# Investment Commentary

## 4th Quarter 2014

*Bragg Building*
*1031 South Caldwell Street, Charlotte*

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### COWBOYS ON WALL STREET

My son Charlie (7) was given a gift certificate to Toys & Co. for Christmas by his grandparents. As you might imagine, after receiving the gift, not a day passed without Charlie reminding Alice and me that he was ready to go shopping. "Are we going today, Mama? How 'bout tomorrow, Daddy? Why can't we go right now?" As we live on a small farm outside of Huntersville, making the trip to Toys & Co. in south Charlotte would normally require a little planning. But conveniently, our whole family was to be in Charlotte one evening last week for our annual "Country-Come-to-Town, Big-City Christmas Lights Tour" and we thought it might be fun for all six of us to stop by Toys & Co. at Cotswold Shopping Center to help Charlie pick out a toy. Needless to say, Charlie was excited and the rest of us were pretty fired up too. Just thinking about Charlie running around the toy store with all of us making suggestions made me chuckle. Charlie had never been to Toys & Co. and neither had I. We weren't disappointed. Even though it was the week *after* Christmas, the store was packed with inventory–stuffed animals, puzzles, games, whirligigs, action heroes and of course trucks, trains, tractors, tanks and toy guns.

We hadn't been there long before I was drawn into a heated Bragg-family conversation. It seems my wife Alice and my daughter Frances (11) had encouraged Charlie to consider choosing a nice art kit or an innovative puzzle set. Meanwhile, sons Ben (14) and Carlton (13) had shown Charlie a set of cowboy six-shooters, a cap bomb and a set of handcuffs. The toy guns and cap bomb apparently used the old-fashioned gunpowder caps that spark and explode when ignited. Alice let it be known that she did not approve of the boys' choice. As I walked up she was saying, "It says right here on the package that it is for age 8 or older and that it can damage hearing if fired too close to the ear. I don't want Charlie pointing guns at people. He is too young to play with anything that sparks and explodes and I don't want him locking up his sister with handcuffs!" The boys protested, "Ma-mah! They don't shoot anything! They just make a loud noise." I remembered the cap gun I enjoyed as a boy and secretly thought the boys were leading him in the right direction but I wisely kept my thoughts to myself. Instead, I reminded Alice that it was *his* gift card and suggested that we let Charlie choose between the art supplies, the puzzle set and the cowboy set. Let the little guy buy what he wants to buy. Charlie chose the cowboy set of course and as we walked toward the register, I reminded him to also grab a LOT of extra ammunition as he would certainly need it. Alice was disgusted.

The next night when I got home from work, Charlie met me at the door. "Daddy, come to my room right now!" He dragged me to his room and made me crawl under his bed with him. Once there, he pulled aside a pillow case and there were his six-shooters, his cap bomb and his handcuffs. He was elated. "See my stuff, Daddy? I love

*(Continued on page 4)*

### MARKET AND ECONOMIC UPDATE

Another year is in the books! 2014 had its share of surprises but the collapse in energy prices was surely the biggest story of the year. As of this writing (Jan 5th), the price of oil has now declined by more than 50% since the high of 2014 reached last June. The other big surprise was that interest rates actually declined in 2014 even as most economists and market watchers predicted rates would rise. The yield on the bellwether ten-year Treasury bond fell from 3% to 2.2% over the course of the year. Finally, the strength of the US economy and stock market relative to much of the rest of the world is certainly worthy of comment.

*(Continued on page 2)*



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**Market & Economic Update** *(Continued from page 1)*

### Market Index Returns for Periods ending December 31, 2014

| Index | 4th Quarter | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|
| S&P 500 (US Large Cap) | 4.9 | 13.7 | 20.4 | 15.5 | 7.7 |
| S&P 400 US (US Mid Cap) | 6.4 | 9.8 | 20.0 | 16.5 | 9.7 |
| Russell 2000 (US Small Cap) | 9.7 | 4.9 | 19.2 | 15.6 | 7.8 |
| MSCI EAFE (Foreign Equity) | -3.6 | -4.9 | 11.1 | 5.3 | 4.4 |
| Barclays Aggregate Bond | 1.8 | 6.0 | 2.7 | 4.5 | 4.7 |
| Barclays Muni Bond | 1.4 | 9.1 | 4.3 | 5.2 | 4.7 |

*Three-, five- and ten-year returns are annualized. Past performance is not an indication of future performance.*

US stocks enjoyed a sixth consecutive year of positive returns. Including dividends, the S&P 500 was up 13.7% for the year. Mid- and small-company US stocks also fared well with returns of 9.8% and 4.9% respectively. In contrast, the stocks of foreign developed markets lost almost 5% for the year while emerging markets lost 2%. Of note, in dollar terms, Russia's stock market lost half of its value in 2014 as the Russian ruble declined by 40% against the US dollar. Russia's weakness has resulted from the collapse in oil prices as well as the economic sanctions placed upon it by Western nations as a result of its actions in Ukraine.

Bonds had another huge year as interest rates fell. Recall that bond values rise as rates fall. The Barclays Aggregate Bond Index was up 6% for the year while the Barclays Municipal index was up a whopping 9%.

Looking ahead, here are a few things to watch in 2015:

**Divergence in the Global Economy:** The US economy hasn't been booming but it has outperformed much of the rest of the world. The chart below compares US GDP growth to that of Japan and the Eurozone economies. While the US is growing, Europe is struggling with deflationary pressures, high unemployment, weak banks and recession. Japan faces some of the same issues. There also is divergence in monetary policy. In the US, the Fed has ended its bond-buying program and is considering raising interest rates later this year. Meanwhile, Europe is moving to beef up its monetary support and Japan is engaged in the most aggressive monetary experiment the world has ever seen as it desperately tries to end a decades-long period of negligible growth and deflation. China is growing but at slowing rate as it faces the challenge of transitioning to a consumer-led economy. For investors, the question is whether the US economy can maintain its momentum given the weakness in the rest of the world. And more specifically, can US corporations, many of which are global players, continue to grow revenues and earnings, justifying even higher stock prices?

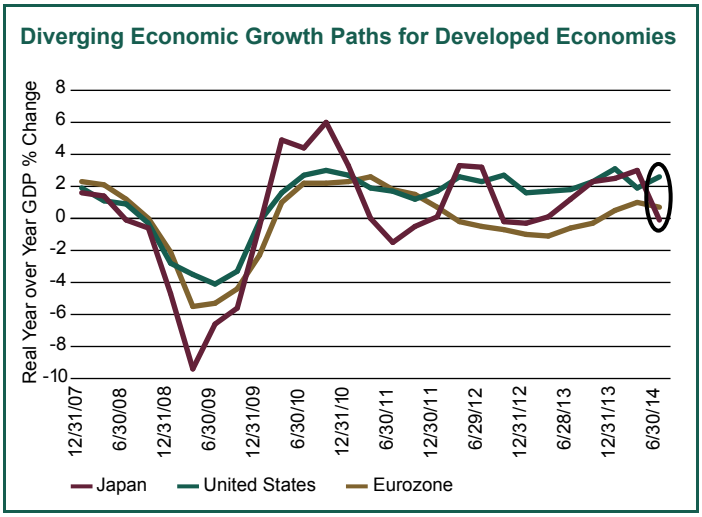



*Chart compiled by American Century Investments. Data from 12/31/2007 to 6/30/2014. Source: Bloomberg.*

**Commodities:** The following chart of commodity prices, including grains, energy, metals and livestock, dramatically illustrates how far commodites have fallen. As emerging

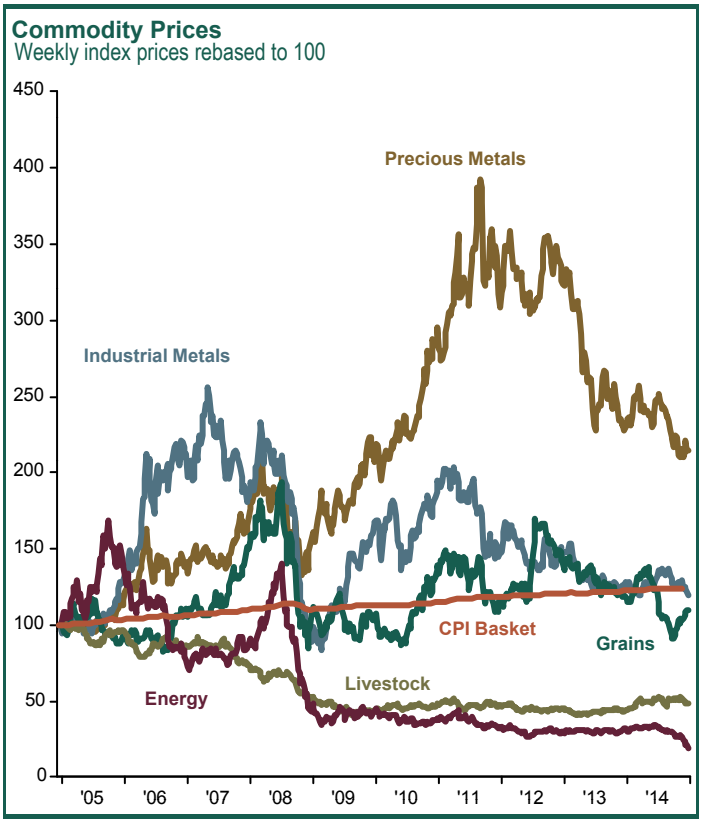



*Chart compiled by JP Morgan. Source: Dow Jones/UBS, EcoWin, BLS, US Department of Energy, FactSet, JP Morgan Asset Management. Commodity prices represented by the appropriate Bloomberg Commodity sub-index. Data as of 12/31/2014.*

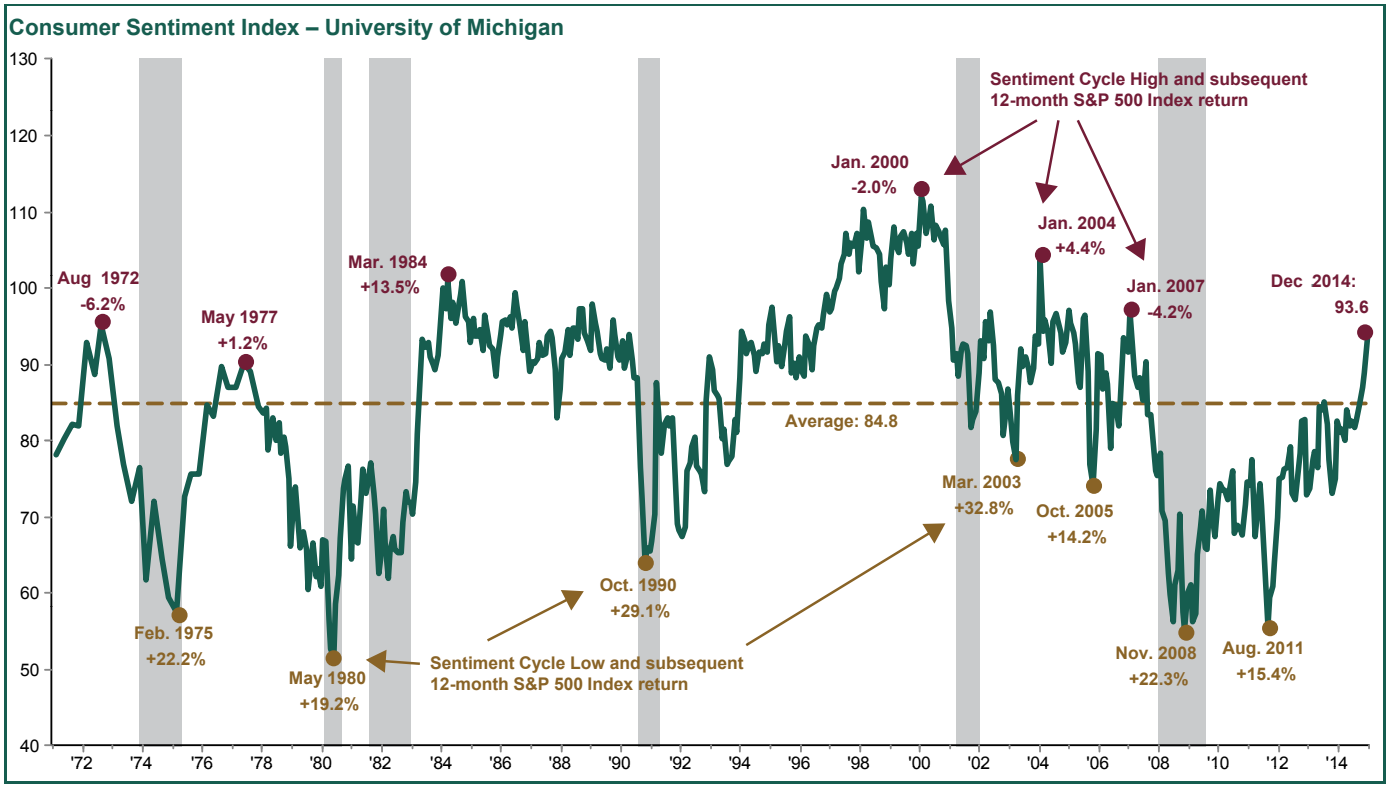
**Market & Economic Update** *(Continued from page 2)*

economies like China have slowed, demand for oil and other commodities has fallen significantly. In the case of energy, falling global demand has coincided with a huge increase in supply as a result of the US energy boom. As commodities represent the raw inputs used by manufacturers, lower input costs equal lower prices for consumers (gasoline is a prime example) or at least negligible inflationary pressure. This is great for consumers, especially for those who spend a significant portion of their income on food and energy. Cheaper food and gas are leaving money in the pockets of consumers and this is good for the economy.

The collapse in energy prices has a dark side however. Many of the jobs created in the US over the last five years have been in the energy field as new technology such as hydraulic fracturing and horizontal drilling has allowed producers to tap heretofore inaccessible oil and natural gas. If energy prices fall too much, these higher-cost extraction techniques won't be profitable and many of these jobs will go away. Falling commodity prices are also proving painful for the resource-rich, exporting countries of South America, like Brazil, Chile and Venezuela, and of Africa, like Zambia, Nigeria, Ghana and South Africa. We've already mentioned how plummeting oil prices have been devastating to Russia which derives almost 70% of its export revenue from oil exports and which funds over 50% of government expenditures using revenue from the energy sector. This "dark side" of the collapse in energy prices likely explains why the stock market seems to have reacted negatively to the latest drops in oil prices. We think energy prices will stabilize lower and on net, we think this will be positive for the global economy.

**Interest Rates:** As mentioned, interest rates fell (again) in 2014 and remain at extremely low levels. The Fed has signaled that it plans to begin raising interest rates to more normal levels sometime in 2015. Whether this can be accomplished without slowing the economy or roiling the markets is unknown. We've written a fair amount about this subject in commentaries you can find on our website (see 3rd Quarter 2013 commentary *Muscadines and Ben Bernanke*).

**Investor Complacency:** It's now been six years since the financial crisis. The US economy is expanding, the stock market has had six years of positive returns and 2014 was marked by a successive string of new all-time highs for the market. It's our sense that investors are getting a bit complacent. History has shown that investors tend to take on risk at exactly the time when they are least likely to be compensated for it. Examples include reaching for yield with riskier bonds or even trading *out* of low-yielding bonds and *into* stocks. The chart at the bottom of the page deals with consumer sentiment which is highly correlated with investor sentiment. Counterintuitively, the chart demonstrates that good stock market returns often follow *low* measures of consumer confidence and poor market returns often follow *high* measures of consumer confidence. Consumers and investors are feeling much more confident these days. A shakeout in the market should tamp that down a bit. Be prepared and please let us know when you would like to discuss your portfolio or your planning.




*Compiled by JP Morgan. Source: University of Michigan, FactSet, J.P. Morgan Asset Management. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends. Impact on consumer sentiment is based on a multivariate monthly regression between 1/31/2000 – 5/31/2014. Data as of 12/31/14.*

**Cowboys on Wall Street** *(Continued from page 1)*

it! I'm glad you told me to get a lot of extra ammunition because Carlton and I shot up a bunch of it already today!" Boys will be boys.

Speaking of letting people buy what they want to buy, the financial industry is exceptionally good at selling investors what they want to buy, even when it's not in the best interest of investors to buy it. I'm reminded of the fact that most mutual fund companies began marketing technology sector funds in the final stages of the technology boom. Investors poured billions into these hot funds in 1998, 1999 and 2000. Fund companies made a lot of money selling investors what they wanted to buy but investors got clobbered when most technology stocks declined by 80%. The financial industry was at it again in the early 2000s, creating exotic mortgage products to help homebuyers purchase houses for which they were unqualified. In this case, the financial industry had the support of Congress which lowered loan requirements for government-backed mortgage agencies Fannie Mae and Freddie Mac, and the support of the Federal Reserve, whose artificially low interest rates encouraged massive amounts of risky debt. Homeowners borrowed far too much money to buy already-overpriced real estate. Sadly, we all know how the story ends.

As gold prices reached record levels in 2011, it seemed that you couldn't turn on the television or radio without having to endure yet another advertisement for gold. On cue, fund companies rolled out gold funds, precious metals funds, commodities funds and other vehicles to capitalize on the demands of investors. As the financial industry raked in the profits, millions of investors bought at peak prices in 2011 only to lose 40% as gold plummeted over the next three years.

*Charlie Bragg*

While individual investors have gotten most of the headlines, institutional investors, the so-called "smart money," have not been immune to this phenomenon. Not all, but *many* pension committees, endowment boards and foundation investment committees are guilty of the exact same behavior. After all, while these are institutional investors, the investment decisions are still made by humans and humans are emotional, irrational, subject to herd behavior, guilty of assuming the future will be like the recent past, and perpetually unable to resist chasing what's recently been hot.

One of the costliest mistakes many institutional investors and financial advisors have made in the last five years is to buy into the concept of "alternative investments." When the stock market was touching the lows of 2009, the losses were so severe (the S&P 500 was down 57% from peak to trough) that many in our industry decided there had to be a better way to invest and they demanded an "alternative" to the stock market. "Buy and hold is over" and "Stocks-for-the-long-run is dead" went the refrain. Instead, consultants, institutions and advisors pursued so-called "alternatives funds" including market-neutral funds, long-short funds, diversified arbitrage funds, absolute return funds and other exotic sounding vehicles. These funds were designed to make money and not be correlated with the stock market. Sound enticing? Well, the demand was there and boy did Wall Street deliver the product! Alternative offerings came out of the woodwork. Many offerings were in the form of limited partnerships (hedge funds) but it didn't take long for the mutual fund industry to jump into the game. Billions of dollars came out of stocks and traditional stock funds and went into these new "alternative" vehicles.

Did I mention that these new investment options are expensive? They are. And boy has performance been a disaster! According to the publicly available database at Morningstar.com, with very few exceptions, these products have delivered bond-like performance with much greater volatility than bonds. Meanwhile, the stock market has soared over 240% since these overpriced, underperforming products first became popular in 2009. Once again, Wall Street simply sold the people what they wanted to buy.

Maybe you're thinking, "Why is Benton dragging me through this?" It's because we want you to know that at Bragg, we consider it our job to protect you from the phenomenon I have described here. And we hope your reading this commentary helps us do our job. Let's face it, it ain't easy to hold back when it sounds like everyone else is making a killing flipping condos, trading internet stocks, overweighting energy, technology, or real estate, loading up on Chinese internet stocks, getting in on the Facebook IPO or buying gold on the way up. It's even harder, yes, *much* harder, to stay invested as the market is falling and especially when people you know and respect tell you they sold out. Charlie Bragg would tell you that choosing the cowboy six-shooters over the art kit was an easy decision. And importantly, his choice is unlikely to change his financial future. With investing, making good choices isn't as straightforward and the stakes are much higher. As always, when the going gets rough (and it will), we at Bragg will be here reminding you to keep the discipline.

We hope your 2015 is healthy, productive and prosperous! As always, thank you for choosing Bragg for your planning and investing.

Sincerely,

Benton S. Bragg

Benton S. Bragg, CFP®, CFA®
President, Bragg Financial Advisors, Inc.