DISCIPLINE • BALANCE • PERSPECTIVE

Maryland Capital Advisors

INVESTMENT COMMENT **January 9, 2016**

2015 Review and Strategy Update

4th Quarter 2015 returns were solidly positive, following a challenging 3rd Quarter. A review of full year 2015 Risk and Low Risk investment returns highlights several cross-currents that impacted investment portfolios. The most significant themes:

- Emerging Markets generated the worst Risk returns (-14.3%)
- Commodity* prices, especially crude oil (-38.8%), plunged
- US Dollar appreciated (+9.3%), particularly against most Emerging Markets currencies
- High Yield bonds* (-6.8%) declined, especially during the 4th Quarter

  ** excluded from our strategy*

Selected Asset Classes As of December 31, 2015	**4th Quarter**	**2015**	**5-Year Annual**
PORTFOLIO RISK SEGMENTS			
US Large Cap	+6.3%	**+0.4%**	+12.1%
US Large Cap Value	+7.0%	-1.0%	+11.7%
US Small Cap	+3.1%	-3.8%	+10.4%
US Small Cap Value	+2.7%	-4.8%	+10.4%
International Large Cap	+3.7%	-0.4%	+3.5%
International Large Cap Value	+1.6%	-5.9%	+2.2%
International Small Cap	+5.5%	**+9.1%**	+6.3%
International Small Cap Value	+6.0%	**+7.5%**	+6.1%
Emerging Markets	+0.1%	**-14.3%**	**-5.0%**
Emerging Markets Small Cap	+4.5%	-12.4%	-5.0%
Emerging Markets Value	-1.0%	-18.8%	-7.9%
US Real Estate Investment Trusts	+7.0%	+2.4%	+11.8%
International Real Estate	+1.8%	-1.8%	+4.1%
SELECTED PORTFOLIO LOW-RISK SEGMENTS			
US Treasury 1-3yr Notes	-0.6%	+0.4%	+0.6%
US Treasury 7-10yr Notes	-1.5%	+1.5%	+4.5%
US Treasury 20-30yr Notes	-1.6%	-1.8%	+8.3%
US Treasury Inflation-Protected	-0.9%	-1.8%	+2.3%
Inv Grade Short Duration	-0.3%	+1.0%	+2.0%
Inv Grade Intermediate Duration	-0.2%	+1.5%	+4.4%
Inv Grade Long Duration	+0.1%	-2.2%	+7.3%
International Bonds (Non-Dollar)	-1.0%	-7.7%	-3.6%
EQUITY INDICES			
MSCI All-Country World Index	+5.1%	-1.8%	+6.7%
S&P 500 Index	+7.0%	+1.4%	+12.6%
BALANCED PORTFOLIOS			
Vanguard 60/40 Fund	+3.4%	+0.4%	+8.6%
DFA 60/40 Fund	+2.3%	-1.7%	**+5.5%**
DFA 25/75 Fund	+0.6%	-0.3%	+3.3%
OTHER NOTABLE MARKET DATA			
Crude Oil Futures	-20.8%	**-38.8%**	-16.8%
Gold ETF	-5.1%	-10.7%	-6.1%
US Doller (Trade-Weighted)	+2.4%	**+9.3%**	+4.5%
High Yield Bond ETF	-2.9%	**-6.8%**	+3.5%

Source: Bloomberg Professional

Note: Returns include reinvested dividends

CAPITAL MARKETS UPDATE

International Small Cap (+9.1%) and Small Cap Value (+7.5%) were the best-performing Risk segments during 2015. US REITs (+2.4%) and US Large Cap (+0.4%) were the only other positive segments of Risk.

The Main Event: Emerging Markets

The negative performance of Emerging Markets stood out from other segments in 2015. Even more notable is the fact that Emerging Markets returns have lagged US and International segments for the past 5 years.

So what has happened with EM?

The collapse of commodity prices – a primary source of export revenue for many Emerging countries – has challenged many economies and pressured their currency exchange-rates lower. China, meanwhile, has been grappling with a slowing economy and, in August, began to allow its currency to weaken. We detailed this mix of commodity/stock market/currency factors in our August Investment Comment[1].

Should we still be investing in Emerging Markets?
Short answer: yes. EM is a diversifying element of a globally-balanced portfolio. As noted in previous Investment Comments, US markets underperformed non-US markets for an entire decade (2000-2009)[2]. We remain committed to the process of managing these strategic global exposures in accordance with our discipline – rebalancing when the return divergences such as 2015 occur.

A look back at our 2015 Investment Comments[3] makes it clear that the whole year was defined by August – actually just six trading days from August 18-25 when global stock markets fell 9%. Such historical observation, of course, is what drives conventional investors to pursue a magical strategy that can deliver on the promise of avoiding down periods while remaining invested during the up periods. Academics[4] have long ago measured the improbability of long-term success from such strategies, but many try.

2015's surprises confounded traders and resulted in a number of high profile fund closures and liquidations. ***By contrast, investors with a globally-balanced strategy, discipline, and patience over the past 5 years have had reasonable growth of wealth.*** Despite the "red ink" in so many Risk and Low Risk segments, for example, the DFA 60/40 portfolio[5] generated +5.5% annualized over the past 5 years. After inflation[6], this results in "real" +3.9% annual growth. While that is lower than the average since 1970, it is positive and inflation-adjusted portfolio returns is a paramount goal of wealth management.

STRATEGY UPDATE
Ongoing monitoring of "allocation drift" is a core element of our risk management. During 2015's turbulence, particularly in Emerging Markets during August and December, we rebalanced portfolio exposures back to predetermined targets.

For taxable investors, 2015 also provided an opportunity to swap out of Emerging Markets funds valued below cost and replace them with alternative funds. Such tax-loss harvesting is tactical and improves tax efficiency while maintaining a consistent investment strategy.

We began 2015 as we did 2014: many market participants concerned with an imminent increase in interest-rates. Although the Federal Reserve raised short-term interest rates in December for the first time in over a decade, interest-rates have taken a back-seat to several other factors. As we begin 2016, global markets are once again focused on the impact of commodity prices, currency exchange rates, and China. The Federal Reserve has been clear that current economic conditions do not warrant significantly higher rates.

---

[1] See "August 23, 2015 – Summer Update" under LIBRARY tab at marylandcap.com
[2] See "Strategy Update", January 6, 2015 and "Why hold non-US investments?", July 8, 2013 Investment Comment
[3] See links under LIBRARY tab at marylandcap.com
[4] For example, see Sharpe, W. F.. (1975). Likely Gains from Market Timing. Financial Analysts Journal, 31(2), 60–69.
[5] Symbol: DGSIX, global 60% Risk / 40% Low Risk mutual fund
[6] 5-year annualized inflation, measured by Consumer Price Index, +1.6%