GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

This Year Proved to be a Difficult One

SYNOPSIS

- We manage the Conservative Income (CI) portfolio in a manner which is designed to limit volatility and generate income on a risk-adjusted basis.
- CI's performance was impacted this year because of our strict discipline of avoiding overvalued securities and an elevated cash balance throughout the year.
- Keep focused on your investment goal, which spans longer than a single year, and remember that consistent returns with low volatility are the keys to a safe financial future.

LACKLUSTER PERFORMANCE IN 2014

Financial markets took investors on another wild ride this year, thanks to several pockets of volatility in both equities and fixed income. Despite these ups and downs, it appears as if the S&P 500 will add to its bull market run as our economy continues to grow at a slow and steady pace.

Many investors have followed the S&P 500 closely and are now questioning why Global Financial Private Capital's Conservative Income (CI) portfolio was unable to capture more of the upside, particularly with such a large equity allocation in the portfolio throughout the year.

This question is certainly warranted, but before I explain why CI did not capture more of the upside in equities, let's first recap the two key objectives of the portfolio:

1. **Capital Preservation:** CI can "go anywhere" to look for income and will often undergo big changes in the overall allocation to shield the portfolio from risks that develop over time.
2. **Consistent Returns:** The portfolio is designed to generate consistent returns by limiting the volatility, in an attempt to protect investors from events like the financial crisis in 2008.

In order to achieve this dual mandate, we manage the portfolio in a conservative manner because when push comes to shove, we would rather preserve capital than meet our return target. This strategy has been proven effective during times of great dislocation in markets, as we saw in 2008 when the S&P 500 lost 38% and CI ended slightly up for the year.

This year proved incredibly difficult to meet the "consistent return" objective, while preserving capital at the same time, because of three reasons:

1. **Avoided Bonds:** We expected the weakness in bonds in 2013 would amplify due to the Fed's exit from the market, along with a continued improving economy. Instead, the demand for U.S. debt surged and expectations for interest rates to rise are now pushed back even further.
2. **Stock Selection:** CI uses stocks that are cheap and pay good dividends, and these stocks were hard to come by this year. We also sold winners too early due to valuation, yet they kept climbing higher as investors took on even more risk to obtain yield. Lastly, most stocks in the S&P 500 don't pay dividends and/or are far too volatile for CI.
3. **Elevated Cash Balance:** Cash is deployed only when opportunity presents itself, and we do

not feel pressure to stay fully invested or chase performance like most mutual funds. CI's cash balance was elevated this year because few securities screened cheap until October when markets began to put stocks and bonds on sale.

Let's go back to early April, when some of the more popular internet and biotech stocks came under severe pressure. Many of these stock prices were cut in half in a matter of days as traders rotated out of high momentum names because their valuation could no longer be justified. There was no warning and certainly no catalyst, and investors who were caught flat-footed were forced to endure the excruciating pain of a valuation-led correction.

Timing these events with any level of consistency is impossible, so we try to keep our investors safe by avoiding overvalued stocks. The unfortunate reality of this strategy is that we occasionally sell our winners too early and screen out sectors/stocks that continue to defy gravity.

Simply put, performance was impacted this year because we anticipated volatility that never arrived, and although we were ultimately wrong, we would much rather be safe than sorry.

***NOTE**: I am not implying that our view on the overall direction of our economy has changed. On the contrary, I am even more bullish today than a year ago. Rather, since I do believe that volatility will continue to be a threat to those who require income, CI will remain tilted more towards protecting capital than to a return target.*

IMPLICATIONS FOR INVESTORS

It's amazing what can happen in a year. Go back to the end of 2013, and you will see that financial strategists across Wall Street were in consensus that U.S. Treasury bonds would face considerable pressure throughout 2014.

Clearly none of us anticipated the turmoil across the globe or the currency wars that have ignited an insatiable demand for our country's debt. For that matter, who could truly claim to have called the crash in energy a year ago? Yet that's precisely what happened.

As we look to 2015, consensus is no longer easy to spot, and herein lies the opportunity. For example, there are those who believe that the recent drop in energy prices reflects a weakening global economy. I strongly disagree, and any short-term pain caused by panic selling will most likely result in long-term gains for patient investors as consumer spend less at the pump and more in the economy.

In regards to the future of interest rates, it's hard to say when they will rise. The events of this year have dramatically impacted the Fed's outlook for inflation, and the anticipated actions from central banks in Europe and Japan will most likely keep our interest rates lower for longer. Therefore, we expect risk-adjusted income to continue to remain under pressure for the next several months and urge income seekers to be patient and avoid the temptation to go further out the risk curve.

Keep in mind that your investment plan is likely one that spans over several years. One period of underperformance, or even outperformance, rarely alters a long-term trend. Think about professional athletes within this context. They almost always endure a few games where things do not go their way, but over the span of their careers, they achieve success because they remain focused on what really matters.

Lastly, one of the easiest ways to lose money in investing is to maintain the same strategy over time because markets are constantly evolving. Investment managers must adapt in order to protect and profit, and we are currently making

changes in CI and our other portfolios, given our views of where we see opportunity for our investors in 2015 and beyond.

However, what will not change is our strict focus on capital preservation and avoiding overvalued securities. Markets may be fueled on speculation and emotion in the short run, but valuation always rules in the long run.

Sincerely,

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