Stocks had another good year in 2013 with the S & P 500 climbing 32% while the MSCI All Countries was up 23.4%. After such a great performance, combined with the S&P 500 returning 16% in 2012, you are probably wondering if there is anything left for 2014. As I have stated many times, I cannot predict short term stock market movements but I will list why the outlook for stocks still seems favorable:

1. Even with a total recovery from the Great Recession and the Tech Bubble imploding in 2000, stocks only recently set a record high after inflation adjustments. In other words, stocks are still about the same level as they were 14 years ago.
2. Valuation levels for stocks are still modest. In the U.S., stocks are selling about 15 times their projected 2014 earnings (assuming about 10% earnings growth) compared to an historical average of 16.5X. In periods of low interest rates/ low inflation the historical P/E (price/earnings) has averaged 18X. One could make a case that stocks still have 20% appreciation potential to reach a fair price.
3. Economic activity worldwide seems to be picking up, particularly in the U.S.
4. Since 1950, there have been 11 years that the S&P 500 had 25% plus gains. After each of those 11 years, with the exception of two recessionary years in 1981 and 1990, the S&P 500 posted positive results the following year, with an average gain of 16%. At this point, 2014 does not project to be a recession year.

Having painted a bullish scenario, what could make 2014 a more difficult year? Although not likely, a strong rise rather than a moderate rise in interest rates would be bearish. Probably this would occur only if inflation picks up substantially, which does not seem likely at this point. An economic/geopolitical shock outside the U.S. such as a widespread war in the Middle East or a debt/loan crisis in China could also cause stocks to pause or weaken. Since we cannot predict, I remain comfortable continuing to hold stocks for the long term which coincides with your investment time horizon. My disposition is based on the moderate valuation level for stocks and the lack of opportunity in fixed income (bonds and money market). However, we have had a good run and <u>markets could consolidate in the short term.</u>

In this environment we have had more stock successes than disappointments and I would like to comment on stocks in a few industry groups. <u>Retailers</u> have made the news on suffering from 50% mark down sales and the onslaught of Amazon. We have had good success investing in retailers…we have focused on companies whose products are difficult for Amazon to sell. We have also concentrated on companies that are expanding abroad with their differentiated products. Names that we have used include Apple, BMW, Daimler (Mercedes), LVMH, VF Corp (Northface, Timberland, etc.), Starbucks, Hanesbrands, Nordstrom, and Dick's Sporting Goods. Occasionally, we have invested in run of the mill retailers when their stock price has declined significantly due to an earnings disappointment. An example would be Express where we were able to achieve a 100% return in the course of a year.

Airlines are another interesting group, as many investors have had a negative bias towards them because of their historical bad earnings performance. We bought UAL (United) and in some cases, Delta, as we perceived that airline fundamentals were changing for the better. The main thesis is that airlines have merged, reducing the number of competitors while remaining airlines have stressed keeping costs in line and moderating capacity. This lesson was learned through many bankruptcies when expanding for the sake of growth was the predominant motivation of airlines. Now, with oil prices moderating we are benefiting from the upswing in airline stock prices. I will have to pick an exit point as much of the industry improvement is reflected in their stock prices.

We have also tried to exploit the monetization of the internet advertising. I lament not pulling the trigger on Facebook when it went down to about $13. However, we do have positions in beneficiaries of this trend including Google, Expedia, and Tripadvisor.

Although I am a global investor I have for the most part shifted away from International markets the last few years as we have been about 80% invested in the U.S. Most foreign markets trailed the U.S again last year. Japan in U.S dollar terms returned about as much as the U.S emerging markets continued to lose ground as we mentioned previously in other letters.

I have added marginally to our European and Emerging Market holdings of late, however, I am not a fan of Japan or most of its companies. I believe that Japan faces huge economic problems and I am skeptical of the potential success of Abenomics. Although there has been progress, most Japanese companies are not managed to maximize profit for stockholders.

Thank you for your continued business with French Broad Global and your trust in us. Although we have had good markets, investing is a very difficult endeavor. I will contact you soon, as I would like to meet with you more often than we have the past few years. I believe that a face to face meeting twice a year is beneficial from a communication standpoint.

Best Wishes,

Daniel Jacobs, CFA