Spring 2015

Market Overview

The first quarter started out with significant and unexpected currency movements when the Swiss National Bank abandoned its three-year-old cap on its currency. Oil prices continued to stay low throughout the quarter and job growth in the U.S. fell well below expectations. The 10-year U.S. Treasury yield dropped while many European countries offered negative yields on their bonds.

Since the Great Recession, the first quarter of each year has experienced weaker economic growth on average compared to the other three quarters of each year. This year's first three months lived up to that pattern with a U.S. GDP growth of just 0.2% (well below the 1% estimates). But if the remainder of the year continues to follow the historical pattern, we should see an increase in economic growth.

The second quarter started with national disasters and ongoing geopolitical turbulences. Opinions remain divided on whether the Fed will attempt to increase interest rates later this year. Despite projected economic improvements in 2015, we expect volatility to continue in the markets.

Investment Strategies

The following are a few thoughts on different asset classes based on the current environment.

Fixed Income – While Bond managers continue to brace for a rise in interest rates, the yield on the 10-year treasury continues to hover below 2.0%. Although we don't expect significant rate increases this year, we currently favor shorter maturities to lower our duration in our bond portfolios to minimize the impact of rising interest rates. In addition to our core exposure, we continue to invest in unconstrained strategies to maintain the managers' flexibility to adjust to market developments. With low rates, investment-grade corporate bonds are more appealing than government bonds and return expectations in this asset class may need to be adjusted. But despite the low yield on U.S. treasuries, they are still more attractive than most foreign government alternatives.

Enhanced Yield – With the uncertainty surrounding investment grade fixed income investments, we continue to fully allocate to high-yield strategies, including private lending opportunities, especially in the energy sector. These investments are less correlated to interest rate fluctuations and have been generating more attractive returns than higher rated fixed income investments. And with the energy sector remaining depressed due to low oil prices, buying their debt on the secondary market at a discount or issuing new debt in a preferred position to the equity on very favorable terms has become an attractive opportunity. Investor mandate for more yield should continue to increase demand for enhanced yield strategies.

Equities – Volatility continues to dominate equity markets. The S&P 500 reached all-time highs during the middle of the first quarter, but then gave most gains back and ended the quarter up just under 1.0%. The strong dollar is hurting U.S. large-cap companies that generate significant portions of their revenue abroad. Small-cap stocks significantly underperformed in 2014, but outperformed most other equities during the first quarter of this year. Despite some investors' concerns about a possible stock market bubble, we expect positive returns from U.S equities for the remainder of 2015. Most investors appear to be optimistic about the U.S. economy and company valuations seem largely attractive.

International and emerging markets are having a good year so far partly because of increased demand fueled by interest rate cuts across the emerging market universe and the European Central Bank's anticipated quantitative easing commitment. We anticipate this trend to continue for international equities during 2015 as the global economy recovers and tries to catch up with the U.S. recovery.

We've also experienced more volatility and lower correlations among equities across the various market caps and trading strategies. A wider dispersion of returns provides an opportunity for active management to outperform passive management going forward which has been difficult for active managers through this market recovery.

Real Estate – With financing remaining very attractive due to low interest rates and with banks making financing more available for buyers, we feel the run in the real estate market is not quite over. That being said, attractive deals aren't as easy to come by compared to just a few years ago, but we are still seeing plenty of opportunities in this inefficient asset class. In addition, real estate continues to be one of our best performers and we continue to pay extra attention to it. With discounts on equity positions gradually decreasing, we are increasingly considering debt positions to decrease risk exposure and balance portfolios with real estate equity positions we've built up over the last several years. We are also exploring with our strategic partners developmental deals where supply has not kept up with the demand in certain geographic markets.

Commodities – We continue to under-allocate to this asset class based on weak forecasts for demand and oversupply, especially in the energy sector. But we still believe that having a small exposure to commodities can be beneficial to the portfolio. Hard assets like commodities could benefit from inflationary pressures; and inflation is re-emerging as a popular headline. Precious metals could perform well if investors panic, market sentiment drops, or concerns increase over the growing amount of sovereign debt being taken on by governments around the world. Commodities can be viewed as insurance for such market shifts and can reduce volatility in the overall portfolio.

Managed Futures – Managed futures finally kicked into gear and generated returns on par with their historical averages these past couple of quarters. We don't recommend over-allocating to this asset class any time soon due to the current low interest rate environment, but believe that its non-correlation to the markets offers a nice diversifier to the portfolio.

Don't miss the next page's pictures from Cornerstone's "Team Notes"

Cornerstone Team Notes

Annual Valentine's Lunch for Women

As every year, we attempt to honor the Cornerstone women by hosting a fun-filled lunch with our female clients, employees, and guests. We enjoyed spending the time with you and greatly value our relationship. We look forward to many more Valentine's luncheons with such wonderful company.

Celebrating Julie's Birthday

We also enjoyed having an occasion to express our appreciation for our Julie who wears many hats and does a fabulous job running our office. In less than a month, we will be able to celebrate her 9-year anniversary with Cornerstone. We're lucky to have her.