INVESTMENT COMMENT **January 6, 2015**

2014 Review and Strategy Update

Unlike the first half of 2014 when all investment segment returns were solidly positive, the second half of 2014 provided some powerful crosscurrents that impacted investor portfolios, including:

- Strong appreciation of US Dollar on foreign exchange markets
- 48% drop in Oil prices
- Renewed Euro currency concerns due to political turmoil in Greece

Table 1: Selected Asset Classes	4th Quarter	2014
SELECTED RISK ASSET CLASS SEGMENTS		
US Large Cap	+4.9%	+13.1%
US Large Cap Value	+4.9%	+13.2%
US Small Cap	**+9.8%**	+5.0%
US Small Cap Value	**+9.4%**	+4.1%
International Large Cap	**-4.2%**	**-6.2%**
Emerging Markets	**-4.1%**	**-3.9%**
International Real Estate	+0.8%	+2.2%
US Real Estate Investment Trusts	**+14.2%**	**+30.3%**
SELECTED LOW RISK ASSET CLASS SEGMENTS		
US Treasury 1-3yr Notes	+0.1%	+0.5%
US Treasury 7-10yr Notes	+3.0%	+9.0%
US Treasury 20-30yr Bonds	+9.3%	**+27.3%**
US Treasury Inflation-Protected	+0.1%	+3.8%
Inv Grade Short Duration	+0.2%	+1.8%
Inv Grade Intermediate Duration	+1.3%	+5.8%
Inv Grade Long Duration	+5.4%	**+18.2%**
Mortgage-Backed Securities	+1.8%	+6.7%
International Bonds (Non-Dollar)	-5.0%	-9.8%
EQUITY INDICES		
MSCI All-Country World Index	+0.6%	+4.8%
S&P 500 Index	+4.9%	+13.7%
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	+3.9%	+9.8%
DFA 60/40 Fund	+0.9%	+3.7%
DFA 25/75 Fund	+0.6%	+2.6%
OTHER NOTABLE MARKET DATA		
Gold (ETF)	-2.3%	-2.2%
Brent Crude Oil (Futures)	**-39.4%**	**-48.3%**
Exchange value of Euro vs US$	-4.2%	**-12.0%**
Exchange value of Yen vs US$	-8.5%	**-12.1%**

Source: Bloomberg Professional

Note: Returns include reinvested dividends

4th QUARTER CAPITAL MARKETS UPDATE

US Real Estate Investment Trusts was the best-performing Risk segment during the 4th Quarter (+14.2%) and 2014 (+30.3%). *US Small Cap (+9.8%) and US Small Cap Value (+9.4%) generated returns much higher than Large companies (+4.9%), reversing their negative 3rd Quarter returns*[1].

Geographically, the US did much better in 2014 than the rest-of-the-World markets (International Large Cap -6.2%, Emerging Markets -3.9%). Why? ***The overriding factor negatively impacting non-US holdings has been the appreciating value of the US Dollar against other currencies.*** Investments denominated in Euros and Yen had to overcome the lower currency value (Euro -12.0%, Yen -12.1%) versus the US Dollar.

Table 2 illustrates the impact of US Dollar appreciation on non-US Risk Asset returns in 2014. *It is interesting to note, that* ***nearly all non-US Risk markets were positive in their local currency***. However, for US-based investors, the currency adjustment overwhelmed those local market gains. US investors did not have to invest in far-away assets in 2014 to experience this effect: note that Canadian Risk (+11.4%) performed nearly as well as the US, but generated a mere +2.0% when converted to US Dollars. Just a few short years ago, some media pundits were decrying a coming *devaluation* of the US Dollar and advising investors to invest abroad to "hedge" the risk of a declining Dollar. It is as impossible

[1] "3rd Quarter Capital Markets Update", October 8, 2014 Investment Comment (LIBRARY tab, marylandcap.com)

to forecast currency exchange rates as it is to predict market movements – though many will still try.

Interest-rate forecasting also proved futile in 2014. We noted in our year-ago Comment that predictions for higher interest-rates had reached a fever pitch[2]. However, interest-rates actually fell in 2014 and the most rate-sensitive Low Risk segments generated solidly-positive returns: US Treasury 20-30yr Bonds (+27.3%) and Investment Grade Long Duration (+18.2%). Once again, we are beginning the year with forecasts of imminent doom in the bond market due to rising rates with headlines like "U.S. Bond Sentiment Is Worst Since Disastrous '09"[3]. Over the past several years we have described how interest-rate sensitivity is best managed within the Low Risk portion of a portfolio[4]. Nothing has changed: our Low Risk strategy maintains relatively low interest-rate risk to preserve capital.

Table 2: 2014 Global Risk Impact of US Dollar Appreciation	**Local Currency**	**US Dollar**
REGIONAL INDICES		
World	***+7.2%***	***+4.8%***
United States	+13.4%	+13.4%
World ex-USA	+3.4%	-3.3%
Europe	+7.6%	-5.5%
DEVELOPED MARKETS		
Developed World ex-USA	***+7.7%***	***-3.6%***
Japan	+9.9%	-3.4%
Germany	+2.7%	-9.5%
France	+3.6%	-9.1%
United Kingdom	+0.9%	-5.1%
Italy	+3.8%	-8.5%
Canada	**+11.4%**	**+2.0%**
EMERGING MARKETS		
Emerging Markets	***+2.5%***	***-2.1%***
Brazil	-3.3%	-13.7%
India	+26.4%	+23.7%
Korea	-8.9%	-12.4%
Mexico	+2.2%	-9.3%
Taiwan	+16.5%	+9.9%

Source: MSCI indexes, Bloomberg Professional

STRATEGY UPDATE

Following a period with such wide divergence between US and non-US returns, what should investors do? One year ago[5] we detailed how a global portfolio strategy including Small, Value, and Real Estate segments compared with a single-segment portfolio holding only US Large company stocks (S&P 500 Index). We highlighted the fact that the S&P 500 Index underperformed a global strategy for an entire decade (2000-2009). A comparison of growth since the "Lost Decade" (Graph 1) with the past 45 years (Graph 2) offers important perspective. ***The lesson for managing long-term wealth is compelling: maintain a portfolio with US and non-US Risk investments, while emphasizing Small, Value, and Real Estate exposures.***

Our exposure to non-US investments is *strategic* – not tactical. In light of the recent performance differential between US and non-US investment segments, we are monitoring portfolio exposures with an eye toward readjusting our US and non-US exposures back to their respective targets. *This process of targeting and periodically rebalancing portfolio exposures, allows us to manage various risk factors such as: Risk versus Low Risk, Small versus Large Company stocks, Value versus Growth, as well as the balance among US, International (non-US Developed) Markets, and Emerging Markets.*

[2] See "Bonds are still Bonds, Stocks are still Stocks" in our January 6, 2013 Investment Comment (LIBRARY tab, marylandcap.com)

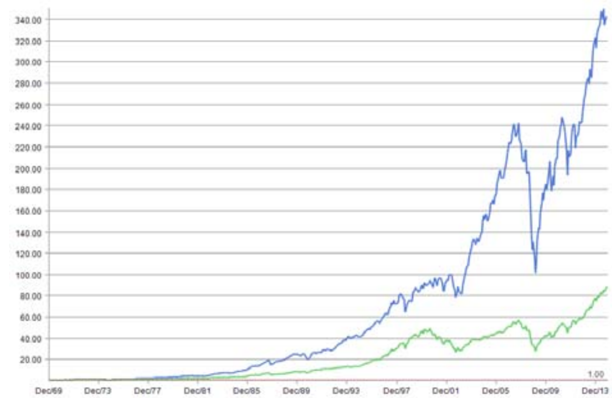
[3] Bloomberg story, December 29, 2014, 11:01am

[4] For example, Maryland Capital Investment Comments: April 7, 2008; October 8, 2011; April 8, 2013

[5] See "Perspective on 2013 Themes" in our January 6, 2013 Investment Comment (LIBRARY tab, marylandcap.com)

Graph 1: Growth of Wealth: 2010 - 2014

Graph 2: Growth of Wealth: 1970 - 2014



Global Risk Balanced Index (Blue) versus S&P 500 Index (Green)
Source: Dimensional Funds, DFA Equity Balanced Strategy Index data through November 2014

As we begin 2015, it appears that the divergence of US and non-US market returns may provide an upcoming rebalancing opportunity and we are monitoring this closely. Some year-end headlines advocated that now is the time to "go global"[6] or rebalance US and non-US exposures[7]. Our portfolios are always global and we rebalance to maintain a targeted exposure to risk segments, not in response to market predictions.

We have previously detailed the diversifying benefits of holding non-US investments[8] and, not withstanding 2014's marked divergence between US and non-US returns, we remain committed to the process of managing these strategic exposures according to our discipline as outlined in each client's Investment Policy Statement.

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

[6] "S&P 500 Beating World Equities Means It's Time to Go Global", Bloomberg, December 22, 2014, Lu Wang
[7] "A 2015 'Rebalancing' Act for Investors", WSJ, December 30, 2014, Burton Malkiel
[8] See "Why hold non-US investments?" in our July 8, 2013 Investment Comment (LIBRARY tab, marylandcap.com)

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