DIVERSIFIED TRUST

2015 INVESTMENT OUTLOOK

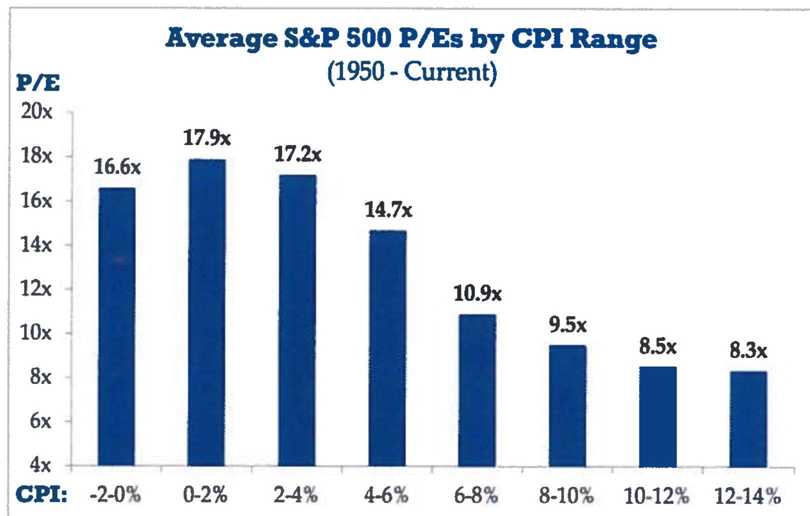
Top Themes from 2014

- U.S. dollar strength was the primary factor in moving markets during the year.
- As anticipated in last year's letter, volatility picked up across most asset classes.
- U.S. Equities and long-term bonds were the top performers.
- Dramatic oil price declines led to de-stabilization in the Energy sector and impacted MLPs.

Although it may not have been obvious, U.S. dollar strength was the primary market theme in 2014. Catalyzed by favorable macro-economic factors in the U.S. – and relative economic weakness in much of the rest of the world – the strong dollar drove U.S. equity valuation multiples higher, commodity prices lower (e.g. oil), and erased international investment gains once converted back to U.S. dollar terms. Dollar strength was acute in the second half of 2014 as economic weakness internationally, particularly in Europe, accentuated the dollar's attractiveness.

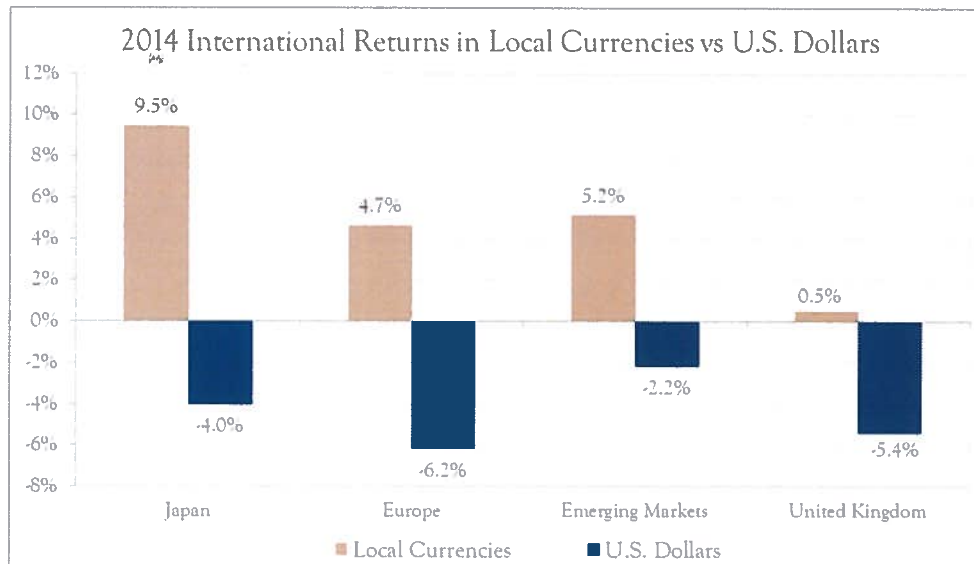
U.S. large cap stocks (+13.7%) were the top equity market performers for 2014. Due to full valuations, smaller capitalization stocks lagged meaningfully (up 4.9%) as anticipated in last year's letter. Surprising most was the strong performance of U.S. treasuries; the 30-year bond had its 6th best year ever up almost 30%, as interest rates declined almost a full percent during the course of the year.

A strong dollar is a positive for U.S. equities because the real (inflation adjusted) return on investment is higher in such an environment. As the chart here illustrates, the market awards equities higher PE multiples in environments where inflation readings are low.



Source: Strategas, as of 1/2/2015

Of course, international investments suffer when the dollar strengthens because those holdings, once converted back to dollars, are worth less than they would have been with no change in the currency. While international returns in local market terms were generally positive, these returns were completely wiped out by this currency translation effect. The chart here highlights how powerful that dynamic was in 2014.



Source: Morningstar, as of 12/31/2014

The impact of dollar strength on commodities is straight forward; a stronger dollar purchases more of a given commodity. The impact on emerging markets is related but less clear. Emerging market economies tend to be commodity-heavy in terms of their output – as a group they tend to be producers (i.e. exporters) of commodities. A rising dollar hurts these economies because they receive fewer dollars for their commodity output. Their fiscal situation can also suffer if they have issued debt in dollars which is a common practice. As the dollar becomes more valuable relative to their own currencies, their debt service becomes more expensive.

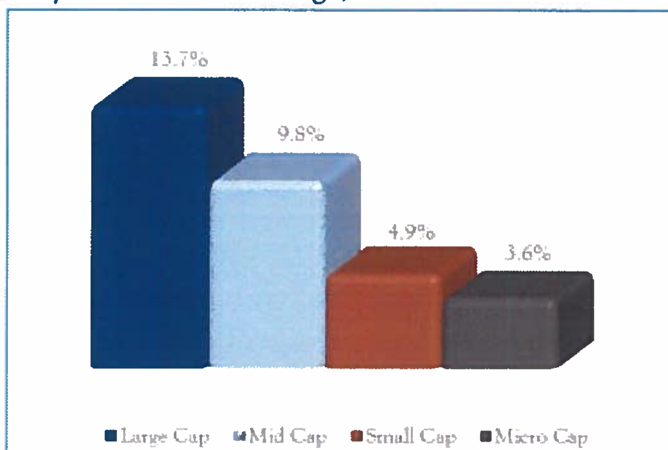
The most powerful impetus for dollar strength began with the Federal Reserve laying the groundwork for ending quantitative easing in 2013. As it became clear the Fed's market involvement was diminishing (would not embark on additional rounds of easing), the dollar began to rise on increased demand – investors secure in the idea the dollar would not be further debased.

While this reduction of central bank involvement was occurring in the U.S., foreign central banks were expanding their quantitative easing programs. The European Central Bank sought unusual methods to purchase European debentures to stave off slowing economic momentum. Japan's central bank continued its focus on purchasing domestic bonds while also influencing fiscal policy changes. As major central banks moved divergently, volatility rose across equity and debt markets, and currency fluctuations were dramatic. Interest rates around the world declined to record lows resulting in better than expected fixed income returns especially for longer maturity assets.

These shifting central bank policies and rising geopolitical risks led to a challenging year for active management. Based on Morningstar data through year-end, 2014 saw the worst annual results for active management in the last 20 years, with just 20% of domestic managers outperforming their benchmarks. Sector focused and alternative funds also struggled, with fewer than one out of three beating their respective benchmarks.

While active management is best evaluated over the long term, a number of factors contributed to this lackluster performance for 2014:

1. Concentration at the top of the market capitalization spectrum, as just 5 stocks (Apple, Microsoft, Berkshire Hathaway, Intel, and Wells Fargo) accounted for 20% of the S&P 500's gain.



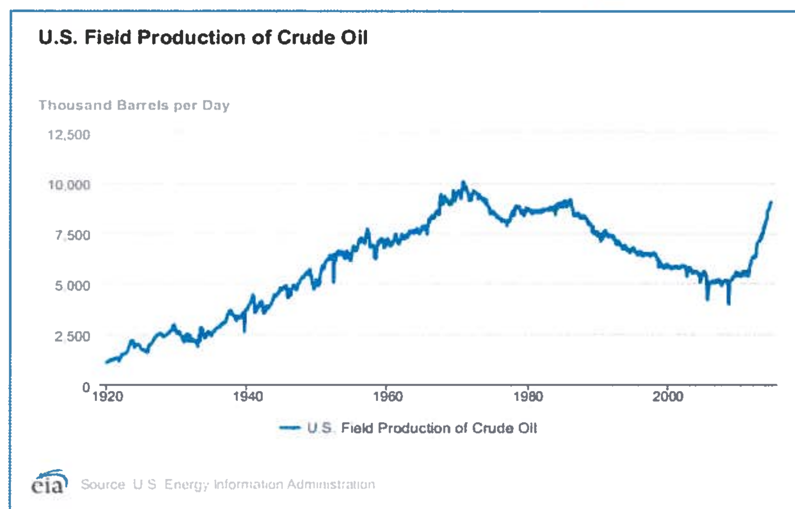
Source: Morningstar, as of 12/31/2014

2. The wide performance spread between larger capitalization stocks and smaller capitalization stocks.

3. Top performing sectors this year were Utilities (+29%) and Health Care (+25%), which tend to be more defensively oriented sectors.

Fund flows of over $244 billion into passively managed products may also have had an impact. While overall stock dispersion remained low, pockets of market strength and shifting trends culminating with oil's dramatic fourth quarter decline challenged active managers in 2014.

Oil prices have fallen by more than 50% since June 20th when West Texas Intermediate crude sold for $107 per barrel. Today it is below $50. The fall began in mid-September when the International Energy Agency (IEA) noted that global oil demand was less than had been expected and gathered steam on Thanksgiving when OPEC announced they would not cut production. Slow global growth (especially outside the U.S.) and the increasing use of alternative energy sources have blunted demand. The strengthening dollar only served to exacerbate the fall in oil prices, but, perhaps more importantly, global oil supply has been rapidly increasing in recent years. While OPEC supply has held steady, production in the U.S. (to the left) has been skyrocketing.



This increase in domestic oil production has been a key investment theme for us in recent years. Production through hydraulic fracturing, or "fracking," has led domestic output of both oil and natural gas dramatically higher over the past five years. With this production growth has come additional infrastructure, fueling outstanding performance for Master Limited Partnerships, or MLPs. Most MLPs own pipelines, storage and/or processing facilities and therefore have little or no direct exposure to commodity prices, instead acting as crucial infrastructure for the companies that actually own the oil or gas. We have had meaningful portfolio exposures to MLPs for several years now and that has generally paid off, with the Alerian MLP index up over 16% annualized over the past five years.

Outlook

As we enter 2015, we continue in a similar policy and economic environment as the back half of last year. The Federal Reserve's monetary policy is likely to remain on hold for longer than initially anticipated; a stronger dollar results in fewer inflationary pressures and less impetus for the Fed to raise rates. While growing slowly, the U.S. economy and the improving employment picture is indicative of further strength. Low energy prices should also be beneficial for consumers, effectively a tax cut for most Americans, and fiscal issues remain longer-term in nature. With this generally positive backdrop, corporate earnings have continued to rise pushing the stock market to new highs.

Against this seemingly benign economic environment, we believe that domestic markets are fully valued. Expanding PE ratios for domestic equities have been a big part of the market's rise in recent years. However, high valuations in and of themselves do not lead to market declines. Most economic signals here in the U.S. argue against a looming recession, and we believe the market is likely to move higher in 2015. Significant stock declines are usually the result of a catalyst, either a recession or crisis of some sort. Taking a look at the last five periods of significant market losses, each and every one of them had a specific trigger, with only the nosebleed valuations of the late 90's tech bubble directly leading to a bear market:

Periods of Large Trailing Twelve Month S&P 500 Drawdowns

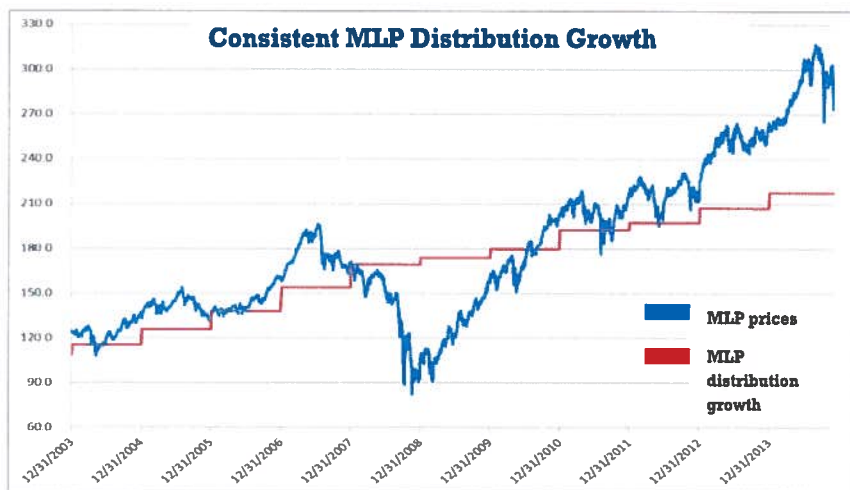
Time Period	Starting Shiller P/E	Return	Reason
10/1973 - 9/1974	15.9	-38.9%	Oil embargo
8/1981 - 7/1982	8.4	-13.3%	Fed interest rate rise
9/1987 - 8/1988	17.7	-17.8%	"Black Monday"
10/2000 - 9/2001	39.4	-26.6%	Tech bubble
3/2008 - 2/2009	22.6	-43.3%	Financial crisis

Source: Morningstar

For the previous chart we used the Shiller PE ratio, which is the current price of the market divided by the average of the last 10 years' earnings. This measure reflects an effort to smooth out the cyclicality of corporate earnings. Higher equity valuations simply change the risk/reward proposition of investing in equities. There is less room for exceptional returns and more room for the market to fall when the inevitable crisis comes. At 26, today's Shiller PE is relatively high, although it may be justified since interest rates and inflation are very low. So although we are bullish on the markets over the short-term, it is more difficult to see a path towards high long-term returns for domestic equities.

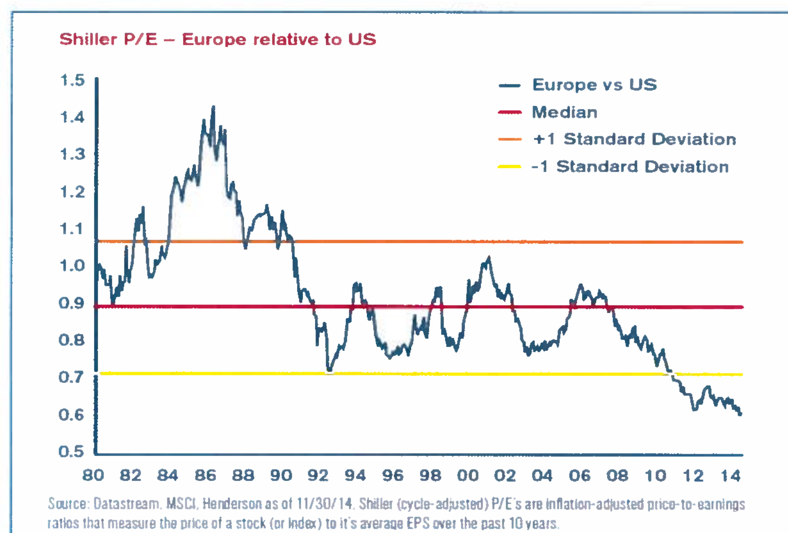
As we said last year, "with less policy intervention on the horizon, we anticipate investment fundamentals coming into focus." We expect the recent higher volatility levels to continue given the divergences in the markets. With limited valuation disparity across capitalizations, we continue to favor larger capitalization, higher quality companies over smaller capitalization companies. We continue to hold MLPs as attractive income producers, but we have reduced positions over the course of the last year and await a clearer picture on the impact of lower oil prices.

With oil prices markedly lower than just a few months ago, we expect the growth in U.S. oil production to slow. That said, we expect production to continue to rise. With MLPs currently paying a distribution yield of roughly 6% and assuming even modest production growth, we believe MLPs can attain high single or low double digit returns over the next few years.



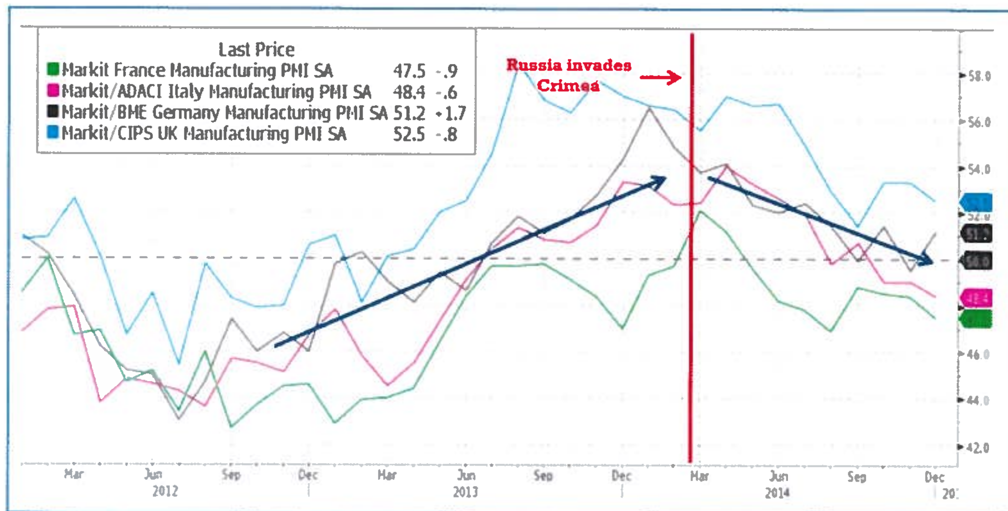
Source: Tortoise Capital Advisors

Outside of the U.S., the opportunity is generally the opposite of what we see here. As shown below, European equities are far cheaper than those in the U.S. But, while valuations overseas are broadly attractive, they are that way because the macroeconomic backdrop is less attractive.



Source: Datastream, MSCI, Henderson as of 11/30/14. Shiller (cycle-adjusted) P/E's are inflation-adjusted price-to-earnings ratios that measure the price of a stock (or index) to it's average EPS over the past 10 years.

For example, valuations in Europe have been low because the region has employed monetary, fiscal and regulatory policies which generally serve to stifle growth. After years of austerity, where highly indebted countries were compelled to raise tax rates only to find tax revenues fall, Europe took a more pro-growth approach of lower tax rates and regulatory reforms, broadly speaking, in 2012. The evidence of those positive developments is seen in the chart here, which shows solidly improving manufacturing growth across Europe from mid-2012 through early last year.

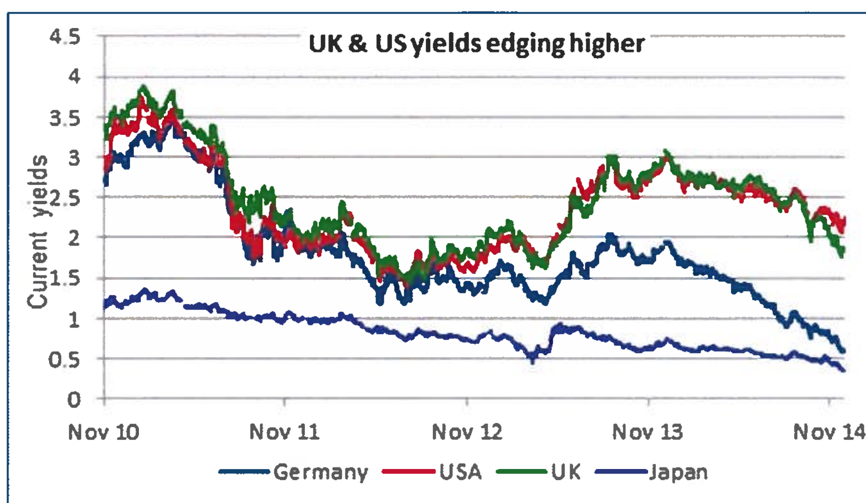


Source: Diversified Trust, Bloomberg, and Prime Executions

The current challenge to Europe coincides with Russia's annexation of Crimea. The uncertainty attendant with those hostilities served to temper economic activity in Europe. That was compounded by sanctions imposed on Russia in an effort to punish that country for its geopolitical aggressions against Ukraine. By definition, trade sanctions hurt both parties and Europe's proximity to Russia as a trading partner means the impact is felt greater there than in the U.S. We make no judgment as to the wisdom or effectiveness of the sanctions, only the observation of their impact on growth and the markets.

In emerging markets, the challenges relate more to the commodity-intensive nature of those economies and how lower commodity prices negatively impact their growth and potentially also their debt burdens. As in the international developed world, equity valuations in emerging markets are broadly attractive. When these macro factors turn positive again – the timing of which is unknowable – currently cheap valuations mean future gains should be attractive. For that reason, we remain constructive on international equities for the long-term.

U.S. 10-year bond yields ended 2014 almost a full percentage point lower than at the start of the year despite the Federal Reserve's reduction of bond purchases and stronger U.S. GDP growth. So far this year rates have continued to fall, with 10-year treasuries solidly below 2%. Typically, falling rates indicate a lack of inflation and/or slower economic growth. In today's case the dramatic and potentially destabilizing decline in the price of oil, concerns over Europe's direction (a possible Greek exit and the impact of Russian sanctions), and the strength of the U.S. dollar indicate more of a "flight to quality" demand for U.S. treasuries. It is also worth noting that government bond yields outside the U.S. are substantially lower (see chart above), with German and Japanese 10-year bonds yielding less than 1%. Municipal bonds continue to offer relatively attractive tax-advantaged yields that are further supported by improving credit quality and limited new supply.



Source: Moneyweek.com

In the alternatives area, hedged strategies continue to play an important role in client portfolios. With low prospective fixed income returns and rising equity market volatility, these strategies are utilized as portfolio stabilizers, helping to reduce the impact of market fluctuations. This role is even more important in today's environment, where traditional fixed income is expected to be volatile as yields are very low and rates may rise. Alternatives offer the potential for asymmetric returns, trading tempered downside exposure for modest upside performance. Our focus remains on selecting skilled investment managers that can add value above their "net" market exposures, deliver a differentiated source of alpha, and provide a meaningful degree of protection in market down turns given these strategies' flexible mandates. Managers can choose to be fully invested, hold significant cash allocations, or even "short" securities viewed as unattractive.

For portfolios that can diversify into the private investment space and withstand the commensurate illiquidity, unique opportunities remain in consumer lending, private equity and private real estate. The broadening opportunity set in consumer lending is evolving, and we continue to evaluate new income generating opportunities. Private equity provides exposure to a wide range of privately-held companies that together produce a differentiated source of return versus the public markets. Examples of this include disruptive technologies that tap into opportunities evolving through the internet and mobile communication, personalized medicine, and energy, as well as exposure to more traditional strategies of adding value to existing business through operational improvements. Within real estate, opportunities exist in the "value-added" sector. Although core real estate yields, including most REITs, remain low and valuations rich, properties requiring development and renovation expertise, financial re-structuring, and/or leasing improvement offer an interesting potential for return. For investors with patient, long-term capital, where illiquidity is not an issue, currently attractive opportunities in private investments are likely to provide rewards over the coming years.

In Closing

Overall, we are constructive on the market outlook for 2015 behind the relative strength of the U.S. economy. As always, potential hazards exist, including the risks that come with a stronger U.S. dollar, meaningful monetary policy changes, continued very low interest rates, geopolitical pressures, and the unfolding story in oil prices. The past few years have seen equities move steadily upwards with very few dips leading us to be wary of increased volatility. Internationally, valuations are more attractive than in the U.S., but for many reasons discussed above, they reflect the challenges faced in many international economies. While fixed income remains an important diversifier in portfolios, the low current yields and subsequent prospective returns keep us underweighted to fixed income overall. Alternatives should prove valuable in what is likely to be a more volatile environment, especially in light of our continued underweight to fixed income.

Because it is so difficult to accurately predict market outcomes over the short-term, we remain vigilant to potential risks and fully diversified across portfolios. We continue to evaluate client allocations individually and rebalance portfolios as needed. The combination of diversification and the appropriate attention to asset allocation will lead to more consistent, long-term results.

Thank you for your continued confidence in Diversified Trust. Please contact us with any questions or feedback you would like to provide.

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