SARGENT BICKHAM LAGUDIS

JANUARY 2015

SUMMARY:

The S&P 500 was up 13%, but the average stock was up only about 6 % – 7% in 2014.

Foreign stocks were down, as were high yield bonds, gold, and commodities.

Interest rates fell with the 10 year Treasury bond falling from 3% to 2.2%.

The economy finished its sixth year of growth and is expected to continue growing in 2015.

Oil prices have fallen 50% in only six months. This will hurt producers, but will benefit the economy generally.

Valuation is no longer a tail wind. Expect more volatility.

Now is a great time to organize your estate.

In This Letter

Market Commentary and Review

by Brad Bickham, CFA, CFP®

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us."
– Charles Dickens, A Tale of Two Cities

Dear Clients and Friends,

Following are returns for the last one, five, and ten years ended December 31, 2014.

Returns as of December 31, 2014	4th Qtr 2014	Last 12 Months	Last5 Yrs. Annual	Last 10 Yrs Annual
60/40 Balanced World Index	1.8	6.2	8.6	6.2
World Stock Index (ACWI)	0.6	3.8	9.5	6.4
Large Cap U.S. Stocks	4.9	13.7	15.5	7.7
Mid Cap U.S. Stocks	6.3	9.4	16.2	9.4
Small Cap U.S. Stocks	9.6	4.7	15.5	7.8
Nasdaq 100	4.9	19.2	18.8	10.8
Foreign Stocks - Developed	-3.6	-4.9	5.3	4.4
Foreign Stocks - Emerging	-4.5	-2.2	1.8	8.4
U.S. Bonds – Taxable	1.8	6.0	4.5	4.7
U.S. Bonds – Tax-Free Municipals	1.1	7.3	4.6	4.3
REITs	12.2	26.7	14.7	6.4
High Yield Bonds	-2.5	0.3	7.6	6.4
Commodities	-12.1	-17.0	-5.6	-1.9
Hedge Fund Index	0.1	2.5	3.1	3.0
Gold	-2.3	-2.2	1.2	10.0

The headlines don't tell the whole story.

I guess they never really do. I've been a faithful reader of the *Wall Street Journal* since the early 1980s. One of the things I always liked about it was the small little summaries of news on the first page. You can read the summaries quickly and then go read the full stories if you feel like it. Now all the news is structured that way. The problem is that most of the time we are so busy we don't read the whole story.

If you look at the headlines, you would think it was a good year to be invested in stocks and bonds. The S&P 500 was up 13% and bonds were up 6%. That will go down in the history books as a darn good year. But take a closer look at the table above. It was a terrible year for some asset classes. Foreign stocks and

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bonds, commodities, and gold all had negative returns. Oil fell over 40% in the last six months.

In this newsletter I will try to go a little deeper than the headlines and explain 2014, and hopefully keep you interested long enough to read the whole story.

The full economic/investment story of 2014 has four chapters (at least):

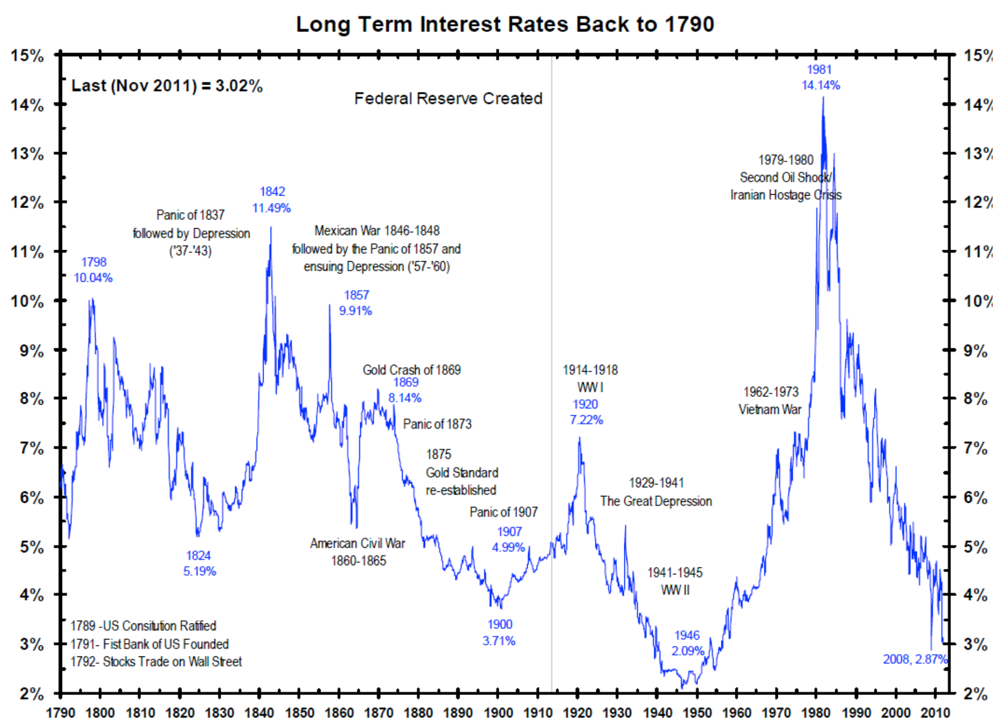
1. The large cap index (S&P 500) was up 13%, which was much higher than small caps, international, or even other large cap indexes such as the Dow Jones Industrials.
2. It was another year of U.S. stocks outperforming foreign stocks.
3. Interest rates were expected to rise, but they fell.
4. Oil prices fell over 40% in less than six months.

Three stocks accounted for over 20% of the return of the S&P 500. They were Apple, Microsoft, and Intel. There were also a few commonly held stocks that had negative returns such as Amazon, Exxon, and IBM. If you had the wrong combination of just these few companies, you would have divergent performance. We use indexes to describe what happened, but last year it was misleading.

It may sound trite or obvious, but the "market" is just that. It is a marketplace. It is where people come together to buy and sell. It really isn't a thing at all, and today it isn't even a place. It is electronic bits of data traveling all over the world and being traded on dozens of exchanges. There are over 5,000 companies traded on major U.S. exchanges alone, and many more on a global basis. So stepping back a little, what we can say is that most U.S. companies increased in value last year a little – maybe 6% on average. Big companies did better than smaller ones, but the average company did not rise 13%.

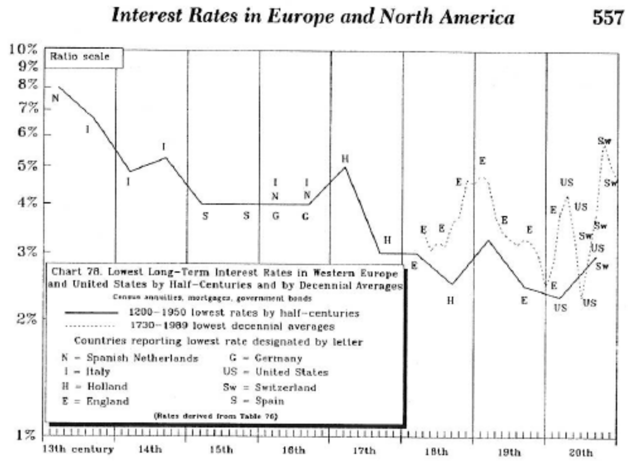
U.S. stocks generally outperformed foreign stocks again last year. The reasons are fairly obvious. Our economy is growing faster, and our companies are making more money. Our central bank, the Fed, seems capable and while our political system is ineffectual, it looks downright efficient compared to Europe. China is a mystery and Japan is undertaking a monetary experiment like the world has historically never seen. Africa has Ebola, and the Middle East is one long running tribal war. Based on historical relationships and a 'reversion to the mean', foreign investments are due for a period of outperformance, but it is hard to make a fundamental case for it.

Almost everyone expected interest rates to rise in 2014, but they were wrong (us included). This has been true for a long time. Why do we all keep getting it wrong? Part of it is anchoring. Most of us are anchored in a period of interest rates much higher than today and that clouds our judgment. However, I would argue that rates should be higher – fundamentally. Interest rates are at their core the rate that a lender charges to a borrower.



A bank acts as an intermediary in the process. They are both a borrower and a lender. They borrow from savers, and they lend to businesses and individuals.
A rational lender will want his principal paid back, a rate of interest commensurate with the risk, and a rate higher than the prevailing level of inflation. We can look at historical levels of interest rates for a guide. For

example, in Sixth Century B.C. the customary rate in Greece was 16% to 18%, and by the Third Century B.C. it had fallen to 10%. As shown below, there has been a general trend of falling rates since the 13th Century A.D., but we are at historically (very) low rates.



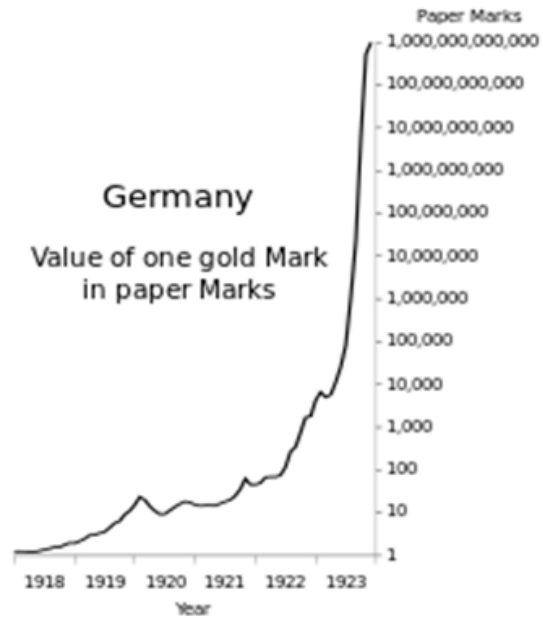
A History of Interest Rates by S. Homer & R. Sylla

I like to use the averages since 1926 in the U.S., which show inflation averaging 3% and short term rates averaging 3.5%. Longer term rates were 2% higher. So, it is not only logical but also empirically true that interest rates are generally .5% to 2.5% higher than inflation.

Today, inflation is somewhere around 1% to 2% depending on how we measure it. It's higher in some areas, and is negative in others (think falling gasoline prices) but at a minimum inflation is 1%. Therefore, short term rates should fundamentally be 1% to 1.5%. Longer term rates such as the ten year U.S. Treasury bond should yield about 3% or 3.5%. Instead, short rates are 0.25% and ten year bonds yield 2%.

Why? The first reason is well known to most investors – the Federal Reserve. The Fed has been keeping short rates artificially low in order to stimulate economic activity. But wait! Didn't the economy grow at 5% in the 3rd quarter? And, isn't unemployment below 6%? What are they waiting for? What is the market waiting for? Why haven't rates moved up? Enter….the rest of the world.

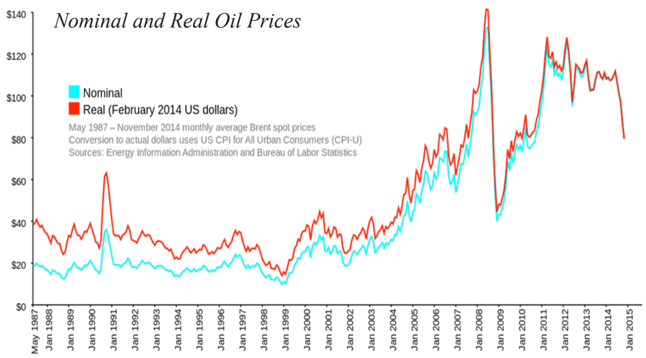
Sometimes the rest of the world matters and sometimes it doesn't; and for different reasons. This time, it matters because interest rates are so low in other countries that demand for our bonds is strong. Strong enough to lower our rates beyond what fundamentals would suggest they should be. Yields on 10 year government bonds in Germany are 0.44%, in Spain 1.64%, in Switzerland 0.19%! Someday, I don't know when, people will look back at these figures and be amazed… kind of like this:



More recently, the topic du jour is oil prices. Having grown up in Oklahoma, and having been a Coloradan for over three decades, I have seen a few ups and downs in oil prices before but it still takes your breath away when things change so quickly. Last June, we were feeling smug about how America was going to become energy self-sufficient, and how our manufacturing companies now had an advantage. I have watched Oklahoma City be transformed over the last few years by Chesapeake, Devon, and lately by Continental Resources. They have built huge campuses and downtown skyscrapers. Black gold has been flowing.

But as before, bust follows boom. Oil is not as big a deal as it used to be, but it is still a pretty big deal. In the longer run, we need to get off the stuff. It's dirty for the environment when we use it, and not good when we drill for it either – fracking or not. But we need energy for everything we do, and until the cost of alternatives is competitive we are going to keep drilling for oil and gas. I would rather buy it from North Dakota than Russia or Iran, but couldn't we just agree to try to do it as environmentally neutral as possible?

This drop in oil prices will end soon, and while lower oil prices will hurt places like North Dakota and Oklahoma, and oil producers, it will be a benefit to the 70% of the economy that is consumer spending. This looks like a good thing to me. Demand has been falling, partly due to more fuel efficient cars and some inroads by alternatives. Supply has been increasing due to new forms of drilling. That sounds like low prices for quite a while, and that is good for the economy.



The U.S. economy finished its sixth year of economic growth since the Great Recession. That's a longer than average stretch, but it doesn't mean a recession is around the corner. In fact, the chance of a recession seems low. GDP growth was over 5% in the 3rd quarter. For the whole year it was about 2.5%, which is about average for this recovery. Longer term, the average is 3%. We went through a borrowing binge for decades. Just like when you borrow money for your personal benefit, you are accelerating the purchase of goods and/or services. When you pay back the debt, you will have less money to buy other things. In the U.S., we have more debt to pay back to get to a more balanced level and therefore growth will be slower than in the past. 0.5% is not a lot in some things, but when applied to a $17 trillion economy it is significant. It means less money to go around. It means things do not feel as good as they could, but it could be worse. In Europe, they have not had any economic growth for several years. In Greece, the economy has gotten smaller.

In 2015 earnings are likely to keep growing. Estimates are for another year of 10% growth, but analysts are always too optimistic at the beginning of each year. Expect earnings to grow in the single digits this year, something in the 5% to 9% range.

Will Rogers once said, "I don't make jokes, I just watch the government and report the facts". It is harder to predict the political influence on the economy and markets than usual. For the last few years, we have expected, and received, nothing but noise from Washington. This year the Republicans have more control, so there is a chance they will advance more legislation and President Obama will find a way to work with them. I doubt it though. The primary players are the same, so the chances of anything significant are slim.

The Affordable Care Act will continue to exert influence on the healthcare sector, and even if Congress chips away at parts of it the trajectory of our system has been changed. Tax reform, the gasoline tax, immigration reform – they all look like moon shots. And then we start the whole election cycle all over again. In fact, it appears to have already started. What a waste of money. The prediction here for 2015 from Congress…little to help, little to hurt.

The geopolitical situation on the other hand could be dramatic, but is unpredictable. Hot spots include Russia, Ukraine, Syria, Iraq, Afghanistan, China-Japan, Africa, Israel-Palestine, Iran, North Korea, and ??? Any of these places could have an influence on the markets this year, but the most likely drama is expected to come from oil exporting countries like Russia. With a 50% drop in oil prices, they are going to have difficulty paying their bills. That is going to cause some problems. We will just have to wait and see how serious they are. From an economic standpoint, it is bad for them and good for the rest of the world; but when cornered desperate people make desperate choices. The risks would seem to be a little higher than normal this year.

Valuation has now reached the level where it is causing us some concern. We are nowhere near the levels seen in 1999 – 2000, but we are at more expensive levels than average. The market is not cheap. This leaves little margin for error. We begin this year expecting our strategy to favor value and income. We will not stretch for growth ideas. We may hold more cash than normal. We have been on the wrong side of the bond market for a while, but there is little value in bonds. 2% for 10 years is not an investment. It is either a mattress, or a bet on the short term direction of interest rates. That is not our cup of tea. We own bonds for safety and income, but our average maturities are only 3 – 4 years, and we have several strategies designed to do better when rates rise.

We continue to allocate to foreign equities and fixed income, but after several years of these sectors underperforming our conviction level is low. Their asset allocation benefit is proven over long periods of time, and when patience fails it is often the exact time when things turn around; so we will maintain holdings but we are not doubling down. Likewise, small caps and high yield bonds will be held but in smaller proportion than in the past due to valuation and risk concerns.

Our Core (Model) Equity underperformed the S&P 500 last year like the other 85% of active managers. That

only makes us more determined. We are increasing our efforts and our resources. Mutual funds, hedge funds, and managers of all types in all asset classes struggled to outperform indexes last year. What worries me is the last time I remember such a narrow market was in the late 1990s before a market top. Therefore, we will be especially alert to changes in fundamentals this year and prepared to move to a more defensive stance. Corrections are inevitable and we don't try to time them, but if we can see something more significant on the horizon we will make some changes.
As always, we look forward to working with you in the coming year.

Financial Planning

By Gary Powell

<u>A Practical Guide to Organizing Your Estate</u>

Through personal experience or distressed stories from friends and acquaintances, we have all heard about messy estates. At the beginning of a new year, it is a great time to make sure your estate is in order. It is easy to procrastinate about handling our affairs because we don't want to think about death. However, the same information will be needed if you become ill or disabled. Think of the time and effort – not to mention money – you will save family members by starting now.

Your mindset should be to assemble the information someone else would need to care for you and your loved ones if you were unable to tell them where to locate it.

Let's break this task into pieces so you can address each over a weekend.

Estate Planning Documents – if you don't have these yet, we can suggest a few estate attorneys.

- Trust documents – wills and living wills.
- Guardian documents for children.
- Trust documents for trusts in which you are the beneficiary.
- Prior gift tax returns.
- Estate tax returns from deceased spouse or relative(s) from which you inherited assets.
- Names and contact information for your personal representative and trustee(s).
- Name and contact information for your estate attorney.

Health Care Documents

- Power of attorney for health care.
- Health insurance coverage information – medical, dental, disability income, and long-term care.
- Do-not-resuscitate order or other end-of-life directions.
- Medications – name, dosage, how often and purpose.
- Documents on medical history for chronic diseases.
- Doctors – phone numbers and specialties.

Financial Information

Compile a list of assets and liabilities:

Assets (List of the estimated balance or value for all assets and property that you own. For all accounts, list each institution, account numbers, phone numbers, personal contacts, etc.).

- Checking, savings and investment accounts.
- Retirement accounts by type of account (IRA, 401(k), deferred compensation, etc.) by custodian.
- In-force life insurance policies by insurance company and policy number.
- Stock options by company with accompanying vesting schedule.
- Annuities by insurance carrier and account number.
- Business investments.
- Real estate and land by address with titling and estimated value.
- Vehicles by year, make and titling.
- Safe deposit box by bank and key location or other access.
- List of contents.
- Art collection or other collectibles
- Listing or pictures of personal property.

List of your income (sources and amounts) and recurring bills and due dates. contacts, etc.)

Make sure your surviving spouse (partner) has access to cash.

Contact information for your CPA.

Liabilities (list estimate value for each institution, account numbers, phone numbers, personal contacts, etc.)

- Real estate mortgages by address and names of borrower(s).
- Line of credit and security; credit cards.
- Consumer installment loans and security; auto leases.
- Commitments to charities, family members, and business partners.

Access to Computer Files and Online Accounts – with increasing concerns around cyber security, this item keeps rising in importance..

- Make a list of online accounts with associated passwords and login information.
- Make a list of email accounts, Facebook, Twitter, and other social media with associated passwords and login information. Terminating these accounts after death should be considered.
- Clean up your desktop of clutter that is not necessary for someone else to determine its relevance.
- Frequently back up your computer to an external hard drive or cloud storage service provided by Google, Apple, Amazon, SBL, and others.
- SBL provides our secure cloud-based storage service, the Stache, to our clients.
    - Speak to your advisor to learn more.

Other Important Documents. These documents are often overlooked but become most important to settle your estate.

- Make a copy of your credit cards and include the phone number for customer service.
- Make a copy of your driver's license, passport, birth certificates for all family members, marriage licenses, the last five income tax returns, divorce papers, etc.
- Business documents including partnership agreements, loan documents, shareholder agreements, covenant-not-to-compete, buy-sell agreements and related life insurance (if any), leases, copies of stock certificates, tax returns for business interest, deferred compensation agreements, restricted shares, etc.

Now that you have assembled all this, what do you do with it? First, date the pile of stuff so your family or friends have some sense of its age. Second, we recommend that you make at least two electronic copies (paper if you prefer, but it becomes less manageable). One copy should be your personal back up for your external hard drive, cloud-based storage or the SBL Stache. The second should be given to someone you trust whom is not a spouse or partner. Third, set a calendar reminder to review the documents next year to make sure everything is still current.

OK, this stuff is not fun to talk about; and far less fun to write about. But do your family a favor and let's get to work together.

Company Update

By Patty Meneley, COO

This winter has been an exciting time for our staff. Both Jordan Kunz and Christiana Glenn became engaged and will be getting married this year! Then Anne Kimmell's daughter gave birth to triplets (!) in December. Little Sam, Gabe and Casey were, not surprisingly, early so they are still growing in the NICU but will be home soon. These are Anne's 4th, 5th and 6th grandchildren, a 100% increase!

On a more operational note, many of you are receiving class action notifications and forms in the mail pertaining to your investments. While these typically yield very little in actual cash to the individual investor, we recommend that you do submit them. We will complete the purchase/sale information and attach the statements required to verify the transaction but please remember to sign them before they are sent to us. They all have a submission deadlines and when you send them to us signed we can get them in more quickly.

Tax season is upon us. Your 1099 from your custodian will be arriving shortly. Remember that these are frequently updated with new information as it is received from the various transfer agents so you might want to wait until later in the quarter to file your tax return. Also, SBL will not send out any tax reports since this information is now captured on your 1099 and this is the official document that is filed with the IRS. We can provide copies of this form to you and/or to your accountant on request.

The Last Word

By Rick Lawrence, CEO

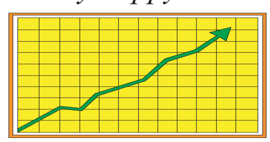
I am writing this on the one year anniversary of my starting work at Sargent Bickham Lagudis. I was a client before I was an employee; and I am pleased to report that from my new perspective, I continue to take pride in the work that goes on here to understand the markets and investment opportunities, and apply the collective reasoning and insights of our staff to each account. Our accounts are benefitting from the balanced, reasonable, and thorough attention of a group dedicated and well qualified professionals.

We know that you have many choices about where to turn for help with investments, and we are working to make sure that our services are the best available. We are beta testing new online access options and have gone through a rigorous security review. More on these and other initiatives in future newsletters. We have also spent significant time over the last several months working to verify and update each client's Investment Policy Statement (IPS). The IPS is a customized document providing us with written instructions detailing your investment objectives and preferences. This document, together with your financial plan – another service you are entitled to access without additional fees – sets the paradigm through which Brad, Chris, and our other advisors make important choices affecting your account.

In this newsletter, Brad shared some thoughts about 2014 and the outlook for this coming year. Who would have predicted a year ago that we would be wondering if oil could go below $40? Clearly some of the strategies that have been in place the last few years are changing now, and that thinking will undoubtedly be reflected in adjustments to many portfolios.

Our company continued its strong growth trajectory in 2014, with a net gain in accounts for the 7th consecutive year and assets under management (a common way of measuring the size of an investment advisory business) hitting a record. We are grateful for the chance to work with you and thank you for the business.

Many happy returns,



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