ROPES WEALTH ADVISORS

Hot Topics Q&A for Q1 2015

Diversification was a disappointment in 2014. Why stick with it?

Our diversified approach is designed to help you increase your chances of meeting your investment goals by allocating to a variety of asset classes that are not highly correlated. Our goal is to smooth out return streams over time and keep you invested in the markets even during periods of extreme volatility. We seek to build portfolios that capture most of the market's gains over a full market cycle while delivering less risk than an investment in a single asset class or in trying to time the markets.

Our tactical asset allocation overlay allows for adjustments to our long-term, strategic asset allocations, to provide us the opportunity to over weight and under weight asset classes based on our views of risk and return for a shorter-term, 12-24 month time frame. Our overlay seeks to add between 100-150 basis points of excess return annually; this risk budget enables us to ensure our tactical decisions do not overwhelm our long-term strategic allocation frameworks.

While we acknowledge 2014 was a disappointing year for diversified portfolios, we stand by our approach. There will be years when single asset classes shine more brightly than others, but we do not believe it is the right time to abandon all other sectors in favor of U.S. large caps. Especially not now, given how the world's economies and central bank policies are diverging. The U.S. Federal Reserve has ended quantitative easing and is poised to raise rates, while the Bank of Japan and European Central Bank are in full easing mode, including QE. Indeed, in January alone, 14 countries cut rates or loosened borrowing standards.

The combination of tighter U.S. policy and easier global policy has led to the surge in the dollar, which has already caused fraying profits at the large U.S. multi-nationals. With U.S. equity market valuations marginally above long-term median levels, the onus is on earnings to do more of the market's heavy lifting—a formidable task in light of these pressures.

There was a 17 percentage point difference between the S&P 500's performance and non-U.S. global equities' performance in 2014; courtesy of stronger performance from both U.S. stocks and the U.S. dollar. This was the widest dispersion for any year since 1992, according to Bloomberg. There were four other periods since 1970 when the U.S. market diverged from international equities at a similar rate as in 2014. Each time, the MSCI All-Country World ex-US Index was up in the following year—beating the S&P 500 by an average 14%.

This is not to say that we have witnessed the finale of the U.S. bull market that began nearly six years ago. However, we expect 2015 to be a year marked by a greater frequency of corrective phases and when global diversification is more appreciated.

What are the risks of a "Grexit"?

Whether or not the Hellenic Republic and its European creditors agree on measures that would allow the Greek government to continue servicing its debts is very much an open question. In our view, there is a better than even chance that the parties eventually will reach agreement and that Greek default will be avoided, at least for now. Nobody in Europe really has an interest in a Greek default and the potential financial market turmoil it could engender.

If the worst case scenario were to unfold, it is important to understand the risks. Obligations to "official" creditors such as the IMF, the ECB, and the governments of other European economies account for the vast majority of Greece's $500 billion worth of external debt. These institutions would bear the brunt of foreign losses from a Greek default. Foreign bank exposure to Greece totals only $46 billion, which is widely dispersed among countries, so the direct effects of a Grexit on the private sector in other countries should be manageable, at least in theory. Of course, financial markets may react negatively if Greece were indeed to leave the Eurozone, and there is the worry that contagion could spread to other European countries. It will be

important to monitor spreads and activity in Portuguese, Spanish, and Italian debt, which have thus far showed no reaction to current events. A sharp backup in government bond yields would cause debt sustainability in those countries to deteriorate.

That said, Europe has more financial backstops in place today than it did during the height of the sovereign debt crisis in 2010-2012. For example, governments in peripheral European countries could draw on the €500 billion European Stability Mechanism, which is now capitalized and operational. In addition, the ECB recently announced its willingness to purchase sovereign bonds, which would limit the rise in government bond yields in other peripheral European countries.

Therefore, we judge the probability of the financial train wreck in Europe resulting from a Grexit to be rather low.

Does the cease-fire between Russia and the Ukraine signal an end to strife, or is war and U.S. involvement inevitable?

The collapse of previous cease-fires has stoked doubts as to whether this one will hold, and Putin has a reputation for not keeping his word in these situations. That said, there is more fatigue now that may stall an escalation: ten months of fighting has killed more than 5,000 people, crushed the Ukraine's economy, and propelled Russia toward a recession through U.S. and European sanctions. One insurance policy to ensure compliance with the ceasefire was the move to keep European Union sanctions -- whether to ease or stiffen them --off the agenda at the meeting in Brussels, with the bloc awaiting proof that the truce is holding. As for a question of war and U.S. involvement, the risks that the U.S. and Russia will clash militarily over Moscow's invasion of Ukraine are very slim. Ukraine is not a member of NATO, and President Obama is unlikely to volunteer for another war. If Russia were to threaten any one of the Ukraine's NATO neighbors, the risks could be higher but still low.

What are the risks/opportunities presented by slumping oil prices?

Overall, the plunge in oil prices should be seen as a shot in the arm for the global economy. The world's many oil importing countries, advanced and developing, stand to benefit from higher household income, lower input costs, and improved external positions. Japan and euro zone consumers are among the biggest beneficiaries, even more than the U.S., which now produces over half of the oil it consumes. China and India are also big winners given the energy intensity of those economies.

In contrast, oil exporting countries are under pressure. For example, energy accounts for 25% of Russia's GDP, 70% of its exports, and 50% of federal revenues. In the Middle East, the share of oil in federal government revenue is 22.5% of GDP and 63.6% of exports for the Gulf Cooperation Council countries. In Africa, oil exports accounts for 40-50% of GDP for Gabon, Angola and the Republic of Congo, and 80% of GDP for Equatorial Guinea. In Latin America, oil contributes 46.6% to public sector revenues, and about 55% and 94% of exports for Ecuador and Venezuela. These regions of the world were already geopolitical hotbeds, even before the slump in oil prices, which may serve to only further destabilize them.

Given global financial linkages, these developments demand increased vigilance all around, but as yet we see more positive benefits than negative fallout.

The investment implications are a bias towards equities, particularly those in Japan and Europe, but also in emerging markets. Active management is critical in emerging markets, given index has an over 20% weighting to oil exporting nations. Frontier market investments should be weighed very carefully given the sector's more than 50% exposure to oil-exporting countries. After the steep price decline in energy, agricultural, and other natural resources, the commodities space looks attractive on valuation and as a diversifying investment, but volatility is still very high and warrants caution.

High yield corporate debt suffered last year as credit spreads widened given the preponderance of energy-related debt (15% of the index) and the risk of rising defaults from a sustained slump in energy prices. Market reaction may be overdone, though, as energy companies have termed out the bulk of their debt, and maturities for 2015 are close to zero. Management teams have many levers to pull, such as reducing capital expenditures, asset sales, issuing equity, and tapping the market with secured financings. As such, we see the high yield market as oversold and remain committed to our allocation and see opportunity at current levels.

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