FLEURUS INVESTMENT ADVISORY

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Overview

The S&P's 500 wraps up 2014 with another annual double digits performance of 13.7% on a total return basis. This puts its annual average three-year performance at 20.7% and its five-year performance at 15.9%. This compares to a 8.1% average annual performance over the past ten years and 9.9% over the past twenty years.

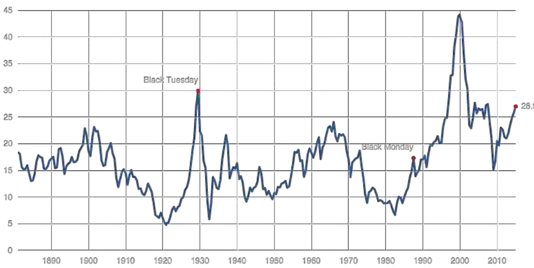
The 2014 S&P's advance masks a more mitigated performance overall. Within this index, many sectors have underperformed, including finance, materials and energy of late. Additionally, the advance has been less sanguine for small stocks, providing another indication of potential choppiness ahead. The graph below shows the performance gap between the S&Ps' 500 and the Russell 2000, a measure of performance in the US small cap sector.

U.S. Stock Market – Trouble Below The Belt

Source: Gerring Capital Partners, StockCharts.com

Small caps generally offer a return premium over large cap stocks in order to compensate for the additional risk associated with the ownership of more leveraged and less established businesses. Currently, that risk is not compensated for. When this gap is filled, as it will eventually be, the performance of the small cap sector will either surpass that of its larger brethren, or bring it down to its level.

As for valuations, below is a chart that I like to take a look at, from time to time.



It represents the Schiller S&P 500 P/E ratio since 1890. The Schiller ratio is calculated using actual realized earnings over the previous ten years. It currently stands at close to 27; not the nosebleed level of 2000 but right on the 2007 level and definitely on the high side of the hundred-plus-year-range.

Where does this leave us?

Inflation is expected to average 2% to 2.5% per annum over the next ten years, real US GDP growth 2%, while the expected yield on the US ten-year note is projected to average 3.5% over the next ten years. Finally, the growth rate of corporate earnings is expected to average 2%. When all these ingredients are mixed together to generate the equity risk premium (ERP), one arrives at an ERP of 2.5% to 3% and to a nominal average annual return for US large caps of about 6%. Currently, this is where the long-term performance of the US Large Cap equities is projected to be, over the next ten years.

Another way to interpret this number is to say that, absent a change of circumstances that would cause all of these ingredients (inflation, interest rates, economic growth, earnings growth) to drastically change, sustaining 10% to 15% annual equity returns much longer looks increasingly improbable.

Allocation tilts for 2015

Based on my review of the overall market conditions, a sample of which was provided above, I intend to marginally reduce allocation to US equities in all of the four diversified model portfolios that I oversee. Within this reduced US equity allocation I intend to maintain the weights of the small and mid cap sectors. In a somewhat contrarian move, I intend to maintain the international and emerging market equity allocations. Valuations have become more compelling in some of these sectors, particularly in the Eurozone. As for the emerging markets, the story there will vary with each country's exposure to commodities and oil in particular. There are opportunities nonetheless after several years of underperformance.

Below is a chart that illustrates perhaps an investment opportunity.

Source: Gerring Capital Partners, StockCharts.com

The price of oil and the US dollar are both likely to continue on their current trends but not in a straight line, adding in the process to the overall market volatility, in the USA and globally. In that context, raising cash via a reduction of exposure to US large cap by 5% across all portfolios seems reasonable. As the year evolves and the tectonic plates represented by: 1) the US dollar relative value, 2) the overall level of interest rates and, 3) oil prices, move in a more predictable manner, a less conservative stance may be warranted.

Concluding remarks

Investing is as much about psychological and behavioral analysis as it is about economic and financial analysis. Good investing pre-supposes not only sound technical skills but also the ability to recognize and to correct for the behavioral biases that may color our investment decisions.

Here are two common biases that psychological research has identified over the past twenty years: The confirmation bias and the availability bias.

The confirmation bias leads investors to focus on information that confirms their pre-existing thoughts and to minimize or ignore the rest. The availability bias leads them to weigh the most recent information more heavily. Both may lead to ignoring or minimizing dissonant or previously known information.

Ways to mitigate these tendencies include: 1) Actively seeking and listening to dissenting opinions, 2) Conducting careful and thorough research that goes beyond the review of the latest data releases. As simple as they are these suggestions are difficult to implement on a sustained basis! There is however much to gain from their practice.

We look forward to hearing from you on these matters as well as on other investment issues and wish you all a prosperous New Year.