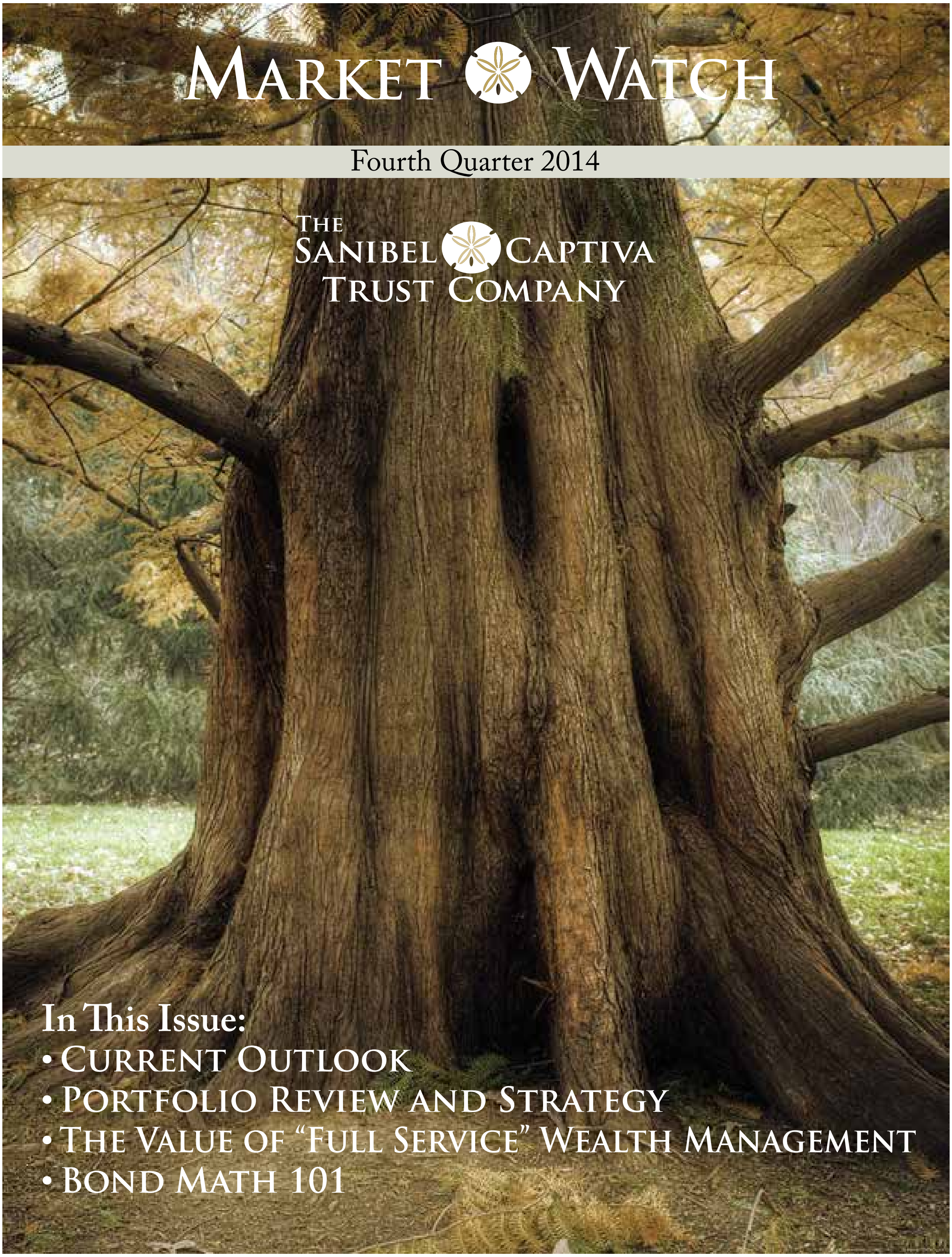
Market Watch

Fourth Quarter 2014

The Sanibel Captiva Trust Company



In This Issue:

- Current Outlook
- Portfolio Review and Strategy
- The Value of "Full Service" Wealth Management
- Bond Math 101

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Current Outlook

With the Fall season already upon us, investors' thoughts are filled with memories of the Winter, Spring, and Summer stock market rallies to new highs and predictions for the remainder of the year. Forward-looking asset managers are even beginning to factor in what may lie ahead for 2015. As we reviewed our previous commentaries, we are at pains to find anything really new and different to say about our Current Outlook. We continue to see signs of a domestic economy that is chugging along at a 2% - 3% annual growth rate. The Consumer Price Index depicts a rate of annual inflation that is comfortably below the Federal Reserve Board's 2% target level. Interest rates continue to remain historically low across all maturity choices. Corporate profits continue to grow at a sustainable pace of 5% - 10% annually. In short, all of the domestic data points we observe appear to signal more "Goldilocks" to come (neither too hot nor too cold).

Internationally, however, there is more concern about each of the above-mentioned data points. Economic growth in the Euro-Zone continues to be hard to come by. Recently, the Organization for Economic Cooperation and Development (OECD) reduced its growth rate forecast for Europe. One potential trouble spot we see is the effect of the economic sanctions put in place by the United States and European Union (EU) targeting Russia's involvement with Ukraine. The EU conducts a large portion of its cross-border trade with Russia, so sanctions could slow the Euro-Zone recovery rate. The European Central Bank has responded by cutting interest rates further. Likewise, we are monitoring China, whose growth rate also appears to be slowing, and whose authorities have responded by loosening monetary policy.

All of these factors have put downward pressure on world-wide interest rates at a time that the Fed is gradually removing the monetary stimulus that has been in place for six years. We may be witnessing, for the first time in a long while, economic and monetary policy divergence on a world-wide scale. This may cause disruptions in the pattern of world trade, as trading partners experience varying rates of economic growth and thereby attempt to manipulate currency values. This variance may explain this year's differences in equity and bond-market returns across different geographic areas. Thus, the five-year bull market in world-wide equity markets may morph into more of a "stock-picker's" or "country-picker's" market.

We expect to see the Fed raise interest rates for the first time in eight years next March or June depending on the data. We do not know exactly what the reaction of trading markets will be to a rate increase. Because the central bank has been completely transparent with their monetary policy under Ben Bernanke, and now Janet Yellen, we do not expect any out-sized change in asset valuations. We also expect 2015 to show economic growth above 2014 and continued mid-to-high single-digit growth in corporate profits. Inflation should not be a major issue next year, either, due to the impact of sluggish world-wide economic growth. Despite a tighter monetary policy, we do not expect much change in longer-term interest rates. This implies a flattening of the interest yield curve (short-term interest rates rising, but long-term rates staying stable) – which will help control the growth rate of the economy and inflation. However, if the yield curve does not flatten, even a little, it will imply that world-wide growth and inflation remains stubbornly subdued.

The Value of "Full Service" Wealth Management

Remember when "Full Service" gas stations were the norm? A time when attendants pumped your gas, cleaned your windows, checked your oil, and evaluated tire pressure every time you filled up. How often when you pump your own gas anymore do you follow this disciplined routine? When all of these services are performed consistently, you achieve better gas mileage, protect your engine from costly repairs, and are better able see the dangers that lie on the roads ahead. Not to mention you keep your hands clean and enjoy the comforts of your vehicle while work is being done for you.

If keeping the tank filled with gas was the only thing your car needed, pumping it yourself would serve your needs, but we know that your car will eventually need the type of maintenance and repairs that requires a trained professional. Reliance on "passive investing" strategies – such as index funds, ETF's, or online trading programs – can work to your detriment in much the same way.

What happens when there is a tax problem, a market correction, an immediate need for cash, or an illness or death in the family? Can a "one-size-fits-all" index product adapt to your unique circumstances? Of course not. An index fund or an ETF (and the creators of these products) neither knows, nor cares, that you own its shares. That's where a "full service" team makes the difference. Each of our clients has a three-person, in-house team who works with you and your outside advisors to assist with insurance and risk management, lending, estate planning, charitable giving strategies, and tax management. This team approach helps give clients the tools they need to make informed decisions.

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an immediate need for cash, or an illness or death in the family?
Can a "one-size-fits-all" index product adapt to your unique circumstances?
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One of the value-added benefits of managed investing is the ability to match your portfolio's volatility to your risk tolerance. Your portfolio manager will also help coach you, or "talk you off the ledge," when your emotions get in the way of making smart investing decisions. Numerous studies have shown that the returns of "do-it-yourself" investors greatly underperform the very investments they buy. A recent study by Richard Bernstein Advisors found that for the 20-year period ending Dec. 31, 2013 the "average" stock investor experienced annualized returns of less than 4%, while even a balanced approach of 50% high-grade corporate bonds and 50% equities returned 8%. Indeed, human nature and emotions cause the majority of investors to swap their assets too often, buy when the market is high, and sell when it's low.

Our portfolio managers will also work with you to set a proper asset allocation. Forward-thinking asset allocation is critical for tax efficiency, increasing returns, reducing risk, and (most importantly) creating a portfolio that matches your current and future financial needs. Having a Wealth Management team working to achieve your goals on a daily, full-time basis can allow you the freedom to focus on what you enjoy – with peace of mind. Your team will be there to build a relationship with you and your family that goes beyond traditional investing and financial planning to encompass the needs of your whole life including future financial needs and trustee and estate settling services. Being here for you – holding your hand in rough times – is one of the greatest benefits we can offer compared to passive index investing.

Bond Math 101

Historically, fixed income has always been a part of a diversified investment portfolio. Investment-grade bonds normally offer stable income, low volatility, and preservation of principal. Over the last several years, however, interest rates have fallen to historical lows. As yield-hungry investors contemplate allocating a portion of their assets to fixed income, we think it might be helpful for investors to understand the basics of bond math.

When a company or municipality issues new bonds, they are priced at "par" (usually $100 per bond) with a fixed coupon yield and maturity date. When investors buy a bond at par and hold it until maturity, they can expect to collect the interest each year and get 100% of their principal back when the bond matures, barring a default by the issuing company (the investment-grade bond default rate is historically less than 2% per year). There are a few questions, outlined below, that investors need to ponder before they commit to a fixed-income portfolio:

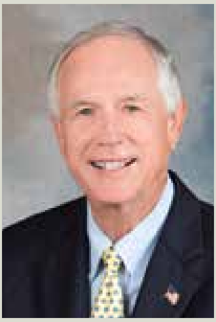
Will you have liquidity needs prior to maturity – If you need to sell a bond prior to maturity, you may be forced to accept less than what you paid due to a change in interest rates or sentiment. When interest rates rise, bond prices generally fall. For example, in April 2013, Apple issued a record $17 billion of bonds, including $3 billion worth that matured in 30 years with a fixed coupon of 3.85%. When rates rose, that same bond fell to $84 at the end of 2013. An investor who paid $100 for the bond, and needed to sell, would have locked in a loss of 16% of principal in just eight months.

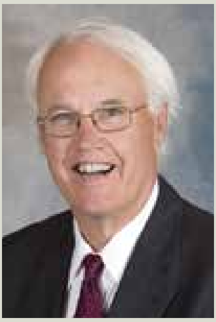
Are the bonds held in your fixed-income fund trading at a premium – Fixed-income funds have been very popular for investors as interest rates have remained at historically low levels. Because of this overwhelming demand, the majority of investment-grade bonds today trade at a premium (above par). This pricing has the effect of lowering the yield to maturity (YTM) of a bond fund, which means that the investor will realize a total return below the current coupon as those premium-priced bonds fall back towards $100 par at maturity. For example, one notable intermediate-term, investment-grade bond fund recently held bonds with an annual coupon of 3.7%. However, since the average bond within the fund was priced at $105, the yield to maturity of the fund was just 2.6%.

What is the "yield-to-worst" of your bond portfolio – The yield to worst is the lowest yield an investor would expect when investing in a bond portfolio that contains callable bonds. If the current yield of a bond portfolio is providing you with enough income to satisfy you living needs, but 50% of the bonds may be called in the next year, those bonds will be priced as if they will mature next year, and as a result yield far less than the coupon. As an example, a client recently asked us to review a laddered municipal bond portfolio that had been in place for many years. Although the current coupon was attractive at 3.5%, the yield to worst was just 1.4% because many bonds were likely going to be called by the issuer in the next several years.

Thus, when exploring the fixed-income arena today – after a 30-year bull market in bond prices – an active manager can analyze the current rate environment and the relative valuation of many asset classes to help you make the right decision. Using some basic bond math can yield some surprising results!

Dear Investors,





As the largest independent trust company serving Southwest Florida, we combine personal service with world-class investment management to create a superior client experience. The Sanibel Captiva Trust Company seeks consistently to provide our clients with experience and vision grounded in results. Preserving and building wealth are fundamental to our investment philosophy and process. We know that your portfolio should be as individual as you are. That is why each portfolio is separately managed and uniquely tailored to meet the total return and cash flow requirements for each of our clients.

Every Thursday, the Trust Company's Asset Management Committee (AMC) meets to discuss investment strategy and how current events may be affecting the securities we own in our client portfolios.

If you would like to learn more about our investment approach and/or would like to attend one of our AMC meetings, we welcome your call at (239) 472-8300.

Warm Regards,

S. Albert D. Hanser
Founder and Co-Chairman

Richard Pyle
President

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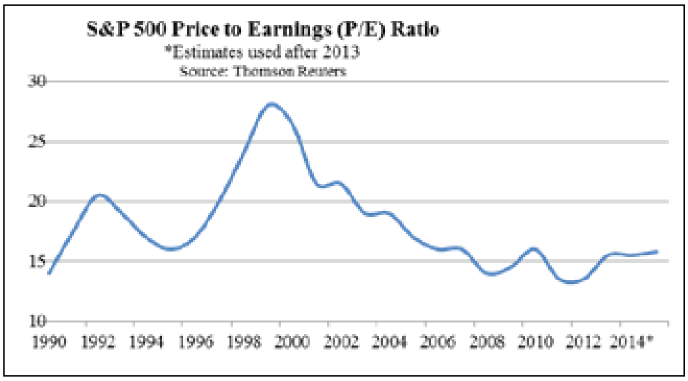
Portfolio Review and Strategy

U.S. equity markets were mostly flat during the third quarter of 2014. We made the case last quarter that despite rising equity markets over the past several years, valuations remain reasonable considering the broader economic landscape and the underlying growth in revenue and earnings from our portfolio companies. As we move closer toward 2015, we have better foresight into revenue and earnings projections for next year, and we remain comfortable with our equity allocations. While equity markets no longer are broadly inexpensive, they are not overvalued compared to long-term historical averages (see chart below). Rather, we view equity markets as "fairly valued," meaning we expect equities to appreciate at rates equal to companies' underlying growth rates, but without the added benefit of earnings multiple expansions we enjoyed over the past few years.

Fixed-income investments moved modestly higher during the quarter as interest rate volatility picked up. The Federal Reserve Board remains on track to terminate its long-standing asset purchase program in October, and we expect the Fed Funds rate will be increased in 2015. It seems inevitable to us that interest rates will rise, though the timing is difficult to predict, particularly in light of Euro-Zone interest-rate policies, which we expect will remain extremely accommodative for the foreseeable future. We believe fixed-income investors will find themselves earning meager (and in some cases negative) real rates of return as interest rates slowly move higher to more-normalized levels. For this reason, we have avoided traditional fixed-income investments and will continue to do so until interest rates rise. In the meantime, we are using high-quality dividend stocks, preferred stock, REITs, and master limited partnerships (MLPs) for many clients requiring current income.



International equity market results were mixed during the third quarter. As we highlight in our Current Outlook, Europe is facing some significant challenges that have weighed on the "developed" portion of international equity markets. Despite aggressive monetary policy to lower interest rates further below zero (effectively charging banks on their savings), stubbornly low growth across Europe persists – exacerbating worries that Europe is flirting with deflation. However, history is a powerful teacher, and we expect European leaders will follow through on their promise to avoid deflation. From a fundamental standpoint, equity valuations remain quite attractive outside the U.S., particularly in "emerging" markets, where we continue to allocate capital for clients desiring long-term growth. Moreover, our active approach toward international investing continues to add value.

Lastly, it is prudent to keep future expectations in check in light of a bull market that has spanned more than five years now. Behavioral psychologists coined the term "availability heuristic" to explain that humans sometimes overestimate the likelihood of future events by how easily they recall past events. After 2009, for example, investors were more likely to fear another financial bubble than see the optimistic signs of recovery taking shape. And today, while we certainly believe there is still upside for equity markets moving forward, it is important to temper our expectations and not look for 2013 to repeat.

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