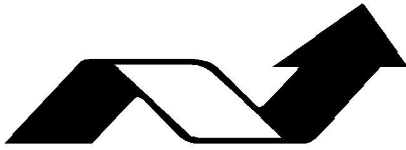


LYNCH FINANCIAL GROUP'S

INVESTMENT REPORT

January 2015 www.LynchFinancialGroup.com

Large-cap U.S. stocks continued their unusually strong and unbroken stretch of gains. The S&P 500 rose 14% and avoided even a modest 10% "correction" for the third year in a row.

Developed international stocks lost 5% and emerging-markets stocks dropped 2%. These returns reflect the significant headwind presented by the strengthening U.S. dollar.

Contrary to the consensus, the 10-year Treasury yield declined further and bond prices rose. The core investment-grade bond index was up nearly 6% for the year and municipal bonds also fared well.

Our analysis continues to indicate that the expected returns from U.S. stocks are in the low single digits (or worse) over the range of outcomes we consider most likely.

We welcome questions or comments regarding this newsletter at jlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.

Investment Review and Outlook

Benchmark and Mutual Fund Performance

The box below contains benchmark (capital market and investment style) performance results. The performance results of our recommended mutual funds and their benchmarks are shown on page 5. U.S. stocks had good gains for the quarter and ended the year with very good returns. International stocks declined during the quarter and lagged significantly behind the U.S. for the year. Domestic bonds had moderate returns for both the quarter and year. The underweighting in U.S. stocks in client portfolios led to returns that trailed their benchmarks.

Fourth Quarter 2014 Investment Commentary

As the year drew to a close, a handful of big-picture issues dominated the investment landscape: the plunging price of oil (see graph on next page), positive economic indicators in the U.S. relative to most of the globe, and the ongoing influence of central banks (a key effect of which has been to bolster stocks and other risk assets). In the financial markets, the year saw strong gains for U.S. large-cap stocks and core bonds with lagging performance elsewhere.

Looking first at the investment environment, oil prices hit five-and-a-half-year lows in late December as new sources of supply met with potentially slowing global demand. While a decline in oil prices is typically viewed as an unambiguously positive development for the global economy, the result this time around is different because of the rapidity of the plunge and the current fragile global economic environment. With deflation concerns already high in Europe in particular, the oil price decline was seen as intensifying the deflationary risks.

One offsetting factor that helped

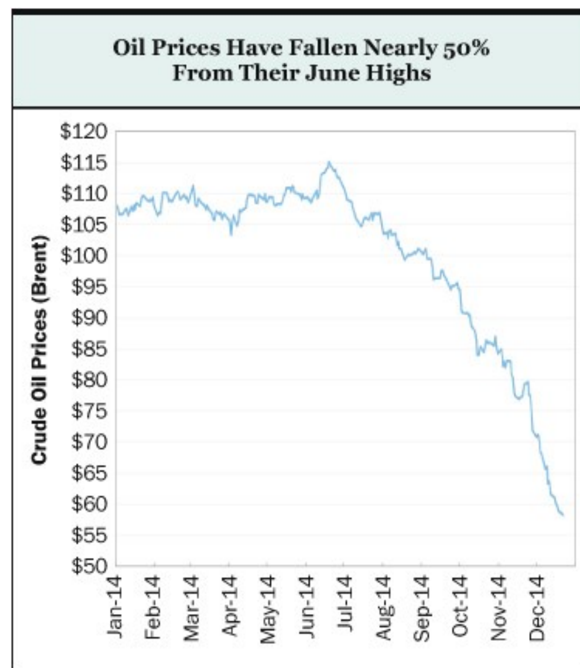
Benchmark Returns (Periods Ended 12/31/14)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	4.9%	13.5%
Russell 1000 Growth iShares	4.7%	12.8%
Russell 1000 Value iShares	4.9%	13.2%
Mid-Cap Benchmarks		
Russell Midcap iShares	5.9%	13.0%
Russell Midcap Growth iShares	5.8%	11.7%
Russell Midcap Value iShares	6.0%	14.5%
Small-Cap Benchmarks		
Russell 2000 iShares	9.8%	4.9%
Russell 2000 Growth iShares	10.1%	5.7%
Russell 2000 Value iShares	9.4%	4.1%
Other Benchmarks		
Vanguard Developed Mkts Idx	-4.2%	-5.8%
Vanguard Emerging Markets	-3.8%	0.4%
Vanguard REIT Index	14.3%	30.1%
Vanguard Total Bond Mkt Index	1.7%	5.8%
Credit Suisse High Yield Index	-1.6%	1.9%

Mutual Fund Performance - See Page 5

the markets regain their footing in the fourth quarter (as it has many times in the post-financial-crisis period) was the ongoing influence of central banks. Even as the Federal Reserve suggests it is on track to begin raising rates in the face of U.S. economic improvement, it once again soothed markets by reaffirming that it would continue to be patient in shifting its stance. Given the poor economic conditions that persist in Europe, investors continue to expect the European Central Bank to take a more meaningful step toward full quantitative easing (i.e., purchasing bonds and other assets with the aim of stimulating the economy). Central banks in Japan and China expanded their stimulative policy efforts over 2014. The takeaway is that even as the Fed may begin scaling back its support, there appears to be no shortage of supportive monetary policy globally. At the same time, the fact that central banks continue to undertake (or contemplate) aggressive action provides a reminder of the broader economic risks we continue to navigate.

Against this backdrop, the S&P 500 index gained almost 14% and, for the third year in a row, avoided even a modest 10% "correction." On the other hand, U.S. small-cap stocks, dropped more than 13% from their summertime high through mid-October, and ended the year up 5%. Outside the United States, most major stock markets performed poorly. Developed international stocks lost 5% and emerging-markets stocks dropped 2% (based on MSCI EAFE and MSCI Emerging Markets indexes, respectively). These returns reflect the significant headwind presented by the strengthening U.S. dollar, which detracted from returns for dollar-based investors.



Data as of 12/22/14. Source: U.S. Energy Information Administration.

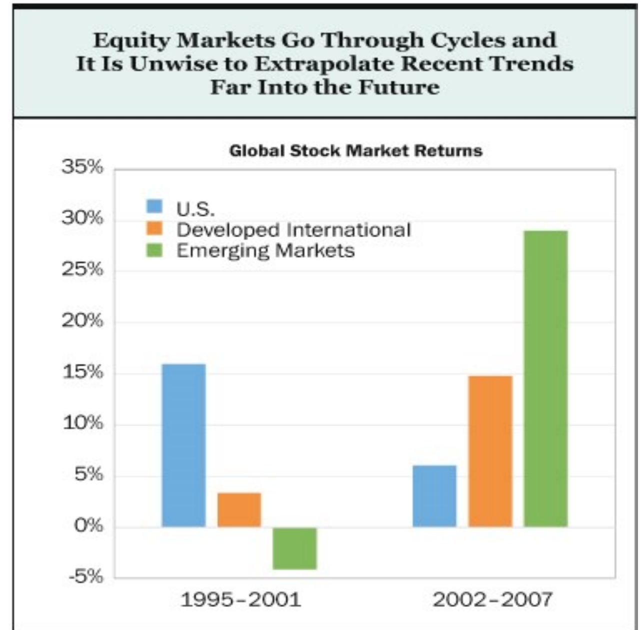
Contrary to the consensus coming into 2014, the 10-year Treasury yield declined and bond prices rose. The core investment-grade bond index was up 5.8% for the year and municipal bonds also fared well. Outside of core bonds, high-yield bonds (to which we have modest exposure through several bond funds) lagged.

While our diversified portfolios participated in the strong U.S. stock returns, they faced several headwinds for the year including our investments in foreign stocks and our underweighting of core, investment-grade bonds. One of the biggest detractors to our portfolios' overall performance in 2014 was the underperformance of our domestic large-cap equity managers. Key among the performance drivers that have broadly affected fund managers is the fact that many managers hold some non-U.S.-based multinational companies and some amount of cash.

We think these factors have some explanatory validity, but they are external to our conviction level in the specific funds we own. Our ongoing due diligence and monitoring of our managers throughout the year confirmed our high conviction in the individuals and teams we have selected for our clients.

When it comes to the financial markets, we think it's worth putting recent results into the context of history. This has been an unusually long and strong period of positive performance for large-cap stocks. Since 1945 there have only been three other periods (out of 51 total) where the S&P 500 has had a longer streak of gains without at least a 10% correction, according to Ned Davis Research. In addition, over the past two years, the S&P 500 has outperformed both developed international and emerging-markets indexes by an unusually large margin relative to history. These observations don't mean U.S. stocks are *necessarily* set to tumble in the near term, but we think this data does provide some perspective as an argument for global portfolio diversification and prudent risk management.

Equity markets and asset classes in general go through cycles and it is unwise to extrapolate recent performance trends far into the future (as we see many investors and commentators doing). Furthermore, investors often suffer from extreme overconfidence that they can predict these shifts and correctly time their buys and sells accordingly (data show actual investor returns lag indexes by hundreds of basis points due to timing errors). Back in the late 1990s/early 2000s U.S. stocks had a streak of outperformance. As shown in the chart at right, in the market cycle that followed from 2002–2007, international stocks trumped U.S. stocks by a wide margin, and emerging markets did even better, outperforming the S&P 500 by more than 20 percentage points annualized. (Of course, toward the end of the latter period people were asking why they didn't have *more* exposure to emerging markets . . . only to see emerging markets meaningfully trail the U.S. market since then.)



Our Asset Class Views Looking Ahead

U.S. Stocks

In terms of the investment environment, the U.S. economy looks to be in pretty good shape for the near term. There are several positives: the labor market continues to strengthen, inflation remains subdued, manufacturing indexes and other leading economic indicators are consistent with solid GDP growth, falling oil prices should boost consumer spending, and government fiscal policy is likely to become more of a growth tailwind than a headwind as the impact of past budget cuts rolls off.

Fed monetary policy remains something of a wild card, but based on the Fed's words and actions, we would be surprised if it shocks the economy or markets with an unexpectedly strong interest-rate hike.

While the economic and monetary backdrop looks likely to remain broadly supportive over the near term, our assessment of the attractiveness of U.S. stocks is based on a longer-term (five-year) assessment of potential returns across a range of scenarios. That analysis continues to indicate that the expected returns from U.S. stocks are in the low single digits (or worse) over the range of outcomes we consider most likely, and therefore not sufficient to fully compensate clients for their downside risk.

European Stocks

In contrast to the United States, the eurozone (ex-U.K.) continues to fight deflationary headwinds. The December year-over-year headline inflation number fell to negative 0.2%, real GDP growth is below 1%, and two-year government bond yields in Germany and France are actually negative, meaning investors are paying the government for the privilege of owning these bonds.

Emerging-Markets Stocks

There is a lot of negative news surrounding emerging-markets stocks—such as slowing growth in China and other BRICs and the decline in emerging-markets currencies. Nevertheless, we remain optimistic about emerging markets' long-term fundamentals and believe they are likely to outperform U.S. stocks over our five-year investment horizon. However, we are conscious of the shorter-term downside risk and volatility they pose. This is one reason why we are only slightly overweight emerging markets relative to U.S. stocks as a percent of our equity allocation. The risk posed by dollar-denominated emerging-markets debt is one specific area we've looked at more closely and that we believe supports the modest approach we've taken to

this asset class weighting.

Investment-Grade Bonds

From an asset class perspective, we believe investment-grade bonds are likely to generate very low single-digit annualized returns over our five-year investment horizon, which incorporates a range of economic scenarios. Our very low return estimates are explained by the very low current yields and our expectations that interest rates will move higher over our time frame, although the timing and magnitude are of course uncertain.

Asset Allocation Funds

Despite what has been a relatively poor recent outcome from our allocation to the Pimco All Asset funds, we think the decision to own them is prudent given the serious risks to the economy and stock markets at this time. Given the valuations of traditional assets, there is certainly a reasonable basis for maintaining our allocation to these strategies.

In Conclusion

Given the recent underperformance of our own portfolios, we have received a number of questions from clients and followers of our investment research. So perhaps we are a good case study for the question of why good managers go through periods of underperformance versus their benchmarks. Our performance often won't track the performance of the benchmarks we're measured against because we are not afraid to construct portfolios that look very different than our benchmarks. Our willingness to do this is a function of our confidence in our investment process, our commitment to do what is right for our clients, and our knowledge that this is what it takes to outperform over the long run. If we always invest in line with our benchmarks, we won't be able to add value to client portfolios.

In the end, we view our responsibility in terms of our clients' needs and not benchmark comparisons. We believe if we do these things well over the long term, we will be able to continue to meet our clients' financial needs.

This article utilizes research from Litman/Gregory Analytics, LLC.

LFG Recommended Mutual Funds
Performance Results for Funds and Benchmarks

Fund Name[1]	Benchmark (BM)[2]	% Returns For The Periods Ended December 31, 2014							
		3 Months		12 Months		3 Yrs Annlzd		5 Yrs Annlzd	
		Fund	BM	Fund	BM	Fund	BM	Fund	BM
Baron Emerging Markets[3]	Vanguard Emerging Markets Index	+0.3	-3.8	+3.8	+0.4	+13.7	+4.1	NA	NA
Parametric Emerging Markets[3]	Vanguard Emerging Markets Index	-8.3	-3.8	-3.8	+0.4	+5.1	+4.1	+2.8	+1.8
Tweedy Browne Global Value	Vanguard Developed Markets Index	-1.9	-4.2	+1.5	-5.8	+12.9	+10.8	+9.4	+5.1
Artisan International	Vanguard Developed Markets Index	+0.5	-4.2	-1.0	-5.8	+15.8	+10.8	+8.8	+5.1
Masters Select International	Vanguard Developed Markets Index	-0.1	-4.2	-2.7	-5.8	+12.3	+10.8	+6.6	+5.1
Rainier Small/Mid Cap Equity	Russell Midcap iShares	+2.0	+5.9	+4.6	+13.0	+16.7	+21.2	+14.1	+17.0
Harbor Capital Appreciation	Russell 1000 Growth iShares	+3.3	+4.7	+9.9	+12.8	+20.5	+20.0	+14.5	+15.6
Jensen[3]	Russell 1000 Growth iShares	+9.2	+4.7	+12.0	+12.8	+19.2	+20.0	+13.5	+15.6
BBH Core Select[3]	Vanguard 500 Index	+3.6	+4.9	+8.4	+13.5	+17.7	+20.2	+14.6	+15.3
Selected American Shares	Vanguard 500 Index	+2.8	+4.9	+5.6	+13.5	+16.6	+20.2	+11.3	+15.3
Dodge & Cox Stock	Russell 1000 Value iShares	+2.2	+4.9	+10.4	+13.2	+23.7	+20.6	+15.6	+15.2
Vanguard Windsor II	Russell 1000 Value iShares	+3.5	+4.9	+11.2	+13.2	+19.2	+20.6	+14.0	+15.2
FPA Crescent[3]	60% Russell 2500 Index; 40% Vang Tot Bd	+2.5	+4.7	+6.6	+6.5	+12.8	+13.0	+10.6	+11.5
PIMCO All Asset	Barclays TIPS Bond iShares	-2.9	-0.1	+0.8	+3.5	+5.5	+0.3	+6.4	+4.0
PIMCO All Asset All Authority[3]	50% S&P 500/50% Barclays TIPS Bond iShares	-4.5	+2.4	-2.4	+8.5	+2.8	+10.3	+4.4	+9.6
Westwood Income Opportunity[3]	25% S&P 500, 25% NAREIT All Equity, 25% Citigroup Treasury Bill 3 mo., 25% Citigroup Treasury 10 Yr	+1.8	-0.1	+9.1	+13.8	+10.5	+9.7	+10.4	+9.6
Osterweis Strategic Income[3]	Vanguard Total Bond Index	-1.0	+1.7	+1.3	+5.8	+5.4	+2.5	+6.1	+4.2
Doubleline Total Return[3]	Vanguard Total Bond Index	+1.4	+1.7	+6.7	+5.8	+5.2	+2.5	NA	NA
PIMCO Total Return	Vanguard Total Bond Index	+1.3	+1.7	+4.7	+5.8	+4.3	+2.5	+5.1	+4.2
Vanguard Intermed Tax-Exempt	Vanguard Total Bond Index	+1.1	+1.7	+7.3	+5.8	+3.7	+2.5	+4.6	+4.2
Loomis Sayles Bond	1/3 CSFB HY, 2/3 Vang Tot Bond	-0.3	+0.6	+4.8	+4.5	+8.5	+4.3	+8.5	+5.7

[1]Funds were selected using the LFG Proprietary Mutual Fund Rating System℠. This system is based on extensive research using both quantitative and qualitative factors. The system seeks to identify top funds in each asset class and investment style. LFG typically combines 8 to 10 funds in client investment portfolios.

[2]iShares exchange traded funds were used where available and respective Russell indices were used for the other periods.

[3]Funds which were not recommended for entire 5 year period.

The above table reflects past performance and should not be considered indicative of future results. The results contained in this schedule were obtained from sources we believe to be reliable. We cannot, however, guarantee the accuracy of this information.