# Stegent Equity Advisors Investment Letter



**Fourth Quarter 2014 *Key Takeaways***

**As the year drew to a close, a handful of big-picture issues dominated the investment landscape:** the plunging price of oil, positive economic indicators in the United States relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets).

**Large-cap U.S. stocks continued their unusually strong and unbroken stretch of gains.** The S&P 500 rose 14% and avoided even a modest 10% "correction" for the third year in a row.

**Most other major stock markets fared poorly in 2014. Developed international stocks lost 5% and emerging-markets stocks dropped 2%.** These returns reflect the significant headwind presented by the strengthening U.S. dollar. Again, relative to history, we have seen an unusually strong stretch of U.S. outperformance relative to foreign markets.

**Contrary to the consensus, the 10-year Treasury yield declined further and bond prices rose.** The core investment-grade bond index was up nearly 6% for the year and municipal bonds also fared well. Credit-sensitive sectors such as high-yield and floating-rate loans lagged.

**December Benchmark Returns (Preliminary)**

| **Large-Cap Benchmarks** | **Dec** | **4Q** | **YTD** |
|---|---|---|---|
| Vanguard 500 Index | -0.3% | 4.9% | 13.5% |
| iShares Russell 1000 | -0.3% | 4.9% | 13.1% |
| iShares Russell 1000 Growth | -1.1% | 4.7% | 12.8% |
| iShares Russell 1000 Value | 0.5% | 4.9% | 13.2% |
| **Mid-Cap Benchmarks** | | | |
| iShares Russell Midcap | 0.2% | 6.0% | 13.0% |
| iShares Russell Midcap Growth | -0.3% | 5.9% | 11.7% |
| iShares Russell Midcap Value | 0.7% | 6.0% | 14.4% |
| **Small-Cap Benchmarks** | | | |
| iShares Russell 2000 | 2.9% | 9.8% | 5.0% |
| iShares Russell 2000 Growth | 2.9% | 10.1% | 5.9% |
| iShares Russell 2000 Value | 2.6% | 9.4% | 4.1% |
| **Other Benchmarks** | | | |
| Vanguard FTSE Developed Markets ETF | -3.8% | -4.1% | -6.0% |
| MSCI World ex USA Index | -3.3% | -3.6% | -3.9% |
| Vanguard FTSE Europe ETF | -4.7% | -4.6% | -7.1% |
| Vanguard FTSE Emerging Mkts ETF | -4.7% | -3.6% | -0.1% |
| Vanguard REIT Index | 1.9% | 14.3% | 30.1% |
| Vanguard Total Bond Mkt Index | 0.1% | 1.7% | 5.8% |
| BofA Merrill Lynch U.S. High Yield Cash Pay | -1.5% | -1.1% | 2.5% |
| Vanguard Int. Term Tax-Exempt Fund | 0.5% | 1.1% | 7.2% |
| S&P/LSTA Leveraged Loan Index | -1.3% | -0.5% | 1.6% |
| Citigroup World Govt. Bond Index | -0.7% | -1.5% | -0.5% |

**While our diversified portfolios participated in the strong U.S. stock returns, they faced several headwinds for the year** including our investments in foreign stocks and our underweighting of core, investment-grade bonds. Our domestic large-cap equity managers, like most of their stock-picking peers, also struggled to keep pace with the broad stock market this year.

**In terms of the investment environment, the U.S. economy looks to be in pretty good shape over the near term.** Fed monetary policy remains something of a wild card, but based on the Fed's words and actions, investors would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike. Investors expect the Fed to start raising interest rates this year, but rate hikes will only make the Fed "less loose" not tight. The federal funds rate will likely end 2015 near 1%, but would have to rise above 3.5% to be considered anywhere near "tight."

**A strong dollar, along with rapid productivity growth, and a banking system that refuses to allow the money supply to surge in spite of Quantitative Easing, signals that inflation should remain subdued.** Consumer prices, which rose less than 2% in 2014, should experience only a modest increase in 2015, allowing 10-year Treasury yields to stay at or below 3% for all of 2015.

## Fourth Quarter 2014 Investment Commentary

As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, positive economic indicators in the U.S. relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets). In the financial markets, the year saw strong gains for U.S. large-cap stocks and core bonds with lagging performance elsewhere.

Looking first at the investment environment, oil prices hit five-and-a-half-year lows in late December (falling 40% in the fourth quarter alone) as new sources of supply met with potentially slowing global demand. While a decline in oil prices is typically viewed as an unambiguously positive development for the global economy, the result this time around is different because of the rapidity of the plunge and the current fragile global economic environment. With deflation concerns already high in Europe in particular, the oil price decline was seen as intensifying the deflationary risks.

Currently, we are in the extreme situation where supply has soared thanks to new technologies and global demand has shrunk due to a weak global economy. Production cutbacks and bankruptcies are starting to slow supply growth but the Energy Information Administration still expects worldwide crude oil production to exceed demand by 900,000 barrels per day during the first half of 2015. This is a unique and extreme situation but as long as supply continues to outpace demand, oil prices will continue falling and oil companies will continue to struggle.

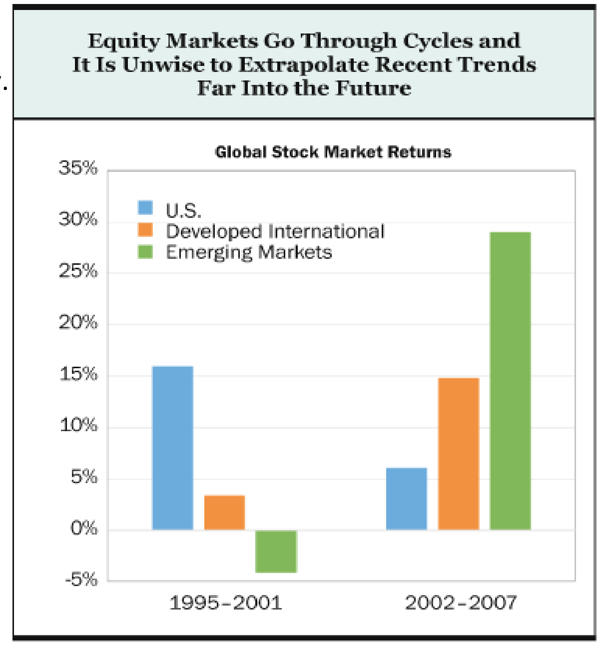
One offsetting factor that helped the markets regain their footing in the fourth quarter was the ongoing influence of central banks. Even as the Federal Reserve suggests it is on track to begin raising rates in the face of U.S. economic improvement, it once again soothed markets by reaffirming that it would continue to be patient in shifting its stance. Given the poor economic conditions that persist in Europe, the European Central Bank announced on January 21 that it intends to embark on its own quantitative easing (i.e., purchasing bonds and other assets with the aim of stimulating the economy) program with $1.3 trillion in new money creation slated for 2015. Central banks in Japan and China expanded their stimulative policy efforts over 2014. The takeaway is that even as the Fed may begin scaling back its support, there appears to be no shortage of supportive monetary policy globally. At the same time, the fact that central banks continue to undertake (or contemplate) aggressive action provides a reminder of the broader economic risks we continue to navigate: inflation vs. deflation and growth vs. recession.

Against this backdrop, the S&P 500 index gained almost 14% and, for the third year in a row, avoided even a modest 10% "correction." On the other hand, U.S. small-cap stocks dropped more than 13% from their summertime high through mid-October and ended the year up 5%. Outside the United States, most major stock markets performed poorly. Developed international stocks lost 5% and emerging-markets stocks dropped 2% (based on MSCI EAFE and MSCI Emerging Markets indexes, respectively). These returns reflect the weakness of economies outside the US, as well as the significant headwind presented by the strengthening U.S. dollar that detracted from returns for us dollar-based investors.

Contrary to the consensus coming into 2014, the 10-year Treasury yield declined and bond prices rose. The core investment-grade bond index was up 5.8% for the year and municipal bonds also fared well. Outside of core bonds, sectors such as high-yield and floating-rate loans lagged, as did unconstrained bond managers who have been positioning for rising, not declining, interest rates.

While our diversified portfolios participated in the strong U.S. stock returns, they faced several headwinds for the year including our investments in foreign stocks and our underweighting of core, investment-grade bonds. One of the biggest detractors to our portfolios' overall performance in 2014 was the significant underperformance of our domestic large-cap equity managers. Key among the performance drivers that have broadly affected fund managers is the fact that many managers hold some non-U.S.-based multinational companies and some amount of cash. We also experienced a year in which the index based returns were driven primarily by a handful of stocks, so managers underweight those stocks dramatically underperformed. For example, the S&P 500 far outpaced other broad equity indexes in 2014, while the top twenty five contributors to performance of the Index accounted for 46% of its gain, the top ten contributors accounted for 28% and Apple, the largest position in the Index, was also the greatest positive contributor at 1.2%. In other words, one stock out of 500 accounted for nearly 9% of the Index's gain.

Finally, when it comes to the financial markets, it's worth putting recent results into the context of history. This has been an unusually long and strong period of positive performance for large-cap stocks. Since 1945 there have only been three other periods (out of 51 total) where the S&P 500 has had a longer streak of gains without at least a 10% correction, according to Ned Davis Research. In addition, over the past two years, the S&P 500 has outperformed both developed international and emerging-markets indexes by an unusually large margin relative to history. These observations don't mean U.S. stocks are set to tumble in the near term, but this data does provide some perspective as an argument for global portfolio diversification and prudent risk management.




Source: Morningstar.

**Asset Class Views**

***U.S. Stocks***

In terms of the investment environment, the U.S. economy looks to be in pretty good shape for the near term. There are several positives: the labor market continues to strengthen, inflation remains subdued, manufacturing indexes and other leading economic indicators are consistent with solid GDP growth, falling oil prices should boost consumer spending, and government fiscal policy is likely to become more of a growth tailwind than a headwind as the impact of past budget cuts rolls off. The new GOP-led Congress virtually guarantees that fiscal policy will stay on a more conservative course.

One popular stock market model (the Capitalized Profits Model) uses after-tax corporate profits discounted by the 10-year Treasury yield. Using the fourth quarter average of the 10-year Treasury yield (2.28%), the model says the "fair value" of the S&P 500 is 4,465. But this number is artificial because the discount rate is being held down by Federal Reserve forward guidance. Using a conservatively high 4% 10-year discount rate gives a "fair value" calculation of 2,545 right now. So, if at the end of 2015, the 10-year Treasury yield were 4% and profits also rose by the average increase of recent years (around 10%), the S&P 500 would be "fairly valued" at 2,800, or 20% above current levels. Not a prediction, just an observation.

***Developed International Stocks***

In contrast to the United States, the euro zone (ex-U.K.) continues to fight deflationary headwinds. The December year-over-year headline inflation number fell to negative 0.2%, real GDP growth is below 1%, and two-year government bond yields in Germany and France are actually negative, meaning investors are paying the government for the privilege of owning these bonds. In Europe we are getting below-trend and below-normal earnings at average to below-average prices, and now with quantitative easing by the European Central Bank, so we will continue with a slight relative overweight to European stocks versus Asian stocks. But we are not increasing our weighting to European or developed international stocks relative to our strategic weighting because we believe the stagnation risk in Europe continues to be high.

***Emerging-Markets Stocks***

There is a lot of negative news surrounding emerging-markets stocks—such as slowing growth in China and other BRICs and the decline in emerging-markets currencies. Nevertheless, we should remain optimistic about emerging markets' long-term fundamentals because they are likely to outperform U.S. stocks over our longer term investment horizon. However, we should be conscious of the shorter-term downside risk and volatility they pose. This is one reason why we are not overweight emerging markets as a percent of our equity allocation.

***Investment-Grade Bonds***

From an asset class perspective, investment-grade bonds are likely to generate very low single-digit annualized returns over the next few years due to the very low current yields and expectations that interest rates will move higher over the near term, although the timing and magnitude are of course uncertain. As such, about one-third of our fixed-income exposure remains in opportunistic, flexible, and absolute-return-oriented bond funds that offer superior longer-term risk/reward profiles compared to core bonds.

***Alternative Strategies***

The alternative strategies we own are intended to generate long-term returns that are better than core bonds, with much lower downside risk and volatility than stocks and relatively low or no correlation to stock and bond market indexes. These strategies are allocated across three areas: absolute return oriented managers, REITs and MLP's. All but the MLP's produced significant alpha (high returns given the level of volatility) in 2014. MLP's were on track to deliver alpha until the collapse in oil prices.

***Natural Resources/Energy Renaissance***

Our natural resource allocation is intended to be two-fold:  as a hedge against future inflation/continued currency debasement and to invest in companies and industries most aligned to take advantage of the re-emergence of the US as the largest energy producer in the world.

We continue to own precious metals and their mining brethren because they tend to be the leading indicators of inflation. Since inflation has been subdued the last three to four years, the precious metals sector has been hit hard. Our returns during this period have suffered as a result but we continue to maintain a modest allocation because the worst time to buy an inflation hedge is after inflation has spiked. And while no spike is expected, it is the unexpected that always catches investors off guard. Interestingly enough, 2015 has ushered in a remarkable and unexpected turn of events for gold. It is up significantly in four of the seven major currencies (euro, pound, and Australian and Canadian dollars), up respectably in two others (US dollar and yen) and down slightly in the last (Swiss franc).

Our energy renaissance position added modestly positive returns from those stocks and managers positioned to take advantage of lower energy prices (mainly utilities in our allocation), but on a net basis our exposure to this sector produced negative returns due to the significant fourth quarter decline in equities involved in the extraction and production of energy. For 2015, our exposure to energy renaissance has been reduced from 5% to 4% of total equity exposure, with the 1% reallocated to mining stocks (from 1% to 2%).

**In Conclusion**

One of the themes seen among investors as a group is the tendency to project current market trends into the future. At its most obvious level, this pattern is apparent in the view that U.S. stocks are destined to continue their rally, developed and emerging markets and commodities will continue to disappoint, and last year's underperformance for many active managers will persist. However, even as we see these biases in the market's herd-like behavior, the past is *not* a predictor of future performance (as the saying goes). From a prudent-man's vantage point, it would be a disservice to clients to invest based solely on past performance or what may seem superficially attractive today, rather than based on detailed, disciplined analysis of the long-term fundamental drivers of investment results.

Our portfolios' performance often won't track the performance of the benchmarks they are measured against because we are not afraid to construct portfolios that look very different than our benchmarks. The willingness to do this is a function of confidence in the investment process, commitment to do what is right for clients, and knowledge that this is what it takes to avoid significant losses

In the end, we view our responsibility in terms of your needs and not benchmark comparisons. If we do these things well over the long term, we will be able to continue to meet your financial needs.

Thank you for the opportunity to continue to serve as your trusted advisor.

Loyd J. Stegent, President
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