PCA PERSPECTIVES

Permit Capital Advisors' Thoughts on the Investing Landscape

It has been almost two years since European Central Bank president Mario Draghi channeled Malcom X and his "by any means necessary" declaration (with an original nod to Jean-Paul Sartre) with his announcement that he would do "whatever it takes" to save the euro. We believe Draghi's intervention represented a turning point in the Eurozone's battle to maintain its common currency, as evidenced by the extent to which borrowing costs of the peripheral countries have since fallen. While there are still significant underlying economic and political problems that rest outside of ECB control, the hemorrhaging has been halted. Interestingly the more acute issues have moved to the core of the continent, as problems in Italy and France continue to fester, with both countries facing double-digit unemployment and triple-digit debt-to-GDP levels. The good news is that both countries have recently appointed promising new prime ministers with liberal economic views.

Regardless of these political developments, the region is still certainly vulnerable to a significant external shock. This could be delivered by further movement of Russian forces into Eastern Ukraine, and the resulting economic sanctions that the EU would be forced to impose. While we don't ignore these risks, we also make an attempt to keep them from taking a stranglehold on our investment decisions. We have seen the damage done in recent years to investors who got bogged down in macroeconomic and geopolitical concerns – as fear of not only the euro crisis, but also the fiscal cliff, debt ceiling, Chinese growth, and assorted other issues have kept many retail and institutional portfolios severely underinvested relative to their strategic targets.

As of March 31, 2014

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	1.8	1.8	21.9	21.2
Russell 2000	Small Cap Equities	1.1	1.1	24.9	24.3
Russell 3000 Growth	US Growth Equities	1.1	1.1	23.5	21.9
Russell 3000 Value	US Value Equities	2.9	2.9	21.7	21.9

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

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INTERNATIONAL EQUITY					
MSCI World exUS GR	Global ex US Equities	0.9	0.9	17.0	16.4
MSCI EAFE GR	Developed ex US Equities	0.8	0.8	18.1	16.6
MSCI Europe GR	European Equities	2.2	2.2	25.2	18.2
MSCI Japan GR	Japanese Equities	-5.5	-5.5	7.8	10.5
MSCI EM GR	Emerging Mrkts Equities	-0.4	-0.4	-1.1	14.8

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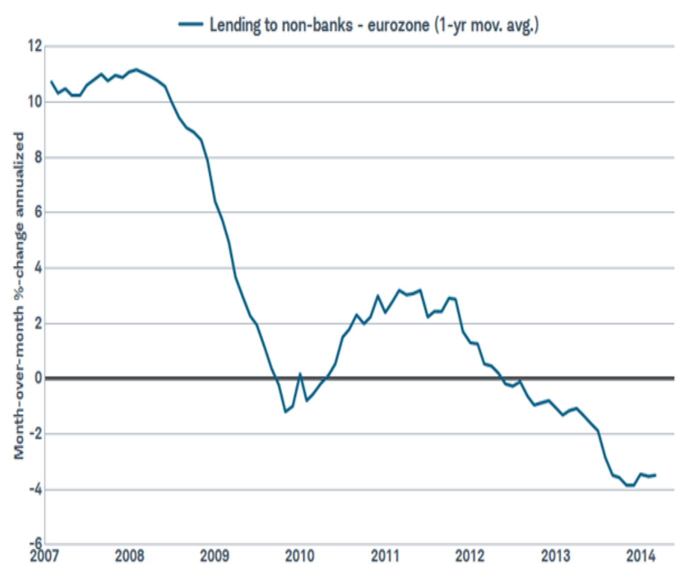
Howard Marks, Chairman of Oaktree Capital Management who is known in the investment community for "memos to Oaktree clients", recently wrote in one of his missives about the difficulties that accompany an investment strategy crafted in the face of fear. Marks stated that, "Most great investments begin in discomfort. The things that most people feel good about – investments where the underlying premise is widely accepted, the recent performance has been positive and the outlook is rosy – are unlikely to be available at bargain prices. Rather, bargains are usually found among things that are controversial, that people are pessimistic about, and that have been performing badly of late." Where supported by fundamentals, we like finding such investment opportunities, and recognize that this strategy is built for long-term success rather than quarterly victories defined by low tracking error. Today, we believe that investing in Europe has become a more attractive relative proposition based in part on both ongoing investor skepticism, and continued momentum with respect to economic growth.

In a recently released Barron's survey, only 11% of money managers felt that Europe will deliver the best equity market performance in the next five years. The majority believed that emerging markets would regain their footing and lead the pack, followed closely by those who favored the U.S. In part the skeptics cite the recovery in Europe, which came later than that in the U.S., and which has lagged in speed. The effects of this delayed recovery have indeed been felt in the banking system, where uncertainty and higher capital requirements have resulted in deleveraging at the expense of lending (though we think that trend is plateauing – see the graph to the right from the European Central Bank as of April 22, 2014) in a region where businesses rely more heavily on banks for funding than they do in the U.S. In the U.S. capital markets play more of a role. Despite the concerns about the banking system, economic growth continues to strengthen, with the preliminary Eurozone composite PMI hitting a three-year peak of 54.0 in April.[i] While because of the concerns about the banking system, at its April meeting the ECB



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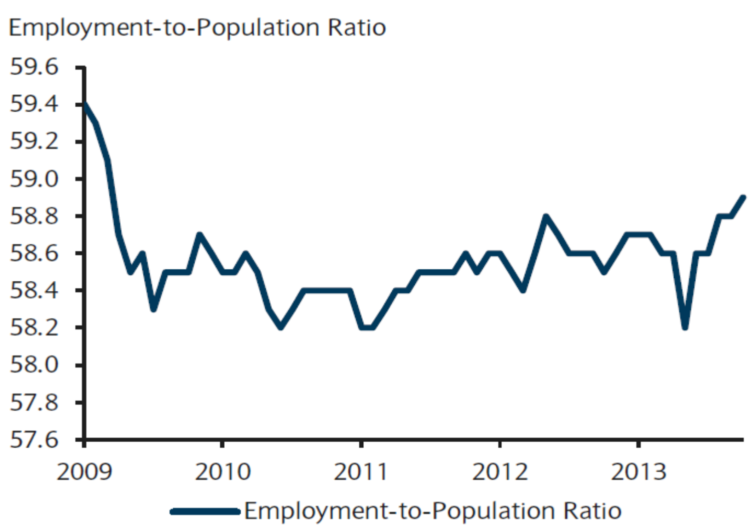
confirmed "unanimous commitment" to using "unconventional instruments" to support growth. We think this is a winning combination for European equities, and accordingly have recently increased our exposure with an active manager that we think is poised to capitalize on this opportunity.

On our shores, the recovery has been steady, slow, and atypical in its composition. There is some evidence for the belief that the pace of growth could pick up over the second quarter, and second half of this year. The whisper number among strategists is that 2Q GDP in the U.S. could be 3.5%. The private sector has delivered 3.4% annual growth since 2009[ii], and a slowing of public-sector retrenchment should allow overall growth to gravitate towards this figure. We are already seeing the fiscal drag easing faster than expected. It is happening around the world, but the biggest change is in the U.S., where the impact of last year's tax hikes and across-the-board spending cuts, or "sequester", has largely passed. This is seen in CBO data that estimates that the deficit in this country will fall by around 1% of GDP in 2014 after declining by 3% of GDP in 2013. By next year the reduction in the deficit will be negligible. Further, labor market conditions appear to be strengthening, as evidenced by data that goes beyond the payroll numbers. In recent months, temporary employment has started to increase at a faster pace, which has a history of leading to bigger bumps in the number of permanent hires. Importantly, the employment-to-population ratio (the proportion of the civilian non-institutional population aged 16 years and over that is employed) continues to rise, indicating that more people are finding jobs. The figure now sits at the highest level since July 2009.



Source: Barclays In Focus, April 17, 2014.

One caveat to the optimistic projections of growth going forward is that it will likely have to take place without much of a contribution from housing. The housing recovery has stalled, at least temporarily, due primarily to two issues: the effects of the severe winter weather and last year's rise in mortgage rates from 3.5%-3.75% to roughly 4.3% today. In March, single-family new home sales fell by 14.5% for the month, and 13.3% against March 2013 figures. Low inventory is another problem, as roughly half of homeowners that normally would be selling, are not putting their homes on the market, stating that they're not in a "financial position to sell their homes" right now. The explanations vary: 19% say low equity in their home, 16% say they are locked into low mortgage rates they don't want to give up, and 14% bought their homes less than seven years ago and deem that it is too soon to sell.[iii] However, this is not as significant of a hurdle as it once was, as residential investment currently accounts for 3.1% of GDP, which is less than half its peak of 6.6% in 2006. A 7.9% annualized fall in residential investment in the fourth quarter of 2013 subtracted 0.3 percentage points from GDP growth, and estimates suggest that the impact will be flat in the first half of this year.[iv]

While the for-sale housing market is experiencing fits and spurts, the rental market remains robust. There is access to an abundance of debt for developers with strong track records, and there is capital looking for yield. The value found in opportunities presented by multi-family housing varies widely from market to market and developer to developer, but where properly identified and researched, it can play an important role in a diversified portfolio. While cap rates are not generally high, the safety of yields and the level of prospective returns are attractive where developers with proven management capabilities can add acquisition and operational value. Real estate investment trusts (REITs) that focus on apartments can be interesting in this environment as well. While they are sometimes thought to be sensitive to interest rates, we believe this dynamic has more short-term than long-term implications. Despite regularly suffering short-term losses in the face of rate increases, REITs have historically exhibited low correlations to both equities and bonds over longer time horizons. Their performance is more likely to be driven by GDP growth, as well as supply and demand dynamics in the commercial real estate market.

There continue to be cross-currents blowing on U.S. equity markets. Certainly a continuation of the Fed tapering its balance sheet expansion is a dynamic to be weighed. While unconventional in nature, it is still a move towards tighter (not tight) monetary conditions. Historical evidence from the seven major tightening cycles since 1970 suggests that there is little reason to expect the market to post large gains once monetary conditions become less favorable. However, the impact of low rates from an absolute perspective does hold tangible benefit to equities. One of these is the fuel it provides to the mergers and acquisitions (M&A) market. M&A reached a fever pitch in the first quarter, with volume up 15% and the average deal size up 47%. The surge was powered by continuing economic growth, low interest rates, and expanded liquidity, all of which, it could be argued, were given a boost by Fed policy. One note of caution – historically a takeover boom is a classic signal of the final stages of a bull market, hardly a surprise considering the fact that the current rally is already the fourth-largest and the fifth-longest since 1928.[v]

A close examination of valuations would seem to support a cautious approach. While a forward price-to-earnings ratio at 16x may look fairly cheap, this figure can be distorted by write-downs or profit-margin trends. An alternative measure is a ratio of stock-market valuation to revenues, which currently stands at 1.67x for the S&P 500, the highest level since the 2000 market high and double historic norms. The metric favored by market participants including Warren Buffet and John Hussman, is stock market capitalization-to-GDP (MCAP/GDP). This metric is based upon the idea that returns in equities are driven by growth in nominal GDP, the reversion in the ratio of MCAP/GDP to its historical norm, and dividend yield. This framework has been extremely accurate in predicting ten-year average total returns for the index. In 1982, with MCAP/GDP at 0.35, it predicted a 19.4% return for the following ten-year period, and we got precisely that. In 2000, with MCAP/GDP at 1.54, it predicted a -1.7% return, and we got slightly worse. Today, with MCAP/GDP at 1.25, the calculation augurs an annualized return of roughly 2% over the next decade.[vi]

While we expect overall equity returns to be lukewarm, we also believe that there are market forces at work that will provide opportunities for prudent active management to outperform. In part this comes from the fact that financial de-levering has created a more narrow set of opportunities, which has resulted in trades becoming much more crowded. Our preference is for active managers to have a contrarian mindset, and to avoid following the herd, which we believe is rife with risk. There has been a clear bifurcation in effect of late: since the end of February shares of the fastest-growing (growth) companies in the market have fallen by 0.6% while slower growers (value) have gained 3.4%.[vii] The magnitude and speed with which that spread was created (the 4% difference between growth and value stocks is the largest in any two months since January 2013) suggests that the rally has legs. Similar periods have generally been followed by up to one year of style outperformance.

On another front, while the previously discussed swell of M&A activity has been a prop to equity markets, its contributing forces also reach other regions of the investment universe. As referenced earlier, the scope of corporate cash is at a peak. At the same time, corporate debt has burgeoned at a rapid rate. In fact, corporate debt is growing far faster than either GDP or net additions to corporate equity. Amid all the talk of corporate cash levels, cash equals just 19% of corporate debt. This can't go on forever, but it can go on for some time, and it isn't a phenomenon confined to the U.S. Numericable, a French cable unit, last week launched the biggest-ever junk bond offering of 7.9 billion euros ($10.9 billion) to fund its acquisition of Vivendi's mobile phone unit.[viii] That 19% figure is an important one to monitor to make sure it doesn't go much lower. If it does, corporate debt repayment becomes more difficult, and the foundation below leveraged corporate finance begins to crumble.

This turn of events would clearly be detrimental to levered high yield. Less clearly, levered high yield could suffer greatly in a rising rate environment. While at the macro level the asset class has less interest rate sensitivity than the investment grade space, at the micro level there will be issuers that suffer. As the cost of leverage increases, the amount of collateral brokers demand will also increase, and default levels could increase as overleveraged issuers are forced to refinance at higher rates. Levered loans offer more protection in a rising rate environment, but most won't start to benefit until three-month Libor (currently at 0.23%) rises to 1%. That probably won't happen until the Fed gets close to raising short-term policy rates.

Other floating rate securities we have been buying include debt of investment-grade financial institutions. These securities have good covenants, and the floating feature can be tied to different variables like dollar swap rates and government bond markets of stable foreign issuers. The biggest winner in a rising-rate environment could be global macro and/or managed futures strategies. They often invest in highly liquid derivatives contracts and employ trend-following strategies that can benefit from such events. If they can get on top of the trend while rates are rising they will benefit and make money.

As of March 31, 2014

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
ALTERNATIVES					
HFRX Global Hedge Fund Index	**Broad Hedge Funds**	1.1	1.1	4.6	3.8
HFRX: Systematic Diversified CTA Index	**Managed Futures**	-3.0	-3.0	-3.4	-3.0
DJ UBS Commodity	**Commodities**	7.0	7.0	-2.1	4.2
Wilshire US REIT	**REITs**	10.1	10.1	4.4	29.2

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar

	As of 3.31.14	Prior Yr End (12.31.13)	One Year Ago (3.31.13)	Five Years Ago (3.31.09)
CURRENCIES				
US Dollar Index Value	80.04	79.77	79.77	81.31
USD vs. Yen	105.31	86.75	86.75	90.64
Euro vs. USD	1.37	1.32	1.32	1.40
GBP vs. USD	1.66	1.63	1.63	1.46
COMMODITIES				
Gold ($ / ounce)	1205.65	1675.35	1675.35	882.05
Crude Oil ($ / barrel)	98.42	91.82	91.82	44.60
Copper ($ / ton)	7375.75	7907.00	7907.00	3041.75
Corn - Generic (Usd/bu)	422.00	698.25	698.25	407.00

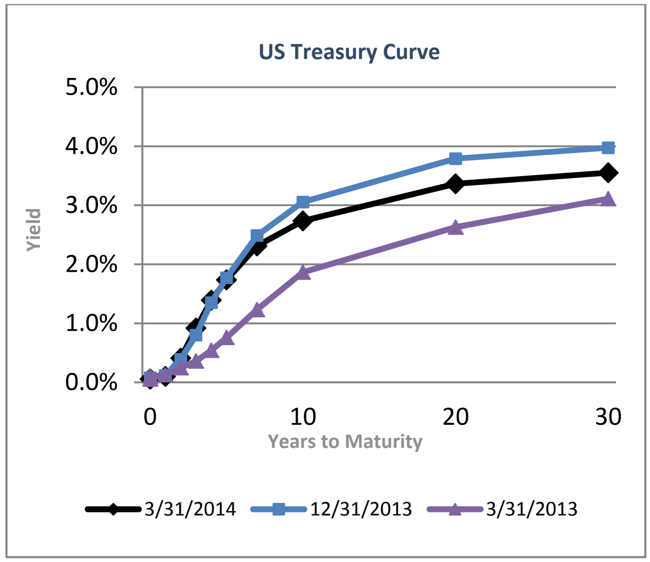
In the tax-free fixed income sector, Detroit and Puerto Rico captured the headlines for most of last year. Recent developments on both fronts will likely assure that this will continue to be the case, potentially creating a window of opportunity in both stable and higher yielding credits. After two prior attempts to gain bankruptcy court approval of a financial settlement, the city of Detroit finally received consent. The same week the city announced it had reached an agreement with the financial guarantors of its general obligation unlimited tax bonds – they will pay 74 cents on the dollar. In Puerto Rico, the Supreme Court surprised many market participants with a decision invalidating portions of Law 160, which raised the retirement age for teachers and introduced other pension reforms. The price of Commonwealth general obligation bonds declined in the wake of the ruling.

Broadly, municipal bond prices continue to be supported by supply/demand factors. On the supply side, new issuance is now running at roughly 30%[ix] below the volume level seen at this time last year, and there is a growing consensus that it is likely to remain tight for the balance of the year. The dramatic drop in refunding transactions is a key factor in the decline of new issuance. Additionally, commercial bank lending to municipal governments has contributed to the decline of public issuance levels. Structurally, the muni curve is still extremely steep, and extension trades make sense. Going from four years out to eight years out allows one to pick up 150 basis points in yield, a jump of significant value on a risk-adjusted basis.

As of March 31, 2014

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
FIXED INCOME					
BofAML T-Bills 0-3 Mon	Cash	0.0	0.0	0.0	0.1
BarCap US Agg Bond	Broad US Investment Grade Bonds	1.8	1.8	-0.1	4.8
BarCap Municipal	Municipal Bonds	3.3	3.3	0.4	5.7
BarCap Treasury	US Treasury Bonds	1.3	1.3	-1.3	2.7
Citi WGBI USD	Global Sovereigns	2.7	2.7	1.4	3.8
BarCap US HY Interm	US High Yield Bonds	2.8	2.8	7.5	17.6
JPM EMBI Plus	Emerging Market Bonds	3.5	3.5	-1.9	10.9

* Performance in USD expressed as a percentage and includes the reinvestment of dividends and earnings. Sources: Bloomberg, Morningstar



Looking out over the global landscape, the most scrutinized tail risks at the moment reside in emerging market geographies, primarily Russia and China. While Putin tries to dictate the course of events in Eastern Ukraine by virtue of strength, represented by roughly 40,000 troops he has stationed along the border, the ultimate outcome may rest in part on the strength of capital markets. Since troops rolled into Crimea, Russian equities (as measured by the MICEX local currency index) are down 11%, the ruble has depreciated by almost 10%, Russian sovereign bonds with a 4.875 coupon due 9/16/23 have backed up by 130 basis points, and the cost of insuring against a default (credit default swaps) has risen by 43%.[x] Where diplomacy fails, perhaps capitalism will prevail. Most recently, S&P downgraded Russia's credit rating to BBB-, one step above junk status. The rating action is unlikely to lead to a significant increase in spreads in the near term, as a lot of the bad news appears priced into the market. However there were two clear triggers in the announcement that would lead to a further downgrade. The first is an escalation of the situation in Ukraine, which is obviously difficult to predict. The second is a further deterioration in the economic outlook. On this front, the IMF just announced that Russia is already experiencing a recession.

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The picture in China is tinged with more optimism from our perspective. It is true that China's GDP growth is slowing for a third time. The first two slowdowns were largely driven by the crisis in Europe and the resulting slowdown in export demand. The latest is self-inflicted. The new government has been trying to reduce capital investment and limit credit growth. They appear to have overshot, and the result has been excessive saving, which have caused output growth to slacken and price inflation to fall too far. The good news is that the government is changing its stance. The People's Bank of China has dropped its reserves requirement ratio for rural commercial banks and credit cooperatives. Rate cuts are possible in the coming months, and the government has unveiled programs to boost growth, including spending on railways, upgrading low-income housing, and providing tax relief for small businesses.

Elsewhere in emerging markets, sentiment has swung in a more positive direction, particularly in Emerging Asia where of late there have been significant net purchases of funds dedicated to investing in Indonesia, Thailand, and India. We believe this interest to be warranted. Granted, the macro overhang that has plagued emerging market equities has only partially subsided, as U.S. monetary policy will continue to be less accommodative and the situation in the Ukraine may yet deteriorate. But valuations in the region, inclusive of China, are low. The price-to-forward earnings ratio remains four points lower in Emerging Asia than in developed markets, whereas there was essentially no difference in the two ratios as recently as late 2010. As indicated previously, it is this discipline of allocating capital into situations where the fundamentals appear favorable despite the existence of worrisome circumstances that we believe leads to long-term success for investors, and we look forward to continuing to work with our clients towards that effort.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

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[i] Charles Schwab- Rhyme or Reason- 4.25.14
[ii] BCA Research- Global Investment Strategy: Growth, Mild Deflation, and Equity Returns- 4.25.14
[iii] The Street- Home Sales Fall Because Sellers Can't Afford to Sell- 4.25.14
[iv] Capital Economics- US Economics Weekly- 4.28.14
[v] The Economist- Sound the retreat- 4.26.14
[vi] Hussman Funds- The Federal Reserve's Two-Legged Stool- 4.21.14
[vii] Barron's- Summer of Value- 4.28.14
[viii] Barron's- Such a Deal- 4.28.14
[ix] UBS Municipal Market Guide- 4.16.14
[x] Barclays- The Bear without a checkbook- 4.25.14