WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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As the not-old and not-Chinese saying goes, "May you live in interesting times." A quick glance at the daily headlines will surely affirm that we are indeed living in interesting times. New military conflicts in the Middle East. A deadly virus migrating to the industrialized world. Historic elections all over the world. The possibility of a new "Cold War" as hotter fighting rages in Eastern Europe. Civil uprisings in usually civil Hong Kong. A hot debate among Fed watchers as to when interest rates may begin to rise. Bond market guru Bill Gross moving to Janus. The surprisingly strong U.S. dollar (does anyone remember Gisele Bündchen's call on the Euro a few years ago?). And (most importantly for our readers), a 5-year+ old bull market that continues to march along nicely, thank you very much, despite all this 'interesting" stuff.

One of the grand ironies of the investment industry is our penchant for quarterly reports. Despite all the research suggesting that the best investment returns are achieved by sticking with an investment strategy (whatever that strategy may be) over the long run, we seem determined to look at our portfolios at least quarterly. Mutual funds do it. Hedge funds do it. Essentially all professional investors do it. We may understand that short-term performance is "lumpy," and yet many of us want to see how we are doing frequently. Sometimes, we even think that we can reach valid conclusions about the markets, our portfolios or even the world simply by reviewing near-term developments. To add to this somewhat futile exercise, we will sometimes want to compare our portfolios to "the market." Doing well may not seem so good if we are not doing as well as "the market." How did we get here? Why do we even care about relative performance? We offer some possible answers after the third quarter review…

**Third Quarter Review**

We would suggest that the markets' performance in the third quarter, using classic Wall Street parlance, was "mixed." The major U.S. stock market indices squeezed out modest gains while small caps, commodities and the rest of the world recorded losses. It feels strange to see oil prices below $90/barrel with U.S. bombs and missiles striking targets in Iraq and Syria. More evidence of "interesting times." The emerging market economies are struggling, in part due to falling demand (and prices) for commodities. A slowing Chinese economy is once again cited as one major cause of this. European economies appear to be struggling once again, leaving the U.S. as the sole source of good news in the global economy. U.S. GDP rebounded strongly in the second quarter, and the bulk of economic data released in the third quarter affirmed the nation's relatively strong (but still modest compared to past recoveries) growth. Bonds also generated gains despite on-going concerns about the future of interest rates.

In our view, the most interesting feature of the quarter was the massive performance gap between the S&P 500 and the small-cap heavy Russell 2000. We have not found a satisfying reason for this performance gap. Small company fundamentals do not appear as bad as their stocks' performance. One could even argue that small companies, given their focus on the U.S., should be doing better than the large multi-national companies who derive much of their revenue from overseas.

Here is what the third quarter looked like by the numbers:

| Index | 3rd Qtr 2014 | Year to Date | Trailing 12 Months |
|---|---:|---:|---:|
| Dow Jones Industrial Average | 1.9% | 4.6% | 15.3% |
| S&P 500 | 1.1% | 8.3% | 19.7% |
| NASDAQ | 1.9% | 7.6% | 19.1% |
| Russell 2000 | -7.4% | -4.4% | 3.9% |
| MSCI EAFE | -5.9% | -1.4% | 4.3% |
| MSCI EAFE Small Cap | -8.4% | -3.8% | 2.4% |
| MSCI Emerging Markets | -3.5% | 0.7% | 1.0% |
| Barclays Aggregate Bond | 0.2% | 4.1% | 4.0% |
| Barclays Municipal Bond | 1.5% | 7.6% | 7.9% |
| Dow Jones Commodities | -12.9% | -6.5% | -7.8% |

**Of Indexes and Indices**

In the late 1600s, New Amsterdam merchants and traders began gravitating to a place in the city that today we call "Wall Street." In the late 1700s, traders formalized trading with the Buttonwood Agreement, which was the origin of the New York Stock Exchange. In the late 1800s, Charles Dow, co-founder of Dow Jones & Company, created the Dow Jones Industrial Average (DJIA), which at that time comprised 12 industrial companies such as the U.S. Leather Company and the National Lead Company. The purpose of an index like the DJIA, then and now, is to show the performance of a group of stocks in a single number.

Today hundreds of stock market indices exist, from broad major ones such as the S&P 500 to the lesser-known ones such as the Borsa Istanbul 100 Index (Turkey). Although we often speak of "the stock market", in reality, there is no such thing – only indices which purport to approximate it. Another source calls a stock index a "mathematical construct." According to Wikipedia, a stock index is "the measurement of the value of a section of the stock market." The DJIA represents only 30 stocks, and accounts for a mere 25% (market capitalization) of the stocks traded in the United States. The DJIA is a price-weighted index. That means the weighting of a stock in that index is based on its dollar share price. 3M has a market capitalization (or market cap) of around $90 billion. Its share price is about $140. General Electric has a market cap of $250 billion, nearly 3 times as large as 3M. Yet because its share price is only $25, GE's representation in the DJIA is only about 1/6th that of 3M's (25/140). Weird, huh?

The S&P 500 index represents about 75% of the stocks traded in the U.S., and it is a market value-weighted index. In this kind of index, the market cap of a company (outstanding shares times share price) determines its weight in the index. Right now, Apple Inc. (AAPL) (with a market cap of nearly $600 billion) is the largest component of the S&P 500. Interestingly, Apple is not a part of the DJIA. The index which captures the entirety of U.S.-traded shares is the Wilshire 5000. Thus, when one speaks of "the market," the Wilshire 5000 should be the reference point. Why then do we use the DJIA and S&P 500 when speaking of the market? History (the DJIA is the oldest Index) and custom. There is no "right" way to do this; just ways that seem familiar and comfortable.

**Unchanging and Immutable? Not!**

Although we might consider the stock indices as solid and stable, they change quite often. The DJIA has seen 53 changes in its long history. The most recent of these occurred in 2012 when Goldman Sachs (GS), Nike (NKE) and Visa (V) replaced Alcoa (AA), Bank of America (BAC) and Hewlett-Packard (HPQ). These changes can occur due to a company acquiring an index member, or when as a firm is view as being in decline or in a declining industry. And yes, this does seem a bit subjective (especially in a price-weighted index, where share price matters so much).

The S&P 500 sees changes even more often given its larger number (500) of stocks. CareFusion (CFN), a member of the S&P 500, was the recent takeover target by Becton Dickinson (BDX) and will eventually be removed from the index. Some people have suggested that the most powerful people on Wall Street sit on the Standard & Poor's Index Committee. This committee comprised of eight analysts and economists determine the composition of the S&P 500. These people decided that Facebook (FB – market cap of $200 billion) should not be a part of the index, but that Abercrombie & Fitch (ANF – market cap of $2.5 billion) should be. Here too, one could argue that some subjectivity could enter into these decisions. To be fair, these large indices do a fairly good job of representing what they are supposed to, yet sometimes (like right now), their composition may be an important factor in the performance of "the market."

The most egregious example of index tampering comes from Japan. In the late 1990s, Japan adjusted the TOPIX, its most popular market index, to reflect the "paradigm shift" of the "Age of the Internet." They gave Technology and Telecommunications stocks (the hot stocks then) a huge weighting in the index to represent the "new economy." The TOPIX was one of the worst performing indices in the subsequent tech stock crash.

**Which Index is Right for You?**

Like it or not, the world is full of comparisons. From test scores in school, to commission sales in business; from golf scores to gas mileage, we compare everything. Hence, it is only natural to want to measure one's portfolio versus "the market." But which "market" index to use? The S&P 500? The DJIA? The NASDAQ? The Wilshire 5000? The TOPIX? Most people are comfortable using a broad index such as the S&P 500 as a benchmark, but if your portfolio holds mostly small-cap names, the Russell 2000 might be more appropriate. If your portfolio contains a sizable amount of non-U.S. securities, some kind of world index (like the Vanguard Stock Market) might work. For a balanced portfolio (one holding stocks and bonds), a blend of a stock index (like the S&P 500) and a bond index (the Barclays Aggregate Bond Index) might be reasonable. Yet, because U.S. Treasuries comprise a large portion of the Barclays index, your portfolio (if it does not hold a large portion of Treasuries) may vary a bit from that benchmark.

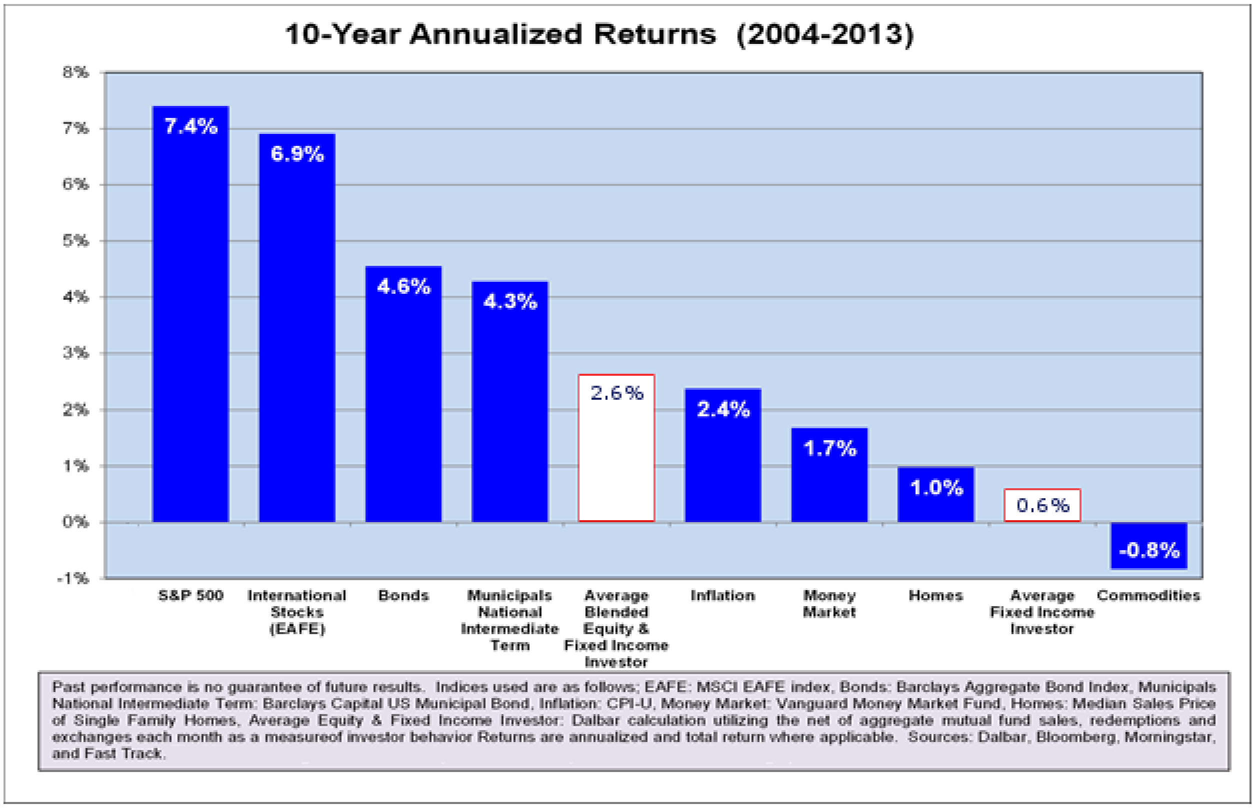
What started out as a simple question ("How am I doing versus the market?") becomes quite complicated in its answer. The reality is that an actively managed portfolio will at times lead and lag the broader market. Another reality is that one can always find an index that did much better than one's portfolio in any given quarter or year. Consider too, that this kind of performance measurement is always backward looking. These comparisons cannot predict the future performance of one's portfolio. Truly, past performance is no guarantee of future performance.

A more meaningful comparison to use may be the realistic investment alternative one might choose without the help of a professional investor. From what many of our clients tell us, these alternatives would often be the return on cash and/or the rate of inflation. We meet many people who are "invested" in cash. In reality, they are not really invested, and are simply watching over a pile of money that is shrinking at the rate of inflation, currently about 2% a year. Thus if your portfolio is doing better than the cash return (now about 0.1% per year) or inflation, you might consider your investment approach a success.

This reminds us of the story of a group of retirees in Boca Raton, a wealthy town on Florida's east coast. As they were sipping mojitos around the pool, the talk turned to investment returns. One of the guys told his friends that his advisor had beaten the S&P 500 by 200 basis points per year. Another one claimed that his advisor pushed his returns up 300 basis points over the DJIA. When asked about his portfolio's returns, one fellow simply said, "I have no idea, I just know the portfolio got me to Boca!" Ultimately, the most important consideration for one's portfolio is how it is doing in achieving one's long-term financial and life goals.

**Bad News for Performance Chasers**

For twenty years, a company called Dalbar has published a study that measures the performance of mutual funds compared to the returns holders of those funds actually achieve. One may wonder why the two performances would differ. The conclusion is that individual investors, left to their own devices, repeatedly make the same kind of damaging investment. Many investors select the mutual funds that have performed well in the near term, and then sell them when the performance is not quite as strong as expected. Doing this hurts long-term returns. The chart below clearly shows this tendency – average investment returns for individuals lag the average returns for the assets they own!




Dalbar's latest report outlines three major conclusions about investor behavior. 1) Investors lose more of their potential returns after (not during) market declines. They tend to sell after the bulk of the decline has already occurred, and fail to reinvest until the market moves higher. 2) Despite the injunction to "buy and hold", average investors "at no point in time have … remained invested for sufficiently long periods to derive the benefits of the investment markets." The average investor bails at the wrong time, usually in response to bad news. 3) Investors who hold both bond and stock funds generally do better than investors holding only one or the other. The reason for this, according to Dalbar, is that balance funds are less likely to show the high volatility of stock only funds, and hence provide the investor less incentive to make damaging investment decisions.

Once again, we can state with confidence that the best way to invest is to find an investment strategy that aligns with one's risk tolerance and stick to it over the long term. We think this is the best way for investors to achieve their financial and lifetime goals, be they Boca or something else.

**The Outlook**

In our view, the factors that truly affect the markets have changed little in the last three months. Sentiment is quite low globally, with good cause perhaps in Europe and the emerging economies, but puzzlingly so in the U.S. The U.S. economy is reasonably and relatively strong, unemployment is at a cycle low, the Fed appears determined to raise rates only when the economy enters a self-sustaining phase, corporate earnings continue to growth at a healthy pace and valuations here are modest (not overly expensive). Bull markets do not die of old age, they end (usually) just before the economy enters a recession, or due to some kind of unexpected exogenous shock. Although shocks are unpredictable, no credible economist sees a recession on the horizon. Despite the ever-present risk of a stock market correction, we think stocks continue to represent the best value of the major asset classes.

The bond market situation is more complicated. As of this writing, the U.S. Treasury 10-year note yields 2.33%. Historically, this level of interest rates would suggest the economy is in recession and an easy monetary policy was being used to jumpstart it! Five years into the economic recovery (the recession ended in 2009, as you may recall), this level of interest rates is surprising. The unemployment rate has fallen to 5.9%, and inflation is running about 2% annually. Both of these numbers are close to the Federal Reserve's targets for becoming less accommodative.

If there is one non-consensus worry out there, it is that either the U.S. economy and/or inflation will be stronger than the Fed currently expects. This could accelerate the timing of Fed policy becoming tighter. Right now, the consensus expects the Fed to raise the Fed Funds rate in mid-2015. Moving that expectation forward could have negative implications for the bond market.

Barring a recession, we think that stocks are likely to outperform bonds and cash in a slowly rising interest rate environment. For investors owning bonds we see no reason for excessive worry. In a balanced portfolio, bonds lower volatility and enhance yield. We continue to think that cash (beyond some reasonable "rainy day" reserve) is the worst asset for investors to hold.

Sincerely,

Wolf Group Capital Advisors