Investment Update

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All is not as it Appears

Have you ever heard the phrase, "be like a duck—act calm on the surface, but paddle furiously underneath"? Well this analogy also fits the market action of 2014. The duck, like the market, may look serene from above, but there is much more happening below the surface that determines its balance and direction. By looking only at broad market indexes, investors may miss many lessons that are hidden from view. In this *Update*, I would like to go below the surface and study aspects of 2014 in greater detail to emphasize a few lessons that influence our current asset allocation positioning as we near the end of the first quarter.

The Market within the Market

Overall, 2014 was an extraordinary year with 53 record-setting highs on the S&P 500 Index. Typical of a mid-to-late stage bull market, large capitalization stocks led their mid and small capitalization counterparts: large cap stocks delivered 13.7%, while small cap stocks as measured by the S&P 600 generated 5.8%. Momentum in the market also contributed to the dominance of large cap stocks, with high price momentum stock industries, such as biotech and semiconductors, ending the year delivering 33.2% and 35.9%, respectively.

Beneath the surface, however, multiple corrections within sectors and industries took place during the year. For example, automobiles and auto components suffered in September with declines close to 12%, but performance improved within the following months. Even momentum stocks were affected by volatility, with biotech stocks falling more than 18% in April from a February high, only to more than fully recover by the end of summer.

But the granddaddy bear market within the overall bull market was in energy stocks. Beginning its decline in June 2014, the price of oil has since been cut in half, taking many stocks within the energy sector with it. The energy sector peaked on June 23 and fell 26.7% to a low on December 15. Meanwhile, the overall market held its own in spite of this sector's downturn, with the S&P 500 delivering a positive 1.3% during the same period.

On a recent trip visiting clients, I was asked whether the decline in energy stocks would spill over to the broader market. In my response, I cited research by the Leuthold Group. Their research describes the most recent downturn in the energy sector as a 'stand-alone' bear market—when one sector experiences a pullback of 20% or more, while the overall market does not. Leuthold found that, historically, 'stand-alone' bear markets recover within a short timeframe and outperform the S&P 500 by 7% three months after the trough, 5% six months after, and 15% one-year later.

Just as we saw with the 'stand-alone' bear markets in September and October, the energy sector may have already begun to stabilize. In the long-term, lower gas prices, lower input costs, and improved consumer confidence should serve to offset the initial negatives of lower energy sector earnings.

Applying Lessons Learned

Lesson 1: Bull markets can be volatile, at many levels

Volatility typically picks up at the mid-to-late stage of a bull market —either in the broad market or within sectors, industries, or industry groups. As we envisioned, 2015 has been and will continue to be a year of heightened volatility as evidenced by the average daily swings in the S&P 500 Index, which have averaged 14 points, compared to 11 points for the first two months of last year. Just because we expect more volatility, however, doesn't mean equities cannot deliver positive returns.

We continue to favor equities but believe it's important to add shock absorbers to cushion the volatility. We recommend lower correlated strategies such as managed futures, absolute return, and long/short hedge funds to help control risk and provide an element of downside protection for investment portfolios. Whether it is geopolitical events, decisions by central banks to loosen or tighten their policies, or the impact of oil prices or the dollar on earnings, volatility will likely persist for the foreseeable future. These shock absorbers should smooth the ride and allow investors to more easily stay the course.

Lesson 2: Diversify, Diversify, Diversify

When large cap stocks lead, many investors believe that's all they need. One of the first rules of investing is that asset classes perform differently over time, with leadership shifting from one asset class to another as time passes. That's why it is paramount to have a globally diversified portfolio of asset classes including equities, fixed income and lower correlated strategies.

While we expect large cap stocks to perform well again in 2015, we are also seeing opportunities in asset classes that have been lagging. For instance, valuations in developed international markets are looking more attractive as fundamentals are improving. A globally diversified portfolio has the advantage of being able to position for these opportunities, whereas investing in only one asset class does not. A well-diversified portfolio also offers investors lower risk and volatility compared to investing in just one asset class, which helps to manage the emotional side of investing.

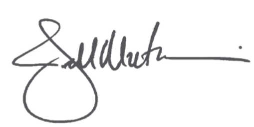
Lesson 3: Take a Disciplined Approach

Often investors are tempted to follow the latest trend even if it deviates from their investment plan. In fact, some investors are only now beginning to jump on the bull market bandwagon, as shown by the latest sentiment indicators. According to a recent Ned Davis Research crowd sentiment poll, investor sentiment reached extreme optimism in 2014. This, coupled with a rise in equity fund flows into the end of 2014, was a signal that the bull market was finally being embraced. However, just as investors were flocking to the equity markets, the tides shifted in January 2015, with a plunge in equity fund flows and a drop in crowd sentiment to neutral.

While we believe this secular bull market is in full force, it is important to remember that market leadership shifts at different points in a market cycle. Thus, there's a point when today's 'favorites' are replaced by new ones. Rather than be enticed by these momentum leaders, investors should avoid flocking to the latest winners and adhere to a well-thought-out investment plan that aligns with their long-term wealth objectives. Our disciplined approach looks beyond a static view of asset allocation, evaluates market inefficiencies and adjusts portfolio positioning in anticipation of market events so that investors are armed with a game plan throughout the market cycle.

Like a duck in water

The lessons of 2014 are, in many ways, continuing to play out in early 2015. While it is too early to declare trends for 2015, the observations we have presented do serve to illustrate that often you must dive below the surface to gain a proper perspective. Like a duck in water, investors need the right balance and direction to navigate through complex markets, as they are rarely as straightforward as they seem.



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