JJ BURNS

2014: Year-End Newsletter

"It was the best of times, it was the worst of times…" Charles Dickens

What investors hoped for in 2014 was a repeat of the stellar equity returns they experienced in 2013 and positive performance from bonds; what they got was something more realistic.

- U.S. equities were again positive, an acknowledgment that the U.S. made better monetary decisions coming out of the 2008 Financial Crisis;
- A re-thinking of the global economy due to an oil shock and what foreign bankers and politicians must do to stimulate growth hurt non-U.S. stocks and some currencies;
- A bounce-back in U.S. bonds that provided good, old-fashioned low-correlation returns to U.S. stocks during the fall sell-off.

The recap isn't that simple, however. Here's a brief summary of various markets and how they performed in 2013 and 2014, and their two-year annualized rates of return:

Index	2013	2014	Annualized 2 Year Returns
Fixed Income			
Barclays US Agg Bond TR	<2.02%>	5.97%	1.89%
Barclays US Corp. High Yield TR	7.44%	2.45%	4.92%
Citi WGBI [Global Bonds]	<4.00%>	<0.48%>	<2.25%>
U.S. Equities			
Russell 1000 TR [Large-cap Stocks]	33.11%	13.24%	22.77%
Russell 2000 TR [Small-cap Stocks]	38.82%	4.89%	20.67%
S&P 500 TR	32.39%	13.69%	22.68%
International Equities			
MSCI ACWI Ex USA NR [All Stocks]	15.29%	<3.87%>	5.28%
MSCI EAFE NR [Developed Markets]	22.78%	<4.90%>	8.06%
MSCI EM NR [Emerging Markets]	<2.60%>	<2.19%>	<2.39%>
Real Assets			
Morningstar US Real Asset Index TR	0.11%	3.35%	1.72%
Bloomberg Commodity TR	<9.52%>	<17.01%>	<13.35%>
S&P Global Ex US REIT TR	3.31%	11.88%	7.51%
S&P United States REIT TR USD	2.40%	30.26%	15.49%

Source: Morningstar Inc. All data are USD total returns with dividends and expressed as %.

Investors clearly ignored weak real-assets, international and investment-grade bond returns in 2013, as global equities – aside from emerging markets – had gangbuster years. This past year was a stark contrast: U.S. equities were positive but muted, U.S. bonds did better, certain real assets did well (real-estate securities) while international stocks, non-U.S. bonds and commodities had poor returns. An investor holding equities of virtually any type over the two-year period was well rewarded, particularly by U.S. stocks.

"…it was the age of wisdom, it was the age of foolishness…" Charles Dickens

This level of returns often leads to the question, "Why don't we hold all U.S. stocks (i.e. the S&P 500)"? The simple answer is, we don't know what will happen, but we think a lot about investor behavior, and find that most investors focus on what's happening at a given moment and make decisions or form opinions based on short-term analysis. Using data supplied by Dimensional Fund Advisors LP and Russell Investment Group, we compared selected U.S. headlines for each of the calendar years 2013 and 2014 and looked at the returns of the S&P 500. The highlights follow:

MONTH	2013 HEADLINE	2014 HEADLINE
INDEX	**S&P 500 Total Return: +32.39%**	**S&P 500 Total Return: +13.69%**
January	"Fiscal Cliff Deal Leaves US Economy on Slippery Slope"	"Industrial Production Notches Strongest Yearly Gain since 2010"
February	"S&P 500 Hits Five-Year High"	
March	"Weak Hiring Weighs on US Recovery"	"Bond Investors Still Waiting for Yields' Rise"
April	"Gold Sinks into Bear Territory" "US Economy Fears Weigh on Markets"	"Housing Slow to Take Off in Spring"
May	"Low Inflation Poses a Growth Test"	
June	"Markets Extend Slide over Fed Concerns" "Poll: 87% Risk of Stock Crash by Year-End"	"Fed Officials Signal that Rates to Stay Low for Long Time"
July	"Why Gas Prices Are Likely to keep Climbing " "Record Bankruptcy for Detroit"	
August	"QE Plan Leaves Investors with Nowhere to Hide" "US Prepares for Solo Strike on Syria"	"Unemployment Claims Hit Eight-Year Low"
September	"The Government Shutdown: Americans on the Edge"	"EU, US Widen Sanctions on Russia"
October		"Fed Closes Chapter on Easy Money"
November	"Housing Data Brightens US Economic Growth Outlook"	"Oil Prices Tumble to Five-Year Lows" "Soft New-Home Sales Weigh on Recovery" "Gold Prices Fall to Four-Year Low"
December	"Fed Tapers, Stocks Soar" "Gold Falls, On Track for Worst Year since 1981"	"US Economy Posts Strongest Growth in More than a Decade" "Dollar Ends Best Year in More than a Decade"

As we review some of these headlines, and recognizing that items pertaining to the 'ebola crisis' and the gruesome tactics of the Islamic State that occurred in the Fall of 2014 are missing, we would argue that the news for U.S. investors in 2014 was better than 2013, yet S&P 500 returns were much lower. U.S. investors arguably have more robust data than any others, so we asked, why would 2013 be better than 2014? A company called SigFig provides some insights.

During the fall of 2014, when global stock markets had a brief but sharp correction, investors who trade their accounts on SigFig had the following profiles and returns:

INVESTOR TYPE	TURNOVER RATE	6-MO. AVG. RETURN	LARGEST HOLDING	MOST BOUGHT	MOST SOLD
Buy And Hold	Less than 10%	-1.01%	General Electric Co.	SPDR S&P 500 ETF	Guggenheim S&P 500 Pure Value ETF
Active	11% - 50%	-5.27%	Apple Inc.	Energy Select Sector SPDR ETF	Apple Inc.
Very Active	51% - 100%	-6.87%	Apple Inc.	Gilead Sciences Inc.	Apple Inc.
Aggressive	100%-plus	-6.82%	Apple Inc.	Energy Select Sector SPDR ETF	Apple Inc.

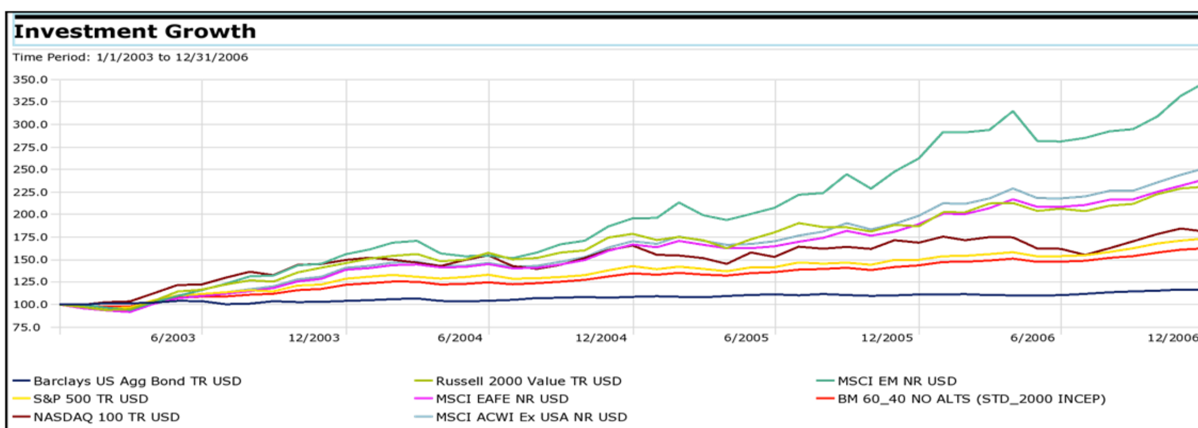
Data provided by USA Today and SigFig as of 12/31/2014. Data presented for illustration only, and is not a recommendation of any strategy or security. SigFig tracks the behavior of over 500,000 investors, from which this data is collected.

What does the data from the second half of 2014 tell us? Well, Apple Inc. is a common holding for many investors. No surprise. It's also a popular mutual fund holding, too, and investors may be overexposed. 'Buy and Hold' investors bought a popular broad-market ETF and sold a value-biased ETF; again, good call over the fourth quarter.

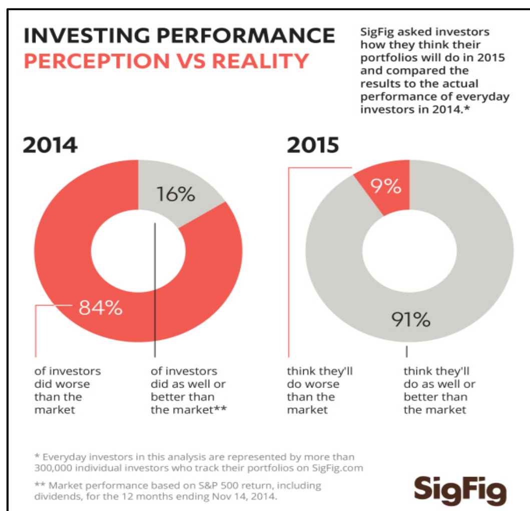
More active investors took advantage of plummeting oil prices to look for an entry point into energy stocks, particularly large integrated oil-and-gas firms such as ExxonMobil and Chevron Corp. Makes sense, right? But the most surprising fact is that the boring 'buy and hold' investor rode the volatility to a substantially better return than more-active investors; quite an accomplishment in a year when losing a little meant a lot.

Some additonal assumptions we make from the data are (1) the ‘Buy and Hold’ investor follows a portfolio allocation strategy, as evidenced by the trading in ETFs, and (2) investors in all four categorizations aren’t sanguine about international stocks, as no ETFs were listed by SigFig. International stocks of all types had a rough 4th quarter, and, while their retreats weren’t as dramatic as the decline in the price of oil and energy-related securities, some entry points emerged.

We mention international stocks because of the following graph from Morningstar, which begins at the end of the deflation of the ‘Tech Bubble’ that ended in 2002. International stocks handily outperformed the S&P 500 over a three-year period of market recovery and economic growth. As we like to remind our clients, nobody knows which particular investment will do well over a given time period.



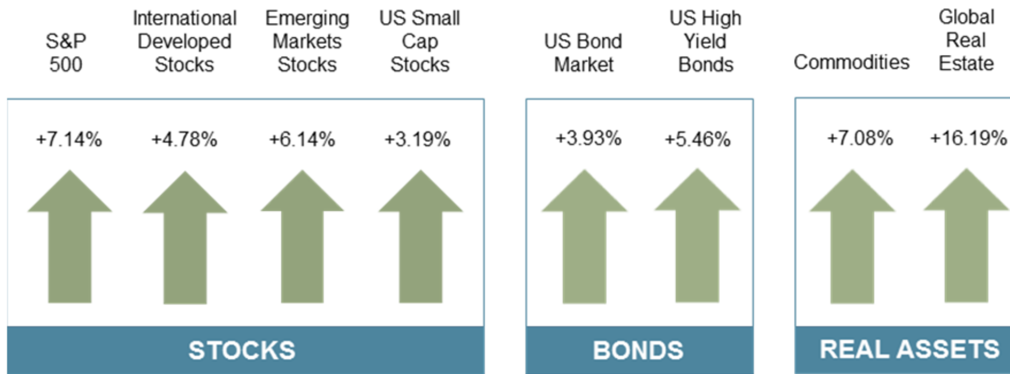
As we see it, investors were trading based on current news in the second half of the year, and the results reflect what happens with such a short-term focus:



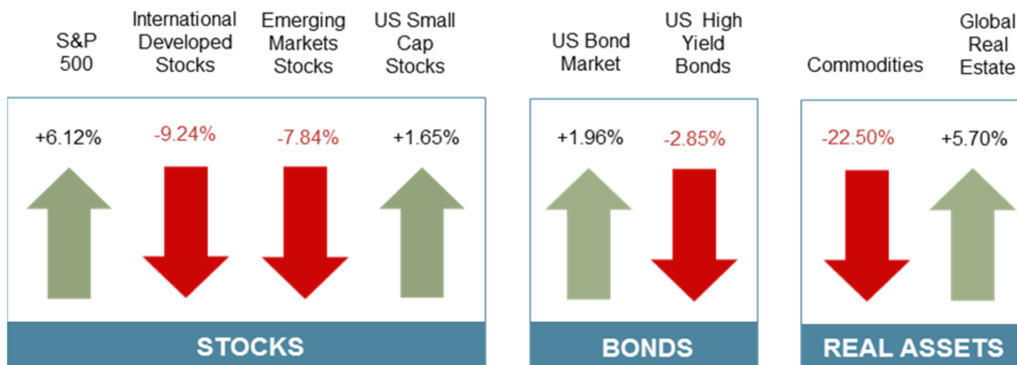
Additional data from SigFig indicated that many investors THINK they do better than the S&P 500 index, but many don’t. About 30% of tracked investors ended the year with negative returns. And, despite this data, many believe they’ll do better than the market in 2015.

“You can’t always get what you want…” The Rolling Stones

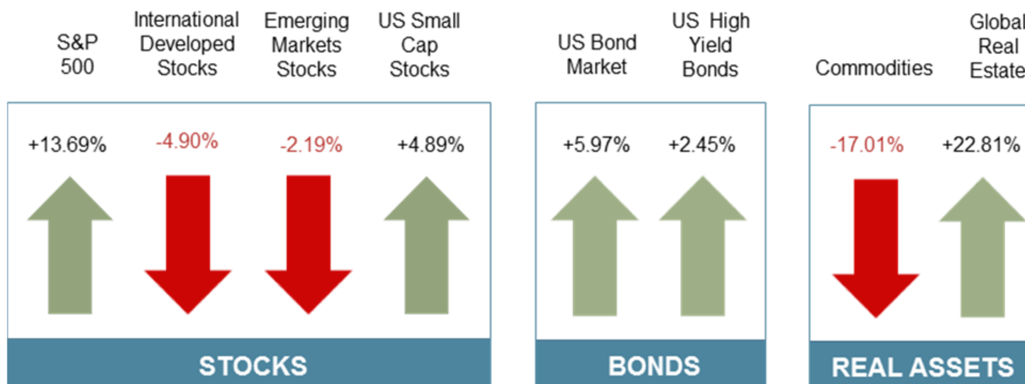
What should we have learned from 2014? It was definitely a tale of two ‘halves.’ The first half of the year made all investors happy:



Every asset class was positive and all were seemingly headed for strong years. But, as summer changed to fall, investors contended with warnings on global growth, Eurozone and China issues, unfounded Ebola scares, Islamic State fears and shocks to oil producers. As you can see below, the markets diverged:



At the end of the year, the markets looked like this:

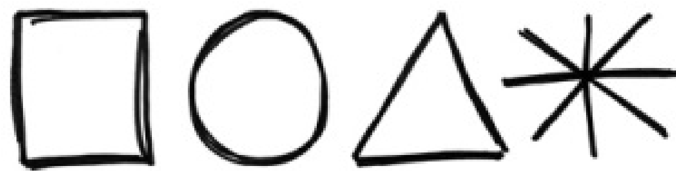


“…But if you try sometime you find / You get what you need” The Rolling Stones

As usual, bad news meant that investors sold energy-related and international stocks and bonds. This money was plowed into U.S. stocks based on better growth and market news. This is not necessarily a bad strategy, but it promotes volatility – normally seen as the investor’s enemy – in the markets. Our view on these topics is mixed. We don’t like volatility either, and we understand that economic changes (e.g. changes in the supply-and-demand relationship for oil) serve as a repricing mechanism for future earnings for companies.

Earnings are the fundamental drivers of stock and bond prices, and changes to the downside usually mean ‘sell.’ On the plus side, U.S. investment-grade bonds rebounded and provided a safe haven for investors during the fall correction, and U.S. small-cap stocks fell almost 10% before outpacing U.S. large-caps in the 4th quarter. (We already owned them in most of our portfolios so we experienced both the drop and the recovery.) Also as usual, all markets benefit from a periodic purge, and that’s a good time to remember another key portfolio theory: *nobody* has a perfect crystal ball. Guessing what oil stocks or Eurozone bonds or the U.S. dollar might do next year is just that: guessing.

We manage globally diversified portfolios because we don’t want to constantly be guessing what a particular market segment is going to do or *not* do in any time period. As the data above demonstrates, *investing* rather than *trading* promotes better outcomes. Sure, there are stocks or funds we like, but not enough to base a complex, long-term allocation on their ultimate success. We’ll continue to focus on what we can control – expenses, manager selection and asset allocations – and let the marginal traders help us with our portfolio rebalance signals.



“Go ahead, make my day” Clint Eastwood

So, what do we expect for the year ahead? The U.S. has a strong story:

- An improving economy
- Signs of real wage growth
- Record U.S. household wealth
- Low inflation
- Declining oil prices (still a net positive for most nations)
- Lower unemployment
- Improving corporate earnings

Given the above, stocks should be positive. As foreign bond yields fall, current thinking is that U.S. bond yields will too, as money seeks higher nominal yields in the United States. Challenges exist in non-U.S. markets, of course, and this will hurt commodity producing nations. Some of these are:

- Slowing growth or recessions in many economies
- Global currencies depreciating against the dollar
- Continued lingering effects from poor post-2008 policies
- Falling commodities prices
- Continued geopolitical tension in the Ukraine and the Middle East

When you put these things together, we might expect a good year for U.S. stocks and bonds, and the dollar, and not so good for commodities, non-U.S. securities and currencies. That means, of course, that something different will happen, since the broad market consensus is usually wrong. As always, we intend to stay diversified and focused on long-term investing. We will not abandon our global-allocation approach of limiting risk by following the herd into non-diversified portfolios simply because that’s what’s working right now. This is simply the wrong approach and it could have dire consequences in a market correction. We believe in the fundamental dynamics of the capital markets and that asset allocation is a most proven strategy that will allow for portfolio growth while limiting downside risk.

As always we welcome your comments, questions and feedback. We wish you and all you hold dear a healthy, happy and prosperous new year.

-Your Wealth Management Team at JJ Burns & Company

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