



## Investment Review

*December 31, 2012*

# Ormond Beach Pension Funds

Presented by:

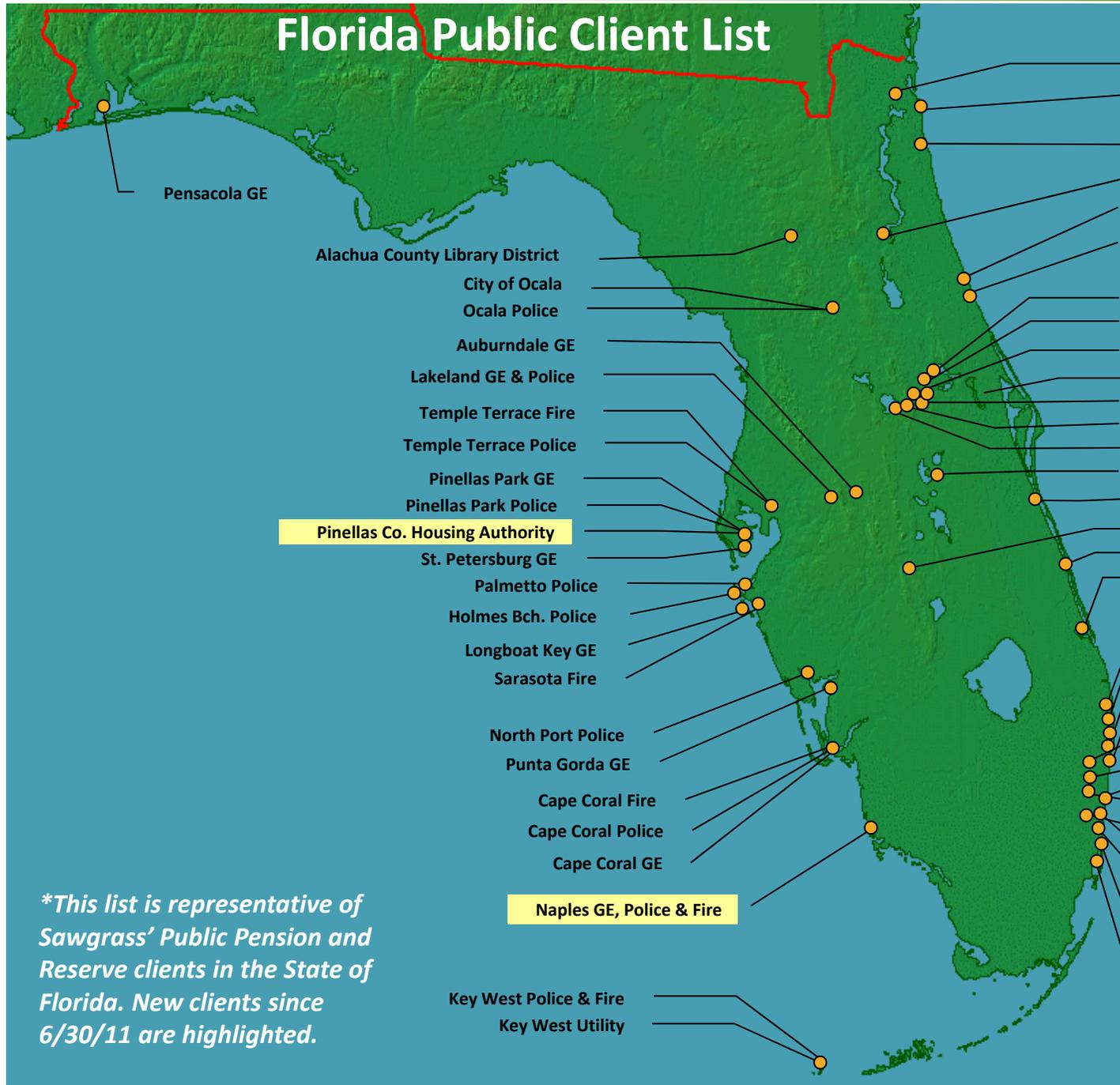
Sawgrass Asset Management, L.L.C.  
(904) 493-5500

February 15, 2013

**Marc Davis, CFA**  
*Equity Portfolio Manager*

**Gregg Gosch**  
*Client Relationship Manager*

# Florida Public Client List



*\*This list is representative of Sawgrass' Public Pension and Reserve clients in the State of Florida. New clients since 6/30/11 are highlighted.*

- City of Jacksonville
- Jacksonville Bch. GE, Fire, & Police
- St. Augustine GE & Police
- Palatka Police & Fire
- Ormond Bch GE, Police, & Fire
- Daytona Bch P&F
- Sanford Police
- Deltona Fire
- City of Altamonte Springs
- City of Casselberry
- Maitland Police & Fire
- Ocoee Police & Fire
- Winter Garden GE
- St. Cloud GE, Police & Fire
- Melbourne Fire
- Avon Park Fire
- Vero Beach Police
- St. Lucie County
- Riviera Beach Police
- Lake Worth GE & Pol.
- Delray Beach P&F
- Boca Raton P&F
- Deerfield Bch. Fire
- Coral Springs Fire & Pol.
- Tamarac Police
- Ft. Lauderdale P&F
- Sunrise Fire
- Cooper City GE, P&F
- Broward Co. #4321
- Hollywood Fire
- Hallandale P&F
- Bal Harbour Village Police

Alachua County Library District

City of Ocala

Ocala Police

Auburndale GE

Lakeland GE & Police

Temple Terrace Fire

Temple Terrace Police

Pinellas Park GE

Pinellas Park Police

Pinellas Co. Housing Authority

St. Petersburg GE

Palmetto Police

Holmes Bch. Police

Longboat Key GE

Sarasota Fire

North Port Police

Punta Gorda GE

Cape Coral Fire

Cape Coral Police

Cape Coral GE

Naples GE, Police & Fire

Key West Police & Fire

Key West Utility

# Sawgrass Diversified Large Growth Equity – 4Q12 Portfolio Review/Outlook

## **Market Review – It's All About Politics**

Between the politics of the election and most recently the fiscal cliff, the fourth quarter was dominated more by politics than fundamentals. Perhaps representing political stalemate, the markets were essentially flat for the period as the Russell 3000 posted a 0.25% gain. Under the surface there was more dichotomy. Value stocks posted small gains while Growth stocks posted small losses (Russell 3000 Value +1.7% vs. Growth -1.2%). Larger stocks were flat while mid and small cap stocks posted small gains (Russell 1000 0.1%, Russell Midcap 2.9%, Russell 2000 2.9%). From a sector perspective, there were more divergences. Sector performance had more of a “risk on” flavor as Financials, Industrials, and Materials led while Consumer Staples and Utilities lagged. The one exception was Technology which, dragged down by Apple, posted negative returns. Looking at factor performance, higher Beta did surprisingly well. Generally the fourth quarter was indicative of the whole year which had a riskier tone in a year of very solid gains for stocks (Russell 1000 +16.4%).

## **Portfolio Review:**

Our portfolio slightly lagged the Russell 1000 Growth's small loss for the quarter. While on the surface this is surprising, when examining the tone of this quarter we can reconcile the performance of our portfolio. What was most surprising, and detrimental, was the outperformance of higher Beta stocks in a down period for Growth stocks. Our lower Beta profile is usually a contributor in these environments but was not in the fourth quarter. Though our underweight to Apple was a positive relative contributor, we were hurt by weak performance in Discretionary (WMT), Energy (XOM), and Healthcare (ESRX). We were also not helped by our larger cap emphasis as midcap and smaller stocks outperformed. Despite the headwinds of the quarter, our performance was very close to the Russell 1000 Growth.

## **Outlook & Positioning:**

As we look to the coming year, one has to believe the market's tone will be set in the first quarter as politics continue to take center stage. While some signs of cooperation have been evident, the heavy lifting is yet to be done.

The way in which our politicians address the Debt, Spending, and Revenue challenges at hand will absolutely effect the ability of our economy to grow. These actions will have great impact on the confidence of investors. Even without the political challenges, economic growth has clearly slowed. Though low interest rates help to support current valuations, it is hard to imagine those valuations significantly expanding. Given slower growth and limited opportunity for multiple expansion, modest stock market returns seem likely. In an environment of modest returns with volatility amplified by politics, we like the chances of our stable consistent growth profile.

## **Sawgrass Composite Portfolio versus Russell 1000 Growth (as of 4<sup>th</sup> Qtr 2012):**

### **What Helped:**

Apple Underweight  
Lower Valuations Bias  
Staples Selection

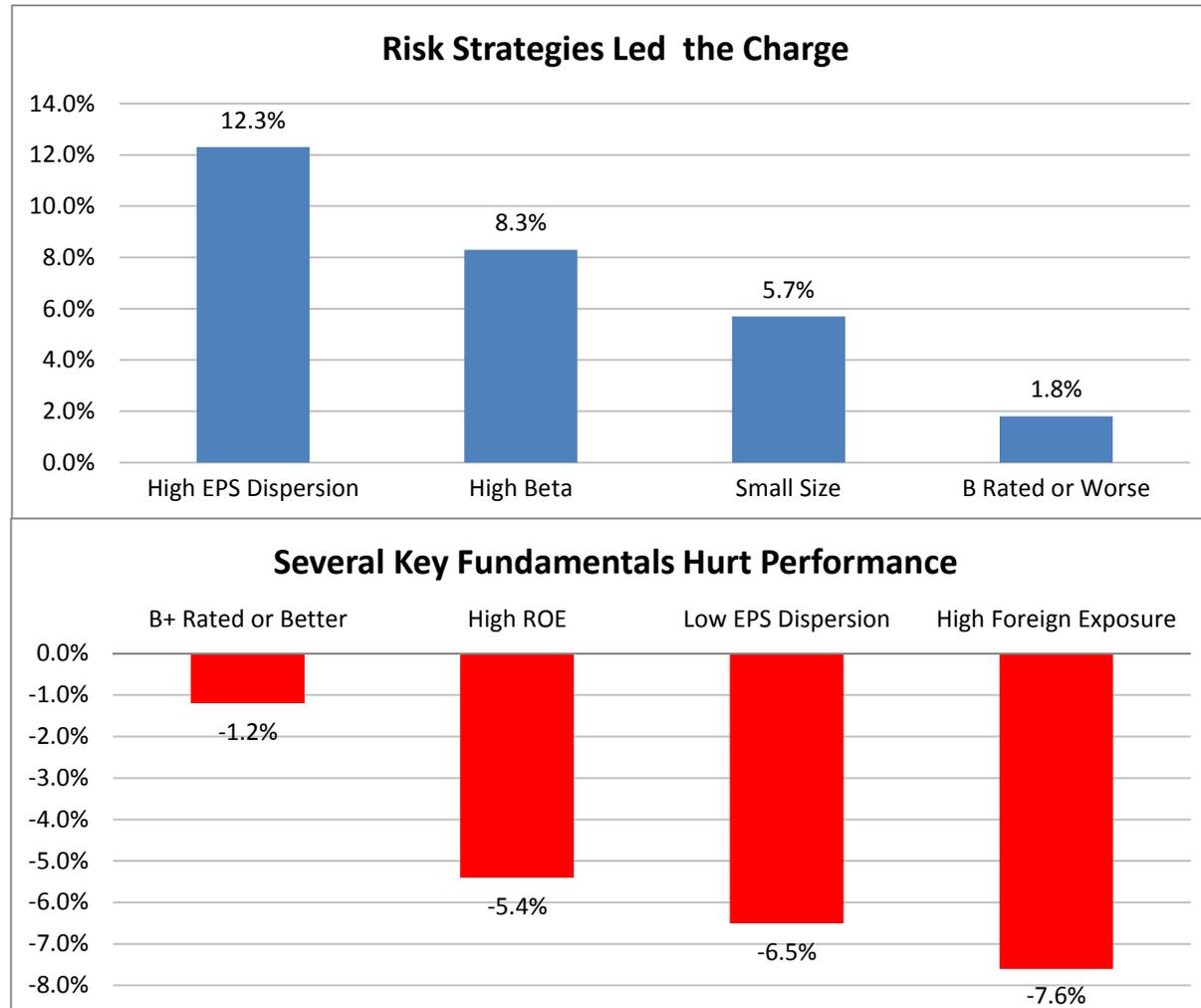
### **What Hurt:**

Lower Beta Bias  
Discretionary Selection  
Industrials Selection  
Energy Selection



# Strategies Performance for Calendar 2012

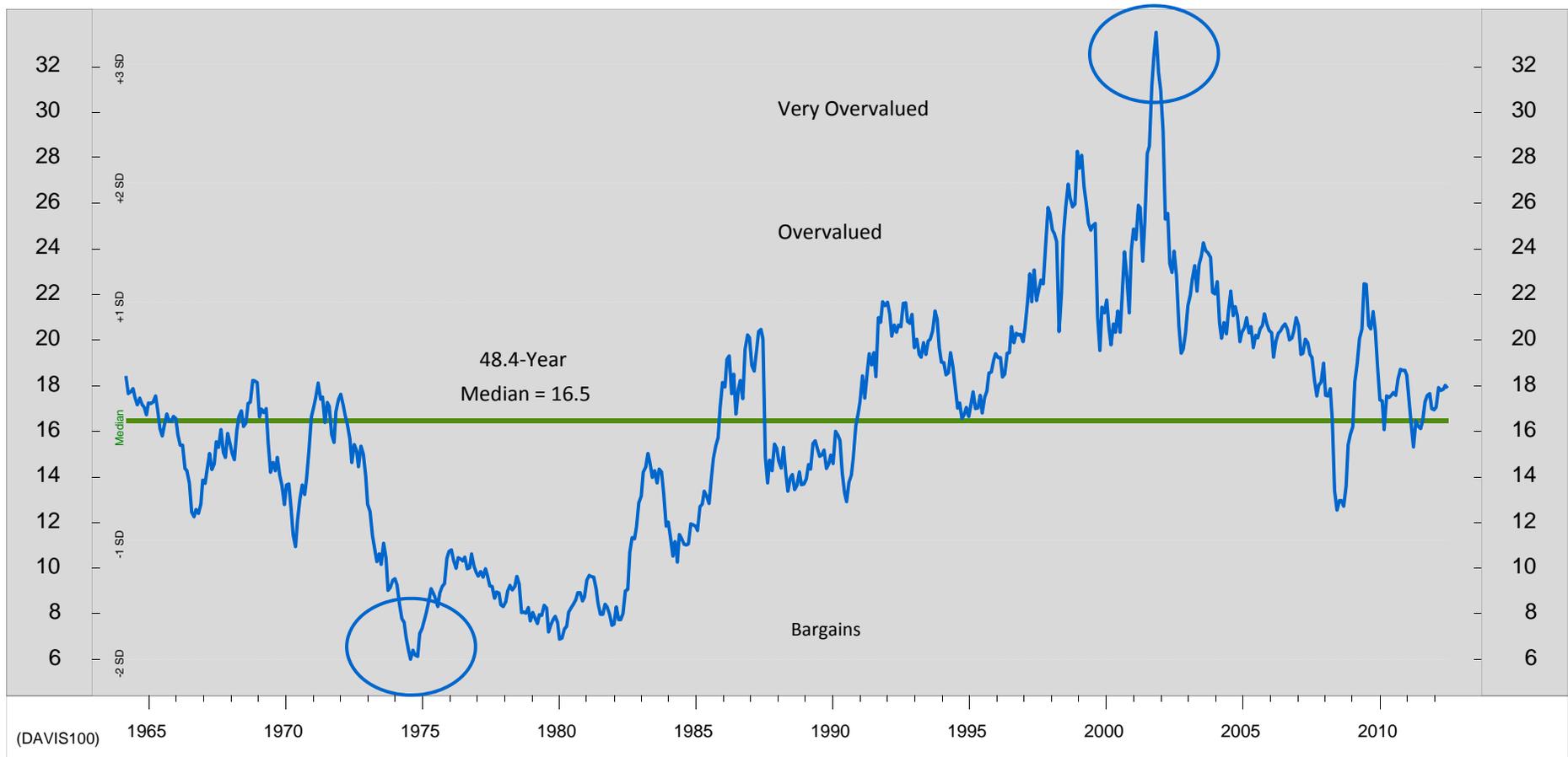
Relative to S&P 500 Price Return



Source: Bank of America Merrill Lynch, Quantitative Analysis, January 2, 2013



# Stocks Look Fairly Valued on a P/E Basis



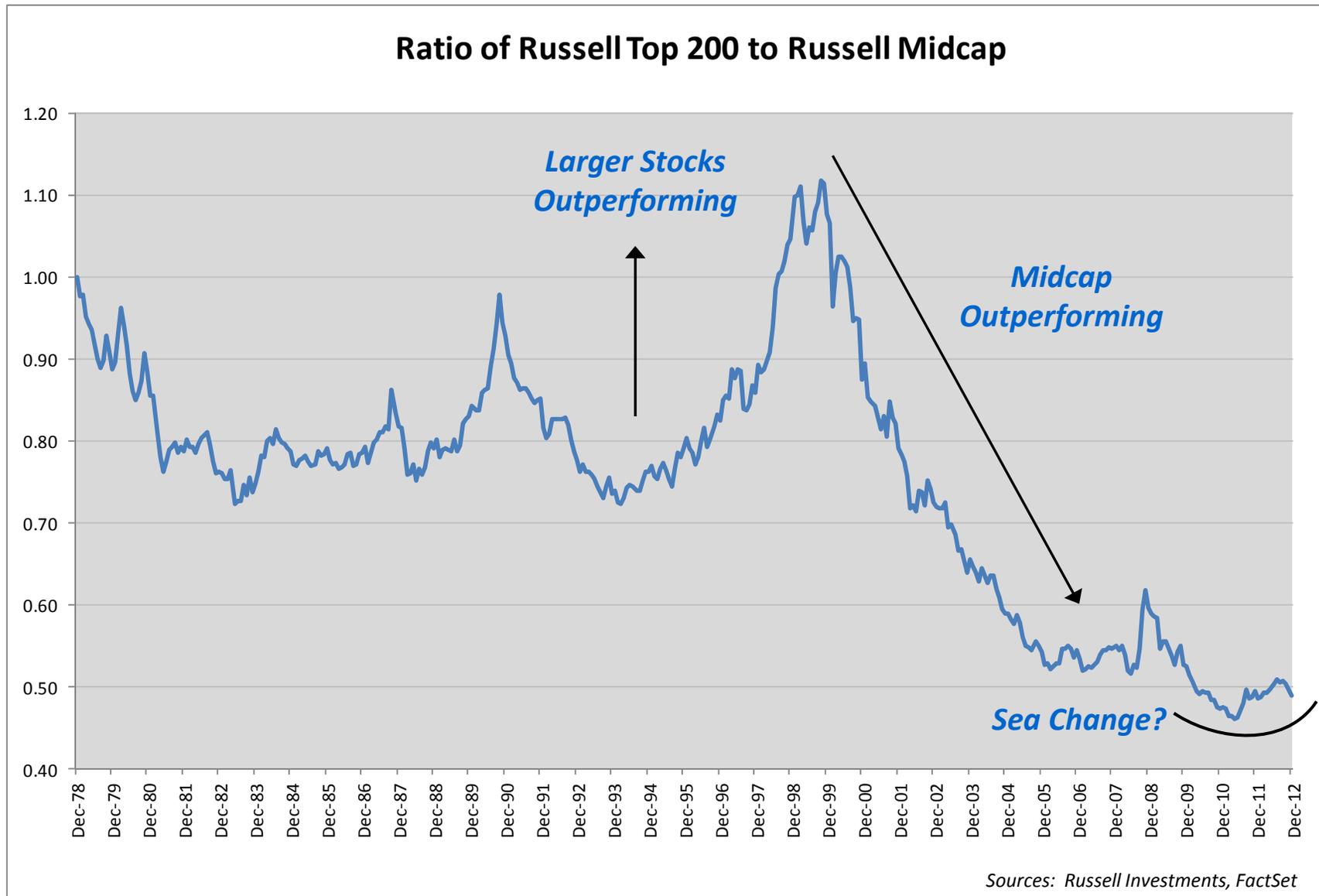
S&P 500 Median Price/Earnings Ratio (NDR Calculation) with Historical Median

Source: S&P Index Alert

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# Mid Cap Has(?) Been the Place to Be



# Sawgrass Diversified Large Growth Equity vs. Russell 1000 Growth

## Consistent Results Across Various Markets

Negative Markets			Positive Markets of 0-15%			Strong Positive Markets > 15% returns		
	Sawgrass	R1000G		Sawgrass	R1000G		Sawgrass	R1000G
(2000)	-12.10%	-22.42%	(2004)	7.11%	6.30%	(1998)*	12.37%	20.45%
(2001)	0.65%	-20.42%	(2005)	8.16%	5.26%	(1999)	15.80%	33.16%
(2002)	-19.74%	-27.88%	(2006)	10.42%	9.07%	(2003)	27.47%	29.75%
(2008)	-36.83%	-38.44%	(2007)	13.20%	11.81%	(2009)	28.54%	37.21%
			(2011)	9.29%	2.64%	(2010)	10.85%	16.71%
						(2012)	14.28%	15.26%
Years Sawgrass outperformed		4/4		5/5			0/6	
Cumulative Returns	-55.1%	-72.6%		58.3%	40.1%		170.1%	284.1%
Annualized Returns	-14.8%	-22.8%		9.6%	7.0%		22.0%	30.9%

\*The inception of the Sawgrass Large Cap Growth product was March 31, 1998, therefore these two returns are not representative of a full calendar year.

Performance Across Various Markets		
As of Year-End 2012	Sawgrass	R1000G
Cumulative Return	91.71%	47.46%
Annualized Return	4.51%	2.67%
Standard Deviation	14.4%	18.9%

\*Since Inception March 31, 1998

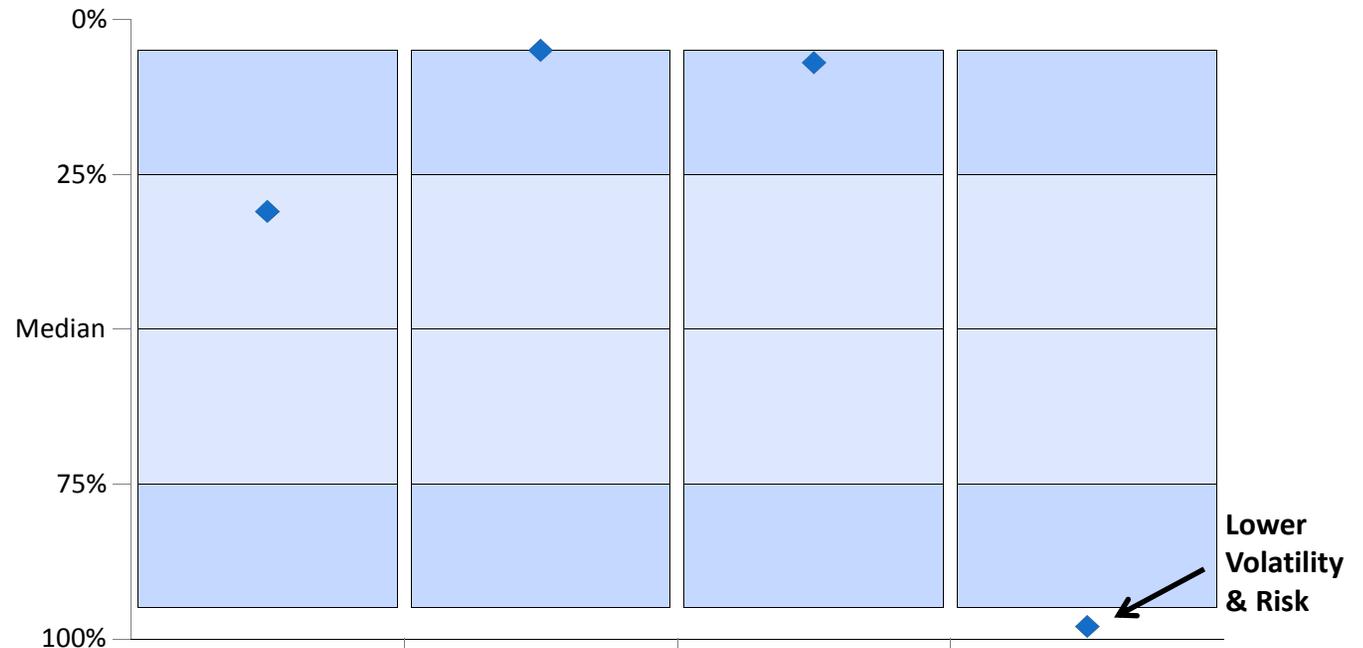


# Sawgrass Diversified Large Growth Equity Peer Ranking

## Top Ranked Risk-Adjusted Returns with Less Volatility

◆ Diversified Large Growth Equity

3 Years As Of: December 31, 2012



	Information Ratio <sup>1</sup>	Sharpe <sup>2</sup>	Alpha <sup>1</sup>	Standard Deviation
◆ Diversified Large Growth Equity	0.03	0.91	2.34	12.55
Rank	31	5	7	98

*Information Ratio* – a measure of the value added per unit of active risk by a manager over an index

*Sharpe Ratio* – a measurement of efficiency utilizing the relationship between annualized risk-free return and standard deviation

*Alpha* – is the extra return of a product due to non-market factors

*Standard Deviation* – a measure of the historical volatility of a products returns

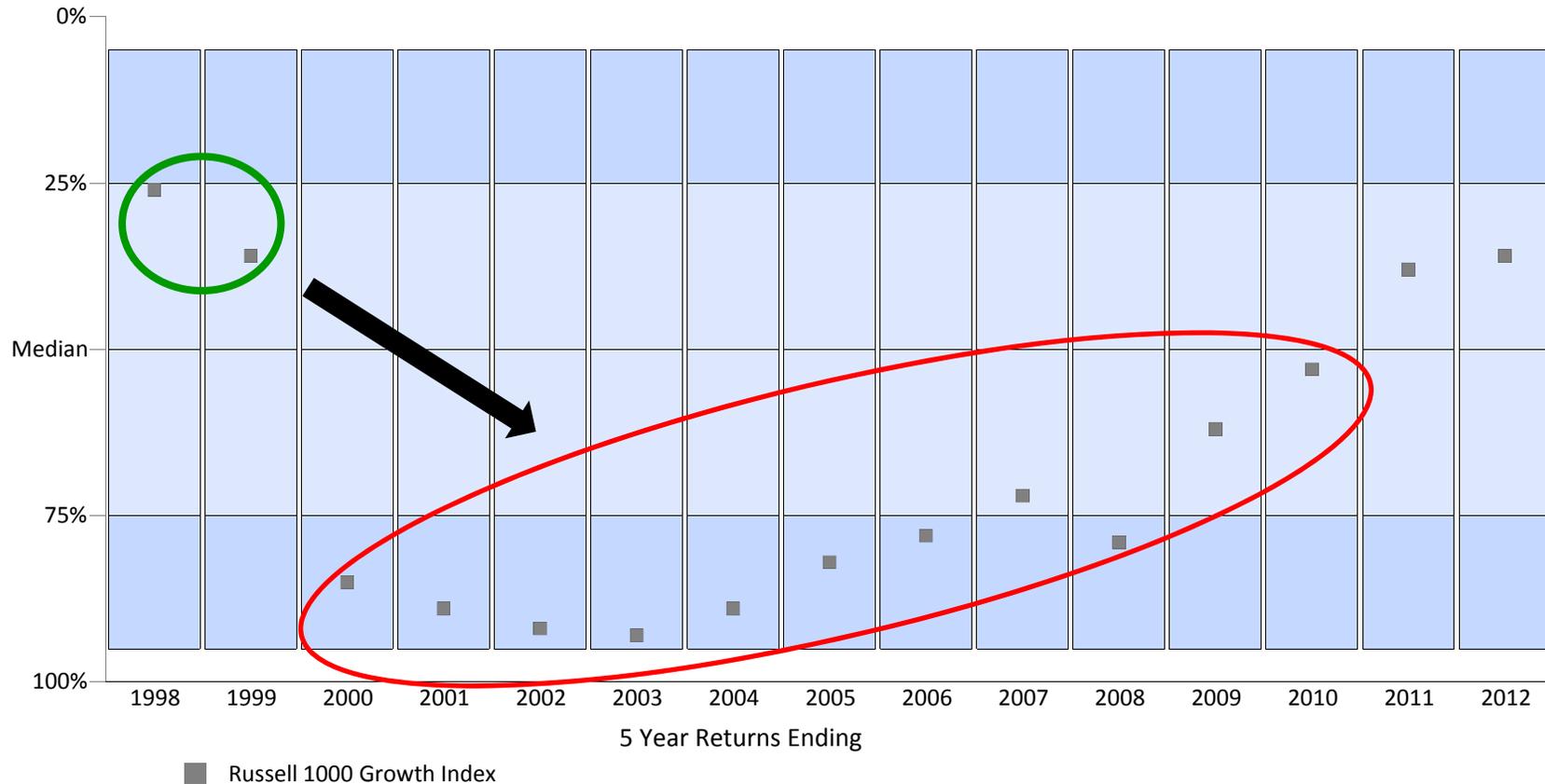
<sup>1</sup> Russell 1000 Growth, <sup>2</sup> Citigroup 3-Month T-Bill

Source: eVestment Alliance, Large Cap Growth equity universe as of 12/31/12.



# Index Ranking Over Time

## Rolling 5 Year Universe Return Ranking of the Index



***The last time the Index ranked this strongly, it was followed by 11 consecutive years of below median 5 year returns.***

Source/Universe: eVestment, US Large Cap Growth Equity





## Ormond Beach Firefighters' Pension Trust Fund

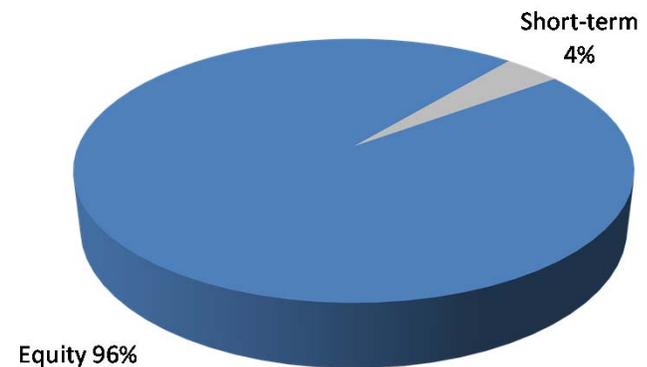
### Portfolio Summary

<u>Security Type</u>	<u>Market Value</u>	<u>% Assets</u>
<u>Equities</u>		
COMMON STOCK	\$2,032,447	96.1
	<hr/>	<hr/>
	\$2,032,447	96.1
<u>Cash and Equiv.</u>		
CASH AND EQUIVS.	\$82,333	3.9
	<hr/>	<hr/>
	\$82,333	3.9
<b>TOTAL PORTFOLIO</b>	<hr/> <hr/>	<hr/> <hr/>
	\$2,114,780	100.0

### Portfolio Market Values

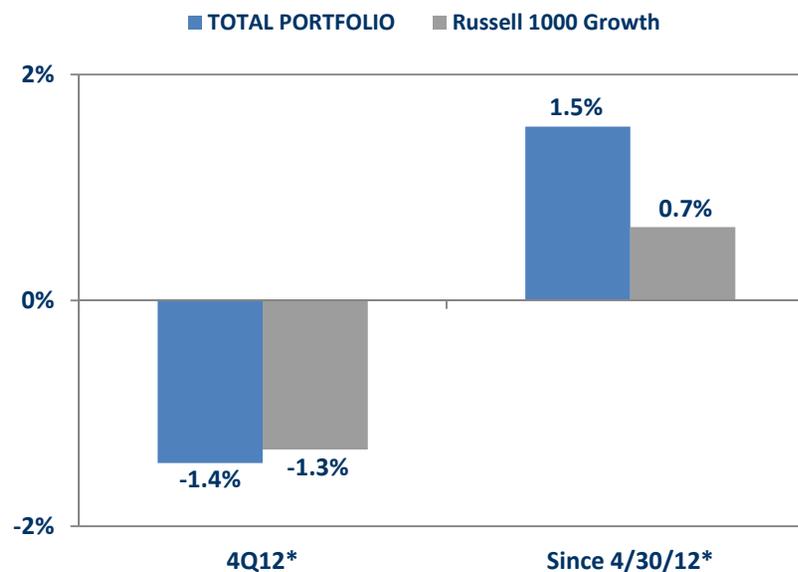
<b>Portfolio Value on 9-30-12</b>	<b>\$2,148,799</b>
Contributions	\$0
Withdrawals	(\$3,129)
Investment Loss	(\$30,889)
<b>Portfolio Value on 12-31-12</b>	<b>\$2,114,780</b>

### Asset Allocation





## Ormond Beach Firefighters' Pension Trust Fund Portfolio Performance



	4Q12*	Since 4/30/12*
<b>TOTAL PORTFOLIO</b>	-1.4%	1.5%
<i>Russell 1000 Growth</i>	-1.3%	0.7%
<i>S&amp;P 500</i>	-0.4%	3.7%

*\*Unannualized Returns*

*Returns are gross of investment management fees*



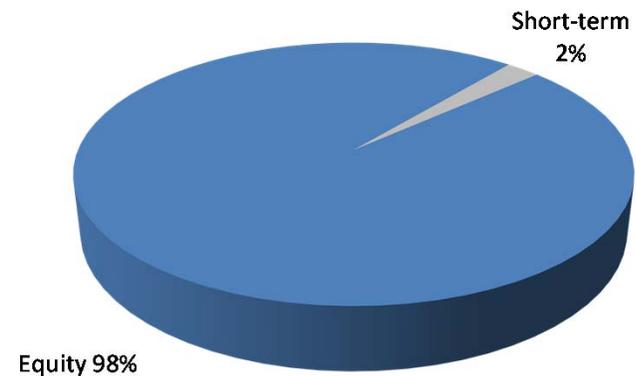
## Ormond Beach General Employees' Pension Fund Portfolio Summary

<u>Security Type</u>	<u>Market Value</u>	<u>% Assets</u>
<u>Equities</u>		
COMMON STOCK	\$3,645,560	97.7
	<hr/>	<hr/>
	\$3,645,560	97.7
<u>Cash and Equiv.</u>		
CASH AND EQUIVS.	\$86,955	2.3
	<hr/>	<hr/>
	\$86,955	2.3
<b>TOTAL PORTFOLIO</b>	<hr/> <hr/>	<hr/> <hr/>
	\$3,732,515	100.0

## Portfolio Market Values

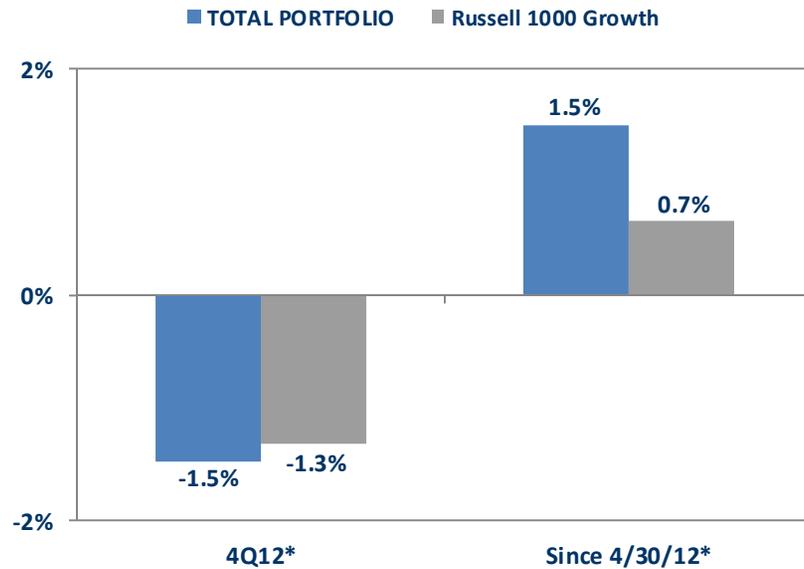
<b>Portfolio Value on 9-30-12</b>	<b>\$3,793,804</b>
Contributions	\$0
Withdrawals	(\$5,524)
Investment Loss	(\$55,765)
<b>Portfolio Value on 12-31-12</b>	<b>\$3,732,515</b>

## Asset Allocation





## ***Ormond Beach General Employees' Pension Fund Portfolio Performance***



	4Q12*	Since 4/30/12*
<b>TOTAL PORTFOLIO</b>	-1.5%	1.5%
<i>Russell 1000 Growth</i>	-1.3%	0.7%
<i>S&amp;P 500</i>	-0.4%	3.7%

*\*Unannualized Returns*

*Returns are gross of investment management fees*



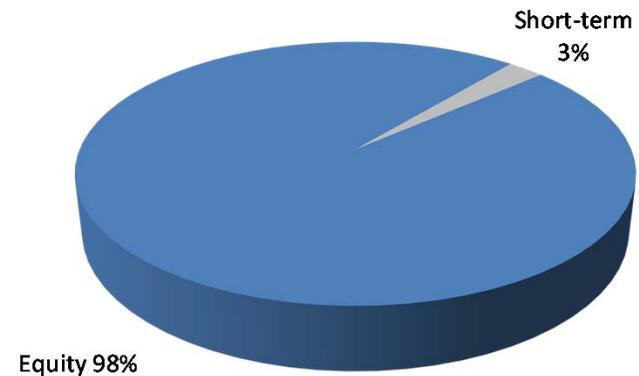
## ***Ormond Beach Police Officers' Pension Fund Portfolio Summary***

<u>Security Type</u>	<u>Market Value</u>	<u>% Assets</u>
<u>Equities</u>		
COMMON STOCK	\$2,522,384	97.5
	\$2,522,384	97.5
<u>Cash and Equiv.</u>		
CASH AND EQUIVS.	\$64,314	2.5
	\$64,314	2.5
<b>TOTAL PORTFOLIO</b>	<b>\$2,586,698</b>	<b>100.0</b>

## ***Portfolio Market Values***

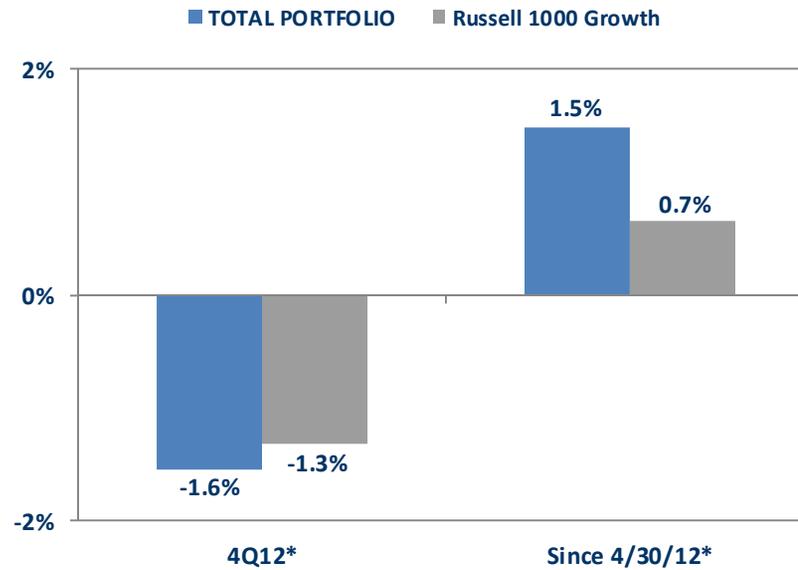
<b>Portfolio Value on 9-30-12</b>	<b>\$2,631,269</b>
Contributions	\$0
Withdrawals	(\$3,832)
Investment Gain/Loss	(\$40,740)
<b>Portfolio Value on 12-31-12</b>	<b>\$2,586,698</b>

## ***Asset Allocation***





## ***Ormond Beach Police Officers' Pension Fund Portfolio Performance***



	4Q12*	Since 4/30/12*
<b>TOTAL PORTFOLIO</b>	-1.6%	1.5%
<i>Russell 1000 Growth</i>	-1.3%	0.7%
<i>S&amp;P 500</i>	-0.4%	3.7%

*\*Unannualized Returns*

*Returns are gross of investment management fees*



### **Portfolio Characteristics**

	<u>Portfolio*</u>	<u>Russell 1000 Growth</u>
1 Year EPS Forecast - Growth (%)	13.3	11.4
Portfolio P/E	17.0	18.8
Price/Cash Flow	12.5	13.5
Portfolio Price/Sales	2.8	3.3
Portfolio Price/Book	4.1	4.7
Market Cap - \$ Wtd Avg - \$ Billion	112.6	99.9
Number of Holdings	44	571

### **Top 10 Holdings**

	<u>% Weight</u>
Apple Inc.	4.4
Microsoft Corp.	4.0
Coca-Cola Co.	4.0
Google Inc.	3.9
Abbott Laboratories	3.9
Wal-Mart Stores Inc.	3.7
QUALCOMM Inc.	3.6
Verizon Communications Inc.	3.3
Celgene Corp.	3.2
CVS Caremark Corp.	3.2
	<hr/> 37.2

*\*Diversified Large Growth Equity Composite Data*



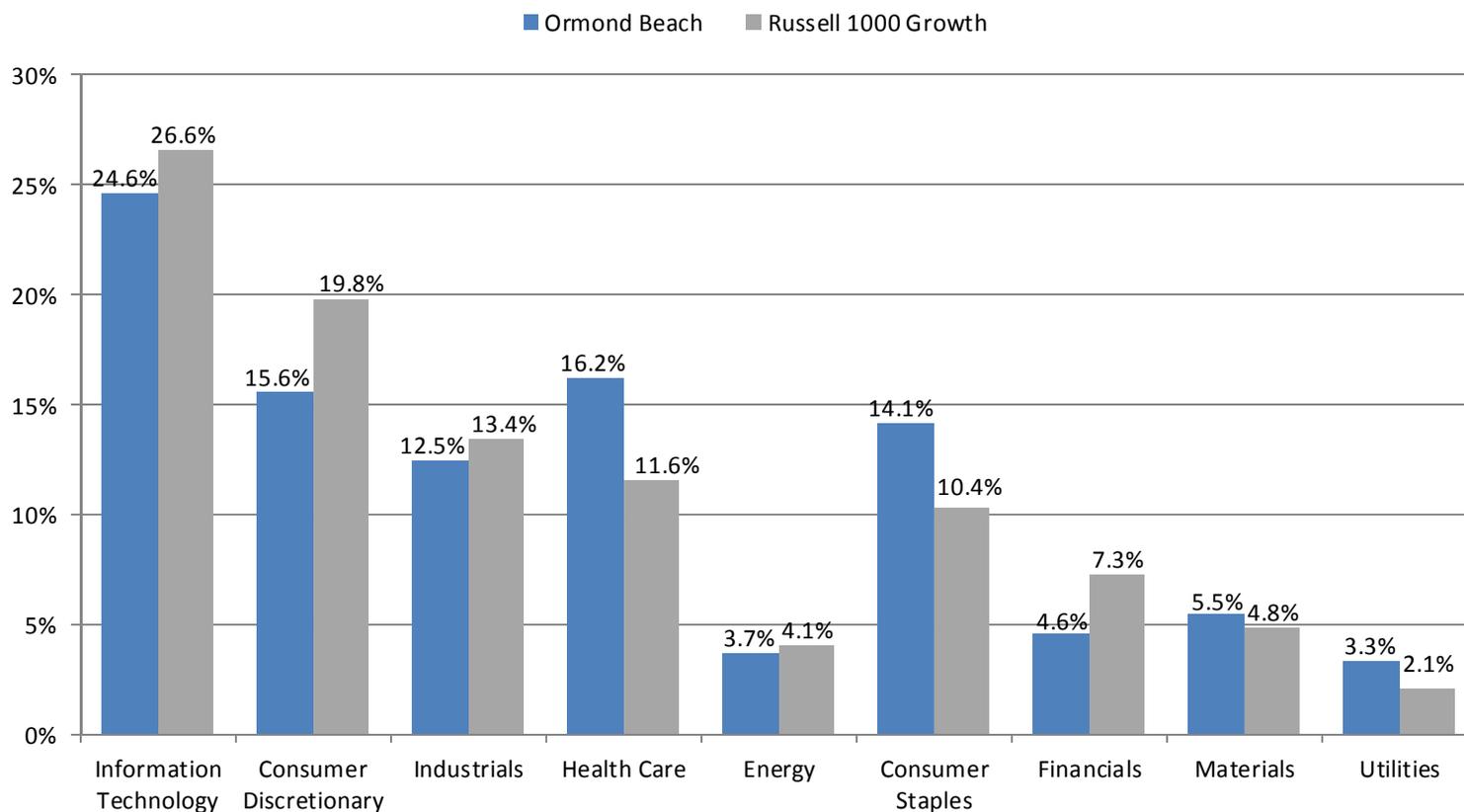
## Portfolio Attribution – Quarter

	Diversified Large Growth Equity			Russell 1000 Growth			Variation			Attribution Analysis		
	Average Weight	Total Return	Contribution To Return	Average Weight	Total Return	Contribution To Return	Average Weight	Total Return	Contribution To Return	Allocation Effect	Selection Effect	Total Effect
Sawgrass Russell Sector												
<b>Information Technology</b>	22.15	-8.81	-1.99	27.08	-8.26	-2.36	-4.93	-0.56	0.37	0.38	-0.14	0.24
<b>Consumer Discretionary</b>	17.35	-1.58	-0.26	19.77	0.75	0.15	-2.43	-2.33	-0.41	-0.05	-0.40	-0.45
<b>Health Care</b>	16.22	-0.10	-0.03	11.69	-0.49	-0.05	4.53	0.39	0.03	0.05	0.06	0.11
<b>Consumer Staples</b>	12.82	1.40	0.20	10.60	-2.37	-0.23	2.22	3.77	0.43	-0.08	0.49	0.42
<b>Industrials</b>	10.32	3.99	0.44	13.04	5.63	0.70	-2.73	-1.64	-0.26	-0.19	-0.15	-0.34
<b>Materials</b>	5.15	7.85	0.38	4.62	5.65	0.26	0.53	2.21	0.12	0.04	0.09	0.13
<b>Energy</b>	4.54	-5.93	-0.37	4.02	-1.49	-0.06	0.52	-4.44	-0.31	-0.01	-0.19	-0.20
<b>Financials</b>	4.32	5.53	0.23	7.07	5.34	0.36	-2.75	0.19	-0.13	-0.17	0.01	-0.16
<b>[Cash]</b>	3.86	0.02	0.00	--	--	--	3.86	0.02	0.00	0.07	--	0.07
<b>Utilities</b>	3.27	-4.01	-0.14	2.11	-4.43	-0.10	1.17	0.42	-0.04	-0.04	0.02	-0.02
<b>Total</b>	<b>100.00</b>	<b>-1.55</b>	<b>-1.55</b>	<b>100.00</b>	<b>-1.34</b>	<b>-1.34</b>	<b>--</b>	<b>-0.21</b>	<b>-0.21</b>	<b>-0.01</b>	<b>-0.20</b>	<b>-0.21</b>

*\*Diversified Large Growth Equity Composite Data*



## Sector Breakdown



# Sector Changes

As of 12/31/12

## Sawgrass Diversified Large Growth

Sawgrass Russell Sector	9/28/2012	12/31/2012	Changes
Consumer Discretionary	19.19	15.22	(3.97)
Consumer Staples	11.99	13.92	1.94
Energy	5.87	3.48	(2.39)
Financials	4.15	4.43	0.29
Health Care	16.47	15.73	(0.74)
Industrials	8.74	12.28	3.55
Information Technology	23.32	24.30	0.97
Materials	4.86	5.31	0.44
Utilities	3.33	3.21	(0.12)
[Cash]	2.09	2.11	0.02

*Our changes for the quarter saw Discretionary slowing as Industrials showed some signs of acceleration.*

Source: FactSet



# Contribution to Return – 1 Year

As of 12/31/12

## Sawgrass Diversified Large Growth

Ticker	Security Name	Port. Beginning Weight	Port. Ending Weight	Price Change (%)	Contribution To Return
AAPL	Apple Inc.	4.45	4.40	31.40	1.64
TJX	TJX Cos.	2.51	1.96	31.53	0.84
ROST	Ross Stores Inc.	2.75	--	40.30	0.82
HD	Home Depot Inc.	1.49	1.31	47.12	0.80
ABT	Abbott Laboratories	3.05	3.73	16.49	0.62
AXP	American Express Co.	2.61	1.92	21.86	0.60
ECL	Ecolab Inc.	2.07	2.60	24.37	0.54
EMC	EMC Corp.	2.29	2.33	17.46	0.54
MA	MasterCard Inc. Cl A	2.77	2.52	31.77	0.51
CVS	CVS Caremark Corp.	2.32	3.10	18.56	0.49

*While Apple was the most talked about stock, we had a number of strong performers.*

DOV	Dover Corp.	1.02	--	(1.00)	0.01
AGN	Allergan Inc.	--	1.42	0.97	0.00
UPS	United Parcel Service Inc. Cl B	--	0.99	0.23	0.00
ORCL	Oracle Corp.	--	1.69	(0.86)	(0.01)
SLB	Schlumberger Ltd.	2.36	1.52	1.45	(0.05)
ESRX	Express Scripts Holding Co	--	1.00	(2.26)	(0.07)
DPS	Dr Pepper Snapple Group Inc.	2.48	--	(2.36)	(0.07)
CSX	CSX Corp.	1.33	--	(9.73)	(0.07)
OXY	Occidental Petroleum Corp.	2.28	--	(17.47)	(0.25)
MCD	McDonald's Corp.	3.62	--	(11.55)	(0.44)

*Only two stocks did any material damage for the year.*

Source: FactSet



# Portfolio Changes – Quarter

As of 12/31/12

## Sawgrass Diversified Large Growth

Sawgrass Russell Sector	9/28/2012	12/31/2012	Changes		9/28/2012	12/31/2012	Changes
<b>Consumer Discretionary</b>	<b>19.19</b>	<b>15.22</b>		<b>Industrials</b>	<b>8.74</b>	<b>12.28</b>	
Wal-Mart Stores Inc.	3.28	3.67	0.39	United Technologies Corp.	2.56	2.72	
Comcast Corp. Cl A	2.59	2.75		Stericycle Inc.	1.43	2.06	0.63
DIRECTV	2.39	2.32		Caterpillar Inc.	1.39	1.47	
Home Depot Inc.	2.33	1.31	(1.02)	Boeing Co.	1.22	1.34	
TJX Cos.	2.03	1.96		CSX Corp.	1.12	--	(1.12)
Viacom Inc. Cl B	1.97	2.36	0.39	Danaher Corp.	1.01	1.67	0.66
<b>Yum! Brands Inc.</b>	1.42	--	(1.42)	<b>United Parcel Service Inc. Cl B</b>	--	0.99	0.99
<b>McDonald's Corp.</b>	1.33	--	(1.33)	<b>Union Pacific Corp.</b>	--	1.02	1.02
<b>Ross Stores Inc.</b>	0.99	--	(0.99)	<b>Honeywell International Inc.</b>	--	1.01	1.01
Costco Wholesale Corp.	0.86	0.86		<b>Information Technology</b>	<b>23.32</b>	<b>24.30</b>	
<b>Consumer Staples</b>	<b>11.99</b>	<b>13.92</b>		Apple Inc.	5.20	4.39	(0.80)
Coca-Cola Co.	4.11	3.99		International Business Machines Corp.	4.58	2.98	(1.60)
CVS Caremark Corp.	3.05	3.10		Google Inc. Cl A	4.32	4.11	
Kroger Co.	2.67	2.99		Microsoft Corp.	4.31	3.93	
Kimberly-Clark Corp.	2.16	2.16		EMC Corp.	1.82	2.33	0.50
<b>ConAgra Foods Inc.</b>	--	1.69	1.69	QUALCOMM Inc.	1.82	3.44	1.62
<b>Energy</b>	<b>5.87</b>	<b>3.48</b>		Motorola Solutions Inc.	1.28	1.43	
<b>Chevron Corp.</b>	2.26	--	(2.26)	<b>Oracle Corp.</b>	--	1.69	1.69
Exxon Mobil Corp.	2.05	1.97		<b>Materials</b>	<b>4.86</b>	<b>5.31</b>	
Schlumberger Ltd.	1.56	1.52		Ecolab Inc.	2.31	2.60	
<b>Financials</b>	<b>4.15</b>	<b>4.43</b>		Praxair Inc.	1.67	1.79	
MasterCard Inc. Cl A	2.28	2.52		Sigma-Aldrich Corp.	0.88	0.92	
American Express Co.	1.87	1.92		<b>Utilities</b>	<b>3.33</b>	<b>3.21</b>	
<b>Health Care</b>	<b>16.47</b>	<b>15.73</b>		Verizon Communications Inc	3.33	3.21	
Abbott Laboratories	3.84	3.73					
Celgene Corp.	2.97	3.10		<b>Sold</b>			
Express Scripts Holding Co	2.48	1.00	(1.48)	Yum			Dissapointing Guidance/Valuation
McKesson Corp.	1.89	2.16		McDonald			Slowing growth
Amgen Inc.	1.44	2.04	0.61	Ross			Slowing growth/Valuation/Extended
Allergan Inc.	1.39	1.42		Resmed			Valuation/Extended
<b>ResMed Inc.</b>	1.32	--	(1.32)				
Thermo Fisher Scientific Inc.	1.14	1.25		<b>New</b>			
<b>Life Technologies Corp.</b>	--	1.03	1.03	Conagra			Union Pacific
				Life Technologies			Honeywell
				UPS			Oracle





## Portfolio Holdings

<u>Portfolio Holdings</u>	<u>% Weight</u>	<u>Portfolio Holdings</u>	<u>% Weight</u>	<u>Portfolio Holdings</u>	<u>% Weight</u>
<b>Consumer Discretionary</b>		<b>Financials</b>		<b>Information Technology</b>	
Wal-Mart Stores Inc.	3.7	MasterCard Inc.	2.7	QUALCOMM Inc.	3.6
Comcast Corp.	2.9	American Express Co.	1.9	EMC Corp.	2.4
Viacom Inc.	2.5	<b>Health Care</b>		Motorola Solutions Inc.	1.5
DIRECTV	2.3	Celgene Corp.	3.2	Google Inc.	3.9
TJX Cos.	2.0	Abbott Laboratories	3.9	Microsoft Corp.	4.0
Costco Wholesale Corp.	0.8	McKesson Corp.	2.1	International Business Machines Corp.	3.2
Home Depot Inc.	1.4	Thermo Fisher Scientific Inc.	1.2	Oracle Corp.	1.7
<b>Consumer Staples</b>		Amgen Inc.	2.1	Apple Inc.	4.4
CVS Caremark Corp.	3.2	Allergan Inc.	1.5	<b>Materials</b>	
Kroger Co.	3.1	Life Technologies Corp.	1.1	Ecolab Inc.	2.7
Coca-Cola Co.	4.0	Express Scripts Holding Co	1.0	Praxair Inc.	1.8
Kimberly-Clark Corp.	2.2	<b>Industrials</b>		Sigma-Aldrich Corp.	1.0
ConAgra Foods Inc.	1.7	Stericycle Inc.	2.0	<b>Utilities</b>	
<b>Energy</b>		United Technologies Corp.	2.7	Verizon Communications Inc.	3.3
Exxon Mobil Corp.	2.1	Danaher Corp.	1.7	<b># of Securities</b>	
Schlumberger Ltd.	1.5	Boeing Co.	1.4		<b>44</b>
		Caterpillar Inc.	1.5		
		Honeywell International Inc.	1.0		
		United Parcel Service Inc.	1.0		
		Union Pacific Corp.	1.0		



## ***Protecting Florida's Investments Act Compliance***

January 2013

Re: Protecting Florida's Investments Act

This notification is intended to inform you of Sawgrass Asset Management's understanding of and compliance with the Protecting Florida's Investments Act (PFIA). As you may know, the Florida State Board of Administration has issued a guidance regarding some prohibited investments for municipal plans in Florida.

We have reviewed the information from the December 11, 2012 Board of Administration quarterly report and can verify that we hold no securities in your portfolio(s) that are identified on the list of scrutinized companies and any of the other companies on watch regarding the PFIA.

We will continue to monitor this list and notify you should we have any questions regarding our ability to comply. Given the nature of this list, we believe it is unlikely that we would have any problems.

Please contact us if you have any questions regarding the PFIA or your investment with Sawgrass Asset Management.

Best Regards,

Sawgrass Asset Management Team

## Stock Market: Quarter in Review

- Even with mixed fourth quarter performance, the equity markets finished off an impressive double digit annual percentage gain as supportive announcements of continued extraordinary support from the Federal Reserve were countered by worries over to the fiscal cliff. Small and mid-cap stocks ended with moderate gains while the large cap indices were negatively impacted by Apple's twenty percent decline.
- After breaking out to new bull market highs in September, stocks succumbed to an early quarter correction that saw the major indices fall roughly ten percent by mid-November before staging a year-end rally to offset most of the earlier losses.
- Investor focus generally returned to more cyclical stocks and sectors during the fourth quarter as higher beta was once again a significant factor for the year as it has been for much of the time since the March 2009 lows.
- Volatility and correlations continued their declines from multi-year highs as concerns over the European debt crisis faded further from the foreground but began to rise again as year-end approached with no deal to avert the fiscal cliff.
- Value and small cap outperformed growth and large cap in the quarter as the best performing sectors were financials, materials, and industrials while the worst performers were information technology, utilities, and energy.

## Stock Market: The Quarter Ahead

- The large cap indices ended 2012 near their all-time highs after showing tremendous resilience over the past few years. However a number of headwinds remain that could keep investors on edge and stock gains more moderate in the New Year.
- The political wrangling over the debt ceiling will likely dominate investor focus early in the year and could lead to heightened volatility as the potential effect of fiscal cuts on economic growth are still uncertain.
- The recent performance of cyclically oriented sectors and small and mid-cap stocks offers hope for further strength in the coming year.
- Valuation multiples, despite the historically low interest rate environment, are less likely to experience expansion given the magnitude of the rally over the last few years and an uncertain, decelerating earnings growth backdrop.
- The outsized influence of the Fed's historical support for the financial system has helped to buoy investor sentiment. However, the boost from each successive monetary stimulus has been smaller leaving equities vulnerable if that support wanes in any measurable way.
- The S&P 500 Volatility Index (VIX) recently set a five year low reflecting less investor skepticism and fear to help the markets climb the wall of worry to higher levels.

## 4<sup>th</sup> Quarter Scorecard

Table 1

Index	Quarter	1 Year
S&P 500	-0.4%	16.0%
Russell 1000	0.1%	16.4%
Russell 2000	1.9%	16.3%
Russell 3000	0.3%	16.4%
Russell 3000 Growth	-1.2%	15.2%
Russell 3000 Value	1.7%	17.6%
Barclays Capital US Aggregate	0.2%	4.2%
3 Month T-Bills	0.04%	0.11%

Source: Bloomberg & Russell Investments

- Economic data generally remains less than hoped for at this point of an expansion as the bond and equity markets remain at apparent odds over the economic strength implied by their respective levels and recent performance.
- As the bull market heads toward its fourth anniversary in the first quarter, further significant equity gains will likely be more challenging given the numerous global political and economic uncertainties, less favorable valuation, and already impressive four year run.

(Continued on back)

## Interest Rate Summary

Table 2

	12/31/11	9/30/12	12/31/12	Qtr Change	12-Month Change
3 Month T-Bills	0.0	0.1	0.1	—	+0.1
5 Year Treasury	0.9	0.6	0.7	+0.1	-0.2
10 Year Treasury	2.0	1.7	1.8	+0.1	-0.2
30 Year Treasury	2.9	2.8	2.9	+0.1	—
5 Year Corporate ('A')	2.8	1.6	1.7	+0.1	-0.3
10 Year Corporate ('A')	4.1	2.9	3.0	+0.1	-1.1
30 Year Fixed Rate Mortg.	4.0	3.5	3.4	-0.1	-0.6

Source: Bloomberg

## The Economy: Passing Grade But Improvement Needed

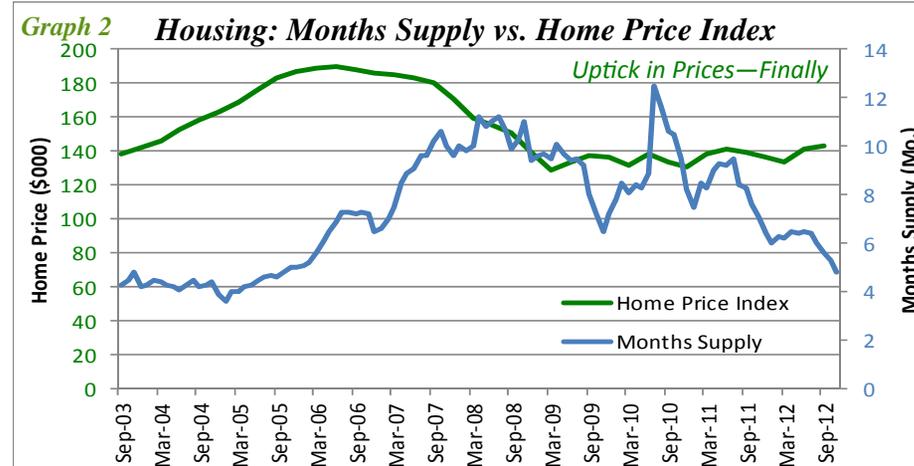
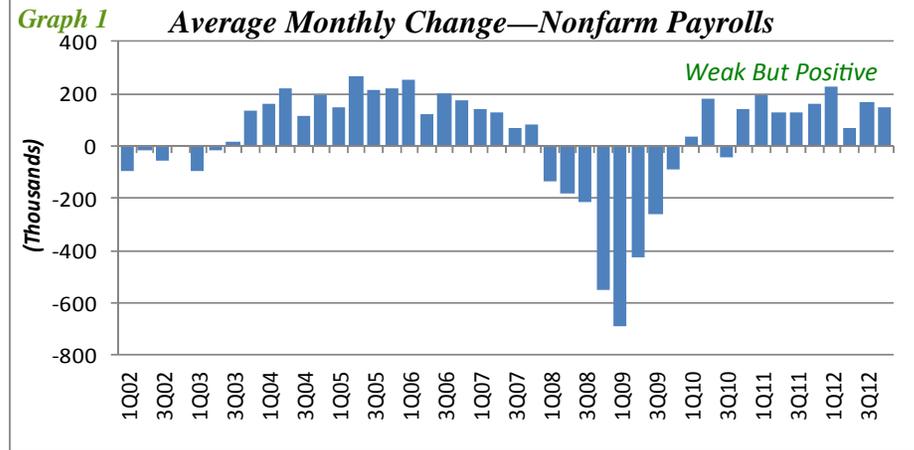
Since the start of the current economic recovery in June 2009, inflation adjusted GDP has grown for 13 consecutive quarters as overall conditions continue to show steady but painfully slow improvement. As we move forward into the fourth year of the recovery, we make the following observations:

- GDP growth has been positive but weak. Year-over-year growth has hovered mostly in the 2-2 ½ percent range – well below normal for an expansion phase of the economic cycle. Over four years into recovery, current GDP levels are barely two percent ahead of where they stood just before the onset of the 2008-09 recession.
- Employment growth has been steady, averaging near 150 thousand per month during the past six months (see Graph 1). While positive, higher levels of employment growth will be needed to reduce unemployment rates by a meaningful amount.
- Housing, which for several years dragged down economic growth, has improved significantly and is now a notable bright spot. While home prices are up marginally, they have increased for nine consecutive months. Importantly, the inventory of existing homes for sale has fallen to less than five months – the lowest level since October of 2005 (see Graph 2). While there remains a shadow inventory of homes yet to be placed on the market, housing affordability remains extremely high and conditions favor further improvement.
- The political environment remains an ever present wild card. Anecdotal evidence during the recent fiscal cliff drama as well as the debt extension theatrics in 2011 seem to suggest at least a temporary negative affect on consumer behavior.

## The Fed & Interest Rates: Throttle Wide Open

With its near zero interest rate policy and aggressive purchases of securities, the Fed continues its mission of attempting to push economic growth forward. Clearly mortgage rates, near 3 ½ percent have been a major catalyst for improving housing market conditions. Moreover, during the past 12 months, overall credit conditions have continued to improve as investment grade corporate bond yields have dropped in yield by over a full percentage point while government bonds have remained mostly unchanged (See Table 2). High yield bonds have also fallen in yield as investors' appetite for risk has risen during the past year.

The accommodation by the Fed during the past several years has been dramatic and by many measures, unprecedented. The Fed has indicated its intention to keep its current interest rate posture in effect for more than two additional years. As economic conditions gradually improve, however, the market will begin to incorporate an expectation that the unprecedented stimulus program may be nearing an end. We expect the first evidence of that will be some uptick in longer term rates as we move through the next 12 months.



*Alright fellas, looks like we successfully navigated around the fiscal cliff. I think we're in the clear now...*