# Investment Commentary: 11/2014

Stocks bounced back from their brief October decline and posted solid gains in November. The S&P 500 was up 2.7% for the month and has risen 14% for the year to date. Smaller-cap stocks also rebounded strongly from their mid-October lows, but continue to trail larger caps by roughly 12% year to date.

Positive economic indicators released during the month included revised third-quarter U.S. GDP growth, which showed the U.S. economy rising 3.9%, driven in part by upward adjustments of consumer and business spending. The month also saw a continuation of strong jobs data. New job creation in the United States has averaged more than 200,000 jobs per month for the past six months and unemployment is at 5.8%. However, measures of long-term unemployment remain elevated and wage growth, while showing signs of improving, has been very slow.

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U.S. economic trends continue to contrast sharply with those of other major economies: Japan has officially entered recession, Europe's growth is barely positive with inflation worrisomely low, and major emerging markets—China, India, and Brazil—have all shown signs of slowing. Global central bank policy reflects these divergent conditions. The People's Bank of China cut rates in November while European Central Bank President Mario Draghi reiterated his willingness to undertake more aggressive stimulus measures to boost Eurozone inflation. These followed the Bank of Japan's move to increase the scale of its asset purchases (announced October 31). More recently, Japan's Prime Minister Shinzō Abe dissolved parliament and called for a December election as a referendum on his "Abenomics" program of economic improvement.

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International markets posted mixed returns in November, with the MSCI EAFE gaining 1.4% and the emerging markets losing 1.1%. Strength in the U.S. dollar continues to weigh on returns for U.S. investors. Near-term we expect this trend to continue, however relative valuations are attractive enough to maintain allocations. As we approach year end, stocks are following a similar pattern to 2013, with the U.S. market significantly outperforming developed and emerging foreign benchmarks. Barron's magazine cites a telling statistic: "The Standard & Poor's Global Broad Market Index, which includes 48 markets, has gained 4.4% this year. Subtract the U.S. however, and the S&P Global BMI is down 1.6%."

Oil prices continued downward during the month with prices dropping sharply following OPEC's announcement on Thanksgiving that it did not intend to cut production. The fall in oil prices is favorable for U.S. consumer spending, and that of businesses such as airlines, as gas takes up a smaller share of the budget.

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However, the price decline has hit energy-related stock-market sectors hard and, accordingly, funds that have exposure to those names. Oil-exporting countries face an economic headwind with less economically resilient countries (such as Russia and Venezuela) viewed as more vulnerable.

Turning to the bond market, long-term Treasury yields declined further in November and the aggregate bond benchmark rose 0.71%. Bond yields in other major markets (Europe and Japan) are at record lows, helping to boost demand for the relatively attractive yield of U.S. Treasury bonds. High-yield bonds declined slightly in November.

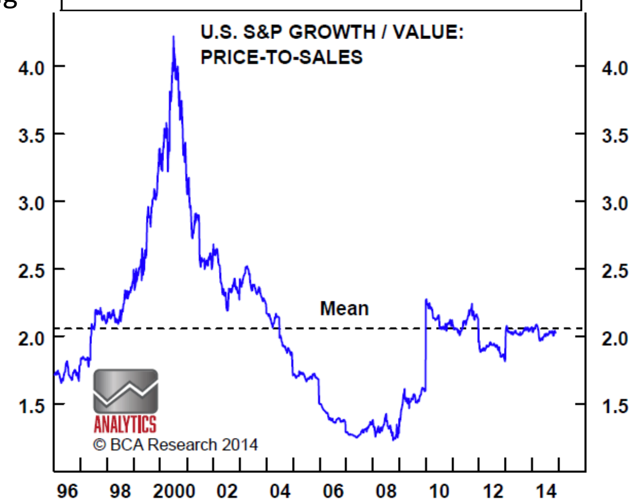
This period continues to be a challenging one because of the disconnect between market levels, interest rates, different stress points in the global economy, and the sizable impact of central bank policies—just some of which we've touched on above. Overall this is a combination of influences that should keep any sensible investor from being overly confident in their portfolio positioning; we expect volatility will continue to increase in 2015.

## Growth vs. Value

2014 looks to be another strong year for U.S. stocks, with major indices regularly hitting new highs. However, beneath the surface we are seeing several shifts, defensive stocks are outperforming cyclical stocks, large caps are leading small caps, service companies are beating goods producers and growth stocks are leading value stocks. It is counter-intuitive but growth stocks often outperform when economic growth is slow, and their relative performance frequently shows an inverse relationship with leading economic indicators. Many investors think of growth stocks as speculative companies. However the reality is they tend to have higher quality earnings and lower operating leverage, which helps explain why they tend to outperform in slow growth environments. The top table shows how the sector composition for the growth indices skews towards tech and healthcare compared to a heavy weighting in financials and energy for the value indices. The bottom chart shows that the relative valuation of growth vs. value is near its historical average of the past 20 years. Given our expectation of a continued but slow recovery, the sector composition and relative valuation, we think growth stocks are likely to see a small tail-wind and continue their outperformance.

**Sector Composition**

| SECTOR | S&P 500 GROWTH SECTOR % WEIGHT | S&P 500 VALUE SECTOR % WEIGHT |
|---|---|---|
| INFORMATION TECHNOLOGY | 28 | 10 |
| HEALTH CARE | 17 | 11 |
| CONSUMER DISCRETIONARY | 16 | 7 |
| INDUSTRIALS | 12 | 9 |
| FINANCIALS | 9 | 24 |
| CONSUMER STAPLES | 8 | 11 |
| ENERGY | 5 | 14 |
| MATERIALS | 4 | 3 |
| TELECOM SERVICES | 1 | 4 |
| UTILITIES | 0 | 7 |




Source: BCA Research

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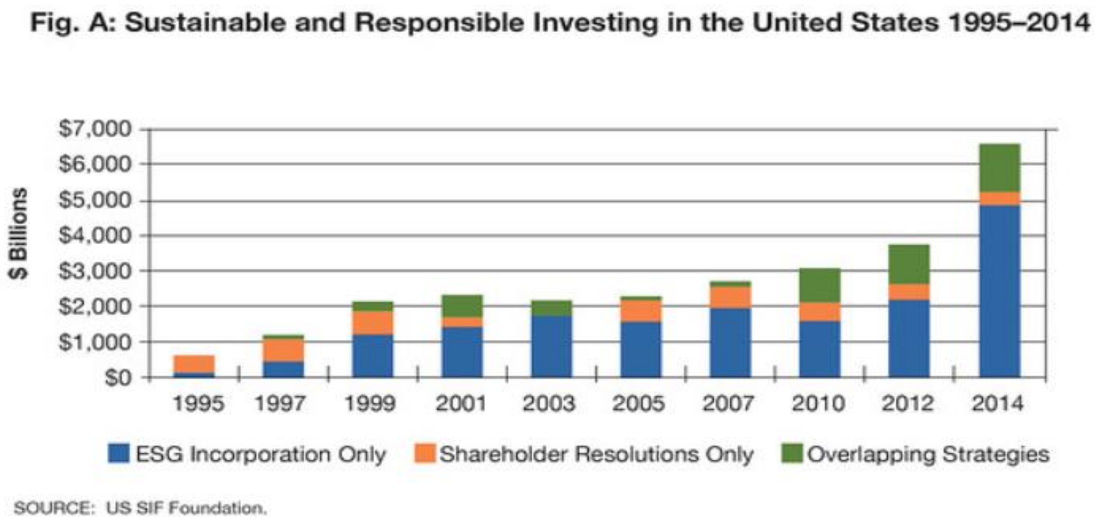
## Growth of Sustainable and Responsible Investing (SRI)




A recent study by the U.S. SIF Foundation, an advocate for the SRI industry, shows how large the demand for socially-responsible investing has become. According to the study the SRI industry in the U.S. has grown 76% over the past two years and now accounts for $6.57 trillion in assets, which is roughly 18% of all professionally-managed assets. Regardless of the exact figure the trend is clear and clients are looking for their investment managers to incorporate socially-responsible investing into their offerings. We continue to grow our skills in this area and will make this an available option for clients that are interested. If this is something you would like to discuss or incorporate into your portfolio, please let us know.

## Do you think like a Hedgehog or a Fox?

One of our favorite books from the past couple of years is Nate Silver's "The Signal and the Noise." The premise of the book is that in an era of readily available data and technology, there are still a lot of ways for predictions to go wrong thanks to bad incentives and bad methods. In other words, increased access to information can do more harm than good. Making it easier for people to cherry-pick the data that supports their premise, or to perceive patters where there are none. According to Silver our thinking style impacts how well we make predictions (and invest). Specifically our success may depend on whether we think like a "hedgehog" or a "fox", below is a brief description of each thinking style.

**Hedgehogs:** are usually supremely confident, dismiss opposing views and are drawn to big conclusions based on models or big ideas. They to stick with their "all-in" approach and use new data to refine their old models. Mistakes are blamed on idiosyncratic circumstances, in other words their good model just had a bad day.

**Foxes:** tend to be cognitively flexible and take a multitude of approaches to a problem. They tend to be humble, consider competing views, and doubt the power of models and big ideas. They typically incorporate ideas from different disciplines and sources and see the universe as complex and recognize some fundamental issues are unpredictable.

Needless to say, Foxes tend to be better predictors and investors. We think Silver's book is highly applicable to the financial markets and has valuable lessons for both professionals and layman. In our opinion, the majority of professionals in the financial industry tend to be hedgehogs, regularly making boastful claims and slavishly following errant models. Thankfully our temperament, experience and process keeps us firmly in the Fox camp.

We remain humble in our ability to predict markets and events, but stridently seek new information from the best independent research providers to help us make good decisions on behalf of our clients. We expect that markets will undergo some significant changes over the next couple of years as global monetary and financial policies change and hopefully normalize. Making it important that we think more like Foxes than Hedgehogs to navigate the changes we expect.

We believe our passion to succeed on behalf of our clients and our ability to think like Foxes is why we have been able to serve our clients so well for so long. We believe it also positions us well as we move into an uncertain future. We appreciate your confidence in us and wish you and your family a very Happy Holiday season!

—AWM Investment Team