



Learning from 2014:

A NOD TO DIVERSIFICATION



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“We have always had a philosophy of diversification and an unwillingness to ‘bet the ranch’ on any one stock or group of stocks.”

- In one of the great surprises of the year, long-term interest rates fell sharply, confounding many who expected rates to rise.
- The second great surprise of the year was the sharp collapse in oil prices, which, on balance, we judge to be a net positive for the U.S. economy.
- If history has taught us one thing, it is that predictions, while sometimes interesting, can be dangerous if conditions change and the people making the predictions are inflexible.
- We continue to worry about geopolitical factors that the markets have ignored and will be watching for signs of excess in stocks, but for now, we will revert to last year’s forecast of modest but positive returns in 2015. We expect dividends will continue to be significant contributors to returns.

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Before sitting down to write this year-end letter, we read last year's commentary. It strikes us that so much of what we wrote a year ago still applies. There have been some big surprises in the economy and the world, but for the financial markets, the 2014 playbook and the outlook for 2015 are similar to what we discussed a year ago.

In 2013, the stock market benefitted from a revaluation in the prices that investors were willing to pay for earnings. After three years of disbelief, and of trying to reconcile a weak economy with strong stock prices, people finally realized that the Federal Reserve (Fed)¹ would keep interest rates low for an indefinite period. Money moved out of assets, with virtually no return, and into stocks. Price-earnings (P/E) ratios² rose from 13x to 17x by year-end. Stocks, in aggregate, gained four and five times as much as corporate earnings. With the economy limping along, we credited the zero interest rate policy of the Fed for the benefits accruing to stockholders.

The market gains of 2014 were about twice as much as we had expected, as stocks benefitted from rising allocations. We were not in the camp that interest rates would rise, and our view was that low interest rates would keep stocks from falling materially. Being directionally correct helped keep us in many stocks that had already had large moves.

In one of the great surprises of the year, long-term interest rates fell sharply, confounding many who expected rates to rise. This continued low-rate environment offered support for stock prices, as over a third of the stocks in the S&P 500³ yielded more than 10-Year Treasuries.

The second great surprise of the year was the sharp collapse in oil prices. For the global economy, lower prices are a positive as they benefit consumers and every industry save for the oil industry. For oil-producing countries such as Venezuela, Russia and Brazil, the implications are more onerous, as their near-total reliance on energy production

is really pinching. For the United States, the impact of lower oil prices is more nuanced. Consumers benefit and manufacturing benefits, but the energy industry has been a strong driver of job growth. For financial markets, moves like this one can be troublesome – as sharp, unexpected moves often unearth previously unforeseen risks. For example, smaller exploration and production companies issued copious amounts of debt to finance their operations — debt that will be harder to service in a lower commodity price environment. On balance, however, we judge the huge drop in prices to be a net positive for the U.S. economy.

One can reasonably ask why, with measures of the economy showing improvement, the Fed is so reluctant to raise interest rates. We believe that for every sign of improvement in measures like retail sales or unemployment there are some offsets. Wages have been stagnant and labor force participation has declined. The jobs being created are not the high-paying ones of yesteryear. Home prices have slipped from recovery levels. The asset inflation that rallied stocks and bonds did not benefit the average working person. The drop in gasoline prices is helping consumers — the largest driver of the U.S. economy, and yet the Fed hesitates for fear of potentially derailing the recovery.

Clearly, the Federal Reserve remains more concerned with potential deflation than inflation. As we have said repeatedly, the financial crisis was exceptional and entirely different from other post-World War II recessions. Asset prices collapsed across the board, and the fallout continues to impact both businesses and consumers. Household balance sheets have improved from the very stretched and dangerous levels of 2007, but remain strained relative to prior decades. While wages appear to be rising a bit, consumers are increasing their spending more than their incomes are rising.

As we reflect on the role that the Fed has played in lifting the markets since the crisis, concerns begin to arise. Without the measures deployed in the teeth of the crisis, the global economy's downturn would have been far worse. However, more than five years have passed, and it is unsettling that so much of the world economy depends on central bank

¹ **The Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

² **The price-to-earnings (P/E) ratio** is a stock's price divided by its earnings per share.

³ **The S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

actions. Rising capital markets ought to reflect strong underlying economic activity, not central bank manipulation. The very low cost of money has resulted in some excesses, as the availability of cheap money enabled large amounts of leverage⁴ to be used in markets. One sign of such excess can be seen in the collapse of commodities prices in 2014. The unwinding of leverage likely had as much to do with the declines as fundamental factors.

We have always had a philosophy of diversification and an unwillingness to “bet the ranch” on any one stock or group of stocks. The market in 2014 had a rapid rotation from sector to sector. While the collapse in oil prices recently dinged some energy investments, other areas more than offset those declines. Our view of the “Golden Age of Dividends”, as we named it in March 2013, continues to play out. Utilities, thought by many to be candidates for worst performers for 2014, turned in the best performance of any sector as their steady dividends continued to appeal to yield-starved investors.

If history has taught us one thing, it is that predictions, while sometimes interesting, can be dangerous if conditions change and the people making the predictions are inflexible. We continue to worry about geopolitical factors that the markets have ignored. The instability in all of the Mideast and Russia seems to have been overshadowed by a sense of financial invulnerability stemming from central banks’ actions. We will be watching for signs of excess in stocks, but for now, we will revert to last year’s forecast of modest but positive returns in 2015. We expect dividends will continue to be significant contributors to returns.

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⁴ **Leverage** refers to the amount of debt held by a company or sector of the market.

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