Outlook 2014

REMOVING THE TRAINING WHEELS

Macro Strategy and Domestic Equities

by George W. Hosfield, CFA
Principal and Chief Investment Officer

What a year it's been. Following handsome gains in 2012, 2013 proved to be another blockbuster, producing returns on blue-chip stocks that few envisioned. Monetary policy has begun to diverge as emerging market countries like Brazil, India and Russia battle incipient inflation, much of it the result of currencies weakened by capital outflows, which in turn resulted from expectations for Fed tapering. Accordingly, equity returns have become much less correlated, with the U.S. leading and emerging markets lagging.

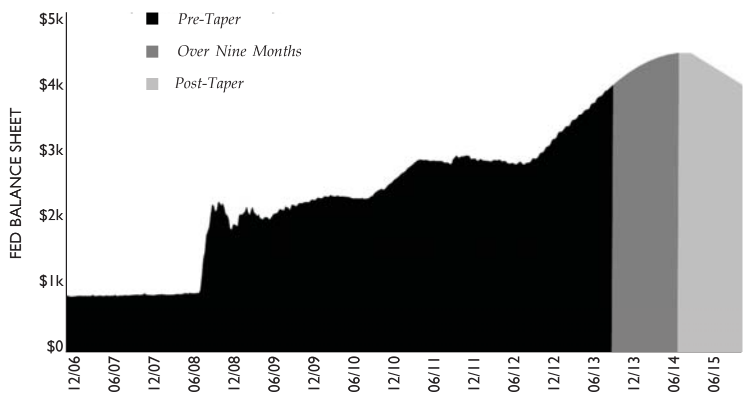
Amidst subdued economic growth, corporate America will have produced another year of single-digit profit growth, but the real story behind 30 percent-type U.S. equity returns was the increased value investors placed on those earnings. While P/E ratios have risen to 50-year average levels, low inflation and lackluster job growth have enabled the type of easy-money Fed policy that renders valuations justifiable, if not conservative, against a backdrop of rising real rates.

As 2014 comes into focus, we foresee the renaissance of U.S. energy production and manufacturing continuing to benefit the economy. With fiscal policy becoming less of a drag domestically, economic growth should accelerate. Even though mortgages have become more expensive, housing will still support the expansion, given that rates remain relatively low. Also, consumer confidence is benefitting from a healthier job market and the "wealth effect" that is a result of rising home and stock prices.

With all eyes on the Fed, we reiterate our belief that tapering of quantitative easing will be for the right reasons; namely, better job growth and a stronger economy that should produce a healthy backdrop for earnings and stock prices. While a new bike rider occasionally experiences a fall, we don't anticipate a dramatic market tumble as the economy rides a two-wheeler unassisted by the ballast of unconventional Fed stimulus. Against this backdrop, we foresee more subdued equity returns ahead and believe that 2014 could be a year when the economy and earnings catch up to stock prices.

Tapering is Not Tightening

Source: Federal Reserve



For now, we retain our overweight to equities, but can foresee a stronger dollar environment that may induce us to pare our weighting internationally, as well as potentially book some profits in small-cap stocks that have led the market higher. Longer-term interest rates are likely to continue grinding higher as monetary policy normalizes (i.e., "tapering"); thus we retain our underweight allocation to bonds and a modestly short duration within our fixed income portfolios. In such an environment, alternative investments, such as fund of hedge funds and private equity, could receive a higher allocation.

FERGUSON WELLMAN'S 2014 INVESTMENT OUTLOOK PRESENTATIONS

01/15 Bend, OR	*01/30 Salem, OR*	*02/06 Boise, ID*	*02/26 Roseburg, OR*
01/28 Vancouver, WA	*02/04 Corvallis, OR*	*02/12 Spokane, WA*	*03/12 Palm Springs, CA*
01/29 Portland, OR	*02/04 Eugene, OR*	*02/18 Astoria, OR*	*10/07 Medford, OR*

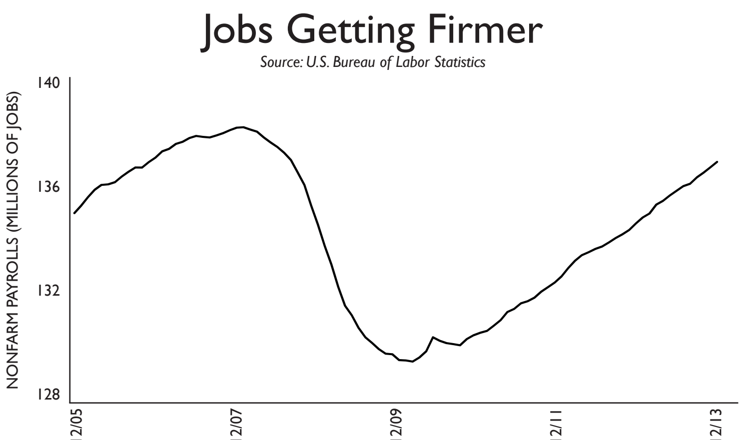
FERGUSON WELLMAN'S CO-HOSTED INVESTMENT OUTLOOKS

01/16 West Bearing Investments, Portland, OR
02/05 Umpqua Private Bank, San Francisco, CA
02/11 Umpqua Private Bank, Seattle, WA

FIXED INCOME

by Marc Fovinci, CFA, Principal
Fixed Income Strategy and Portfolio Management

Change is in the air. Recent moves in nonfarm payrolls, published by the Bureau of Labor Statistics, confirm that the economy is a bit firmer. The Federal Reserve believes this improvement has a good chance of sticking, as evidenced by their December 18 announcement to start tapering their monthly purchases of securities. The Fed is now reducing their incremental stimulus to the economy. After prior negative reactions to the prospects of tapering, both stocks and bonds had remarkably little reaction to the announcement. Markets obviously had anticipated the change and realize that the Fed is not truly tightening yet.



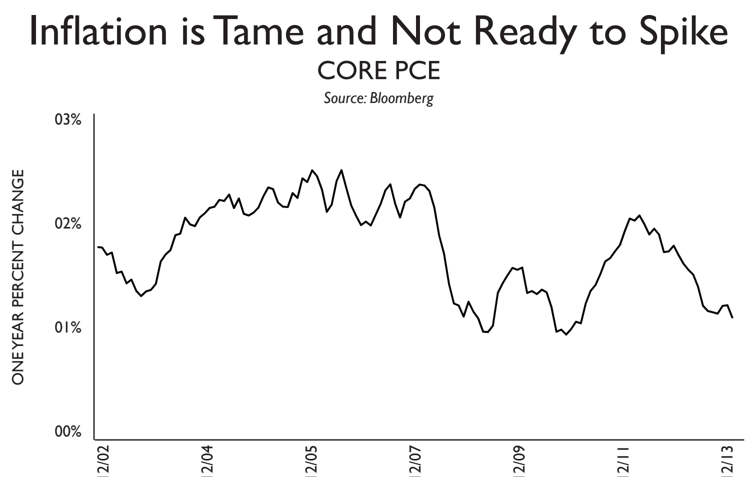
Tapering does not reduce the amount of money in the financial system nor the size of the Fed's balance sheet. As an analogy, the Fed is merely filling the party punchbowl "less fast" and is far from taking it away. The next question facing the markets is *when* the Fed will start "draining the punchbowl" (reducing the money in the financial system and raising interest rates). A Fed shift to higher rates is completely dependent on the future course of the economy. We see no catalyst to spike economic growth higher; thus, we see no rapid move to a Fed rate hike. Therefore, we believe a Fed interest rate raise is a 2015 or later event.

In the meantime, as the economy gradually plods ahead to a better growth rate, the fixed income markets will start anticipating the Fed move and long-term interest rates should grind higher. Constrained economic growth and inflation will not generate a major spike in interest rates; however, a slightly firmer economy will firm interest rates as well. Our expectation is for the bellwether 10-year U.S. Treasury yield to move higher by 1 percent by 2014 end. This will be "wind in the face" for the bond market, limiting returns to low single-digits or perhaps a modest loss.

Continued economic growth should benefit corporate issuers of debt. Corporations should be able to grow profitability and credit quality should be stable to improving.

Mortgage-backed securities will continue to feel the pressure that they felt in 2013. Fed purchases of mortgage backs have helped support that market, and now that tapering will happen, that support is going away. Mortgage interest rates cannot move too high though. Should they spike, the housing market would sputter, making rates come back down.

The other "change in the air" is the anticipated new Federal Reserve chair. Janet Yellen looks certain to be confirmed in January. While Wall Street considers Yellen to be a "dove" (i.e., someone who consistently leans toward more monetary economic stimulus), we believe she is also vigilant on inflation. This gives us assurance that the Fed will be true in the long run to its 2-percent target for inflation, putting a cap on how high interest rates will ultimately move.



While we forecast weak bond market returns for 2014 and currently are underweighting them in our clients' portfolios, we firmly believe bonds are an important part of an investment portfolio through diversifying and dampening the volatility of equity markets.

MUNICIPAL BONDS

by Deidra Krys-Rusoff, Senior Vice President
Tax-Exempt Trading and Portfolio Management

Financial stress from the lingering effects of the recession is receding and state governments are both collecting more revenue and increasing their budgets. State governments increased 2013 spending by 3.8 percent over 2012 and only 16 states were forced to deal with budget shortfalls. However, total shortfalls were *only $6.4 billion in 2013 versus $37 billion in 2012*. In an amazing turnaround, California drastically improved their financial health, moving from a severe 2012 budget shortfall to a $2.2 billion surplus in 2013. This improvement has lowered California's debt issuance costs, improved their rating outlook and given the market in their bonds a big boost. Cities and local governments tend to lag the states' funding cycles, but they should also report improving fundamentals in the upcoming year.

Despite a fourth year of increasing revenues, states continue to restrain their spending, which in aggregate remains below the peak of 2008. States are funding fewer new projects and paying close attention to their financial profiles, which has resulted in a lower supply of new bond issues and increased redemptions of outstanding bonds. The 2013 new bond issue supply decreased about 12 percent last year and we expect supply to drop another 10 to 15 percent off of these levels in 2014. This scarcity is providing extra demand for existing bonds which serves to support prices.

Pension and bankruptcy issues continue to dominate the headlines. Municipalities have been underfunding their pension contributions for years, creating pent-up liabilities to be funded in the near future. The poster child for underfunded pension plans is Illinois which recently trimmed pension costs and was rewarded with a lower interest rate on their latest debt offering. The majority of states have made some pension adjustments since 2009, through cutting benefits for new employees to requiring workers to increase their contributions. The outperformance by the stock market should also help most pension plans "earn their way" out of this funding crisis. We continue to closely monitor the Detroit bankruptcy case. Of particular interest will be whether the court treats pensioners and bondholders equally at the bargaining table.

The economic recovery continues to strengthen the credits of the municipal market. Municipal bonds may ultimately turn in a weaker performance in a rising interest rate environment, but we have reduced our fixed income allocation and believe that municipal bonds play an integral role in a tax-sensitive investment portfolio.

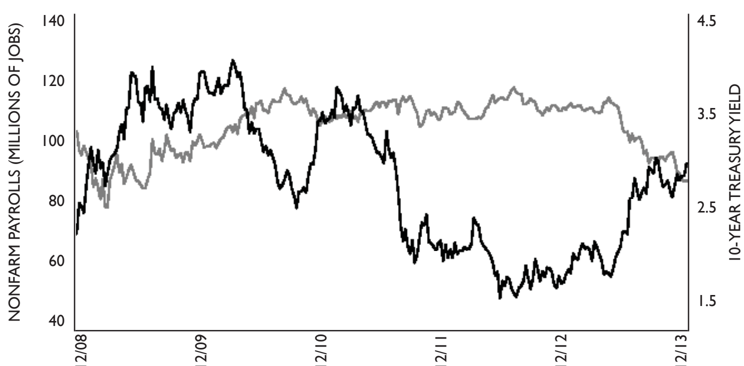
REAL ESTATE INVESTMENT TRUSTS (REITS)

by Brad Houle, CFA, Executive Vice President
Fixed Income Research and Portfolio Management

REITs were the worst performing sector of the stock market in 2013. The REIT index is barely positive for the year, underperforming the S&P 500 by more than 25 percent. Rising interest rates have been the primary cause for their downturn. REITs are interest rate sensitive because they often depend on debt financing to buy properties. As rates rise, the debt funding costs for REITs rises, putting pressure on investment returns. According to ISI Research, REITs have lagged the broader market in *five of the last six rising rate environments.*

REITs in Rising Rates

Source: FactSet



Furthermore, even with the sell-off in REITs, the valuation of the sector is not particularly attractive. Prior to the rise in interest rates last year, investors sought out REITs to provide income in a low interest rate environment. As a result, valuations had become stretched as investors chased the current income REITs provide.

Most valuation metrics based upon income generated from rents suggest that REIT valuation is well above the long-term averages. In keeping with our forecast of gradual rising interest rates over the coming year and challenged valuation, we have significantly underweighted the sector.

There are some sectors of the REIT market that are moderately attractive. Specifically, in rising rate environments REITs that own hotels, industrial buildings and malls have a tendency to be more resilient than other type of real estate investments. These categories of real estate benefit from an improving economy which often accompanies a rising rate environment.

DIVIDEND VALUE

by Jason Norris, CFA, Executive Vice President
Equity Research and Portfolio Management

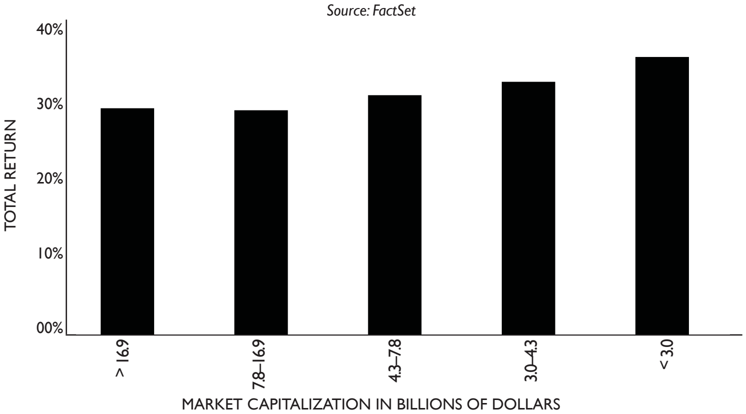
2013 began with investor concerns over rising taxes on dividends, as well as questions regarding the impact of rising interest rates on dividend-paying stocks. While we believe the tax issue had a minimal impact on dividend-paying securities, rising rates were not as accommodating.

Over the course of the second and third quarter, rising rates had a particularly adverse effect on higher yielding sectors such as utilities, REITs and telecommunication services. The accompanying charts highlight the performance of equities and different yield levels as well as by market value. Rising rates and investor focus on smaller growth companies resulted in yield underperforming.

Total Return of Equities at Different Market Capitalizations*

DEC 31, 2012 - DEC 19, 2013

Source: FactSet

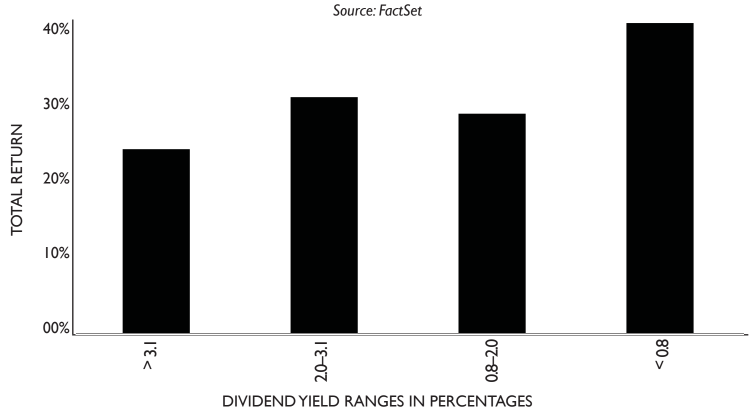


As we dust off our crystal ball and look into 2014, we believe interest rates will continue to climb higher as the economy picks up steam. Investors will likely seek growth over higher yield, thus deemphasizing those sectors that provide the income support. While this may be viewed as a negative, the dividend universe of equities is vastly larger than over the last several years. Furthermore, Ferguson Wellman's *Dividend Value* strategy is not reliant solely on the high yield. We balance yield with dividend and cash flow growth, thus gaining exposure to those companies offering higher growth while still receiving a steady income stream.

Total Return of Equities at Different Yields*

DEC 31, 2012 - DEC 19, 2013

Source: FactSet



The dividend growth rate of the strategy has consistently been between 10 and 15 percent, with an overall yield between three to five percent. We would anticipate the yield in 2014 to be at the low end of that range, while the growth rate should be at the high end. This is consistent with our view of having increasing exposure to those sectors with greater economic sensitivity (e.g., consumer discretionary and industrials).

Historically, it has been difficult to find any income in these sectors. However, with companies operating at record margins and cash flows more stable, we are witnessing more "cyclical" companies returning cash flow to shareholders in the form of dividends, which should "pay dividends" for our *Dividend Value* strategy in 2014.

* Equities are defined by the Russell 1000 Index which is an index that measures the large-cap segment of the U.S. equity universe and represents approximately 92 percent of the U.S. market.

INTERNATIONAL EQUITY

by Ralph Cole, CFA, Executive Vice President
Equity Strategy and Portfolio Management

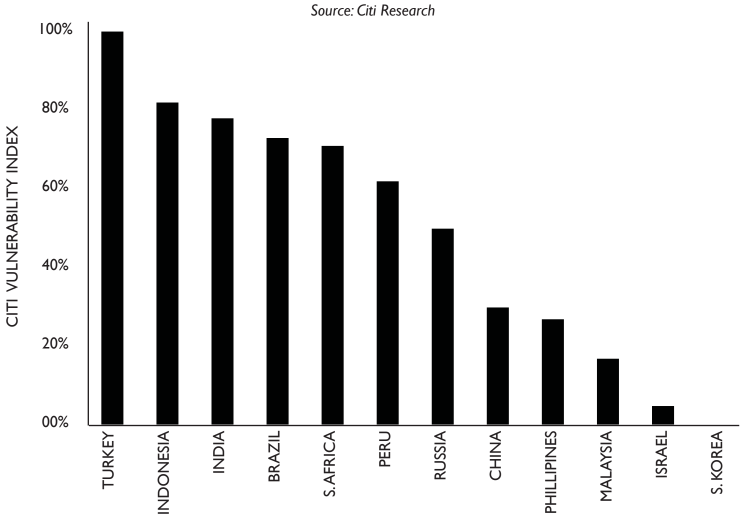
All international markets are not created equal, and this was clearly on display last year through disparity in returns between developed markets and emerging markets. For the year, developed markets outperformed emerging markets by nearly 20 percent. As we embark on 2014, it is important that we understand the drivers of this divergence and determine which themes will endure into the future.

By far the biggest surprise of 2013 was the performance of Japanese equities. Japan was the *best performing developed economy* for the first time since 2005 as an unprecedented amount of monetary stimulus drove the Yen down, creating a boon for the stock market. Japan's goal is to escape the shackles of deflation and return to the global economy. We think continued stimulus, along with some structural changes, should drive Japanese markets higher in 2014.

Our biggest mistake in 2013 was overweighting the emerging markets throughout the year as many emerging market countries' growth rates came under pressure due to inflation and slower global demand. The other phenomenon that hurt emerging markets in the middle of the year was the talk of Fed tapering.

Citi Emerging Market Vulnerability Index*

Source: Citi Research



During the summer months, the back up in U.S. interest rates caused an exit from weak emerging market economies with investors dumping both stocks and bonds of those countries. The fact is, *tapering never occurred*, but we likely gained a preview for 2014. With this in mind, we will try to avoid countries that rate high on Citigroup "vulnerability" index which is detailed on the accompanying chart outlining relative vulnerability to currency shocks. Today the highest risk areas are in Turkey, Indonesia, India and Brazil.

In the past 12 months we have added two mutual funds to our international portfolio: the Harding Loevner Emerging Markets Portfolio** and Franklin International Small Cap Growth Fund.*** The Harding Loevner fund invests in both emerging market securities and frontier markets, which are even less developed than emerging markets and virtually void of any ADRs. The Franklin fund invests in small capitalization companies in developed markets. Both funds contributed to our international strategy performance this past year.

Going forward, thematically we are underweighting countries with a heavy exposure to commodities. As such, three of our larger country underweights include Canada (a long-time favorite), Australia and Brazil. While lower commodity prices hurt these countries, it is a benefit for consumers and markets around the world.

If the dollar strengthens in 2014, it would obviously present a drag to international performance. We will most likely be maintaining a small overweight to frontier and emerging markets, but our primary focus in 2014 will be gaining more exposure to countries with accelerating growth.

* The Citi Emerging Market Vulnerability Index is calculated using four variables: current account balances as a percentage of GDP, inflation, credit growth and reserves as a percentage of GDP.

**The Harding Loevner Emerging Markets Portfolio: This strategy seeks long-term capital appreciation through investment in equity securities of companies based in emerging markets countries.

***The Franklin International Small Cap Growth Fund: This fund invests predominantly in the equity securities of smaller international companies that the managers feel are poised for long-term growth.

ALTERNATIVE INVESTMENTS*

by Dean Dordevic, Principal
Alternative Assets and Portfolio Management

Over the past few years, we have developed relationships with some outstanding managers in private equity, distressed debt and real estate. In addition, we have forged alliances with select hedge fund managers and highly specialized mutual funds. We continue to search both nationally and internationally for new alliances that are attractive and appropriate for inclusion in select client portfolios.

Below is a brief summary of the offerings that we have chosen to participate in as of December 2013.

ALTERNATIVE INVESTMENTS

Asius Fund is a fund focused on China, India, Korea and southeast Asian (Asean) countries. This fund gives unique access to local managers in these respective markets.

Cube Global Multi-Strategy Fund is a high conviction, London-based global fund-of-hedge-funds. Cube expresses strong macro views by investing in hedge funds with few primary return drivers. In addition, Cube employs a beta (volatility) management overlay. Emerging Asia and Africa have been consistent themes in Cube's funds.

Hatteras Funds 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. Hatteras was recently acquired by RCS Capital Corporation. We do not foresee any major changes to their investment philosophy as a result of the acquisition. Hatteras Global Private Equity Partners II is a global fund of private equity funds that closed earlier in the year. The use of exchange listed private equity and a fund purchased in the secondary market have resulted in healthy first-year returns.

Lazard Alternative Strategies is a fund-of-hedge funds that invests in four principal strategies: relative value, long/short, event-driven and tactical trading. This past November, the funds' limited partners voted to close the fund and roll their investments into a very similar and complementary strategy. This strategy is also managed by Lazard. This change is something we strongly endorsed, since rather than issuing a K-1, investors will now receive a 1099. Returns have been in-line with funds of equal volatility.

Neuberger Berman Absolute Return Multi-Manager Fund combines the structural advantage of a mutual fund with a stable of high quality hedge fund managers. The fund delivers true hedge fund strategies within the context of a greatly reduced fee structure. In addition, the fund has the flexibility to go both long and short. The performance and volatility has been on par with hedge funds even though this is a daily-valued, highly-liquid mutual fund.

ILLIQUID ALTERNATIVE INVESTMENTS

Acorn NW Real Estate Fund is a Portland, Oregon-based real estate fund that targets high quality multi-tenant retail centers, medical offices and business parks. Acorn closed on its first portfolio purchase in late 2013 with the acquisition of a medical property (Northwest Center for Orthopedics and Rehabilitation).

Keystone National Private Equity Fund II was our first investment with Keystone. This fund is a traditional private equity fund-of-funds which has now finished its investment period and is now generating distributions. **Funds III** and **IV** and recently launched **Fund V** are distressed credit-oriented funds. Keystone's most recent offering (**Fund V**), closed in 2013 and is now 75 percent invested.

Vista Ridge Diversified Fund is a traditional private equity fund-of-funds. The portfolio is now fully committed and is already seeing distributions. Nearly 25 percent of paid in capital was returned in 2013 and we estimate that remaining capital calls will be self-funding. Vista Ridge has achieved extremely strong returns on invested capital.

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