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# It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness



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**Charles Dickens opening to “A Tale of Two Cities” captures well the investment landscape for 2014.** With record gaps between winners and losers, there was little middle ground as some asset classes yielded strong positive returns while others saw disappointing declines.

The quarter opened in the midst of a decline that had begun in mid-September. For U.S. markets the decline ended a few weeks into October. For the 4th quarter, Large Cap U.S. stocks bounced back and advanced 4.9% to finish the year up 13.7%. These handsome gains were achieved with historically low volatility – the S&P500 had no more than 3 consecutive down days all year – the shortest streak for a calendar year since data began in 1928. Small Cap stocks were in negative territory for the year on September 30th and were down even more in October before vaulting off their lows and finishing the quarter up 9.7%. With their late surge, Small Caps stole a small victory from the jaws of defeat, advancing a modest 4.9% for the year. Nonetheless, Small Caps trailed Large Caps by the widest margin since 1998.

It was a far different story for non-U.S. stocks. The stocks of non-U.S. developed markets fell 3.5% in the last three months, clocking a full year decline of 4.5%. Emerging Market stocks slid 4.4% in the 4th quarter, and ended the year down 1.8%. The results for non-U.S. stocks warrant some further explanation as they were largely affected by a sharp spike in the value of

the U.S. Dollar versus other currencies (Euro, Yen, etc.) to a degree not seen in 17 years. The following table reveals some surprising results about non-U.S. stocks in 2014 – *across the board they actually were UP in their local currencies, both in the 4th quarter and for the full year.* But for U.S. investors, the appreciation of the U.S. Dollar knocked ~5% off returns in the 4th quarter and a whopping 5.8% (Pacific ex-Japan) to 13.2% (Europe ex-U.K.) for the year.

Stock Market	4th Quarter Returns			2014 Returns		
	Local Currency	Currency Effect	U.S. Dollar	Local Currency	Currency Effect	U.S. Dollar
U.S. Large Cap	4.9%		4.9%	13.7%		13.7%
Non-U.S. Developed	1.8%	-5.3%	-3.5%	6.4%	-10.9%	-4.5%
Europe (ex-U.K.)	0.2%	-4.5%	-4.3%	7.4%	-13.2%	-5.8%
Pacific (ex-Japan)	3.1%	-4.6%	-1.5%	5.8%	-5.8%	0.0%
Emerging Markets	0.1%	-4.5%	-4.4%	5.6%	-7.4%	-1.8%

For both the quarter and the calendar year, these currency effects for U.S. dollar based investors turned positive non-U.S. stock market results into disappointing losses. The 18% dispersion in returns between U.S. and non-U.S. stocks was the greatest gulf since 1997.

This wide dispersion of returns was not limited to stocks. Within alternative assets, Real Estate Investment Trusts booked large gains while

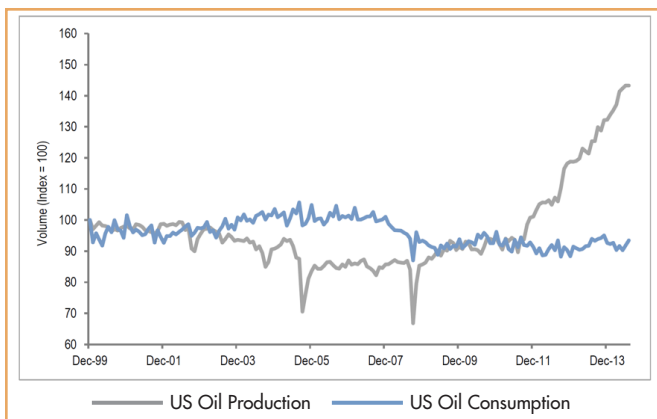


Commodities plunged 17% - the 2nd worst year since commodity indices were created over 40 years ago. Within Bonds, long maturity and high quality bonds rallied while lower quality bonds trailed. Specifically, 30 year U.S. Treasury bonds posted their best year ever and 10 Year U.S. Treasuries posted total returns of 10.4% while High Yield Bonds were up a meager 2.4%.

Besides the unusual gap in returns within asset classes, over time, 2014 will go down in the history books as an epic failure for forecasters and one during which it was a remarkably hard year to be an "expert". Consider this:

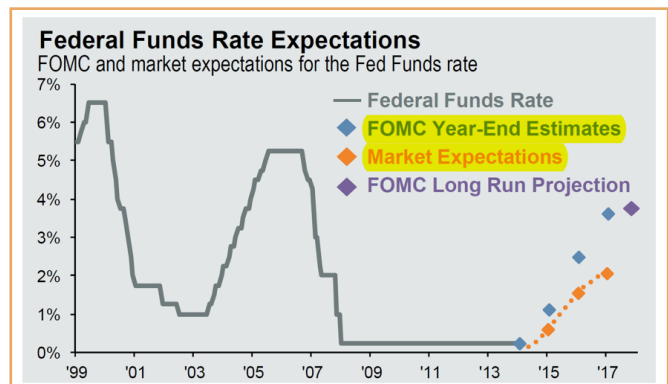
- In a Wall Street Journal survey, 48 out of 49 economists expected the yield on the 10 year U.S. Treasury to rise in 2014, with an average forecasted year-end yield of 3.5%. It finished the year around 2.2%. The same economists forecasted oil to rise from \$92/barrel to \$95/barrel. It finished around \$50/barrel.
- Hedge Funds, in aggregate, posted modest returns of 3.2% for the year. Two "celebrity" hedge fund managers, John Paulson, who correctly called the 2008 housing collapse, and Meredith Whitney, a famous long-time Wall Street analyst, had horrible years. Early estimates are that one of Paulson's funds dropped 36% last year while Whitney's flagship fund declined 11%. Joining the list of 2014 clunkers was the largest alternative strategy mutual fund, the Marketfield Fund, which declined over 12% for the year.

No review of 2014 would be complete without addressing oil. The sudden plunge in oil prices fueled the spike in volatility the past few months - Wall Street always prefers certainty and predictability and sharply falling oil prices are unsettling because the reasons are not totally clear and the bottom is unknown. The popular economic rationale is that lower prices are a symptom of a slowing global economy. There is likely a little truth to this, but we (and many others) feel this is much more an "excess supply" story than a "low demand" story. The excess supply coming largely from the U.S., which as the chart below dramatically illustrates, has sharply increased production the past few years while consumption has been relatively flat.



This increased oil output in the U.S. is a result of the U.S. being both lucky and good – lucky of course in that we have massive oil reserves in our country, but good also in that our innovation, capitalism, and hard work has allowed us to profitably access oil reserves in shale rock formations that were previously prohibitively difficult and expensive to drill. Nobody really knows where the price of oil will bottom, but once the dust settles and prices stabilize at levels sure to be much lower than they were a year ago, the net impact will be a meaningful positive for the global economy. Sure, there will be some losers – namely Russia, Iran, Venezuela, and many energy companies and their employees – but there will be many winners – most notably the global consumer and the economies of China, India, South Korea, Turkey, France, Germany, Japan and the U.S.

Looking forward, 2015 will be similar to 2014 in at least one respect – the conversation will continue to surround Central Bank policies. Will the Fed raise rates or will we have QE4 in the U.S.? What will the European Central Bank do? What about in Japan? China? Overall, there appears little doubt that the global banks are diverging – with Europe and Japan focused on adding stimulus, but the U.S. inching toward removing stimulus.



As you can see on this chart, the blue diamonds show the Fed's own forecasts are for the Fed Funds rate to rise to 1.13% by the end of 2015 and to 2.50% by the end of 2016. But the market (orange diamonds/line) doesn't think the Fed will follow through on their forecasts, and expects short-term rates to rise more slowly. Why? Because even though unemployment is now below 6.0%, it's hard to imagine the Fed aggressively raising rates and risking slowing down the economy too much. This theory is bolstered by the drop in oil and other commodity prices, which is deflationary. Even though we don't see sharply rising interest rates, the possibility exists. And with yields so low, much of the bond market now offers "return-free risk". As a result, we think investors are well served continuing to maintain reduced (but still modest) core bond allocations (for portfolio diversification purposes).

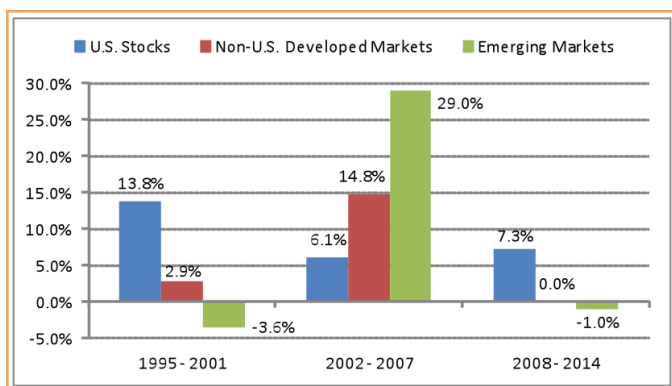


Perhaps the hardest portfolio design question remains the U.S. vs. non-U.S. decision. In light of the performance mentioned earlier, it is times like these that try the patience and discipline of diversified investors. When U.S. stocks are performing so much better than non-U.S. stocks, it's both smart and emotional to ask "why bother?"

The reasons of course, are many. For one, there's the simplest high level economic rationale for international investing – a large and growing investment opportunity set. Since 1970, the U.S. share of global GDP and stock market capitalization has declined from 47% and 66% to 20% and 49% respectively. In plain English...there are lots of businesses around the world launching products and services, innovating, producing, and growing, and their stocks have the potential to do so as well. Investors who avoid or severely curtail their portfolio exposures to non-U.S. stocks forfeit opportunities in over half of the world's opportunity set. That sounds good in the abstract and makes sense, but the returns and diversification benefits have to be there as well. And nowadays, those can be hard to remember. The emotional allure of U.S. stocks over their non-U.S. counterparts is probably as strong as it's been in 15 years. Those times, and what happened next, can be hard to remember, so let's take a look:

From 1995 to 2001, U.S. stocks trounced non-U.S. stocks. Emerging Market stocks posted losses while U.S. stocks racked up average annual gains of 14%. We know how this ended – non-U.S. stocks, led by Emerging Markets, thumped U.S. stocks from 2002 – 2007. By the end of 2007, investors everywhere were rushing into Emerging Market stocks. That didn't end well either. Not only do these cycles and the performance disparity of the past 7 years argue for some mean reversion in favor of non-U.S. stocks, but valuations do as well, as most U.S. stocks sit at moderately high valuation measures while many non-U.S. stocks, and particularly Emerging Markets stocks, sport much more attractive valuations.

A year ago, there was an overwhelming consensus on Wall Street that U.S. interest rates would rise, Europe would emerge from its doldrums, oil would be no lower than \$95/barrel, and volatility would pick up. None of that happened. As we begin 2015, there is once again an overwhelming consensus - the S&P500 will have another good year, the U.S. Dollar will continue to rally, Europe is unfixable, and interest rates on bonds will finally rise. Coming off of such a terrible year for the "experts" in 2014, we would not be surprised to see most of these fail to materialize. Nowadays, we think the chances for another "best of times, worst of times" year are increasing, but with roles changing. While unlikely, if the Fed is too aggressive raising rates, we could get a very nasty correction (remember 1987?). However, if inflation remains subdued and interest rates remain low while economic growth accelerates, we could also get a late 90's style "melt up" in the stock markets, but with more global participation. With such a wide range of potential outcomes and no "fat pitch" tactical opportunities, we will endeavor to be wise, remaining committed to prudent diversification, patience and discipline, while steering clear of big, popular bets and forecasts that can make it easy to look foolish a year later.



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