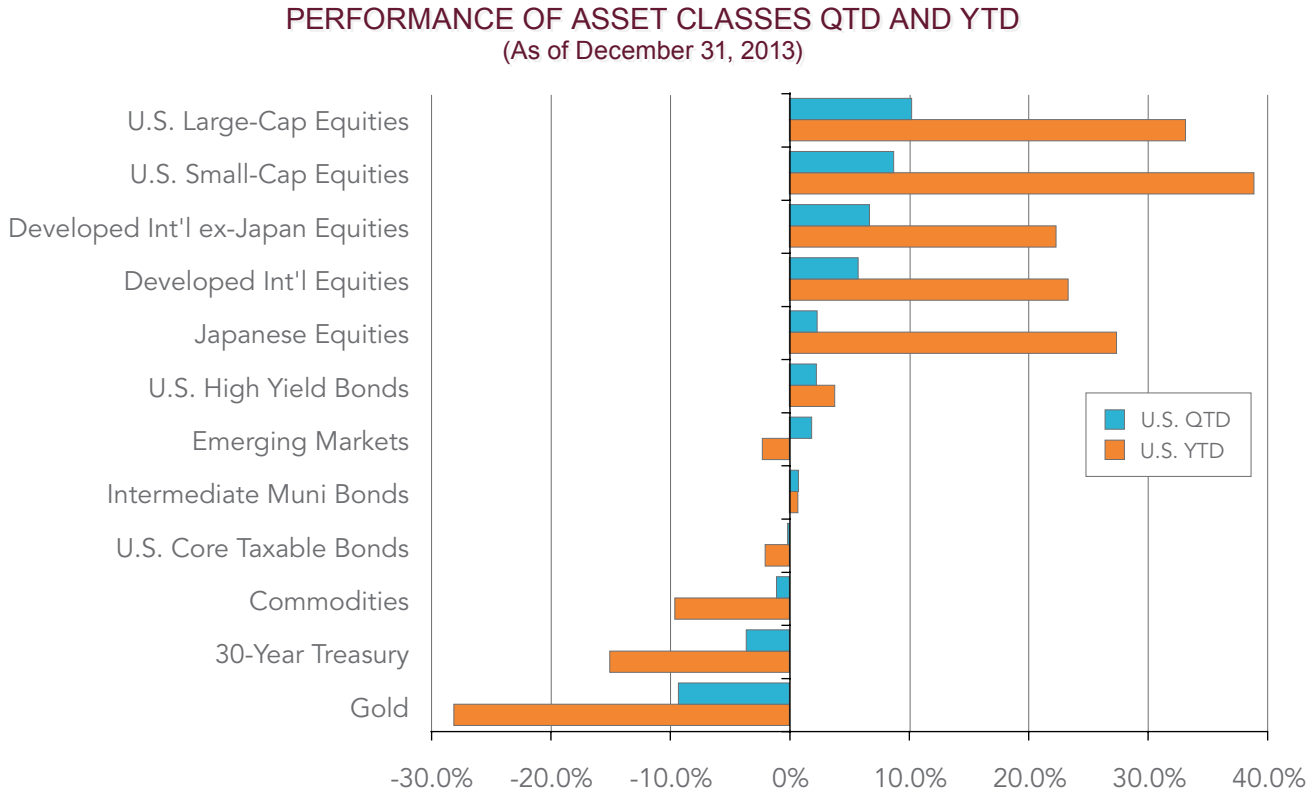
LOOKING FORWARD: Our Expectations for 2014

"It was the best of times, it was the [worse] of times." – Charles Dickens, *A Tale of Two Cities*

Altered a bit, this famous phrase from Dickens pretty much sums up the markets in 2013. It really was the best of times for stocks, especially those of developed nations, and also pretty good for "junk" bonds (high-yield bonds issued by less creditworthy companies). But as the chart below shows, most other asset classes fared considerably worse, including investment-grade bonds, commodities, and emerging-market equities.

Given these disparate results, quite a few investors have opted to put blinders on. That is, they're focusing almost exclusively on developed-market equities. Either they're committing new money to stocks, and/or they're allowing stocks to be a higher portion of their portfolios given last year's run-up.



SOURCE OF DATA: Morgan Stanley, Barclays Capital, Russell Indices, and Bank of America Merrill Lynch, Dow Jones UBS, Bloomberg, U.S. Treasury

Of course, investing with blinders on is never advised – neither is concentrating one's investments in one asset class. Instead, it's now more necessary than ever to take an unfettered look at where we are, how we got here, and what's likely to be coming our way.

OUR GENERAL ASSESSMENT: We are cautiously optimistic heading into 2014. We expect developed market equities to have a decent year – with gains in the single-digit range – for the reasons outlined below. Likely to continue struggling are investments vulnerable to rising interest rates, including the majority of bonds and REITs (Real Estate Investment Trusts). For commodities and emerging-market equities, we don't envision a significant rebound.

ECONOMIES AND EQUITIES: Playing catch-up.

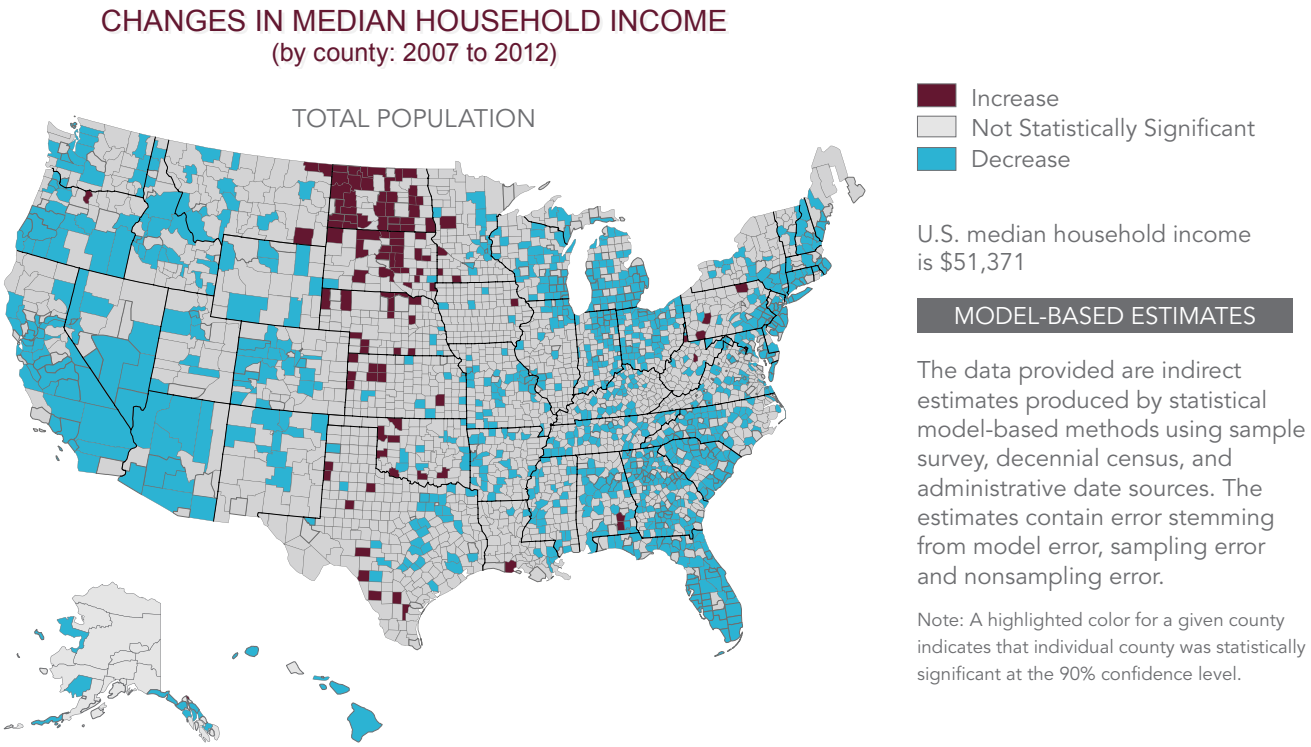
As noted, developed market equities had a spectacular 2013. And this happened despite lackluster economic growth. Stocks rose due to higher corporate profits and investors' increased appetite for risk, driven by a remarkably loose monetary policy and the anticipation of growth – some of which we think will materialize in 2014.

ALTHOUGH U.S. ECONOMIC GROWTH IS PICKING UP, IT'S NOT LIKELY TO EXCEED 3% FOR 2014. The GDP (Gross Domestic Product) of the U.S. did expand by a hefty 4.1% in third-quarter 2013 (the most recent data point); however, this pace is probably not sustainable. Much of this growth was due to higher inventory levels. If businesses can't sell this inventory at a profit, they're not likely to restock.

Fortunately, solid consumer demand was evident in the final tally for third-quarter GDP. In 2014, it's quite likely that increases in consumer spending, housing, and capital investment by businesses will all help push U.S. GDP up closer to 3.0% – versus the 2.3% the economy has averaged since the end of the recession.

U.S. GROWTH, HOWEVER, SHOULD CONTINUE TO OUTPACE THAT OF OTHER DEVELOPED ECONOMIES, due to an accommodating monetary policy coupled with pockets of economic strength.

- DOMESTIC PRODUCTION OF U.S. OIL AND GAS IS BOOMING. The lion's share of U.S. counties with rising household income are in North Dakota, South Dakota, Texas and Oklahoma – all areas participating in the production and transportation of energy (see chart below). This trend appears to have legs. The International Energy Agency predicts the U.S. will replace Saudi Arabia as the world's largest oil producer in 2015. Adding more fuel to the argument, the Energy Information Administration predicts that the U.S. will supplant Russia as the largest natural gas producer by the end of this year.



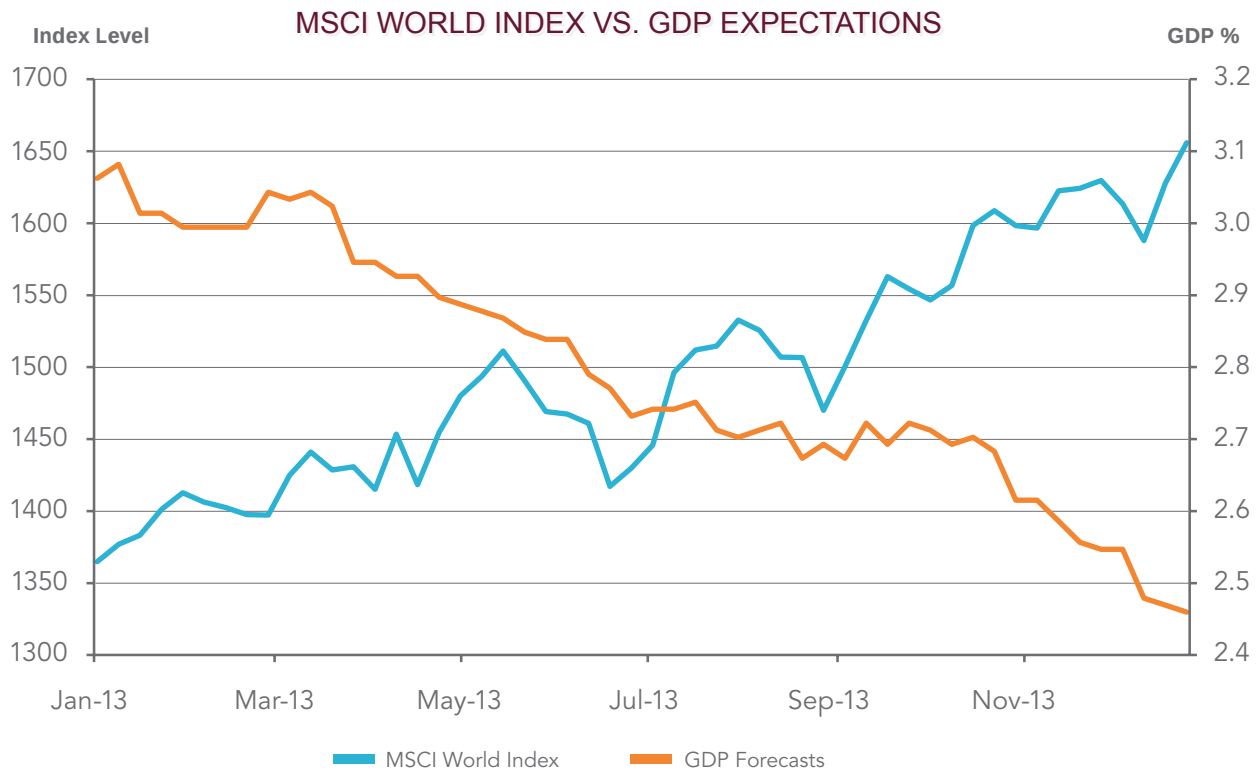
SOURCE OF DATA: U.S. Census Bureau, Small Area Income and Poverty Estimates (SAIPE) Program, Dec. 2013

Currently, oil produced in the U.S. cannot be legally exported, greatly limiting the market for one of our fastest-growing sectors. In place since 1975, this ban was enacted during a time of energy shortage. Its removal could lead to a virtuous cycle: the U.S. energy sector would benefit from increased sales, while oil exports would help lower energy costs outside the U.S., which would in turn reduce the cost of our imported goods.

▪ U.S. MONETARY POLICY IS LIKELY TO HOLD FEWER SURPRISES IN 2014. Last year, debate about when and how the Fed would taper its monetary stimulus program roiled the markets. But at the end of 2013, things stabilized. The Fed initiated a slow and patient tapering schedule, and Janet Yellen (a veteran Fed economist) recently became the Fed's new Chair.

WHAT'S LIKELY TO HAPPEN TO EQUITIES?

To get a sense of the disconnect between stock prices and economic growth, take a look at the chart on the following page. It shows the 2013 performance of equities worldwide relative to expectations for global economic growth.



SOURCE OF DATA: Morgan Stanley Capital Int'l, Bloomberg Consensus Survey

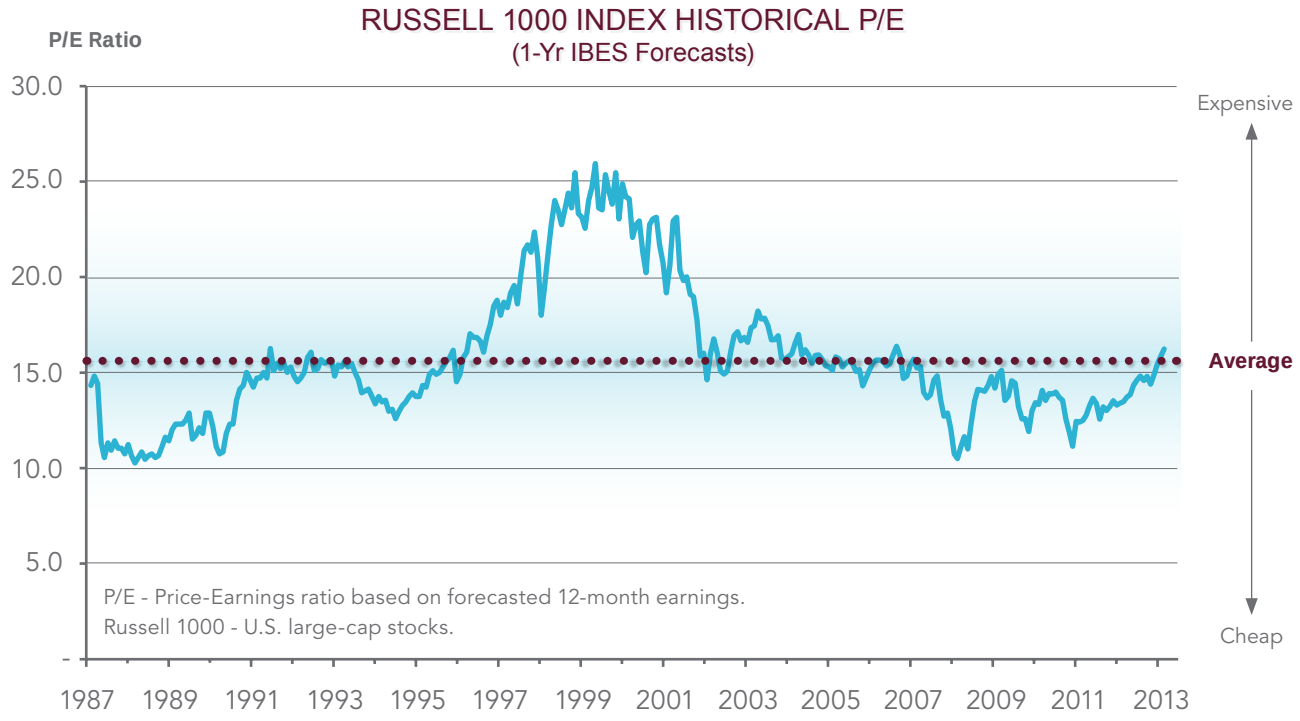
The vast majority of analysts did not expect such wide divergence. On average, Wall Street strategists expected a gain of "only" 8.2% for the S&P 500 Stock Index in 2013 (Birinyi Associates survey). We at LNWM were on the higher end of forecasts, with a 10% projected gain. So the S&P's actual return of 32% defied expectations, albeit in a very pleasant way. After such strong and surprising outperformance, it's logical to ask:

ARE STOCKS HEADING FOR A MAJOR CORRECTION IN 2014? OUR RESPONSE: Not yet.

WE THINK 2014 SHOULD BE A DECENT YEAR FOR U.S. AND MANY FOREIGN EQUITIES. By decent, we mean 2014 equity returns are likely to be lower – and harder to generate – since valuations have become less attractive. The chart below shows historic P/E ratios (price divided by earnings) for large U.S. stocks, based on earnings forecasted 12 months out.

By this metric, "fair value" is right around a P/E of 15, the average since 1987. And that's about where we are now (with P/Es for smaller U.S. equities considerably beyond their historical average). Moving forward, gains in equities are likely to be driven by higher earnings – which

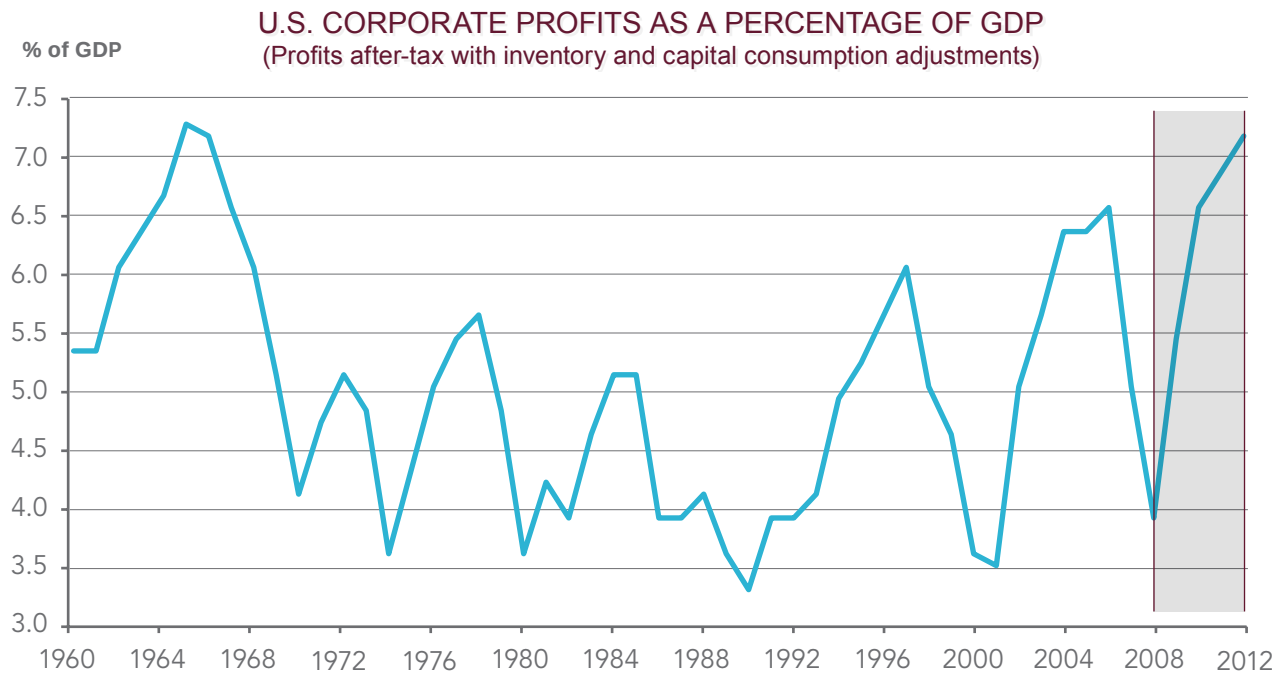
will be harder to come by – and inexpensive capital, rather than by an increase in how much investors are willing to pay for stocks (higher P/E ratios) or major cost-cutting programs. U.S. equities no longer seem underpriced as we begin 2014.



SOURCE OF DATA: Russell Indices

U.S. EQUITIES STILL HAVE SOME TAILWINDS, however. Since 2009, American corporations have greatly increased their profitability. Even though sales or revenue is barely rising in many industries, corporations are logging more of each sales dollar as profit due a convergence of factors that are likely to stay in place for a while.

These factors include: reduced operating costs, much lower financing costs (thanks to having refinanced debt at very low interest rates), and operational efficiencies due to use of technology and other efforts. Many corporations today are producing more with fewer workers, leading to robust productivity gains. The result: corporations' share of U.S. domestic income is the highest it has been in nearly 50 years (see chart below). This strong position is not likely to change significantly this year. And we continue to believe U.S. corporations are well-positioned to capitalize on economic growth here and abroad.



SOURCE OF DATA: Federal Reserve

INTERNATIONAL STOCKS: A mixed bag.

INTERNATIONAL STOCKS IN DEVELOPED MARKETS NO LONGER SEEM UNDERPRICED. And they have additional issues clouding their outlooks.

- ALTHOUGH OFFICIALLY OUT OF RECESSION, THE EU IS LIKELY TO TREAD WATER IN 2014. Simply put, the EU is not generating sufficient domestic demand. The region continues to rely on exports, which are not likely to rise significantly given moderate global expansion. Longer term, the region's prospects are threatened still by risks to the banking sector and the ability of EU members to reduce their debt.

- JAPAN'S ABILITY TO MAINTAIN ITS CURRENT RATE OF EXPANSION IS QUESTIONABLE. The Land of the Rising Sun has finally achieved some price inflation and growth in GDP due to its very large stimulus program. History has shown, however, that growth generated by fiscal and monetary stimulus is short-lived absent ever larger spending plans.

Emerging markets (down 2.3% in 2013) are vulnerable to flat commodity prices and tepid global growth, both of which we envision for 2014. Their weak performance in 2013, however, suggests that much of these issues may already be priced into the asset class. LNWM is now analyzing our exposure to emerging markets, which could result in adjustments later this year.

FIXED INCOME: More pressure from rising rates.

RATES WILL LIKELY CLIMB HIGHER IN 2014, even given the moderate economic growth we expect and a very slow-paced taper by the Fed. In this type of environment, interest-rate risk is not likely to be rewarded, as investors realized last year. Most U.S. bonds suffered in 2013 as interest rates rose. Long-dated Treasury bonds, which are the most vulnerable to rising rates (they are considered to have no credit risk), were down 15% for the year.

LNWM began reducing the interest-rate exposure in client portfolios at the end of the third quarter 2013. Our new fixed-income strategy (discussed in the Q4 2013 Economic Outlook) replaces much of the interest-rate risk with credit and manager risk – risks we believe will be better compensated going forward. Heading into what we think will be a period of rising rates, we have reduced the overall risk of our fixed-income portfolios by altering the types of risk taken on.

LNWM PORTFOLIOS WERE SHIELDED FROM MAJOR CREDIT-RELATED LOSSES IN MUNICIPAL BONDS, since we emphasize muni bond managers who pay careful attention to credit quality. In fact, none of our separate account managers had exposure to Puerto Rican bonds, which were down 20% in 2013.

Except for a few bad apples, overall credit quality in the muni bond market is improving. Pension and budget reforms, along with a pickup in revenue, are helping state and local governments get their finances in order.

OUR BOTTOM LINE

Despite the economic obstacles we foresee in 2014, we remain cautiously optimistic regarding the opportunity for positive returns. While stocks are no longer as attractively priced, the U.S. and the global economies appear to be grinding forward. The pace may be frustratingly slow, but resulting stability and strength in the U.S. economy should provide welcome relief for investors.

With stocks looking to outshine other asset classes again this year, it's tempting to chase returns and place all of your eggs in the equities basket. Although we believe a major correction in equities isn't likely in 2014, markets fluctuate due to unforeseen factors. Diversified portfolios mitigate risk and help protect value.

Heading into 2014, LNWM has in place a high-quality mix of traditional equities and bonds along with alternative strategies. This should allow us to capitalize on rising equity markets while protecting against negative surprises, including the potential for higher interest rates.

ABOUT THE AUTHOR

Robert Benson is chief investment officer at Laird Norton Wealth Management. He is responsible for setting and implementing investment strategy at the firm, as well as selecting managers for our client portfolios. Bob has more than 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. He has an MBA from Northwestern University. Bob has served on the boards of both startup firms and non-profit organizations.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With more than $4 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Originally founded to serve the financial management needs of the Laird and Norton families in 1967, the firm now provides personalized wealth management solutions for more than 425 individuals, families, business leaders, private foundations and nonprofit organizations. For nearly half a century, Laird Norton Wealth Management has been driven by a passionate commitment to help its clients and their families achieve security, find happiness and thrive in every aspect of their lives. The company is relentless in the pursuit of client satisfaction and is committed to never fail at putting a client's best interest as the number one priority.

DISCLOSURE