Fourth Quarter 2014 Investment Commentary

As the year 2014 drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, strikingly positive economic indicators in the United States relative to most of the globe, and the ongoing influence of global central banks. Each played an important role shaping returns across major asset classes.

The S&P 500 rose 14% for 2014 and for the third year in a row avoided even a modest 10% “correction.” Compared to history, this has been an unusually strong and unbroken stretch of large-cap performance. In fact, since 1945 there have only been three other periods (out of 51 total) where the market has had a longer streak of gains without at least a 10% correction, according to Ned Davis Research. This doesn’t mean stocks are necessarily set to tumble in the near term, but this data does provide some perspective for where current results lie in the historical spectrum of stock market returns. (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 of U.S. large caps, most 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.

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, we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.
Investment Environment

Oil prices hit five-and-a-half-year lows in late December (falling 40% in the fourth quarter alone). While a decline in oil prices is typically viewed as an unambiguously positive development for the global economy as it benefits consumers and most businesses and reduces inflationary pressures, 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. In Russia, falling oil prices exacerbated an already precarious economic situation, and the Russian ruble plunged more than 40% against the dollar during the quarter, renewing talk of a potential repeat of the emerging-markets currency crisis of 1997–1998.

One offsetting factor that helped the markets regain their footing in the fourth quarter (as it has many times in the post-financial crisis period), was the ongoing influence of central bankers. 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 with its December statement reaffirming that it would continue to exert patience in shifting its stance. Given the poor economic conditions that persist in Europe, investors increasingly expect the European Central Bank to take a more meaningful step toward full quantitative easing (an asset purchase program). Similarly, central banks in Japan and China expanded their efforts over 2014. The takeaway is that even as the Fed may begin scaling back its support (the timing and market reaction to which remains a wild card in our view), there appears to be no shortage of supportive policy globally. On one hand, this has served as a buoy for stocks and risk assets, but it also provides a valuable reminder of the broader economic risks we continue to navigate.

How Our Portfolios Fared in 2014

Our portfolios faced multiple headwinds for the year given our positioning. In our balanced portfolios (those that own both stocks and bonds), our tactical underweights to both U.S. large-cap stocks and core investment-grade bonds hurt us. The performance for our arbitrage/event-driven strategies was disappointing, particularly relative to U.S. stock and bond market returns. Arbitrage investors suffered largely negative returns in the second half of the year due to fallout from merger deal breaks (the highest volume since 2008, according to Dealogic) and the cascading losses from hedge funds selling the same positions into a market with poor liquidity. Merger spreads also widened due to the increased volatility and uncertainty. We think this positions such strategies for a rebound in the coming years, but we have increased our scrutiny of them.

On the positive side, our tactical underweight to U.S. small-cap stocks paid off strongly, as small caps underperformed large caps by a wide margin, and our developed international active fund managers collectively beat the index.

One of the biggest detractors to our portfolios’ overall performance in 2014 was the significant underperformance of our domestic large-cap equity managers. Since all of our managers are bottom-up stock pickers and each implements a distinctive investment discipline, it is often difficult to identify common factors that impacted performance across all the funds in any given year. But we think there are a few points worth making in regard to the widespread
underperformance and our ongoing due diligence. First, it has been a “narrow” market, driven by
the largest companies generating the strongest performance. So any large-cap manager who
owned anything but the largest stocks faced a headwind versus the index. Second, most large-cap
managers have some exposure to non-U.S.-based multinational companies. As noted earlier,
foreign stocks massively trailed the U.S. market last year. Third, many active managers,
particularly valuation-sensitive ones, have been holding some cash waiting for better investment
opportunities. This was a drag on returns with the market up so strongly. Fourth, the range of
returns across stocks in the index is at historical lows. Historically, this type of market is more
difficult for active managers because the opportunity to add value from picking winners and
avoiding losers is more limited. We think all of the above factors have some explanatory validity,
but none of them impact our view of the ability of our managers to outperform the market index
over the longer term.

Update on Our Asset Class Views and Portfolio Positioning

**U.S. Stocks**

In terms of the investment environment, the U.S. economy looks to be in pretty good shape over
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 roll off.

Fed monetary policy remains something of a wild card, but based on the Fed’s words and actions,
we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-
rate hike. Nevertheless, looking out over the next several years, significant uncertainty remains as
to the consequences of the current Fed policy and of its eventual exit for financial markets and the
“real” economy.

While the economic and monetary backdrop looks likely to remain broadly supportive over the
near term, our assessment of the attractiveness of U.S. stocks is based on a longer-term (five-year)
assessment of potential returns across a range of scenarios. That analysis continues to indicate
that corporate earnings are higher than is sustainable and that stock prices are also high. The net
result of this assessment is our view that U.S. stock market returns are likely to be below their
long-term averages over our five-year analysis period.

**European Stocks**

In contrast to the United States, the eurozone (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). Many
investors are suggesting Europe is already on a Japan-like stagnation path, which has depressed
European stock market valuations. Our view is that in Europe we are getting below-trend or
below-normal earnings at average to below-average prices, which is why we have a slight
overweight to European stocks versus U.S. stocks. But we are not increasing our weighting to
European or developed international stocks relative to our strategic weighting because we believe the deflation or stagnation risk in Europe is not yet adequately priced in.

As noted earlier, the ECB is signaling it is highly likely to undertake additional monetary stimulus in the first quarter of 2015. But unlike the Fed, the ECB has to cross political and regulatory hurdles to implement quantitative easing, so there is uncertainty in investors’ minds whether and to what extent QE will happen there. If the ECB does implement aggressive QE early in the year, it is likely to boost European risk assets. We do not know what the ECB will do, or when, and we don’t base our investment decisions on such prognostications. As always, we base our investment decisions on key fundamentals we believe drive stock-market returns in the long run (i.e., earnings growth, valuations, and dividend yields). When the combination of these factors gives us what we believe is an adequate margin of safety against plausible risk scenarios, we will add to European stocks, whether or not the ECB has undertaken QE.

**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 steep decline in the ruble and other emerging-markets currencies. Nevertheless, we remain optimistic about emerging markets’ long-term fundamentals and believe they are likely to outperform U.S. stocks over our five-year investment horizon. However, we are conscious of the shorter-term downside risk and volatility they pose. This is one reason why we are only slightly overweight emerging markets relative to U.S. stocks as a percent of our equity allocation. The risk posed by dollar-denominated emerging-markets debt is one specific area we’ve looked at more closely and that we believe supports the modest approach we’ve taken to this asset class weighting.

**Investment-Grade Bonds**

From an asset class perspective, we believe investment-grade bonds are likely to generate very low single-digit annualized returns over our five-year investment horizon, which incorporates a range of economic scenarios. Our very low return estimates are explained by the very low current yields and our expectations that interest rates will move higher over our time frame. Interest rates have trended lower for the past three-plus decades, providing a tailwind to bond returns. But looking ahead over our multiyear investment horizon, we think higher rates are likely, although the timing and magnitude are of course uncertain. As such, more than half of our fixed-income exposure remains in opportunistic, flexible, and absolute-return-oriented bond funds that we believe offer superior longer-term risk/reward profiles compared to core bonds, including Guggenheim Macro Opportunities, a new fund we added in December to replace the sale of PIMCO Unconstrained.

**Municipal Bonds**

Municipal bond fundamentals, overall, are continuing to improve. State revenue trends remain positive, supported by a generally improving economy. At the local level, fundamentals are also improving, although it’s more hit and miss. The recovery in home prices should continue to support property tax revenues, providing support for local government bonds. At current price levels, we think muni bond returns will be in the low single digits over our five-year investment horizon under our base case, subpar economic growth scenario. Under a more pessimistic scenario, where interest rates decline, we believe muni returns will be in the 3% range. Despite
our low return forecasts, we plan to maintain exposure to intermediate-term municipal bonds in our balanced tax-sensitive portfolio, as they serve as a defensive risk-management position, similar to taxable core bonds.

**Floating-Rate Loans**
The environment also continues to be attractive for floating-rate loans, as companies have taken advantage of historically low interest rates, locking in attractive levels of fixed-rate financing. As a result, there are few loan issuers with significant near-term maturities, and as a whole, companies have healthy levels of cash flow and interest-coverage. Although there is the potential for short-term downside risk, we believe the asset class will generate mid-single-digit returns over our three- to five-year investment horizon under a range of economic scenarios. (Based on our assessment of loans’ relative attractive return potential, we introduced a floating-rate loan allocation to our 60/40 portfolios when we made the trades to add the Guggenheim fund.)

**Alternative Strategies**
Despite what has been a relatively poor outcome from our allocation to alternative strategies thus far, we think the decision to own them was prudent given what were serious risks to the economy and stock markets at the time. As a reminder the 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. We believe that given the valuations of traditional assets, there is certainly a reasonable basis for maintaining our allocation to conservative alternative strategies. When our outlook for stocks improves and our tactical equity allocation moves back toward a full strategic weighting, we’d expect to fund a larger portion of our alternatives position from bonds rather than stocks.

**Concluding Comments**
In the comments above we discussed why many of our good fund managers are struggling to keep pace with their benchmarks. Given the recent underperformance of our own portfolios, we have also received that same question from clients and followers of our investment research. So perhaps we are a good case study for the question of why good managers go through periods of underperformance versus their benchmarks. Our performance often won’t track the performance of the benchmarks we’re measured against because we are not afraid to construct portfolios that look very different than our benchmarks. Our willingness to do this is a function of our confidence in our investment process, our commitment to do what is right for our clients, and our knowledge that this is what it takes to outperform over the long run. If we always invest in line with our benchmarks, we wouldn’t have been able to add the value that we have over the many years we’ve been in business.

Over the life of our firm we’ve beaten our benchmarks net of our fees. This is something academics have shown is very hard to do over extended time periods. And if you look at rolling 10-year time periods (a new period starting every month) covering the track record of our model portfolios offered through our research publishing service, we’ve bested our benchmarks in 174 out of 178 periods, or 98% of the time (1/1/1990–9/30/2014). We think that high success percentage reflects skill. But we know that there have been and will be periods when we will lag our benchmarks—and that’s what has happened recently. Sometimes we will be early in our moves
(e.g., our equity underweight in the late 1990s) and sometimes we will be wrong. Sometimes we will focus more on risk management and those risks may not play out. And sometimes factors that can’t be anticipated will be material to results.

In the end it is critical to stick to our investment process, execute on our thorough research, remain intellectually honest with respect to what we can and can’t know and the effort we make, and remember that we manage money for real people. We view our responsibility in terms of our clients’ needs and not benchmark comparisons. We believe if we do these things well over the long term, we will be able to continue to meet our clients’ financial needs.

—Litman Gregory Research Team (1/5/15)

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