VNB Wealth Management
2013 Year-end Investment Review

January 28, 2014

It's always a beneficial exercise to review where we've been, have an appreciation for where we are and look forward to what lies ahead. This past year will be remembered as the time when the fear trade abated. The threat of a repeat market collapse stemming from the 2008 financial crisis has been an underlying theme around the globe for many years. As it turned out, 2013 proved to be a very difficult year for the doomsayers.

Economic growth coming from the United States seems to be leading the world out of the hangover from market dislocations of the past few years. Normalcy has begun to return to the financial sector, housing and auto sales continue to rebound and the prospect of energy independence in the U.S. is an incredibly exciting development. In the S&P 500, expanding multiples were responsible for 78% of the price return. Multiple expansion accounting for such a significant portion of the market's gain could be a signpost of continued improvement in investor confidence.

As we extend our view globally and to other asset classes, it's clear that U.S. Stocks were 2013's shining star.

Asset Class	As Measured By:	2013 Return
US Small Cap Stocks	Russell 2000	38.8%
US Large Cap Stocks	S&P 500	32.0%
US Large Cap stocks	Dow Jones Industrial Average	29.6%
Int'l Developed Stocks	MSCI EAFE Index	23.6%
Oil	Light, sweet crude oil as traded on NYMEX	7.2%
Hedge Funds	HFRX Equal Wtd Strategies Hedge Fund Index	6.7%
Emerging Market Stocks	MSCI Emerging Markets Index	-2.4%
US Gov't Debt	Bloomberg Index of 7-10 year maturities	-5.9%
Gold	GLD (ETF)	-28.3%

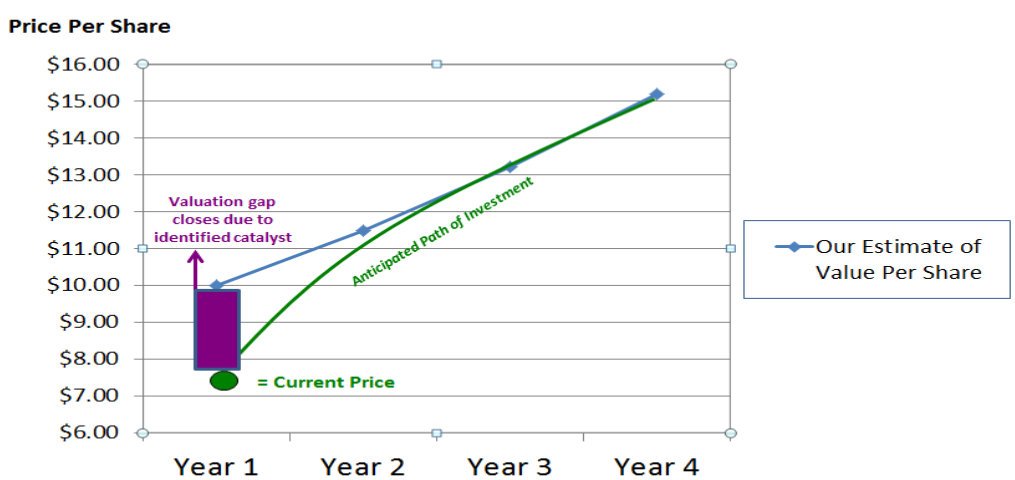
'Is the stock market expensive' was a refrain heard throughout the latter parts of 2013 and into 2014. The market's price-to-earnings ratio is clearly higher today than last year at this time. What is not known with any certainty is how expensive it is relative to where it should trade. As a firm, we don't spend time analyzing and anticipating the price levels of the overall market; however, it is a relevant data point for us because a more expensive broad market tends to limit our opportunity set. There is no question that good investment ideas are harder for us to find today than at any other point since 2009. It's also clear to us that the discount between what we deem as fair value for our investments and where they currently trade has shrunk dramatically. This is to be expected when the S&P 500 is up +30% in a year. As a result, the expected internal rate of return (IRR) of our portfolio is now in the low-to-mid teens versus the low-to-mid 20's just one year ago. Consequently, the inherent risk in the portfolio and the equity market in general, is elevated from what it has been the last few years. In the present environment we generally have more cash than we might normally. Two conditions need to be present to aide our ability to find undervalued securities:

1. Low valuation levels versus historic norms for the broad market. These lower valuations increase our opportunity set.
2. Greater volatility, which measures standard deviation or variance in the movement (up or down) of stock prices. Counterintuitively, more volatility is better when looking for "cheap" assets.

Putting capital to work in new investment ideas is more challenging in an environment with high valuations and a lack of volatility like we saw last year (the largest market drop for the S&P 500 was 5.8% in 2013).

Review of Investment Philosophy

We continue to employ a value-based, catalyst-driven investment strategy that is focused on generating absolute returns. We like to buy $1 bills for $0.50. An even better scenario is if we can pay $0.50 for a $1 bill (or $1 of value) that is growing over time. The presence of a catalyst more quickly closes the gap between the current price of a security and our estimate of the intrinsic value and speeds up the compounding process of the money entrusted to us.



We invest across the capital structure in any security and situation where we can ascertain the underlying value. Our best investment opportunities tend to be off the beaten path. We search where other managers cannot or will not look. Before we make an investment we always consider the downside before the upside. Conservative assumptions are made in our analysis. When done correctly, this creates a margin of safety that will limit downside and avoids the permanent impairment of capital.

The flagship product of VNB Wealth Management is our Enhanced Core Strategy. There are clearly defined investment characteristics of the businesses we want to own in the "Core" portion of the portfolio. The goal is to structure a portfolio of Core investments exhibiting specific characteristics in meaningful concentrations. Investments are made in those companies that have high and increasing returns on invested capital, recurring revenues and substantial free cash flow generation. The "Enhanced" portion of the portfolio supplements the Core positions and are best described as having a higher risk/reward profile than a typical Core holding. Investments are made throughout the capital structure and usually occur in companies undergoing various types of corporate events.

Core Investments

The criteria we employ when looking to commit capital is below:

Business Characteristics:

- Essential product or service
- Generates high and increasing returns on invested capital
- Currently produces, or has the potential to produce, substantial free cash flow
- Leadership in an attractive market niche or industry
- Understandable business model
- Minimal risks and variables that are outside of managements' control

Intangibles:

- Open market purchases of company stock by directors & officers
- Integrity of management
- Managements' ability to execute on strategy and allocate capital
- Presence of a catalyst

Valuation**:**

- Targeting +15% IRR on investments: free cash flow yield and/or earnings growth + increases in multiple + dividends; in any combination

Enhanced Investments

These include:

- Refinancings
- Balance sheet restructurings
- Distressed debt, sum-of-the-parts
- Spinoffs and divestitures

A particular emphasis is placed on microcap securities in this portion of the portfolio. Most institutions are not able to capitalize on these situations due to the small size of the opportunity or their unwillingness to invest out of the mainstream. We have developed the ability to uncover, value and trade in these assets through many years of practical experience.

<u>Select Portfolio Positions</u>

We became involved in **Liberty Media Corporation (Core)** through our interest in Sirius XM Holdings (SIRI). Liberty is a sum-of-the-parts play in that they own a variety of businesses whose aggregate value is worth more than the market's current valuation of Liberty Media shares. Over 60% of the value of Liberty is made up of SIRI. We have owned SIRI in accounts periodically from the late fall of 2011 to today.

SIRI broadcasts various channels of audio to remote devices and cars from its satellites for a monthly subscription fee. When we originally purchased SIRI it was based on the tenet of virtually exponential free cash flow growth and limited capital expenditures going forward as their satellites had been paid for and launched. The keys to the ultimate success of the business became solidifying their operations to leverage their existing infrastructure and efficiently adding customers to their platform. Multiple catalysts were present including: potential for price increases (which they had agreed to delay in exchange for merger approval with XM Radio), deleveraging (paying down or refinancing expensive debt), increasing penetration in new car market, and the launch of a used car offering. All of the above pointed to high and increasing free cash flow growth, high and increasing returns on invested capital and recurring revenues provided through a loyal customer base.

In buying Liberty Media you were able to purchase SIRI at a substantial discount. By valuing the reported holdings of Liberty Media and backing out the cash on the balance sheet, SIRI could effectively be "purchased" at an approximate 25% discount to its share price. With hope that Liberty Media would be able to monetize their interest in SIRI in a tax-effective manner (which is what they are known for), we felt very comfortable making Liberty Media, SIRI and the other underlying businesses (27% of Charter Communications, Atlanta Braves) a substantial holding.

Stein Mart Inc. (Enhanced) is a small cap stock purchased in mid-December of 2012 at approximately $7.25 per share. Stein Mart operates a chain of retail stores that offer moderate to designer brand name apparel. At the time of purchase, we felt the market was underestimating the turnaround effort led by Jay Stein, Chairman and CEO. Jay instituted changes aimed at driving up same-store-sales and improving operating efficiencies. Interestingly, a simple concept like offering Stein Mart store branded cards has cardholders spending 50% more in stores than non-cardholders.

We believed that as their results improved over the coming quarters, the multiple on the earnings would increase. Using conservative projections, factoring in the net cash on the balance sheet, and forecasting Stein Mart's ability to generate substantial cash flow, we concluded we had a very favorable risk/reward proposition. The downside was cushioned by the free cash flow generation of the business and net cash on the balance sheet. The upside was calculated to be 2x the current price (EPS and free cash flow estimates using 15x multiples) arriving at a price target of approximately $13.75 per share. The stock has almost doubled during this past year but we believe there is room left to run as earnings expectations improve and new initiatives continue to take hold.

In the attached appendix to this letter we further highlight these and additional securities that were researched and purchased by the current investment team over the past few years.

The Big Picture and a Look Ahead

It's important to mention we do pay attention to macro-type events. One of the lessons learned in 2007–2009 was that investors ignore the macro at their peril. Although we are cognizant of the macro environment, we do not let it lead or drive our investment process. We monitor oil prices (year-over-year price level changes too high or too low impact the stock market), the LEI (Conference Board U.S. Leading Index Ten Economic Indicators), the ISM Index (from the Institute for Supply Management) and the Unemployment rate. Perhaps most interesting and telling to us is what large, multinational companies (DuPont, Dow Chemical, Caterpillar) are saying about their businesses, both here and abroad. Understanding these factors may not lead to the avoidance of short-term market corrections. However, it has proven in the past to foreshadow large drops in the stock market due to economic turbulence, and has allowed us to navigate treacherous waters without sinking the ship.

We approach 2014 with a hint of cautiousness, a healthy amount of cash, the willingness to take risk off the table, along with some excitement about the prospect of returning to normalcy in this country - at least economically speaking. Valuations of the equity markets in the U.S. remain reasonable. They are neither overly expensive nor cheap. Investing in the broad bond market could prove hazardous again in 2014, just as it was in 2013. We suspect we will see a marked increase in volatility this year as the market calm of last year was most likely an anomaly since, historically, drops of 10% or more in the broad stock market are not at all unusual. It's highly likely that anticipated and actual changes in Fed policy regarding the reduced level of open market bond purchases (commonly referred to as "tapering") and the level of short term interest rates will bring about more volatile markets for both bonds and stocks. We will continue to avoid making bets on the actions of the FOMC (Federal Open Market Committee) but we do need to understand the impact their decisions have on the securities we own.

In the event of higher volatility (and lower prices) we are ready and prepared to commit capital to a host of positions where we love the business but don't like the price.

In Conclusion

In Malcolm Gladwell's new book, *David and Goliath*, he puts forth the notion that many times success comes as a result of great struggles and tribulations and through thinking independently from the crowd. In the story of David and Goliath, David, a small shepherd boy, approached his fight with Goliath, a giant, by utilizing his skill sets (nimbleness and accuracy from a distance) and deciding not to compete with Goliath on Goliath's terms (hand-to-hand combat) which was the common form of battle at that time.

There's much to be learned from the idea of doing things differently either out of necessity or by choice. We believe we need to have a differing perspective than the consensus to outperform the "giants." Our goal is to achieve absolute returns rather than relative returns which are measured against an index.

Our approach, which has guided us through two substantial bear markets, a global financial collapse, and numerous other challenges, remains disciplined and differentiated. We try to model ourselves as Davids in an investment world full of Goliaths.

May all of us approach the year ahead by continuing to utilize our talents, forged through adversity, to find success in investing and also in life.

Respectfully submitted on behalf of the investment team at VNB Wealth Management,

Mark

Mark A. Meulenberg, CFA
Chief Investment Officer

Disclosures

This Investment Review is furnished for general information purposes in order to provide some insight into the investment management process and techniques that VNB Wealth Management uses to make investment decisions. It is provided for illustrative purposes only. Opinions and information provided are as of the date indicated. This material is not intended to be a formal research report, and as such, it should not be construed as an offer or recommendation to buy or sell any security, nor should information contained herein be relied upon as investment advice. Opinions and information provided are as of the dates indicated. VNB Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. The statistics in the article were obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed.

This article contains commentary regarding several securities that have been purchased by VNB Wealth Management on behalf of our clients. Individual account holdings may vary, and the views expressed herein may change at any time subsequent to the date of this article. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities referenced in this article. The price and value of securities referenced in this article will fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed and a loss of all of the original capital invested in a security discussed in this article may occur.

Past performance is not indicative of future results.

Performance results are not GIPS compliant.

Indexes represent securities widely held by investors. You cannot invest in an index.

Russell 2000® index measures the performance of the 2,000 smallest companies in the Russell 3000®, which represents approximately 8% of the total market capitalization of the Russell 3000®.

S&P 500 Index is a capitalization-weighted index calculated on a total-return basis with dividends reinvested. The Index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

The Dow Jones – UBS Commodity index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. The index is composed of futures contracts on 19 physical commodities. No related group of commodities (e.g., energy, precious metals, livestock, and grains) may constitute more than 33% of the index as of the annual re-weightings of the components. No single commodity may constitute less than 2% of the index.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of June 2007 the MSCI EAFE Index consisted of 21 developed-market country indices.

Crude Oil is the world's most actively traded commodity, and the NYMEX Division light, sweet crude oil futures contract is the world's most liquid forum for crude oil trading, as well as the world's largest-volume futures contract trading on a physical commodity.

The HFRX Equal Weighted Strategies Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to, convertible arbitrage, distressed securities, equity hedge, equity market neutral, event-driven, macro, merger arbitrage, and relative value arbitrage. The HFRX Equal Weighted Strategies Index applies an equal weight to all constituent strategy indices. This index cannot be invested in directly.

Hedge Funds trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences.

The MSCI Emerging Markets Index captures large and midcap representation across 21 Emerging Markets countries. With 824 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg/EFFAS indices are designed as transparent benchmarks for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector.

SPDR Gold Shares is an investment fund incorporated in the USA. The investment objective of the Trust is for the Shares to reflect the performance of the price of gold bullion, less the Trust's expenses. The Trust holds gold and is expected from time to time to issue Baskets in exchange for deposits of gold and to distribute gold in connection with redemptions of Baskets.

Investments and Accounts at VNB Wealth Management:

- Are NOT insured or guaranteed by the FDIC or any other federal government agency
- Are NOT deposits of, or guaranteed by, a Bank or any Bank affiliate
- May lose value