ACROPOLIS®
INVESTMENT MANAGEMENT

# PORTFOLIO INSIGHTS

Volume 13, Issue 2 // David Ott, Editor

## In this Issue:

2 | The Trouble with Forecasting
3 | Inside the Economy
4 | Stock Market Summary
5 | Bond Market Review
6 | Choosing a Trustee
7 | Best Execution for Clients

## Contact us:

P | (888) 882-0072 (Toll Free)
| (636) 449-4900 (St. Louis)
F | (888) 453-1266 (Toll Free)
| (636) 778-2400 (St. Louis)
E | info@acrinv.com
A | 14755 North Outer Forty, Suite 100, St. Louis, MO 63017

## Acropolis was born from a simple idea:

**In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.**

# Off to a Bumpy but Solid Start

Markets are always on the move and the first quarter of 2015 was no exception.

If you simply looked at the change in the Dow Jones or the S&P 500 at the end of the quarter, you might conclude that nothing happened since both indexes returned less than one percent for the quarter.

Other segments within the US enjoyed much stronger returns along with stocks overseas, even when you factor in the negative impact of the rising U.S. dollar, which gained 8.96 percent in the first quarter and is now up almost 25 percent in the last nine months - a historic rally.

"Ed and Helen's portfolio rose 3 points today on Dave's purchase of 100 shares of..."

The strength of the dollar rally can largely be explained by diverging monetary policy around the globe. While the Federal Reserve here in the U.S. is on the verge of raising rates, the European Central Bank announced in the first quarter that they would begin a bond-buying spree much like the program that the Fed concluded at the end of last year.

While stock markets were volatile, the economy continues to grow sluggishly. The Gross Domestic Product (GDP) reading for the fourth quarter of 2014 was finalized at 2.2 percent, but early indicators suggest that growth in the first quarter of this year could be zero or slightly negative. The economy continues to add jobs, but at a slower pace leaving the unemployment rate at 5.5 percent.

The slow pace of the recovery caused bond yields to fall as investors were willing to pay a little bit more for safety and bet that the Fed might hold off a few more months before raising interest rates.

Of course, we cover all of these issues and more in the following pages and hope to provide you with some insight into how we think about the current market risks and opportunities.

As always, we continue to remain well diversified and firm in our beliefs that asset allocation and a long-term time horizon are the key ingredients in a recipe for success especially in uncertain times.

**Pundits forecast not because they know, but because they are asked.**
- John Kenneth Galbraith

# The Trouble with Forecasting

*By Cliff Reynolds Jr., CFA*

Frequent readers of ALM Insights or any of the other Acropolis publications are well aware of our stance on forecasting. Whether we are talking about bonds, the S&P 500 or a high momentum stock like Apple, while it may be fun to speculate on future performance it does more harm than good when it comes to an investment strategy.

Last quarter, in Reading the Tea Leaves, Ryan Craft highlighted some of the strongest cases against speculating on future performance in the bond market. He showed data from studies on bond mutual funds forward rate curves as well as the performance of the 10-year Treasury bond, to build a case for market efficiency.

It's a new quarter, so it's only natural that we have something new to show on the limitations of forecasting.

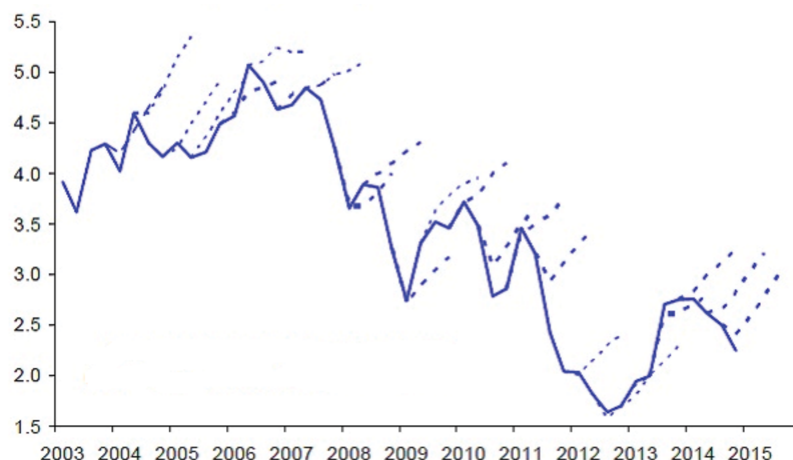
Toward the end of last year, Torsten Slok, an economist from Deutsche Bank Securities, wrote a quick piece calling this chart the "Chart of the Decade." That is quite a title considering the events that have transpired over the last 10 or so years, but I think his argument is a strong one.

The dark blue line shows the path of the 10-year Treasury yield since 2003 and the dotted lines show projected path of the 10-year Treasury yield over the following 12 months, according to the Fed's quarterly Survey of Professional forecasters.

Averaging the variance between the forecasted yield and the actual yield 12 months later shows that the survey was wrong by about 0.60 percent each time. Not only does the forecast hardly ever follow the actual yield, but the forecasts call for future rates to be higher consistently throughout the time period. By my count the forecast is either correct or close to correct five times and incorrect 16 times. In a market where being on the wrong side of the bet can cost an investor a lot over time, it makes you question the real benefit of making the bet in the first place.

The last dotted line on the graph shows that the survey of professional forecasters are expecting the ten-year to finish 2015 at around 3 percent. Do rates have "nowhere to go but up?" According to the chart, forecasters have been saying so for some time now, despite the market's own agenda.

**Wall Street Economists Consistently Wrong About 10-Year Rates**




*Source: Deutsche Bank, December 2014*

# Inside the Economy

*By Ryan Craft., CFA*

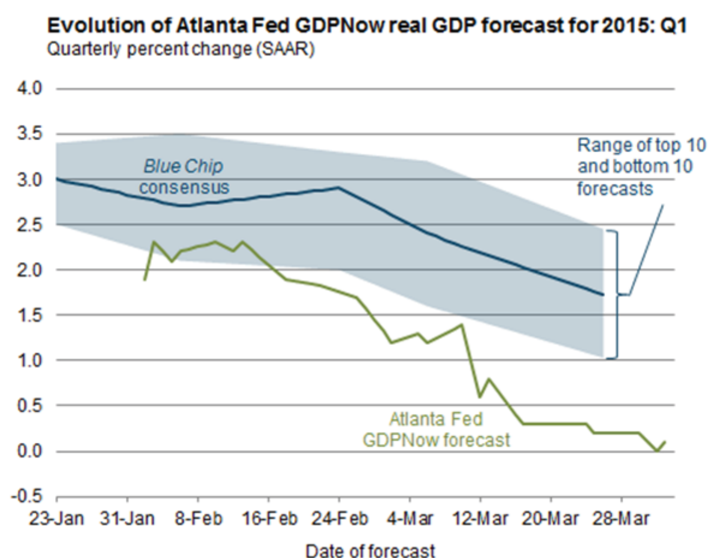
Gross Domestic Product (GDP) growth for 2014 was a wild ride., but, ultimately, the economy expanded at a real rate of 2.4 percent.

The path to get there, though, was quite volatile. The first quarter posted a weather-induced contraction of -2.1 percent, followed by very strong 4.6 percent and 5 percent growth in Q2 and Q3. The year ended with 2.2 percent growth in the fourth quarter.

This year looks to be continuing this pattern of volatility. Durable goods orders, excluding transportation, have declined every month since September. Retail Sales have fallen every month since October. Auto Sales have been declining for the past four months.

When one considers these known components of GDP, it paints a bleak picture for growth in the first quarter. This view is echoed by the Federal Reserve Bank of Atlanta, which publishes a GDPNow Forecast that takes current economic data to determine a real-time forecast for current quarter GDP. As seen in the chart, the Fed's model for GDP has been declining throughout the quarter and is now predicting zero percent growth in the first quarter.

Does this indicate a looming recession? Maybe. Maybe not. It does indicate the problems facing the Fed regarding tightening monetary policy. The Fed has indicated it is likely to raise short term interest rates this year. With the economy slowing, some of which is a result of a very strong US Dollar, it is difficult for the Fed to raise rates.




Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Higher short term rates may push the dollar even higher, especially with much of the developed world currently offering negative interest rates. A strong dollar can hurt US exports and manufacturing. A strong, stable currency is good for the long term prospects of the economy, but sudden moves can result in imbalances on a global level and negatively impact US companies in the short term. For this reason, the Fed will be watching the dollar closely as it debates monetary policy.

**It's a recession when your neighbor loses his job. It's a depression when you lose yours.**
- Harry Truman

**Doubt is not a pleasant condition, but certainty is an absurd one.**
- Voltaire

# Stock Market Summary

*By David Ott*

The first quarter was positive for investors with stocks and bonds up across the board in the midst of major economic news in the US and abroad.

In January, the European Central Bank (ECB) announced that it would embark on a major bond-buying program, known as quantitative easing (QE), which is designed to lower longer-term interest rates and stimulate their economy. Stocks outside the US loved the news and rallied by 10.60 percent if you ignore the value of currency changes.

The same QE news, though, caused the value of foreign currencies to drop by approximately nine percent against the US dollar, so US investors holding non US stocks only earned 4.88 percent on their foreign stocks, as measured by the MSCI EAFE.

The strong dollar had less of an effect on emerging markets. The MSCI EAFE EM gained 3.99 percent in local currency terms, but only made 2.24 percent in US dollar terms.

The EAFE index of developed markets still outperformed most US indexes even after the currency effects were taken into account.

The only major US index to outperform the EAFE was the S&P 400, which earned 5.31 percent. Overall, smaller stocks fared better than US stocks, with the Russell 2000 and Russell Micro Cap indexes earning 4.32 and 3.14 percent respectively compared to the 0.95 percent return for the S&P 500.

Generally, large cap stocks have more foreign currency exposure than smaller companies, so the rising US dollar hurt earnings reports and forward guidance for larger companies, explaining the worse relative performance.

Within US stocks, domestically oriented sectors were the best performers as healthcare stocks earned 6.53 percent and consumer discretionary stocks were up 4.80 percent.

Energy stocks were the worst performers, falling -2.85 percent as energy prices continued to fall. West Texas Intermediate (WTI) crude fell -13.39 percent in the quarter. At the end of last June, WTI Crude went for 98.38 per barrel and closed this quarter at 47.6 per barrel, a cumulative drop of -51.6 percent in nine months.

Overall, earnings data released in the first quarter was relatively good. Sales growth was 1.60 percent and earnings growth was 5.47 percent.

Telecommunications had the best earnings growth at 19.99 percent, and, in keeping with falling oil prices, energy had the worst earnings growth, falling -19.42 percent.

While the ECB engaged in a new bond buying program like the one that the Federal Reserve terminated at the end of the last year, our own central bank dropped the word 'patient' from their forward guidance and markets now anticipate that the Fed will raise short term interest rates later this year.

The prospect of rising rates had different responses between sectors that are sensitive to changing interest rates. Utilities, which have been seen by some as a bond replacement, suffered the most, falling -5.17 percent. Financials fell -2.05 percent during the quarter.

Surprisingly, however, Real Estate Investment Trusts (REITs), gained substantially, as the Dow Jones Equity REIT index gained 4.01 percent.

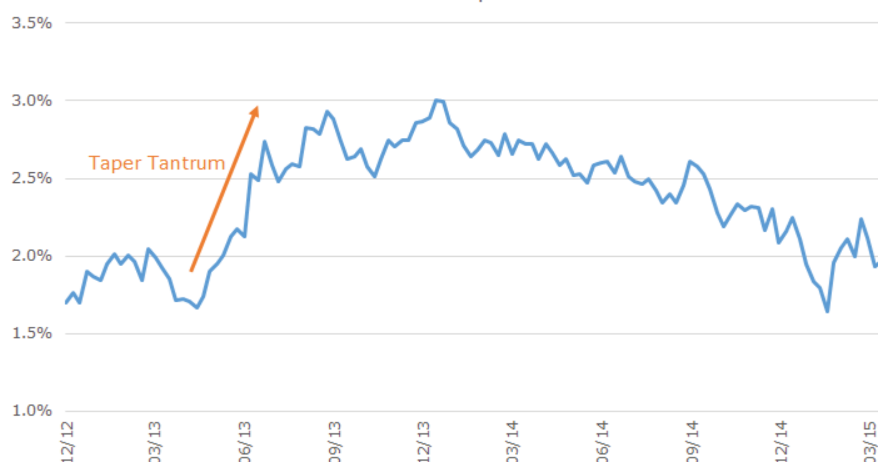
This is a bit of a surprise because higher interest rates tend to increase property values and increase borrowing costs. It's possible that the debate over the exact timing of the rate increases helped provide a tailwind in the first quarter.

# Bond Market Review

*By Cliff Reynolds, CFA*

The bond market has been an interesting place over the last couple years. Bond yields have spent a lot of time since the financial crisis either at or near all-time lows, leaving many to think that yields have nowhere to go but straight up.

More recently the Federal Reserve has remained transparent and steady in its progress toward less participation in the bond market (ending QE) and moving ever closer to the first rate hike since June 2006.




Despite this, intermediate and long-term yields have been on a steady downward trend since 2013, when the Fed first spooked the market with talk of tapering asset purchases, an event that is now called the 'Taper Tantrum.'

To many people's surprise, the effects of the Taper Tantrum turned out to be relatively short-term. Due to a variety factors including economic weakness overseas and tepid inflation domestically, intermediate and long-term US Dollar bonds are in high demand despite the low yields.

The effect of all of this on bond performance has been positive. The Barclays US Aggregate Bond Index is up 1.61 percent so far this year after returning six percent last year.

Sectors of the bond market that are not included in the Barclays Aggregate index have been more of a mixed bag. Treasury Inflation Protected Securities and fully hedged Global Bonds have done well, while un-hedged global bonds have suffered as a result of the strength of the US Dollar in the international currency market.

Going forward, I expect inflation to have a much larger impact on fixed income performance than any future changes to the Federal Funds Rate.

Our typical bond allocation has an average maturity somewhere between 5 and 6 years, which is pretty close to the market average.

Past interest rate hikes have historically had a lot of influence on short-term yields, but not much influence on the part of the curve where we typically invest.

The market expectation is for inflation to be around 1.9 percent for the next five years, down from about 2.5 percent at this time last year.

I expect yields to follow expectations for inflation going forward.

**Everybody has some information. The function of the markets is to aggregate that information, evaluate it and get it incorporated into prices.**
**- Merton Miller**

**Planning is bringing the future into the present so that you can do something about it now.**

- Alan Lakein

# Choosing a Trustee

*By David Ott*

There are many reasons to establish trusts including the efficient transfer of wealth, avoiding probate, philanthropic commitments, tax reduction, or protecting assets, among other things.

Ten years ago, the tax reduction benefits were applicable to more people because the estate tax exemption (the threshold where estate taxes kick in) was $1.5 million. Today, the exemption is $5.34 million and, therefore, affects far fewer people.

That doesn't mean that you don't need an estate plan – on the contrary. The lack of an estate tax simply means that there is less tax planning and more true estate planning – answering the classic questions: who should get how much, when and how?

In my opinion, one of the most difficult – and important – elements when creating a trust is choosing a trustee. Who will manage your financial assets and insurance proceeds for your surviving family members?

There are a number of options worthy of your consideration, starting with family members and friends. The advantage of a family member or friend is that they care, know you and may be in a good position to know what you would want.

The problem is that most people are not experienced in these matters and the responsibilities can be burdensome, from asset management, tax planning and compliance, trust accounting, administration and other duties that require expertise.

Corporate trustees can be a good solution – they are experienced in the technical details and the real world questions (should we distribute assets so the beneficiary can buy a new car?), are objective, and offer long-term continuity.

Of course, unlike friends and family members, they are also more expensive and sometimes people find them uncooperative (although this can be because beneficiaries want the money regardless of what the trust calls for).

Your friendly neighborhood investment advisor, while excellent at many things, is probably not a good choice for a trustee. While they can be great with the money and understand the concept of being a fiduciary, registered investment advisors are legally different from trust companies and actually can't serve as trustee.

Lawyers can be a good solution because they obviously have knowledge of the law and often know the details of a family's affairs, but they may not want to do the trust administration or asset management.

In my experience, a combination is often the best approach, appointing co-trustees like a family member or friend and a corporate trustee.

Until a few years ago, the corporate trustee always acted as the investment manager, but new laws allowed the responsibilities to be split (or bifurcated to use a fancy term), so that the administrative duties are separate from the investment management tasks.

At this point, we've had multiple clients name a corporate trustee in their documents and specify Acropolis as the investment manager, and we've found that with the right corporate trustee, the process can be seamless.

Finding the right balance when choosing a trustee can be difficult, but it's critically important, especially if your situation isn't simple and straightforward.

# Best Execution for Clients

*By David Ott*

A little less than a year ago, author Michael Lewis created a firestorm with his book, 'Flash Boys: A Wall Street Revolt,' that chronicled the world of high-frequency trading (HFT).

At the time of the launch, he went on 60 Minutes and announced that 'the market is rigged' and that everyone who had money in the stock market was a victim of predatory traders. Michael Lewis is one of my favorite authors, but I was pretty annoyed with his gross overstatement about the effect that HFT has on everyday investors.

We are not high frequency traders by any stretch of the imagination and so I don't really have a dog in the hunt, but my view is that HFT keeps markets competitive and has lowered costs for all investors.

Overall, the benefit that HFT brings to the market is greater than the cost in my judgment.

I bring this up again because we recently hired a firm to analyze our trading to find out whether we're being picked off by the HFT community.

When we trade, there are two costs. The first is the explicit cost, which is the commission that the custodian charges to execute the trade. Most of the time, the commission on a stock or exchange traded fund (ETF) is $8.95. That part is easy to identify and evaluate.

The second cost, the market impact of your trades, is harder to see, but is very real.

I am oversimplifying, but basically, if you are trying to buy and everyone else can see it, then they are going to raise the price that they are willing to sell to you in order to increase their profit. The same is true on the other side in a sale, but in the other direction.

Although I don't think that the market is rigged, I did expect to find that our trading had a small negative market impact. We are basically 'price takers,' which means that we have no ability to dictate the prices that we receive.

The trade cost analysis (TCA) covered six month's worth of trading data and in that time, we did 3,408 trades with a notional value of $79.8 million.

Keep in mind that I'm only referring to individual stock and ETF trades. We aren't evaluating individual bonds trades since they aren't done on an exchange, or mutual funds since all investors get the same price after the market is closed.

For the last six months of last year, the TCA firm found that our trading actually had a positive impact on performance. Instead of the market taking money out of our pockets, our trading actually added some value: $807.51.

While I am happy that the number is positive, the more important news is that our market impact is negligible: $800 either way is nothing on nearly $80 million in trades. I would be perfectly happy if the market impact number was negative and actually expect it to be negative on average over time.

We intend to keep doing the third-party TCA to make sure that we are getting best execution on behalf of our clients and will keep you posted about how we fare even when the numbers are negative. In the meantime, we are going to look at opportunities to improve our trading execution.

I don't believe that the market is rigged, but if it is, our clients appear to be protected based on the data we have thus far.

**I was seldom able to see an opportunity until it had ceased to become one.**

- Mark Twain

| Data Center | 2015 Q1 |
|---|---|
| Dow Jones | 0.33% |
| S&P 500 | 0.95% |
| S&P Midcap | 5.31% |
| Russell 2000 | 4.32% |
| MSCI EAFE (Intl) | 4.88% |
| MSCI Emerging Mkt | 2.24% |

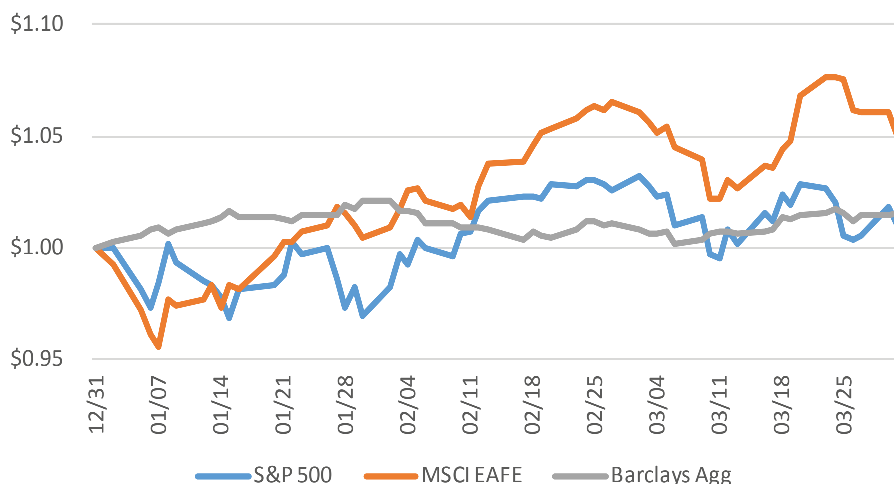
| S&P Sectors | 2015 Q1 |
|---|---|
| Consumer Disc. | 4.49% |
| Consumer Stpl. | 0.99% |
| Energy | -2.84% |
| Financials | -2.05% |
| Healthcare | -6.52% |
| Industrials | -0.85% |
| Technology | 0.57% |
| Basic Materials | 1.00% |
| Telecom | 1.52% |
| Utilities | -5.16% |

| Interest Rates | 2015 Q1 |
|---|---|
| Fed Funds | 0.25% |
| Prime Rate | 3.25% |
| 3-mo. Treasuries | 0.02% |
| 2-yr. Treasuries | 0.56% |
| 5-yr. Treasuries | 1.37% |
| 10-yr. Treasuries | 1.92% |

| Currencies | 2015 Q1 |
|---|---|
| Euro | 1.0731 |
| Japanese Yen | 120.13 |
| British Pound | 1.4810 |

*All Data as of 03/31/2015*

## The Big Picture




## Fast Facts

**1460:** The founding year of the world's first stock exchange in Antwerp, Belgium. The oldest stock exchange in the US opened in Philadelpia in 1790. The NYSE was formed under a Buttonwood tree two years later in 1792 and the first company listed on the new exchange was the Bank of New York.

**1715:** The year that Tokugawa Yoshimune officially authorized the first modern futures exchange, the Dojima Rice Exchange, in Osaka Japan. Samurai were paid in rice, but rice prices were volatile and they wanted a way to convert their commodity payments into cash.

**1924:** The year that the first mutual fund was created, the Massachusetts Investors Trust. The first 'balanced' fund that included stocks and bonds was the Wellington Fund, which was established in 1928. The first index fund was created by Wells Fargo in 1971.

### Notice to Clients

Please remember to contact ACROPOLIS® Investment Management, LLC if there are any material changes to your financial situation or investment objectives or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement as set forth on Part II of Form ADV continues to remain available for your review upon request.

### Legal Disclaimer

This publication is provided as a service to clients and friends of ACROPOLIS® Investment Management, LLC solely for their own use and information. The information in this publication is not intended to constitute individual investment advice and is not designed to meet your particular financial situation. You should contact an investment professional before deciding to buy, sell, hold or otherwise consider a particular security based on this publication. Information in this publication has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation are not guaranteed and have not been independently verified. The information in this publication may become outdated and we are not obligated to update any information or opinions contained in this publication.

© ACROPOLIS® Investment Management, LLC 2015. All rights reserved.