Economic Review & Outlook – Ronald Blue & Co.

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Chairman's Letter

Head: When investing is a lot like baseball

Sub: *Moneyball*, to be precise

The Oakland A's, a small-market baseball team, were struggling. Without the big budget of the mega-teams, they were finding it hard to compete, rarely reaching the playoffs. In a counterintuitive move, the A's turned not to more coaches, but to Harvard-educated statistician Paul DePodesta, who sidestepped conventional wisdom and introduced statistics to the strategy.

DePodesta found the key performance indicator for winning games (players' on-base percentage), and the Oakland A's revamped their lineup accordingly. While coaches and scouts for the rest of the baseball world were looking at things like swing speed and power, the A's found players with great on-base stats, hiring them at lower salaries than the power-slugging stars. As the movie and book *Moneyball* show, this new perspective led to greater success, and Oakland's winning percentages and playoff appearances became consistently above average (with below-average budgets).

Focusing on the right performance indicators to meet goals is equally important in managing money. According to mutual fund manager and advisor AQR, there are four indicators of positive performance in international equities over an extended period of time: 1) the economic performance of the stock's home country, 2) global economic performance 3) the home country's equity price-to-earnings ratios and 4) the global stock market's price-to-earnings ratios.

AQR's study found that, in the short term, ***valuation changes were the primary contributor to stock market performance***. Over the long term, growth of a country's stock market was the strongest indicator. (See Figure 1.) In other words, while short-term stock performance reflects investor sentiment, long-term numbers reflect actual economic fundamentals.

Today, we are all besieged with a 24/7/365 stream of information. We can simply pull out our smartphones to check markets or our portfolios. Television offers experts' thoughts for the next week, month, or year, and with 13,000+ mutual fund choices, there are always those that have performed better. Most input is focused on the recent past and the immediate future.

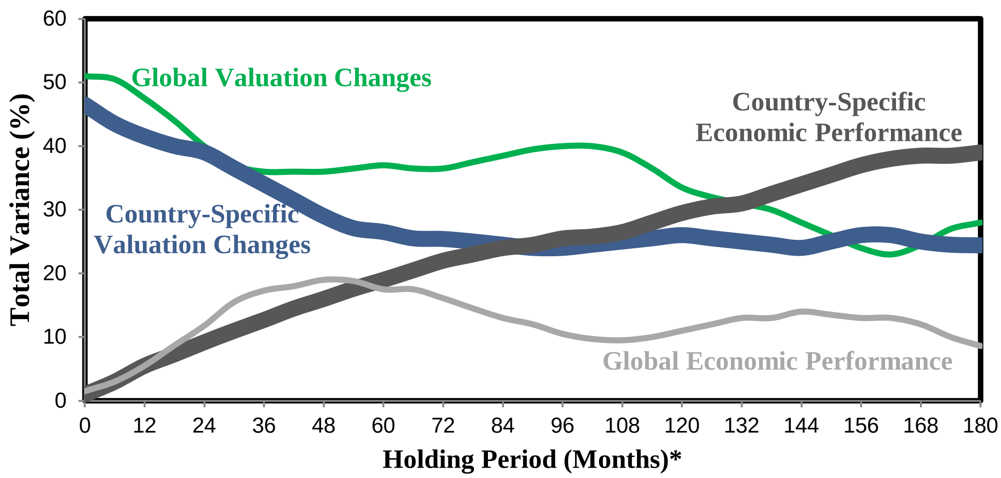
Positive short-term performance can be exhilarating. But winning or losing in the short term rarely predicts long-term performance with accuracy.

Many times in the past, short-term performance did not lead to long-term gain. At the end of 1998, AQR's long-term indicators of economic growth predicted that the U.S. economy would grow at average rates. But as AQR noted, short-term market performance owes more to sentiment than to long-term fundamental growth. The technology bubble was thriving in 1998 and investor sentiment was very bullish, driving prices higher than long-term fundamentals warranted.

Investors with a long-term perspective judged U.S. stocks to be valued too highly to meet long-term return goals. Investors with a short-term perspective were eager to participate in the positive short-term returns of the tech craze. In 1999, the short-term investors were rewarded with a 25% annual return, while long-term investors missed that run-up. However, the tech bubble burst, and the next nine years punished the short-term investor. The 25% gain of 1999 was erased, giving them a 10-year return close to 0%.

While short-term performance does not accurately foreshadow long-term performance, positive long-term performance often does not necessarily translate into good short-term performance. In 2001, the growth rate and stock valuations of emerging market countries suggested this asset class would grow at nearly 15% per year over the next ten years. Investors who focused on the short term watched current negative performance and moved out of the asset class. In 2002, the negative returns of emerging market stocks seemed to validate that move in the short term. But long-term investors who stuck with their convictions (and with emerging markets stocks) were rewarded with an annual return of more than a 15%.

Figure 1. Equity Return Contribution



As many of you might remember, after the 2008-09 financial crisis, also wiped the slate clean of existing assumptions and practices. We reevaluated our investment goals and reconfigured the key performance indicators that we would then use to reach those goals. Somewhat like AQR, we concluded that focusing on fundamental economics and market prices was the key to producing favorable returns for our clients. We also concluded that, because of the industry's current short-term focus, investors were likely to continue to move rapidly in and out of asset classes, increasing price volatility. We decided that it was not prudent to try to time our investing to reflect this unpredictable volatility. Instead, we would monitor asset prices to determine the attractiveness of securities that present long term opportunities.

To implement this revision of our investment strategy, we realigned our corporate investment team to focus on building long-term and shorter-term portfolios. Those portfolios focus on beating specific rates of growth *in excess of inflation*, with the shorter-term portfolios aimed at preserving capital for investments that could be needed in less than ten years.

We also invested our firm's resources to form Vident Financial, an independent research organization that focuses on finding investment opportunities around the world that mesh with Ronald Blue & Co.'s Principled Reasoning investment framework and that present good long-term potential.

It was not easy for the Oakland A's to dismantle their existing system and to implement "moneyball." In a similar way, it has not been easy for Ronald Blue & Co. to reconsider our long-held beliefs about economics and investments, implementing significant change, as well.

For the Oakland A's, rosters changed and popular power hitters were suddenly gone. Moneyball was a game about patience at the plate, with moviegoers wondering if the system would pay off. By the end of the season, the team made the playoffs, beating many teams with larger payrolls.

For investors, it seems to be harder than ever to keep their eyes on long-term goals. There are so many choices and so many returns they "should" have had. While a short-term financial home run can be fun and exciting, it isn't necessarily an indicator of a winning long-term season. As the research points out, we will continue to monitor the key performance indicators to guide our decisions. For those who can remain patient, waiting for the long-term results, we look for a winning season.

The above was written by Pamela Evans. All text below was SME content edited by Pamela Evans.

Investment Strategy

With an interesting year behind us, we look through a dimly lit window into 2014, trying to see what lies ahead for investors. U.S. equity returns were surprisingly strong last year … will they continue? Inflation or deflation or status quo? Will global equities climb or surge or …? Will unexpected sociopolitical events upend even the sharpest foresight?

There are no crystal balls in our investment department, nor copies of the Wall Street Journal's issue of December 31, 2014. But read along with us as we look at the year ahead.

The U.S. stock market was buoyed this year, primarily as a result of continued quantitative easing and the euphoria of optimistic investors not concerned with the lack of improved corporate fundamentals. This momentum could persist into 2014. Late market entrants could unwisely pile on, buying at proverbially-scorned high prices, to their eventual detriment. The danger of the "me, too" sentiment threatens a carefully balanced and diversified portfolio. While U.S. companies have created profits well since the financial crisis, the sustainability of those profits without improved corporate fundamentals is questionable. We will maintain our allocation to U.S. equities, but we do not anticipate increasing that percentage of the portfolio at these elevated prices.

Global equities, in many cases, present a situation of low valuations and positive prospects, and we will continue to monitor them carefully and invest in those countries and companies proven to be worthy in light of our Principles. Among the qualities that we seek in investable countries are good leadership and governance and the opportunity for human productivity to thrive unimpeded.

As we monitor our equity holdings for threats, we look for signs that systemic or inflation risks are becoming a focus, or that structural risk concerns or a repricing to more historical valuations are appearing. Should any of those happen and the U.S. stock market falter, we would expect opportunities for hedges such as gold or commodities. As we go forward, we balance between the structural risks in the developed global economy and the long-term opportunities in developing economies. We believe that developed stock and bond markets do not accurately reflect real structural risks and are responding inordinately to investor sentiment (thus the outstanding performance of the Standard & Poor's 500 stock index without a concurrent improvement in fundamentals).

Inflationary pressures are not high on our list of current concerns, but we continue to watch for signs of both inflation and deflation. While we expect a gradual increase in interest rates, we do not currently expect a quick jump.

As we look ahead, too, we are aware of the danger of taking an isolated year's performance and extrapolating it into a long-term trend. The U.S. equity surge of 2013 is not a surefire indicator of ten-year performance. And the positive but lower returns of developing country equities in 2013 does not predict a long-term trend, either. We continue to patiently invest clients' long-term funds for long-term performance, and encourage clients to continue their financial planning to allocate their funds to the correct time orientation.

U.S. Economic Outlook

The current U.S. Economic Dashboard (Figure 1, below) is based on a five-year time horizon, and as such, has not changed substantially over the past quarter. However, we are hearing calls from several voices that things are about to change. Some see growth increasing (upper left quadrant), as GDP has also increased. Others expect impending deflation (lower left quadrant), as the Federal Reserve tapers its quantitative easing activities. The threat of inflation (two right quadrants) is considered a less likely danger by many investors over the coming year, although we would err if not prepared for that possibility. If the easing of the stimulus program is not executed with great precision, increased inflation is a real possibility. Our portfolios are designed to be resilient throughout our range of expectations (blue-shaded area), meeting our return targets, while still reflecting the firm's predictions for 2014. We continue to encourage clients to view the Short Term Portfolio, Intermediate Term Portfolio, and the Long Term Portfolio in light of the individual time-specific goals of each.

Asset Class Outlook

The outlook time frame for each asset class varies according to the expected holding period of each class. Our outlook for stocks, which make up the bulk of the Long Term Portfolio, focuses on a time period of the next five to ten years. The outlook for the Intermediate Term Portfolio's bond-centric investments focuses on a two-to-five year time frame, while the Short Term Portfolio looks ahead for the next twelve months.

For the Long Term Portfolio, we expect the next five to ten years in U.S. stocks to hold slightly less potential for real returns of 4% or more, based on current valuations. We realize that exceptions could happen; for example, a period of unusual growth due to a disruptive technology that could support higher valuation levels. However, due to stronger demographic trends, cheaper valuations, and improving financial health, developing countries' equities should experience stronger growth than their U.S. counterparts over the long term.

With interest rates rising somewhat in 2013, we are well aware of the need to protect the value of the Intermediate Term Portfolio from potential declines in bond prices attributable to climbing rates. Due to attractive bond valuations in emerging markets, we remain open to a modest exposure to emerging market bonds.

Looking at interest rates broadly, we believe they may be more sensitive to economic fundamentals in 2014. Stronger economic data could lead to higher rates and a steeper yield curve (Figure 2, below), while weaker-than-expected data could lower rates and produce a flatter curve (Figure 3). (Insert graphs from bottom of page 20, QIS) In general, we believe that any upswing in interest rates in 2014 would be gradual, barring exceptional U.S. economic growth, an inflation jolt, or a tighter Fed policy. The Short Term Portfolio remains invested in fixed-income instruments that could quickly take advantage of increases in interest rates.

Portfolio Positioning

The Long Term Portfolio is positioned to take advantage of both global and U.S. equity opportunities, with a small exposure to commodities, given elevated market risk, slowing earnings growth, and the slight risk of higher future inflation. We maintain a significant exposure to U.S. equities, as the U.S. continues to be the global liquidity provider. Those U.S. stock allocations are tilted toward defensive quality and income due to valuation and future debt concerns. However, we monitor the effects of the increase in money in circulation, which could impede economic growth and increase the risk of inflation, which could drive stock valuations lower.

Our international equity holdings continue to provide exposure to favorable valuations and growth opportunities, to guard against a decline in the value of the dollar and to hedge against U.S. national credit risks. Slightly elevated levels of market risk mean that we retain the hedge of gold and commodities.

The Intermediate Term Portfolio is charged with protecting the value of its investments from the negative bond price effects of higher interest rates. With that in mind, durations are short, holdings are well-diversified, available valuation opportunities are seized, and bond sectors with historically low correlation to interest rate movements are prioritized. Corporate debt continues to be a prime holding.

With regard to the Short Term Portfolio, we remain allocated to short-term bonds (80%) and a high-quality money-market fund to achieve additional yield, maintain liquidity, and reduce overall portfolio volatility.

Fourth Quarter 2013 Market Review

Several facts are prominent as we look back at the final quarter of 2013. One is that most asset classes underperformed the Standard & Poor's 500 (S&P 500). In a rough year for fixed income, the benchmark Barclay's Aggregate Bond Index posted a rare negative return for the year (-2%). Inflation hedges struggled, including gold and most commodities (except the energy sector). U.S. REITS turned in a slightly positive absolute return for the year, but underperformed U.S. equities.

Reviewing the U.S. economy, growth appeared to accelerate in the second half of 2013, for which final figures have not yet been released. Increased consumer spending and stronger inventories highlighted the third quarter. Manufacturing numbers have expanded for seven months, while retail sales, consumer confidence, housing starts, and housing prices all seem to be going in the right direction. Payrolls were going strong but finished with a weak December.

The Fed began tapering its current asset purchase program, while indicating its preference for low rates over a longer period of time. Because this move was expected, tapering had minimal negative impact on equity markets over the short-term.

While U.S. stocks performed well beyond expectations, that performance is largely attributable to continued central bank stimulus, as was the case with a similar surging stock market in Japan. Continued investor optimism not backed by corresponding financials was also a big factor. It was a dismal year for fixed income, with a prominent index (footnote – Bank of America/Merrill Lynch Broad Bond Market Index) showing that the -2.25% loss was the second-worst annual return on record. It was only the third time in the index's 38-year history that annual returns were negative.

Gold reached its lowest level in over three years in the fourth quarter, due to a confluence of factors including improving economic data, higher investor demand for traditional risk assets, the Fed's move toward tapering, and near-term disinflationary trends in the U.S., along with some technical considerations. Other commodities also struggled with broad-based price weakness. U.S. REITS were slightly positive for the year.

We believe that gold's price decline in 2013 was primarily due to the uptick in U.S. growth, but also to Fed tapering threats (and eventual enactment), and a strong dollar due to concerns of a China slowdown. Will gold continue to have a place in Ronald Blue & Co. portfolios, and if so, for how long?

We don't intend to hold gold permanently, but we believe that elevated risks continue to make it a wise call. Those risks include:

- Burgeoning U.S. debt, now in excess of 600% of GDP.
- The Fed's unprecedented expansion of its balance sheet. It is now equal to 23% of GDP; in the 5th year of economic recovery, it has risen 38% over the last year.
- Excess reserves on banks' books are the highest they've ever been, at $2.4 trillion (14% of GDP). This is a 60% increase (from $1.5 trillion) since the beginning of 2013.
- Low interest rates, low equity market volatility, and elevated equity valuations (in the 8th decile of historical valuations).

In order to trim or eliminate our gold holdings, we would expect to see:

- Significant change in equity valuations compared to gold.
- An abatement of systemic risks; for example, a decline in public debt, a decline in excess reserves, a shrinkage of the Fed balance sheet.

The past year challenged many of us to think deeply about our convictions, and in the end, the Ronald Blue & Co. investment team reaffirmed our commitment to our Principles and to our long-term thinking. We believe that our portfolios are appropriately positioned for their distinctive time orientations, and we look into 2014 with confidence.