The Lam Group

Investment Management

This was a challenging quarter for the portfolio, particularly for our investments with exposure to non-US dollar currencies. Geopolitical unrest (ISIS, Ukraine, HK protests, Ebola outbreaks etc.) have caused a flight to the quality/stability of the US dollar. While a stable US dollar may seem like an oxymoron when our own domestic problems are considered, many feel we are in a **TINA** (**T**here **I**s **N**o **A**lternative) environment with respect to global currencies. While domestic large cap stocks and investment grade bonds were up marginally in 3Q 2014, almost all other asset classes were down. On a 2014 YTD basis, domestic large cap stocks, emerging markets (equity and debt), global real estate, and US-dollar denominated bonds have made positive contributions to the portfolio.

Our investments in non-US dollar equities and fixed income (foreign currency debt and commodities) and not surprisingly domestic small cap stocks (the top performing asset class in 2013) have negatively-impacted portfolio performance for the quarter and YTD. The short-term underperformance of these asset classes is disappointing, however, we continue to believe in the discipline of global diversification and portfolio balance as a long-term strategy.

While reporting a negative quarter is never pleasant, the flight to quality/stability has historically not been a one-way ticket.

Obviously, the resurgence in domestic large cap stocks is welcome. As many will remember, for the 10-year period from 2000 to 2009 ("the lost decade"), the S&P 500 returned a cumulative negative 9%, while all other asset classes had positive double and triple digit cumulative returns over the same period. The recovery in domestic markets can be traced back to the Emergency Economic Stabilization Act of 2008 (implemented six years ago this month) which provided massive stimulus to the US economy and at the same time allowed the US dollar to strengthen.

As the US markets return to record levels, it is possible that current prices reflect all the benefits that this stimulus intended. As the Fed begins to unwind the stimulus (QE3 does not become QE4ever?), it is possible that similar programs begin overseas. The stimulus playbook has no copyright protection.

It is worth noting the recent performance of the S&P 500 has brought domestic large cap stock's 10-year performance back in line relative to other asset classes (see column on far right of Table 1). In fact, some valuation metrics have US stocks and real estate at close to 2007 (pre-global financial crisis) levels, whereas non-US stocks (both developed and emerging) are less expensive and candidates for rebalancing/higher-expected return.

Table 1: Periodic Asset Class Returns as of 9/30/14

EQUITY ASSET CLASSES	***3Q 2014***	***2014 YTD***	**12 Months**	**3 Years***	**5 Years***	**10 Years***	***10 Years***
S&P 500 Index - Domestic Large Cap Stocks	+ 1.13%	+ 8.34%	+19.73%	+22.99%	+15.70%	+ 8.11%	+118.05%
Russell 2000 Index - Domestic Small Cap Stocks	- 7.36%	- 4.41%	+ 3.93%	+21.26%	+14.29%	+ 8.19%	+119.66%
MSCI EAFE Index - International Large Cap Stocks	- 5.88%	- 1.38%	+ 4.25%	+13.65%	+ 6.56%	+ 6.32%	+ 84.52%
MSCI EAFE SC Index - International Small Cap Stocks	- 7.82%	- 2.74%	+ 3.00%	+14.49%	+ 8.91%	+ 8.02%	+116.23%
MSCI EM Index - Emerging Markets Stocks	- 3.49%	+ 2.43%	+ 4.30%	+ 7.19%	+ 4.42%	+10.68%	+175.76%
DJ US Select REIT Index - Domestic Real Estate	- 3.00%	+14.69%	+13.44%	+16.19%	+15.77%	+ 8.21%	+120.14%
S&P Global (ex-US) REIT Index – International Real Estate	- 5.02%	+ 7.73%	+ 6.64%	+13.74%	+ 9.26%	+ 5.81%	+ 75.87%
FIXED INCOME ASSET CLASSES	***3Q 2014***	***2014 YTD***	**12 Months**	**3 Years***	**5 Years***	**10 Years***	***10 Years***
BarCap Aggregate Bond Index - US High-Grade Bonds	+ 0.17%	+ 4.10%	+ 3.96%	+ 2.43%	+ 4.12%	+ 4.62%	+ 57.13%
BarCap High-Yield Bond Index	- 1.87%	+ 3.49%	+ 7.20%	+11.09%	+10.57%	+ 8.33%	+122.56%
BarCap TIPS Index - US TIPS	- 2.04%	+ 3.67%	+ 1.59%	+ 1.34%	+ 4.48%	+ 4.63%	+ 57.43%
Bloomberg Commodities Index - Commodities	-11.83%	- 5.59%	- 6.58%	- 5.34%	- 1.37%	- 1.04%	- 9.91%
Citigroup Non-$ World Govt Bond Index - Non-$ Bonds	- 5.38%	+ 0.25%	- 0.99%	- 1.13%	+ 1.01%	+ 3.99%	+ 47.88%
JPM EMBI Global Diversified Bond Index - Emerging Markets Debt	- 0.59%	+ 8.02%	+ 9.67%	+ 7.95%	+ 8.03%	+ 8.32%	+122.47%

Sources: Morningstar, JP Morgan, and Dimensional.

* Annualized

The narrow nature of the market's recent performance may have some questioning the benefits of global diversification and portfolio balance. Over short periods of time (and with 20/20 hindsight), it is easy to argue against diversification and balance. In any given year there are always a few asset classes that will have superior performance, and if one could predict these investments in advance, diversification and balance would not be necessary. However, over the long run, the benefits of portfolio diversification and the importance of disciplined rebalancing become more obvious (as illustrated by the data in Table 1).

With a stronger US dollar, some of the diversifying elements of the portfolio, such as commodities have declined. As commodities are highly-negatively correlated to the US dollar, this is not a surprise. We expect this exposure to be a positive contributor to the portfolio in a weaker US dollar environment.

Directional predictions of markets and interest rates continue to confound followers of the financial media. Last year's prediction of the "inevitable" increase in US interest rates have again disappointed investors who tried to capitalize on this market view (long-duration US Treasuries are up 15% YTD 2014). The performance of the bond markets serve as a reminder of the foolishness in trying to predict the direction of markets (or interest rates).

Of course, one difficult quarter does not lessen our dedication to our globally-diversified investment strategy. Over the long-run, the inclusion of allocations to non-US investments can add positively to the performance and risk management of an investment portfolio. However, in exchange for the benefits of global diversification, many non-US asset classes can experience periods of higher volatility that may negatively affect short-term performance. 3Q 2014 was one of those periods. The historical resilience of the asset classes that have underperformed this quarter/YTD 2014 gives us optimism for the future.

We have updated our website (www.thelamgroup.com) to be more iPad and mobile device friendly. We hope to publish a new newsletter soon.