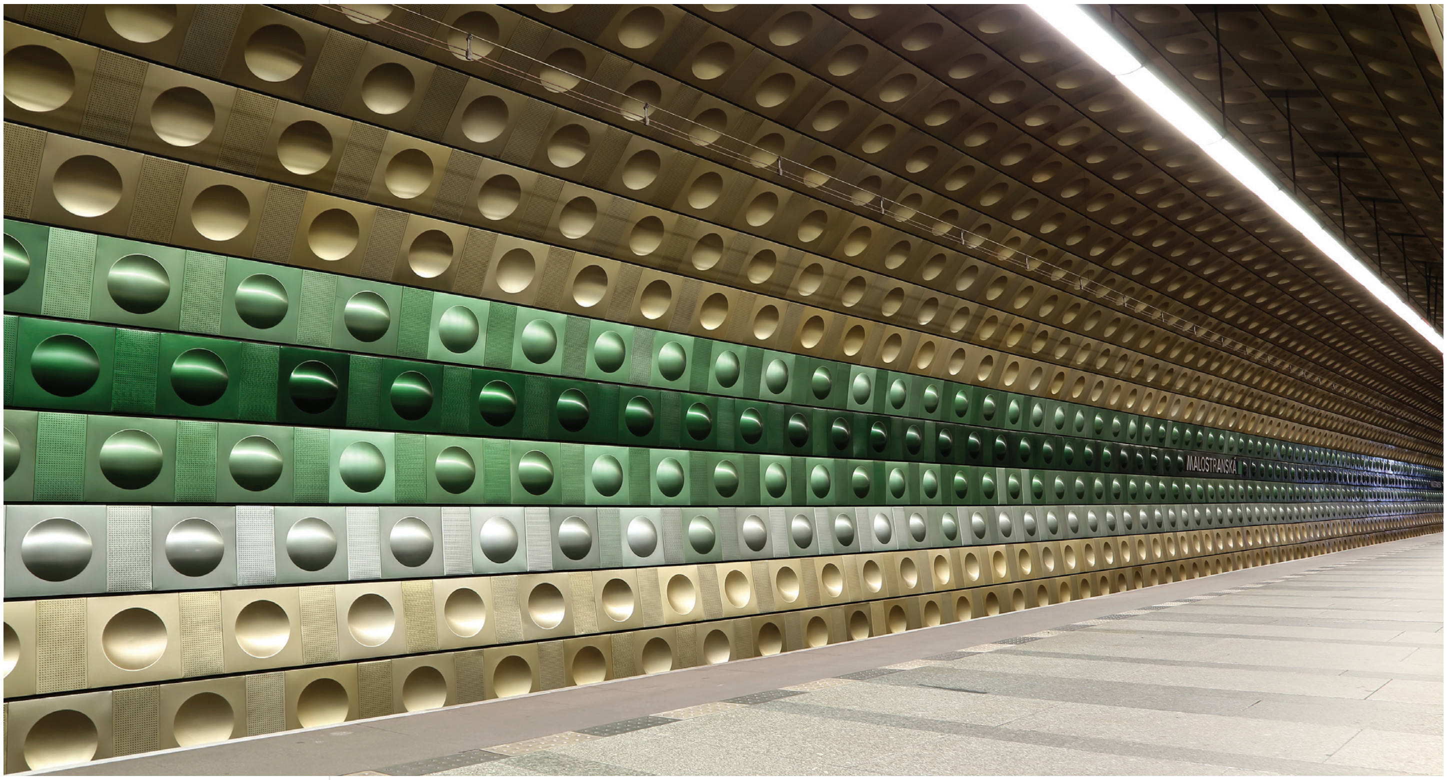
THE
Envestnet Edge
INSIGHTS FROM ENVESTNET | PMC



DECEMBER 2014

Our Perspective on 2015: Maintain Yours

In 2014, interest rates remained low, U.S. equities stayed strong, mid-year geopolitical events barely shook the markets, and a sudden, late-year drop in oil prices took many by surprise. What should investors expect in 2015?

Zachary Karabell
Head of Global Strategy
Envestnet, Inc.

'Tis the season for looks back and looks forward. The financial world will be replete with such missives in the weeks to come, and that is actually all for the best. Given the fluid nature of money and planning and investing, regular assessments of what worked and what didn't, how the year played out versus expectations, and what might lie just ahead, are vital. While it is true that forecasts about the future usually say more about present sentiment, thinking ahead does provide a framework for assessing likely risks and potential opportunities.

The year that passed

The short summary of 2014 is that interest rates were not nearly as volatile as expected and stayed lower than most thought they would. U.S. equities were strong, as expected, while international and emerging markets were not.

Two unexpected trends during the year were the trajectory of energy prices and the massive divergence between how U.S. large cap equities performed versus small- and mid-cap stocks. The plunge in oil and energy prices in November into December was anticipated by very few, and yet that drop was not part of some economic collapse or sudden contraction of activity; it was instead a function primarily of global oversupply of oil and most base commodities. The unfolding of the shale oil and gas revolution in the U.S., combined with the near-complete inability of the once-mighty OPEC oil cartel to set production quotas, led not just to oversupply but to substantial uncertainty in energy markets about just how long an oil glut might last.

Less noticed but quite dramatic for investors was the substantial gap between how various equity classes performed. If you just looked at the S&P500, you might have thought that it has been a good year for equities. But that masks a wide gap between how large-cap U.S. listed stocks performed and how international and smaller cap stocks performed—in the last three years, the S&P500 saw 75.56% growth, while MSCI EAFE and MSCI Emerging saw 41.58% and 11.43% respectively (looking just at the past year, the S&P500 saw 15.1%, and MSCI EAFE and MSCI Emerging saw 0.24% and -2.72% respectively)[1]. The gap between U.S. and international and emerging equities may simply reflect the gap between the relative strength of U.S. companies and the overall economy versus weakness elsewhere. While U.S. economic growth remains unimpressive at about 2% GDP growth, that compares favorably to a Europe and Japan that are barely flat-lining, to a China whose headline growth may be 7% but whose activity is undoubtedly slowing and shifting, and to an emerging world with significant chunks that in the short term are directly connected to the price of oil and commodities.

The gap between large companies and smaller ones, however, is mysterious. It's not as though small and mid-sized companies struggled compared to larger ones. Mergers and acquisitions have been decent, which tends to help smaller companies. What may help explain some of the divergence: larger companies have been taking advantage of lots of cash on their balance sheets to repurchase their own stock, which can help bolster and boost stock prices. Smaller companies usually use their cash—if they have it—to invest in growth, so they have not had that same benefit as their larger counterparts.

Another oddity of 2014: investors in general have plowed their dollars not into the sectors with the best returns, namely U.S. equities and large-cap stocks (Figure 1). They instead have yanked money from funds that invest in those and put money into bonds and the very international and global equities that have so underperformed (Figure 2). Either this is a case of unusual investor acumen of buying low in anticipation of a move higher (a possible explanation for investing in underperforming global and emerging stocks), or a case of investor skepticism that the strength of U.S. equities is based on years of Federal Reserve bank liquidity rather than fundamental performance.

Accompanying that skepticism is a year-end bout of selling of "riskier" fixed income assets, especially high-yield bonds and anything attached to emerging economies. The sell-off was intense in early December, as was the amount of money pouring back into U.S. Treasuries, sending back yields on the 10-year towards 2%. The question then is whether this rotation is simply a short-term market phenomenon or whether it is setting the stage for 2015.

What 2015 might hold

We always have assumptions about what lies ahead. Today the most prevalent is that interest rates are going up with the only X factor being: by how much?

Figure 1:
U.S. equity flows are disconnected from investment results

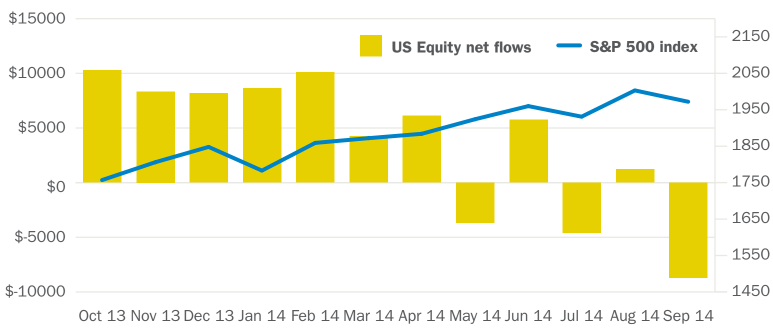
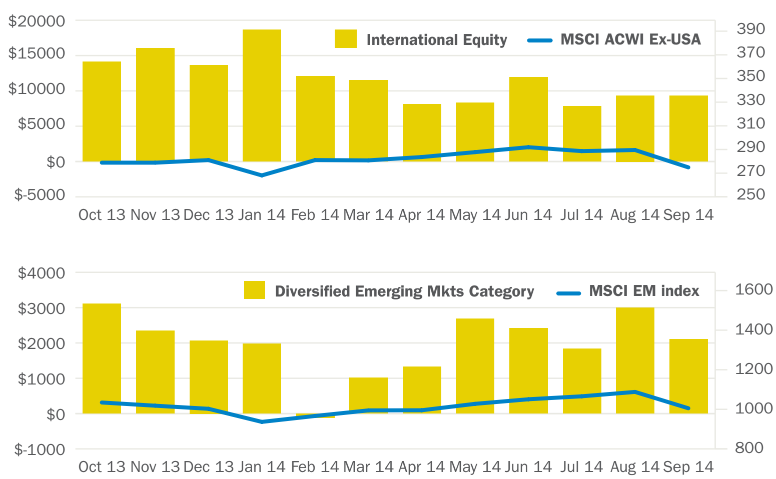


Figure 2:
International equity flows are disconnected from investment results



Source: Morningstar

[1] Source: Bloomberg. Data for S&P500, MSCI EAFE, and MSCI Emerging through December 12, 2014.

Figure 3:
U.S. equities since March 2009 lows

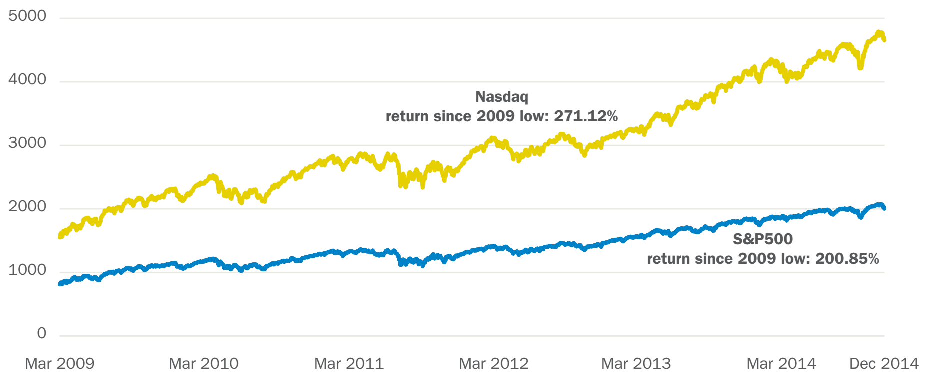
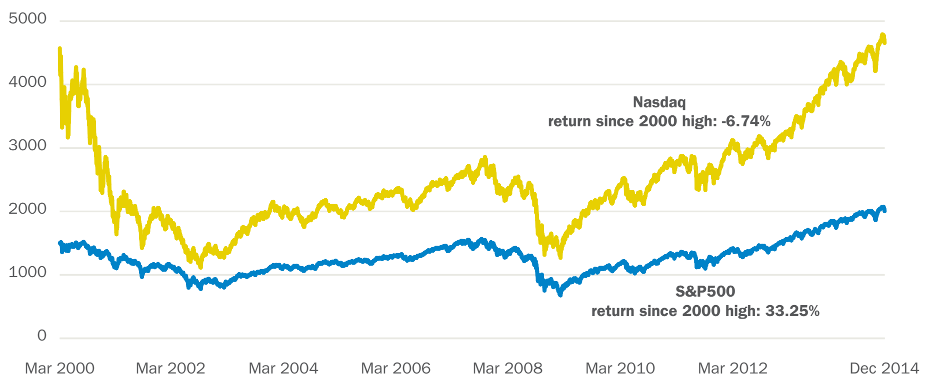


Figure 4:
U.S. equities since March 2000 highs



* Through December 12, 2014

Source: Bloomberg

Clearly, the Fed has signaled that it is likely to start moving short-term rates above zero, though any moves will be "data dependent." However, while there is a high likelihood that 2015 ends with the short-term Fed funds rate somewhere between 50bps and 1%, it does not follow that global rates will be significantly higher.

Almost a decade ago, then-Chairman of the Fed Alan Greenspan remarked in congressional testimony about the "conundrum" of global interest rates declining even as the Fed was raising short-term rates. Indeed, as we noted in a previous piece, the trajectory of interest rates over the past 30 years has been progressively downward. Therefore, the assumption that with Fed policy changing, all interest rates will then rise, should be challenged. That *may* happen, but by no means should we assume that it will. There is ample global liquidity even if the Fed tightens, especially with Abenomics continuing in Japan, moves by Mario Draghi and the European Central Bank, and China increasing lending on the mandate of the central government.

If yields don't go up appreciably, we are left with the same low-yield and low-return environment that has characterized markets for years. Yes, U.S. equities have been anything but low-returning since 2009, with the S&P500 up more than 200% since March 2009 lows (Figure 3). But that is more a function of the bounce-back after the financial crisis. Measuring bull and bear markets is often a function not of actual returns but of what date you pick. U.S. equities have been a "bull" market since March 2009, but the picture since the beginning of the 21st century is rather different and more in line with the low-return paradigm we are now in (Figure 4). In fact, since March 2000, the Nasdaq is still negative, while the S&P500 with returns of about 30% is barely in line with inflation, which means that in real terms, it has yielded nothing.

About Envestnet®

Envestnet, Inc. (NYSE: ENV) is a leading provider of unified wealth management technology and services to investment advisors. Our open-architecture platforms unify and fortify the wealth management process, delivering unparalleled flexibility, accuracy, performance, and value. Envestnet solutions enable the transformation of wealth management into a transparent, objective, independent, and fully-aligned standard of care, and empower advisors to deliver better results.

Envestnet's Advisor Suite® software empowers financial advisors to better manage client outcomes and strengthen their practice. Envestnet provides institutional-quality research and advanced portfolio solutions through our Portfolio Management Consultants group, Envestnet | PMC® . Envestnet | Tamarac™ provides leading rebalancing, reporting and practice management software.

For more information on Envestnet, please visit www.envestnet.com.

So overall, we have been in the midst of a long resetting of yields and equity returns. It has taken just as long for investor expectations to reset, and for many, the assumptions remain too high. Returns at 7% per year—what many consider the long-term average for equities or for pensions—would be lovely, but unlikely.

The positives for 2015: lower energy and commodity prices could help consumer wallets and corporate margins as those input costs go down. Also positive are a stable U.S. economy and continued (albeit not all that impressive) global growth. However, nothing precludes the unexpected, such as the sharp drop in oil prices. The only defense of portfolios against the negative effects of that drop was not to be so overinvested in areas sensitive to oil price declines.

For equities, fundamentals remain very strong for many companies; stronger than the fundamentals of any national economy. That, more than central bank liquidity, has been bolstering stock prices and should continue to. The most overlooked fact in equity investing is that unless you only short stocks, you invest in equities with the expectation that stock prices will rise. If companies are profiting and margins remain decent, stock prices do tend to rise absent some other disturbance in the financial world. All things being equal, 2015 looks to continue that trend. It might be more dramatic to forecast a down year for U.S. stocks, but for the moment, there is no reason to.

As for whether the long underperformance of international and emerging markets will end, the continued emergence of a global middle class is a powerful multi-year trend. To date, the best reflection of that has been on the balance sheets of U.S.-listed multinational companies and not in the equity indices of foreign countries. But the valuation gap is large as is the performance gap, and it is reasonable to forecast that gap narrowing and emerging and international markets having at least a small surge.

A final note: even as return and yield assumptions have gone down and should continue to, this has been a strong multi-year period for capital and investing when juxtaposed to wages and national economic growth as measured by GDP. Mid-single digit returns may feel only OK relative to memories of boom years past, but compared to almost no inflation and minimal wage growth those returns can be seen differently and more constructively. The world at large will continue to oscillate between hope and fear and muddle from crisis to crisis. The financial world for now, along with investing, has been less dramatic and more stable. A crisis is always possible, but there is such a thing as planning too much for a crisis that doesn't happen at the expense of real opportunities that present themselves. Something to think about in the year ahead. ■

Advisor Take-Away:

If many investors got it wrong in 2014—pulling out of U.S. equities (which continued to be strong) and pouring into international and emerging markets (which continued to underperform)—how then do we prepare for 2015? First, despite expected Fed moves, be prepared for interest rates to remain low, following their general downward trend over the past 30 years. The recent volatility in high-yield and emerging debt also shows that even with low rates, bond prices can swing sharply. Second, take the "prolonged" bull market into perspective: yes, the past five years have been roaring, but only because the decline in 2008-2009 was so steep. Going forward, single-digit returns will more likely be the case. Third, keep an eye on a possible narrowing gap between U.S. and international and emerging markets, as well as a narrowing gap between large and small caps. Lastly, there are lessons learned from that surprise in oil prices: consider adjusting portfolios that are too sensitive to one sector or asset class.