ROOF ADVISORY GROUP, INC.®
INVESTMENT ADVISORY & FINANCIAL PLANNING SERVICES

INVESTMENT INSIGHT

1st Quarter Review

Repositioning for a Changing Environment

Domestic equity markets oscillated between positive and negative territory with no clear direction for the first three months of 2015. Investors struggled with anxieties over soft economic data, the timeline for an initial interest rate hike, fallout from the collapse in energy prices, the implications of a strong U.S. dollar on corporate profits as well as elevated equity valuations. Despite these concerns, the S&P 500 Index finished the first quarter with a modest 0.4% gain. International stocks reacted positively to marginally improving economic conditions and aggressive monetary stimulus efforts by the European Central Bank. The MSCI EAFE (developed international equity benchmark) advanced by 4.2%, a rare period of outperformance over U.S. equities. Fixed income markets posted positive quarterly results with the Barclays U.S. Aggregate Index advancing 1.6%. Economic growth concerns, low inflation readings and dovish comments from the Federal Reserve were all contributors to a slight contraction in interest rates and the resulting positive performance from the bond market.

The U.S. economy ended 2014 with positive momentum and appeared to be on track to shift into a higher gear. However, the trajectory has moderated in the first quarter of 2015. This slowdown is evidenced by contractions in retail sales, industrial production, auto sales, and housing activity. While the recent economic data has been disappointing, the general consensus is that a large portion of the slowdown is due to another harsh winter as much of the Midwest and Northeast experienced record cold and snowfall, which likely kept many shoppers at home. We subscribe to this thinking as well but we are also monitoring economic conditions very closely with expectations for an improving environment now that the weather has turned.

While the recent economic weakness has been in focus, we are reminded of previous first quarters when economic activity dissipated only to be followed by a robust recovery in the following quarters. We are also encouraged by the still healthy employment picture with the labor market on a roll. February's job report marked the 12th straight month that employment gains have been above 200,000, the longest such run since 1994. The unemployment rate has dropped to 5.5%, the lowest since May of 2008. Demand for workers also continues to grow with job openings rising to the highest level in 14 years. In addition to improvements in the labor market, consumer confidence sits near an eight-year high and household wealth and real income levels have increased dramatically since the financial crisis. While the current path of the U.S. economy looks a bit murkier than it did a few months ago, we certainly do not see any of the classic precursors to severe economic stress or an inflection point in the economic cycle.

Our overall view on the economy as well as the equity market remains constructive. However, we did make a number of portfolio shifts this quarter in order to capture opportunities we see in asset classes outside of large-cap U.S. equities and also to slightly reduce our level of risk exposure. A brief overview of each of these shifts is detailed below.

After remaining at maximum equity exposure for the majority of the quarter we moved to one step below maximum equity allocation at the beginning of March. This move resulted in a 5% reduction of stock exposure across all Investment Policies. While this adjustment should not be mistaken for a dramatic change of course, we are aware of and concerned about some near-term headwinds. Chief among these concerns are elevated equity valuation levels and the anticipation of several quarters of contractions in corporate earnings driven by a strong U.S. Dollar and the plunge in energy prices. Given somewhat diminished near-term upside expectations, we slightly reduced our risk/volatility profile.

The proceeds from the reduction in equities were reallocated to floating rate bank loans via a diversified mutual fund with an experienced management team. Bank loans possess the following attributes that we find attractive – mid-single-digit yields, a dramatically lower volatility profile than stocks, seniority in a company's capital structure, and a floating rate of interest. We view floating rate bank loans as particularly attractive in the current low interest rate environment because, unlike traditional bonds, interest payments from floating rate bank loans actually increase as short-term interest rates rise. Floating rate bank loans are a credit sensitive segment of the fixed income universe and generally carry below investment grade credit ratings. However, this credit risk is mitigated somewhat by diversification (we hold over 400 securities in the mutual fund) and also by using an experienced and skilled manager that uses fundamental credit analysis to select securities.

As we outlined in our previous Investment Insight summary, international stocks have dramatically underperformed domestic equities over the past five years. While we have largely avoided any meaningful exposure to foreign stocks during this period, we made the decision to establish an initial allocation to developed (mainly Europe and Japan) international stocks. We are also using a diversified mutual fund with an experienced management team for our international exposure. This position was funded by reducing our allocation to large-cap domestic equities.

The decision to rotate a portion of our U.S. equity allocation into international stocks was driven by a number of factors – including – more attractive valuations abroad, moderately improving economic conditions, the economic benefits of lower energy prices and the positive impact to exports from weaker currencies. In addition, as policymakers in the U.S. debate the timing of an initial interest rate hike, the European Central Bank has recently launched a $1 Trillion+ Quantitative Easing program and the Bank of Japan is also maintaining unprecedented monetary stimulus. While the long-term implications are uncertain, the backdrop of these QE programs should remain supportive to international equity markets in the near-term. Our current allocation to international equities is roughly 6%-8% of clients' overall equity exposure (depending on Investment Policy). We anticipate increasing this allocation slightly in the near future.

The sharp rise in the U.S. Dollar and its negative implications for corporate earnings and economic data has been a focal point for investors in the first quarter. The U.S. Dollar has appreciated by more than 10% so far in 2015 and approximately 22% over the trailing one-year period. While this is a vote of confidence for our economy and reflective of our relative strength compared to the rest of the world, it also translates into a challenging environment for U.S. exporters and a drag on corporate profits generated by large U.S. multinational corporations. While these multinational corporations are generally executing well, it is difficult to grow revenue and earnings from already elevated levels when a significant portion of their sales (almost half of S&P 500 revenue comes from overseas sources) are derived in foreign currencies that are rapidly depreciating. Against this backdrop, for clients with limited exposure through our existing strategies, we reallocated a portion of our large-cap U.S. equity exposure into U.S. small-cap stocks, again via a diversified mutual fund that specializes in this segment of the equity market. Small-cap companies generally earn the vast majority of their revenue domestically and as a result are much less exposed to these very significant foreign currency headwinds.

Another shift to diversify our risk exposures was the addition of "MLPs" or Master Limited Partnerships. Our investment here is focused on the energy infrastructure sector or more specifically the "midstream" portion of the MLP universe. Midstream MLPs are primarily involved in the gathering, storage and transportation of oil and gas. Pipelines are an example of a midstream transportation operation. Midstream MLPs are often referred to as "toll takers" as they generate revenue based upon the storage and transportation of oil and gas and their valuations are not as influenced by energy price volatility or the unpredictability of the exploration and development process. MLPs offer a high level of current income with yields around the 5% level. In addition to high current yields, MLPs have also produced a long and impressive track record of distribution growth in the high single-digit range. Our MLP exposure is through a liquid and low-cost exchange-traded-note which avoids the complex tax reporting requirements generally associated with the asset class. Consistent with the portfolio shifts outlined above, the MLP investment was funded from our large-cap domestic equity allocation.

The first quarter has been marked by wide swings and shallow gains. We expect this volatility to continue into the second quarter as the upcoming earnings season kicks off and the issues addressed above continue to unfold. However, to put this volatility in context, the S&P 500 Index just recorded its 9th consecutive quarter of positive returns and has not seen a 10% correction in the past three and a half years. A 10% correction in equity markets is not uncommon, in fact over the past 25 years the frequency of this type of pullback has been about once per year. We are reminded that the last three to four years have been a relatively smooth ride. We are certainly due for a pickup in volatility. We were well positioned for the environment that unfolded in the first quarter and we feel our recent shifts to diversify risk exposures will enhance our ability to withstand periods of elevated volatility going forward.