Walker & Associates

Fourth Quarter 2014 *Key Takeaways*

As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, positive economic indicators in the United States relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets).

Large-cap U.S. stocks continued their unusually strong and unbroken stretch of gains. The S&P 500 rose 14% and avoided even a modest 10% "correction" for the third year in a row.

Most other major stock markets fared poorly in 2014. Developed international stocks lost 5% and emerging-markets stocks dropped 2%. These returns reflect the significant headwind presented by the strengthening U.S. dollar. Again, relative to history, we have seen an unusually strong stretch of U.S. outperformance relative to foreign markets.

Contrary to the consensus, the 10-year Treasury yield declined further and bond prices rose. The core investment-grade bond index was up nearly 6% for the year and municipal bonds also fared well. Credit-sensitive sectors such as high-yield (to which we have modest exposure through some of our absolute-return-oriented bond funds) and floating-rate loans lagged.

While our diversified portfolios participated in the strong U.S. stock returns, they faced several headwinds for the year including our investments in foreign stocks and our underweighting of core, investment-grade bonds. Our domestic large-cap equity managers, like most of their stock-picking peers, also struggled to keep pace with the broad stock market this year.

In terms of the investment environment, the U.S. economy looks to be in pretty good shape over the near term. Fed monetary policy remains something of a wild card, but based on the Fed's words and actions, we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.

However, our assessment of the attractiveness of U.S. stocks is based on a *longer-term* (five-year) assessment of potential returns across a range of scenarios. That analysis continues to indicate that the expected returns from U.S. stocks are in the low single digits (or worse) over the range of outcomes we consider most likely, and therefore not sufficient to fully compensate clients for their downside risk.

Our view is that Europe offers higher return potential (low double digits in our base case), reflecting the fact that we believe earnings are temporarily depressed, while valuations are reasonably attractive. However, we are not increasing our allocation to European or developed international stocks because we believe the deflation or stagnation risk in Europe is not yet adequately priced in.

Similarly, we remain optimistic about emerging markets' long-term fundamentals and believe they are likely to outperform U.S. stocks over our five-year investment horizon, but have held off on increasing our exposure based on potential shorter-term downside risks and volatility.

On the fixed-income side, we think higher rates are likely over our multiyear investment horizon, although the timing and magnitude are uncertain. As such, more than half of our fixed-income exposure remains in flexible and absolute-return-oriented bond funds.

Fourth Quarter 2014 Investment Commentary

As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil, positive economic indicators in the U.S. relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets). In the financial markets, the year saw strong gains for U.S. large-cap stocks and core bonds with lagging performance elsewhere.

Looking first at the investment environment, oil prices hit five-and-a-half-year lows in late December (falling 40% in the fourth quarter alone) as new sources of supply met with potentially slowing global demand. While a decline in oil prices is typically viewed as an unambiguously positive development for the global economy, the result this time around is different because of the rapidity of the plunge and the current fragile global economic environment. With deflation concerns already high in Europe in particular, the oil price decline was seen as intensifying the deflationary risks.

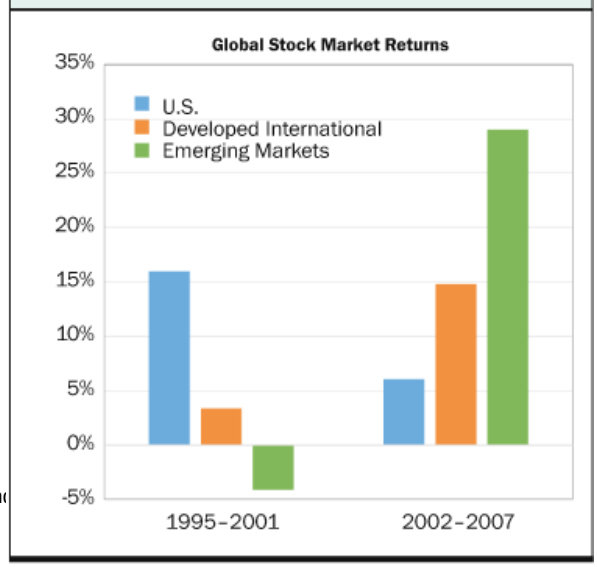
One offsetting factor that helped the markets regain their footing in the fourth quarter (as it has many times in the post-financial-crisis period) was the ongoing influence of central banks. Even as the Federal Reserve suggests it is on track to begin raising rates in the face of U.S. economic improvement, it once again soothed markets by reaffirming that it would continue to be patient in shifting its stance. Given the poor economic conditions that persist in Europe, investors continue to expect the European Central Bank to take a more meaningful step toward full quantitative easing (i.e., purchasing bonds and other assets with the aim of stimulating the economy). Central banks in Japan and China expanded their stimulative policy efforts over 2014. The takeaway is that even as the Fed may begin scaling back its support, there appears to be no shortage of supportive monetary policy globally At the same time, the fact that central banks continue to undertake (or contemplate) aggressive action provides a reminder of the broader economic risks we continue to navigate.

Against this backdrop, the S&P 500 index gained almost 14% and, for the third year in a row, avoided even a modest 10% “correction.” On the other hand, U.S. small-cap stocks, dropped more than 13% from their summertime high through mid-October, and ended the year up 5%. Outside the United States, most major stock markets performed poorly. Developed international stocks lost 5% and emerging-markets stocks dropped 2% (based on MSCI EAFE and MSCI Emerging Markets indexes, respectively). These returns reflect the significant headwind presented by the strengthening U.S. dollar, which detracted from returns for dollar-based investors.

Contrary to the consensus coming into 2014, the 10-year Treasury yield declined and bond prices rose. The core investment-grade bond index was up 5.8% for the year and municipal bonds also fared well. Outside of core bonds, sectors such as high-yield (to which we have modest exposure through some of our absolute-return-oriented bond funds) and floating-rate loans lagged.

Finally, when it comes to the financial markets, we think it’s worth putting recent results into the context of history. This has been an unusually long and strong period of positive performance for large-cap stocks. Since 1945 there have only been three other periods (out of 51 total) where the S&P 500 has had a longer streak of gains without at least a 10% correction, according to Ned Davis Research. In addition, over the

Equity Markets Go Through Cycles and It Is Unwise to Extrapolate Recent Trends Far Into the Future



Source: Morningstar.

past two years, the S&P 500 has outperformed both developed international and emerging-markets indexes by an unusually large margin relative to history. These observations don't mean U.S. stocks are *necessarily* set to tumble in the near term, but we think this data does provide some perspective as an argument for global portfolio diversification and prudent risk management.

Our Asset Class Views Looking Ahead

U.S. Stocks

In terms of the investment environment, the U.S. economy looks to be in pretty good shape for the near term. There are several positives: the labor market continues to strengthen, inflation remains subdued, manufacturing indexes and other leading economic indicators are consistent with solid GDP growth, falling oil prices should boost consumer spending, and government fiscal policy is likely to become more of a growth tailwind than a headwind as the impact of past budget cuts rolls off.

Fed monetary policy remains something of a wild card, but based on the Fed's words and actions, we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.

While the economic and monetary backdrop looks likely to remain broadly supportive over the near term, our assessment of the attractiveness of U.S. stocks is based on a longer-term (five-year) assessment of potential returns across a range of scenarios. That analysis continues to indicate that the expected returns from U.S. stocks are in the low single digits (or worse) over the range of outcomes we consider most likely, and therefore not sufficient to fully compensate clients for their downside risk.

European Stocks

In contrast to the United States, the eurozone (ex-U.K.) continues to fight deflationary headwinds. The December year-over-year headline inflation number fell to negative 0.2%, real GDP growth is below 1%, and two-year government bond yields in Germany and France are actually negative, meaning investors are paying the government for the privilege of owning these bonds. Our view is that in Europe we are getting below-trend or below-normal earnings at average to below-average prices, which is why we have a slight relative overweight to European stocks versus U.S. stocks. But we are not increasing our weighting to European or developed international stocks relative to our strategic weighting because we believe the deflation or stagnation risk in Europe is not yet adequately priced in.

Emerging-Markets Stocks

There is a lot of negative news surrounding emerging-markets stocks—such as slowing growth in China and other BRICs and the decline in emerging-markets currencies. Nevertheless, we remain optimistic about emerging markets' long-term fundamentals and believe they are likely to outperform U.S. stocks over our five-year investment horizon. However, we are conscious of the shorter-term downside risk and volatility they pose. This is one reason why we are only slightly overweight emerging markets relative to U.S. stocks as a percent of our equity allocation. The risk posed by dollar-denominated emerging-markets debt is one specific area we've looked at more closely and that we believe supports the modest approach we've taken to this asset class weighting.

Investment-Grade Bonds

From an asset class perspective, we believe investment-grade bonds are likely to generate very low single-digit annualized returns over our five-year investment horizon, which incorporates a range of economic scenarios. Our very low return estimates are explained by the very low current yields and our expectations that interest rates will move higher over our time frame, although the timing and magnitude are of course uncertain. As such, more than half of our fixed-income exposure remains in

opportunistic, flexible, and absolute-return-oriented bond funds that we believe offer superior longer-term risk/reward profiles compared to core bonds.

Floating-Rate Loans

The environment also continues to be attractive for floating-rate loans, as companies have taken advantage of historically low interest rates, locking in attractive levels of fixed-rate financing. As a result, there are few loan issuers with significant near-term maturities, and as a whole, companies have healthy levels of cash flow and interest-coverage. Although there is the potential for short-term downside risk, we believe the asset class will generate mid-single-digit returns over our three- to five-year investment horizon under a range of economic scenarios.

Alternative Strategies

Despite what has been a relatively poor outcome from our allocation to alternative strategies thus far, we think the decision to own them was prudent given what were serious risks to the economy and stock markets at the time. As a reminder the strategies we own are intended to generate long-term returns that are better than core bonds, with much lower downside risk and volatility than stocks and relatively low or no correlation to stock and bond market indexes. Given the valuations of traditional assets, there is certainly a reasonable basis for maintaining our allocation to these strategies.

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