First Quarter Outlook 2015

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

> ***" Goodness is the only investment that never fails"***
>
> Henry David Thoreau

Client Q&A With ISG

Once again, we offer up our views and investment tactics in Q&A format, based on questions gathered from client meetings and other correspondence.

Client: Thank you for taking the time to meet with me today to go over your macroeconomic and financial markets outlook, as well as your investment tactics in the year ahead. Before we get to that, however, why don't you review the past year for me?

ISG: It is our pleasure to go over things with you today and we can certainly start with a review of what happened in 2014. For the financial markets, it was a year of great disparity in returns across asset classes. For example, larger U.S. stocks (as tracked by the S&P 500 index) turned in lower double digits returns, while other stock sub-sectors here in the U.S. and elsewhere turned in sub-par performance. Smaller U.S. companies (as measured by the Russell 2000 Index) gained 4.89% for the year, while the MSCI World Index which is a widely followed composite of stocks around the globe grew similarly at 4.94% for the year. If we take the U.S. stocks out of that mix the composite's return drops to -4.32%. Emerging markets also ended up slightly negative at -2.19%. Bottom line, investors were penalized last year for diversifying their stock investments outside of U.S. borders.

Client: Thank you. That was my take on it too. I must confess to you, it seems this has happened before in recent years and, candidly, I am starting to wonder whether the financial tactic you call "diversification" should be changed to "diworsification?" Really, what benefit am I getting by investing money outside of the U.S. when everyone knows the U.S. has been the place to be?

ISG: You are asking a good and important question. First, let us say it is emotionally challenging when one asset class performs better than the others for a multi-year period of time…although we should point out that as soon as one diversifies into two investments one of them inevitably performs better than the other. When this happens over a reasonable stretch of time, investors will question the whole philosophy of diversification, abandon it, and jump on the band wagon of the hot investment…usually, at the wrong time. We witnessed this in the late eighties when money chased Japan's booming stock market and in the late nineties when everyone wanted more concentration in tech stocks…both inclinations coming at the wrong time!

Client: So you don't agree that the U.S. stock market has been the place to be since the Great Recession years of 2008/2009?

ISG: We don't disagree with your assessment. But we might take exception to the ease in which you have drawn your conclusion. In investing, clarity truly comes only in hindsight. Coming out of the Great Recession, U.S and global economic conditions remained quite fragile and were underpinned by a massive monetary experiment among the world's central banks that some say remains today without a clear end game. In addition, ISG's clients were reeling from retirement planning adjustments following the 2008/2009 period and wanting more assurances that a similar scenario might not befall them again anytime soon. We felt the prudent course for most was to side with caution until such time when stronger and sustainable economic growth could validate higher exposures to stocks (both U.S. and foreign). Today, we are close to our longer term target weighting in stocks and quite comfortable with our overall 60/40 mix between U.S. and foreign stocks.

Client: So you are continuing to preach global diversification within our stock mix?

ISG: Absolutely. It is unwise to extrapolate the recent performance trends far into the future and even though the U.S. economy looks the strongest at this moment, it doesn't mean its *stock market* offers the best risk/return profile right now. We will address this shortly. The case to hold a globally diversified portfolio over the long haul remains a compelling one. Since 1970, a global portfolio (60% S&P 500 and 40% non-U.S. stocks) has improved annual returns by about 11% (12.5%/yr. vs. 11.3%/yr.) and done this with less risk (i.e. short-term volatility).

Client: Ok, let's move on. I am curious as to your views on the U.S. and other markets.

ISG: The outperformance of the U.S. market has been impressive, but this has now taken its toll on its relative attractiveness to other parts of the world despite the U.S. economy remaining the best of a bad bunch in 2015. From a valuation perspective, the S&P 500 is trading slightly above its historical average by some measures…and looks pricy from other longer term measures which try to smooth out earnings numbers which jump around over the short term. We remain constructive on U.S. stocks but with the official ending of easy monetary policy potentially later this year and ongoing uncertainties about the sustainability of economic growth sans the Fed's support, it's fair to expect more volatility and a slower pace to U.S. stock advances than what investors have become accustomed to in recent years.

Client: Working harder for less?

ISG: Precisely.

Investment Security Group, Inc. (ISG) is a Registered Investment Advisor providing individuals with creative investing and financial planning solutions. ISG's research is thorough and independent and our ultimate goal is to enhance your life experience through prudent financial decisions.

Client: What about the positive impact of lower oil prices? I filled up my SUV yesterday at a cost I haven't seen in years. Won't some of that leftover cash find its way into the cash registers of other stores and won't that help out our economy?

ISG: We agree that lower oil prices should be a net positive as it serves as a nice tax cut for consumers but in the short term it is wreaking havoc on an energy sector that is rapidly cutting back on business investment, shedding jobs, etc. This will put a crimp on GDP growth in the first half of the year. As reported in Barron's, S&P 500 annualized earnings by the third quarter are expected to drop from 11% (optimistic?) to 6.6% due to a mauled energy sector. That's a big hit. So, bottom line, not-so-good news for the economy in the short run, hopefully better news longer term if prices remain low.

Client: Before we move on to other regions, any final remarks on U.S stocks and how they figure into my portfolio?

ISG: U.S. stocks (mostly larger, established companies) remain the largest component of your stock holdings. The U.S. economy and company earnings growth have been superior to most other places, and until recently, the Fed has been the most aggressive central bank in terms of easy money policies. Yet, we have been reluctant to overweight the U.S. because while the leading economic indicators suggest the recovery is gaining traction there are inconsistencies in the data chain that stir up some yellow lights. For example, unemployment has been coming down yet the growth in incomes has remained stubbornly low. Industrial production is probably the best monthly gauge on the state of the economy and for the third time in the last five months the numbers have been signaling contraction…which is something we have not seen since 2009. Finally, decent U.S. economic growth and higher interest rates relative to Europe has driven up the dollar which, ironically, may now cut into U.S. exporters' earnings and global competiveness due to pricier goods and services. Despite what the stock market has done, the underlying economy which ultimately justifies those price moves remains a mixed bag. Diversification has gotten a bad rap in recent years but we suspect this time tested tactic will show its true colors in 2015.

Client: Perhaps that's a good segue into your foreign stock market outlook. I keep reading that Europe is still a mess. Do you agree, and, if so, why would anyone invest there given all the economic and political turmoil?

ISG: We agree that Europe still battles with near-recessionary conditions and deflationary headwinds. But these dismal conditions are already priced into their stock market so it would not take much positive change at the margin to potentially stir up renewed investor interest in the area, especially if the European Central Bank implements aggressive monetary stimulus efforts…which it has recently done.

Client: So you have some of my money in Europe?

ISG: Yes, through an international strategy that hunts the globe–not just Europe - for cheap, fundamentally sound businesses. Remember, stock markets tend to anticipate so if investors perceive small improvements or even think things have just stopped getting worse, this would prove beneficial for European stocks.

Client: Where else am I invested?

ISG: Your international exposure presently has an Asian tilt as we continue to believe in the long term growth story there. And a year ago, we backed off our dedicated exposure to emerging markets and replaced it with a more selective strategy that moves in and out of those markets on a company by company decision-making process. For now, we are comfortable with the more flexible mandate as these fast-growing markets look to remain quite volatile in the near term.

Client: That sounds good. May we switch gears now to my defensive holdings? I read bonds did surprisingly well last year…which was NOT the forecast made by most "experts." Everyone has been worried about rising rates and how that will cause prices of existing bonds to fall in value (to keep their yields in line with new bonds coming out at the higher rates). That hasn't happened yet. What is your take and how did my bond investments fare last year?

ISG: The solid performance of higher credit quality bonds (as tracked by the Barclay's Aggregate Bond Index) was clearly a surprise to many investors, coming in around 5.9% for the year. Our view heading into 2014, was that rate increases were inevitable but the frail nature of the recovery and a lack of inflationary pressures meant that these rate increases were coming *later* rather than sooner. Therefore, we stayed with core defensive strategies that were fairly traditional in their tactics and which, on average, outperformed their benchmark last year.

Former Fed Chairman Bernanke seeks much-needed ISG advice from CEO, Dave Giocomo!

Client: Don't I own other types of bonds that are not, as you say, "core" bonds?

ISG: Yes you do. We have diversified into other areas, including foreign and lower credit bonds, business loans, and reinsurance bonds whose results are not tied to the financial markets but instead to the frequency and magnitude of various insured perils…the goal of all of this diversification is to provide superior long term returns to traditional bond investments without compromising much on risk mitigation. Specific results vary of course from client to client depending on the timing of purchases but overall we were very pleased last year with this diversified pool of income-producing assets.

Client: And your view looking ahead?

ISG: Well, at some point in the future rates will have to move up from their historically low levels. No one will know for sure the timing and magnitude of these increases but our sense is that significant rate increases are a ways off until the Fed sees faster wage growth and higher inflation… neither of which are currently present. We will be monitoring changes in these metrics closely. For now, we're comfortable with our core bond positions serving as lower returning "insurance" against unexpected economic/financial market shocks along with our other more flexible and opportunistic bond strategies. In a nutshell, however, it looks to be a challenging year ahead for bonds.

Client: Working harder again, for less?

ISG: We think so.

Client: We have covered a lot of ground and, as always, I have appreciated the opportunity to get into some more detail behind your views and strategies. But before we finish up today, I want to bring up something that has been on my mind lately, which is the recent popularity of "passive investing", a strategy that doesn't try to outsmart the market but instead mimics certain market proxies like the S&P 500 by maintaining identical holdings and exposures as those proxies. With minimal trading and no research-related costs, these products promote lower expenses than their actively managed counterparts and in recent years –at least in the U.S. stock market- have outperformed most actively managed strategies. What is your take on all of this and does passive investing have a place in my portfolio?

ISG: This is a great final question to our discussions today and let us start by saying we are always on the lookout for ways to reduce the overall operating expenses in your portfolio, whether that be through an efficiently run ETF product or an "institutional" mutual fund with a lower cost structure that only professional investors have access to. Regarding passive vs. active strategies, the question of which is better is in our view not the right question to ask. We believe there is a place for both, so the question becomes, "where should I use active managers and where should I use passive?" We've been spending a lot of time on this question and our research suggests that passive works best in the more popular, more heavily researched areas of the market; specifically, larger well covered stocks in the U.S. stock market which are represented by such proxies as the S&P 500 or Dow Industrials. Furthermore, these strategies tend to be more competitive during bull markets when stocks across the board often rise, rather indiscriminately. During more volatile and side-ways markets, good active managers often do better.

Client: So do I have some low cost, passive strategies in my portfolio?

ISG: Yes, you do. Most clients today have up to 75% of their U.S. larger company holdings via several low cost, passive strategies that we are using. We're also looking at whether there's a place for similar strategies in the developed economies abroad.

Client: Anywhere else?

ISG: We're looking, but our research shows good, active stock-pickers do better in the less- travelled places like smaller stocks, emerging markets, and throughout the "hybrid" space which includes real estate, business loans, etc.

Client: Bonds too?

ISG: Our active managers have consistently beaten passive strategies over meaningful time periods.

Client: Let's hope that continues. Well, I think I have run out of stamina for any further discussion. I want to thank you for your time in going over all these issues with me. I appreciate your thoughtful responses and look forward to our working together in the year ahead.

ISG: It is always our pleasure. We very much appreciate our relationship and your continued confidence in us.

Financial Tidbits

Inflation

A little inflation can have a big impact: even at today's inflation rate of 2%, in 15 years' time, 32% of purchasing power will have been lost.

Long-term Health Costs

Today, the median annual cost for a nursing home stay is $87,600. In 30 years, the average stay of 2 years and 2 months is estimated to deplete retirement savings by nearly $700,000.

Market Volatility

The S&P 500 experiences a down market 3 out of every 10 years.

Taxes

36% of retirees surveyed reported that taxes were a larger expense than they had anticipated; 23% didn't even consider taxes an expense for which to plan.

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