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Q4 Quarterly Market Review

Fourth Quarter 2014

Quarterly Market Review

Fourth Quarter 2014

This report features topics of interest as well as world capital market performance and a timeline of events for the past quarter.

The world capital market performance discussion begins with a global overview, then features the returns of stock and bond asset classes in the US and international markets.

The report also illustrates the performance of globally diversified portfolios.

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Overview:

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The Dow: What's in a number?

Fourth Quarter 2014

Most everyone follows the Dow Jones Industrial Average (DJIA), but very few seem to know what it actually is. The latter point might not be a problem if the methodology behind the DJIA is not flawed, but is it?

Charles Dow, journalist and founder of the Wall Street Journal and co-founder of Dow Jones & Company[1], first calculated the DJIA on May 26, 1896 by averaging[2] the price per share of the following industrial[2] companies[3].

- American Cotton Oil Company
- American Sugar Company
- American Tobacco Company
- Chicago Gas Company
- Distilling & Cattle Feeding Company
- General Electric Company
- Laclede Gas Company
- National Lead Company
- North American Company
- Tennessee Coal, Iron and Railroad Company
- U.S. Leather Company
- United States Rubber Company

Before the DJIA was created it was difficult to discern how the overall market was performing. Through the sampling and averaging of stock prices, Charles Dow made it easy for even the lay person to measure the health of the stock market. In fact, at the time DJIA was created, prudent investors bought bonds. The creation of the DJIA helped to make stocks the widely accepted investment vehicles that they are today.

Since the DJIA is meant to gauge the health of the overall stock market, the representative sampling of stocks must be just that: representative. This, in large part, has caused the component companies of the DJIA to change many times since 1896. The DJIA now consists of 30 different stocks with approximately one-third *not* being industrial. The current DJIA stock list and prices can be found here, but the level of the DJIA is no longer calculated by taking a simple average of the price per share of the 30 component stocks.

Since the DJIA is meant to gauge the health (growth and volatility) of the US stock market, a simple average will no longer do. The reason is that as time goes on there are spin-offs, mergers, acquisitions, distributions, splits, etc. as well as companies being added/deleted as DJIA components; all of which would caused an unadjusted DJIA average to behave differently than the market itself. In other words, the formula itself would cause the benchmark to fail, thus it must be constantly adjusted. To do this the DJIA Committee (part of McGraw Hill Financial) must adjust the denominator of the equation. Today, instead of the denominator being 30 (the number of companies), it's 0.15571590501117. If you add up the per share value of the 30 component stocks, then divide by the adjusted divisor, you'll arrive at the DJIA. Of course the efficiency of computers allows the DJIA to be computed for us on a nearly real-time basis, but you should at least understand the methodology if you choose to follow the DJIA.

The fact the DJIA consists of only 30 different companies leaves me with little faith in it as an indicator of the US stock markets health when there are over 5,000 public companies that trade on U.S. stock markets. As if this weren't bad enough, I also believe the general DJIA pricing methodology is flawed.

Most indices are market weighted. This means that instead of index holdings being equal shares of each company (as is the case with the DJIA), companies are instead weighted according to their relative size. For example, Exxon Mobil Corp. (XOM) is currently 1.72% of the U.S. stock market, thus is 1.72% of most total U.S. market weighted indices (that is, those employing full replication). This means that the performance of each market weighted holding has a relative impact on the performance of the index as a whole according to its size. For example, let's say XOM increased by 1% on a given day. The impact of this on a market weighted index would be:

$$1.72\% \times 1\% = .0172\%$$

With the DJIA pricing methodology, however, a numerical change in any one of the component stocks, from whichever source, has the same effect on the level of the DJIA. For example, two of the DJIA components are Visa Inc. (V) and General Electric Company (GE) which are trading at about \$240/share and \$24/share, respectively. If either stock were to increase by \$2.40/share it would have the same exact impact on the level of the DJIA even though GE would have increased by 10% while V increased by only 1%. Market weighted portfolios solve this problem (among many others).

I don't expect you to stop following the DJIA, but you should at least now understand some of its major flaws. As an investor you should also realize there's literally a world of investment opportunities. Focusing just on U.S. markets alone (see: home bias) neglects roughly 50% of the stock investments available for investment, thus a major source of diversification.

[1] Edward Jones was his co-founder
[2] The "A" and "I" in DJIA
[3] You may notice that General Electric is the only identifiable company still in existence

Living with Volatility, Again

Fourth Quarter 2014

Volatility is back. Just as many people were starting to think markets only ever move in one direction, the pendulum has swung the other way. Anxiety is a completely natural response to these events. Acting on those emotions, though, can end up doing us more harm than good.

There are a number of tidy-sounding theories about why markets have become more volatile. Among the issues frequently splashed across newspaper front pages: global growth fears, policy uncertainty, geopolitical risk, and even the Ebola virus.

In many cases, these issues are not new. The US Federal Reserve gave notice it was contemplating its exit from quantitative easing (an unconventional monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective). Much of Europe has been struggling with sluggish growth or recession for years, and there are always geopolitical tensions somewhere.

In some ways, the increase in volatility could be just as much a reflection of the fact that volatility has been very low for some time.

Markets do not move in one direction. If they did, there would be no return from investing in stocks and bonds. And if volatility remained low forever, there would probably be more reason to worry.

For those still anxious, here are six simple truths to help you live with volatility:

1.Don't make presumptions.
Remember that markets are unpredictable and do not always react the way the experts predict they will. When central banks relaxed monetary policy during the crisis of 2008-09, many analysts warned of an inflation breakout. If anything, the reverse has been the case with central banks fretting about deflation.

2. Someone is buying.
Quitting the equity market when prices are falling is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks," remember someone is buying them. Those people are often the long-term investors.

3. Market timing is hard.
Recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was at its worst—the S&P 500 turned and put in seven consecutive months of gains totalling almost 80%. This is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.

4. Never forget the power of diversification.
While equity markets have turned rocky again, highly rated government bonds have flourished. This helps limit the damage to balanced fund investors. So diversification spreads risk and can lessen the bumps in the road.

5. Nothing lasts forever.
Just as loading up on risk when prices are high can leave you exposed to a correction, dumping risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

6. Discipline is rewarded.
The market volatility is worrisome, no doubt. But through discipline, diversification, and understanding how markets work, the ride can be made bearable. At some point, value re-emerges, risk appetites reawaken, and for those who acknowledged their emotions without acting on them, relief replaces anxiety.

Adapted from "Living with Volatility, Again" by Jim Parker, Outside the Flags column on Dimensional's website, October 2014. Dimensional Fund Advisors LP ("Dimensional") is an investment advisor registered with the Securities and Exchange Commission. Diversification does not eliminate the risk of market loss. There is no guarantee investment strategies will be successful. The S&P 500 Index is not available for direct investment and does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. All expressions of opinion are subject to change without notice in reaction to shifting market conditions. This content is provided for informational purposes, and it is not to be construed as an offer, solicitation, recommendation, or endorsement of any particular security, products, or services.

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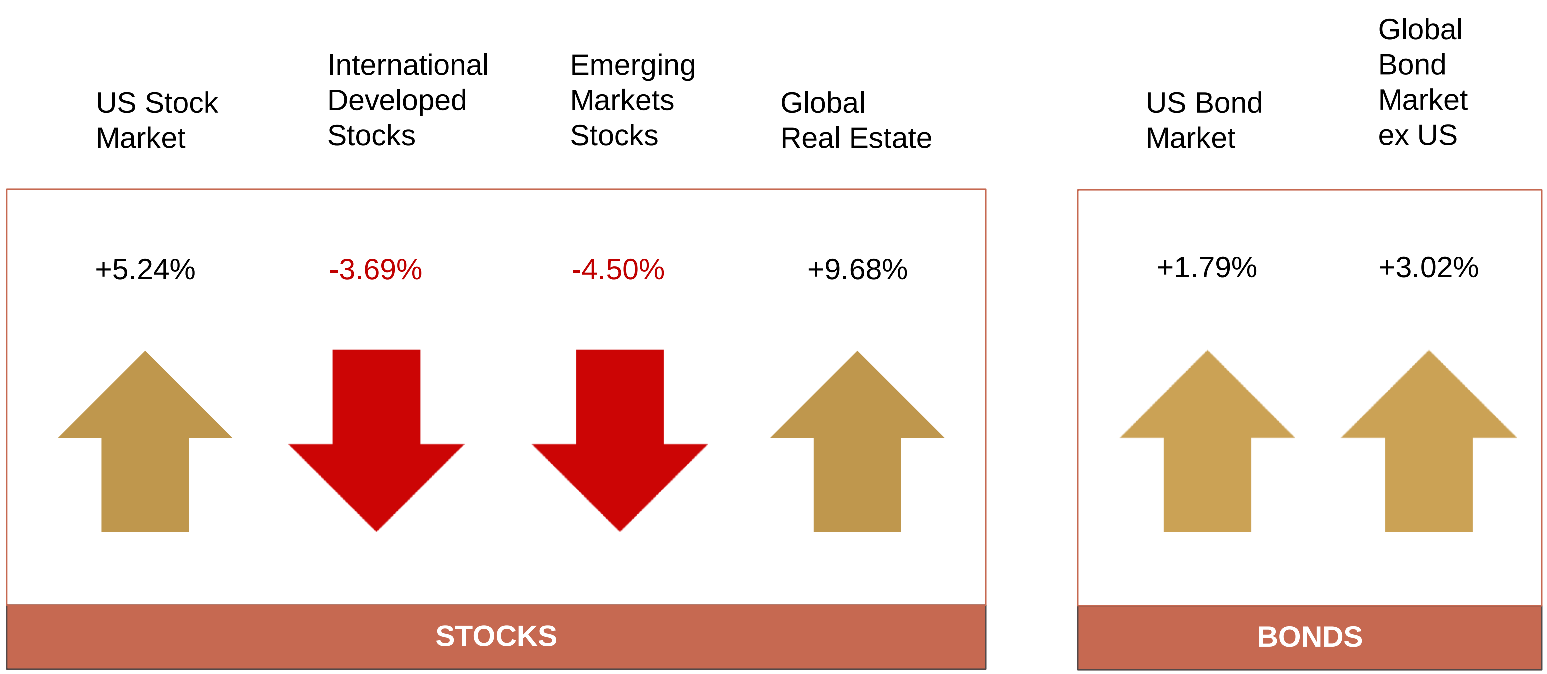
Market Summary

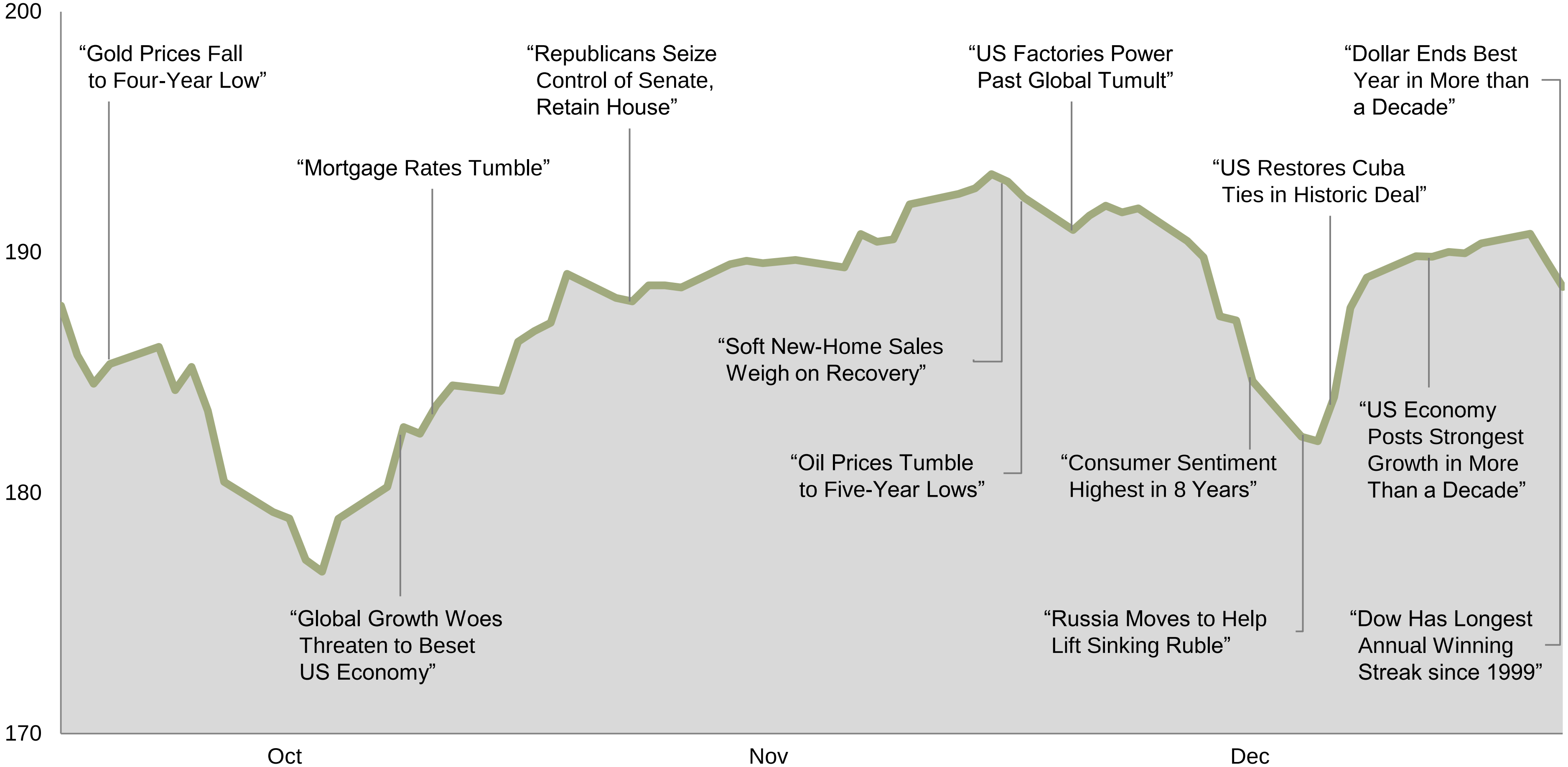
Fourth Quarter 2014 Index Returns



Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index), US Bond Market (Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citigroup WGBI ex USA 1−30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. Russell data © Russell Investment Group 1995–2015, all rights reserved. MSCI data © MSCI 2015, all rights reserved. Barclays data provided by Barclays Bank PLC. Citigroup bond indices © 2014 by Citigroup.

World Stock Market Performance

MSCI All Country World Index with selected headlines from Q4 2014



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

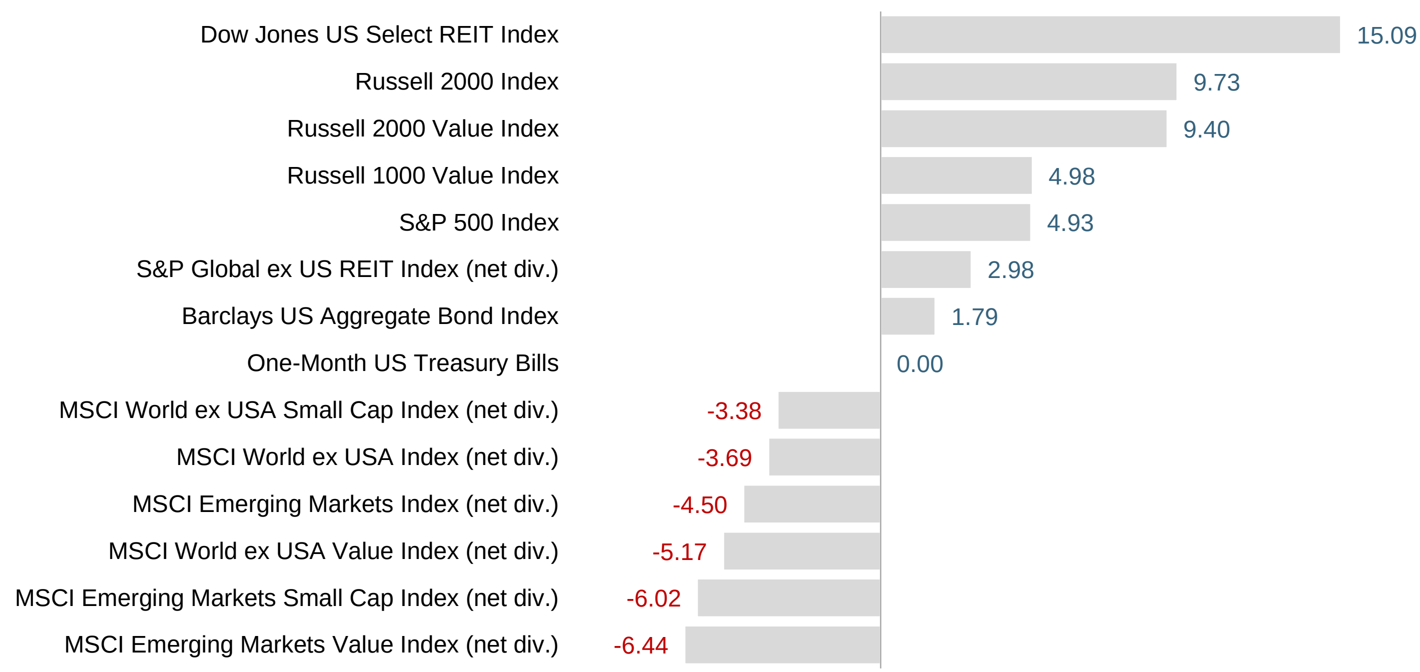
Graph Source: MSCI ACWI Index. MSCI data © MSCI 2015, all rights reserved.

It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results**.

World Asset Classes

Fourth Quarter 2014 Index Returns

REITs, particularly in the US, had higher returns than most asset classes in the fourth quarter, outperforming equity indices. US equities performed better than non-US developed and emerging markets. Many equity markets outside the US declined in US dollar terms. Currency movements played a role; the dollar appreciated against most currencies. Small caps outperformed large caps in the US. In developed markets outside the US, small caps slightly outperformed large caps but underperformed in emerging markets. Broad market value indices outperformed growth indices in the US but underperformed in developed markets outside the US and in emerging markets. The results were mixed across size ranges in the various markets.



Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
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US Stocks

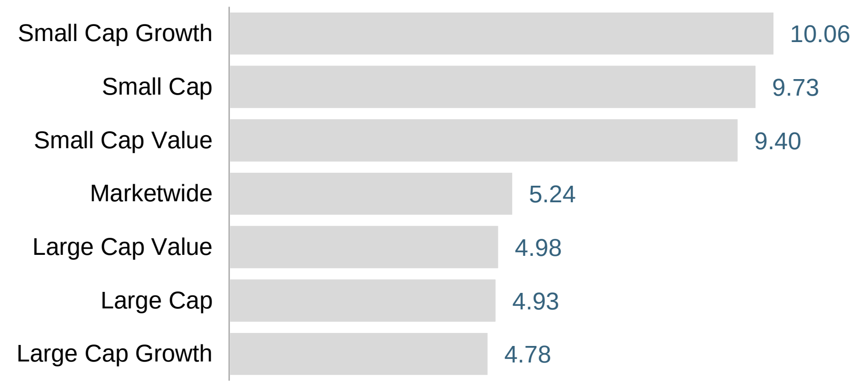
Fourth Quarter 2014 Index Returns

The US equity market performed better than most other markets for the quarter. Small cap indices outperformed large cap indices.

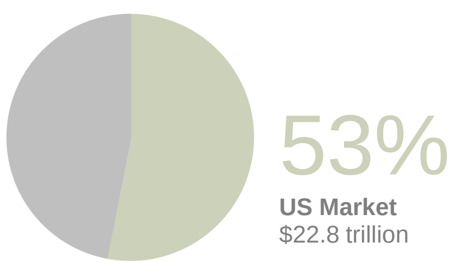
Marketwide value indices outperformed growth indices, and large and mid-cap value indices outperformed their growth counterparts. However, value underperformed growth among both small and micro cap stocks.

REITs, which are included to varying degrees in many benchmarks, boosted index returns.

Ranked Returns for the Quarter (%)



World Market Capitalization—US



Period Returns (%)

** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
Marketwide	12.56	12.56	20.51	15.63	7.94
Large Cap	13.69	13.69	20.41	15.45	7.67
Large Cap Value	13.45	13.45	20.89	15.42	7.30
Large Cap Growth	13.05	13.05	20.26	15.81	8.49
Small Cap	4.89	4.89	19.21	15.55	7.77
Small Cap Value	4.22	4.22	18.29	14.26	6.89
Small Cap Growth	5.60	5.60	20.14	16.80	8.54

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
Market segment (index representation) as follows: Marketwide (Russell 3000 Index), Large Cap (S&P 500 Index), Large Cap Value (Russell 1000 Value Index), Large Cap Growth (Russell 1000 Growth Index), Small Cap (Russell 2000 Index), Small Cap Value (Russell 2000 Value Index), and Small Cap Growth (Russell 2000 Growth Index). World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. Russell 3000 Index is used as the proxy for the US market. Russell data © Russell Investment Group 1995–2015, all rights reserved. The S&P data are provided by Standard & Poor's Index Services Group.

International Developed Stocks

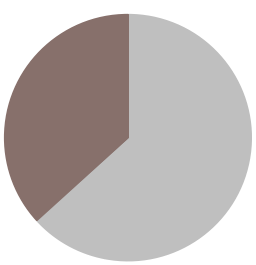
Fourth Quarter 2014 Index Returns

International developed broad market indices measured in US dollars underperformed the US indices but outperformed emerging markets as a group. Small caps slightly outperformed large caps.

Value underperformed growth across all size segments.

The US dollar strengthened against most currencies during the quarter.

World Market Capitalization—International Developed

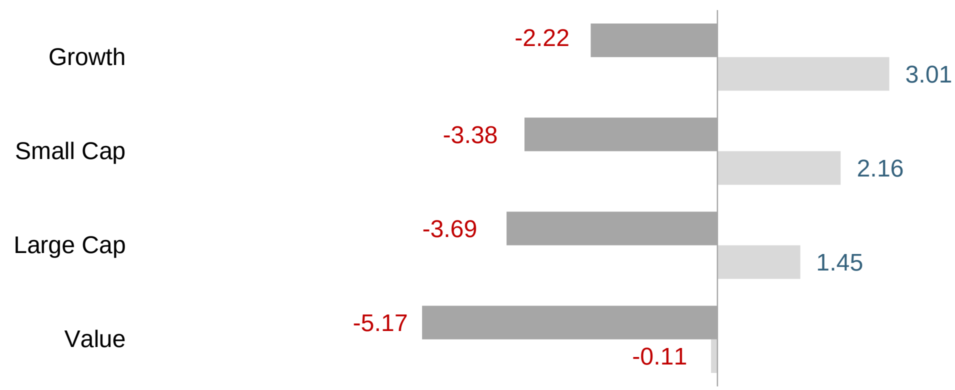


37%

International Developed Market

$15.8 trillion

Ranked Returns (%)



Period Returns (%)

** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
Large Cap	-4.32	-4.32	10.47	5.21	4.64
Small Cap	-5.35	-5.35	11.77	7.91	5.87
Value	-5.41	-5.41	10.46	4.52	4.18
Growth	-3.26	-3.26	10.43	5.85	5.04

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Market segment (index representation) as follows: Large Cap (MSCI World ex USA Index), Small Cap (MSCI World ex USA Small Cap Index), Value (MSCI World ex USA Value Index), and Growth (MSCI World ex USA Growth). All index returns are net of withholding tax on dividends. World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. MSCI World ex USA IMI Index used as the proxy for the International Developed market. MSCI data © MSCI 2015, all rights reserved.

Emerging Markets Stocks

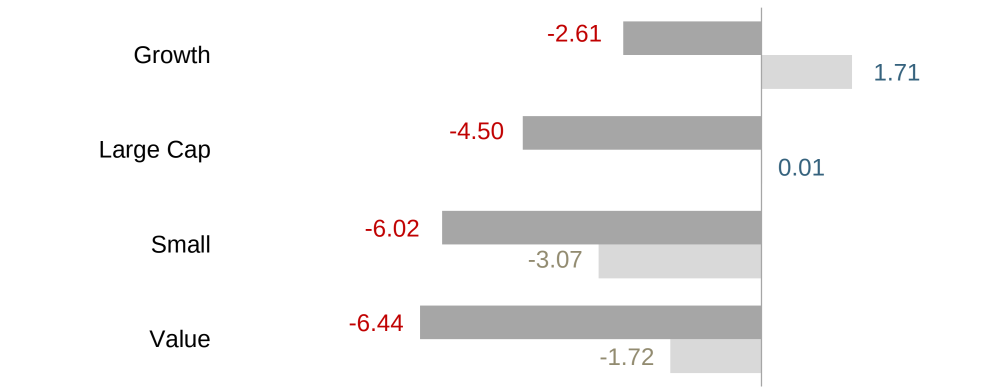
Fourth Quarter 2014 Index Returns

Broad market emerging markets indices underperformed developed markets, including the US.

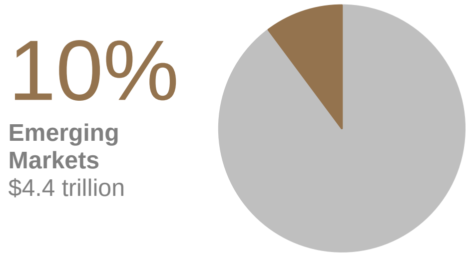
Small cap indices underperformed large cap indices for the quarter. Value indices underperformed growth indices in large caps and mid-caps but outperformed in small caps.

The US dollar strengthened against most currencies during the quarter.

Ranked Returns (%)



World Market Capitalization—Emerging Markets



Period Returns (%)

** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
Large Cap	-2.19	-2.19	4.04	1.78	8.43
Small Cap	1.01	1.01	7.65	2.93	9.63
Value	-4.08	-4.08	1.79	0.51	8.59
Growth	-0.35	-0.35	6.24	3.00	8.22

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Market segment (index representation) as follows: Large Cap (MSCI Emerging Markets Index), Small Cap (MSCI Emerging Markets Small Cap Index), Value (MSCI Emerging Markets Value Index), and Growth (MSCI Emerging Markets Growth Index). All index returns are net of withholding tax on dividends. World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. MSCI Emerging Markets IMI Index used as the proxy for the emerging market portion of the market. MSCI data © MSCI 2015, all rights reserved.

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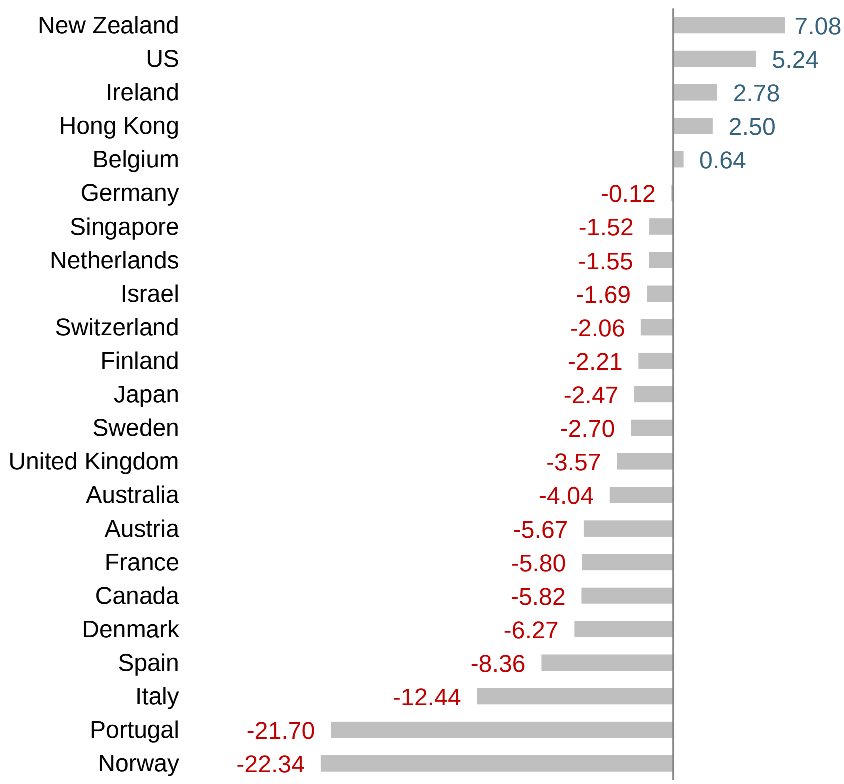
Select Country Performance

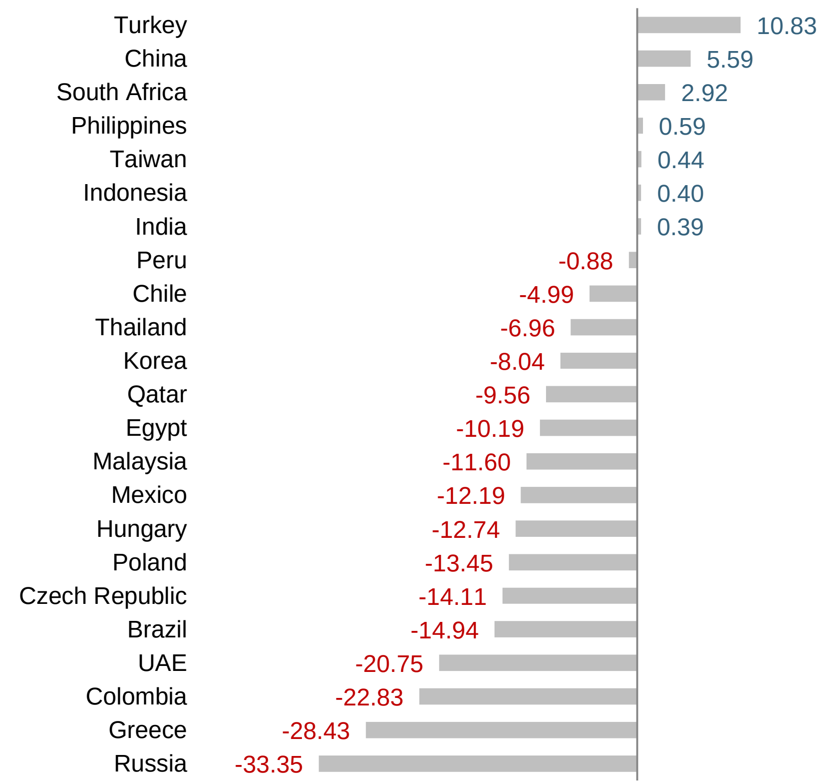
Fourth Quarter 2014 Index Returns

In US dollar terms, New Zealand was the best performer in developed markets during the fourth quarter. The fall in commodity prices, in particular the decline in the price of oil, contributed to the lower performance of commodity-dominated countries such as Norway and Russia. Turkey and China recorded the highest performance among emerging markets.

Ranked Developed Markets Returns (%)



Ranked Emerging Markets Returns (%)



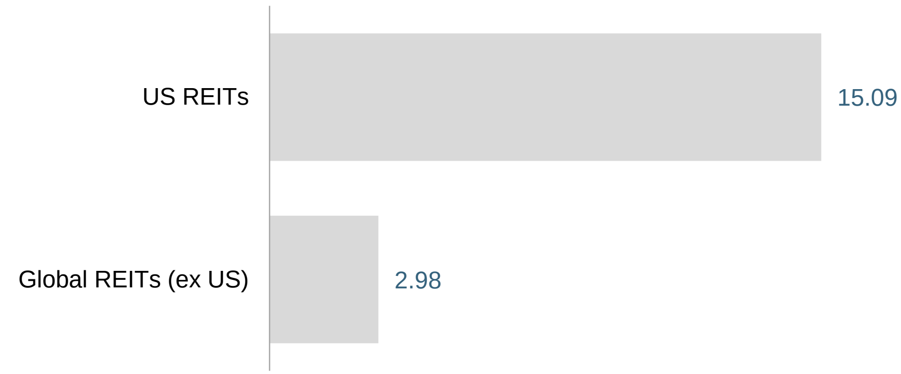
Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Country performance based on respective indices in the MSCI World ex US IMI Index (for developed markets), Russell 3000 Index (for US), and MSCI Emerging Markets IMI Index. All returns in USD and net of withholding tax on dividends. MSCI data © MSCI 2015, all rights reserved. Russell data © Russell Investment Group 1995–2015, all rights reserved. UAE and Qatar have been reclassified as emerging markets by MSCI, effective May 2014.

Real Estate Investment Trusts (REITs)

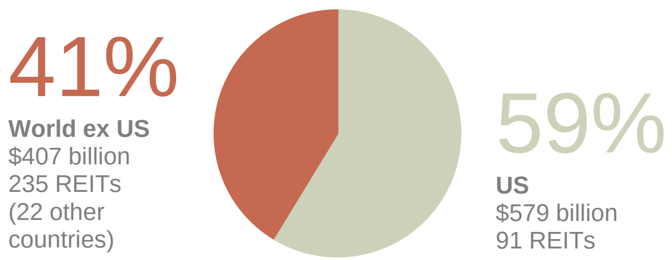
Fourth Quarter 2014 Index Returns

US REITs outperformed the broad equity market for the quarter. REIT indices in developed markets outside the US outperformed broad market equity indices.

Ranked Returns (%)



Total Value of REIT Stocks



Period Returns (%)

** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
US REITs	32.00	32.00	16.10	16.99	8.13
Global REITs (ex US)	10.94	10.94	14.42	9.86	4.29

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.
Number of REIT stocks and total value based on the two indices. All index returns are net of withholding tax on dividends. Total value of REIT stocks represented by Dow Jones US Select REIT Index and the S&P Global ex US REIT Index. Dow Jones US Select REIT Index used as proxy for the US market and S&P Global ex US REIT Index used as proxy for the World ex US market. Dow Jones US Select REIT Index data provided by Dow Jones ©. S&P Global ex US REIT Index data provided by Standard and Poor's Index Services Group © 2014.

Fixed Income

Fourth Quarter 2014 Index Returns

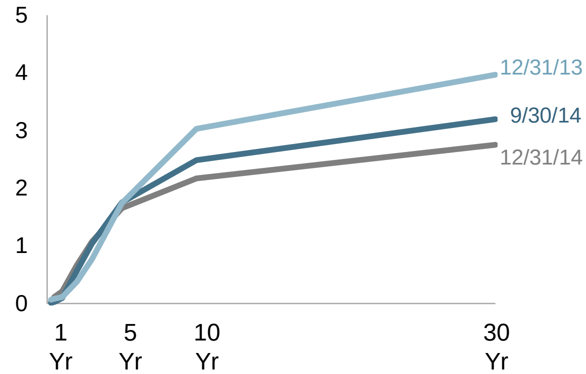
Interest rates across US fixed income markets generally declined during the quarter. The yield on the 10-year Treasury note ended at 2.17%, a dip of 34 basis points over the period. (One basis point equals one-hundredth of a percentage point.) Long-term US Treasury bonds gained 27% in 2014.

While intermediate- and long-term rates declined, short-term rates increased. The two-year Treasury note was up 10 bps to 0.68%.

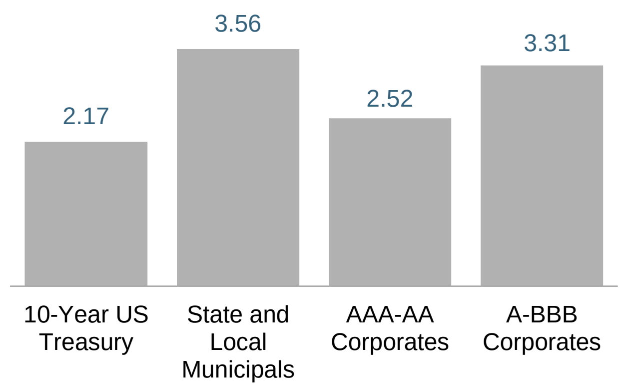
Long-term corporate bonds returned 3.98% for the quarter and 15.73% for the year. Intermediate-term corporates gained 85 bps for the quarter and 4.35% for the year.

Municipal revenue bonds (+1.54%) again slightly outpaced municipal general obligation bonds (+1.11%) for the quarter. Long-term munis continued to outperform all other areas of the curve.

US Treasury Yield Curve



Bond Yields across Issuers



Period Returns (%)

** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
BofA Merrill Lynch Three-Month US Treasury Bill Index	0.04	0.04	0.07	0.09	1.54
BofA Merrill Lynch 1-Year US Treasury Note Index	0.18	0.18	0.23	0.41	2.00
Citigroup WGBI 1−5 Years (hedged to USD)	1.90	1.90	1.54	1.78	3.11
Long-Term Government Bonds	23.87	23.87	4.29	9.88	7.48
Barclays US Aggregate Bond Index	5.97	5.97	2.66	4.45	4.71
Barclays US Corporate High Yield Index	2.45	2.45	8.43	9.03	7.74
Barclays Municipal Bond Index	9.05	9.05	4.30	5.16	4.74
Barclays US TIPS Index	3.64	3.64	0.44	4.11	4.38

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Global Diversification

Fourth Quarter 2014 Index Returns

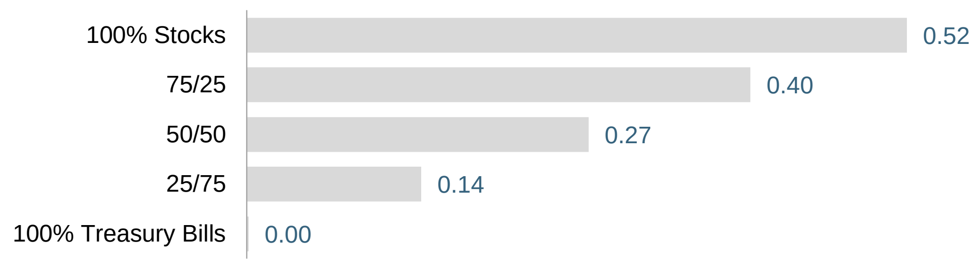
These portfolios illustrate the performance of different global stock/bond mixes and highlight the benefits of diversification. Mixes with larger allocations to stocks are considered riskier but have higher expected returns over time.

Period Returns (%)

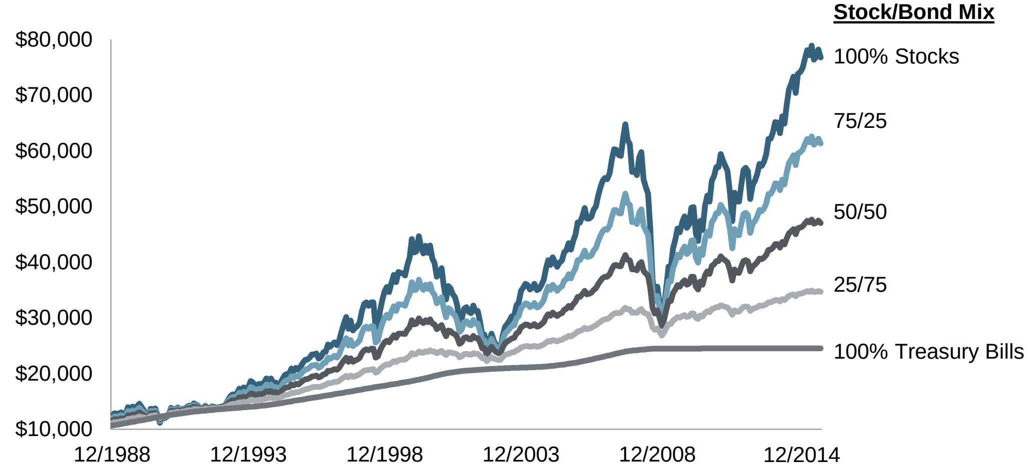
** Annualized*

Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*
100% Stocks	4.71	4.71	14.72	9.74	6.65
75/25	3.58	3.58	10.99	7.45	5.60
50/50	2.43	2.43	7.29	5.07	4.37
25/75	1.24	1.24	3.64	2.60	2.98
100% Treasury Bills	0.02	0.02	0.03	0.05	1.42

Ranked Returns (%)



Growth of Wealth: The Relationship between Risk and Return



Diversification does not eliminate the risk of market loss. **Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management an actual portfolio**. Asset allocations and the hypothetical index portfolio returns are for illustrative purposes only and do not represent actual performance. Global Stocks represented by MSCI All Country World Index (gross div.) and Treasury Bills represented by US One-Month Treasury Bills. Globally diversified allocations rebalanced monthly, no withdrawals. Data © MSCI 2015, all rights reserved. Treasury bills © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield).

In Closing

Fourth Quarter 2014

Remember: *Develop a financial plan according to your unique situation and manage your investment portfolio according to a well thought out and documented investment policy. Doing so will greatly increase the probability you will actually meet your financial goals.*

Troy Sapp, CFP®
Commencement Financial Planning LLC
www.commencefp.com

This letter is intended to address broadly defined financial planning issues. If you need assistance developing a wealth management program tailored to your unique situation, then seek the assistance of a fee-only NAPFA registered financial advisor who is also a CERTIFIED FINANCIAL PLANNER™ professional having the proper education and experience. Consult with your tax advisor before implementing a particular tax strategy.