INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 4TH QUARTER 2014

The ACM Journal

Modeling

Just a few months ago, my daughter, Nyla, was struggling with an important life decision. At the ripe old age of four, she was pondering her future. She couldn't decide whether to be a "fashion girl" or a princess when she grows up. A tough choice indeed.

It will likely be a few years before she has to finally cross the Rubicon, but interestingly, a couple of recent events may help her along her career path.

The first was an invitation to model socks for my wife's friend who lives, and owns a business, in Toronto. This friend designed a line of novelty footwear, and needed some willing participants for her website. Nyla's pictures didn't make the final cut, but she had fun posing for the camera. My boys and I reluctantly agreed to participate, had less fun, complained the whole time, but did make it to the website. You can view us here: www.mummewear.com (then click on "Dad & Me").

The second opportunity was to model boots for a friend who is importing a line of high-end British Wellingtons to the U.S. My friend, Jack, asked me at least a week in advance if it would be ok to take some pictures of Nyla, the boys, and my wife Nipa in the boots. I readily agreed, but somehow forgot to tell anyone

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Portfolio Review

The good news is that the stock market had a strong year in 2014. The S&P 500 returned almost 14%. The bad news is that almost no one earned returns that high.

Because virtually every other asset class underperformed, a diversified portfolio likely earned around half of the return of the S&P 500. Mid-cap stocks earned a still-respectable 10%, but small-cap stocks returned only 6%. International stocks actually lost money.

Economic Improvement at Home
The economy picked up steam last year. The unemployment rate dropped to below 6%, automotive sales hit a record high, consumer spending rebounded some, and interest rates and inflation remained tame. Economic growth, as measured by GDP, still wasn't terribly robust, but slow, steady improvements to the economy created a favorable environment for stocks.

Continued Turmoil Overseas
Overseas, the story was less rosy. Economies in the developed and emerging markets have been slowing down, and some ended the year in outright recession. International stocks posted losses for the fourth quarter and full year periods. Interestingly, as measured in local currency, international stocks actually didn't perform so badly. Developed markets were up almost 6%, and emerging markets were up a little better than 5%. However, the U.S. dollar appreciated versus foreign currencies late in the year, which hurt international stock market returns for U.S. investors.

Despite the poor performance, there are reasons to be optimistic about the future. For example, valuations are significantly lower in international markets than they are in the U.S. Also, despite slowing economic growth, many emerging market economies are still growing much faster than our domestic economy.

Looking forward, it is also very likely that the European Union will cut interest rates, starting a round of "quantitative easing," similar to what we have done in the U.S. over the past several years. This should be good for international stocks, at least in local currency. However, if interest rates in the U.S. rise, as interest rates overseas fall, it is likely additional pressure will be put on foreign currencies, which could continue to hurt international stock market returns for U.S. investors. We'll have to see which force is bigger: stock gains or currency depreciation.

REITs: A Shaky Foundation
Investors' love affair with yield continued in 2014. Real estate investment trusts (REITs) returned twice as much as stocks, earning

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over 27%. With valuations for REITs at record highs, and tepid business conditions, the only logical conclusion I can come to for REIT's strong showing is that they pay a lot of income. With Baby Boomers aging, the logic goes, they will increasingly need to generate income from their portfolios. Accordingly, REITs, master limited partnerships (MLPs), utility stocks, junk bonds, and other high-yielding investments have earned returns that seem almost unreal. I'm not expecting the party to last, particularly if the Federal Reserve raises interest rates later this year, as it is threatening.

Bond Rally Continues

Surprisingly, bonds continued to defy gravity last year. As prices rose, interest rates for the ten-year Treasury bond, which move inverse to prices, dropped to roughly 2% toward year end from almost 3% at the beginning of last year. This resulted in a gain of 6% for the broad bond market, well ahead of what most were predicting for the year. The Fed has been warning of a rise in short-term interest rates in 2015, which could finally put an end to the bond market's rally. Even so, I don't expect a major rout, just a slow deflating of bond values as interest rates slowly rise to more reasonable levels.

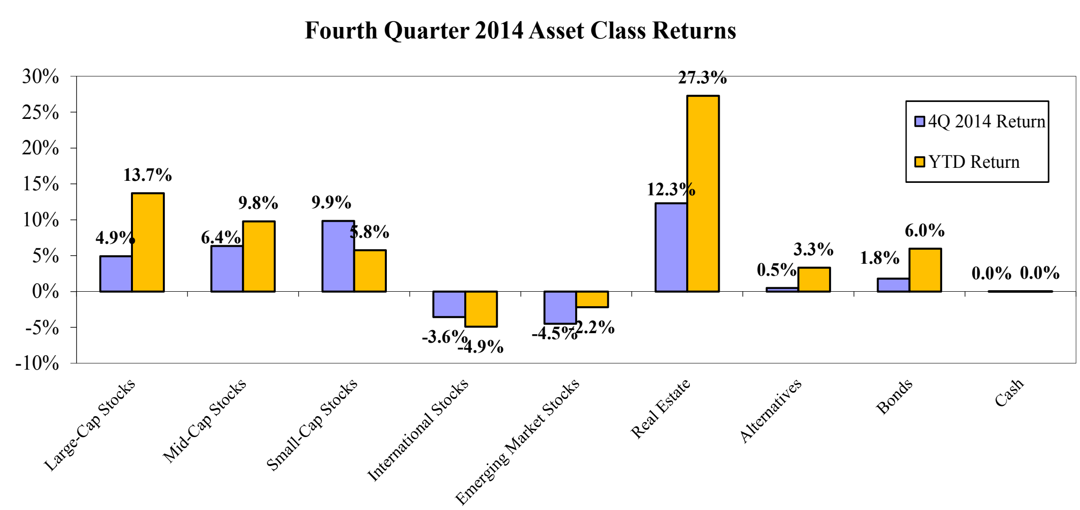
Alternatives Strong…Finally

Alternative investments, as measured by the HFRI Index, posted modest returns. However, many of the alternative funds we use performed much better. The reinsurance fund we use was up roughly 11% for the full year, our managed futures fund rose almost 10%, our multi-strategy hedge fund returned over 7%, and our "style premia" fund earned over 11%. It has been several years in the making, but as stock market volatility picked up late in the year, alternative investments are finally having their moment in the sun. In fact, this is exactly why we use them. They provide a nice hedge against declines in the stock market, and alternatives may be the only form of diversification that offered much benefit in 2014.

A Look Ahead

Looking ahead, many of our clients have expressed trepidation about the direction of the stock market. It seems everyone expects a large decline in the near future. This is certainly possible, and no one can predict the market, but there are many positive characteristics to our economy, which could support the stock market for some time to come. Corporate profits remain high, stock valuations do not appear overly stretched, a dramatic decline in oil prices should add to economic growth, and there is some nascent evidence of wage growth, which should fuel additional consumer spending.

There will of course be surprises and headwinds as well. The Fed is likely to tighten monetary policy sometime in 2015, which could slow down economic growth and hurt valuations. However, during past Fed tightening cycles, it took several years, and an overshoot by the Fed, to finally bring the market down. We therefore don't expect that 2015 will be the year of a dramatic decline. It will, however, probably be a year of increased volatility. After five years of strong gains, we expect to see stocks bounce around more than we are used to. It would not be surprising to see a dip of 10% to 15% at some point during the year, but we expect that will be short-lived. If such an event does come to pass, we'll be using it as an opportunity to rebalance, take tax losses, and improve our position for the long term.



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

The Hard Way

We're constantly telling my middle son, Amer, that there is a hard way and an easy way to do things. The translation is: you will do what we are asking, so you can do it now, or you can do it after we yell and get upset for a while. Invariably, he chooses the hard way.

In fact, he's so obstinate, that he practically starved to death a few years ago. We told him that unless he ate his salad, he could eat nothing else. Two and half days later, during which he didn't eat at all, we caved. He has missed birthday parties, family events, and even Halloween one year, rather than give in to whatever small demand we made of him in exchange for participation. One year he carried a grudge for several months against Santa Claus because, weary from his global travels, Santa had eaten part of Amer's gingerbread house. This is a kid with unshakable convictions.

Sure, obstinacy runs in my family, and while she wouldn't admit it, I've seen some similar traits in Nipa's family as well. So, poor Amer likely inherited some of this from both his mom and dad, but our other kids aren't nearly as stubborn. However, it occurred to me the other day that I may be more to blame for this than I previously thought.

I woke up one Saturday morning a month or so ago. I fed the chickens, cleaned out the wood stove, brought in some wood, and started a fire. I then decided it would be nice to make some juice with the juicer Nipa bought for us. I looked in the refrigerator, but there weren't many vegetables, so I decided to get some carrots from the garden. The ground was frozen, so I had to get a shovel from the barn, pry up the carrots, break the snow and frozen soil away from them, and then rinse them off with the hose. By the time I got inside to make juice, it was twenty minutes later, and my hands were frozen and bleeding.

It struck me sometime later that this is probably not the way normal people spend their Saturday mornings. They likely wake up, turn up the thermostat, pour some juice from the jug, and read the paper. It also occurred to me that the way we live is not necessarily a bad thing (despite what my wife thinks).

That carrot juice tasted pretty darn good because of all the effort that went into making it. I also take a certain masochistic pleasure in cutting and stacking firewood. There's something special about having a fire in your house and knowing that you can stay warm, even during a prolonged power outage. The same goes for the eggs and food we raise: they somehow taste better because of the effort. Thoreau called this living deliberately, and I think it is great.

We also bring this philosophy to work. At Armbruster Capital, we do most things the hard way. In an era of prepackaged products, cookie-cutter model portfolios, and standardized advice, we still do our own research, and customize each portfolio we build. We read the research that the rest of our industry seems to ignore, and put into practice ideas that make sense. We also crunch our own numbers to test everything we do. While this seems prudent and intuitive, most of our industry does not follow these practices. In the end, I think our long-term results, particularly after fees and taxes, will reflect the extra effort.

So, it has become clear that my son is doomed to a life of doing things the hard way, and it is all my fault. In the end, that probably isn't so bad.

Indexing Continues to Shine

Practically every year, the stock market pundits declare that the coming year will be a "stockpicker's market". What they mean is that selectivity will be key, and only a serious stockpicker will be able to ferret out the winners and avoid the losers.

Well, the data shows that few years are actually stockpicker's markets, and 2014 was no exception. In fact, 2014 was the year that proved a dire embarrassment for stockpickers. Through September, the latest data available, only 9.3% of actively-managed mutual funds that invest in large-cap U.S. stocks have outperformed their benchmark, the S&P 500. In an average year, 38.6% of managers outperform their benchmark, according to the data.

It turns out that this particularly nasty environment for active managers has been in place since 2008. Through mid-year 2014, 87% of large-cap managers had underperformed their benchmark over the prior five years. The numbers were similar for mid-cap and small-cap managers, and even worse for actively-managed real estate funds.

We've been able to find data back to the early 1900s indicating that this is not a new phenomenon. The

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Firm News

We had another busy year at Armbruster Capital. We grew our assets under management and the number of clients we serve. However, more importantly, we continued to augment our infrastructure and capabilities.

We added two team members in the past several months, including one in early January. There are now seven of us working at ACM, which is a huge leap from where we were a few years ago. Robert Wendler is our newest addition. He is a recent college graduate, and will be helping us with a number of administrative and research tasks while he learns our business. He will likely be sitting for the CFA exam in the not-too-distant future, so we have high expectations for him in the future.

We also continued to enhance our technology in order to increase productivity and data security. We installed a new server late in the year, and added a number of safeguards to our systems. While all of this costs way more than I could have ever imagined spending, the improvements are significant and important.

Our 401(k) business also grew nicely in 2014. We've always had a smattering of these accounts, but it was never a focus for us. That changed with the addition of Bill Skuse to our team last year. Bill has created a new, enhanced offering, and has been out finding new clients for us. Interestingly, Bill has found that our approach to 401(k) plans is a huge improvement over what we find in most of the market. We've been able to save our clients very substantial amounts on fees, improve their return potential, and enhance their ability to meet their fiduciary obligations. I expect this will be a big market for us going forward.

We'd all like to send a huge "thank you" to our clients. Your support and confidence mean the world to us. We appreciate being trusted not just with your money, but also with the good times, tough times, family moments, new business endeavors, retirement plans, and dreams that you share with us. Please feel free to call on us if you need ANYTHING.

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marketing muscle behind large, active managers has kept them afloat, but significant underperformance, high fees, and a lack of focus on tax-efficient investing are finally coming to the fore.

Index funds, which simply mirror the returns of market benchmarks for a low cost, have significantly outperformed their actively-managed brethren, and investors are starting to take notice. Through last November, investors poured $244 billion into index funds year-to-date, while pulling $13 billion from actively-managed funds. Ten years ago, roughly 10% of stock market assets were invested in index funds, today the number is above 30%.

We've been using index funds in our portfolios since the inception of our business. The benefits are hard to ignore.

Modeling

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else of our arrangement. Jack and his photographer showed up one day, just as Nipa was getting home from running errands. I explained that she needed to get ready for the photo shoot right away. Not having the proper time to adequately primp and beautify, Nipa was less than happy with me that day. Still, they took some great photos, and Nyla and Nipa made it to the home page of www.pbwellies.com (you have to wait a couple minutes for the pictures to cycle through).

So, while I don't want her to rule out the princess option, Nyla is handily building her modeling resume. Perhaps she could combine her interests and become a foot model specializing in glass slippers.

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