2014: What Happened and What Did Not

2014 may go down in financial history as the year that a lot of things didn't happen to investors. For example, despite numerous nervous headlines in late 2013 that it might be best to prepare for the worst, there was no universal global stock correction. And despite the US Federal announcements on tapering quantitative easing, there was no major slump in the bond markets.

Perhaps an unexpected positive outcome for globally diversified investors was the continued strength of US equities. Large U.S. companies happened to enjoy a remarkable, double-digit year, even as other markets experienced more muted results, especially for international, emerging market and small-cap stocks.

The direction of bond yields yet again surprised many forecasters. While most expected rates to eventually start rising, the opposite occurred in 2014 and helped produce better than expected fixed income returns.

Possibly the biggest story for Canadians in 2014 was the collapse of oil and commodity prices in turn leading to an 8.32% decrease in the Canadian dollar vs the US dollar—its biggest decline since 2008. Oil dropped from $107 USD per barrel in June to just over $53 USD at year-end. For the year, Brent crude was down 48% and West Texas Intermediate crude down 46%. The price decline most affected the economies and currencies of oil-exporting countries, including Canada.

2014 Index Returns *(in Canadian dollars)* [i]

Cash	+ 0.89%
Short Term Canadian bonds	+ 3.06%
Canadian Bond Universe	+ 8.79%
Canadian stocks	+ 10.55%
US stocks	+ 23.10%
International stocks	+ 4.01%
Emerging market stocks	+ 6.98%
Canadian Dollar	- 8.32%

2014 yet again reinforces the merits of diversification & discipline

As the future remains as inscrutable as ever, our advice remains the same: Target market risks and expected rewards according to your long-term personal financial goals. Diversify broadly – and include US, International and emerging market companies – to counteract the risks inherent to any overly concentrated position, anywhere in the world.

There remains decades of resounding evidence that investors should not allow their long-term strategy to be led astray by short-term performance. That's why; we remain as convinced as ever that individualized diversification is the right policy every year for all our clients. Maintaining a globally diversified portfolio according to your personal goals and risk tolerances does not guarantee that you will outperform other lucky scores you might have made instead. But it continues to offer the most rational approach to reaching your desired destination while managing the rocky risks along the way.

LIVING WITH VOLATILITY – AGAIN [ii]

Increased volatility returned in the second half of 2014. Just as many people were starting to think markets only ever move in one direction, the pendulum has swung the other way. Anxiety is a completely natural response to the jitters of the market. Acting on those emotions, though, can end up doing us more harm than good.

There are a number of tidy-sounding theories about why markets have become more volatile. Among the issues frequently splashed across the 2014 newspaper front pages: global growth fears, policy uncertainty, geopolitical risk, and even the Ebola virus.

In many cases, these issues are not new. The US Federal Reserve gave notice it was contemplating its exit from quantitative easing (an unconventional monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective). Much of Europe has been struggling with sluggish growth or recession for years, and there are always geopolitical tensions somewhere.

In some ways, the increase in volatility could be just as much a reflection of the fact that volatility had been very low for some time.

Markets do not move in one direction. If they did, there would be no return from investing in stocks and bonds. And if volatility remained low forever, there would probably be more reason to worry.

Below are six evidence-based observations to help us live with and conquer volatility:

1. Don't make presumptions.

Remember that markets are unpredictable and do not always react the way the experts predict they will. When central banks relaxed monetary policy during the crisis of 2008-09, many analysts warned of an inflation breakout. If anything, the reverse has been the case with central banks now fretting about deflation.

2. Someone is buying.

Quitting the equity market when prices are falling is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks," remember someone is buying them. Those people are often the long-term investors.

3. Market timing is hard.

Recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was at its worst—the S&P 500 turned and put in seven consecutive months of gains totaling almost 80%. This is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.

4. Never forget the power of diversification.

While Canada's resource sectors have turned rocky again, non-resource US and international based companies have flourished. This helps limit the damage to balanced equity investors. So diversification spreads risk and can lessen the bumps in the road.

5. Nothing lasts forever.

Just as loading up on risk when prices are high can leave you exposed to a correction, dumping risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

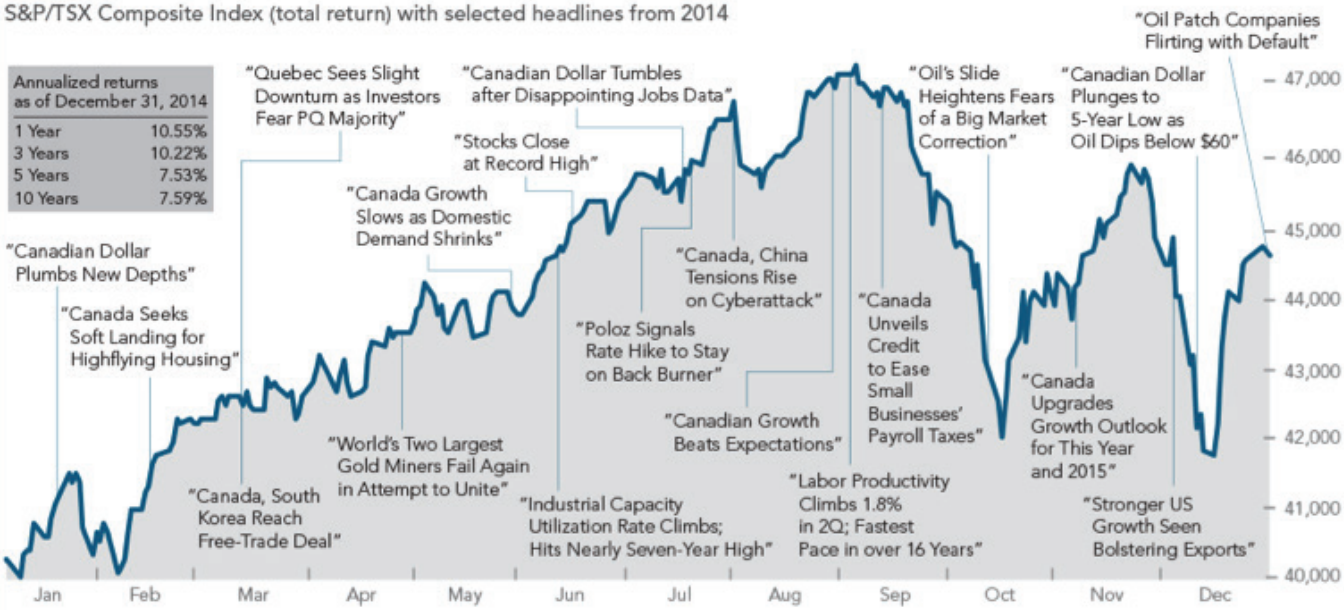
6. Discipline is rewarded.

The market volatility is worrisome, no doubt. But through discipline, diversification, and understanding how markets work, the ride can be made bearable. At some point, value re-emerges, risk appetites reawaken, and for those who acknowledged their emotions without acting on them, relief replaces anxiety.

CANADIAN ECONOMIC REVIEW

Canada Stock Market Performance

S&P/TSX Composite Index (total return) with selected headlines from 2014



Source: S&P/TSX

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In Canadian dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Declining resources sector

Canadian oil and gas producers emerged from an 18-month slowdown early in 2014 to reach record output. The resulting oversupply, combined with lower global energy demand and OPEC's lack of production cuts, contributed to a major decline in world oil prices. By year-end, crude oil had skidded to a five-year low, bringing spending cuts among Canadian firms. Other mining sectors also declined due to weak global demand and supply gluts.

Weaker loonie

The Canadian dollar fell dramatically during Q1 and continued its retreat throughout Q3 and Q4 after a slight summer rebound. The weakness was attributed to falling oil prices, the global slowdown, and expectations of a US central bank rate hike.

Rising home prices

Through November, average prices for single-family homes were up 6.8% nationwide (year-over-year) and on pace to exceed growth of 5.2% in 2013. Rising values were attributed to low borrowing costs and tight supply in major markets.

Employment gains

Canada's jobless rate fell from 7% in January to 6.6% in December. October unemployment dropped to a 40-year low of 6.5%. Through November, the average monthly gain in 2014 employment reached 241,000, compared with the 194,000 average in 2013. The early Q4 employment gains reflected a shift from growth in resource-based western Canada to growth in Quebec and Ontario.

Increasing consumer debt

Household indebtedness reached a record high in Q3 as Canadians accumulated debt faster than their incomes grew. The ratio of household debt to personal disposable income climbed to 162.60%, up from 161.45% in Q2. Mortgages accounted for the biggest share of the total, followed by consumer credit. Household net worth rose 1.3%, slowing from 2.2% in the previous three-month period as residential real estate outpaced equities.

Manufacturing improvement

Business conditions at Canadian manufacturing firms improved during the second half of 2014. Despite falling to a three-month low of 53.9 in December, the RBC Canadian Manufacturing Purchasing Managers' Index (PMI) averaged 54.8 in Q4—the best since Q3 2011 (A reading over 50 indicates general economic expansion).

US & INTERNATIONAL ECONOMIC REVIEW

US Stock Market Performance

Russell 3000 Index with selected headlines from 2014

Source: Russell Investment Group.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Non-US Stock Market Performance

MSCI All Country World Index ex USA with selected headlines from 2014

Source: MSCI.

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based solely on the news. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

Accelerating US Recovery

The US economy showed signs of weakening in early 2014, with Q1 GDP growth reported at an annualized -2.9%. In Q2, GDP rebounded strongly at a 4.6% annual growth rate (seasonally adjusted)—the highest since 2003. Growth in Q3 was even stronger at 5%, capping its best six-month stretch since 2003 and reaching the highest annualized GDP growth rate in 11 years. If the Fed's Q4 estimates hold, 2014 GDP growth will have been in the 2.4% range.

A host of indicators pointed to improving US conditions during the year, including:

Employment

The US economy added 2.7 million jobs through November, the best employment growth in 15 years. Claims for jobless benefits ran lower than at any point since 2000. By year-end, the US had recovered all jobs lost to the past recession, and joblessness was at a six-year low. Despite the lowest labor force participation rate since the 1970s, the economy entered 2015 with record employment.

Manufacturing

Economic activity in the manufacturing sector improved throughout most of 2014. The Institute for Supply Management (ISM) reported its purchasing managers index (PMI) at 59.0 in October, 58.7 in November, and 55.5 in December (a reading above 50% indicates general expansion). For the year, the PMI averaged 55.8, the best reading since the first full year after the recession in 2007–09.

Consumer spending

An improving labor market and lower energy prices translated into higher income and purchases among American workers. Real personal consumption expenditures increased at a seasonally adjusted 3.2% rate in Q3, compared to 2.5% in Q2. US equity market gains over the past three years have added $7 trillion to household wealth, which many believe has helped fuel spending.

Company earnings

The Department of Commerce reported a 2.8% rise in US corporate profits in Q2, followed by a 5.1% increase in Q3, marking 12 straight quarters of year-over-year growth. According to GDP data, Q2 after-tax profits hit a record high. However, after adjustments for depreciation and inventory changes, profit margins—particularly among smaller companies—appeared to be declining due to rising labor costs and capital expenditures.

Weak Inflation

Across the world's largest economies, inflation eased for the sixth straight month in November, with the Organization for Economic Cooperation and Development (OECD) reporting average annual inflation for its 34 members at 1.5%.

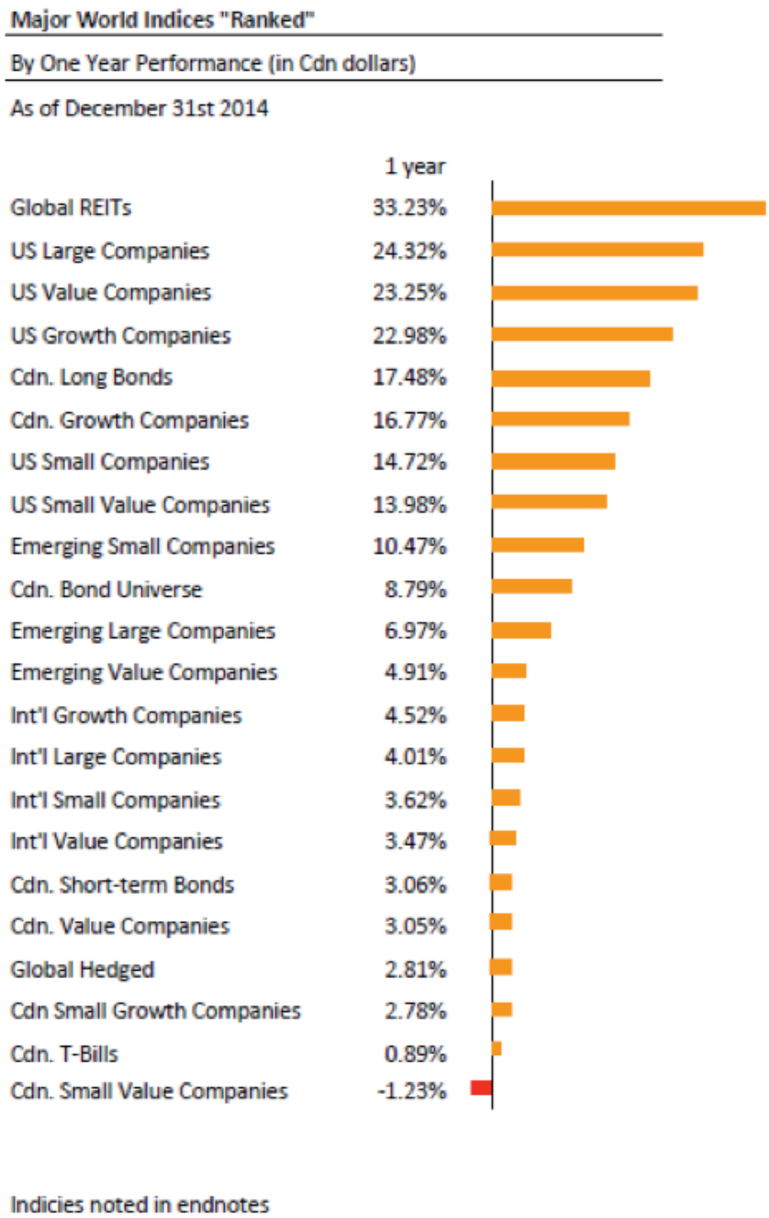
2014 ASSET CLASS & INVESTMENT RETURNS (all returns in Canadian dollars)

Surprise! No Selloff in 2014

Despite the economic headwinds, all major equity market indices were positive in 2014, with US markets posting the strongest equity gains.

Canadian companies delivered positive performance. Although returns were below those of the US large cap market, the Canadian broad market outperformed most international developed and emerging markets. For the calendar year, the S&P/TSX Composite Index delivered a 10.55% total return. Returns among Canadian equity asset classes were dispersed but mostly positive: Value stocks returned 3.05%, growth stocks 16.78%, small cap stocks 0.79%, small value stocks -1.23%, and small growth stocks 2.78%.

US companies and particularly the large cap segment of the market—logged a strong year. The S&P 500 Index returned 24.34% while the Russell 2000, a popular benchmark for small company US stocks, returned 14.72%. US market volatility, measured by the Chicago Board Options Exchange Market Volatility Index (VIX), increased to its highest level in two years, with most activity occurring in Q3. Average volatility for the year, however, was the lowest since 2006.



International companies experienced low-key performance across almost all major indices The MSCI EAFE, a benchmark for large cap stocks in developed markets outside North America returned 4.01%. The small cap and value versions of the MSCI EAFE index returned 3.62% and 3.47%, respectively. Emerging market companies had slightly higher returns at 6.97%

Among the equity markets tracked by MSCI, more than half of the countries in the non-US developed markets index had negative total returns and the range of returns was broad. The top three return countries were Israel (22.77%), New Zealand (7.34%), and Denmark (6.18%). Countries with the lowest returns were Portugal (-38.24%), Austria (-29.77%), and Norway (-22.04%) (in USD returns).

In the emerging markets, 13 of 23 countries tracked by MSCI logged negative total returns and the dispersion of returns was broader. Egypt (29.33%), Indonesia (26.59%), and the Philippines (25.59%) were the top-performing countries in the index. The lowest returns in the index came from Russia (-46.27%), Greece (-39.96%), and Hungary (-27.44%) (in USD returns).

Returns of major ***Canadian fixed income indices*** were positive due to falling yields and rising prices. Short-term Canadian fixed income indices returned 3.06% while the overall bond universe returned 8.79%.

Currency Impact

The Canadian dollar weakened by 8.32% vs the US dollar. This had a positive impact on US equity returns for Canadian investors with holdings in unhedged US assets.

Diverging style and capitalization returns

Large company stocks in both Canada and the US outperformed their respective small company counterparts in 2014. While value and growth companies were somewhat equal in performance within the US, large growth companies significantly outperformed large value companies in Canada.

In the international markets large and small caps stocks were similar, while large growth slightly outperformed large value. In the emerging markets, small cap, outperformed large cap, and growth outperformed value.

The lagging results of many of the global equity “size” and “value” premiums in 2014 were not unusual from a historical standpoint. Although small cap and value stocks have offered higher expected returns relative to their large cap and growth counterparts over the long-term, these return premiums do not appear each year. For example, since 1979, US small cap has outperformed large cap in 19 of the 36 calendar years—or 52% of the time. Results are similar for the value premium: Since 1979, value has outperformed growth in 20 calendar years—or 55% of the time. Small cap value has outperformed large cap growth in 58% of the calendar years.

History also has produced **multiyear periods** in which **small cap and value did not outperform large cap and growth**. Noteworthy periods include 1984 to 1987 and 1994 to 1998, when small cap underperformed large cap, often by a wide margin each year. Since 1979, the value premium has also experienced extended periods of underperformance—and, in some cases, the differential exceeded 15% margin. The same is true of small value vs. large growth stocks. In the three-year period from 2009 to 2011, both value and small cap underperformed. Yet, despite even extended negative-premium periods, small cap and value have outperformed over time, and when the premiums reversed, they often did so strongly and in multiple years.

[i] Note: Indices are not available for direct investment and performance does not reflect expenses of an actual portfolio. Note: index returns are from: Canadian One-Month T-Bills, DEX Short-Term Canadian Bond Index, DEX Canadian Universe Bond, DEX Long-Term Canadian Bond Index, S&P/TSX Composite, S&P 500 Index, MSCI EAFE (net dividend), MSCI Emerging Market Index (net dividend)

[ii] Adapted from"Living with Volatility, Again" by Jim Parker, Outside the Flags column on Dimensional's website, October 2014.

Past performance is no guarantee of future results. This information is provided for educational purposes only and should not be considered investment advice or a solicitation to buy or sell securities.

Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

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