recession, the strength of the dollar and slowing Emerging Market growth, US companies will realize continued pressure to achieve EPS growth that is priced into equity markets.
- Companies are beating Q3 EPS; however, it is important to note that these are significantly reduced earnings expectations. Excluding the Financials, corporate profits have *decreased* approximately 3.1% from a year ago. Moreover, only 41% of companies have beaten revenue estimates, far below the average of 56% realized during the past four quarters.
- Forward looking analyst expectations remain too high (Q4 expectations are for an increase of 10% and 2013 EPS is expected to increase by 17% by the Street) and will need to be lowered given continued softening in top line revenue growth and operating margins.

Given the above, as well as stated concerns on the health of the consumer and lingering overhang of government regulatory and tax uncertainties, we would expect equities to produce single digit returns going forward.

JH: Any major changes in your views on interest rates, inflation and fixed income allocations?

AB: Despite the continued business media focus on the impending bursting of the "bond bubble," we continue to maintain our posture regarding our fixed income allocations. This is based on two fundamental points of view:

- 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.

Thus, we do not expect any changes in our posture towards duration and inflation rate sensitivities. Corporate balance sheets remain quite healthy and both investment grade and high yield issuers at the larger capitalization size have been able to access the market. While the absolute level of rates are low, relative spreads remain attractive (both investment grade and high yield spreads are actually *higher than pre-Lehman levels*) given our top down macroeconomic view and serve to add compelling risk-adjusted yield to portfolios in a challenging zero-low interest rate environment.

JH: Perhaps, before we close this conversation, it might be helpful to outline some of the ongoing research that is on your office's White Board. What are some of the specific areas of interest?

AB: We have a very robust research pipeline here at CGTC, as you know John. Despite an environment that is defined by well known macroeconomic headwinds and landmines, we believe there are potentially compelling attractive risk-adjusted returns across a variety of strategies. For example, despite the ongoing weakness and concerns regarding Chinese/Asian growth, we are researching the role for Emerging Market equities given a longer term theme based upon:

- Significantly better monetary and fiscal "houses" in the Emerging Markets
- Increased opportunity for P/E multiple expansion
- Improving business environments, private property laws and capital markets
- Compelling demographics
- Favorable currency dynamics

Of course, the downside risks are readily apparent in Emerging Market equities; however, the longer term growth opportunities may translate to increased relative return versus developed market equities. In the same vein, European equities have been broadly beaten down into interesting valuations across various regions and sectors; however, given continued uncertainty regarding the Euro zone debt crisis, it is unlikely that a near term tactical increase in such equities is prudent risk management. US Large Cap stocks continue to be the most attractive, risk-adjusted return segment in our view, and we have re-affirmed this view at our most recent Investment Committee meeting.

In terms of fixed income, two areas of current research interest include bank loans and Emerging Market debt. Senior, floating-rate bank loans are variable rate, senior secured debt instruments that are issued by non-investment grade corporations. The appeal of these types of instruments is twofold:

- Senior bank debt sits on the top of a corporation's capital structure; hence they are the most senior claim and are collateralized by the underlying equipment, real estate and accounts receivables. This provides downside protection for the principal investment.
- These instruments adjust the interest rate paid every 30 to 90 days.

Currently, bank debt offers a yield of approximately 5.8%-6.0%, which is about 35 to 40 bps less than High Yield investments; however, bank loans are actually senior to High Yield and have a lower average default rate (3% versus 4.75%). Lastly, given the floating rate component, once interest rates do in fact begin to rise, bank loan yields will rise in concert. It is important to stress, nonetheless, that there is credit risk from such instruments and at times, underlying liquidity may be of concern. We will share our findings with you in more detail, should we add this exposure.

Lastly, Emerging Market debt is another area of research given the factors outlined above for the Emerging Market equity thesis. To be more specific, Emerging Market countries have enjoyed a broad, "credit upgrade" over the last several years. As a result, both Emerging Market bonds of sovereign and corporate issuers have produced very compelling risk-adjusted returns in recent years.

In addition, Emerging Debt is available both in US Dollar terms (known as "External Debt") and Local Currency terms. The latter exposure may also prove to be an attractive way to hedge an investor's concerns that "all the money printing here in the US" will ultimately serve to debase the Greenback versus other currencies, in particular the currencies of Emerging Asia. We expect to share our continued research with you in coming months.

JH: Thanks, Al. Clearly, you are not only focused on current managers and strategies, but equally seeking new investment ideas as well. We all look forward to future developments on the research agenda and hope to discuss any actual implementations with you in future "On My White Boards."

This serves to conclude our newly re-launched Quarterly Letter. We actively seek your thoughts and feedback on this new format. Our goal is to provide you a firsthand look into the points of view of our Chief Investment Officer and his research agenda. We thank you for the opportunity to be a steward of your capital and look forward to reviewing your portfolio soon.

Sincerely,

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