

To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Oil Prices, the 1% and the Tortoise and the Hare

Dear Client,

For 2014, the Dow Jones and S&P 500 stock market indices closed at close to record-high levels with respective gains of 10% and 13.7%. Of the major asset classes, only Global Real Estate posted a larger gain (+14.2%) with most of the other major stock asset classes delivering either small gains or small losses. The biggest loser was Natural Resources, which fell by nearly 13% reflecting the precipitous collapse of oil prices. For investors, diversification was not particularly helpful in 2014; in fact, *close to one-half of the entire gain for the S&P 500 came from just 60 of the largest stocks*. Of the remaining 440 stocks in the Index, the average return was 7.9%. At the other end of the size spectrum, *the smallest 2,000 US stocks gained just 3% on average*. Looking overseas, the Developed Markets indices were down by about 5%, after currency adjustments, while the Emerging Markets were only modestly better (-2%). Overall, the Global Stock Market advanced by just 4.2% (US stocks comprise about 52% of the MSCI All Country World Index). So while the media focused attention on the records being set for “the stock market”, *most of the gains on a dollar-weighted basis were generated by just 60 stocks, or less than 1% of the entire stock market worldwide. The other 99% didn't fare nearly as well.*

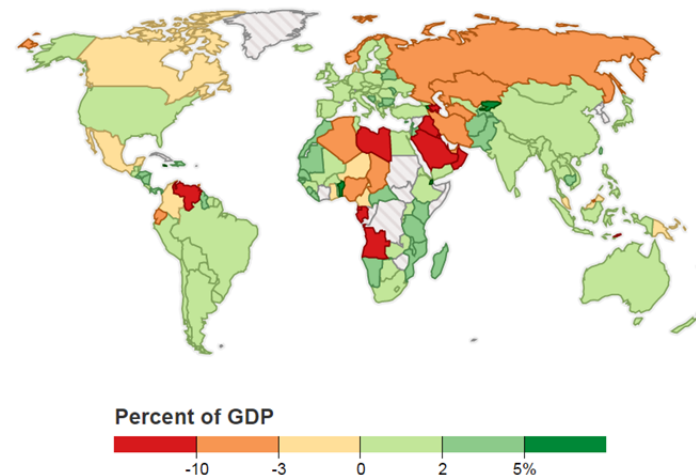
### The Impact of Plunging of Oil Prices

For consumers, the collapse of oil prices has provided a much welcomed economic stimulus (e.g., I paid \$10 less the last time I filled-up my tank compared to the cost six months ago). Consumers will also benefit from lower home heating costs as will corporations which are dependent upon energy for operations and production. Economists estimate that if oil prices remain depressed, the US economy could benefit from cost savings of \$200 billion, or more, over the next twelve months (that's almost as much as the country spends

on Medicaid and about a third of what we spend on national defense). This savings should propel economic growth and help the job market. While most Americans will benefit from lower energy costs, some parts of the country will suffer. Companies involved in the shale energy boom in North Dakota, Texas and Appalachia have seen their profits fall and those which are heavily leveraged could be forced out of business (the price of oil needs to reach about \$60 to \$70 per barrel for the shale industry to thrive). Looking beyond our

### Oil's Fall: Winners & Losers

As crude prices plunge to a five-year low from above \$108 a barrel in June, oil importers will save on their energy bills while exporters will lose revenue. Here's the annualized value of those gains and losses, expressed in percent of GDP:

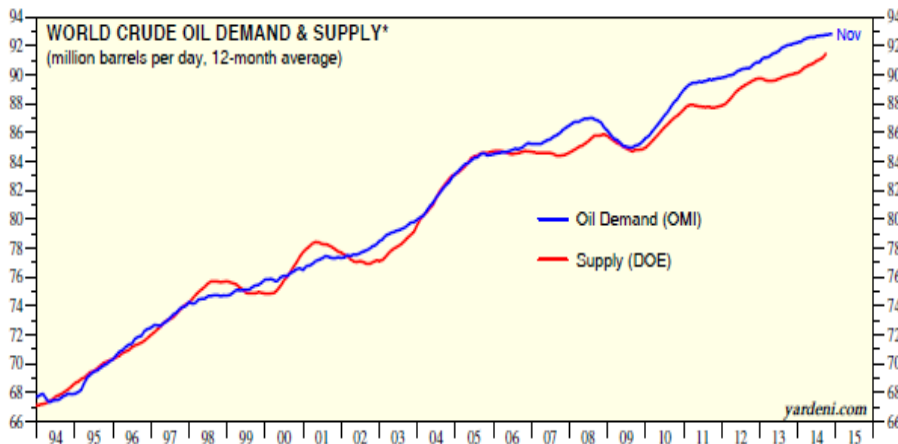


Source: Rhodium Group, EIA and IMF

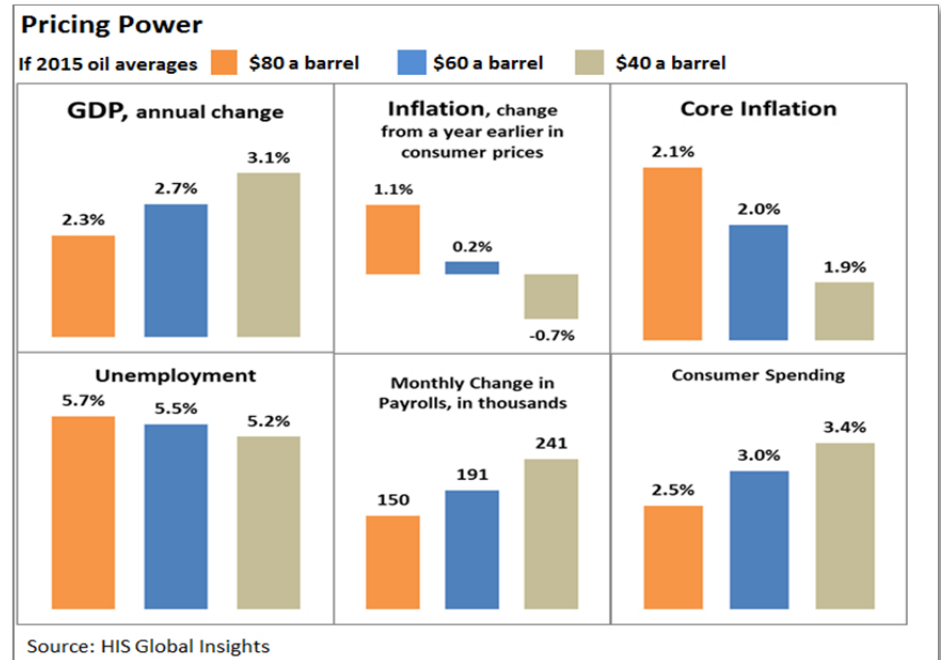
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borders, most of the world's population will also benefit from lower oil and energy costs. The map above indicates in green those countries which stand to benefit from depressed oil prices; countries in red and orange stand to lose the most. Note that while Saudi Arabia is in the red, their cost of production is so low they could withstand low prices indefinitely. Some oil experts surmise that Saudi Arabia is purposely flooding the oil market in order to maintain market share against growing competition from US shale oil production, Canadian tar sands, Russia, Iran and Iraq. Others attribute the collapse to falling demand from a slower growing global economy as well as increased supply.

With all of the potential benefits to the global economy, why has the stock market apparently reacted so negatively to falling oil prices? One would think that low energy costs would be positive for corporate earnings and future stock prices. In looking for answers, we found some pundits suggesting that investors attribute falling oil prices to weakening consumer demand, which might be a sign of a slowing economy. However, based upon a recent analysis of oil demand and supply, we don't believe the falling demand argument is the answer; note in the chart below, **World Crude Oil Demand & Supply**, how the demand through November was rising more or less in line with the supply. While it is true demand is falling slightly in the Developed Economies, growing demand from the Emerging Economies appears to be picking up the slack. Other pundits attribute recent stock market weakness to the bleak outlook for energy stocks against a backdrop of lower oil prices. While stock prices of smaller energy companies, especially, have fallen precipitously over the past few months, the energy sector as a whole comprises just 8% of the Global Stock Market. Given that many more industries will benefit from lower energy prices, it's not clear why investors would turn sour on the entire stock market.

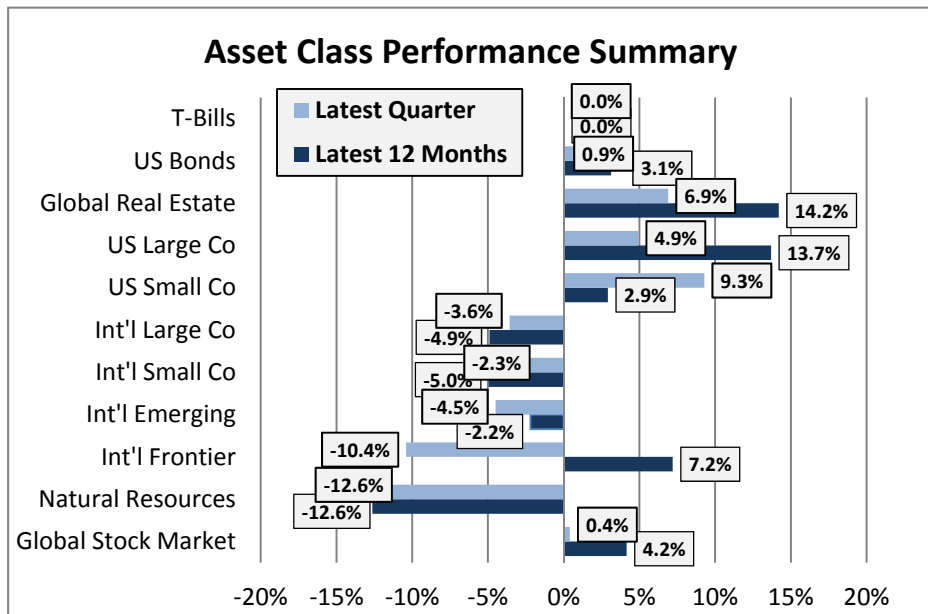


To measure the potential benefit of low oil prices for the US economy (and presumably the global economy), HIS Global Insight, a macroeconomic forecasting firm, has estimated the economic impact under three different oil price scenarios; \$40, \$60 and \$80 per barrel (the price as I write is just under \$47). By all of their measures, including GDP growth, unemployment and inflation, the US economy should benefit significantly from low energy prices (please refer to the **Pricing Power** chart to the upper right). With a few exceptions and despite the recent stock market turbulence, the collapse in oil prices is an unexpected good news story!



### Asset Class Performance Review for 2014

As mentioned at the opening, the Global Stock Market posted a sub-par 4.2% return in 2014 (over the past twenty years, the average gain has been closer to 8%). By far the best returns came from two asset classes; Global Real Estate and US Large Cap Stocks with gains of 14.2% and 13.7%, respectively. The only other bright spot was Frontier Markets which posted a gain of 7.2%. Bonds were surprisingly positive (+3.1%), contrary to dire predictions by those expecting the Federal Reserve to begin raising interest rates (we believe rates will gradually rise and, as a defense, we continue to recommend bonds with short maturities). All of the other asset class returns were in negative territory led by Natural Resources (-12.6%), Int'l Small Co's (-4.9%), Int'l Large Co's (-4.9%) and Emerging Markets (-2.2%). Other than Natural Resources, the International losses were largely attributable to weakening foreign currency relative to the US Dollar (in their local currencies, the foreign markets were generally in positive territory). A strong Dollar diminishes foreign returns for US investors and vice versa; over the long-run, however, such currency swings provide important diversification benefits and should ultimately improve risk-adjusted returns. In 2014, the Dollar was king making this an even better time to rebalance into foreign stocks, or perhaps have even more fun by traveling to Europe where the strong Dollar has discounted prices by about 10%.



For the fourth quarter, the story was pretty much the same. The Global Stock Market barely eked out a gain (+0.4%) with foreign stock returns generally negative and US stock returns positive. US Small Co's provided the strongest return (+9.3%), followed by Global Real Estate (+6.9%) and US Large Co's (+4.9%). Bonds gained about 1% and US T-Bills, once again, had no return. The sharpest decline was in Natural Resources (-12.6%) which had been in positive territory for most of the year until the oil price collapse in the fourth quarter (the full year's loss came in the fourth quarter alone). On the International front, the worst to best performers were Frontier Markets (-10.4%), Emerging Markets (-4.5%), Int'l Large Co's (-3.6%) and Int'l Small Co's (-2.3%). (The fourth quarter swoon for the Frontier Markets reflects the fact that many FM countries are oil exporters.)

#### Active Manager Performance in 2014

As mentioned previously, about half of the S&P 500's gain for the year was derived from just the largest 60 companies (i.e., about 12% of the 500 stocks in the Index). With so few big gainers, one would think that active managers, e.g., managers attempting to beat the S&P 500 Index, should have been able to identify the top performing stocks and deliver above average returns to their investors. As it turned out, however, *85% of all US Large Cap stock managers underperformed the S&P 500 Index. Expanding the stock mutual fund universe*

*even further, we found that only 8% of all 5,500 mutual funds in Morningstar's database out-performed the S&P 500 Index in 2014 (the other 92% had an average return of 3.6%). Would it have been possible to have known which funds would end up in the top 8% in advance? Let's wind the clock back to a year ago and examine the track record of the fund managers who beat the S&P 500 Index in 2013; surely most of those managers would have outperformed in 2014...right? Well, as it turned out, 87% of 2013's winners failed to beat the S&P 500 Index in 2014 - and they missed by a long-shot!*

#### Diversification in Perspective (i.e., the Tortoise or the Hare?)

A globally diversified strategy in 2014 produced a relatively disappointing result, especially compared to the extraordinary returns in 2012 and 2013 of 16% and 23% respectively. With the Dow and S&P 500 Index ending up at near record highs, globally diversified investors were probably surprised to see low single digit gains for their portfolios in 2014. Diversification by its very nature, however, is not designed for short-term results (think of globally balanced diversification as the *tortoise* and any one year's highest performing asset class as the *hare*). Furthermore, the extraordinary return from the S&P 500 in 2014 should be viewed in the context of a longer-term picture. To illustrate this point, *over the past fifteen years, the S&P 500 Index has provided investors with an average compound annual return of just 4.2%.* In contrast and at the other end of the size spectrum, US Small Company stocks (as measured by the DFA US Micro Cap Fund) provided investors with an average compound annual return of 9.9%. Putting those returns into dollars and cents, \$100,000 invested in the S&P 500 Index over the past 15 years would have grown to \$187,000 compared to \$413,000 for Small Cap stocks; more than double the S&P 500 fund's value! Of course, no one knows *in advance* which asset classes will become the best performers. A globally balanced approach, on the other hand, removes the guesswork by allocating across a wide range of *potentially* high performing asset classes and balancing, or mitigating, the volatility of stocks with short-term bonds. While this strategy will never match the return of the best performing asset class in any one period, as in 2014, we believe that a globally balanced approach will continue to provide our clients with the most effective way to achieve their long-term financial goals and objectives.

Asset Class	15 Year Avg Annual Return	2014
US Bonds	5.7%	3.1%
US Large Co's	4.2%	13.7%
US Small Co's	9.9%	2.9%
Int'l Large Co's	2.5%	-4.9%
Int'l Small Co's	8.6%	-5.0%
Int'l Emerging Mkts	7.1%	-2.2%
Globally Diversified with 25% in Bonds	7.4%	3.7%

