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Market Outlook & Strategy

First Quarter of 2015

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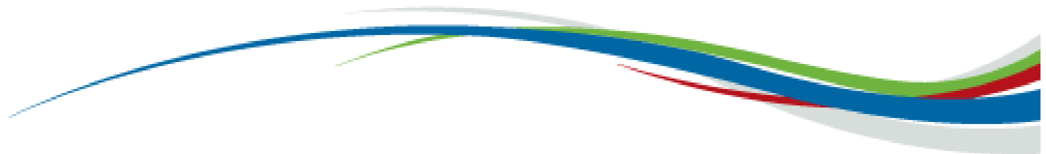

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Executive Summary

- It was a bumpy ride in the U.S. market this quarter with stocks gyrating almost on a daily basis. In the end, the S&P 500 barely notched a gain, increasing only 0.8% during the quarter. Large multinational companies were negatively affected by the strong dollar and a dock strike in Los Angeles. Smaller companies did much better helping the overall U.S. equity market to increase by 1.8%.

- European equity markets had a stellar quarter due to the introduction of a massive quantitative easing program by the European Central Bank and the impact of a weaker currency on export competitiveness. Emerging markets also had a decent quarter, thanks in large part to China stimulating its economy as well.

- Back in the U.S., bond prices increased again as the Fed signaled that it might take longer to increase interest rates than originally expected. This quarter's increase in Treasury prices marked the longest winning streak in more than a decade.

- In this issue, we discuss the importance of, and rationale behind, holding a diversified portfolio, even when one market or region of the world is performing much better than others. We discuss the advantages of diversification, explain why it is a superior investment approach for many, but also why it is not a panacea. Most importantly, we remind the reader that diversification only works when you stick with it all of the time.

- In terms of Artemis strategy, the only moves we made during the quarter were to place a currency hedge on our international holdings and modestly increase our allocation. In addition, we are continuing to replace our anchor emerging market equity fund, which has underperformed for quite some time now.

- We also continue to favor holding a diversified array of fixed-income and particularly like municipal income. As we have written before, we believe the Fed is going to takes its time in increasing interest rates.

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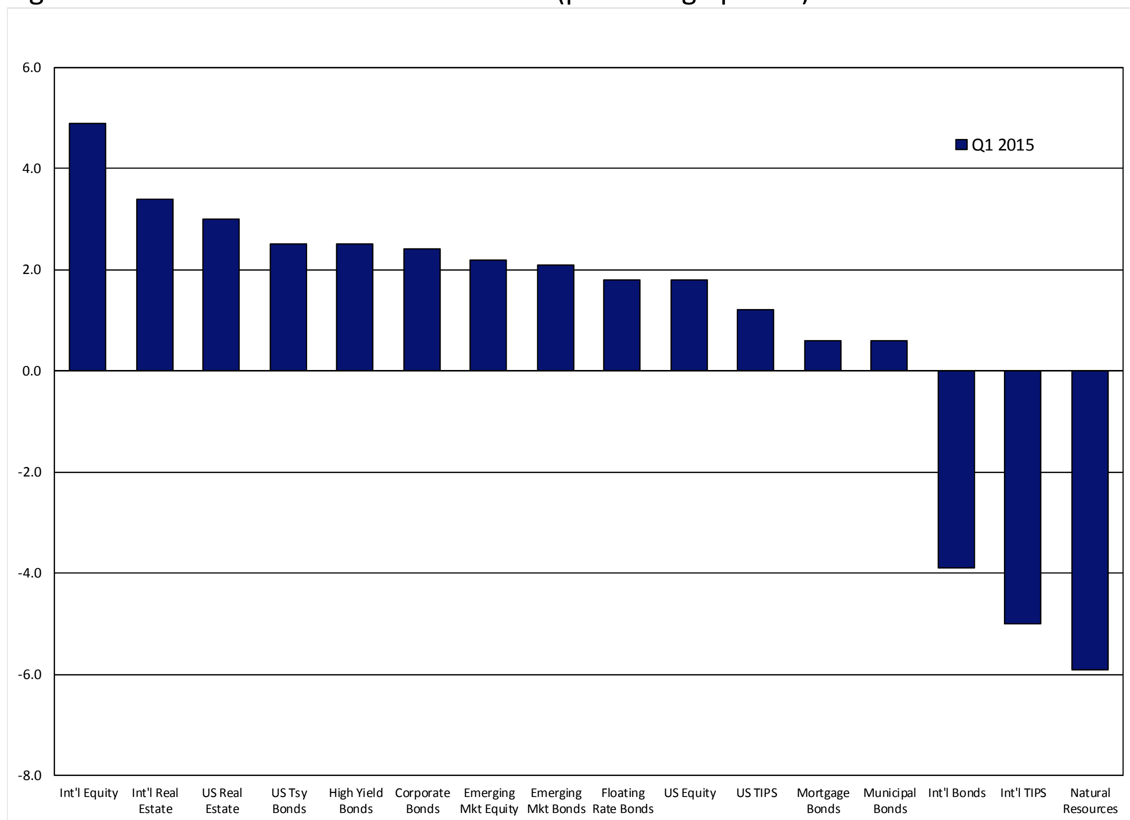
Markets in Review

It was a bumpy ride in the U.S. market this quarter, with one analyst summing it up nicely in a nod to U2 by calling her recent market commentary "Running to Stand Still: Wild Swings Taking the Market Nowhere," The S&P 500 barely notched a gain, increasing only 0.8% during the quarter. U.S. corporate profits actually declined in the first quarter, as the strong dollar took a toll on large multinational companies such Coca-Cola, Procter & Gamble, and Caterpillar. The U.S. dollar rose 12.7% against the euro, its biggest quarterly jump since the common currency was created in 1999. Bad weather in much of the country and a dock strike in Los Angeles didn't help company profits either, despite the boost in gasoline prices.

Figure 1. Asset Class Performance in 2015 (percentage points)



The strong dollar also led to a yawning gap between the performance of value-oriented, high-dividend paying stocks and large-company growth stocks because the share of overseas earnings from the former is much higher. Specifically, the Russell 1000 Value index returned 0.8%, while the Russell 1000 Growth index returned 5.6%.

Notwithstanding the above, the overall U.S. equity market notched up a 1.8% return for the quarter, helped by the solid performance of smaller companies. (See Figure 1.) If you recall, smaller companies had a dreadful 2014 so it was nice to see them bounce back.

Outside the U.S., developed markets had a very strong quarter, gaining 4.9% in U.S. dollar terms and much more in local currency terms. The European market was buoyed by the ECB's long-awaited announcement of full quantitative easing. The package surpassed the market's expectations in size and will last at least until September 2016. For a nice change, the European market was also buoyed by some decent forward indicators that suggest manufacturing activity and credit growth are picking up nicely.

Emerging markets also posted positive gains over the period, increasing 2.2%. Emerging Asian markets led the advance, with Chinese equities surging as the central bank stimulated the market to help boost flagging growth. In contrast, Latin American markets lagged, with Brazil, especially, mired in anemic growth and various corruption scandals.

In terms of fixed income, once again the news was that U.S. government bonds rose during the quarter, to cap the fifth quarterly gain in a row and the longest winning streak in more than a decade. Mixed economic readings in the U.S. during the harsh winter bolstered investors' expectations that the Fed will maintain an accommodative monetary policy, which tends to benefit bond prices. Another reason for solid demand was that U.S. Treasuries are offering higher yields than comparable debt elsewhere in the developed world.

For a nice change, however, corporate bonds performed better than Treasuries during the quarter. Debt sold by lower-rated U.S. companies, known as junk bonds, posted a return of about 2.5%, and investment-grade corporate bonds returned 2.1% over the same period. In contrast, a basket of mixed-maturity Treasuries returned. 1.5%.

Special Theme: The Power of Diversification

As U.S. stocks have been in a six-year bull run and far outpacing returns everywhere else, clients are inevitably questioning the value of holding a globally diversified portfolio. There is no question that it is tough to feel satisfied earning mid-single digits on a globally diversified portfolio when the U.S. equity market seems to be delivering double-digit returns year after year.

So why be diversified? In this section, I review the key goals and the philosophy of diversification in the hopes of dissuading most of you from throwing in the towel.

Goal of Diversification – Risk Reduction

The primary goal of holding a diversified set of asset classes in a portfolio is to reduce overall portfolio volatility. This is because different asset classes and securities react differently to market and economic conditions, and market leadership across asset classes rotates. Another way to put it is that different asset classes have less than perfect correlation. By definition then, a properly diversified portfolio is never going to match the return of the highest-performing asset class in the portfolio in any given year, nor is it going to match the return of the lowest-returning asset class. It will give you a smoother ride overall.

As an example, in the late 1990s and into 2001, U.S. stocks enjoyed a good streak of outperformance relative to international stocks, and investors became restless to rid their portfolios of international securities. What happened? As shown in Figure 2 below, in the market cycle that followed up until the crisis in 2008, international stocks trumped U.S. stocks by a huge margin, and emerging markets stocks did even better, outperforming the S&P 500 by more than 20 percentage points annualized. While it is true that the investor who correctly foresaw this shift would have enjoyed both the high U.S. returns in the late 1990s and also the high international returns in the subsequent period, this presumes that he/she was able to correctly predict the shift and time their trades accordingly. Research has shown that this form of market timing is almost impossible to do consistently.

Figure 2. Global Stock Market Returns: 1995-2001 versus 2002-2007

Source: Morningstar

Advantage: Protection Against Human Tendencies

Why does volatility matter? If you attempt to maximize returns by investing in a portfolio that has higher risk than what you are comfortable with, then you are likely to experience more volatility than you would like. The research indicates that most people when faced with more volatility than they prefer, tend to sell when the portfolio decreases in value. Of course, markets are cyclical, so this behavior causes the average investor to earn less than they would if they just stuck with their portfolio. We probably all know someone who threw in the towel in early 2009 and "cashed out," only to sit on their cash for quite some time in fear of going back in. These investors suffered permanent losses to their portfolios, rather than enjoying the strong gains of the last five years.

Advantage: Reduction in Sequence-of-Returns Risk

Sequence-of-returns risk is about how the order of returns affects portfolio longevity, especially when withdrawals are being made. The point is that poor returns in the first decade of retirement can cause immense damage to the portfolio, even if these poor returns are then followed by good returns. This occurs because returns in early years of retirement have a disproportionate effect on the outcome because the absolute size of the portfolio is greatest in the early years of retirement. After cash outflows are happening, it's not enough for returns to average out in the long run because the portfolio could be severely decimated before the good returns finally have a positive effect. A diversified portfolio can help to inoculate one from sequence-of-returns risk because when risky assets suffer poor returns, one can always take distributions from those assets in the portfolio that have not declined in value, thereby allowing the risky assets to recover.

Advantage: Access to a Broader Opportunity Set

Holding a globally diversified portfolio enables one to access a much broader investment opportunity set, which should, in turn, enhance portfolio performance over time. This is the most important reason for maintaining exposure to global markets. Today, the U.S. comprises only 49% of the world's total stock market value. If an investor chooses to only invest in U.S. stocks, he or she would be excluded from over half of the world's total investment opportunity set. Figure 3 quantifies this benefit by examining the performance differential of a globally diversified equity portfolio between 1970-2013 versus one comprised exclusively of the S&P 500. The result is not only that the global equity portfolio outperformed the S&P 500, but that it did so with lower volatility.

Figure 3. Global versus U.S. Stock Portfolios, 1970-2014

	Annualized Return	Standard Deviation	Starting Value	Ending Value
Global Equity Portfolio	11.4%	14.9%	$1M	$128,383,142
S&P 500	10.5%	15.4%	$1M	$88,750,665

From 1970 to 1987, global equity portfolio is 60% S&P 500 and 40% MSCI EAFE. From 1988 onward, portfolio is 60% S&P 500, 20% MSCI EAFE, and 20% MSCI Emerging Markets. Source: Morningstar

Advantage: Superior Risk-Adjusted Returns

As many of you know, what matters in investing is how much bang you get for your buck; specifically, how much return you get for a given amount of volatility. A diversified global equity allocation should produce better longer-term volatility-adjusted returns than the stock of any single country held in isolation. As already demonstrated in Figure 3, this has been the case over the last 45 years.

This point is made even stronger, in my view, when looking at the last 15 years. For example, J.P. Morgan tracks the performance of a globally diversified composite portfolio, which, in addition to diversified equity, also includes a diversified set of fixed income holdings, commodities, and real estate. In Figure 4, those annual asset class returns have been ranked from high to low.

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Figure 4. Asset Class Returns: 2000-2014 – Gross of Fees

Asset Class Returns

Asset Class

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD	15-yrs '00 - '14	
																Ann.	Vol.
Comdty. 31.8%	REITs 13.9%	Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	DM Equity 5.0%	REITs 12.7%	REITs 22.0%
REITs 26.4%	Fixed Income 8.4%	Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Small Cap 4.3%	High Yield 8.7%	Small Cap 21.6%
Fixed Income 11.6%	Cash 4.1%	High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	REITs 4.0%	Small Cap 7.4%	EM Equity 21.3%
Cash 6.1%	Small Cap 2.5%	REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	EM Equity 2.3%	EM Equity 7.4%	Comdty. 19.2%
High Yield 1.0%	High Yield 2.3%	Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	Asset Alloc. 1.9%	Fixed Income 5.7%	DM Equity 17.5%
Asset Alloc. 0.0%	EM Equity -2.4%	Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Fixed Income 1.6%	Asset Alloc. 5.3%	Large Cap 17.3%
Small Cap -3.0%	Asset Alloc. -3.9%	EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	Large Cap 1.0%	Large Cap 4.2%	Asset Alloc. 13.7%
Large Cap -9.1%	Large Cap -11.9%	DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	High Yield 0.6%	DM Equity 3.0%	High Yield 11.7%
DM Equity -14.0%	Comdty. -19.5%	Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	Cash 0.0%	Comdty. 2.7%	Fixed Income 3.5%
EM Equity -30.6%	DM Equity -21.2%	Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -5.9%	Cash 1.9%	Cash 1.0%

Source: Russell, MSCI, Bloomberg, Standard & Poor's, Barclays Capital, NAREIT, FactSet, J.P. Morgan Asset Management. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays HY Index, Fixed Income: Barclays Capital Aggregate, REITs: NAREIT Equity REIT Index.The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Capital Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. All data represents total return for stated period. Past performance is not indicative of future returns. Data are as of 3/31/15."15-yrs" returns represent period of 12/31/99 – 12/31/14 showing both cumulative (Cum.) and annualized (Ann.) over the period. Please see disclosure page at end for index definitions.
Data are as of March 31, 2015.

J.P.Morgan
Asset Management

Several points can be made. First, as discussed earlier and shown in the diagram, a diversified portfolio never achieves the returns of the highest- or lowest-performing asset class in any given year. Second, market leadership (i.e. which asset class earns the most in a given year) varies a lot. Third, and perhaps surprising to many of you, during the last 15 years the diversified asset allocation portfolio returned on average 5.3% annually (see the next-to-last column), whereas Large Cap (proxied by the S&P 500) only earned 4.2%. Moreover, the volatility of the Large Cap portfolio was higher (shown in the last column).

Disadvantage: No Guarantees!

The goal of diversification is not to boost performance – it won't ensure gains or guarantee against losses. During the 2008-2009 bear market, correlations went up and many different types of investments lost value at the same time. While it may have felt as though diversification failed during the downturn, it didn't. The major asset classes were more correlated than they had been in past downturns, but diversification still helped contain portfolio losses, as shown by the relative position of the asset allocation portfolio in 2008 (Figure 4).

One other disadvantage: diversification is not a return maximization strategy. The data in Figure 4 indicate that if one really wants to turbo-charge their returns, a portfolio of REITS, emerging market equity and small company stocks, would have been the winning mix over the last 15 years. The problem is that nobody knows this in advance, and even if you were to get it right, you may have ended up cashing out in 2008-'09 when these asset classes suffered extreme declines.

Bottom Line

Diversification only works when you stick with it all of the time – you can't pick and choose when you want to be diversified because you never truly know when you will need to be.

Artemis Portfolio Strategy

We made two changes in client portfolios during the first quarter. In late January, we placed a currency hedge on international developed holdings. This turned out to be as easy as swapping out our current preferred index-based fund for one that embeds a currency hedge

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for almost the same price. This proved fortuitous as the dollar index appreciated 9% during the quarter.[1]

Towards the end of the quarter, we also increased our international equity exposure at the expense of U.S. equity. Admittedly, Europe has caused a lot of "head fakes" in recent years, but having looked long and hard at the recent data coming out of the region, we felt the risk worth taking. Our expectation is that the drop in the euro, the massive correction in oil prices, and quantitative easing by the European Central Bank will give growth in the region a meaningful lift over the next two years. We are not fully hedging the currency exposure of this latest increase, however, in the hopes that our blended exposure will lower the massive volatility we have had in this asset class.

We also continue to swap out our anchor emerging-market equity vehicle, which is weighted toward smaller company and value-oriented companies, in favor of a pure market cap-weighted index. The reason is that due to these tilts, our fund has lagged its benchmark for quite some time, and there is little evidence to suggest a turnaround any time soon.

On the fixed-income side, we are not swayed by the view that "bonds are dead." We are holding a diversified allocation in all client portfolios. It is becoming increasingly clear that Fed hikes are going to be slow and small – low growth, the strong dollar, and lack of sufficient wage growth are putting a damper on yields and causing the Fed to slow the march to "normalization."

Indeed, the central dilemma facing the Fed is that increasing interest rates while the rest of the developed world is still trying to reduce theirs fuels demand for the U.S. dollar. Expectations of this outcome has already caused the U.S. dollar to massively appreciate, and now the Fed is worried about the impact of the strong dollar on corporate profits and growth. Bonds are a great hedge against any signs of faltering growth or lower-than-expected corporate earnings, both increasing risks in the view of Artemis.

[1] References to the U.S. dollar index refer to the Wall Street Journal Dollar Index, which measures the U.S. dollar's performance against a traded-weighted basket of currencies and is the index most commonly used for hedging purposes. An increase in the index indicates that the dollar is strengthening against the basket.