DISCIPLINE • BALANCE • PERSPECTIVE

Maryland Capital Advisors

INVESTMENT COMMENT — October 8, 2014
3rd Quarter Review and Strategy Update

Global capital markets were challenging in the 3rd Quarter. Following a first half that we described as "nirvana"[1], *virtually all Risk segments generated* <u>*negative*</u> *returns during the 3rd Quarter*. Daily price volatility of Risk and Low Risk markets increased markedly in the face of US interest-rate policy anxiety, global terrorism (ISIL), regional conflict (Ukraine), and concerns about an over-heating stock market. ***Clients may note that during the last week of July we reduced Risk in each portfolio, where warranted.***

Selected Asset Classes September 30, 2014	**3rd Quarter**	**2014 YTD**
SELECTED RISK ASSET CLASS SEGMENTS		
US Large Cap	+0.6%	+7.8%
US Large Cap Value	-0.2%	+7.9%
US Small Cap	**-7.4%**	-4.3%
US Small Cap Value	**-8.6%**	-4.8%
International Large Cap	-6.2%	-2.1%
Emerging Markets	-3.9%	+0.2%
International Real Estate	-5.8%	+3.1%
US Real Estate Investment Trusts	-3.1%	**+14.1%**
SELECTED LOW RISK ASSET CLASS SEGMENTS		
US Treasury 1-3yr Notes	+0.0%	+0.4%
US Treasury 7-10yr Notes	+0.6%	+5.9%
US Treasury 20-30yr Bonds	**+3.2%**	**+16.5%**
US Treasury Inflation-Protected	-2.0%	+3.7%
Inv Grade Short Duration	-0.1%	+1.6%
Inv Grade Intermediate Duration	+0.0%	+4.5%
Inv Grade Long Duration	**+0.8%**	**+12.2%**
Mortgage-Backed Securities	+0.3%	+4.8%
International Bonds (Non-Dollar)	-5.1%	+0.0%
EQUITY INDICES		
MSCI All-Country World Index	-2.2%	+4.2%
S&P 500 Index	+1.1%	+8.3%
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	+0.0%	+5.7%
DFA 60/40 Fund	-2.4%	+2.8%
DFA 25/75 Fund	-1.0%	+2.0%
OTHER NOTABLE MARKET DATA		
Gold (ETF)	-9.2%	+0.1%
Emerging Markets Bonds (ETF)	-2.8%	+5.9%
Exchange value of Euro vs US$	**-7.7%**	-8.1%
Exchange value of Yen vs US$	**-7.6%**	-4.0%

Source: Bloomberg Professional
Note: Returns include reinvested dividends.

3rd QUARTER CAPITAL MARKETS UPDATE

The main investment themes were: ***Small Cap sell-off and strong US$ appreciation.***

US Small Cap and US Small Cap Value – last year's best-performing Risk segments – had the lowest returns in Q3 (-7.4%, -8.6%) and now lag US Large Cap by more than 12 percentage points in 2014. Although the 3rd Quarter performance gap between Large and Small company stocks is not without precedent, *such a wide quarterly disparity last occurred over 15 years ago (March 1999).* It is important to note that since March 1999, Small Cap returns have, in fact, exceeded Large Cap by +120.8%[2] (+3.03% annualized). The lesson? <u>Small Cap Risk segments are more volatile, but generate superior returns over time.</u>

It has been three years since the US$ strengthened against the Euro as much as it did in Q3 (Euro -7.7% vs US$). Two factors that drove US$ strength:

- The US$ is widely considered a "safe haven" currency during times of global uncertainty (ISIL, Ukraine)
- Currency exchange-rates are largely driven by interest-rate differentials. With the US economy performing well, US interest-rates are expected to rise in 2015. In contrast, economic activity in the Eurozone economies is weak and interest-rates are lower, thus demand for the US$ increased.

[1] See our July 8, 2014 Investment Comment (LIBRARY tab, marylandcap.com)
[2] Total return of Russell 2000 Index (Small Cap) compared with Russell 1000 Index (Large Cap)

As global investors, our portfolios benefit from the diversity of holding non-US investments[3] over time. However, in periods of US$ appreciation, non-US may lag US segment returns. Note, for example, the 3rd Quarter disparity between US Large Cap (+0.6%) and International Large Cap (-6.2%).

Two other 3rd Quarter events captured market attention, but had little direct impact on our portfolios:

- **Public offering of shares in Alibaba Group Holding Ltd, an e-commerce company doing business in China, raised $25 billion and became the largest share-offering ever**. As a measure of stock market willingness-to-take-risk, this transaction supports the notion that former Federal Reserve Chairman Alan Greenspan's *"irrational exuberance" has made a comeback*[4]. *Such public offerings do not fit our investment strategy, so our involvement was merely as spectator.*
- **Bill Gross, manager of what has been the World's largest bond fund (PIMCO Total Return), abruptly resigned.** *Although this event garnered media attention, it has no impact on our investment strategy*. Why? Total Return has a broad investment mandate that allows the fund manager flexibility to actively trade investments. Under Gross's control, he freely speculated on the direction of interest-rate movements or relative movements between different bond segments (ex. Corporates vs. Mortgages, etc). We have previously noted that such attempts to "beat the market"[5] introduce an undesirable portfolio risk and, therefore, we avoid such funds. We prefer to own bond funds that are constrained to a specific Low Risk segment of the bond market or are managed to match the performance of a stated index. This allows us to allocate, monitor, and manage our client exposures to market segments and avoids "manager risk".

STRATEGY UPDATE

We last rebalanced portfolios near the end of July by reducing Risk exposures back to targeted levels, where needed. As we enter the 4th Quarter we may be presented with additional opportunities to rebalance, depending on market movements.

Although volatility picked-up, global capital markets are behaving within long-standing norms and we remain committed to our process and disciplined investment strategy.

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

[3] See "Why hold non-US investments?" in our July 8, 2013 Investment Comment (LIBRARY tab, marylandcap.com)
[4] See "Risk Factors" section of Alibaba's prospectus – have BABA investors actually read this?
[5] For example, see Investment Comments from July 8, 2013 and October 8, 2011 (LIBRARY tab, marylandcap.com)