

## Overview

March was a volatile month. The S&P's500 was down 1.6%. Emerging markets were, on average, down about 2% and the USD was up 4% against the Euro as measured by the performance of EUFX, a short Euro ETF.

Our four model portfolios were basically unchanged for the month and finish the first quarter at +3.36% for the most equity sensitive of them and at +2.82% for the most conservative. All numbers are presented net of fees. As a reference, a 60/40 portfolio consisting of the MSCI ACWI (Morgan Stanley All Country World Index) as a proxy for global equities and the Barclays US Aggregate as a proxy for our fixed income allocations would have been up about +1.74% over the same period.

In a good and significant development for our portfolios, the month of March saw the US Small Cap index finally catch up with its Large Cap brethren in a robust manner. The VTWO, Vanguard's Small Cap ETF, was up 1.76% while SPY, the S&P's 500 Large Cap ETF, was down about 2%. The chart below illustrates this development:



In early March, the VTWO (dark green line) went decisively above the SPY (light green line) and the Small Cap index reduced significantly part of the ground lost over the Large Cap index in 2014.

## Market Commentary

The equity markets are directionless and could remain so for a while. There are many reasons for this, among them: 1) the timing of the FED's next move remains uncertain, 2) equity valuations are high historically, 3) the US economy is chugging along but not on a tear,

4) inflationary policies in Europe, Japan and China seem to offer better investment opportunities for the time being.

Adding to this complicated picture is the persistent strength of the USD and the still unsettled oil market. In that environment, most investors find it difficult to commit more to US equities. Yet, they also do not have enough reasons to move away from them, hence the back and forth since the beginning of 2015.

After reducing our overall equity allocation at the beginning of the year, we do not find ourselves compelled to drop it further at this point although risk levels are rising.

## Tilts and Allocations

Below is the chart of EUFX since the beginning of 2015. EUFX is a short Euro/Long USD ETF that we bought, in late February, in order to partially hedge our exposure to EZU, our Eurozone equity investment vehicle of choice.



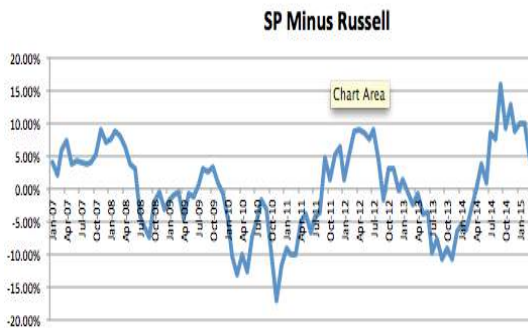
EUFX went up about 4% in March. During the same time, EZU was trading water at -10%. As a result, our partially hedged Eurozone position was up a little over 1% during the month. Since the beginning of the year, our Eurozone equity allocation is up 7.1%. The inflationary measures of the ECB over the next few months should continue to provide good support for it. We anticipate additional gains.

Since the beginning of the year, our second major portfolio tilt has been in favor of the US Small Cap sector.

In an earlier newsletter, I indicated that the large performance gap that developed in the first part of 2014 in favor of the Large Caps was not likely to last. I decided to capitalize on a probable reversal of this trend by reducing our Large Cap allocation, increasing in the process the relative weight given to our Small Cap investments in our portfolios. We have been well rewarded for it in March, when the S&P 500 dropped 1.6% while the Russell 2000 increased by 1.76%.

As far as our analysis indicates, this trend is not over and we intend to maintain our bias until the gap is filled and a bit beyond.

The chart below illustrates why.



It plots the difference between two moving averages: the last twelve months performance of the S&P's 500 index minus that of the Russell 2000. It is adjusted monthly as a new monthly performance data point replaces an older one in each series.

Since 2007, the average differential between the two series has been close to zero, with wide swings in both directions around that average. The gap tends to oscillate between extremes of -15% to +15%. It tends to reverse itself in the +/-10% to +/-15% zone.

In July 2014, the gap was at 15%, in favor of the S&P's 500 (last top on the above chart). This is what prompted us to go overweight the Russell 2000, within our US equity allocation. Since then, the Russell 2000 has filled about 66% of the gap. The differential is still at a solid 5% and above the long-term average. Consequently, we think that this retracement is not over yet and will keep our relative bias unchanged.

Mean reversion is a powerful force.

## Concluding remarks

A friend of mine, reader of this newsletter, suggested that I use a benchmark against which to measure the performance of the model portfolios discussed here. My response to this request will conclude this newsletter.

First, I believe that benchmarking does more bad than good in general. I manage portfolios to deliver to my clients risk adjusted performances that meet their requirements both in terms of performance and in terms of risk. I do not manage portfolios to beat a benchmark. A long-term annual performance of 4.5% may be perfectly adequate for an older investor who is particularly risk averse, whether the S&P's 500 has delivered 6% over the same period or not. On the other hand, a 6% long-term annual average performance may be needed for another investor to amass enough of an asset base before retiring. I will manage his portfolio differently, again not paying real attention as to where the S&P's 500 is over that period of time.

Second, as soon as an investment manager uses a benchmark and is judged by his clients on her ability to beat it, her management style changes and she ends up managing, not to perform, but to avoid losing against the benchmark. The interest of the investor is not really well served in the end.

Now, I also understand the very human need to measure. So, here is what I am willing to do going forward.

Each month I will present the performance of the four model portfolios together with that of a 60% equity, 40% fixed income portfolio. This "reference" portfolio will be made of a 60% allocation to the MSCI ACWI, since my equity allocations are global, and of a 40% allocation to the Barclays US Bond Aggregate, since my fixed income allocations are all US. I will not manage the model portfolios to beat this "benchmark". Rather, I will offer it monthly as a signpost for those of you that may find it useful. I offered the first such signpost earlier in this letter.

As always, please feel free to give me your comments and suggestions. I wish you all a great spring season. We need it!