KEEL POINT

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The Year in Review; the Year Ahead

As is our custom we leap into the new year with some analysis of the one we leave behind and some thoughts on the one ahead. We trust you had a wonderful holiday season and wish you all the best in the coming year. We are enormously grateful for the trust you place in us and the opportunity to help you reach your financial goals.

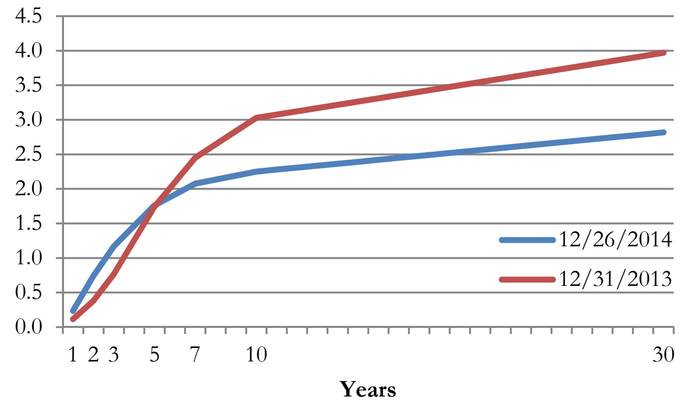
Domestic Strategies

It paid to invest in America in 2014. Chances are you earned a positive return if you bought American stocks or real estate. Standard & Poor's thinks the companies in the S&P 500 will earn $117 per share this year, a 9% year-over-year increase. Profit growth has coincided with a strong year for the economy – over the last four quarters for which data is available GDP has grown by 2.7% while an average of 190,000 jobs have been added each month in 2014. Consumer confidence is riding high (16 points above the 10 year average according to the latest University of Michigan survey). Equity markets were up between 5.8% (Russell 2000 index of small cap stocks) and 15.3% (S&P 500)*. Real estate thrived – the FTSE NAREIT, a broad measure of real estate investment trusts (REITs), generated a 29.6% return for the year.

Securities related to the oil business were the exception to our American heuristic. Weakening demand and OPEC's move to defend market share revealed the oil market's half-life: the drop from $101 to $51 took just six months from June. The viability of many unconventional US fields is questionable at these prices. Generally, clients are most directly exposed to the recalibration of energy business share prices through their stakes in master limited partnerships (MLPs). The asset class was duly hit by the decline in oil prices but still sits at a 7.7% gain for the year (as measured by the Alerian MLP Infrastructure Index). Our view is that the asset class remains attractive, but garners a disproportionate amount of our time at these oil price levels.

The surprise of 2014 has been the direction of interest rates. After a substantial increase in 2013, ostensibly in anticipation of the Fed's gradual removal of stimulus, rates reversed course and moved significantly lower even while the Fed followed through on their withdrawal. The benchmark ten year Treasury bond yields 2.21% today versus 3.03% at the beginning of the year. The curve has flattened though (see Figure 1). Short-term rates have moved up as the Fed has inched closer to allowing interest rates increases. Fixed income assets benefitted from the intermediate rate tailwind – the Barclays Aggregate Bond Index returned 5.6% and the Barclays High Yield Index generated 2.4%.

Figure 1: Treasury Yield Curve (%)
Source: Bloomberg



Our opinion of interest risk has adapted a bit over the year. A strong preference for taking credit risk in lieu of rate risk in bond investments has softened to consider more of the latter. The thesis is twofold: a) we believe the Fed would rather err on the side of tardiness when it comes to rate increases thus reducing the likelihood of a bond rout, and b) we have seen the prospective returns on many credit sector assets diminished as their popularity has grown.

International Strategies

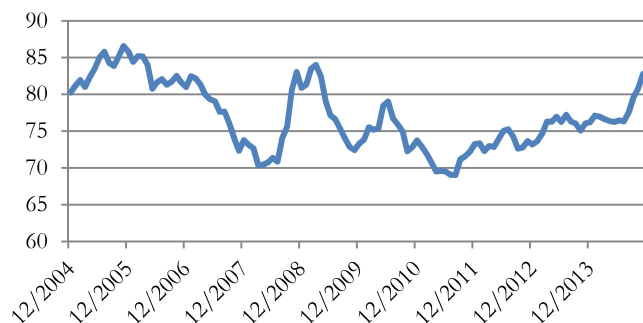
The success of the US stands in contrast to the struggles in other countries. The euro area is forecasted to finish the year with a sub 1% growth rate. The Japanese will find themselves in the same situation after an increase in their consumption tax flattened GDP. Even China's growth trajectory downshifted enough for their Central Bank to cut interest rates in late November.

The relative strength of the US economy buoyed the dollar against its trading counterparties (see Figure 2 on next page), notably the euro and yen, both of which lost about 12% of their value relative to the dollar. Most international investment strategies treaded water (in USD terms). The developed economies measured by the MSCI EAFE Index are down 3.4%. Emerging economies are set to turn in their second consecutive disappointing year: the broad MSCI Emerging Markets Index is off 2.5%.

This is not to say the US was the only positive contributor to investor's equity performance. India, in particular, is a bright spot. After electing Narendra Modi, a pro-business reformer, to the prime minister's post, India enjoyed an equity renaissance. The MSCI India Index was up 21.0% (in USD terms). The Chinese equity market

contributed as well, returning 7.3% (as measured by the MSCI China Index in USD terms). Our approach to unhedged emerging market equity has been exclusive to Asia wherever appropriate. The relative strength of the two largest emerging Asian markets has benefitted this thesis.

Figure 2: USD Trade Weighted Index
March 1973 = 100
Source: Bloomberg



Alternative Strategies

Reinsurance risk was rewarded in 2014: the Swiss Re Index earned 6.3%. Evaluated in the context of this calendar year, we are certainly grateful for the scarcity of natural disasters – and thus minimal claims on our reinsurance funds. Over the long run, though, we believe the strategy succeeds on the back of smart underwriting rather than luck. That said we make haste to remind clients that there will be years with significant losses when natural disasters do strike. If there were no risk to the strategy the rewards wouldn't exist!

The environment for trading strategies was much improved this year. Volatility resurfaced, primarily in currency and commodity markets, after a very long hiatus. Currencies moved as global central bank policy diverged. Specifically, the Fed moved to end quantitative easing and signaled potential rate increases next year while the European Central Bank and Bank of Japan announced or expanded easing programs. OPEC's late November surprise no-action announcement was a major cause of volatility in commodity markets. The currencies of commodity exporters were duly hurt. These choppy conditions are favorable for our global macro and other short-term tactical strategies.

Before we leave 2014, we would like to highlight the launch of our multi-strategy access fund, managed in partnership with Blue Arc. This collection of managers – some have been mainstays in portfolios for years, others are new additions – represents, in our opinion, the best way to get exposure to a diversified mix of hedge fund strategies. Please look for the monthly letter describing the progress of the fund and underlying managers alongside market context.

A Toast to 2015

The year ahead will be the same as every other year in at least one respect: there will be opportunities to capture and risks to defend against. Perhaps the biggest opportunity will arise from a dislocated energy sector. Energy equities (as measured by the Vanguard Energy ETF: VDE) have sold off 20% from their peak. As mentioned earlier, MLPs were not immune. Further, Bloomberg reports that since 2010 $550 billion has been loaned to energy producers. Most of this debt falls into the high yield category which is now trading at 9% over Treasuries versus 4% earlier this year. There are undoubtedly bankruptcies in this group, but herein lies potential for buying resilient companies and/or restructuring the debt of their fragile peers.

There are risks to monitor as well. US stock returns outstripped underlying profit growth again in 2014 meaning valuations are higher than at the start of the year. Monetary policy outside of the US suggests continued US dollar strength – if true, this is a negative for dollar based investors with assets overseas. And of course interest rates must appear on this list. Before the Fed gets to raising rates fixed income investors need a plan in place.

International political processes pose risks too. Europe continues to teeter on the edge of deflation making the pace and magnitude of monetary stimulus and structural reform on the continent important to watch. Will Greece elect an anti-Europe party and negotiate themselves right out of the union? How does Russia cope with reduced oil revenue and a plunging currency?

The best place to begin 2015, or any year for that matter, is with a well-diversified portfolio. We believe such a portfolio includes equities and bonds, both domestic and international, as well as alternative strategies. Throughout the year, sometimes opportunities become risks and vice versa, which is why we monitor and adapt portfolios as necessary. Happy New Year! □

* All return figures and price levels cited in this article are through December 26, 2014 unless otherwise noted.

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