

OUTLOOK 2013

AN ANNUAL PUBLICATION OF FERGUSON WELLMAN CAPITAL MANAGEMENT

Beyond the Cliff Macro Strategy and Domestic Equities



by George Hosfield, CFA
Chief Investment Officer

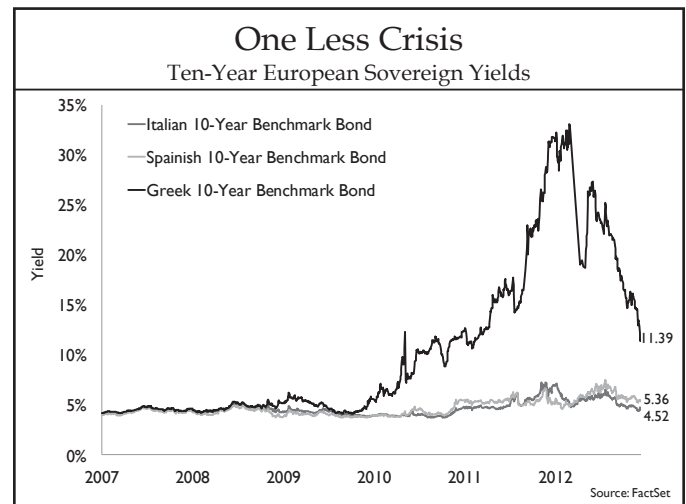
U.S. earnings growth slowed to single-digit levels in 2012 and politics provided plenty of turbulence for investors on both sides of the Atlantic. Ultimately, “easy money” policies by central bankers worldwide proved decisive as blue-chip U.S. stocks chalked up double-digit gains while increasingly thin bond yields provided less competition for funds and the risk of a Eurozone breakup faded (see accompanying chart). Small-cap stocks lagged, but international stocks staged a fourth quarter comeback to finish the year with returns on a par with domestic.

While Washington was able to come to a fiscal cliff compromise at the eleventh hour, there is still plenty of uncertainty regarding the effect of higher taxes and reduced spending in 2013. We believe that the current compromise will result in a 1.5 to 2 percent hit to GDP this year. Fiscal uncertainty notwithstanding, our economy is proving to be surprisingly durable. Aided by rock-bottom interest rates, the U.S. housing market is once again a source of growth and consumers continue to spend despite predictions to the contrary.

In terms of positive catalysts for the domestic economy, no success story rivals that of U.S. energy. Producers and service providers have developed horizontal drilling and hydraulic fracturing techniques that have unlocked so much additional oil and gas, that North America could actually become *energy independent* by 2020. The economic benefits are substantial and include a material reduction in our trade deficit, a rebound in manufacturing and perhaps most important, significant job creation.

Against this backdrop, we foresee the economic positives outweighing fiscal headwinds. We expect Fed policy to remain highly accommodative and look for another year of slow progress for the U.S. economy. Globally, we expect China’s economy to demonstrate further evidence of a rebound while the “New Tiger” economies of Southeast Asia continue to grow at attractive rates. Europe is likely to remain in recession and as Japan elects yet another government in an attempt to staunch its economic malaise, we foresee the economy there continuing to struggle.

With “coupon-plus” returns unlikely to repeat, we expect stocks to outperform bonds in the year ahead. Nevertheless, our current allocation to fixed income securities is only modestly underweight as the defensive nature of the asset class remains a key shock absorber for the unpredictable. We have recently increased our international equity allocation by adding to emerging markets and foresee further such moves in the search for late cycle growth. Ultimately, we would become more constructive toward risk assets if U.S. politicians were to successfully address entitlement spending and tax policy beyond temporary measures.



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Fixed Income

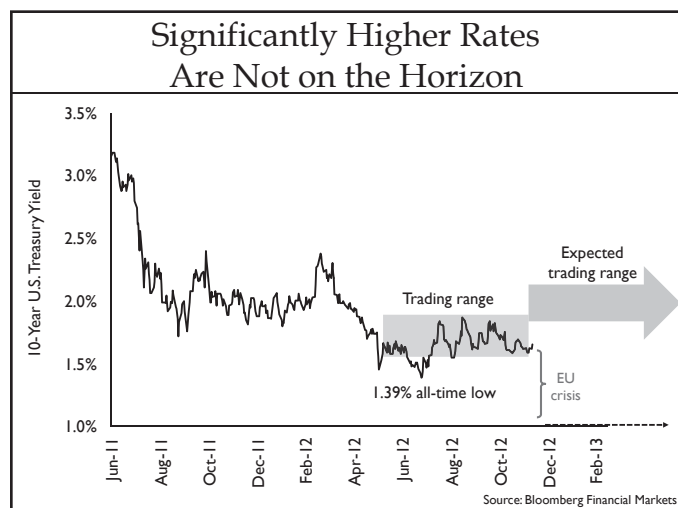
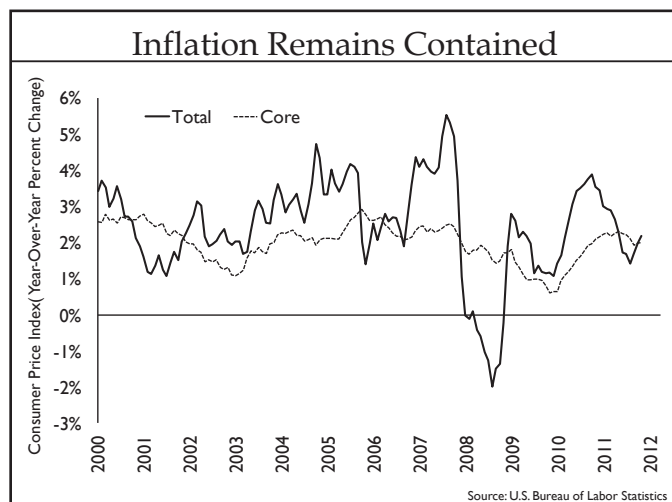


by Marc Fovinci, CFA
Principal

Despite interest rates starting 2012 at record lows, rates ended the year even lower. Federal Reserve quantitative easing, an anemic U.S. economy and European fiscal woes are all conspiring to prevent rates from rising significantly in the foreseeable future.

For the time being, European news has moved to the background for the markets. Europe is slowly moving down a bumpy path toward closer fiscal integration and has survived the first stress tests of Greece. While the pace is uneven and slow, the trend has been in the direction of healing the European Union. We expect continued progress, punctuated by political hesitation and stress. While this healing should exert mild upward pressure on U.S. interest rates, the magnitude may be a few tens of basis points and may be overwhelmed by our own domestic events.

As we write this publication, the fiscal cliff is only partially resolved. However, what is certain in 2013 is increased taxes *and* reduced federal spending. In a word, austerity. This will serve to contain U.S. economic growth to much the same pace as 2012. As a counterbalance, an improving housing market and reduced uncertainty regarding government policy will help compensate for the fiscal drag.



Weak economic growth should keep inflation contained, and the Federal Reserve will not likely back off on its quantitative easing program. This means more of the same low interest rates that we experienced in 2012. While low interest rates mean low income for investors, something is better than nothing. Bonds will continue to provide stability and income (albeit low income) in 2013 and, for equity investors, bonds continue to offer the best diversification during equity sell-offs. As we have seen in the past, stocks decline and bonds rally when a recession occurs.

The quest for yield by investors will continue in 2013. With short-term interest rates between 0.0 and 0.4 percent, investors will continue to push their risk

boundaries in search of more income. This means extending maturities and trading-down in quality to the lowest acceptable level. Therefore, demand for higher-yielding corporate bonds and for tax-free municipal income will not abate.

Longer-term, we expect the directional bias of interest rates to be modestly upward; but in light of continued weak but positive economic growth, we have portfolios at nearly full benchmark duration and continue to maintain an overweight to corporate bonds.



Municipal Bonds



by Deidra Kryz-Rusoff
Portfolio Manager

2012 was another terrific year for municipal bonds, with the broad-based Barclays Municipal Bond Index returning 6.8 percent and the Barclays Intermediate/Short Municipal Bond Index returning 3.07 percent. This price appreciation can be attributed to anticipated increases in federal and local taxes, investors' preference for conservative assets and lower bond issuance for new municipal projects. In addition, most state and local governments are experiencing modest revenue gains. Ironically, the riskier sectors outperformed the more conservative ones, with the best returns coming from the industrial revenue sector.

The debate in Washington, D.C., over federal tax exemption of municipal interest continues. We do not expect a wholesale scrapping of the tax exemption to occur. However, we wouldn't be surprised if some attention is paid to capping the interest exemption for wealthier taxpayers. We believe that changes to the tax exemption would be met with resistance from lawmakers, not only because of the extreme hardship that higher borrowing costs would place upon state and local municipal issuers, but also due to the potential for costly and protracted lawsuits that would certainly follow.

We expect local issuers to continue to exhibit restraint in issuing new bonds given slow economic growth, persistently high unemployment and continued budgetary caution. Refunding opportunities will also be diminished next year, since most higher-cost debt that *could* be refunded has already been refunded. Low issuance, increasing tax levels and the Federal Reserve's expressed intention to hold rates low through 2014 should allow nominally-low municipal rates to persist throughout much of 2013.

Real Estate Investment Trusts (REITs)



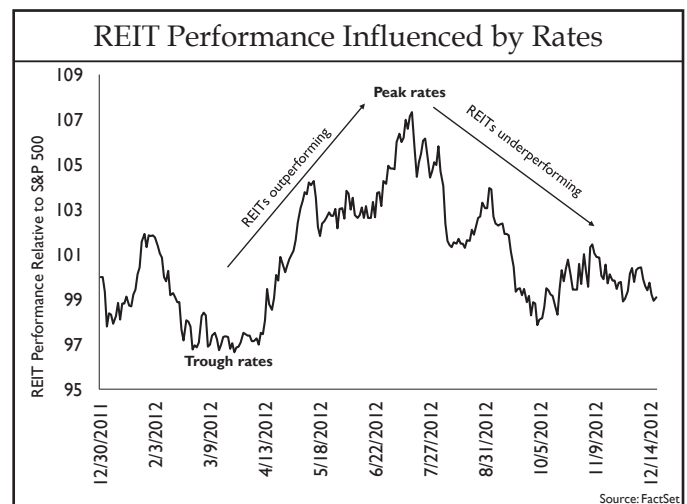
by Ralph Cole, CFA
Senior Vice President of Research

Posting mid-teen returns, Real Estate Investment Trusts (REITs) had another good year in 2012.

Our REIT portfolios had a difficult year in a relative sense to the benchmarks. Several factors contributed to this lag: (1) small-cap REITs rallied much more than larger cap REITs, and our portfolio of high quality securities didn't own many of these smaller names, (2) high quality names underperformed as rates dropped, which really benefitted highly levered REITs and (3) a number of our REITs issued new equity this year, which diluted current shareholders.

With job growth expected to expand slowly and limited anticipated new supply, we believe REITs can appreciate in-line with earnings growth in 2013. As such, we remain constructive on REITs, but in a measured way. We still believe that valuations are stretched, but REITs related to timber, storage and apartments look attractive.

The one caveat we would place on our forecast is interest rates (see accompanying chart). As you can see, REITs underperformed early in the year when yield on the 10-year Treasury rose to 2.37 percent. Then, as the European crisis unfolded, the rate fell to 1.39 percent and REITs rallied sharply versus other equity asset classes. Thus demonstrating that in the short term, if rates rise, REITs will likely underperform large-cap stocks despite what we might believe about their inflation-hedging characteristics.



Dividend Value



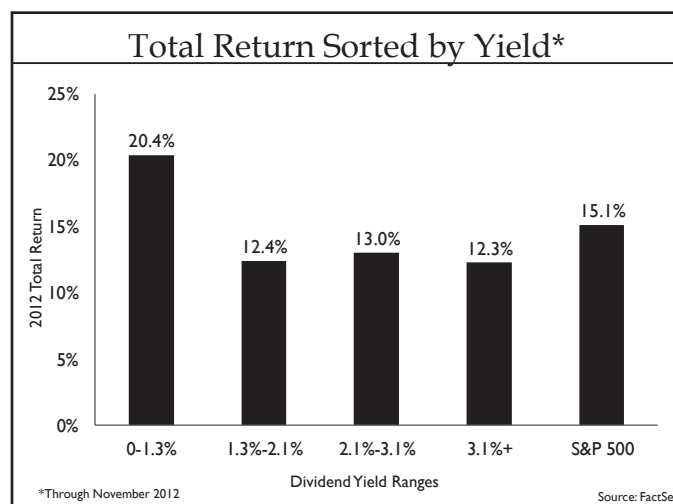
by Jason Norris, CFA
Senior Vice President of Research

In 2012, the Federal Reserve aggressively stimulated the economy, thus encouraging investors to increase the “riskiness” of their portfolios. This resulted in dividend-paying stocks underperforming the broader market.

Although there isn’t any concrete evidence suggesting that pending tax hikes on dividends were behind this phenomenon, it certainly encouraged companies to issue special dividends and increase their payouts before the end of 2012.

As we look ahead to 2013, dividend growth will be an important component of equity returns. While corporate cash levels and profits are at peak levels, we still believe they will grow in 2013 and companies will be active in returning that cash to shareholders.

Although tax rates on dividends will increase modestly in 2013, we don’t anticipate a negative impact on equity returns performance because the majority of equities are held in tax-deferred accounts. With the lack of high income generating investments, we believe that dividend stocks should remain an important part of investors’ portfolios.



Strategic Opportunities



by Dean Dordevic
Principal

Emerging from the extreme volatility of 2011, we entered last year with only a token allocation to spin-offs and a reduced position in our global macro strategy. We elected to invest this capital in our special situations strategy which proved to be fortuitous since stocks with solid potential for growth and momentum performed very well. We expect this trend to continue into the new year and our special situations strategy to remain the largest segment of our portfolio.

While our spin-off strategy began the year at its lowest allocation ever, as the year progressed, smaller cap stocks (i.e., spin-offs) began to outperform. As such, we opportunistically added to this sector with higher quality, small-cap spin-offs. Looking ahead, with their more growth-oriented characteristics, we would anticipate these stocks performing well in a slow GDP growth, higher tax regime.

Our global macro strategy currently comprises the smallest portion of the portfolio. In 2012, we focused primarily on U.S.-centric themes, but we continued to take advantage of ongoing European difficulties and dislocations as the year progressed. More recently, we have added to positions that would benefit from a weaker Japanese Yen and an improving outlook in China. Looking to 2013, we believe that global uncertainties and mispricings will continue to provide ample opportunity for capital appreciation in this strategy.



International Equity

by Ralph Cole, CFA
Senior Vice President of Research

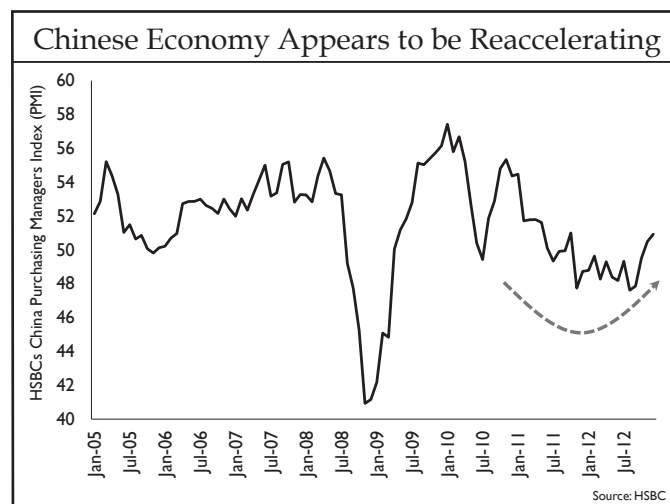
As we predicted in this publication last year, 2012 was a tale of two halves for international markets. We discussed at length the challenges that faced the European Union to start 2012, but we also predicted that the EU would remain intact and provide opportunities for international investors.

On July 26, European Central Bank President Mario Draghi stated that he would do “whatever it takes to preserve the euro” and added that, “believe me, it will be enough.” This press conference proved to be the line-in-the-sand for international equity performance. As these statements set the stage for a rally in European equities and an easing of credit market stress.

Before Draghi’s statement, the Eurozone equity markets were down 10 percent for the year; underperforming the ACWI ex US index by 7.5 percent. Since that time, the MSCI European Monetary Union Index has rallied nearly 30 percent and we subsequently began repositioning our portfolio for a world with the EU intact ... for now. The crisis created value in many sectors of the economy, especially within financial stocks. We began buying banks in France and other financial stocks that would benefit from the healing credit markets. While we lagged for a short period of time during the reversal, we were nimble enough to maintain our performance edge over the benchmark. Though in many respects things are beginning to stabilize, we believe that the debt overhang in peripheral countries, combined with fiscal austerity will keep much of Europe in recession for most, if not all, of 2013.

Looking ahead, in a world struggling to find growth, we are again turning our sights to emerging markets. Three members of our investment team had the opportunity to visit China and India this year, and we returned home excited about growth opportunities in both countries. The reacceleration of China’s economy (see accompanying chart) during the fourth quarter is serving to provide investors with greater confidence that China will successfully execute a “soft landing.”

We began weaving the theme of emerging market growth into our portfolio during the second half of the year when we made commitments to luxury retailers and auto manufacturers that should benefit from the continued growth of the aspirational emerging market citizen. We’ve also added to banks in India and Mexico.



We also increased our commitment to emerging markets through an actively traded mutual fund. Our preferred fund is the Harding Loevner Emerging Markets fund which focuses on fast growing, large capitalization companies in emerging market countries around the world.

We expect that international equities will play an increasingly important role in our clients’ portfolios in the years ahead. We will continue to identify vehicles in both the public and the private markets that will allow our clients to benefit from the exciting growth opportunities across the globe.



Alternative Investments*

by Dean Dordevic
Principal

Our allocation to tactical and alternative asset managers is a tale of liquidity. That is, the more illiquid the asset, the more robust the returns. The large run up during the first quarter of this year was largely missed by hedge funds and “alternative strategies;” however, our private investments are less influenced by the public markets as illustrated by their returns this year. Over the past few years, we have developed a number of relationships with some outstanding managers in private equity and debt, as well as with hedge fund and specialized mutual fund markets. Below is a brief summary of the offerings in which we invested in 2012.

Keystone II is a \$75 million fund that invests in three basic strategies: debt, buyout funds and energy funds. The fund saw its first distribution, a little over 6 percent, and is valued at a 1.34x multiple.

Keystone III & IV employ a very similar strategy focusing on private credit with consistent contractual cash flows. Both funds’ cash flow generation easily covers their targeted 8 percent distributions. Keystone launched their fifth fund last year which targets the same strategy. **Keystone V** will have its final close early in the new year.

Vista Ridge Diversified Fund is a traditional private equity fund-of-funds. It consists of a private equity portfolio purchased at a significant discount. Due to the seasoned nature of the underlying investments, last year’s capital calls were self-funding.

Lazard Alternative Strategies is a fund-of-hedge-funds that invests in four principal strategies: relative value, long/short, event-driven and tactical trading. Returns have been muted by market volatility, but as with most hedge funds, the drawdown has been as well.

Hatteras is a leading provider of alternative investment funds. Their **Core Alternatives Funds** strategy provides a diversified multi-strategy fund-of-funds that is structured to provide investors with a return profile more commonly associated with larger endowment funds.

Forward Tactical Growth Fund was added in October of 2011. It is designed to help investors reduce risk exposure during downturns while participating in market growth through an active asset allocation strategy. The fund uses a momentum model, a fundamental model and a macro overlay to identify mispriced securities. It primarily invests long or short in a variety of exchange-traded funds, with net equity exposures to U.S. large cap, U.S. small cap and emerging markets. The fund was primarily in U.S. stocks most of the year; however, their models lagged as equities rebounded in 2012.

Altegris Macro Strategy Fund was also added last year. This strategy invests in managed futures funds whose strategies are macro based, as opposed to trend following.

As is the case with alternative investing, criteria, composition and frequency of these opportunities will vary throughout 2013. We are continually monitoring these distribution channels for compelling investments in what is an increasingly important and growing portion of our recommended global asset allocation.

**May not be appropriate for all investors. The appropriateness of an investment or strategy will depend on investor’s circumstances and objectives.*

