The Top Five Investment Surprises of 2014

January 2015

Happy New Year! We hope you, your family, and friends made the holiday season one to remember and that you are feeling relaxed and recharged as we begin 2015.

All in all, 2014 was a rewarding year for investors, particularly those with a healthy allocation to U.S. equities. Here are asset class returns for the fourth quarter and full year:

Index	Asset Class	Fourth Quarter 2014	Full Year 2014
Barclays Capital U.S. Int. Government / Credit Index	Fixed Income	0.9%	3.1%
S&P 500	Large U.S. Stock	4.9%	13.7%
Russell 2000	Small U.S. Stock	9.7%	4.9%
MSCI All Country World ex-USA	Foreign Stock	-3.9%	-3.9%
S&P Global REIT	Real Estate Securities	9.7%	21.5%

Inevitably, the turning of the calendar from December to January is accompanied by a spate of lists recapping events of the past year and predicting what may lie ahead in the new. As our regular readers will attest, we are not especially comfortable peering into crystal balls and making prognostications, but we are always willing to employ our 20/20 hindsight and remind you of what has already transpired.

So, in no particular order, here is our list of **The Top Five Investment Surprises of 2014:**

- **Interest rates declined.** As we began 2014, the benchmark 10-year U.S. Treasury yield sat at 3.03%, and nearly all market strategists were predicting rates would continue to rise as they had in 2013. These forecasts implied a bumpy road ahead for bond investors. Instead, the 10-year yield declined steadily throughout the year, dipping as low as 1.87% (intra-day) on October 15th, and finishing the year at 2.17%. As a result, the intermediate-term bond index that we follow tuned in a respectable 3.1% total return for the year. Apparently the reports of the death of the bond bull market were greatly exaggerated, or at least quite premature.

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- **Oil prices plunged.** As recently as June, a barrel of U.S. crude oil was trading at $107. Today, that same barrel is priced in the low $50s, and drivers in some parts of the country are paying less than $2 for a gallon of gas. The purported cause of this 50%+ collapse in oil prices is slowing global demand, compounded by OPEC's decision not to reduce exports (cut supply) to support prices. This story is still in the very early stages, and we expect that it will have wide-reaching ramifications, of both the economic and perhaps geopolitical variety. The collapse of crude prices has undoubtedly provided substantial relief to middle-class Americans at the pump, but countering that positive effect is the adverse impact on economic output and American jobs that will occur now that the U.S. is a significant oil producer.

- **The U.S. dollar surged against foreign currencies.** The greenback gained nearly 13% against a basket of other major currencies in 2014, the dollar's best performance since 1997. Stronger than expected U.S. economic growth, particularly in the second half of the year, led investors to conclude that the Federal Reserve would finally act to raise short-term interest rates in mid-2015. Simultaneously, both Japan and the eurozone continued to struggle to get their economies on a growth trajectory, resulting in looser monetary policies and even lower interest rates than those seen in the U.S. While the strong dollar is good news for U.S. tourists traveling abroad and consumers of imported goods, it does not bode well for U.S. exporters. Additionally, for U.S. investors in foreign stocks, the currency exchange effect singlehandedly knocked the performance of most foreign funds into negative territory for the year. Many foreign stock markets generated positive returns in their local currency, but the returns turned negative once they were translated back into dollars.

- **U.S. stocks notched their sixth straight year of positive returns.** The bull market in U.S. stocks since 2009 seems to have snuck up on many investors. Scarred by the Great Recession, many have approached equities with caution and trepidation, with a vague feeling that the other shoe was about to drop, that a major correction was right around the next bend. But each of the past six calendar years, the market has turned in a positive total return performance. Anyone brave enough to commit $10,000 to a diversified U.S. stock market index back on December 31, 2008—the dark days of the Great Recession—would today have $26,531 (assuming reinvested dividends), notching an annualized return of 17.7%. Even more impressive, the U.S. stock market has now turned in a winning performance in 11 of the last 12 calendar years, with 2008 (-37%) being the one notable exception.

- **Active management fell short (yet again).** A study of the mutual fund industry by Dimensional Fund Advisors found that for the 10-year period from 2004 to 2013, just 19% of stock mutual funds survived and outperformed their benchmark—and that does not take into account the near impossibility of identifying those "winners" ahead of time. The talking heads on CNBC routinely and longingly declare that we are entering a "stockpicker's market" in which fundamental, bottom-up analysis will prevail over more passive, diversified investment approaches like indexing, but that most certainly did not happen last year. Estimates by Morningstar suggest only about 15% of actively-managed mutual funds beat their benchmark in 2014, the worst single-year performance in decades. Investors have taken notice; on January 5, 2015, The Wall Street Journal reported that Vanguard Group, a purveyor of primarily index-based mutual funds and exchange-traded funds (ETFs), raked in $216 billion of new assets in 2014, an all-time record inflow for any mutual fund group.

We don't know, and won't hazard any guesses, what might come to pass in the coming year. As detailed above, even the most well-informed and widely followed market watchers and economists failed miserably to forecast the most important changes in the investment landscape in 2014. We continue to firmly believe that the best antidotes to an uncertain world are appropriate asset allocation, broad diversification, disciplined rebalancing, and cost minimization. A certain level of contrarianism—exercising healthy skepticism when confronted with herdlike behavior and groupthink—doesn't hurt either.