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**2014 Year-End Review**

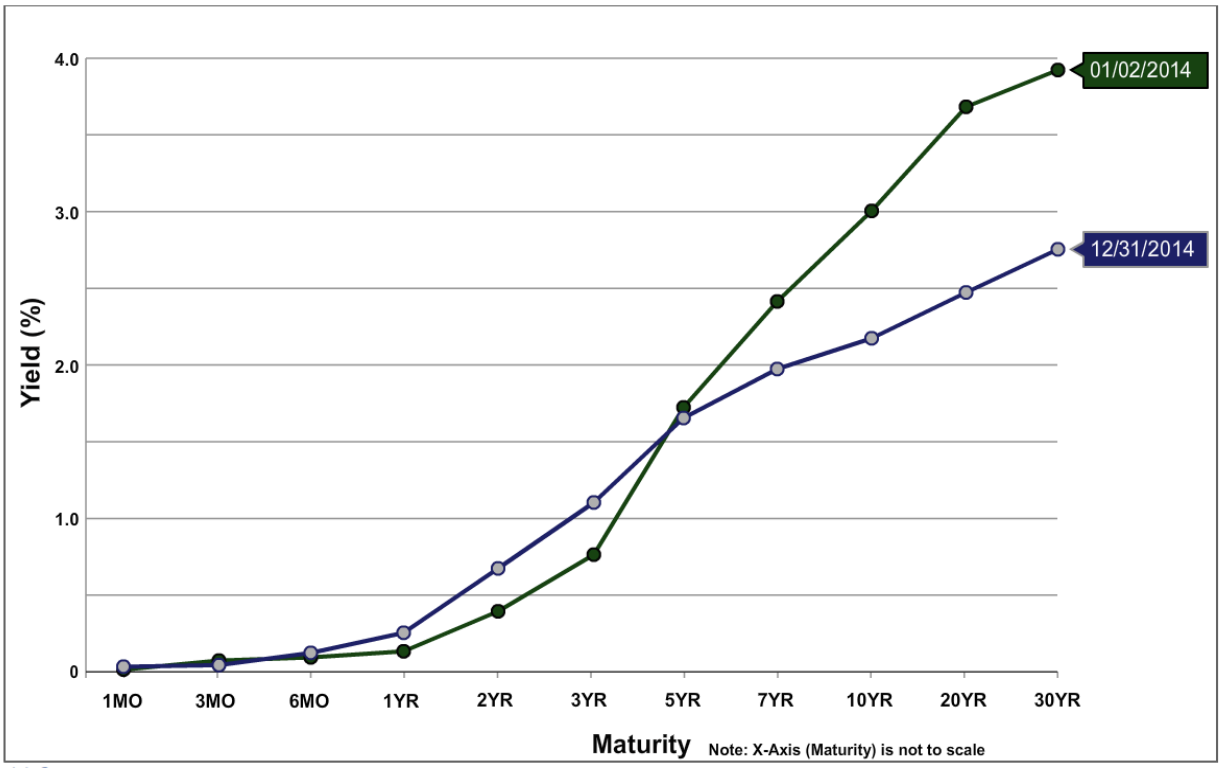
## The Year In Review

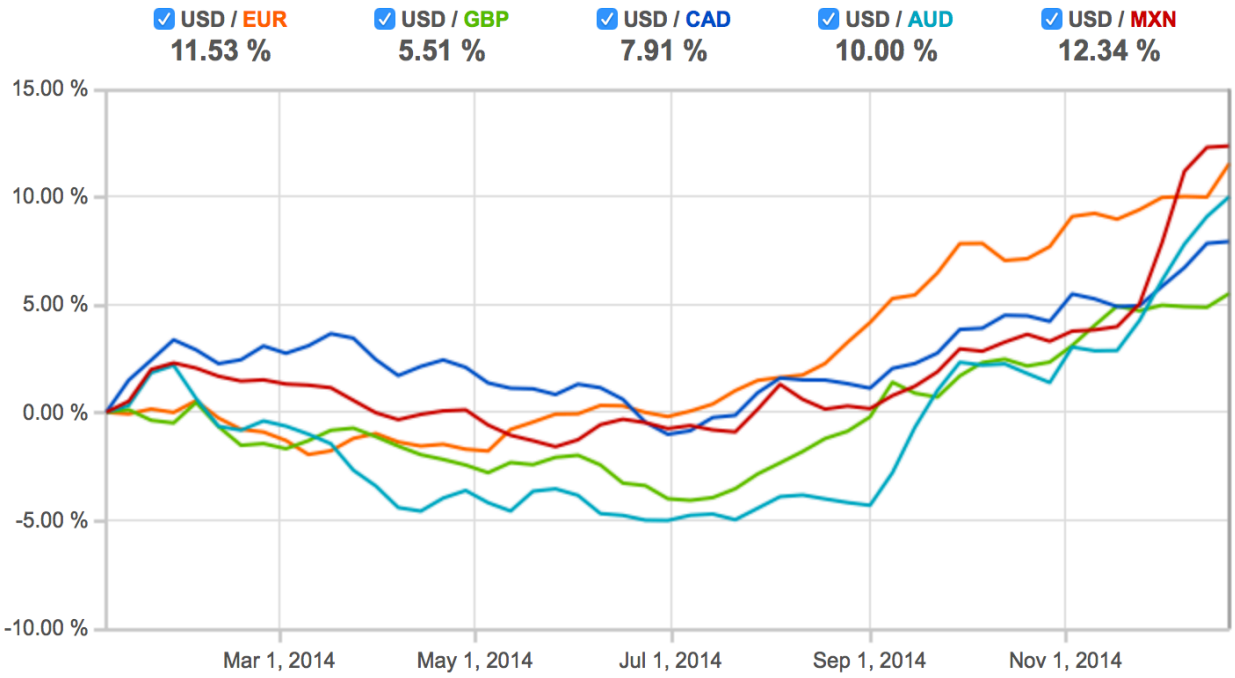
2014 was a tale of two halves in investment markets with the biggest surprise being the out-performance of long-dated US treasury bonds. Most analysts, portfolio managers, and investment professionals, including myself, were quite bearish on long-dated US bonds at the beginning of 2014. The reason being that with interest rates so low and the Federal Reserve gradually stopping their quantitative easing program and indicating a possible increase in interest rates somewhere in the not-too-distant future, the expectation was this would be bearish for fixed income investments whose prices go down as interest rates rise. The longer the maturity of a fixed income security the greater the interest rate risk and so pretty much everyone in the industry was recommending staying away from fixed income at the beginning of 2014, or at least holding short-term rather than long-term bonds.

As it turned out long-dated treasuries were up over 20% on the year, easily outperforming all other asset classes. The reason behind this is that yields on long-dated treasuries actually dropped substantially over the course of the year despite the lifting of the Federal Reserve's quantitative easing program.

The first chart on the next page shows a comparison between the US treasury yield curve at the beginning of 2014 with the same curve at the end of 2014. A yield curve shows the yield, or interest, paid on bonds of various maturities – in this case US treasury bonds. As you can see the yield curve was quite steep at the beginning of the year, but over the course of the year the yields on bonds longer than 5 years decreased substantially leading to a flattening of the yield curve at longer maturities.

It is a bit of a mystery as to why this should occur at a time when quantitative easing is being lifted (which amounts to a de facto increase in interest rates) and so one would expect short-term yields to rise and long term yields to at least remain stable. I suspect two things led to this decrease in long-term rates: First of all, while the Federal Reserve did exit its quantitative easing program it also indicated that an increase in interest rates was still some time away and would depend on the state of the US economy and on inflation. The US economy seems to be doing well, especially compared to other regions, however there is still a great deal of uncertainty as to whether this can last – "fragile" is the word that is often used. Also, inflation is still very low and so there seems little reason for the Fed to raise interest rates yet. Secondly, the US Dollar increased in value over the course of 2014 vs. many other currencies. This can be seen in the second chart on the next page in a comparison of USD vs. the Euro, British Pound, Australian and Canadian Dollars, and the Mexican Peso. I suspect the strengthening USD attracted positive investment flows into US treasuries, helping to drive down yields.



The charts below show the performance of various types of investments over the course of 2014. As I said, it was a tale of two halves, as can be seen from the two charts – the first representing the first half of 2014 from January to end of June and the second the second half from July to the end of 2014.

There are a number of curves on these charts but the sense is clear. Here is a key to what each curve represents:

SPY: US Stocks (S&P500 index)
DJP: Commodities (Dow Jones – AIG Commodity index)
EFA: Non-US Developed Market Stocks (MSCI EAFE index)
EEM: Emerging Market Stocks (MSCI Emerging Market index)
GLD: Gold
TLT: Long-dated (20 year+) US treasury bonds
AGG: US Bonds (Barclay's aggregate bond index)

As can clearly be seen, the first half of the year was characterized by a general increase in all asset classes, with gold, long-dated treasuries, emerging markets, and commodities outperforming the US stock market. However, the second half of the year was totally different. A strengthening USD, a dramatic and sudden decrease in the price of oil, and concerns about an economic slowdown outside the USA along with an improving economic picture in the USA, led the US stock market and long-dated US treasuries to significantly outperform other asset classes. Commodities suffered the most as the price of oil fell about 50% in the second half of the year. The Dow Jones – AIG commodity index fell by 25% in H214 since this index has a significant oil price component. Emerging and non-US developed stock markets as well as gold fell by 10% in the latter half of the year in USD terms.


This is the second year in a row where portfolio diversification has been a significant drag on performance. In 2013 the US stock market did very well while almost all other asset classes did poorly; including, by the way, long dated US treasuries, which were down 15% in 2013. This shows the volatility of long-dated bonds and the perils associated with investing in funds of these bonds. Many people think bonds are inherently safe investments, especially US treasuries, and this may be the case for bonds held to maturity where the yield to maturity is known – but a bond fund is another matter altogether and, as can be seen by the -15% return in 2013 followed by the +20% return in 2014, such bond funds can be quite volatile, even more so than the stock market at times.

Someone holding only US stocks in their portfolio would have done very well over the last two years. However, for most investors who seek to mitigate their investment risk through diversification, these past two years have resulted in this diversification being a significant drag on investment returns.

## Looking Ahead

It is always interesting to review what I wrote a year ago in the Looking Ahead section of this annual review. Last year I went to great lengths to explain why fixed income investments, especially long-dated bonds, would be a poor investment going forward. I even went so far as to call the bottom in this bond market, which has been so strong ever since the 2008 financial crisis. Clearly, with a 20% return in long-dated treasuries in 2014, I spoke too soon. So now I will go out on yet another limb to say that after such a strong year in US treasuries, with 30-year treasury yields now at a miserly 2.75%, it is difficult to

imagine how we could have good returns in such long-dated bonds going forward. Unless there is another financial crisis or a global recession, it is difficult to imagine investors wanting to lock in their money at 2.75% for 30 years. The only possible reason for doing so is if there was a significant perceived risk to investment markets or the global economy, in which case investors tend to turn to the safest investments available, which are still considered to be US treasuries. Barring such an event, it is difficult to imagine long-dated bonds offering good returns going forward and so I would advocate using dividend-producing investments in place of fixed income on the more conservative or income-producing side of investment portfolios.

I did get a few things right a year ago – I sounded the alarm for gold and oil prices, saying that I expected a decrease in both in 2014 and I was especially concerned about a dramatic selloff in oil as shale oil came on-stream in the USA and emerging market economies slowed. As a result of this we mostly managed to avoid the carnage in commodity markets this year. Going forward I think there will be a stabilization in oil prices, perhaps in the $60 - $80 range. There has also been a selloff in many other hard commodities over the last few years and I think we might see some stabilization here as well. At these levels I think it may be wise to once again put some money into commodities. Commodities offer good diversification benefits within an investment portfolio and, with the selloff over the last couple of years, I think much of the downside risk should be gone in this asset class.

Similarly, gold tends to be a good diversifier within a portfolio and with gold prices down 40% since their peak in Q311 it may be a good time to tiptoe back into this market. It should be noted that gold prices are still way up over the last decade, vastly outperforming all other asset classes. Gold is up about 160% over the last ten years; the next best performing asset classes, emerging market stocks and the US stock market, are both up about half that amount. Also gold traditionally does well when the USD is weakening and inflation is increasing, neither of which are present today. On the other hand, many emerging market investors, especially in India and China, like to hold gold. As wealth increases in these countries this should be positive for gold prices. Also, if there is a global slowdown, or some sort of crisis this would be positive for gold. Low interest rates are also positive for gold and other commodities as the opportunity cost of holding non-dividend producing investments versus holding money in a bank account is low the lower the interest rate. All this to say it is a mixed bag for gold, but perhaps a small allocation for diversification purposes might be beneficial.

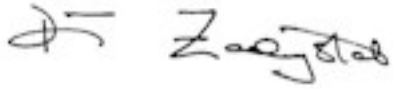
Given the disparity between the current performance of the US economy versus the European economy and certain emerging markets, one would expect the US stock market to, once again, outperform other markets. Also, the USD continues to strengthen vs. the Euro especially as interest rates are lowered in Europe and there are hints of a quantitative easing program being expanded there. A weaker Euro would positively impact profits of European firms that have significant business outside Europe, especially those with large US exposure. For this reason, I would not be averse to an investment in large, blue chip European companies – but I would seek to hedge out the currency exposure vs. the USD.

Many emerging markets are now significantly cheaper than the US market when measured by metrics such as price/earnings or price/book value. Again there may be currency risk here if the USD continues to strengthen and there is also a generally negative view amongst investors with respect to emerging markets these days, so I think it will be important to pick and choose wisely within this asset class over the next year.

I think it will also be important to choose wisely within the US stock market in 2015, we may not see yet another year of good returns in the broad US market but opportunities are likely to appear in some beaten down sectors and perhaps amongst companies that benefit from lower energy costs. Caution also needs to be paid to US companies that receive a significant amount of income from overseas. If the US Dollar continues to strengthen this would be negative for profits of these companies repatriated from abroad. This year it may be a better tactic to focus on companies that derive much of their income from within the USA.

There may also be good opportunities in some commodity-producing companies outside the oil industry if commodity prices stabilize or perhaps even increase. Many mining companies' and other commodity-focused companies' stock prices have taken a beating over the past few years and there has been some consolidation in the industry – now some of these companies offer good dividend yields and perhaps the worst is behind them. I would be more cautious of those companies whose fortunes are linked to the price of oil. Even though their stock prices have gone down recently, the decrease in oil prices has been so rapid that perhaps lower oil prices are not fully reflected in these companies' revenues as yet, especially if they have oil hedging programs in place. As these hedges expire if the oil price doesn't increase, this could lead to much reduced income for such companies going forward.

Best wishes in the New Year,



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