EDELMAN map managed asset program

January 15, 2015

Dear Client:

Here is our annual Year in Review letter for you. **The entire letter follows, or you can just quickly scan this brief summary:**

- 2014 was good for big company stocks, but most other stock sectors fared far worse. Energy, commodities, foreign stocks, natural resources and emerging markets all fell in 2014.
- While a diversified portfolio earned less, its goal is to manage risk, not maximize returns.
- Amazingly, all the sectors that were down for the year displayed remarkable gains in the final two weeks of the year – demonstrating the importance of being patient and maintaining your globally diversified portfolio.
- 2015 is looking good, but there are some worries: If interest rates rise, as many expect, bond prices could fall, some of them sharply. Regulators are also warning consumers about variable annuities and non-traded REITs, two products that produce big commissions for sales reps.
- The best approach for the new year is to maintain cash reserves, stay diversified, remain focused on your long-term goals and recognize that 2015 may see higher levels of volatility than we experienced last year. Let our diversification and rebalancing strategies do their job for you!
- Watch for a big announcement from us next month regarding an important breakthrough for investors. And in the meantime, talk with your Edelman Planner so we can make sure all of the following are up to date: college, estate and retirement planning, beneficiary designations, credit and debt management, long-term care and life insurance, umbrella liability protection, mortgage and employee benefits.

Now, on to the letter!

==

We always like to start the New Year by looking back at the one just completed. This letter will provide you with our thoughts about 2014, a preview of what we expect for 2015 and important advice for your investments and financial planning.

From the perspective of the financial markets, 2014 was a remarkable year – but that fact wasn't truly apparent until the last two weeks of December. Given the hustle and bustle of the holiday season, you likely missed the important lesson those final two weeks provided, so allow me to recap it for you here.

To understand why the last two weeks of December are so important to our review of 2014, we need to look at the 50 weeks leading up to the middle of that month.

First, let's acknowledge that 2014 was an excellent year for large-cap stocks — meaning the biggest publicly traded companies in the United States. The Dow Jones Industrial Average (an index of 30 of the biggest stocks) ended the year up 10% — the sixth year in a row that its made money. That's the Dow's longest winning streak since 1999.

The S&P 500 Stock Index, comprised of the 500 biggest companies in the country, was up 13.7%. The S&P 500 actually hit an "all-time high" 53 times during 2014! It was the third year in a row that the index grew more than 10% — a streak that has occurred only two other times in its history.

However, many sectors of the financial marketplace didn't fare as well. To wit:

- The energy sector, as measured by the S&P 500 Energy Index, was down 7.8% — the most since 2008 — and we all know why: Oil prices plunged 45.9% during 2014.
- Commodities suffered their biggest loss since 2008 — 17%, according to the Bloomberg Commodity Index. It was their fourth straight year of losses, which hasn't happened since 1991.
- EAFE, a major index of foreign stocks, fell 4.9%, according to Morningstar. Falling oil prices, a rising dollar and the fact that Europe is still trying to climb out of a recession were factors.
- The Russell 2000 Index, a measure of smaller companies, was up only 4.9% for the year.
- Natural resources, measured by the S&P Global Materials Index, was down 7.5% as well.
- The spot price of gold fell 1.6% to $1,206, continuing its 3.5-year decline from $1,895 per ounce (36% below its high).
- Ditto for emerging markets. The MSCI Emerging Market Index ended 2014 down 2.2%.

These wildly disparate results confirm that 2014 was a terrific year for your portfolio if you had all your money invested solely in large U.S. companies. But a portfolio that also held small-cap stocks, foreign stocks, emerging markets, precious metals and natural resources didn't make nearly as much money.

There’s no other way to say it: Last year, a diversified portfolio earned less than a highly concentrated stock portfolio. Of course, there’s a simple reason we encourage you to maintain a globally diversified portfolio: It was impossible to know last January 1 which sectors of the financial market would outperform the others!

In fact, a diversified portfolio — by its very nature — is certain to earn less than the best-performing asset class. So why, then, do we bother to diversify?

We diversify because we’re not trying to produce maximum returns. Instead, we’re trying to manage risk.

Think back to 2008. In that year, you would have been happy to own a diversified portfolio instead of one that was solely invested in stocks.

With all this in mind, let’s focus on those final two weeks of December. Something incredible happened in the financial markets during those two weeks:

- The North American natural resources sector, which was down 17.6% as of December 15, suddenly jumped in value. It ended the year down 9.8% — thus cutting its 2014 loss by 44% in just two weeks.
- The international sector, down about 7.4% through December 15, ended down 5%. It reduced its loss by 33% in the final two weeks.
- The emerging markets sector was down 5.7% through December 15, but finished the year off by just 2.2%. It eliminated 61% of its losses in the last 14 days of the year.
- Small-cap stocks, which had been down nearly 1% for the year through December 15, finished the year with a 4.9% gain — a whopping turnaround in just two weeks!
- Mid-cap companies were enjoying a modest gain, up by 5.2% through December 15, but ended the year up 9.8%, a solid return thanks to a 4.6% gain in the final two weeks of the year.
- Similarly, large-cap stocks, as measured by the Russell 1000 Index, gained 4% in those last weeks.
- And the Russell 1000 Value Index jumped 4.2% between December 15 and December 31, while the Russell 1000 Growth Index gained 3.2%.
- Even the S&P 500 rose 3% in the final two weeks of 2014.

No surprise, then, that many diversified portfolios gained more in the final two weeks of the year than they had in the prior 50 weeks! Yes, the annual gain for some portfolios could have literally doubled in the final two weeks of the year! Stated another way, had the year ended on

December 15, the yearly return might have been only half of what it ultimately turned out to be. (My bestselling book, *Rescue Your Money*, features many historical examples of when yearly gains occurred in just a few weeks or months. If you haven't read it, ask us for a free copy.)

But imagine people who stared at their portfolio week after week all year long (something, of course, we discourage you from doing!). Week after week, for 50 straight weeks, might have led to disappointment, perhaps even to the point of giving up hope and dumping the portfolio — just as those up-til-then-underperforming asset classes were about to redeem themselves!

The lesson is clear: It's not enough to build a globally diversified portfolio. You must also be patient and thus willing to maintain it over long periods. As 2014 demonstrated, the moment your gut (and the media) says to sell may well be the moment that owning those assets is most worthwhile.

By the way, what caused the two-week jump in market values? Here are some key factors:

- Investors began to realize that not only are profits for the major oil companies unlikely to be decimated by the fall in crude oil prices, the overall economy is benefitting as consumers save money buying gasoline and home heating oil — money they can funnel back into the economy by purchasing other goods and services.
- Small-cap stocks got a boost after the Federal Reserve indicated that interest rates will remain low for several more months, despite earlier statements that rate increases are likely to occur in 2015. Investors believe that lower rates will continue to help the economy grow — and that's particularly good news for small-cap stocks; these companies sell products to consumers rather than businesses and consumers tend to spend more when interest rates are low.
- Small companies also tend to operate entirely inside the United States, with minimal business overseas, so it doesn't matter much to them that the dollar is strong. Big companies that depend on lots of sales overseas are more sensitive to a strong dollar. This is another reason why small-cap stocks rose more than large-company stocks in late December.
- The Department of Commerce announced revised data during the final two weeks of 2014 showing that the nation's economy grew more in the third quarter than it had previously indicated — an annualized rate of 5% (the fastest in a decade). This generated renewed confidence as investors began to look forward to 2015.

- Although fourth quarter figures aren't available yet, early indications show that the growth in consumption will be even greater than in the third quarter. This further pushed consumer sentiment to its highest levels since 2007, as shown by several surveys, including the Thompson Reuters/University of Michigan Surveys of Consumers published in December.
- Meanwhile, unemployment continued to fall steadily. More than 300,000 jobs were added in December and millions more during the year. People with jobs have incomes they can spend on goods and services, which in turn creates even more jobs — a "virtuous cycle" that investors love.

All these positive developments at year's end gave investors much confidence to buy stocks, causing prices of various asset classes to rise sharply as we reached the end of 2014.

What does all this mean for 2015?

If all this good news is making you feel quite confident, you're not alone. A recent study from the Retirement Advisor Confidence Index published in December by *Financial Planning* magazine found that confidence is at a five-month high — for both advisors and their clients.

However — and you knew I'd have a *however* — the survey also showed that these new confidence levels mean that consumers now have a higher risk tolerance than they did a year ago.

That's troubling. We don't want you to become so confident that you might consider jettisoning some portions of your diversified portfolio in favor of sectors you think are poised to perform particularly well.

While there are many reasons to have strong confidence in the continued growth of our economy, there are also reasons for pause. For example, despite the Fed's recent assurance that interest rates will stay low for a little while longer, the Fed remains committed to starting to raise rates at some point in 2015. Indeed, the Fed's position is widely regarded as its most aggressive since 2009. If interest rates rise, you can expect losses to occur in bonds — especially long-term bonds. (This is why your EMAP portfolio holds bonds of far shorter duration; they aren't as sensitive to interest rate movements, reducing your risk. If you hold bonds elsewhere, please call your Edelman Planner to discuss your options.)

How big might bond losses be? Well, 74 economists and market strategists were surveyed in December by Bloomberg and the consensus was that interest rates are expected to rise to 3% — an increase of 0.75%, or twice as high as earlier predictions. That's the most bearish prediction since 2009, which was the worst year for the bond market since 1978. In other words, 2015 could be the worst for bonds in 37 years.

There are also worries about investments in a variety of financial products. The Financial Industry Regulatory Authority (FINRA) has recently issued an Investor Alert to warn about investing in gold, silver, platinum and palladium. FINRA warns of sellers who charge high commissions and fees, but don't deliver the goods. Meanwhile, the Securities and Exchange Commission's recent annual report cites dangers associated with investing in variable annuities and non-traded REITs. I've warned you about all these products many times in recent years, and these new warnings from federal regulators show that consumers are still at risk from these products. (Please call your Edelman Planner if you have questions about these products if you've been pitched one by an insurance agent or broker.)

Also, some are beginning to worry that the six-year bull market — already the fourth longest in history — is due to end. Indeed, three common measures of market value are all at high levels:

- The Price to Earnings Ratio (which compares prices of the companies comprising the S&P 500 to their aggregate profits) is currently 19.96, above the historical average of 15.53. The higher this figure, the more overpriced stocks are considered to be. (It was 22.19 in 2007, shortly before the 2008 crash began.)
- The CAPE (Cyclically Adjusted Price to Earnings Ratio) is 64% above average; it has reached its current level only three other times — 1929, 2000 and 2007. (Before you say "uh-oh," keep in mind that the CAPE has a terrible record at predicting short-term market movements. And since CAPE is a derivative of the P/E Ratio above, it's not surprising that it's showing the same view.)
- The Buffett Valuation Indicator — so-named because legendary investor Warren Buffett once called it his favorite measure of market valuation — compares the nation's GDP to the total market capitalization of the entire Wilshire 5000 Stock Index (meaning, roughly, every publicly traded stock in the United States). A review of this ratio suggests that stock prices are significantly overvalued; the only other time since 1950 this indicator has been so bearish was prior to the 2000 crash. (But let's keep in mind that the 2000 crash affected NASDAQ the most, reflecting the quick rise and demise of early dot-com stocks. No one — not even proponents of this indicator — is suggesting that today's market looks anything like the dot-com mania of 1999.)

While this data offers worriers several reasons to worry, it's important to remember that these measurements have weaknesses that undermine their credibility. The CAPE index, for example, includes data from the 2008 Credit Crisis that skew its results. And all the above fail to take our historically low interest rate environment into consideration.

That last item is vital to consider. With interest rates so low, income-oriented investors can actually generate more income from dividend-paying stocks than they can from many bonds and many other income-oriented investments (albeit with different risks and costs) — and this clearly affects investor sentiment. Investor inclination to buy stocks is surely different when interest rates are 10% instead of 1% — but these index formulas aren't sophisticated enough to adjust for that.

This is not to say that the messages offered by these and other measurement tools should be completely dismissed. Clearly there are many reasons to worry about stock prices and the overall economy: The federal debt is $18 trillion and we persist in annual deficits (although it's currently $929 billion less than it was in 2009). Millions of Americans still live at or below the poverty line, the strong dollar is making it hard for American companies to compete overseas, and constant threats of terrorism and virus contagion remind us of how vulnerable we really are.

At the same time, however, corporate profits have never been higher, according to an April 2014 article published by *The New York Times*; the Fortune 500 have more than $2 trillion in cash at their disposal — ample assets to build new companies, engage in stock buybacks, acquire others and distribute dividends to shareholders. The employment rate is down to 5.6% — the lowest level since June 2008. Auto sales in 2014 were 16.4 million units, the biggest since 2006 according to the National Automobile Dealers Association, and housing prices across the country have risen sharply since 2008.

After considering all this data and more, we remain confident, although we remain cautious and vigilant because dangers lurk. This is why, perhaps now more than ever, the best approach for achieving your long-term goals is to maintain the highly diversified portfolio we've provided you. This is no time to make "big bets" by shifting big chunks of your money to cash (out of fear) or into stocks (out of greed).

Instead, maintain adequate cash reserves, stay diversified, remain focused on your long-term goals and recognize that 2015 may see higher levels of volatility than we experienced last year. You can also be certain that we'll leverage that volatility for you: EMAP's daily strategic rebalancing review allows us to act on price fluctuations, selling assets that are too high in

EDELMAN map managed asset program

price while buying others that have dropped in value — grabbing a bargain as we get to, in essence, buy cheap assets, just as if a department store was suddenly having a sale!

We've applied our rebalancing strategy for all our clients for years and you can be sure we'll continue to do it for you throughout 2015 as opportunities arise. Rebalancing reduces volatility, may improve returns and ensures that your portfolio stays consistent with your objectives while helping you maintain that all-important long-term focus, especially during periods of uncertainty or market turmoil.

But we're not content to merely monitor the investments inside your current EMAP portfolio. We are always looking for ways to improve and enhance your portfolio. About 10 years ago, we began to adopt behavioral finance and neuroeconomics into our investment management approach to help both us and you improve investment outcomes.

And for several years now, we have been studying the emerging field of exponential technologies. There is no question that innovations in big data and analytics, nanotechnology, medicine and neuroscience, networks and computer systems, energy and environmental systems, robotics, 3-D printing, bioinformatics and financial services are rapidly and profoundly changing every aspect not only of our daily lives, but of our entire planet. We have been seeking ways to participate in the investment opportunities afforded by these new technologies, but have been stymied in our efforts. We believe we may have solved this challenge with invaluable support from BlackRock and Morningstar and next month we'll be announcing an important breakthrough for investors.

Watch for that news soon — and in the meantime, of course, please let us know if you have any questions in any area of your personal finances. While this letter has focused on the investment landscape, it's important to remember that we offer you so much more than just investment management: If you haven't talked with your Edelman Planner recently, please do — it's an easy New Year's resolution to check off! — so we can make sure you're completely up to date with your college, estate and retirement planning, beneficiary designations, credit and debt management, long-term care and life insurance, umbrella liability protection, mortgage and employee benefits. We're devoted to helping you enjoy financial and personal success and we'll do everything we can to help you attain your goals.

Regards!

Ric

EDELMAN map managed asset program

P.S. If you haven't visited Edelman Online recently, take a quick tour! Over the past year, we've added reports to help you review your EMAP accounts. Let us know if you need help gaining access to the password-protected client-only site at RicEdelman.com.

P.P.S. Did you know that 401(k) contribution limits were increased on January 1? You can now contribute up to $18,000 ($24,000 for those 50 and older). Talk with your Edelman Planner to make sure you're getting the most from your workplace retirement plans and IRAs.

Oh and by the way…feel free to forward this email to your friends and family!