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2015

2014 Review & 2015 Outlook

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2014 Review

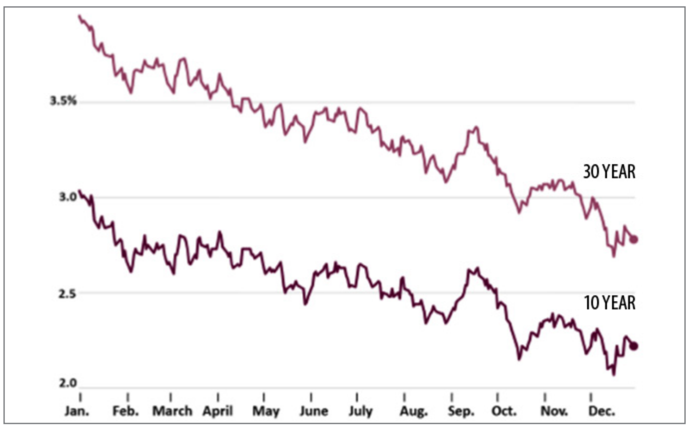
At the beginning of each year, we like to evaluate how our investment theses played out over the course of the prior year. Typically, our calls have been more right than wrong, but we have tended to under or overestimate the magnitude of some of our directional calls. For the majority of portfolios, we generated excess risk-adjusted returns, or alpha, versus benchmarks. Our results were aided by tactical allocation away from core fixed income to opportunistic bond funds as well as greater allocation to higher quality, lower beta U.S. equities.

U.S. Stock Market: At the beginning of 2014, many customers feared a significant market correction after posting a 32% return in 2013. We wrote at that time that we expected the market to continue to rise and that 30%+ return years were typically followed by a year of 10%+ returns. As detailed in Table 1, the S&P 500 generated a total return of 13.7% in 2014.

TABLE 1

Index Returns	12/31/2014
S&P 500	13.68%
Russell 2000	4.90%
MSCI EAFE	-4.20%
MSCI EME	-2.11%
MSCI BRIC	-5.89%
Barclays Aggregate	6.37%
Barclays G&C Intermed.	3.13%
Barclays U.S. H/Y	2.50%

Source: Bloomberg



Source: Federal Reserve via NY Times

Interest Rates: The bond market posted its first loss in 14 years in 2013 and the 10-year Treasury started 2014 with roughly a 3% yield. We expected positive fixed income returns in the low single digits in 2014, but we thought interest rates would edge 0.25%-0.50% higher over the course of the year as the Fed stopped purchasing securities in October 2014 (QE3). Intermediate bonds returned around 3%, but the 10-year bond yield ended 2014 below 2.2%.

Most investors were underweight long-term bonds, which generate larger losses as rates rise. Indexes with longer term bonds returned 5%-7% in 2014. Like most investors or forecasters, we did not foresee the significant drop in European rates having such a significant impact on U.S. rates.

Global GDP: We expected the U.S. to be one of the better performing economies in 2014. Nevertheless, we did not expect to see as strong a recovery until 2015. Moreover, we thought China and Japan would be a little stronger. We expected Europe to be weak, but not approach deflation.

China's anti-corruption reforms resulted in 15%-20% cuts to government budgets, which implies massive graft within their party-controlled economic system, in our opinion as outsiders. We expect the pain endured by the Chinese to clean up their government will pay off in higher future growth. Japan raised tax rates in the spring, stalling its economic recovery, then created a new stimulus package in October, when economic data showed declines. Despite record low interest rates, loan growth declined in Europe, pushing Germany and France into recession.

Inflation: We expected U.S. and global inflation to creep higher in 2014. Instead inflation drifted lower in the U.S. and across the globe – falling to deflationary levels in Europe. Implied future 5-year inflation rates remained below historical averages in the U.S. dropping from 2.0% over the course of the year to 1.3%.

TABLE 2

Global GDP & Inflation Data	2014E			
	GDP Growth %	Inflation %	GDP $T	% of World GDP
European Union	0.8%	0.8%	$18.4	24%
United States	2.4%	1.6%	$17.4	22%
China	7.3%	2.0%	$10.4	13%
Japan	0.1%	2.7%	$4.8	6%
Rest of World	4.5%	NA	$26.6	34%
World GDP	3.2%	3.5%	$77.6	100%

Source: IMF, October 2014 World Economic Outlook for 2014 GDP $USD data. Goldman Sachs data for 2014 GDP Growth & Inflation.