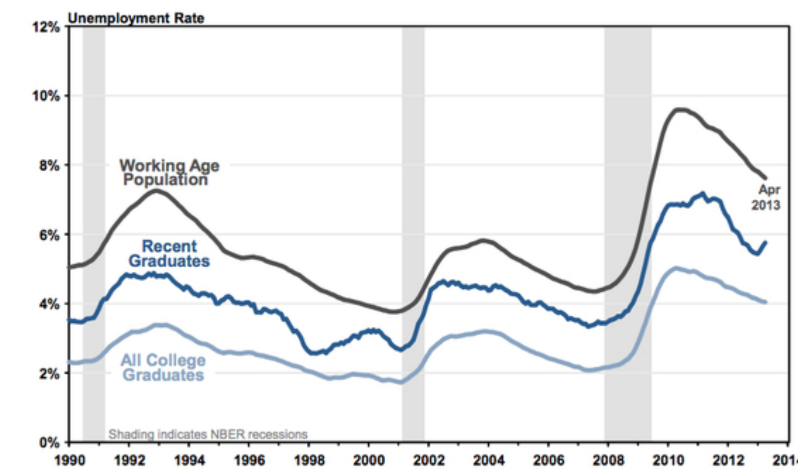
PCA PERSPECTIVES

Permit Capital Advisors' Thoughts on the Investing Landscape

Even the best intentioned attempts to discuss the state of affairs in our country today have a propensity to result in a strident and partisan exchange. The tendency on most topics is to begin a debate by pointing fingers at a political party or its perceived doctrinaire representative, and then to devolve from there. There are, however, certain issues that transcend partisan politics because their rightful remediation is both clear and critical. One of those is the need for our educational system to be recalibrated, so as to better train our population to fulfill the needs of a modern economy.

The US used to be number one in the percentage of young people with a college degree. Now, it is number twelve. With unemployment at 6.7%, but unemployment for those with bachelor's degrees or higher at less than half of that figure, or 3.3%, reversing that trend is of paramount importance. In an economy where enhanced productivity has eliminated the need for 35 million jobs since 2001, the leverage in the marketplace would seem to rest with training our workforce in the technical skills that result in productivity enhancement rather than training them in the fields that are being systematically eliminated.



Source: U.S. Census Bureau and U.S. Bureau of Labor Statistics, Current Population Survey.
Note: College graduates are those with a BA degree or higher; recent college graduates are those aged 22-27; figures exclude those currently enrolled in school.

This would imply an emphasis on what are commonly referred to as the STEM fields, of science, technology, engineering, and mathematics. Instead, the government has significantly cut its support for basic research in science and engineering. What had amounted to 4.5% of GDP in the 70s is now down to 2.5%.[i] The negative impact is felt today on both our competitiveness and economic growth trajectory. Of course, in a world in which the Fed fears deflationary forces more

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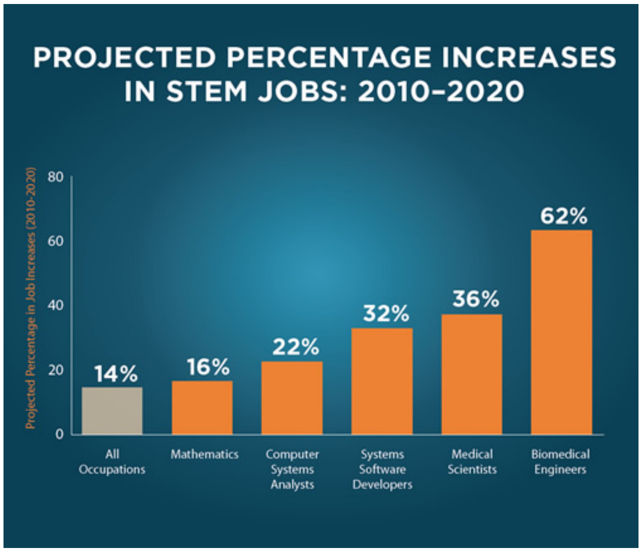


than those that are inflationary because deflation boosts the real burden of our debt, we can't escape the fact that we may be faced with less money to spend on education going forward, not more. Even if tapering were to continue, we are still adding to a $4 trillion balance sheet that is five times higher than it was prior to 2008, and is heading to $5 trillion by the end of this year.

With public indebtedness at its highest peacetime level in many advanced economies, solutions to raise cash are in high demand. One area that is being increasingly explored is the privatization of public assets. State-owned enterprises in OECD countries are worth $2 trillion, with another $2 trillion in minority stakes in companies and utilities.[ii] For governments that are looking for ways to delever, privatization is a useful tool. It allows governments to cut their debts, shore up their balance sheets, and improve their credit ratings, thus lowering borrowing costs. Historically, it also improves an economy's efficiency by boosting competition and applying private-sector capital and commercialized skills to newly unencumbered assets. Both Margaret Thatcher and Ronald Reagan used it as a tool to transform utilities, telecoms, and the transport sectors, and recent trends would seem to indicate that their approach has been studied by today's leaders.

Another issue that engenders general agreement amongst our citizenry is the importance of shifting our external accounts to a more sustainable profile – and the improvement has been marked. At the end of 2005 the current account deficit reached 6.2% of GDP, indicating a society that was living conspicuously beyond its means. By the end of the third quarter of 2013 it had dropped to 2.2%, the lowest since 1998. The two primary factors at work were the surge in domestically produced oil and gas, and demographics. On the latter, as baby boomers age they have a tendency to spend less on imported goods and more on domestically-produced services. With respect to what some are calling an "energy revolution", the impact is felt on not only our current account deficit, but on capital expenditures as well. According to a study from HIG Global, hydraulic fracturing (or "fracking") will generate $890 billion to $1.15 trillion in new infrastructure spending – pipes, railcars, storage tanks, pumps, refining equipment – from 2014 through 2025.

The timing for this surge in spending couldn't be better, as within other industries the flood of central bank liquidity is deterring corporations from investing in real capital goods in favor of financial engineering in the form of recapitalizations and stock buybacks. Corporations spent $500 billion, or 2% of the S&P 500, buying back their shares in 2013. These debt-financed repurchases boost earnings-per-share but not growth. This is why metrics like price/sales and market cap/GDP are at levels not seen since the dot-com boom of the late-90s. Also supportive of stock prices has been historically high margins. Much of this stems from controlling labor costs. As noted previously, productivity gains have allowed companies to eliminate jobs, as evidenced by the ongoing skew of national income towards the corporation and away from labor. Corporate profits as a percentage of national wages have swelled to 27%, from levels below 15% in the 80s. Cheap oil and natural gas, a byproduct of the "energy revolution", has also played a major role in altering businesses margin structure. It's hard to say whether margins need to naturally come down (one threat would be a strengthening dollar since about half of the earnings of S&P 500 companies come from overseas), but it's equally hard to see room for much improvement.

The support for earnings that came from a reduction in share count and an increase in margins contributed to gains in equity markets last year, but the real octane that propelled domestic equity indices up more than 30% was the jump in valuations. US equity valuations rose by 20% last year, the largest increase since the tech boom in 1998, chiefly because central banks flooded the markets with easy money and investors became willing to pay more for each dollar companies earned. As a result, the S&P 500 now trades at 15.4x projected profits, up from 12x in 2012. Using the cyclically adjusted price-to-earnings ratio developed by Professor Robert Shiller of Yale University, which attempts to eliminate the fluctuation of the ratio caused by variation of profit margins during business cycles, the market looks even more expensive. The most recent reading of 25.6x is 55% above the historic average of 16.5x.[iii]

Valuations weren't the only metric to elevate during the course of 2013 – 10-year Treasury yields went from 1.75% at the beginning of the year to just over 3% at the end. Historically when both long-term interest rates and stock valuations rise, the subsequent year has seen modest returns for stocks. Between 1954 and 2013 there were 14 years when both equity valuations and the yield on the 10-year advanced; on average, the S&P 500 returned just north of 2% the following year.[iv] We think such muted gains are likely in 2014, though investors will be subject to heightened volatility (with a starting point of the VIX, or volatility index, under 13) and drawdowns along the way. We will focus on actively managed strategies to dampen that volatility, as correlations have fallen from 0.65 across stocks in the S&P 500 to 0.27 in the last two years, providing an opportunity for stock pickers to add value. We will focus on disciplined allocation decisions to take advantage of the drawdowns.

As of December 31, 2013

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
DOMESTIC EQUITY					
S&P 500	Large Cap Equities	10.5	32.4	32.4	17.9
Russell 2000	Small Cap Equities	8.7	38.8	38.8	20.1
Russell 3000 Growth	US Growth Equities	10.2	34.2	34.2	20.6
Russell 3000 Value	US Value Equities	10.0	32.7	32.7	16.7

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
INTERNATIONAL EQUITY					
MSCI World exUS GR	Global ex US Equities	5.6	21.6	21.6	13.0
MSCI EAFE GR	Developed ex US Equities	5.7	23.3	23.3	13.0
MSCI Europe GR	European Equities	7.9	26.0	26.0	14.1
MSCI Japan GR	Japanese Equities	2.3	27.3	27.3	7.8
MSCI EM GR	Emerging Mrkts Equities	1.9	-2.3	-2.3	15.1

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

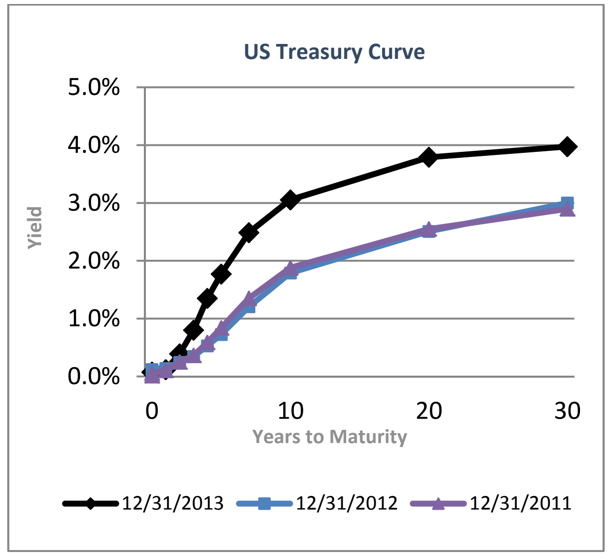
The trajectory of European equities may be more reminiscent of the domestic experience in recent years, as while the Fed is beginning to taper, the European Central Bank said it expects to maintain its easy-money policies for an extended period. ECB President Mario Draghi said recently that they were ready to "take further decisive action if required" to keep inflation from weakening too much. They may not necessarily utilize long-term refinancing operations, but rather could attempt to rekindle bank lending by buying securities backed by loans to small businesses. Overall 2014 earnings growth for companies in the S&P Europe 350 is pegged to reach 14.1%, the highest profit growth forecast since 2010.[v]

Within fixed income, contrary to conventional wisdom, we continue to see pockets of relative value that we are comfortable exploiting. In the taxable world, given non-investment grade yields and spreads that are near post-crisis lows, it may appear at first blush to be an area of the market to avoid. We think that fails to capture elements of the decision making process that include relative attractiveness and relative risk. Against most backdrops, a coupon of 6% with little room for spread compression would not be a desirable profile for investment. However, in an environment in which default rates remain low, recoveries remain high, and equity valuations are stretched, we would take a coupon-matching return for higher conviction swaths of the market.

As of December 31, 2013

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**	-0.1	-2.0	-2.0	4.4
BarCap Municipal	**Municipal Bonds**	0.3	-2.6	-2.6	5.9
BarCap Treasury	**US Treasury Bonds**	-0.8	-2.7	-2.7	2.1
Citi WGBI USD	**Global Sovereigns**	-1.1	-4.0	-4.0	2.3
BarCap US HY Interm	**US High Yield Bonds**	3.5	7.6	7.6	18.3
JPM EMBI Plus	**Emerging Market Bonds**	0.6	-8.3	-8.3	10.7

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



While spreads could widen and cause temporary difficulties, the default cycle which can really wreak havoc in the space should stay relatively sanguine. The 2.1% figure for high-yield bonds and 2.2% for bank loans remain well below their historical averages of 4.9% and 3.4%, respectively. The spate of recent issuance carrying weaker investor protections ("covenant lite bonds") would be worrisome were credit conditions not so favorable. Not only has there been an improvement in coverage ratios, to 4.2x EBITDA from a recent low of 3.2x, but the maturity wall has largely been pushed beyond 2016.[vi] Record capital market conditions have been used by issuers to term out debt. Combined bond and loan issuance in 2013 reached a record $990 billion, exactly two-thirds of which was used for re-pricing/refinancing purposes. This has left only $149 billion of high-yield bonds and loans coming due between now and the end of 2015, a figure down from $412 billion last June.

Sovereign bonds and mortgage-backed securities are two additional fixed income sectors that can play an important role in portfolios today. Diversified sovereign bonds, by currency and issuer, can

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serve as a hedge of sorts against equity market risk, as they have a low correlation to the US equity market, and importantly it trends lower during periods of peak stress. Within the mortgage-backed market, non-agency residential securities can be hard to buy given Fed participation, but should be evaluated opportunistically when big sellers come into the market. Combined-loan-to-value ratios are going down and modifications are working to lower potential defaults. Also, voluntary prepayments are trending upwards and conversely delinquencies are stabilizing. A diversified portfolio in fixed income is essential to both find and protect value, in a world in which we no longer have falling interest rates as a wind at our backs.

We are also starting to see more compelling opportunities in the tax-free market. In part, the story is similar to that in the non-investment grade corporate space. Default rates are low, having dropped for the second straight year, from 0.144% to 0.107% within the S&P Municipal Bond Index. Where the story diverges is in the impact of issuance. While high-yield benefits from record high issuance that solidifies the leverage profile, in the municipal bond world, gross issuance expectations for 2014 of $294.3 billion is a 9% reduction from last year's $330 billion. Couple this with an expected $309 billion coming out of the market over the course of the year - $147 billion of maturing bonds, $72 billion in advanced refundings, and approximately 48% of currently callable paper to be exercised ($90 billion of $188 billion) – and prices should be well supported by a net negative supply of $15 billion.[vii] We think unrated munis, which account for roughly $130 billion of a $3.7 trillion market, are particularly interesting.

This is typically debt issued at an early stage for essential services including prisons, charter schools, and senior communities. We are looking at yields in this area of roughly 7% to 7.5%, tax-free. The amount of debt issued for such projects is small, often below $30 million, and the construction period is often under two years. The purpose of a credit rating is to reduce borrowing costs, and given the small size and short amount of time to complete, it can be uneconomical for these issuers to get rated. Seeking a credit rating is a business decision that may be independent from a borrower's financial strength. Further, some of these issuers may not have the experience to navigate the process, which includes engagement with specialized counsel, an industrial authority, and a potentially complex set of rating agency requirements. These bonds are generally supported by a first mortgage lien on property, plant and equipment. Liquidity is low, but a patient investor can be well rewarded.

As of December 31, 2013

INDEX	ASSET CLASS	3 Months	YTD	1 Year	5 Years (ann)
ALTERNATIVES					
HFRX Global Hedge Fund Index	Broad Hedge Funds	2.3	6.7	6.7	3.7
HFRX: Systematic Diversified CTA Index	Managed Futures	2.8	-1.3	-1.3	-2.8
DJ UBS Commodity	Commodities	-1.1	-9.5	-9.5	1.5
Wilshire US REIT	REITs	-0.8	1.9	1.9	16.7

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

	As of 12.31.13	Prior Yr End (12.31.12)	One Year Ago (12.31.12)	Five Years Ago (12.31.08)
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

Facing a landscape in which the traditional barometers of value and risk are tenuous, a vigilant approach to managing exposures will be the key to achieving goals set forth in an investment policy. We believe that taking advantage of premiums offered by illiquidity and volatility, being willing to make investments into parts of the market that most are eschewing, and a focus on an appropriate allocation to uncorrelated assets, will allow investors to continue to grow portfolio value in the face of ongoing challenges. We look forward to continuing to work with 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] Abbey Joseph Cohen- Barron's Roundtable- 1.20.14
[ii] The Economist- The $9 Trillion Sale- 1.11-17.14
[iii] Yale.edu- Shiller's PE- 1.15.14
[iv] BlackRock- Weekly Investment Commentary- 1.6.14
[v] S&P Capital IQ- Lookout Report- 1.10.14
[vi] Guggenheim Partners- High Yield and Bank Loan Outlook- 1.10.14
[vii] BMO Capital- US Fixed Income Strategic Analytics- 1.7.14