Mosaic Fi

Q4 2014

Sophisticated planning for complex clients

Clarity…Courage…Commitment

As we reflect on 2014, there were several key factors that had a strong influence on the performance of the global markets for stocks and bonds. Some were anticipated and some were quite surprising. The expected ones: a U.S. economy that continues to build momentum including an improving employment picture, an ex U.S. global economy that is muddling along at best, and a benign inflationary environment on a global basis. The big surprises of 2014: oil prices cut in half and the dramatic ascent of the U.S. dollar relative to virtually every other currency.

So what did all of this translate into in terms of performance of our investment portfolios? First of all, it meant that the U.S. equity markets were the shining star in the global arena. But it also meant that a U.S. investor who implements diversification into their investment portfolio did not experience the full effects of a 13.69% rise in the S&P 500 in 2014 (with the sector award going to U.S. REITs that were up a whopping 32%). Given that the Russell 2000 (U.S. small cap index) returned 4.89% and the MSCI World ex USA index had a -4.32% return on a dollar basis, an investor with a diversified portfolio would have likely enjoyed a mid-single digit return on their overall equity portfolio. Not bad. Still in the range of the 7-9% return that one can expect over the long term.

Diversification is an understood and accepted portfolio management concept for many investors, at least as it relates to equities. The idea is that it is important to have exposure to different segments of the markets such as large cap, small cap, international, emerging markets, REITs, etc. (as well as sectors of the economy such as energy, financial services, manufacturing, etc.). The idea is that when one segment of the market does poorly, some of the other parts of the market do better and that over time it all balances itself out and our portfolios perform in line with an average expected return with less volatility. An investor's equity portfolio provides the growth engine that allows them to achieve the financial goals and objectives.

What many people don't realize is that the same diversification concept holds when it comes to our fixed income portfolios. Like equities, the different components of the fixed income markets perform differently than others based on several factors. These factors include: the current economic environment both domestically and internationally, the absolute level of interest rates, the relative level of interest rates to other countries, currencies, the stock market, etc. So it is important to structure one's fixed income portfolio with the same diversification concept in mind. This includes considering interest rate/yield curve exposure, overall credit quality, issuer concentration, inflation protection, etc. A fixed income portfolio should act as a source of stability, liquidity, and income generation. Employing diversification allows our fixed income assets to serve an investors needs in this way, over time.

And what about the Fixed Income markets…

The strong performance of the fixed income markets in 2014 once again came as a surprise to many investors. We began the year with a UST 10yr yield of 3.03% and ended it at a 2.17%. The thought was, by many, as we started 2014 that interest rates had been too low for too long and with evidence that the

U.S. economy was gaining traction, the market would begin pricing in a higher inflation/interest rate environment. This never happened. While the Fed did end the QE3 program, inflation remained tame even with an improving economic growth and employment picture. What had an even greater impact on U.S. interest rates were the historically low yields of other developed markets. The German 10 year Bund closed out the year at .54% and Japan's 10yr yield was .33% at year-end. As we discussed in our last newsletter, these historically low yields on a global basis caused investors outside the U.S. to demand U.S. dollar denominated debt in their search for yield, as the U.S. bond markets were very attractive on a relative basis. This dynamic put a lid on how high U.S. interest rates could go.

Similar to the equity markets for 2014, performance in the fixed income markets diverged significantly. The Barclay's Intermediate Bond Index was up 6.96% in 2014 while the Short-term Bond Index was up 1.26%. This was due to the flattening of the yield curve. Municipal bonds had a very strong year with the Barclay's Intermediate Municipal Bond Index up 6.36%. While the High Yield bond market received a lot of negative press in 2014, overall that market still returned 2.45% for the year.

Outlook for 2015

As we move into 2015, we see cause for optimism as well as a few things to watch out for. We are pleased that the ECB is finally putting their money where their mouth is and beginning a QE program of their own. Add in a declining Euro (which should drive growth in their markets as the world buys more of their goods and services), and we should start to see Europe begin a more substantial recovery. Low oil prices will continue to help the U.S. consumer spend more and be a driver of growth domestically. This will also help to keep stated inflation contained, which will allow interest rates to stay low.

There are a few things we are looking out for in 2015. The rising dollar will (and has) put a crimp on earnings for companies that do business outside of the U.S. (as our goods and services become more expensive to the rest of the world). Another factor to look out for relates to our improving job market in the U.S. At some point, demand for labor will out way supply and wages will need to rise to compete for the shrinking pool of qualified prospective employees. This is what will drive inflation in the U.S. We are not there yet but we have entered the ballpark. When this does happen, we will see U.S. interest rates disconnect with the rest of the world (similar to what we saw in 2014 in the equity markets).

Once again we would like to reiterate our fundamental beliefs as it relates to investing in the global markets. We remain confident that in time the global economy will recover and continue on it's natural growth trajectory. How long that will take is hard to say but when it does, the markets will reflect it appropriately through price valuations. Since we don't know when this will occur or how quickly, staying invested continues to be the logical choice and the foundation of our investment philosophy. Utilizing basic, sound, logical investing principles such as diversification, risk management and discipline allows an investor to see through the interim volatility and maintain a longer-term perspective. The most important guidance that we can provide for our clients is to create an investment policy and asset allocation that is appropriately designed for their unique financial picture. We work with our clients over time to come up with financial solutions that are well suited to their needs and circumstances.

As always, we would love to hear from you so please feel free to contact us at any time.

Mosaic Fi
250 Parkway Drive, Suite 150
Lincolnshire, Illinois 60069

Please feel free to contact us at:
Main: (773) 425-6790
Email: jenifer@mosaicfi.com
Visit us at: www.MosaicFi.com

A Registered Investment Advisor, Mosaic Fi is an independent, privately owned company. Mosaic is a fee-only advisor. Mosaic does not sell any financial products or receive any commissions.