Quarterly NEWSLETTER

Spring 2014

Commonwealth Bank & Trust Company

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The 2014 stock market tug-of-war continues to gyrate between quick surges followed by sharp pullbacks, but has yet to experience a long overdue 10% correction during the past 33 months. Meanwhile, the recent burst of M&A activity serves to elevate market enthusiasm, and the rotation to High Quality/ Large Cap Value stocks bodes well for conservative minded investors accustomed to seeking relative bargains in their stock purchases. We expect these trends will continue through the summer/fall season and, consistent with our investment style, we will be seeking to capitalize on these quality and value-oriented trading opportunities within our portfolios. With the ongoing help of the ever accommodative Federal Reserve, along with central banks around the globe, our forecast calls for cautious optimism as the markets continue to digest numerous economic and geopolitical curve balls. We invite you to catch up on our thinking concerning these matters in this spring edition of our newsletter and wish all of our friends and clients a Happy Derby season and the very best of luck on race day!

Commonwealth is a privately owned community bank offering a full complement of financial services including: Personal and Business Banking, Mortgages, Private Banking, Trust and Wealth Management. We are always looking for ways in which we can better serve our current clients and prospects and we encourage you to contact us for details concerning any of our banking services.

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Cautious Optimism...

The first quarter of 2014 saw a return of volatility for equity markets as they experienced a sharp pullback in January only to rebound in February and just barely rise to new highs in early March. By quarter end, they were essentially right back where they started the year, with most indices showing only slight increases. The S&P 500 Index finished up 1.30% for the quarter, while the Russell 2000 index finished up 0.81%. The Nasdaq was the best performer of the quarter, gaining 1.81% while the Dow Jones Industrial Average ended down -0.15%. International markets continued to lag U.S. markets, with the MSCI EAFE up 0.66% for the quarter and the MSCI Emerging Markets Index down -0.80%.

Despite the economy's continued improvement, market fundamentals as well as perceptions of international risk and the coming end of government programs have investors' caution levels rising. The Federal Reserve began to "taper" their purchasing of bonds in January by $10 billion per month, and if they continue at this rate, the program will be completely phased out by fourth quarter. Employment and housing growth have also slowed. Employment gains for the first two months of 2014 were below expectations, though data in March suggests a return to more normal job growth. The supply of homes for sale declined during the quarter, affecting sales volume, while the inordinately cold winter weather stalled new home construction. The major geopolitical news of the quarter came in early march with Russian intervention in the Ukraine and the subsequent annexation of the Crimea region. While the U.S. is responding with diplomatic actions to penalize Russia, many European countries depend on Russia's natural gas and an interruption in supply could derail the fragile recovery. While China continues to grow at a strong annual rate, the pace of growth is slowing and concerns are rising that they are facing a housing bubble and significant debt problems. Despite these numerous concerns, consumer confidence rose in March to a six year high.

Chart 2

S&P 500 Sector Performance
Q1 2014 - Total Returns

	Q1	YTD
Utilities	10.09%	10.09%
Healthcare	5.81%	5.81%
Materials	2.86%	2.86%
Financials	2.61%	2.61%
Information Technology	2.28%	2.28%
Energy	0.78%	0.78%
Consumer Staples	0.50%	0.50%
Telecommunication	0.47%	0.47%
Industrials	0.14%	0.14%
Consumer Discretionary	-2.80%	-2.80%

Chart 1

Market Performance
Q1 2014 - Total Returns

	3.31.14 Level	Q1	YTD
Dow Jones	16457	-0.72%	-0.72%
S&P 500	1872	1.81%	1.81%
NASDAQ Composite	4198	0.84%	0.84%
Russell 2000	1173	1.12%	1.12%
S&P Midcap	1378	3.03%	3.03%
Russell 1000 Growth	864	10.44%	10.44%
Russell 1000 Value	928	10.01%	10.01%
MSCI EAFE	1916	0.84%	0.84%
	Yield	Q1	YTD
Barclays Municpal	3.15	1.60%	1.60%
Barclays Aggregate	2.48	1.84%	1.84%
Barclays High Yield	5.64	3.50%	3.50%

Proprietary Performance Results

	1st Quarter	1 Year	3 Year	5 Year	Since Inception
Focused Equity Fund [2]	2.01%	18.40%	13.97%	20.61%	17.09%
Aggressive Growth Fund [1,3]	-0.57%	23.44%	17.16%	22.34%	9.00%
Science/Technology Fund [4]	1.55%	25.09%	12.94%	20.05%	7.25%
S&P 500	1.81%	21.83%	14.61%	21.12%	17.40%[2], 7.06%[3], 6.96%[4]
Russell 2000	1.12%	24.90%	13.18%	24.29%	20.05%[2], 8.23%[3], 6.97%[4]
MSCI EAFE	0.83%	18.32%	7.92%	16.77%	13.18%[2], 3.14%[3], 4.23%[4]
Strategic Income Fund [5]	2.08%	9.18%	9.62%	14.60%	12.05%
60% Russell 3000 Val/ 40% Barclay Agg	0.84%	12.61%	10.44%	15.11%	12.05%

There is no assurance that any of these investment strategies will meet its investment objective. Performance results for each strategy are computed on the strategy's overall returns. Each strategy and index includes the reinvestment of dividends. Past performance does not guarantee future results. Current performance may be lower or higher than the performance results quoted. [1]Net of management fees; performance results of SMC Capital and/or its principals as advisor from inception to 2/28/06 and as sub-advisors to CBandT since 3/1/06. [2]Inception date 12/31/2008. [3]Inception date 7/1/1989. [4]Inception date 3/31/2006. [5] Inception date 12/31/2008.

Fixed Income

The Federal Reserve continued its $10 billion taper in asset purchases at both FOMC meetings during the quarter. This was despite mixed labor market indicators and economic activity which slowed in part due to adverse weather conditions. Nonfarm payroll reports have been mostly disappointing while the unemployment rate fell in December from 7.0% to 6.7% and has basically remained at that level. The Fed also dropped its 6.5% unemployment rate threshold, linking rate hikes instead to “a wide range of information” including employment, inflation and financial developments.

Janet Yellen assumed Fed leadership at the beginning of February and briefly roiled markets in March by indicating that rates could start going up sooner than the market had foreseen (i.e., potentially mid-2015). As a result, short to intermediate Treasury rates (3-7 yrs) increased roughly 0.2% and long-term rates were actually down slightly. She has since reiterated that the Fed would not be quick to eliminate its support and that markets could continue to count on accommodative policy for the foreseeable future. During the quarter, the yield curve flattened as the widely quoted 10-yr fell 0.31% to 2.72%.

Broad investment-grade indices finished the quarter with a solid return of 1.8% compared to -2% in ’13. Research shows that back-to-back down years for the bond market are fairly rare, with the steepest calendar year decline of 5% indicative of a worst case scenario. Our view is that if rates do creep higher, the 10-yr Treasury should find strong support around 3.5% as long as the Fed has short-term rates pegged at zero.

The low rate/default environment has benefited the high-yield bond market. High-yield indices finished the quarter up 3% and were up 7.4% in ’13. Its yield of 5.6% is 4-5% below longer-term averages. Spreads are now below 4% compared to averages closer to 6%. Due to these metrics, we now consider this asset class even more overvalued. Emerging market bonds had similar results for the quarter despite volatility and negative returns in January.

Municipal bonds returned 3.8% according to the BofA ML index. It was the highest quarterly return since ’11 and the best 1st quarter since ’09. This more than offset last year’s -2.9% return. Long-term bonds (22+ yrs) were up 6.1% recapturing ’13 losses. We are not surprised by the recovery. In January we wrote “We believe that the soon to be apparent higher tax rates (including the new 3.8% Medicare Tax) and projected net negative supply should provide some tailwinds next year. In addition, historical yields vs. Treasuries (often converted into ratios) are attractive.”

We continue to recommend a tactical underweight to core bonds, and an overweight to taxable absolute-return-oriented fixed-income and other alternative strategies. Fixed income examples include PIMCO Unconstrained and in our most-conservative portfolios, floating-rate loans, which can benefit from rising interest rates.

Managed Equities

Total return for the Managed Equity Composite, which consists of all equities under discretionary management (Large, Mid, Small, International, etc.) was 1.44% for the first quarter of 2014 compared to 1.80% for the S&P 500, 0.83% for the MSCI EAFE Index and 1.12% for the Russell 2000 Index.

Focused Equity

For the quarter, the strategy was up 2.01% versus 1.80% for the S&P 500 Equity Index. Since inception, the strategy narrowly trails the benchmark’s return of 17.40% by 0.31% with a gain of 17.09%. The strategy has a beta of .76, so we anticipate that it will lag in strong up markets and outperform in corrections. On a risk-adjusted basis, the results continue to be strong. The strategy has generated an annualized 3.0% alpha since its inception (1/1/09).

Teva Pharmaceutical Industries (TEVA), an Israeli generic pharmaceutical company, had an exceptional quarter returning 31.08% to the fund. Investors applauded the firm’s announcement of their new CEO and the upbeat tone struck at a JP Morgan Healthcare Conference in early January. Shortly after, the firm posted a 19% increase in fourth-quarter earnings on stronger revenue, led by its specialty medicines. These earnings, along with an announced 5% increase in their quarterly dividend, led to a slew of upgrades from Barclays, Morgan Stanley, and Goldman Sachs. We have trimmed our position in Teva following its outperformance this quarter. Microsoft Corp. (MSFT) was another strong performer with a return of 9.62%. The firm saw a number of changes in the quarter with the naming of Satya Nadella as the successor to CEO Steve Ballmer and Bill Gates’s resignation as chairman. The company’s shares reached $40 after Nadella launched their Office iPad apps as he moves the company away from a Windows and PC-centric focus toward a mobile/cloud environment. We continue to hold a positive view of the company and have used the recent rally as an opportunity to realize a portion of our gains.

Teva Pharmaceutical Industries Ltd. (TEVA)
1/1/2014 – 3/31/2014

Laggards in the fund included MasterCard, Inc. (MA) and Phillip Morris International (PM) returning -10.46% and -4.89%, respectively. MasterCard was dealt a blow early in the quarter when an EU court advisor rejected Mastercard’s appeal on card fees claiming that the fees violate antitrust rules. The firm also missed on earnings by $0.03 per share. Management cites a higher level of rebates and incentives paid out as an offset to increased spending by cardholders. Phillip Morris International carried its struggle over into the new year amidst increasing regulation of e-cigarettes and more negative reports on the impact of smoking from the Surgeon General. Investors are wary of future regulation as the FDA continues to evaluate the effect of e-cigarettes. We continue to appreciate PM’s impressive operating margins, returns on invested capital, and wide economic moat, but we have sold a portion of our position this quarter to hedge against the challenges facing PM.

Strategic Income Builder

For the quarter, the strategy was up 2.08%, slightly behind the benchmark return of 2.53%. Since inception, the SIB strategy has returned an annualized 12.05%, in-line with the blended benchmark return of 12.05%. The yield (income) from the strategy has consistently exceeded that of its benchmark, which is comprised of a 60% weighting to the Russell 3000 Value Index and 40% to the Barclay’s Aggregate Index. The success of the fund is the result of an attractive mix of income producing securities, exposure to global markets and tactical allocation. Since its inception (1/1/09), the strategy has generated a positive alpha of 1.80% annualized.

Performance was driven by Eli Lilly and Co. (LLY) and Wells Fargo & Co. (WFC), returning 16.36% and 10.26%, respectively. LLY began the year strong as the broader market declined in January. Despite a decline in net profit for the fourth quarter of 2013, shares rose with a reported earnings per share (EPS) of $0.74, in-line with estimates and higher-than-expected revenues for the same quarter. The biggest catalyst for the company in the first quarter was encouraging news that its oncology candidate, Ramucirumab, met the main goal of a Phase III lung cancer trial by improving survival rates when compared with a placebo. Wells Fargo & Co. announced that they would once again begin courting subprime borrowers to help boost business in a slow mortgage market. Management notes that they are now “more comfortable with [their] own processes and controls” and it is easier for them to make loans. Investors also favored the decision by the Fed to not object to the Company’s 2014 Capital Plan which includes a 16.7% increase in their quarterly dividend to $0.35 per share and a buyback of 350 million shares.

Darden Restaurants, Inc. (DRI) saw its shares fall 5.60% in the first quarter amidst negative reports from Barrington Capital Group and Starboard Value questioning management’s ability to lead the company. The negative press comes after Darden announced its plan to separate their Red Lobster business in an attempt to enhance shareholder value. Management cites weak restaurant traffic due to poor weather conditions and the challenges associated with the implementation of its new strategic plan.

The first quarter proved to be difficult for freight stocks due to less-than-optimal macroeconomic conditions. Both Expeditors International (EXPD), down 10.44% for the quarter, and C.H. Robinson Worldwide (CHRW), down 9.65% for the quarter, missed earnings estimates by $0.06 per share. EXPD cited a weak and volatile ocean freight market and CHRW attributed their underperformance to increased cost-per-mile in their truckload division which led to lower net revenue margins. We have begun to sell a portion of our position in CHRW due to uncertainty in the third-party logistics industry.

Science & Technology Strategy

The Science & Technology strategy's 1.55% 1Q14 return was above the S&P Information Technology, Healthcare and Telecom sector results of 1.32%, 1.09% and 0.72%, respectively. It also was higher than the Nasdaq 100 return of 0.41% and the broader Nasdaq Composite return of 0.83%. The strategy's fortunes started to reverse at the end of the first quarter as biotech and growth technology stocks continued to sell off into April. By April 15, the fund was down slightly year-to-date, but continues to outperform the NASDAQ and NASDAQ 100.

LEADERS: Technology began to outperform Healthcare in 4Q13 and continued in the first quarter. Harman International (HAR, 30.37%), a leader in consumer electronics, rallied as growth in software and hardware for automotive and home electronics accelerated. It is becoming a key player in one of our long-term investment themes, "The Internet of Things", where devices, appliances and electronics become increasingly connected and "Smart". Alexion (ALXN, 14.48%) prolonged its five-year track record of stellar returns as its lead drug, Soliris, was recognized by the United Kingdom's healthcare guideline governing body, NICE, as the first line treatment for aHUS, a life-threatening disease that causes blood clots often resulting in renal failure. Soliris was also granted orphan drug status in the U.S. and the EU for prevention of Delayed Graft Function, an immune response resulting in the failure of a transplanted organ. Alexion has been a 16 bagger for the fund, since it was first added in 2006.

Harman International (HAR)
1/1/2014 – 3/31/2014

LAGGARDS: Celgene (CELG, -17.38%) declined in 1Q14 as the biotech sector started to sell off in last half of March. The biotech index (IBB) jumped over 65% in 2014. We believe the biotech sell-off is part profit-taking, part valuation, part de-risking. We believe that speculation in biotech increased over the past year and enabled several private companies to hold IPOs in the last twelve months. We have remained selective and bought companies with one or more first-line products as well as catalysts within the next twelve months. Nevertheless, in the last few weeks, we have trimmed holdings in Celgene, Gilead (GILD, -5.65%) and Medivation (MDVN, 0.86%) as technical indicators started to break down in April. From a valuation standpoint, these companies trade at a significant discount to their growth rates relative to other S&P healthcare stocks. While we may have trimmed some of these selective holdings and jumped to the sidewalk to let the sellers stampede in the street, we expect to buy these shares back when technical indicators stabilize.

Small Cap Composite

The Small Cap Value Composite returned 6.18% for the first quarter of 2014, versus 1.12% for the Russell 2000 index.

The sectors with the highest contribution to relative return in Q1 were Health Care and Materials. One top contributing holding in the Portfolio during Q1 was Myriad Genetics Inc. (MYGN, +63%), a genetic testing company with a dominant position in the breast and ovarian cancer markets. Despite an unexpected Medicare reimbursement cut, which triggered a selloff in late 2013, several positive developments have supported our investment thesis in early 2014. First, MYGN reported strong quarterly results with minimal market share loss from its BRCA test. Second, MYGN published data demonstrating its new prostate cancer test, Prolaris, is an accurate predictor of disease progression. Lastly, shortly after quarter end, the Centers for Medicare & Medicaid Services (CMS) revised its late 2013 reimbursement cut on Myriad's BRCA test, raising its payment level by +52%, and the latest 'doc fix' bill was signed into law, which froze current CMS reimbursement levels until 2017. These collective developments led us to increase our multiple on MYGN. Another top contributor during the quarter was Nordion Inc. (NDZ, +36%), a healthcare company that produces and distributes medical isotopes for the prevention and diagnosis of disease. NDZ reported in-line results in Q4 but gave strong guidance for FY 2014. Very late in the quarter, NDZ announced an agreement to be acquired by private equity firm GTCR at $11.75/share (or 90% of our $13 AV). We began trimming the position shortly after quarter end. Also performing well in Q1 was Motorcar Parts of America Inc. (MPAA, +26%), which sells remanufactured alternators and starters to the nation's largest auto parts retailers. MPAA delivered another strong quarter with +29% revenue growth and improved margins from higher facility utilization. We exited our remaining position during the quarter as the stock traded at a premium to our valuation.

DST Systems, Inc. (DST)
1/1/2014 – 3/31/2014

The sectors with the lowest contribution to relative return in Q1 were Information Technology and Consumer Staples. One large negative contributor to performance in Q1 was NeuStar Inc. (Cl A) (NSR, -35%). The company is the exclusive provider of telephone number portability in the United States. This contract represents 50% of total revenues and expires on June 30, 2015. The contract is undergoing a new bidding process that has been marked with significant delays and a lack of transparency. Our research suggests that NeuStar will at least retain a large portion of the contract, but make pricing concessions. Thus, we maintained our position during the quarter. Another poor performer during the quarter was Ascena Retail Group Inc. (ASNA, -18%), operator of dressbarn, maurices, Justice, Lane Bryant, and Catherine's specialty apparel stores throughout the United States. In a heightened competitive retail environment, ASNA posted a flat Q2 comp as strong e-commerce growth of +28% was offset by a -3% decline in same store sales. Improvements at newly-acquired concepts Lane Bryant and Catherines were mostly offset by highly promotional activity at Justice. We took no action during the quarter. RentACenter Inc. (RCII, -20%), the largest rent-to-own (RTO) operator in the United States with 40% of all RTO stores, was also a poor performer during Q1. RCII reported disappointing Q4 results and initiated 2014 guidance well below expectations, which caused a sharp decline in its shares. Due to the declining core results and a loss of conviction, we trimmed the position during the quarter.

Kentucky Municipals

Quarterly bond issuance by Kentucky municipalities declined to $734.3 million from $1.2 billion (44 issues). New issue size averaged $26.7 million. Non-BQ issuance was $632 million or 86% with bank-qualified "BQ" issuance of only $64 million or 9%. For our clients, we tend to utilize non-BQ because yields are typically higher. Taxable issuance was $38 million or 5%.

The University of Kentucky (Aa2/AA-) was the largest issue at $190 million. Projects include Expansion and Renovation of the Gatton College of Business and Economics & Commonwealth Stadium. Stadium plans include many spectator driven improvements (concessions, restrooms and security), a new multi-purpose recruiting room, 16 to 20 private suites, new home team facilities, approximately 2,000 new club seats, new press facilities, a new full service kitchen, and a new team store. Funds will also be used for the construction of an Academic Science Building. The projects are expected to be completed in '16.

During the strong quarter, our 10-year Kentucky tax-exempt yield target fell 0.25% to 3.05%. Our 15-year yield target fell 0.40% to 3.60% during the quarter.

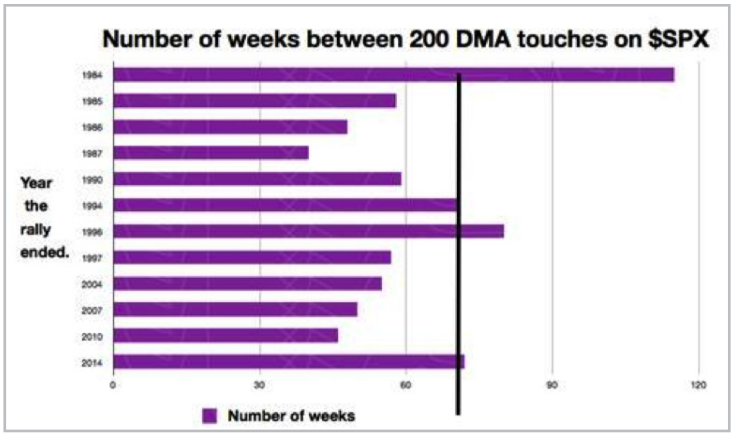
While issuers' credit quality are broadly improving due to the recovery, Puerto Rico, one of the largest issuers and widely held in funds, is an important exception. Previously we discussed that Puerto Rico was the visible wild card for municipal bonds in '14. Much of the uncertainty for this year is quickly behind us. During the quarter its credit rating was cut to junk status by Fitch, Moody's and Standard & Poor's without market disruption. In March, Puerto Rico was able to borrow $3.5 billion (GO's) making it the largest junk-rated issue ever. The issue had a single 8% coupon and maturity (July '35) and were priced to yield 8.73% at $93 cents on the dollar. The deal was very successful as it attracted atypical investors such as hedge funds.

Also positive for municipals, S&P raised bond insurers' credit ratings for MBIA & Assured Guarantee units. While we still advocate comfort with the underlying credit, municipal insurance gives issuers options for keeping overall borrowing costs low.

We continue to think intermediate bonds are the most attractive part of the market particularly given recent curve changes. Our bias remains defensive coupons of 4% or greater with a focus on premium callable municipals sometimes referred to as "cushion" or "kicker" bonds. Our performance themes continue to evolve around "rolling the steep yield curve" and opportunistic buying/selling within a somewhat volatile market. We continue to evaluate portfolio positioning, balancing risk/reward in a manner that is consistent with our longer-term philosophy and each client's objectives.

OUTLOOK: TIMING A TURN IN THE MARTKETS

As we write, the current rally which dates to November 20, 2012 has become the second longest in the past thirty years. For this purpose we define a rally as the number of weeks the S&P 500 stays above its 200 day moving average (DMA).



Source: Stock Charts (4/3/14)

By most measures the current rally seems a little "long in the tooth", but that in itself is not necessarily a reason to sell. We have also been on record that valuations for the stock market look stretched, but have not reached extreme levels. And, of course, valuation by itself is a notoriously poor market timing tool. Anyone remember what year Alan Greenspan's Irrational Exuberance speech took place? It was 1996, right before the market went on to produce 20% + returns in 1997, 1998 and 1999! A good reminder that valuation only becomes a good market timing tool when it reaches extremes, like it did in 1999.

In our opinion, successful long-term investors need to be able to both recognize value and have a general sense of timing when looking for opportunities to both seek and take profits. This is easier said than done, and the normal fundamental signals we look for may be skewed due to "artificial" monetary policies. Frequently, the internal action of the market can provide clues when market conditions are changing. In this age of artificial monetary policy and pricing of asset classes, the market internals may provide more insights than normal. Although these internal indicators are far from fool-proof, we have highlighted here some we believe are worthy of watching:

- New 52-week highs can be an early indication that a market is turning unhealthy. Look for divergences between index-price highs and new 52-week highs. When a major index such as the S&P 500 is making new highs but the number of SPX stocks making 52-week peaks begins declining, that divergence can be a warning sign.
- We monitor for divergences between the advance/decline line (stocks going up vs. down) and the broader markets. Similar to new 52-week highs, this is a signal of market breadth, a term that describes how much of the market is participating in the advance. As markets peak, we often see fewer and fewer stocks pulling the market upward. We saw a classic example in the "Nifty Fifty" during the 1960s, and again in the dot-com bubble with a handful of leading stocks driving the NASDAQ.
- Another signal we look for is a change in market capitalization leadership. Usually when markets begin to peak, we start to see small caps underperform. Often the smallest companies start to turn south, while the rest of the market appears healthy. The tendency for big-cap-dominated indices to peak last is a function of their composition. Since these indices are market-cap weighted, a small number of the mega-caps can keep the index moving higher while the majority of stocks lag.
- Lastly, we monitor the percentage of stocks in a bear market. As a rough estimate, any equity down 20 percent from recent highs can be considered in its own bear market. Based on Lowry market studies, it is typical during healthy bull markets that less than 10 percent of stocks are down 20 percent from recent highs. As the small caps and mid-caps roll over, this percentage will increase. At the market peak, we typically see one-fifth of stocks in their own bear market.

Fortunately, we are not seeing any imminent danger signs from the above criteria that would cause us to be overly defensive. However, that could change quickly, which may lead us to adopt a more conservative position in portfolios, especially since valuations look a little stretched and the added uncertainty of artificial pricing in the markets. We hope that we have provided you with some insights to the things we are monitoring for signals on the direction of markets. Just to be clear, we are not advocating a market timing approach, however, we do think it is important for long-term successful investors to look for clues that can improve both their sense of timing and value.

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