# The Lam Group
Investment Management

2014 was a great year for US asset classes. Domestic stocks and real estate surged as bonds rallied amid falling interest rates.

However, non-US asset classes (international and emerging stocks and bonds, and commodities) struggled in dollar-terms. The major driver of capital market returns for 2014 was the appreciation of the US dollar. The dollar (as measured by the DXY currency index) was up 12.79% in 2014, with all of this appreciation coming in the last six months (up 13.16%). The surge in the value of the dollar in such a short period of time was unexpected. *The last time the greenback was at these levels was 2006.*

If we look at the breakdown of 2014 asset class returns in Table 1, the first six months of the year (where the US dollar was flat) asset class contributions were more broad-based when compared with the last six months of the year. *Currencies had a significant impact as non-US equity markets actually had positive returns in 2014 when viewed in local currencies (EAFE +5.92%, EAFE SC +6.01%, EM +5.17%).*

**Table 1: Periodic Asset Class Returns as of 12/31/14** (in US Dollars)

| EQUITY ASSET CLASSES | 4Q 2014 | 2014 | 2014 2nd half | 2014 1st half | 5 Years* | 10 Years* | 10 Years |
|---|---|---|---|---|---|---|---|
| S&P 500 Index - Domestic Large Cap Stocks | + 4.93% | +13.70% | + 6.12% | + 7.14% | +15.45% | + 7.67% | +109.47% |
| Russell 2000 Index - Domestic Small Cap Stocks | + 9.73% | + 4.89% | + 1.65% | + 3.19% | +15.55% | + 7.77% | +111.26% |
| MSCI EAFE Index - International Large Cap Stocks | - 3.57% | - 4.90% | - 9.24% | + 4.78% | + 5.33% | + 4.43% | + 54.29% |
| MSCI EAFE SC Index - International Small Cap Stocks | - 2.27% | - 4.95% | - 9.91% | + 5.50% | + 8.63% | + 6.04% | + 79.74% |
| MSCI EM Index - Emerging Markets Stocks | - 4.50% | - 2.19% | - 7.84% | + 6.14% | + 1.78% | + 8.43% | +124.62% |
| DJ US Select REIT Index - Domestic Real Estate | +15.09% | +32.00% | +11.64% | +18.24% | +16.99% | + 8.13% | +118.42% |
| S&P Global (ex-US) REIT Index – International Real Estate | + 2.98% | +10.94% | - 2.19% | +13.42% | + 9.86% | + 4.29% | + 52.17% |
| **FIXED INCOME ASSET CLASSES** | **4Q 2014** | **2014** | **2014 2nd half** | **2014 1st half** | **5 Years*** | **10 Years*** | **10 Years** |
| BarCap Aggregate Bond Index - US High-Grade Bonds | + 1.79% | + 5.97% | + 1.96% | + 3.93% | + 4.45% | + 4.71% | + 58.44% |
| BarCap High-Yield Bond Index | - 1.00% | + 2.45% | - 2.85% | + 5.46% | + 9.03% | + 7.74% | +110.70% |
| BarCap TIPS Index - US TIPS | - 0.03% | + 3.64% | - 2.07% | + 5.83% | + 4.11% | + 4.38% | + 53.52% |
| Bloomberg Commodities Index - Commodities | -12.10% | -17.01% | -22.50% | + 7.08% | - 5.53% | - 1.86% | - 17.11% |
| Citigroup Non-$ World Govt Bond Index - Non-$ Bonds | - 2.91% | - 2.68% | - 8.14% | + 5.95% | + 0.85% | + 2.64% | + 29.77% |
| JPM EMBI Global Diversified Bond Index - Emerging Markets Debt | - 0.55% | + 7.43% | - 1.14% | + 8.66% | + 7.57% | + 7.78% | +111.47% |

Sources: Morningstar, JP Morgan, and Dimensional. * Annualized

The dramatic appreciation of the dollar coincided with the steep decline in the price of oil (down 50%). Because oil (and commodities in general) has a high negative correlation with the US dollar, the decline in oil prices over the last six months is not completely surprising, but it is unclear whether these trends will continue.

Obviously, cheaper oil adds to the disposable income of consumers worldwide, but it may also have a destabilizing effect on countries who rely heavily on oil exports and companies whose business models are based on high/rising oil prices. While many pundits are concerned with oil prices, we are more focused on currency valuations and their effect on all markets.

While the performance of our non-US investments over the last six months had a negative impact on the portfolio, a diversified strategy often means that not all investments perform well at the same time. Buying low and selling high is never easy or obvious and with the recent volatility of our non-US holdings, ***we have already paid for the risk, and it would be imprudent not to wait for the return.***

With the Fed planning to pare back its unprecedented stimulus program, foreign central banks are implementing their own stimulus plans (lower interest rates/QE) to support foreign markets in the same way our program supported US markets. As central banks around the world stimulate their local economies, the resulting weakness of foreign currencies may allow for non-US companies to become more globally competitive which will be positive for their equity markets.

As the US equity markets have returned to record levels, it is important to remember that current prices reflect all available information. *By some valuation metrics US stocks and real estate are currently close to 2007 (pre-global financial crisis) levels, whereas non-US stocks (both developed and emerging markets) are trading close to their 2008 valuations.* Because it is our belief that no asset class can be in (or out of) favor indefinitely, the US outperformance and the underperformance of the rest of the world in 2014 suggest rebalancing opportunities in 2015.

It is worth noting that last year's prediction of the "inevitable" increase in US interest rates again disappointed investors who tried to capitalize on this market view as the performance of the domestic bond market (long-duration US Treasuries were up 25% for 2014) provides a reminder of the foolishness in trying to predict the direction of markets, interest rates, or even currencies.

The US-centic 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 be unnecessary*. As the ability to make successful predictions <u>in advance</u> is more a function of luck than skill, diversification, discipline and patience still offers the best path for most investors.

It is important to remember that the recent strength in US large cap stocks began after a 10-year period (2000-09) where returns for this asset class were negative (-9.1% cumulatively). *Undiversified investors suffered during this "lost decade" and the surge in US large cap stocks since 2009 is a long-awaited recovery from 10 years of disappointing performance.* On the other hand, investors who adhered to a globally-diversified and balanced strategy during this "lost decade" benefited from contributions from other asset classes, almost all of which posted double and triple digit returns during this period.

As we begin 2015 with all the attendant risks and uncertainties, we remain confident our investment approach will continue to serve the long-term investor well.

Happy New Year.