VERITY
Asset Management

Commentary

Core Model March 31, 2014

During 1st Quarter, the S&P 500 traded down 5.8% into early February before rebounding to finish up 1.8%. Compared to most of 2013, daily volatility has expanded materially, with substantial intraday swings. The general consensus of those who like to offer predictions is that the U.S. equity market could continue its rise in 2014, but return expectations have been muted, with most anticipating only single digit gains. However, the intraday gyrations seem to suggest an equity market uncertain of its footing and thus susceptible to breaking sharply in one direction or the other, possibly in response to some unforeseen catalyst.

Given these conditions, we have been active in a disciplined but opportunistic manner. We are devoting this quarter's commentary to the illustration of some of the activity in our Core Model.

Commodities

The year is still young, but commodities, many of which suffered significant declines last year, have rebounded in early 2014. However, they are diverse, and we most often narrow our focus to those we judge to be positioned to sustain longer term uptrends.

- Grains – Given our favorable long term outlook for grain prices, we used the relentless price weakness of 2013 as an opportunity to add shares to our existing position, seeking to build value for the future. In the short run, the portfolio has benefited from shares we added in late 2013 and into 2014, as grain prices moved up sharply during the quarter.

- Uranium – Prices plunged in 2011 following the tsunami-related nuclear disaster in Japan, and prices remain near the lowest levels in the past 8 years. Yet, as nations consider their energy options, uranium as a cheap and reliable source is hard for many to ignore, and there are now more reactors under construction, planned, and proposed (555) than immediately before the disaster (541). With prices of uranium producers showing indications of rebounding materially from depressed levels, we added a new commodities-related equity position in one of the world's largest producers.

U.S. Equites

Within a portfolio that is quite broadly diversified, U.S. equities make up the largest segment. Late in 2013, we took selective profits in several U.S. equity positions, capturing some significant gains. But, despite previously expressed concerns with the sustainability of record corporate profit margins, among other things, we have to date seen no reason to change the overall concentration.

- Biotechnology has been a notable winner, and, capitalizing on its multiyear climb, we took substantial profits during 2013 in four increments from May to December. The more recent stage of the sector's rise has prompted "bubble" talk in many quarters. There are without question many speculative members of the group, but thoughtful analysis of many of the primary names suggests that their prices are being driven in large part by very legitimate revenue growth, unlike the dotcoms of the late 1990s. As a consequence, we have been patient with our remaining shares and began watching for an attractive opportunity to add to them again as share prices corrected very sharply into the end of 1st Quarter.

- Agriculture had significant winners and losers in 2013. During the course of the year, we eliminated two losers, consolidating our holdings into two remaining companies, and then used sharp price declines from late January into early February to add shares to both positions.

- Chemicals – Seeking additional opportunity as the market rebounded off its early February lows, we added a new position in a chemical company identified in a proprietary value screen.

- Homebuilders – As noted in our year-end commentary, we took a position in homebuilders late in 2013 as the market re-accelerated following a period of weakness. Valuations in the group appear solid, and there is potential for significant gains if the somewhat weaker housing market of the first quarter responds to increased demand as the economy strengthens. However, with the data still inconclusive, we have actively traded the position as conditions have warranted. In March, as the sector weakened after surging from December into February, we sold more than half the position, deploying part of the proceeds to a new position in …

- Utilities, which were attractive fundamentally and trending higher after being significantly out of favor during the second half of 2013.

Emerging Markets

Emerging markets have been severely buffeted over the past year, both by negative developments in certain specific countries and by unfavorable international capital flows. Fortunately, though we were not unscathed, we had significantly reduced our emerging markets exposure in the spring of 2013 as we observed this trend unfolding. With our remaining exposure, we have made selective adjustments designed to take advantage of the advantageous characteristics found within many emerging markets while limiting the effects of external capital flows.

- Frontier markets – Confronted by a breakdown in the multi-year trading range of our Colombia ETF position, we elected to rotate into an actively managed fund diversified across a combination of frontier market and small emerging market countries. Frontier markets, speaking broadly, share the favorable demographics and strong GDP growth prospects we have observed in many emerging markets, but they tend to have a smaller percentage ownership by foreign investors and have thus been prone to respond more to local conditions than international capital flows. In such markets, a fund management team with local contacts and insights can bring significant added value to selection of companies with strong business models and unique competitive advantages in their home markets.

Other Allocations

- Merger arbitrage is a sophisticated strategy which is lower in volatility than traditional equity investing and is not dependent on market growth to generate positive returns. In March, we transferred assets from a straight merger arbitrage fund to a newer arbitrage event driven fund under the same management. The event driven fund expands the range of strategy options available to the portfolio managers. In addition to merger arbitrage, managers may utilize various other opportunities related to the timelines of corporate events such as recapitalization, restructuring, refinancing, corporate distress, and bankruptcy. Volatility is somewhat higher than merger arbitrage alone, but still considerably lower than equities. In sum, this portfolio adjustment provides added growth potential with limited additional risk, and it retains a very low correlation to other elements of the portfolio.

While diversification was a serious disadvantage in 2013, we have not forgotten its considerable and sometimes critical value across wide ranging market circumstances. As a consequence, we remain structurally well diversified, while at the same time placing our active focus in areas we believe to hold superior opportunity for growth over time.

This material contains forward looking statements; there is no guarantee these outcomes will be achieved. All investing involves risk of loss, and there is no guarantee that strategies which may have been successful in the past will be similarly successful in the future. Certain asset classes, including emerging markets, commodities, and gold, carry greater risk and are more volatile than broad domestic bond and equity indices. Because they do not closely correlate with certain other asset classes, their inclusion in combination with other asset classes may actually reduce overall portfolio volatility, but there is no guarantee this will always be achieved.