MARKET STREET TRUST COMPANY

Annual Investment Review | 2013

IN THIS ISSUE

Detailed commentary on the year, along with insight and outlook from the Market Street investment team

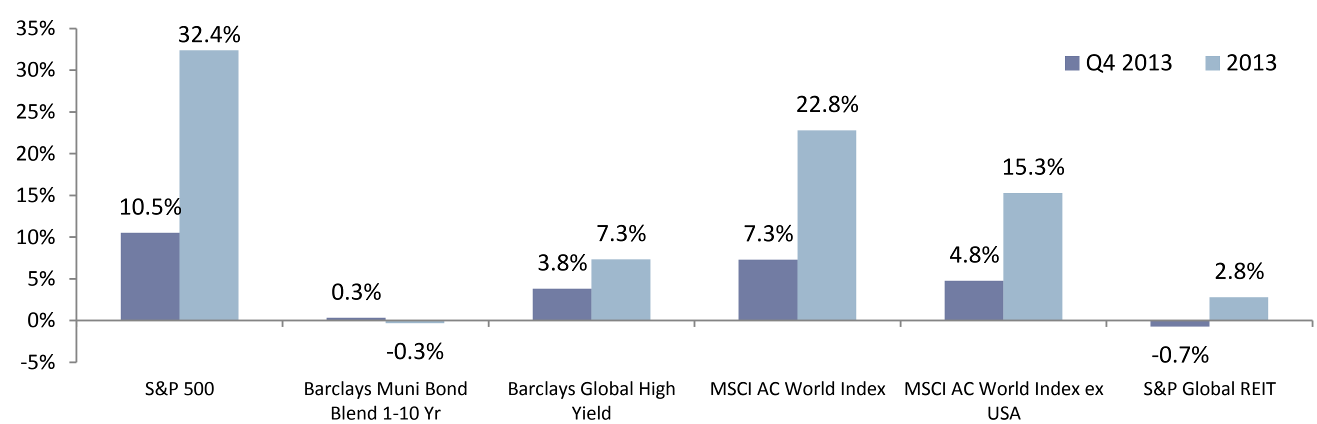
OVERVIEW

Michael R. Eisner, Chief Investment Officer

Investment returns in 2013 were very strong, with diversified portfolios up double digits for the year. Performance was driven mostly by a 32.4% return in U.S. equities (S&P 500 Index), which was the S&P 500's 5th best year in the last 50 years. Other strong performers were foreign developed markets, as represented by the MSCI EAFE Index, up 23% and high yield credit, up 7.3%. See Chart 1 for additional market returns.

Looking back, results in 2013 were surprisingly good. We started the year with tax increases and spending cuts that were expected to shave 1.5% from U.S. gross domestic product (GDP). European credit issues resurfaced (Cyprus), crude oil prices were high, and 10 year U.S. Treasury rates fell, reflecting economic weakness (they hit 1.63% in May). In spite of all this, the markets roared out of the gate, gaining 18% through mid-

Chart 1: General Market Returns

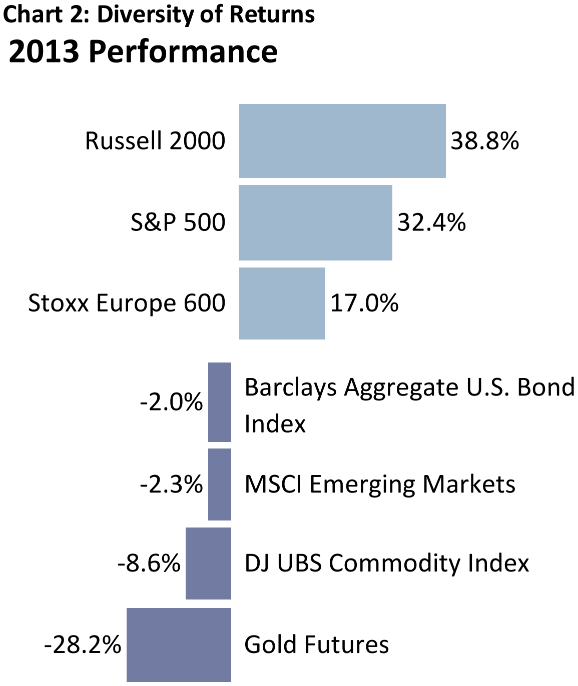


May. In May, miscommunications by the Federal Reserve (or a misunderstanding by the market place) led to a huge selloff in bonds and a faltering of the equity markets for most of the summer. As we approached the fourth quarter, political squabbling in the U.S. led to a partial government shutdown and flirtation with technical default on the country's debt. Result: the equity markets powered further ahead as if they could not be bothered.

So, what is really going on in the markets? Do we have another bubble in the making or is there a reasonable explanation for the good returns? Although the global Central Bank's easing has helped tremendously, we believe after five years of a weak recovery, somewhat better global economic data has fueled recent optimism. In the U.S., unemployment continues to decline, manufacturing activity continues to improve and our political situation, though still rancorous, has not harmed economic progress. In Europe, 2013 seems to have been an inflection point, with many countries showing improving economic growth rates. To be clear, these growth rates are unimpressive, but reflect a reversal of the dismal and/or declining rates of the past few years. Japan's economy also improved in 2013, helped by strong fiscal and monetary easing policies. Lastly, emerging markets, such as China, Brazil and India have struggled all year as a strengthening dollar, falling commodity prices and fears of the coming tapering of easy liquidity have hurt their economies. But the strengthening in the developed world has bought them more time to address issues.

Interestingly, from a return perspective, diversification detracted more than it helped in 2013. Chart 2 illustrates that many asset classes actually performed poorly during the year. One must keep in mind that diversified portfolios are built to do well over the long-term by not being either the top or bottom performer in any given year. By consistently staying away from the extreme ends of performance, diversified portfolios can deliver exceptional long-term results with lower volatility.

Chart 2: Diversity of Returns



** Sources: Bloomberg, AJO, WSJ. Data as of 12/31/13*

Equity markets at the beginning of the year were driven by decent fundamentals and fair valuations, but received an additional boost from the continued easy monetary policy of the Federal Reserve, European Central Bank and Bank of Japan (various forms of quantitative easing). Market Street believed these actions would drive decent equity returns and increased allocations to global equities to above average exposures during the year. We also underweighted traditional high quality bonds and cash, believing their performance would be sub-par. These themes proved to be correct in 2013, although 20% - 35% equity returns were even more than we imagined.

As the year progressed, strong equity returns drove overweights further from targets, and we began rebalancing back to targets to maintain reasonable risk profiles within portfolios. A client's target allocation is the portfolio best designed to meet their objectives given the individual's risk tolerances, liquidity needs and financial situation. We believe these goals are best met by managing to this target allocation and only taking certain risks when there is an above average expected payoff.

Looking ahead, we expect decent equity returns, but valuations are less favorable and monetary policy less friendly. Therefore, we believe it prudent to take some profits from the big winners and recycle them back into areas that may have more attractive fundamentals. According to JP Morgan Asset Management, since 1980, the average intra-year decline in the S&P 500 is 15%. In 2013, the largest pullback in the S&P 500 was 6%. We cannot predict when a decline will happen, but we think 2014's drawdown may be closer to average, which could provide better buying opportunities.

FIXED INCOME

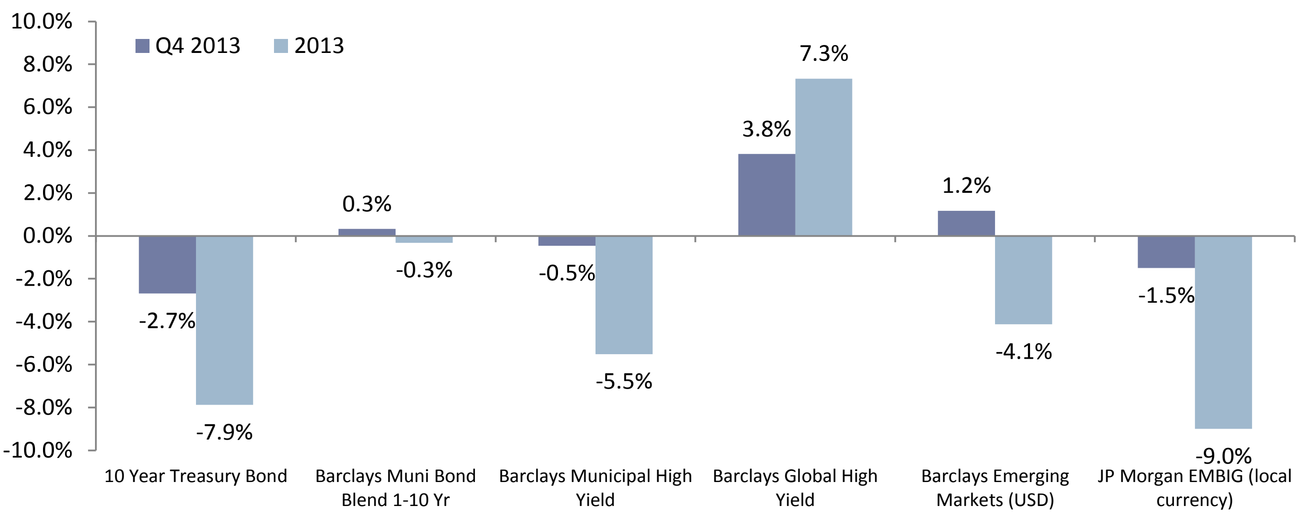
Robert White, Investment Manager

A 'Great Rotation' from bond funds to equity funds occurred in 2013. Through the end of November, investors withdrew over $49 billion from municipal bond funds. While taxable bond funds saw net inflows of $28 billion during the year, the headline number masks a significant divergence among the sub-sectors. Intermediate and inflation protected bond funds suffered a $130 billion outflow while bank loan, short-term bonds, international bonds and non-traditional bond funds saw inflows of over $167 billion.

Following a positive first quarter, bonds as an asset class declined during the second quarter due to market concerns that the Bernanke Fed would start to taper sooner than expected. However, after a September announcement that the Fed was not actually going to start tapering, bonds staged a short-lived rally. As the year drew to a close, better economic data coupled with the December Fed announcement that a reduction in quantitative easing would indeed start in January 2014, resulted in bond yields rising again.

During 2013, the yield curve steepened as long-term term yields increased more than shorter term yields (hence the redemption of intermediate-term bond funds and the purchase of short-term bond funds). Investors feared that tapering would have a greater effect on the long-end of the curve given that short-term rates are tightly anchored to an unchanged Federal Reserve interest rate policy. While the yield on 2-year Treasuries only increased from 0.25% to 0.35% during the year, that of 10-year Treasuries rose from 1.76% to 3.03% while 30-year Treasuries also suffered an increase over 100 basis points, ending the year at

Chart 3: Fixed Income Index Performance



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3.97%. With bond returns being an inverse of yield movements, the 30-year Treasury performed worst, with a 2013 loss of 15%.

Although the municipal bond yield curve also steepened through the year, high quality municipal bonds outperformed U.S. Government bonds, with the Barclay's Municipal Bond Index (1-10 years) losing just 0.3%. The ratio of the 10-year Barclays Municipal Bond yield to the 10-Year Treasury Bond yield rose slightly over the year to 97% from 95% at the start of the year (the higher the ratio, the more attractive municipal bonds are). However, there was significant volatility through the year caused by investor concern after Detroit announced its bankruptcy, as well the selling pressure caused by massive mutual fund redemptions. With a trading range from 86% to 115% during 2013, municipals ended the year reasonably attractive when compared to an average ratio of 94% since 2001. The high yield municipal debt market, as represented by the Barclay's Capital Municipal High Yield Index, declined for a third consecutive quarter, losing 0.5%. The Index lost 5.5% during 2013 amid $9 billion of redemptions from high yield municipal bonds funds.

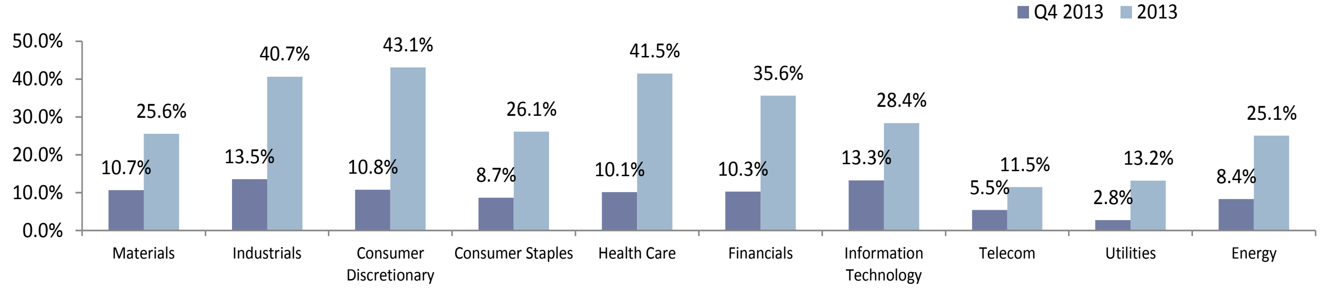
Corporate high yield was one of the best performing fixed income segments during the year, gaining 7.3%. Funds in this space have continued to see net inflows, with investors attracted by both their relatively high yields as well as the continued strength in corporate balance sheets.

Emerging Markets also had a roller-coaster ride in 2013, with a steep second quarter decline of 5.1%, followed by two quarters of modest gains. The Barclay's Emerging Market Debt Index (US $ denominated) gained 1.2% in the fourth quarter to end the year with a loss of 4.1%. Fund flows through the end of November remained modestly positive for the year, as the asset class continues to attract investors with relatively high yields and strong economic fundamentals. Local currency bonds performed even worse as a result of emerging market currency weakness against the U.S. dollar. The J.P. Morgan Emerging Local Debt Index (local currency) lost 1.5% during the fourth quarter, resulting in an annual loss of 9.0%.

EQUITIES

U.S. equity markets continued their rally through the fourth quarter with the S&P 500 Index gaining 10.5%, bringing its annual return to 32.4%. This represents the best annual performance for U.S. stocks since 1997. Stock prices were boosted by positive economic fundamentals coupled with strong corporate earnings. In particular, gains in consumer confidence, household net worth and house prices combined to foster a solid increase in investor confidence: the State Street Investor Confidence Index rose from 81.4 at the start of 2013 to 95.9 at year-end.

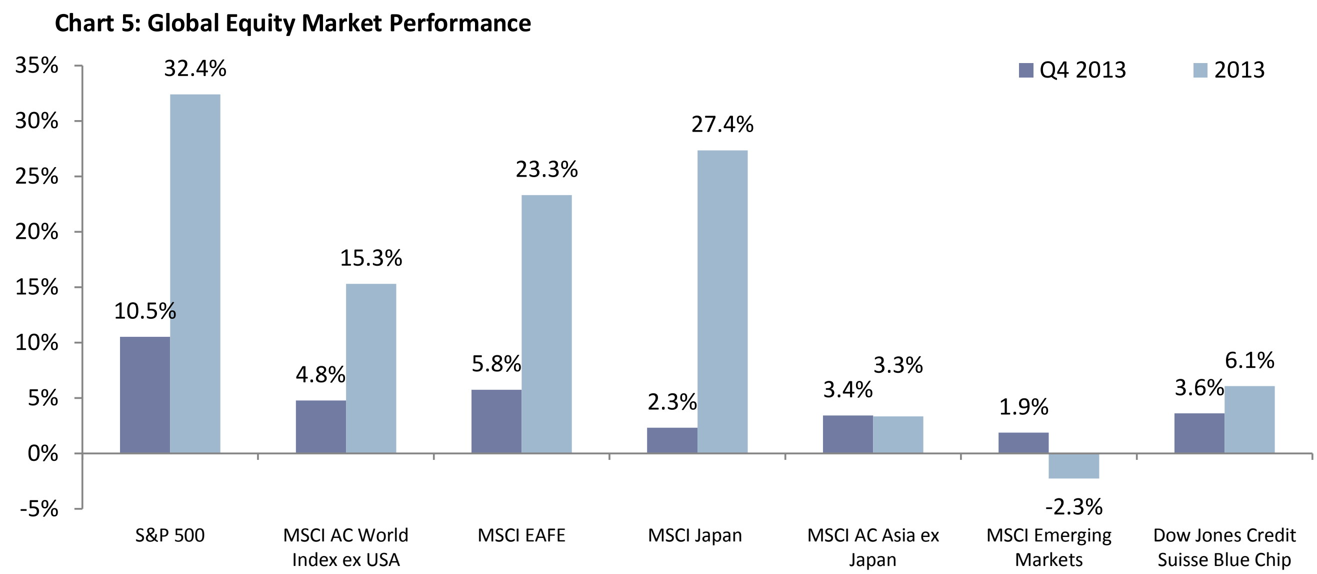
Chart 4: S&P Sector Returns



Within the U.S. equity market, all sectors provided positive returns during the year, with Consumer Discretionary and Healthcare stocks the top performers gaining over 40% each (see Chart 4). Within the healthcare sector, it was biotech stocks such as Biogen Idec, up 191%, and Gilead Sciences, up 204%, which gained the most. Financials and Industrials also outperformed the broader market during the year. The worst performing sectors were Telecomm and Utilities with gains of just 11.5% and 13.2%. Telecomm stocks have underperformed due to continued high levels of industry competition coupled with relatively benign earnings growth, while Utility stocks have suffered as a result of their interest-rate sensitivity.

In terms of market capitalization, while small and mid-cap stocks lagged during the fourth quarter, they handsomely outperformed larger-cap stocks over the full year, with the Russell 2000 Index and Russell Mid-Cap Index gaining 38.8% and 34.8% respectively. Micro-cap stocks performed even better, with the Russell Micro-Cap index gaining 10.3% during the final quarter and 45.6% for 2013. In terms of growth and value styles, growth stocks generally performed marginally better than value stocks.

International equities (in local currencies) underperformed U.S. markets by 4% during the fourth quarter and lagged by almost 5% over the year. Developed markets, as represented by the MSCI EAFE Index (local currency), ended the final quarter up 6.4%, bringing the year to date gain to 27.5%. However, for the U.S. investor the underperformance was more pronounced due to the strength of the dollar during 2013. In U.S. dollar terms, the MSCI EAFE Index gained just 23.3% during the year. See Chart 5 for additional market returns.



Among the developed markets, Japan performed best with a fourth quarter return of 9.6% resulting in an annual gain of 54.8% (local currency). Japanese stocks rallied throughout the year on the back of extremely accommodative monetary policies ("Abenomics"). While European stock markets gained as a result of attractive valuations coupled with improved economic conditions, the MSCI Europe ex. U.K Index (local currency) lagged other regions with a gain of 6.5% during the final quarter and 24.2% for the year.
Emerging markets again underperformed developed markets during the final quarter, with a return of 3.0%. The MSCI Emerging Markets Index (local currency) gained just 3.8% during 2013, although for the U.S.

dollar investor the index actually lost 2.3% during the year. Investor sentiment towards the emerging markets, which had been a key beneficiary of the global liquidity provided by quantitative easing, suffered from U.S. Federal Reserve tapering fears. Furthermore, slower growth fears and rising interest rates in some countries also served to dampen enthusiasm. In particular, the Chinese stock market gained just 4% during 2013 as investors feared a continued slowdown in China's economic growth as well as increasing concerns regarding corporate credit.

Hedge funds in general trailed broader equity market indices by about 10% during 2013, hampered by low net equity exposure. Despite this poor relative performance, hedge funds remain attractive given their long-term risk adjusted returns and portfolio diversification properties. The Credit Suisse Blue Chip Hedge Index gained 3.6% during the fourth quarter and posted an 5.5% return for 2013. The long/short equity and event driven managers performed best during the year with gains of 20.5% and 12.6% respectively. Given the bullish equity market, it is no surprise that short-biased managers performed worst, generating an annual loss of 26.0%.

REAL ESTATE AND COMMODITIES

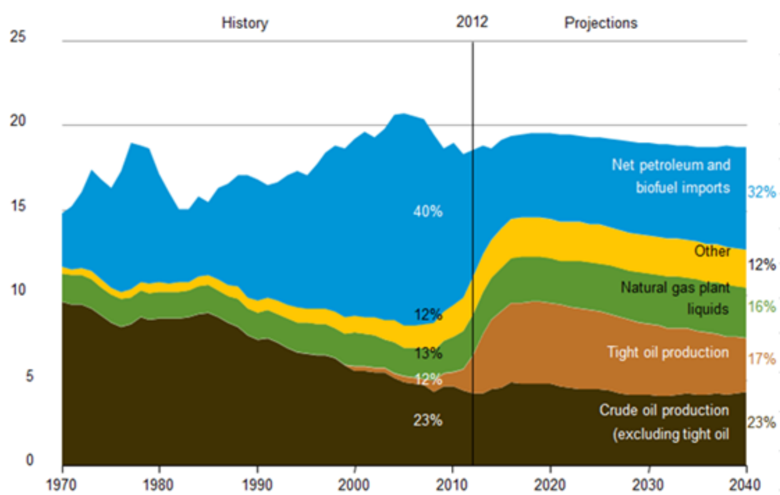
Bulezim Azemi, Investment Analyst

The price of U.S crude oil during 2013 traded as low as $91.97 per barrel in May and as high as $107.65 per barrel in August. The price volatility reflects the turmoil in the Middle East, increased supply and global accommodative monetary policies. U.S. crude oil finished the year up about 7.2% at $98.42. The increasing use of natural gas in other industries coupled with a cold winter has lifted up the price of natural gas from $3.33 per British thermal unit (BTU) in January, 2013 to $4.31 per BTU in December, 2013. Growing domestic production of natural gas and crude oil continues to be an integral part of the U.S. economy and is changing the domestic energy market. Crude oil production is approaching the historical high of the 1970s of 9.6 million barrels per day. The national average gasoline price finished at $3.26 during the fourth quarter, up 0.58% from one year ago.

MLPs (energy infrastructure partnerships) gained 5.3% in the fourth quarter to end the year up 27.6%. Investors continued to be attracted by the sectors dividend growth potential, as well as its involvement in the U.S. energy independence theme. The massive increase in oil and gas production that is forecast (Chart 6) will necessitate continued build-out of pipelines and storage facilities.

Precious metal returns were disappointing during 2013, with gold ending the year down 28.3% at $1,201.64/oz. and silver down 35.8% at $19.47/oz.

Chart 6: U.S. Petroleum and other liquid fuels supply by source, 1970-2040 (million barrels per day)



Source: U.S. Energy Information Administration (EIA)

Furthermore, precious metal finished the year as a worst performing asset class due to a fear of stronger U.S dollar and less U.S. monetary stimulus.

Global REITS, as represented by the S&P BMI Global REIT Index, lost 0.7% during the fourth quarter to finish the year up 2.8%. During the year, U.S. REITs were down in the fourth quarter by 0.7% but for the year returned 2.6%. Within the U.S., market performance was led by Industrial and Diversified REITs, up 26.9% and 17.0%, respectively.

OUTLOOK *FROM THE CHIEF INVESTMENT OFFICER*

The themes we have discussed over the previous quarters remain consistent. We believe global economic policy and conditions should remain favorable for investors: Monetary policy around the world will remain accommodative (the Federal Reserve tapering still provides approximately $400 billion of liquidity), Europe's economy moves out of recession and global growth slowly improves. Underlying economic data support this thesis, including improving employment, strengthening manufacturing, increasing consumer confidence, and low interest rates.

As mentioned previously, 2013 was an exceptional year in developed market equities, with strong returns and very little downside volatility. We expect more normal levels of market volatility in 2014, which means a probable market correction of 10% or so at some point. This could occur for any number of reasons, such as policy missteps, unexpected inflation, or an exogenous geopolitical event. The markets have priced in equity valuations for continued improving economic growth, and any deviation from this expectation could give investors a moment to pause (and sell) after such a strong run.

In our opinion, success in 2014 will be contingent on more than just Central Bankers' liquidity, as we will need to see improving economic fundamentals. Recent economic data has been better providing optimism to the markets. Even so, with valuations higher, there is more risk for a bigger let down if a negative surprise or event occurs. We therefore urge investors to stay diversified and remain focused on the long-term. We believe the investment environment remains favorable and will reward those with the ability to be patient.

"...stay diversified and remain focused on the long-term"

Please visit our website, www.MarketStreetTrust.com and as always, please feel free to contact us if you have any questions about the investment program.

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