

2014 and Beyond

Perspective

We take no comfort in being among the large percentage of investment managers and advisers explaining in their year-end letters why 2014 didn't work out as they had expected at the outset of the year. Interest rates declined rather than increased as widely anticipated, and interest rate sensitive stocks and long term bonds produced outsized gains. Shares of companies focused on the consumer discretionary sector did not flourish in the equity markets notwithstanding that domestic consumer sentiment is at an eight year high. Europe did not gain traction and China slowed (recently reporting a contraction in manufacturing activity). Mid-size and small capitalization companies substantially underperformed larger companies notwithstanding their more robust earnings growth outlook at the outset of the year. Hedge funds struggled. The price of oil collapsed (recently firming but still far off from its high) thrusting Russia and other oil based economies into crisis.

For the most part, investors who achieved S&P 500-like performance were invested in the S&P 500 and accepted the increased risk of not maintaining cash or short-term bond positions. They also accepted the higher risks of portfolio concentration by not diversifying market capitalization and geography. Some also accepted – perhaps unwittingly – the sector concentration that comes by exclusively mirroring a portfolio to a market capitalization weighted index.

Those that invested in longer term bonds certainly elevated risk in the portfolio, but at least in 2014 it paid off as intermediate term municipal bonds provided investors with approximately a 6% return for the year. Although (after concluding that interest rates would not rapidly increase) we introduced increased duration and interest rate sensitivity in most client portfolios during the year, we maintain a conservative posture with regard to interest rate risk. We opted to utilize a combination of fixed income strategies that positioned the portfolio not only for the current year but to also allow portfolios to adapt as interest rates adjust in the coming years. One of the fixed income funds emphasizes a more tactical approach to the yield curve, another a barbell approach that hedges the risk of investing in longer term bonds by also investing in short term bonds and cash, and the third fund invests in a laddered portfolio of maturities with a modest duration or sensitivity to interest rate risk. Additionally, most client portfolios maintain cash as a further hedge against rising interest rates.

With regard to equities, we have adhered to the principles of sound portfolio construction, diversifying on the basis of market capitalization, geography, sectors, and passive vs. active management. We have also remained invested, although at reduced levels, with tactical managers who have discretion to invest in varying assets classes and markets.

The inclusion of an allocation to diversified international equities even at markedly underweight levels was also a drag on performance relative to the S&P 500, notwithstanding that many of the sectors and companies we invested in for clients were supported by attractive valuations. A small- and mid-cap equity allocation in the portfolio provided a further drag on performance relative to the S&P 500. Finally, the active managers included in client portfolios underperformed the S&P 500 even though their longer term performance records are reflective of competitive or superior performance relative to the index.

In a properly structured portfolio there will always be asset classes, sectors and portions of the portfolio that perform well and portions of the portfolio that lag at any given point in time. This is a reality in a properly constructed portfolio that should lead to moderated drawdowns in declining markets and consistent positive compounding over time.

Coming into the year, most client portfolios were substantially underweight foreign equities relative to the MSCI All Country World Index. During the year, we further reduced international exposure and increased the allocation to domestic passive management as compared to active managers. As we assess the prospects for the coming year, we may further adjust equity sector and tactical fund allocations as economic and market conditions evolve.

Performance of the Capital Markets

As of this writing, during the fourth quarter of 2014, amidst substantial volatility and economic and geopolitical uncertainty, the Dow Jones Industrial Average gained 6.15% (+11.03% ytd); the S&P 500 and Russell 1000 Indices gained 6.02% (+14.86% ytd) and 5.94% (+14.38% ytd), respectively; while the Wilshire 5000 returned 6.31% (+13.84% ytd). The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index increased 10.49% (+5.62% ytd) and 7.47% (+10.9% ytd), respectively. The MSCI EAFE Index lost 3.4% (-4.73% ytd). The MSCI All Country World Index returned .99% (+4.76% ytd). The MSCI EM Index decreased 4.68% (-2.36% ytd). The European Equity Index declined 4.06% (-6.17% ytd).

Oil

The price of oil was cut almost in half in the last six months of the year. Fear was injected into the capital markets as investors attempted to discern whether the decline was attributable to excess supply created by the robust drilling and production activity in the United States or a decline in worldwide demand signaling economic contraction. Undoubtedly the answer is both. With European economies and China and other Asian trading partners under economic pressure, demand for energy is surely affected while increased production in the United States together with OPEC defending its market share (by not reducing its production) added “fuel to the fire.” As for oil dependent economies such as Russia, the rapid price decline was destabilizing, elevating fear in capital markets as to the potential for unknown Black Swan events impacting banks, government debt and corporate debt dependent on oil revenues. Similarly, domestic private equity investments and high yield debt in energy companies have been negatively impacted by the decline in oil prices.

Publicly traded energy company stocks sustained losses as the decline in oil prices depressed the outlook for corporate earnings in the energy sector. Mitigating the impact on overall corporate earnings, however, is the stimulative effect that lower energy prices may have on consumers, domestic and abroad, thus leading to greater economic activity and higher corporate profits supporting equity markets.

Foreign Economies

Although the yen has weakened relative to the dollar in part as a consequence of Japanese government policies, Japanese export activity remains under pressure. Given increased competition in Asia and other emerging economies and a slower worldwide economy, the lower yen may not be sufficient to compensate for the cost differential as compared to developing economy competitors. The potential for the yen to continue to weaken against the dollar is cautionary for inbound investment in Japan by U.S. investors.

The Eurozone economy and neighboring European economies remain stagnant or in decline. Unemployment in Europe remains high. The dollar gained approximately 12% against the Euro in 2014 though the stimulative effect on European export activity is not yet evident. As we have previously observed, Europe's weakness as a consumer negatively impacts China's GDP as well. China in the meantime is doing its part to stimulate its economy by relaxing bank capital requirements to spur spending and aid its housing markets.

The European Central Bank continues to talk up the market saying that it is prepared to be more aggressive while Europe still wrestles with the risks of deflation. We are still waiting for action. While we wait, with investor fears stimulating safe-haven deposit activity in Swiss francs, the Swiss National Bank recently imposed negative interest rates on deposits at the central bank to curb gains in its currency and combat the risks of deflation.

The recent destabilization of the Russian currency as a result of the collapse of oil prices creates further uncertainty and risk in international capital markets. Price inflation resulting from the currency's debasement gave rise to hourly ruble denominated price increases on consumer products and disrupted international trade as appropriate pricing could not be established. The economic sanctions imposed by Europe and the United States following Russia's annexation of Crimea exacerbated the impact of collapsing oil prices on the oil dependent Russian economy.

Other geopolitical issues also loom over the capital markets. The potential success of an anti-austerity political party seeking to form a government in Greece adds further uncertainty into the politics and economic relationships of the Eurozone which, together with the destabilization of the Russian economy, undermine consumer and investor sentiment. And perhaps the collapse of oil prices was a factor in Cuba's receptivity to U.S. overtures as it imports much of its oil from Venezuela, whose economy is adversely affected by the slashing of its oil revenues. A similar dynamic could play out with other oil dependent nations that may now be more receptive to U.S. entreaties.

Increased terrorist activity in Pakistan and the Middle East, a lone wolf attack in Australia, continued violence in Africa, and cyber-attacks emanating from North Korea all have economic and trade consequence although the capital markets have been more focused on central bank policy and oil prices.

The Domestic Economy and Capital Markets

The U. S. economy continues its resilience with consensus estimated growth to be 2.5% for 2014 and 3.0% for 2015.

The decline in energy prices may be a net benefit to the domestic economy as the U.S. uses more oil than it produces. A reduction in trade deficit (supportive of the dollar) should follow. Yet with a stronger dollar, U.S. exports are less attractive and may detract from GDP growth. With imports less expensive due to reduced energy based costs of production and relative currency strength moderating costs, inflation is not a present concern.

In its year-end policy statement the Federal Reserve provided assurance that a relatively low interest rate environment would be maintained for a considerable period of time, but noted that the increased pace of employment and wage gains were encouraging signs of economic strength that bode in favor of the Fed starting a program of short term interest rate increases in mid-2015. The Fed Chair characterized the coming rate increases as restoring interest rates to levels consistent with historical levels and economic conditions. As we have observed in earlier commentaries, we question the merits of characterizing interest rates as "normal," as rates should be a function of economic and free capital market forces that function to allocate capital and assess risk. With the economy growing modestly, we expect rates to increase gradually. Further, there is some debate as to whether price deflation due to energy cost declines and the strength of the dollar (as well as a modest and perhaps fragile growth environment) should lead the Fed to err on the side of caution underscoring its commitment to be patient in raising rates.

Equity markets immediately soared following the Fed's announcement of continued economic support (recovering previously lost ground). Subsequent to the Fed's announcement, third quarter GDP growth was revised to 5% while at the same time November durable goods orders softened. Consumer spending increased perhaps due to the decline in fuel prices. The DJIA and the S&P 500 raced to new highs and the pundits announced that the outlook for the economy was better than expected prior to this news. We caution however, that the U.S. economy though stable and growing is affected by the larger less healthy world economy and the currency relationships that will be greatly impacted by central bank policies. The risk remains however, that given this third quarter data, the Fed may not be as patient as they had originally announced.

Looking Forward

The U.S. economy is expected to continue its pace of modest growth (approximately 3%) in the coming year. Corporate operating earnings per share are also projected to grow, driven by a combination of modest revenue gains, operating leverage and share buybacks. The earnings growth rate (projected by S&P) for small- and mid-cap companies is more than twice the anticipated growth rate for the S&P 500. Smaller companies are also less exposed to weaker global demand and the adverse effects of a strong dollar than are larger companies. Finally, the small business optimism index is presently at a 7 year high of 98.1. Although the share performance of smaller companies lagged in 2014, with PE ratios for the S&P 500 at approximately 18.0x 2014 EPS and estimated to be 15.9x 2015 EPS, mid and small cap shares at approximately 23-24.4x 2014 EPS and estimated to be 18-18.6x 2015 EPS and with twice the anticipated growth in 2015 EPS, we continue to maintain our allocation to mid- and small-cap companies in most client portfolios. In most client portfolios we remain modestly underweight large-cap shares and modestly overweight mid- and small-cap shares.

With long-term Baa corporate bonds yielding approximately 4.7%, the implied PE ratio for equities is 21x. While PE expansion is possible, it is more likely that interest rates will rise thus lowering the implied equity multiple. The drivers of share price increase going forward should be growth in EPS rather than multiple expansion.

Our asset allocation is informed by the relative risk/reward balance among asset classes and the impact of economic developments. We therefore continue to emphasize domestic equities and are underweight foreign equities. While we have introduced modest duration exposure to most fixed income portfolios, we remain cautious and do not anticipate extending maturities as the Fed has signaled that tightening (or raising interest rates) will commence in mid-2015. We continue to invest in high quality municipal bonds held as a risk mitigator in most client portfolios.

During 2014, employment gains were realized as the economy continued to improve. Recent wage gains are also a positive sign as such enhances consumers' ability to spend thus increasing economic activity. Housing starts are modestly increasing. Inflation remains low, continuing to run below the Fed's target rate. The Fed's "patience" in raising rates is important so as not to derail the domestic economic engine.

In 2015, the issues confronting global demand and currency relationships will be of critical importance. The role of central bank policy will be a major factor with respect to exchange rates impacting domestic and international economies. After advancing by 11% against a broad basket of currencies in 2014, the dollar is likely to continue to strengthen due to a combination of factors. Lower oil prices result in a lower U.S. trade deficit that support a stronger dollar. The Federal Reserve implementing higher interest rates is also supportive of a stronger dollar. The central banks of Europe and Japan continue to depress interest rates, weakening the euro and the yen. With China, Europe and Japan on different trajectories and timelines, and central bank policies complicating the ability of free capital markets to set appropriate exchange rates, respective central bank policies have far reaching implications not limited to their borders. The results may be a supercharged dollar (or not if the Fed restrains itself).

Given the geopolitical and energy market uncertainties worldwide and the weakness in emerging markets and Europe, investors are incentivized to direct capital flows to the U.S. This is also supportive of the dollar and may drive equity market performance as valuations favor equity over debt. U.S. residential real estate may similarly benefit.

A strong dollar may also create some economic headwinds as U.S. exports become more expensive to foreign buyers and imports from abroad may rise, thus redirecting GDP growth from the domestic economy. A stronger dollar may also result in a drag on corporate earnings due to currency losses upon conversion of unhedged operations into U.S. dollars for financial reporting purposes. Finally, the collapse in oil prices may result in reduced capital expenditures in the coming year, a negative for the economy, but may also provide a larger stimulus to U.S. and global discretionary consumer spending.

Reading the Tea Leaves

In uncertain times, the importance of sound portfolio construction is paramount. Investing in the 30 year bond at the outset of 2014 would have yielded a return near 30% but the risks were great and could have resulted in a large loss if interest rates rose. The valuation thesis for Europe seemed enticing but the European economy suffered a setback. Although small cap stocks have a history of outperforming larger companies, the large caps attracted capital due to worldwide uncertainties and depressed bond yields. Our goal is to participate in the high performing sectors of the capital markets while balancing the downside risks. We therefore continue to fully diversify client portfolios while deploying our best judgment with respect to asset class and sector allocations.

Best Wishes for the New Year

All of us at KLS greatly appreciate the confidence and trust that our clients have in our firm. We are mindful that we must earn this each and every day. We wish you and your loved ones a Happy, Healthy and Prosperous 2015.

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.

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