# INVESTMENT COMMENT — January 6, 2014
## 4th Quarter and 2013 Review and Strategy Update

This is the time of year investors are inundated with recommendations based upon a review of recent experience and "obvious" market movements to come. 2013 was a strong year for stock returns and weak year for bonds and sentiment seems generally positive for 2014. However, *investors should avoid the temptation to deviate from their carefully-crafted investment strategy by selling bonds to buy more stocks.* Instead, this is a good time to review personal financial goals and affirm a consistent long-term investment strategy.

**2013 CAPITAL MARKETS REVIEW**

4th Quarter and full year 2013 returns were solidly positive, driven by portfolio exposures to Risk (global equity markets). US Stock market performance was the best since 1997 and non-US market gains were the best since 2009. Low Risk investments, meanwhile, generated the lowest returns since 1994. Below is a summary of Risk and Low Risk indices.

| **Table 1: 2013 in Perspective**<br>Total Return | | Index | **2013** | **10 Year**<br>Annualized | **10 Year**<br>Growth of |
|---|---|---|---|---|---|
| **SELECTED RISK INDICES** | | | | | |
| Global Stock Market | ***Best return in 4 years*** | MSCI AC World | **+23.4%** | **+7.7%** | $2.10 |
| US Market | ***Best return in 16 years*** | S&P 500 | **+32.4%** | **+7.4%** | $2.04 |
| Non-US Markets | ***Best return in 4 years*** | MSCI AC World ex US | **+15.8%** | **+8.0%** | $2.17 |
| **SELECTED LOW RISK** | | | | | |
| 1-5yr Bonds | ***Worst return in 19 years*** | Barclays 1-5 Govt/Corp | +0.3% | +3.4% | $1.40 |
| Broad Bond Market | ***Worst return in 19 years*** | Barclays Aggregate | -2.0% | +4.6% | $1.56 |

*Source: Bloomberg, MCA. Returns include reinvested dividends.*

A comparison of 2013 returns with the past 10 years offers some perspective that last year was far better-than-average for Risk and much lower-than-average for Low Risk investments. *The two major themes of 2013 – rising interest-rates and US stock market returns out-pacing non-US markets – began in May.* ***Please review our 2nd Quarter Investment Comment[1] where we detailed these issues and how our strategy manages such risks.*** *The bottom-line is that 2013's Risk and Low Risk returns are within historical ranges and our disciplined strategy is managing risks according to plan.*

The following table details return contribution from various segments of Risk and Low Risk assets. Some 2013 highlights:

- Geographically, *US stocks overall generated the most positive returns and US Small Cap stocks generated the strongest returns. Due to our strategic greater-than-market exposures to low-priced (value) and smaller company stocks, our primary US portfolio investments out-performed relative to their benchmarks.*
- Japan's stock market, an element of our International (Developed non-US) Risk, soared +59.3% (Nikkei 225 Index), but the Yen's weakness versus the US Dollar (-17.6%) muted the impact. Overall, International stocks performed well and generated over +20%.
- *Emerging Markets stocks posted negative returns.* Our July 8 Investment Comment, noted that we "… are monitoring the performance gap between US Risk and non-US

[1] 2nd Quarter Review and Strategy Update, July 8, 2013 available at www.marylandcap.com under LIBRARY tab.

Risk segments, particularly Emerging Markets for an eventual readjustment back to our targeted portfolio exposures." *In late September we brought exposure back in-line with targets and 4th Quarter Emerging Markets returns were positive.*

- Precious Metals are not an element of our portfolio strategy, but it is worth noting that speculators in Gold generated a -28.3% return.
- Low Risk segment returns ranged from negative to slightly positive. As interest-rates rose in 2013, note that US Treasury and Investment Grade bonds with longer maturities fared worse. Our Low Risk portfolios are relatively short-term with modest sensitivity to interest-rate changes and, therefore, held up relatively well last year.
- Treasury Inflation-Protected bonds generated -8.9% as inflation remained low (currently only +1.2% year-over-year), market fears of rising inflation waned, and interest-rates rose.

**PERSPECTIVE ON 2013 THEMES**

*What are the lessons from last year?*

**Maintain a Global, Diverse Risk Exposure**

Year-to-year return variations across Risk segments can be significant. Correspondingly, portfolios constructed with concentrated "bets" in a limited number of segments will perform differently than global, well-diversified portfolios. In 2013, a single-segment portfolio of 100% US Large Cap stocks outperformed portfolios diversified into International, Emerging Markets, or Real Estate segments.

Our 2nd Quarter Investment Comment presented the longer-term rationale for diversifying Risk well beyond a US Large exposure such as the S&P 500 Index. *Many investors mistakenly view the S&P 500 Index as a measure of overall stock Risk – it is merely one Risk segment (US Large Cap).*

*A striking example of significant variation between a US Large only (S&P 500 Index) portfolio and a global Small and Value "tilted" portfolio is the so-called "Lost Decade" from 2000 through 2009.* Financial media and some investors claimed that stocks earned no return for the period. The Growth of Wealth graph (below, left) compares the value of $1.00 invested in the S&P 500 Index with a Global Risk Balanced Index[2] over the Lost Decade. *$1.00 invested in the S&P 500 Index (dividends reinvested) resulted in $0.91 (-9.1% cumulative loss over 10 years) while the Global Balanced*

| **Selected Asset Classes**<br>December 31, 2013 | **2013** | **4th Quarter** |
|---|---|---|
| **SELECTED RISK ASSET CLASS SEGMENTS** | | |
| US Large Cap | +32.8% | +10.1% |
| US Large Cap Value | +32.1% | +9.9% |
| US Small Cap | **+38.7%** | +8.6% |
| US Small Cap Value | **+34.3%** | +9.3% |
| International Large Cap | +21.4% | +6.1% |
| Emerging Markets | -3.7% | +3.5% |
| International Real Estate | +4.4% | -0.1% |
| US Real Estate Investment Trusts | +2.3% | -0.9% |
| **SELECTED LOW RISK ASSET CLASS SEGMENTS** | | |
| US Treasury 1-3yr Notes | **+0.2%** | 0.0% |
| US Treasury 7-10yr Notes | **-6.1%** | -2.2% |
| US Treasury 20-30yr Bonds | **-13.4%** | -4.3% |
| US Treasury Inflation-Protected | **-8.9%** | -2.2% |
| Inv Grade Short Duration | **+1.0%** | +0.6% |
| Inv Grade Intermediate Duration | **-1.4%** | +0.5% |
| Inv Grade Long Duration | **-5.9%** | +1.2% |
| Mortgage-Backed Securities | -2.2% | -0.6% |
| International Bonds (Non-Dollar) | -3.8% | -0.5% |
| **EQUITY INDICES** | | |
| MSCI All-Country World Index | **+23.5%** | **+7.4%** |
| S&P 500 Index | **+32.4%** | **+10.5%** |
| **BALANCED PORTFOLIOS** | | |
| Vanguard 60/40 Fund | +18.0% | +5.9% |
| DFA 60/40 Fund | +16.0% | +4.9% |
| DFA 25/75 Fund | +5.9% | +2.0% |
| **OTHER NOTABLE MARKET DATA** | | |
| Gold (ETF) | **-28.3%** | **-9.4%** |
| Emerging Markets Bonds (ETF) | -7.8% | +0.8% |
| Exchange value of Euro vs US$ | +4.2% | +1.6% |
| Exchange value of Yen vs US$ | **-17.6%** | **-6.7%** |

*Source: Bloomberg Professional*

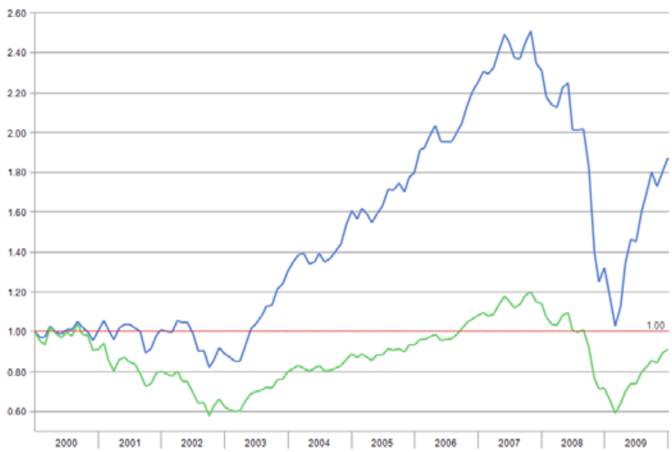
*Note: Returns include reinvested dividends.*

[2] DFA Equity Balanced Strategy Index, Total Return, [Large, Small, and Value stocks in US, International, and Emerging Markets]

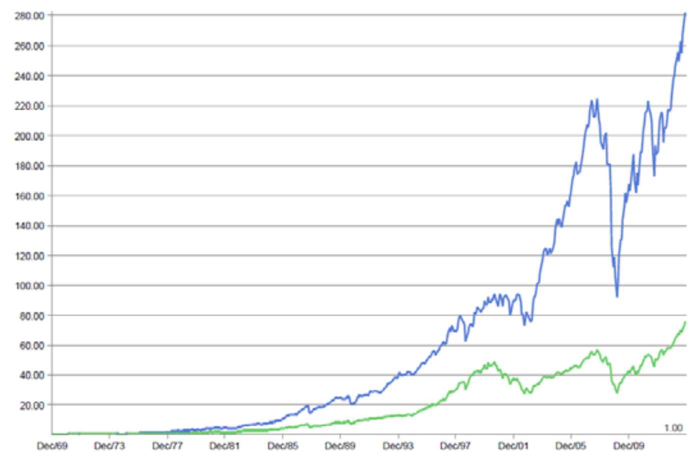
*Strategy Index grew to $1.87 over the same period.* Clearly, *there was no "lost decade" for investors holding a global portfolio with targeted exposures to Small and Value stocks – only for investors with wealth concentrated in US Large. It is worth noting that the Lost Decade ended just 4 years ago.* ***Investors that avoided stocks following the Lost Decade focused on a narrow segment of global Risk and, as a result, drew the wrong lesson from that period. Similarly, current investors should not move investments from bonds to stocks based on recent investment experience.***

As we extend the analysis from 10 years to 44 years ending in 2013, this comparison becomes even more dramatic (below, right). The period from 1970 is the longest period where reliable data is available for both International equities (1970) and Emerging Markets (1988) equities.

**Growth of Wealth: "Lost Decade" 2000-2009**




**Growth of Wealth: 1970 - 2013**




Global Risk Balanced Index (Blue) versus S&P 500 Index (Green)

*Source: Dimensional Funds, DFA Equity Balanced Strategy Index data through November 2013*

| **Benefits of Global Risk Diversification** Annualized returns through November, 2013 | **5-Year** | **10-Year** | **Lost Decade** | **20-Year** | **Since 1970** | **Risk*** |
|---|---|---|---|---|---|---|
| **S&P 500 Index** | +17.6% | +7.7% | **-1.0%** | +9.2% | +10.4% | 19.00 |
| US Domestic Balanced Strategy Index | +20.9% | +8.4% | **+3.6%** | +20.9% | +12.5% | 22.26 |
| **Global Balanced Strategy Index** | +20.3% | +9.8% | **+6.5%** | +20.3% | **+13.7%** | **15.64** |
| *Source: Dimensional Funds* | | | | ** Annualized Standard Deviation* | | |

**<u>Bonds are still Bonds, Stocks are still Stocks</u>**

Following a difficult year for Low Risk investments in 2013, some investors might consider moving money from Bonds to Stocks. Incredibly, *I recently heard a comment from an investment broker that "bonds are now riskier than stocks". That is simply not the case!* The Low Risk portfolio component plays a critical long-run capital preservation role, even in a low interest-rate environment.

Against the backdrop of strong portfolio returns for 2013, we remain committed to our disciplined process and respectful of the power and diversity of global capital markets. Most importantly, we look forward to reviewing with clients how their wealth management strategy complements their financial goals.

*The helpful comments of Paul Cucchissi and Shelley Quade are greatly appreciated*