SAGE FINANCIAL GROUP
Investment and Wealth Management

SAGE INSIGHTS
MONTHLY ECONOMIC & MARKET ANALYSIS

April 2015

Diversification – A Rewarding Investment Strategy

Overview

Disciplined, diversified investors should be pleased with the first three months of 2015. They have been generally rewarded for not jettisoning last year's laggards in exchange for last year's leaders. The S&P 500 Index, for instance, is up 0.95% through March, but comparable large foreign developed market stocks in the MSCI EAFE Index are up 4.88%, and U.S. small cap stocks are up more than 4%, too. A diversified approach to stock investing is proving through the first quarter of this year to be a better alternative to one big bet on one of last year's top-performing stock indices. U.S. economic growth has continued to move upward at a comfortably fast pace, despite a slower month of job gains in March. Economic data in Europe confirms key pockets of improvement, supported in large part by the European Central Bank's quantitative easing program. In this issue of *Sage Insights*, we touch on a few of the major economic and investment factors that clients currently face. Most important, we continue to stress that diversification across many asset classes is the best way to make the most of the economic picture at home and improvement abroad while also protecting your portfolio against the inherent risks associated with investing.

Performance

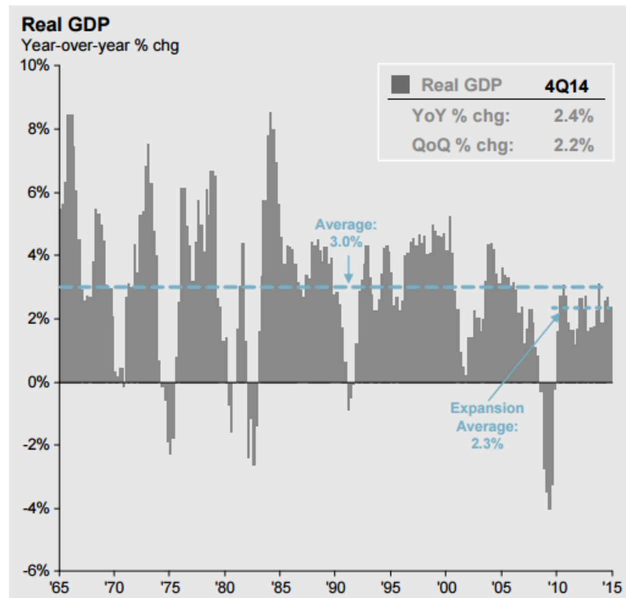
Asset class performance in March was mixed. Large U.S. stocks and international equities surrendered some gains from February, but large foreign developed market stocks are still outpacing U.S. large caps for the year. Core U.S. and foreign U.S. dollar-denominated emerging market bonds inched higher.

Index Name	Mar 2015	2015 YTD	5-Year Annlzd	10-Year Annlzd	Category
BarCap Municipal TR USD	0.29	1.01	5.11	4.85	US Muni Bonds
BarCap US Agg Bond TR USD	0.46	1.61	4.41	4.93	US Taxable Bonds
BarCap US Corporate High Yield TR USD	-0.55	2.52	8.59	8.18	US Corporate HY Bonds
JPM EMBI Global Diversified TR USD	0.22	2.01	7.10	8.11	Int'l/Emerging Bonds (USD)
JPM GBI EM Global Diversified TR USD	-2.98	-3.96	0.73	6.25	Int'l/Emerging Bonds (Local)
HFRX Equity Hedge USD	0.60	2.20	1.19	0.69	Hybrid/Hedged Equity
DJ Industrial Average TR USD	-1.85	0.33	13.23	8.17	US Equity -- Large
S&P 500 TR	-1.58	0.95	14.47	8.01	US Equity -- Large
NASDAQ Composite TR USD	-1.17	3.79	16.72	10.46	US Equity -- Large
Russell 1000 TR USD	-1.25	1.59	14.73	8.34	US Equity -- Large
Russell Mid Cap TR USD	0.06	3.95	16.16	10.02	US Equity -- Mid-sized
Russell 2000 TR USD	1.74	4.32	14.57	8.82	US Equity -- Small
MSCI EAFE NR USD	-1.52	4.88	6.16	4.95	Int'l Equity -- Developed
MSCI EM NR USD	-1.42	2.24	1.75	8.48	Int'l Equity -- Emerging
Bloomberg Commodity TR USD	-5.14	-5.94	-5.71	-3.56	Commodities
HFRX Global Hedge Fund USD	0.33	2.06	1.12	1.01	Multi-Asset Alternative Invm't

Source: Morningstar Direct. Data through 3/31/2015

Outlook

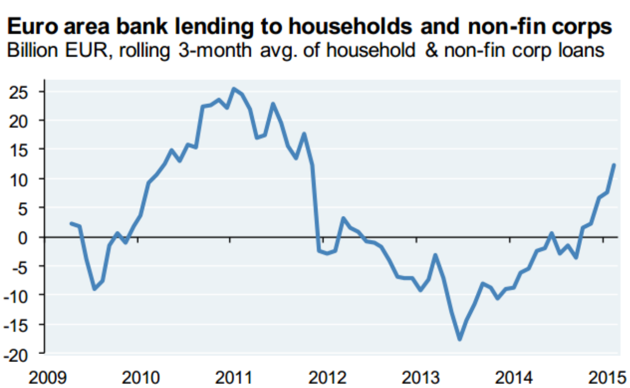
We still believe that the U.S. economic condition is solid, notwithstanding the lackluster employment report and some other economic data in March. In the middle of economic cycles, soft patches appear, and we may have had a slight one to start the year. But the prospects for continued and mostly steady economic growth in the U.S. are good. Inasmuch as economic growth will filter into earnings growth for companies, and earnings growth will translate into higher stock valuations, the prospect for modest U.S. stock price appreciation over the medium-term is also good.



Source: BEA, FactSet, J.P. Morgan Asset Management.

We have previously noted that the U.S. economic recovery since the financial crisis in 2008 has been solid but not spectacular. GDP growth over the last three calendar years has been 2.3%, 2.2%, and 2.4%, and that is about the average rate over the current expansion. By comparison, the long-term historical average GDP growth in the U.S. has been about 3.0% (see nearby chart). Higher-than-average U.S. stock market returns have attended this below-average economic expansion. However, euphoria has not accompanied these returns and certainly not the slow and steady economic growth, and that suggests to us that there is still room to run for the current U.S. expansion. Employment is only just now getting back to levels considered "normal," and businesses have finally shifted from hunkering down to engaging in capital expenditures and job creation. Energy prices have declined, and not only Walmart but also now McDonald's has announced plans to raise its minimum wage salaries. Both factors should help increase disposable income for many American workers.

Europe has continued its quantitative easing program to stimulate economic activity through unconventional central bank monetary policy. Early indications are that the plan has helped to expand Euro-area lending and to increase retail sales and automobile registrations, all drivers of economic growth (see charts below).



Source: ECB. February 2015.

Source: European Commission, Eurostat. March 2015.

These incipient economic gains have not yet trickled through to European company profits, at least based on a comparison with U.S. earnings growth. But that may just be a matter of time, because earnings rebounds tend to follow shortly on the heels of economic improvement, as you can see from the nearby chart. It shows how closely coordinated future earnings growth is to a survey of business activity (the Purchasing Managers Index, PMI). If this turns out to be the case, then already impressive gains in European stocks this year in local terms may very well continue, or at least may have a second stage based less upon central bank stimulus than on organic business cycle dynamics.

Europe still faces challenges, however. Low employment growth is perhaps chief among them, and high levels of sovereign, corporate, and household debt in countries other than Germany may slow the economic recovery across the Euro-zone. Reckoning with the Greek debt situation has only been delayed. All of these things bear monitoring; however, there are some fundamental improvements, in addition to massive monetary policy, that cannot be ignored.

These factors inform the investment landscape in a couple of ways. The first implication is that continued economic growth provides support for U.S. profits. According to Standard & Poor's, analysts are forecasting earnings growth of approximately 4.77% for the full year of 2015. Lower energy costs provide an important boost to growth also, especially considering that consumption makes up about 68% of U.S. GDP. This is all to say there is a solid backdrop that should support continued appreciation for U.S. stocks. The second implication, however, is that investors must balance expectations of decent growth with the fact that U.S. stock returns have been nothing short of sensational over the last three years. To have some cooling off in U.S. stock price appreciation would not be surprising in the least.

Last month we reminded clients that we anticipate positive rates of return for U.S. stocks going forward, but at a less historically elevated level than the major indices have experienced recently. We also made a case that if U.S. stocks do post more modest returns, it would imply that investors must continue to look abroad for both adequate diversification and future return opportunities. And we encouraged Sage's clients to maintain their international equity exposure. Although returns of foreign stocks, relative to those in the U.S., have been weak in recent years, this relationship should not always be the case.

With three months of the new year under our belt, we can pause to review briefly and confirm that this is indeed still our position. The reversal in stock returns that we noted above -- that the S&P, which led returns of U.S. small caps and foreign large caps last year, is trailing them this year -- is one component of why we repeatedly emphasize the prudence of diversification as an investment approach. There are also other reasons, which may address more head-on the emotional impulse or second-guessing, even the internal dissatisfaction that all investors feel at one time or another. Our impulse too often is to move after the fact into an investment asset that has just posted eye-popping returns. We second-guess ourselves and wonder, "Why didn't I own so much more of that a year ago when it was 'obvious' that it was going to outperform?" And we fall victim to the dissatisfaction that not everything in our portfolio performed in the stratosphere (some things actually performed either humbly or even poorly!).

One way to address these common investor thoughts and emotions is to acknowledge that there is no proven model for selecting the next top-performing asset class. Recalling this fact may help when the moments hit in which you might berate yourself for not having gone all-in (or at least a lot more in) on the most recent best-performing asset. It is often said -- because it is true -- that a diversified portfolio pretty much guarantees that you will be unhappy with at least one investment in your portfolio each year. Investors who experience this emotional discontent are generally doing diversification right.

At Sage we emphasize a diversified approach to investing and also a longer-term time frame within which to evaluate investment success. In any given year or two, some assets will outperform others, but then others will outperform them over the next year or more, and so forth. In other words, a key reason to diversify your portfolio is because you do not know in advance how a single asset will perform over the next decade. No one does. With prudent diversification and rebalancing, you do not have to know.

Source: Bank of America, Haver Analytics, Bloomberg. Annual data.

Our emphasis on diversification, of course, does not mean that we do not try to position our clients' portfolios in advance to capitalize on investment ideas or to avoid certain risks, or both. For instance, we look at the current historically low bond yield levels (the 10-year Treasury is below 2% and the 3-month is still near zero) and realize that eventually rising yields will put pressure on bond prices. Reducing exposure to traditional long-term bonds and increasing exposure to unconstrained strategies with low or even negative duration, as well as other tactical features, should help when yields do move back up.

Or we observe that the 5-year average annualized return (14.47%) for the S&P 500 is nearly 2 times its 10-year average of about 8%. (These figures are for the period ending 3/31/2015.) The S&P 500 tends to revert to the mean over longer periods of time. So we have been asking, *where might we find additional source of return for portfolios if traditional U.S. stocks might be poised, after a high-flying period, for below-average returns*? We believe that alternative investments like multi-asset vehicle and managed futures may provide supplemental and less correlated returns to core U.S. stocks.

The potential for rising rates and for below-average U.S. large cap stock returns underscores the continued need for alternative investments in portfolios. We continue to believe that an allocation to alternative strategies is necessary within a well-diversified portfolio. Not only can alternatives reduce the overall level of risk to which a portfolio is exposed; they can provide returns at a time when traditional fixed income investments may be challenged by rising rates and stocks may be challenged by the end of monetary stimulus. Alternative investments can be a prudent component of a well-diversified portfolio, but they, too, should be measured like other assets—not in a given year, but over time. After all, remember: In any given year, you are almost assured of being unhappy with at least one asset in your portfolio. But be encouraged. That unhappiness means that you are doing diversification right.