Prepared Comments from 1/16/2015 Conference Call

The S&P 500 is up 9% from three months ago, despite being down so far this year.

US stocks continued their rise in the 4th quarter, led by small-caps, while foreign stocks fell 3½%. Bonds rose under 2%. The best results for the quarter came from real estate (up 13%), while natural resource funds fell 13%. For all of 2014, real estate again led (up 28%), with healthcare rising over 27%. Latin America stocks and natural resource funds each lost over 12% for the year. So far this year, precious metals have leapt over 12%, while financial stock funds and natural resource funds are each down over 5%.

There were several 'big stories' for 2014, with the collapse of oil prices, and the leap in the US dollar heading the list. Oil reached $100 a barrel in June, fell below $90 by September 30th, and then plummeted to $50 by year-end. The US dollar, which did not move much in the first half of 2014, took off in July, and kept going. It rose over 15% versus the Euro in the 2nd half of 2015. The dollar's rise led to losses for most foreign assets, both stocks and bonds.

A third 'big story' was the further decline of US interest rates, 1% for 10-year government bonds, to about 1½% for 30-year government bonds. This was driven by investors' cash flow—after being net sellers of bonds in 2013, investors returned to the bond market in 2014.

Let's review the basics. The US economy grew 2.7% (after inflation) in the 3rd quarter versus 2013. The Fed expects growth to remain just under 3% this year and next.

The most recent inflation figures for the US come in at under 1% versus a year ago, and only 1.6% when food (which is rising) and energy (which is falling) are backed out. The Fed expects inflation to remain very low in 2015, but rising closer to 2% in 2016 and beyond.

Unemployment has fallen from 10% in 2009 to only 5.6% last month, well below the 50-year average of 6.1%. Interestingly, this hasn't had much effect on wage growth, which remains around 2%, while its long-term average is 4.3%. When employees recognize that unemployment is low, they may demand and drive wage growth, which can in turn bring higher inflation. Just not yet.

The federal budget deficit is under 3% and continues to decline.

Manufacturing growth across the globe is positive, with only Ireland, India, and Mexico stronger than the US—Canada's rate ties ours. France, Italy, Korea, and Russia are seeing manufacturing shrinkage. While Europe has several weak areas, and is weaker than this time last year, it remains far above its level from two years ago.

In the US, vehicle sales continue to grow, as do housing starts and real capital goods orders. Housing prices continue to recover, loan delinquency rates continue to decline, bringing a modest increase to loan growth.

What is expected for the global economies in 2015? The US economy appears to be in the final innings of its recovery, but as one analyst explains, the game could well go into extra innings. While this recovery is unusually long in duration, its pace has been very low, and thus there are good reasons for its extended length. The UK and Canada are similarly enjoying an economic forecast of 2% or more real growth for 2015.

Europe has stumbled a bit in 2014, however there are two factors in Europe's favor in 2015. First, the drop in oil prices helps Europe significantly, as it is a big importer of oil. Second, European central banks continue to be 'stimulative,' with no end in sight. In contrast, the Fed here in the states is expected to reduce the pressure on the accelerator by mid-year. With this continued fiscal stimulus in Europe, Germany and France are expected to grow at a low pace in 2015, with near-breakeven results expected from France and Italy.

Asia has winners and losers in the oil game. India could be the big winner, as it is also a big importer of oil, and South Korea should also benefit. China's growth expectations, if they are to be trusted, remain at attractive, high single-digit levels. Much of Latin America is a net seller of oil, and thus could be under a cloud for 2015.

To the extent that foreign stock results in 2014 were driven by the rising US dollar, foreign stock investors can benefit in two ways in 2015. Should the US dollar return to its year-end 2013 levels, foreign stock returns should directly benefit when translated to US dollars. Should the US dollar fail to fall back much, then these foreign companies will be much better able to compete with their US competitors, due to the currency alone, and see sales rise..

Valuations remain a little above fair for US stocks at this time. Stock prices for Europe remain depressed, and this could change quickly, if/when European companies see their earnings recover, which has eluded them for over four years. Finally, emerging market stock prices appear attractive, you don't pay a lot today for a dollar of emerging markets earnings.

Bonds confounded most investors in 2014. A year ago it appeared crystal clear that rates would most likely rise, that prices would fall, and that this would hurt bond investors of all maturities (such that the losses would be greatest for the long-term bond holders). The exact opposite occurred.

In 2014, bond prices rose and yields fell, with this being most pronounced for long-term bonds. This was due to investor confidence (confidence in the US economy, lack of confidence in Europe, and most of the rest of the world). Another way to label 2014 was that it saw a 'flight to quality,' a flight that was blind to valuations, how cheap or expensive an asset was.

Let me put today's government bond rates in perspective. You can be paid 0.02% to hold a 3 month bond, 0.15% for a one-year bond, 1.28% for a five-year bond, 1.81% for a ten-year bond, and 2.43% for a 30-year bond. Inflation has averaged 3.00% in the past 32 years. The investors who drove the 2014 bond market have put their money in investments which are close to certain to lose them money versus inflation.

What is an investor to do? While flights to quality, and the disregarding of value or lack thereof, can persist, jumping into last year's winners appears to be highly unwise. Given that much of 2014's results were driven by emotion, which is by its nature short-term, one theme for 2015 is to emphasize what didn't work in 2014.

Merely consistent rebalancing delivers buying bargains and selling overpriced assets. After a year like 2014, rebalancing should provide better-than-normal advantages.

In late 2014 we introduced precious metals. As is often the case, we were early to the game, as this sector fell in the 4th quarter. However they are up 12% so far this month. We don't believe that investors should put much in precious metals, however rebalancing a small

amount in a highly volatile asset class such as precious metals, and beginning to do so after it has suffered several down years can provide benefits over time.

Continuing to hold US stocks feels good, as the underlying economy is clearly working. That said, there are few bargains in US stocks, and so we are careful to avoid getting swept up in the 2014 strong results. The rising US dollar can serve to diminish the 2015 results from these companies.

It is natural to want to reduce or avoid foreign stocks in 2015. However, most, if not all, of the bad current state of foreign economies is already priced into those markets. While they are not priced for failure, they are much closer to that than being priced for perfection. There is downside protection in today's low prices for foreign stocks.

We continue to believe in, and invest in emerging market stocks. We feel that the (very) long-term is brightest for these economies, with their very favorable demographics, and their low 'bases' (as they say, you can't fall out of a basement). Emerging market stock investing is challenging, and in 2014 saw headwinds from both a rising dollar and falling oil prices. Nonetheless, we are unchanged in our conviction that a meaningful amount of foreign stock money should be in emerging markets.

Bonds are very challenging, especially after a year like 2014 in which the market moved in the exact opposite direction to expectations from a year ago. On the other hand, bonds behave like a pendulum more than stocks do. The more uneconomic a bond price gets, the sooner the piper will be paid and its price tends to return to normal, if not the opposite extreme.

Due to the surprisingly strong returns of 'safe' bonds, we are cutting back on clients 'quality bonds,' and boosting 'opportunity bonds.' We are up against the wall, with only 65% of bond money in quality bonds, our likely minimum level. Within quality we have a 33/16/4% balance of short-, intermediate- and long-term bonds, along with a 12% allocation to inflation bonds.

In opportunity bonds we have 15% in high-yield bonds, which had a very yawn-inspiring 2014 (up about 1%), 10% in multi-sector, 5% in unconstrained bonds, 3% in emerging market bonds, and 2% in Asia bonds. The Asia bond sleeve uses dollars previously in emerging market bonds, and this move is tied to the lower energy prices.

2014 was a disappointing year for well-balanced, economically-informed investors. That happens. It doesn’t change the fact that over time economics trumps emotions, and that disciplined rebalancing harnesses the markets’ emotional roller-coaster.

Questions?

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