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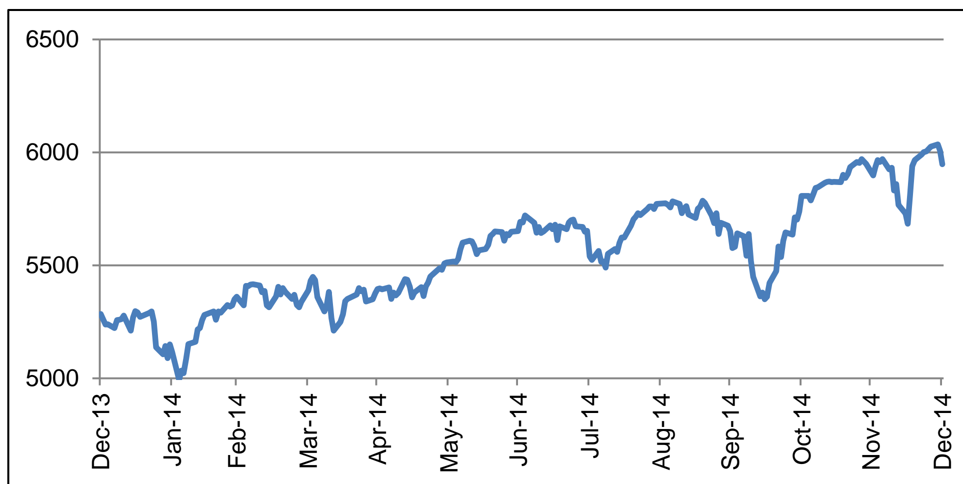
2014 Year in Review

The year that was could be summed up in a few high level bullet points:

- Bigger was better – Mega cap stocks outperformed small cap stocks by over 8%
- US assets led – US stocks outperformed their developed market peers by over 16% (partially on the strength of the US dollar)
- Sectors mattered – Health Care was up 25%, Energy was down 10%. Biotechs were up 29% and REITs were up 30%!
- Oil – Having taken two years to go from $50 to $100 and then generally staying there for the next three years, it only took six months to go from $100 to $45

Unlike 2013 which was mostly a straight path upwards, 2014 was characterized by alternating periods of rally and reversal, so much so that the Russell 3000 Index was essentially flat through mid-October. Strong US economic and company fundamental performance, along with continued central bank accommodation, helped to close the year on a strong performance note. US equities as represented by the Russell 3000 Index finished with a +12.6% return, the developed market MSCI World ex US Index returned -4.3%, and the MSCI Emerging Markets Index returned -2.2%. Performance in the fixed income markets was solid with the Barclays US Aggregate Index returning +6.0%.

Figure 1. Russell 3000 Index – 2014 Performance



[Source: Bivium Capital Partners, LLC; Bloomberg]

Q1: A Slow Start

Following the dramatic run-up in most equity markets in 2013, the directionless nature of trading early on was to be expected. Macro weakness in China and some earnings disappointments triggered a sharp sell-off in the markets at the end of January, but expectations for better economic growth and a "clean" suspension of the US debt limit for a year gave further impetus to buying for most of February. Political turmoil in Italy, Turkey, and (more bloodily) Ukraine only served to dampen enthusiasm slightly. In early March, sentiment turned sharply on the Health Care (Biotech) and Technology names that had been leading, volatility increased, and returns were choppy. The Russell 3000 Index returned +2.0% while the developed market MSCI World Ex US Index returned +0.8% and the MSCI Emerging Markets Index returned -0.4%. Fixed Income markets were competitive with the Barclays US Aggregate Index returning +1.8% as long US Treasurys and credit paced the gains.

Q2: Ignition!

The quarter began with a brief retreat as sellers focused on the turmoil in Ukraine and concerns over market valuations. In the downdrafts, biotech and momentum stocks were particularly shunned. However by the end of May, M&A sparked a market rally with mega cap stocks leading the way to record index highs. While macroeconomic data was mixed, volatility was low and ongoing central bank accommodation (highlighted by the ECB's unprecedented fee on funds deposited at the bank) continued to drive return-seeking behavior. The Russell 3000 Index returned a robust +4.9% while the developed market MSCI World Ex US Index matched it with a similar +4.9% return. After a sustained stretch of underperformance, the MSCI Emerging Markets Index bounced back with a +6.6% return. Fixed Income markets were steady as the Barclays US Aggregate Index returned a solid +2.0% as long duration continued to be an outperformer.

Q3: Stall?

The month of July was thirty days of relative calm in the markets punctuated by a sharp selloff on the last day. Economic data was generally positive, but deflation once again became a concern in Europe along with the realization that the ECB will likely have to stay accommodating for much longer than their UK and US peers.

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By August, the tragic downing of a Malaysian Airlines flight over Ukraine, Argentina's default, and the rescue of Portuguese bank Banco Espirito Santo raised investor anxiety. Economic news turned weak with the US unemployment rate edging up slightly and data disappointing in both China and Europe. However, as in many recent rallies, central bank accommodation fueled a mid-month recovery as the ECB moved closer to quantitative easing and central bankers worldwide generally affirmed the appropriateness of easy monetary policy given current economic conditions. By mid-September, concerns regarding global growth, voiced most notably by the IMF, served to highlight the limits of monetary policy and a meaningful market sell-off closed out the quarter. The Russell 3000 Index finished the quarter essentially flat at +0.0%. However, US small cap stocks were significantly worse with the Russell 2000 Index returning -7.4%, bringing the underperformance of small cap versus large cap to over 15% in the past 12 months! Outside of the US, developed markets were generally negative as the MSCI World ex USA returned -5.7% and the MSCI Emerging Markets Index returned -3.5%. Fixed Income markets took a pause and the Barclays US Aggregate Index returned +0.2%.

Q4: Bounce! (In the US, at least)

Starting the quarter, October looked like a perfectly reasonable recovery from the declines of the prior month. However, end-point results masked significant intra-month volatility as the markets swung from bearishness to bullishness in the blink of an eye. Macroeconomic concerns in Europe and China gave the bears reasons to sell mid-month, but better US data and strong US company earnings reports reignited the rally. November saw a consolidation of the market rally, and most days saw steady if unspectacular gains. The most meaningful macro story of the quarter was the acceleration of the collapse in the price of oil which had started in earnest in July. By the end of the quarter, the price of oil was down close to 50%. Bears saw the decline as a reflection of weaker global growth, but Bulls focused on the on-going accommodative stance of the Fed (despite the end of the latest round of QE). Volatility increased and the quarter (and year) ended on an uncertain note. The US broad market Russell 3000 Index finished the quarter up +5.2%. US small cap stocks staged a strong recovery from the underperformance of the past 12 months with the Russell 2000 Index returning +9.7%. Outside of the US, developed markets were again negative as the MSCI World ex USA Index returned -3.7% and the MSCI Emerging Markets Index returned -4.5%. Fixed Income

resumed its steady march upwards as the Barclays US Aggregate Index returned another +1.8% on continued strength in long Treasuries and credit.

Outlook

While we do not tend to make major adjustments based on market outlooks, we do assess and note the dynamics which may impact our portfolios. To that end, over the past year we have observed some macro stylistic trends and micro sector trends which may provide opportunities for outperformance over the next 6-12 months.

At the macro style level, 2014 was a particularly challenging year for growth-biased active managers. While the small cap growth index outperformed the small cap value index, the median small cap growth manager underperformed significantly. While the fundamental performance of companies was somewhat normal, there was a narrowness to the market that benefited niche areas such as biotech and yield (REITs, utilities) disproportionately. Compounding that was the fact that the fastest growing stocks (the favored universe of our growth managers) were not necessarily the best performers. To the extent these cyclical dynamics reverse, that should provide a tailwind to our managers' focus on differentiated and diversified growth.

At the micro sector level, the collapse of Energy in the second half of the year was quite notable for its speed and depth. While some managers (to their detriment) tried to buy into the collapse, most have elected to hold steady, biding their time for better opportunities. Over the short- to medium-term, those opportunities are likely to be presented in energy-related names (industrials, servicers) than direct plays such as E&P. If a company can weather the storm from a revenue and financing perspective, then the current depressed valuations present an opportunity for "being greedy when others are fearful."

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