The Lam Group
Investment Management

2013 was a good year, particularly for US stocks.

The surge in domestic stocks to record levels in 2013 was certainly welcome news, and for those old enough to remember the "Lost Decade" (1/2000 to 12/2009) when US large cap stocks declined (down over 9% cumulatively for the 10 year period) while all other asset classes posted meaningful/positive returns (see Lost Decade column at the right of Table 1), this recovery in domestic stocks was long overdue.

While our globally-diversified and balanced strategy only has a portion of the portfolio dedicated to US stocks, our investments in domestic equities were up over 35% for US large cap and over 40% for US small cap in 2013. This relative outperformance of our domestic investments relative to their benchmarks was attributable to our strategy tilts towards value-oriented and smaller cap stocks. These tilts also benefited our developed-market equity exposures.

In 2000, at the beginning of the lost decade, investors were convinced that US stocks were the place to be and that investments in other riskier parts of the world (such as emerging markets) were not worthy of consideration. At the end of the Lost Decade (in 2009), many investors questioned the necessity of holding US stocks when future growth was so clearly in the emerging markets stocks (MSCI EM up 154% vs. S&P 500 down 9% during the Lost Decade).

This year, US large and small stocks were very popular, but investors must remember that just because a particular asset class has done well (or poorly) one year does not mean it will continue to do so in the next (please see our colorful "periodic chart"). While tempting, it is essential not to fall in love with (or entirely avoid) any particular asset class or to place "all of one's eggs in one basket".

Table 1: Periodic Asset Class Returns as of 12/31/13

EQUITY ASSET CLASSES	*4Q 2013*	*2013*	3 Years*	5 Years*	*10 Years**	10 Years	*Lost Decade*
S&P 500 Index - Domestic Large Cap Stocks	***+10.51%***	+32.39%	+16.18%	+17.94%	*+ 7.41%*	**+104.30%**	***- 9.10%***
Russell 2000 Index - Domestic Small Cap Stocks	***+ 8.72%***	+38.82%	+15.67%	+20.08%	*+ 9.07%*	**+138.30%**	***+ 41.23%***
MSCI EAFE Index - International Large Cap Stocks	***+ 5.71%***	+22.78%	+ 8.17%	+12.44%	*+ 6.91%*	**+ 95.09%**	***+ 12.38%***
MSCI EAFE SC Index - International Small Cap Stocks	***+ 5.91%***	+29.30%	+ 9.26%	+18.50%	*+ 9.48%*	**+147.31%**	***+ 86.89%***
MSCI EM Index - Emerging Markets Stocks	***+ 1.83%***	- 2.60%	- 2.06%	+14.79%	*+11.17%*	**+188.32%**	***+154.28%***
DJ US Select REIT Index - Domestic Real Estate	***- 1.09%***	+ 1.22%	+ 9.04%	+16.36%	*+ 8.22%*	**+120.35%**	***+175.59%***
S&P Global (ex-US) REIT Index – International Real Estate	***- 1.01%***	+ 2.36%	+ 7.26%	+14.79%	*+ 6.62%*	**+ 89.80%**	***N/A***
FIXED INCOME ASSET CLASSES	***4Q 2013***	***2013***	**3 Years***	**5 Years***	***10 Years****	**10 Years**	***Lost Decade***
BarCap Aggregate Bond Index - US High-Grade Bonds	***- 0.14%***	- 2.02%	+ 3.26%	+ 4.44%	*+ 4.55%*	**+ 56.00%**	***+ 84.75%***
BarCap High-Yield Bond Index	***+ 7.44%***	+ 3.58%	+ 9.32%	+18.93%	*+ 8.62%*	**+128.54%**	***+ 91.58%***
BarCap TIPS Index - US TIPS	***- 2.00%***	- 8.61%	- 3.55%	+ 5.63%	*+ 4.86%*	**+ 60.66%**	***+110.02%***
DJ UBS Commodities Index - Commodities	***- 1.05%***	- 9.52%	- 8.11%	+ 1.51%	*+ 0.87%*	**+ 9.02%**	***+ 99.12%***
Citigroup Non-$ World Govt Bond Index - Non-$ Bonds	***- 1.24%***	- 4.56%	+ 0.62%	+ 2.27%	*+ 4.10%*	**+ 49.52%**	***+ 89.41%***
JPM EMBI Global Diversified Bond Index - Emerging Markets Debt	***+ 1.53%***	- 5.25%	+ 6.10%	+11.72%	*+ 8.19%*	**+119.85%**	***+181.52%***

Sources: Morningstar, JP Morgan, and Dimensional.   * Annualized

Our investments in emerging markets (both debt and equity) and inflation-oriented investments (TIPS and commodities) negatively-influenced portfolio performance in 2013. While the underperformance of these asset classes in 2013 was disappointing, we feel the long-term prospects for emerging markets and the likelihood of higher inflation in the future are strong, especially given their recent underperformance.

It is worth noting that over short periods of time (and with 20/20 hindsight), it is easy to argue against portfolio diversification. In any given year there are always a few asset classes that will have superior performance, and if one only had all their investments in that asset class, it "wouldda, shouldda and couldda" been better than a diversified and balanced strategy.

Over the long run, however, the benefits of portfolio diversification and the importance of disciplined rebalancing become more obvious (as illustrated by the data in Table 1). As the research that won the Nobel Prize in Economics for Professor Eugene Fama stipulates, all available information is already priced in the markets. As the US markets are at record levels, the news that has caused this optimism is already factored into prices. Similarly, in the asset classes that have suffered, the news that has caused these asset classes to become out-of-favor is already imbedded in those prices too.

This means that trying to predict what markets or asset classes will do is a fool's errand. It is better to have a disciplined asset allocation plan and to patiently manage the portfolio towards long-term goals, selling asset classes after they have done well and buying asset classes that have become more attractively-priced.

While large and small cap domestic stocks made the greatest contributions to 2013 portfolio performance, history tells us that it is unlikely that these asset classes will lead the pack in coming years. At the same time, emerging markets equities have struggled and by some measures, this asset class may now be at valuation levels not seen since the darkest moments of the 2008-09 financial crisis. Similarly, emerging markets debt and inflation-oriented investments (TIPS and commodities) have done poorly enough this year to warrant our attention as the historical resilience of these asset classes demand that they figure prominently in any implementation of portfolio rebalancing. Buying low and selling high is never easy or obvious.

Happy New Year.