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VOLUME 8

2014 Stocks Up Again!

**U.S. Large Cap Stocks ...
The place to be.**

S&P 500 equity returns in 2014 did their job exceeding 10% historical average returns for a 13.7% total return. Fixed income helped on down days and down weeks but didn't contribute as much to portfolios over the course of the year. Avoiding gold and direct developed and emerging international investments once again helped portfolio returns.

In the 5th year of an equity bull market, second-longest annual winning streak on record, we continued to re-position portfolios to improve relative valuation. At times, we sold some positions in full and we trimmed other positions to take profits or reduce portfolio risk. We were also focused on harvesting losses, if available, throughout the year.

Only 16% of large-cap core mutual funds outperformed the SP500 in 2014.

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2015 Market Themes

Cautious Optimism Prevails...

1. Equities - Now Fairly Valued
   - S&P 500 trades at a forward P/E of 16.2
   - compares to its 20 year average of 15.6
2. Developed Markets - Economic Decoupling
   - U.S. stronger than Europe and Japan
   - global economic correlations decline
3. Oil Disorder - Economic Impact
   - disposable income increasing stimulates economy
   - increases geopolitical risks over oil supply
   - increased pressure on capital expenditures
4. Low Inflation - Economic Risk
   - unwelcome low inflation below global targets is a risk
   - commodity disinflation remains powerful
   - increases potential for global monetary easing
5. The Dollar Bull Market
   - adds pressure to earnings from currency exchanges
   - strong dollar eventually hurts demand for U.S. goods
6. Fed Rate Hikes
   - consensus expectations for June interest rate hike
   - talk starting of potential rate hike delay to September
   - timing expectation debate adds to market volatility
   - unemployment rate now at just 5.6%!
   - first talk of wage pressures develop in late 2015
7. China's Economic Growth - Deceleration
   - growth continues but at a slower and uneven pace
8. Economic Growth - Positive
   - "Goldilocks" ... healthy growth, subdued inflation
   - entering the mature phase of the bull market

2014 Benchmark Performance

Asset Class	2014	As Measured By
Fixed Income		
Investment Grade Muni	6.1%	Barclays Muni Bond 7 Year
Investment Grade Taxable	6.0%	Barclays U.S. Aggregate Bond
High Yield Bond	2.5%	Barclays U.S. Corp High Yield
Global Bond	0.6%	Barclays Global Bond Index
Equity		
Large Capitalization	13.7%	S&P 500 Index
Small & Mid Cap	7.1%	Russell 2500 Index
International Equity	-3.4%	MSCI All Cap World Ex US
International Developed	-4.5%	MSCI EAFE
International Emerging	-1.8%	MSCI Emerging Markets
Gold	-21.3%	CBOE Gold Price

Data Source: Tamarac and providers to Tamarac

S&P 500 ANNUAL RETURNS

Year Ending	Total Return Change
12/31/2014	13.69%
12/31/2013	32.39%
12/31/2012	16.00%
12/31/2011	2.11%
12/31/2010	15.06%
12/31/2009	26.46%
12/31/2008	-37.00%
12/31/2007	5.49%
12/31/2006	15.79%
12/31/2005	4.91%
12/31/2004	10.88%
12/31/2003	28.68%
12/31/2002	-22.10%
12/31/2001	-11.89%
12/31/2000	-9.10%
12/31/1999	21.04%
12/31/1998	28.58%
12/31/1997	33.36%
12/31/1996	22.96%
12/31/1995	37.58%
12/31/1994	1.32%
12/31/1993	10.08%
12/31/1992	7.62%
12/31/1991	30.47%
12/31/1990	-3.10%
Avg Last 25 Years	**11.25%**

Table Source: S&P Dow Jones Indices

2014 Performance Commentary

Domestic equity and bond markets had positive performance in 2014 whereas international equities were negative and international bonds were flat.

Investment grade bond returns were higher than anticipated. Factors impacting the returns included a strong U.S. dollar, flight to quality (treasuries), end of U.S. Quantitative Easing (QE's), and a weak international economic environment.

Core high yield bonds were yielding 5-7% during the year. The 2.5% total return for the year is indicative of the 4th quarter selling pressure led by energy sector weakness.

The positive equity returns were also fueled by the relative strength of the U.S. economy compared to global economies. Additionally, the strong U.S. dollar attracted foreign investors looking to diversify their currency exposure.

Small & Mid Cap Equity (SMID) also performed well as measured by the Russell 2500 SMID index, gaining 7.1%. SMID faced a headwind from the liquidity pressures of the high yield market, which is a source of capital, and a tailwind from the strong dollar. Many of these companies do business primarily in the U.S. and have less international currency risk.

Our overweight on equities and underweight on fixed income in 2014 enhanced performance for our portfolios.

Tactical Outlook: Timing is Still Everything

Some say … The equity market seems due for a correction after rising 32% in 2013 and another 13.7% in 2014. This is after the 58 month bull market has risen 245% cumulatively since March 2009.

Some say … The long-term bull market for fixed income seems near an end. Given the 2014 bond market rally and the Federal Reserve comments, the market expectations are set for rate hikes to start in mid-2015.

When and where do you invest if there are concerns over both equities and bonds?

The old adage "Timing is Everything" is still relevant.

The timing focus should be squarely on the investors' timeframe (1) when will they need money from their investments and (2) at that time, how much will be needed.

Those two "Timing" decisions, as well as risk tolerance and financial tolerance, should drive the long-term equity vs. fixed income personal (known as strategic) investment decision. Both a longer investment timeframe and a lower anticipated distribution amount allow for increased equity exposure in portfolios.

Most investor timeframes are much longer, multi-year periods, allowing investors to take a certain amount of risk to achieve their goals. Throughout the year, we make tactical adjustments to the portfolios. This may emphasize or de-emphasize certain asset classes.

We've outlined our tactical asset allocation views which remain positive on equities and defensive on fixed income in the table below.

Our decision making focus is on the relative valuation between asset classes.

Investment decisions based upon the news in the immediate term tend to be more emotional than strategic and can be a danger to long term investment goals.

Current Tactical Asset Class Views

Asset Class	Current Tactical View
Cash	We maintain minimal cash positions while yields are unusually low. Cash positions could be raised once money market yields return. In addition, a cash position can be used as a defensive tactical position.
Fixed Income **Investment Grade** **High Yield**	We are currently positioned defensively within fixed income in two ways. We have a lower overall fixed income position than the longer term strategic targets (underweight). In addition, we use lower duration targets to reduce fixed income sensitivity to changing interest rates. Investment grade has been positioned defensively for over 4 years while we just reduced high yield exposure in August 2014.
Equity **Large Cap** **Small & Mid Cap**	We have had larger equity positions than long term strategic targets since November 2010 (overweight). The emphasis has been on domestic large cap equities with multi-national exposure. We also emphasize SMID exposure and have had this larger target since the summer of 2013.

Tactical views are focused on the shorter term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer term market cycles up to 10 years.

Portfolio Positioning for 2015

Large Cap Equity - More Value and more Holdings

- While maintaining a growth style bias, we enter 2015 with increased exposure in 'value' style equity.
- We enter 2015 with an increased number of holdings in portfolios. This broadens diversification and reduces concentration risk in preparation for increased volatility.
- We shift exposure between long term quality (Anchor) stocks and shorter term more aggressive (Opportunistic) stocks during different market cycles. Our current 83% Anchor and 17% Opportunistic exposure is positioned with a quality bias and defensive tilt.

Small & Mid Capitalization Equity (SMID) - Opportunity

- SMID equities are a direct beneficiary of a continued U.S. economic expansion trend.
- This asset class should benefit from the U.S. dollar strength relative to other equity asset classes.
- SMID is traditionally more risky than Large Cap equities.
- With significant U.S. revenue exposure, SMID sales are safer from foreign currency weakness.

International Equity Exposure - Indirect

- Entering 2015, we have no direct international holdings after eliminating it in the summer of 2013.
- We are positioned with significant indirect international equity exposure. This is accomplished through our multi-national stock portfolio and holdings within our equity mutual funds.
- We like this 'indirect' approach as the strong U.S. dollar and weak international economies increase direct investment risks.
- Typical indirect international revenue exposure has been 30-40% for the large cap holdings.

Fixed Income Positioning - Building out Bond Ladders

- Higher short term rates in 2015 may hurt some bond prices.
- Focus on higher quality individual municipal and taxable bonds to 'lock' in the yield to maturity.
- We favor building out bond ladders, where appropriate, to control and preserve principal.
- The strategy ... As bonds mature, the proceeds can be re-invested into new 'higher' yielding bonds if rates have risen.

High Yield Bond Exposure - Reducing

- We enter 2015 with less high yield exposure.
- This reduction to high yield exposure was implemented by reducing the 'floating rate' high yield exposure and maintaining the 'fixed' rate high yield.
- Further reductions to high yield with energy sector pressures and 'crowded space' issues may arise.

Summary

Some key market dynamics:

1. Earnings will drive stock valuations more than price/earnings (P/E) ratio expansion.
2. Short term interest rates rise and yield curve flattens.
3. Strong dollar puts pressure on foreign earnings creating a headwind for domestic stocks.
4. As unemployment declines and wage growth starts, Main Street may participate with Wall Street.
5. A 'not-too-hot' and 'not-too-cold' economic environment can be very good for stocks.

For history buffs ... Since 1905, the market has never been down in a year ending with a 5 🙂

You may notice we haven't mentioned the baby boomers. This demographic theme is not an event but rather an 18 year evolution. In addition, the 'echo boomers' (kids of the boomers) now outnumber them by about 10 million.

Even with a bull market in its mature stage, modest economic growth, availability of liquidity, and reasonable valuations support modest growth in 2015. In addition to the unknown shocks that arise every year, the pending Fed (FOMC) moves and geopolitical instability are known core risks.

We prepare for these risks through portfolio construction and make adjustments based upon our tactical views. Please feel free to contact us for further details or with any questions. We thank you for your business.

Sincerely,

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Sources include: *Levitate: More Market Mood Swings in 2015?,* Liz Ann Sonders at Charles Schwab, January 5, 2015. *US Weekly Kickstart,* Goldman Sachs, January 2, 2015. *The J.P. Morgan View,* J.P. Morgan, January 2, 2015. *2015 US Economic Outlook,* J.P. Morgan, December 3, 2014. *Global Viewpoint*, *Issue No: 14/01,* Goldman Sachs, November 19, 2014. Data source providers include Thomson Reuters, and Tamarac.