Aequitas Investment Advisors

Investment Report - First Quarter 2015

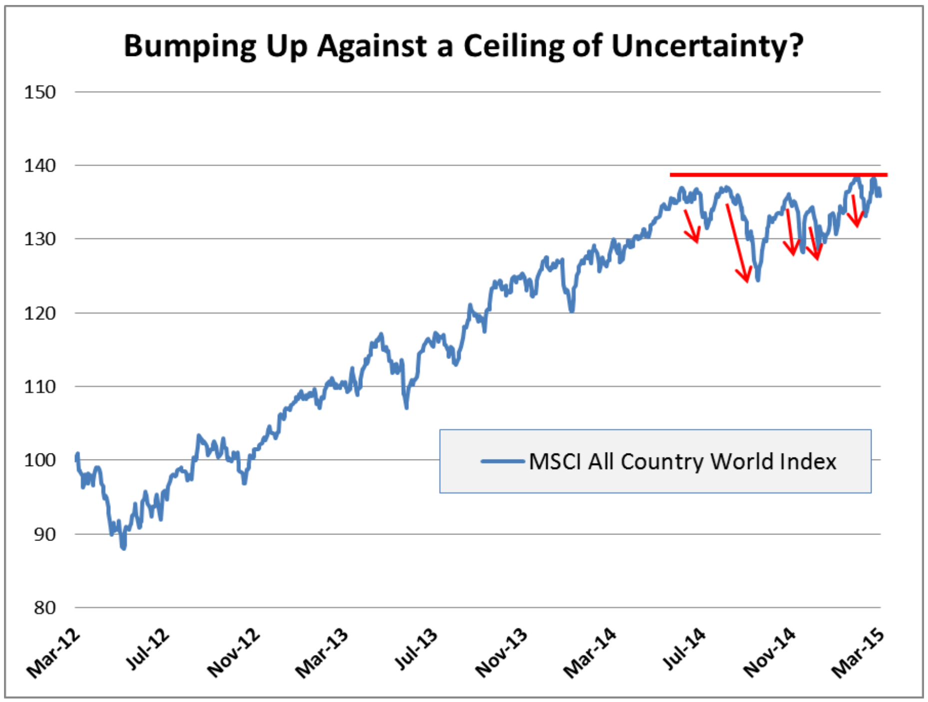
To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Bumping Up Against a Ceiling of Uncertainty?

Dear Client,

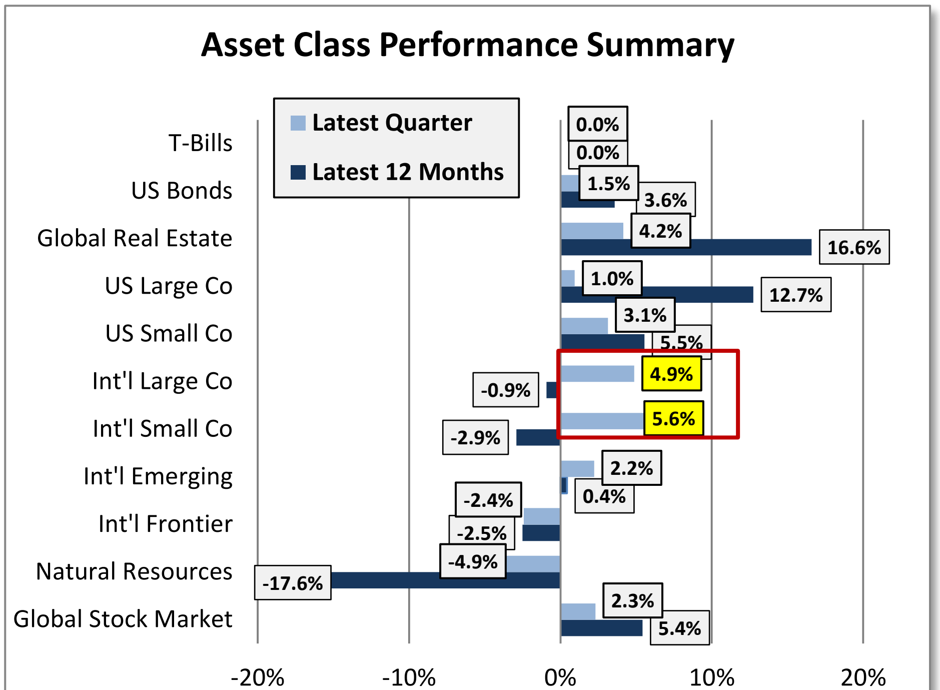
Over the past nine months, the Global Stock Market appears to have been bumping up against a ceiling of uncertainty as investors reacted to a mixed string of economic reports and troubling geopolitical developments. Growth in the US has been a bright spot in the global economy, but the latest employment figures suggest the expansion may be slowing. Some economists predict stronger growth later this year while others see a "new normal" of sub-par growth for the foreseeable future. In Europe, the picture has stabilized and improved somewhat given the positive impact of a weak Euro and aggressive monetary policies, but Eurozone growth is anemic and the situation in Greece remains problematic. Across the Pacific, despite robust stock market returns this year, Japan's economy is barely growing and their long-term outlook is challenged by an aging labor force. In the Emerging Markets, the picture is likewise mixed with oil exporting countries suffering from the collapse in oil prices while oil importing countries, primarily in Asia, are benefiting from reduced energy costs. Although Asia is the bright spot in the developing world, for the first time in more than two decades, China's GDP growth rate slipped below 7%. The challenge facing President Xi Jinping's government is to avoid a sharp economic downturn while implementing various governance and anti-corruption reforms. In addition to the aforementioned uncertainties, investors are concerned about the timing and impact of the Federal Reserve's interest rate hikes. Just a few months ago, it appeared all but certain the Fed would begin raising rates in June following several months of strong jobs reports; however, the latest sluggish figures suggest the Fed may further delay rate hikes.



With all of the mixed signals and uncertainty around the world, it's no wonder the stock market appears to have hit a ceiling. What will it take to break through and further extend the current six year bull market? Most likely, a big part of the answer is a combination of stronger consumer spending and more robust corporate hiring and capital investment. On the consumer spending front, lower energy prices *should* lead to more robust economic growth, but so far, consumers appear to be paying off debts and/or saving rather than ramping up spending. Corporations, of course, want to see stronger consumer demand before they gain the confidence to hire more workers and invest their accumulated profits (a real chicken-and-egg dilemma). Of course, an elephant in the room is the crisis in the Middle East and the threat of global terrorism which weighs upon our psyche and constrains investor confidence. Yet, *despite all of these uncertainties and concerns, consumers and business are more upbeat today than since before the Great Recession began.* According to the University of Michigan's First Quarter Consumer Survey, consumer optimism in the US has reached a ten-year peak. Similarly, the Nielsen Global Consumer Confidence Survey found consumers *worldwide* to be more optimistic about their futures today than they've been in more than seven years. Finally, the April 13th report from Moody's Analytics Survey of Business Confidence reported, “Global business sentiment remains near record highs. US businesses are very upbeat, but confidence has improved in recent weeks across the world.” Perhaps these high readings of confidence will translate into stronger economic growth and help to break through the ceiling of uncertainty.

Asset Class Performance Review *(A Comeback for Foreign Stocks?)*

Globally, stock market performance over the trailing twelve months was modestly positive with a 5.4% gain in the MSCI All Country World Index (about half the historic average return). Reflecting a strong Dollar, Domestic stocks outperformed foreign stocks with US Large Co’s gaining 12.7% and US Small Co’s posting a sub-par 5.5% gain. Overseas, the strong Dollar diluted performance with Int’l Large and Int’l Small Co’s losing 0.9% and 2.9% respectively. The Emerging Markets were flat (+0.4%) while the Frontier Markets, which encompass many oil exporting countries, were slightly negative (-2.5%). Natural Resources were the biggest loser (-17.6%) due to the oil price collapse and slackening demand for resources (good news for keeping inflation low). The biggest winner was Global Real Estate (+16.6%) as investors continued pouring money into higher yielding securities. T-Bills stood still (0.0%) while US Bonds posted a somewhat respectable 3.6% gain (rates fell slightly which boosted bond prices).



For the first quarter, the story was somewhat reversed as foreign stocks outpaced US stocks. Leading the way were Int’l Small (+5.6%) and Int’l Large Co’s (+4.9%) reflecting a shift out of relatively over-priced US stocks toward more attractively priced stocks in Europe and Japan. Global Real Estate was next in line with a gain of 4.2% followed by US Small (+3.1%), Emerging Markets (+2.2%) and US Large Co’s (+1.0%). The Frontier Markets (-2.4%) and Natural Resources (-4.9%) were the only losers for the quarter. T-Bills were flat and US Bonds were in positive territory (+1.5%). The Global Stock Market gained 2.3% which was close to its historic average three month return. The big story for the quarter was the comeback of foreign stocks following a dismal showing in 2014.

The Master Chef of Investing?

In the popular TV program *MasterChef*, contestants face a series of cooking challenges. From low quality ingredients to inadequate preparation and poor implementation, so many things can, and do, go wrong. It’s a bit like investing where there are two broad approaches: active management and “index” investing. Active management is where portfolio managers attempt to find “mispriced” securities or seek to time their entry and exit points in an effort to beat the stock market. This approach is akin to the *MasterChef* challenge which requires inventing a new and distinctive dish within a set time frame. The apparent advantage for the “active” chef is flexibility of concept. Likewise, in the investment world, the active stock manager often focuses on investment themes and/or stock selection. The manager’s goal is to trade on information not believed to be reflected in prices (a major challenge in world where information is instantly available to all market participants). Often, a lot of “chips” are placed on a few investment themes or stocks and the stakes of either winning or losing run high (the vast majority of active managers fail to beat the market).

The second approach, index investing, is where the portfolio manager seeks to track, or mirror, a commercial index such as the S&P 500 or MSCI All Country

World Index. The index approach has become increasingly popular as evidenced by the rapid growth of ETF's (Exchange Traded Funds). The goal here is not to stand out; rather, the primary job of the manager is to track the index as closely and avoid "tracking error" (i.e., deviation from the benchmark). This approach is more akin to the MasterChef challenge in which contestants must cook a standard, popular dish with set ingredients. The focus is not on creativity, but following an established process as dictated by an outside party (e.g., Standard and Poor's or MSCI). However, the drawback of indexing is the absence of flexibility. The contestants can't substitute one ingredient, or individual stock, for another. The recipe must be followed. What's more, it must be achieved in a designated timeframe in order to avoid tracking error.

Fortunately, there's a third approach which combines the creativity of the first approach with the simplicity of the second. In this approach, our contestants do not face unnecessary constraints either in terms of time or ingredients. Instead, they assemble a broad selection of dishes from multiple ingredients appropriate for the season and at times of their choosing. The benefit of the third method is that the chefs can focus on what they can control and eliminate elements that might restrict their choices. After all, their ultimate goal is to efficiently and consistently provide meals that suit a range of palates. In the world of investing, we believe the third way is the optimal approach. Picking stocks and timing the market, like making brilliant-off-the-cuff meals in any conditions and in an efficient and consistent manner, is a tough task - even for the masters. Cooking meals off a pre-selected menu, like the index fund managers, can be inflexible and costly from a performance perspective (costly in that index fund managers must buy and sell their stocks on specific days regardless of the price).

The third way of investing is akin to the approach utilized by Dimensional Fund Advisors (i.e., DFA). Through rigorous academic analysis of historic stock market returns, DFA researchers have identified "dimensions" of expected returns, e.g., Small Cap, Large Cap, Value or Growth, which enable DFA to design highly diverse portfolios that pursue market risk premiums, i.e., areas of risk which have historically provided superior returns. Furthermore, by not being bound to track a commercial index, DFA is able to be more flexible in deciding which securities to buy and when to buy them.

Final Thoughts

We've all heard the expression, "hope springs eternal" in reference to humankind's predilection to choose optimism over despair. In this vein, recent research by the National Academy of Scientists found that humans, regardless of their culture, have a natural tendency to look at life optimistically rather than pessimistically. This may be why the recent University of Michigan and Nielsen consumer surveys report relatively high confidence toward the future despite all of the negative news around the globe. This might also be why many investors (not our clients, of course) look at past performance of active mutual fund managers with the hope of identifying next year's winners despite the overwhelming evidence that historic performance is a poor predictor of future results. Perhaps such investors are displaying what English writer Samuel Johnson called, "the triumph of hope over experience". As a firm, we prefer to use experience as a means of creating hopeful financial futures for our clients. In other words, by utilizing the lessons learned from experience, we can more confidently chart our courses into an uncertain future.

Following one of the most extreme winters in Boston's history, here's to the advent of spring and the opportunity to renew hope for the future!