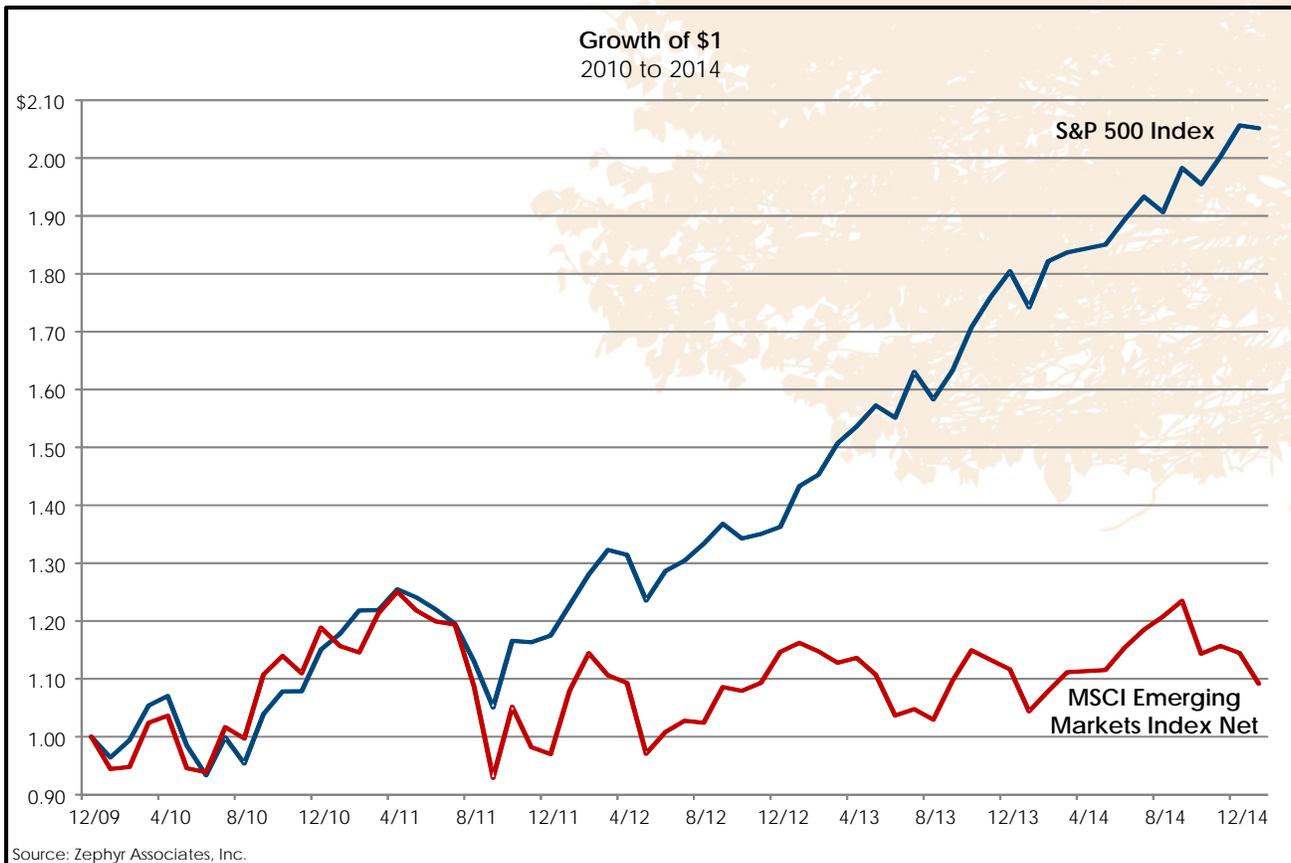


January 2015

CAPITAL MARKETS UPDATE | Globally diversified portfolios earned modest to slightly negative returns for the fourth quarter and full year as domestic and foreign markets diverged. Global equity market returns were nearly break-even for the quarter (+0.4%) and modestly positive for the year (+4.2%). The regional differences were significant. U.S. Small Cap (+9.7%) and U.S. Large Cap (+4.9%) led global equity markets for the quarter while foreign equity markets continued to struggle as growth concerns surfaced in some countries in International (-3.6%) and Emerging Markets (-4.5%). Real Estate led all asset classes (+14.2%) while Commodities plunged (-12.1%) amid the collapse in oil prices. Surprising many, the U.S. bond market continued to benefit from the decline in yields to close the quarter strongly (+1.8%).

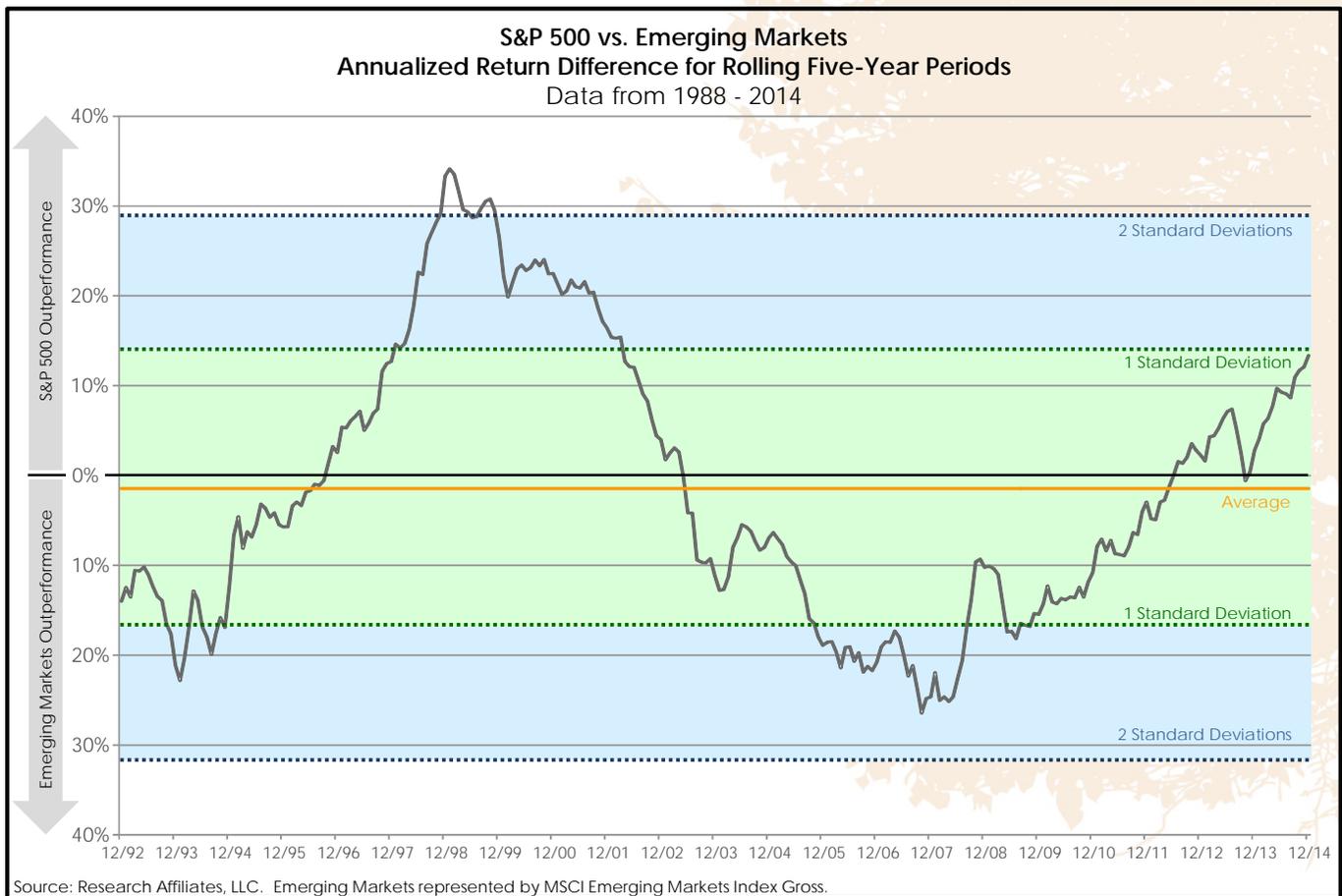
DIVERGING MARKETS | Market divergence continued in 2014 as the U.S. equity market significantly outperformed its foreign counterparts. Domestic dominance intensified in the last four months of the year as the U.S. Dollar spiked in value relative to other major currencies. Most analysts credit these market moves to recent economic data (strengthening in the U.S. vs. weakening/soft abroad) and differences in central bank policy (the U.S. Fed has ended its bond purchase program and expects to raise interest rates in 2015 while Europe and Japan explore more aggressive monetary policy to encourage economic growth).

Widening the scope to the last five years, the divergence in equity market performance has been greatest between the U.S. and Emerging Markets. The chart below depicts the starkly different outcome of investing one dollar in the S&P 500 Index vs. the MSCI Emerging Markets Index.



The annualized return of the S&P 500 beat that of the Emerging Markets by more than 13%. Mathematically, that means the S&P 500 won by more than 13% per year for 5 straight years—dominating indeed!

MARKET CYCLES | Capital market history reminds us that it is normal to have divergent performance among assets in a well-diversified portfolio. Reviewing the full common history of these two asset classes over the last 27 years, it is clear that these markets move in cycles. The line graph below charts the difference in the annualized return of the two markets on a rolling 5-year basis. Plots above (below) the 0% line represent 5-year periods when the S&P 500 (Emerging Markets) outperformed. For example, for the 5 years ending December 31, 1992 the Emerging Markets outperformed the S&P 500 by an annualized amount of 14.0% (29.9% for the Emerging Markets vs. 15.9% for the S&P 500). So, the first plot on the graph for 12/92 is 14.0% in the lower panel. The line graph plots the result of this calculation on a monthly basis from this point through December, 2014. The orange line marks the average difference in annualized returns for the full history of rolling 5-year data. The green band represents data within one standard deviation of the average. The blue bands represent data between one and two standard deviations from the average (an even more unusual event).



Several observations follow:

- Over the last 265 rolling 5-year periods, the S&P 500 and Emerging Markets indices have led/lagged one another by a significant amount for a sustained period in a cyclical pattern.
- The S&P 500's current outperformance at 12/14 has almost reached the one standard deviation level. At one standard deviation, statisticians expect the data to diverge further only 1/6 of the time.
- Though 1/6 is a low probability, the S&P 500's outperformance could easily widen further and/or last longer. The chart confirms that outperformance by both indices has entered the blue shaded area (greater than one standard deviation) in the past.
- Each time index outperformance breached one standard deviation, the trend ultimately reversed (the other index led) and the level of outperformance again reached the one standard deviation level. In statistical speak, the data not only reverted to the mean, it reached a new extreme in the opposite direction.
- Reversal in outperformance can be abrupt, powerful and unexpected. Predicting/timing the turn is close to impossible.

Quarterly Newsletter



INVESTOR EMOTION | Investor emotion tends to play a big role in creating market cycles. It is natural for past returns to shape investor sentiment. How we feel about an asset often depends on how it has recently performed. Strong S&P 500 returns embolden our confidence in U.S. Equities while weak or lagging returns in Emerging Markets challenge our convictions. Reinforcing headlines may even sway investors and perpetuate current trends. However, history tells us that investor sentiment is volatile, subject to abrupt reversals and prone to overextension. The episodic swings in the prior chart illustrate the cyclical change in sentiment among these two asset classes.

As we begin 2015, the consensus opinion of market pundits is to favor U.S. equities over other assets. That is the popular view. The late Benjamin Graham, mentor of Warren Buffet and generally regarded as the father of value investing, famously observed, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Graham was an early advocate of understanding the importance of market psychology (in today's terminology, behavioral finance). In the short run, market prices are the result of a popularity contest (investors vote with their dollars). Accordingly, prices are prone to swing above and below their intrinsic fair value. Over the long haul, the market weighs the fundamental factors and leads undervalued (overvalued) assets to mean revert to the fair value via relative price increases (declines). Compared to the developed world (U.S., Canada, U.K., Europe, Japan, Australia), the Emerging Markets (China, India, Brazil, Russia, Eastern Europe, Latin America, parts of Asia) in aggregate boast more than double the economic growth rate, less than half the level of government debt/GDP, lower labor costs and much more attractive demographics: four big advantages in a slower growth world. The Emerging Markets fundamentals are indeed attractive.

INVESTMENT IMPLICATIONS | Markets will continue to have cycles in which some assets outperform and others disappoint. The pendulum tends to over swing in both directions. History reminds us that maintaining discipline has rewarded long-term investors at the expense of market timers and performance chasers. By systematically rebalancing to strategic asset class targets, we contra-trade against human emotion and use the inevitable emotional swings of the market to our advantage. Following this discipline, we trim what is popular and has done the best and add to what has lagged and disappointed the most. Though uncomfortable at times, systematic rebalancing has paid handsome dividends over the long haul.

TAX ITEMS | Tax time is here again. Fidelity expects to have complete tax data by mid-February and will both post online and mail its annual Tax Reporting Statement at that time. This information is not distributed sooner in order to avoid a series of corrected tax reports (mutual funds often submit several amendments). This statement will provide information that you will need for your 2014 tax return including Form 1099 Dividends and Distributions, Interest Income, Realized Gains and Losses and Arbor's Investment Management Fees that are debited from taxable accounts. Some clients will also receive Form(s) 1099-R summarizing certain IRA activity. Separately, we will send you a summary of any charitable gifts of appreciated stock. Please let us know if you have any questions. Thank you.

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