May 2015

Market Update

April was a month that we saw significant divergences in the equity market indices' performance. The US large cap space nearly doubled its years' performance with a .96% run, bringing the YTD number to 1.9%. Great for the month, less so for the year. We contrast that with emerging markets performance at 7.7% on the month for the MSCI Emerging Market Index, bringing its year total to 10.2%. US small caps brought in a negative number on the quarter at -2.6%, followed by the REIT sector with a -5.0% month. The fixed income space didn't break any records either, with core bonds bringing in a negative return of 0.4% on the month, with a YTD number at 1.2%, a coupon clipping year to be sure. This is as a result of the 10 year treasury yield rising for the month, a much anticipated move.

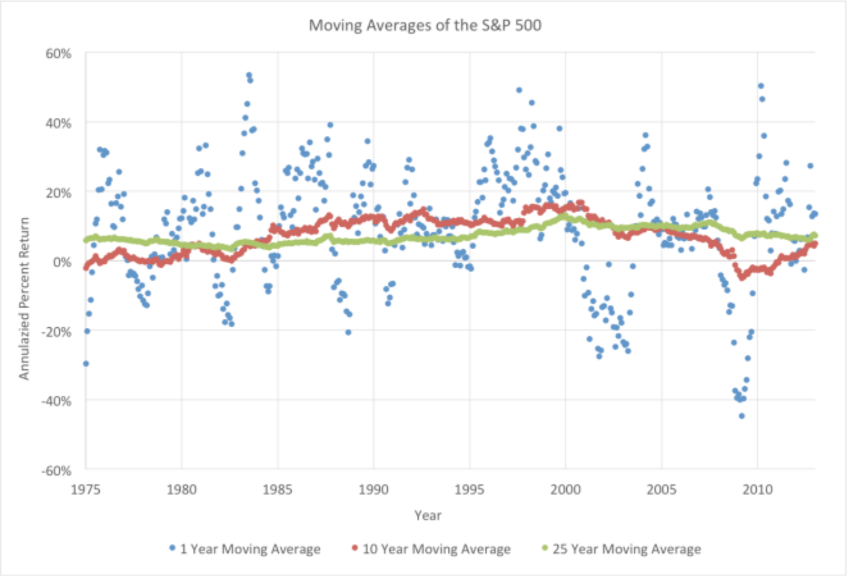
April Benchmark Returns

Domestic Benchmarks	**Apr**	**Q1**	**YTD**
Large Cap: S&P 500	1.0%	1.0%	1.9%
Small Cap: Russell 2000	-2.6%	4.3%	1.7%
International Equity Benchmarks			
Developed: MSCI EAFE	3.7%	4.2%	8.1%
Emerging: MSCI EM	7.7%	2.3%	10.2%
Fixed Income Benchmarks			
Domestic: Barclays Aggregate	-0.4%	1.6%	1.2%
Foreign: Barclays Global Aggregate	0.1%	0.3%	0.4%
Other Benchmarks			
Municipal: Barclays Municipal Bond	-0.4%	0.9%	0.5%
High Yield: ML High Yield Bond	1.4%	2.7%	4.1%
Commmodity: Dow Jones UBS Commodity	5.7%	-5.9%	-0.6%
Real Estate: FTSE NAREIT All REITS	-5.0%	4.0%	-1.2%
Risk Free: US Treasury CD 3 Month	0.0%	0.0%	0.0%

Risk, Return and the Error Term

With the wide divergence of some of the more notable index returns; it is worth an explanation on how we would go about making changes between asset classes, taking on different types of risk in the process. Our first step in the process is to determine what amount of risk we are willing to accept in a given portfolio. If we are looking to maximize returns, presumably an all equity portfolio would be suitable. If we need to disburse income on a regular basis, then lower volatility investment strategies would be appropriate.

As with all investments, risk and return come with a wide variability of degrees. For example, would an investment with a potential return of 12% with a one year downside risk of 20% be appropriate? What about the same return with a three year downside risk of 5%? How about a potential return of 6% with a one year downside loss threshold of 25%? We can see by the chart, the market rarely returns what our expectations are in the short run, but are fairly consistent as we extend our time frame.



As we go through each asset class decision, these are the risk/return tradeoffs that we have to make. While we could be 100% correct in our assessment, the market may prove us wrong due to what we would call the "error term." An error term comes about through random fluctuations in market prices that have little to do with fundamentals or predictable events. We have seen in times past about how the market moved based on things such as erroneous trades, faulty computer systems, or a large rebalance of a large portfolio. All of these events can have a significant movement on prices. Changes to your investment strategy based on random events would be, well, random. As prudent investors, the ability to separate out the true returns versus an "error term" will give predictability a much better chance.

Today's market is giving us quite a lesson in error terms. When will the Fed raise the Fed Funds rate? The true answer for every market commentator should be, "I have no idea." I believe that even if pressed, Janet Yellen would come up with the same, answer: "I have no idea." It depends on the data. Yet day in and day out, it seems, the markets are looking for some indicator that will tell them when the Federal Reserve will begin "liftoff" of their zero interest rate policy (ZIRP). What investors should be evaluating is the risk/return ratio in likely base case scenarios.

Our current base case scenario is that the Federal Reserve will be raising the Fed Funds rate by .25% in the next 12 months. This case is founded on the statements made by Janet Yellen indicating that the Fed will be normalizing rates as soon the market data indicates that it is appropriate. The Federal Reserve mandate is price stability (as measured by the CPI) and full employment (as measured by the unemployment rate.) Both of these numbers are heading in a direction that would indicate that the Fed will be able to raise interest rates soon. We would estimate that with a 95% probability, that will be within 12 months. There is a likelihood that the market believes it will be sooner. In our opinion trying to guess the exact meeting doesn't provide enough value to make a trade on, in other words, it is an error term.

As always, thank you for your continued support.

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