The ACM Journal

An Investment in My Health

The winter months in Upstate New York bring not just snow, but also gray skies, vitamin D deficiency, and ultimately a sedentary lifestyle that leads to seasonal affective disorder. This year seemed particularly tough, and I was not immune. After several months of complaining how I was tired, stressed, and just plain lousy feeling, my wife decided that it was time for me to get healthy.

Diet has certainly been a part of this, but she had a more holistic view of fitness in mind. So, on a recent Sunday, after much cajoling and reassuring, we headed off to my very first Yoga class.

I'm sure Nipa reasoned that this was a way to kill several birds with one stone, as Yoga is as much a mental and spiritual practice as it is physical. Thus, she could make me a better human, and more importantly, husband, across several dimensions all at once.

When we arrived at class, we were crowded into a fairly small studio, and the heat was turned up to around 90 degrees. The stifling heat, I'm assured, is to allow practitioners to "deepen their work". The instructor shared the theme of the class with us, which was "transitions". She talked

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A Forecast for Volatility

Those who regularly make forecasts of the economy, stock market, and interest rates are typically wrong. Independent researchers have found that the experts make correct forecasts 47% of the time. This makes them slightly less effective than a coin flip, or the proverbial blind chimpanzee throwing darts at the stock tables. With a system as complicated as the economy or the stock market, it is virtually impossible to consider all the various drivers of change. Thus, it is virtually impossible to make informed, correct forecasts on a consistent basis.

With that as a preamble, I'd like to issue my forecast for the future of the capital markets. Be forewarned: my forecasts are as useless as anyone else's. However, I'd like to go through this exercise for two reasons. First, I'm constantly asked what I think of the markets, and so, here are my thoughts. More importantly though, I'd like to issue a forecast as a notice that the environment will likely change in the near future.

For the past six years, we have enjoyed a very stable, significant run in the stock market. At the same time, bonds have also performed quite well as interest rates have fallen to record lows. There has been nary a flutter from these trends since March 2009. I believe that is starting to change.

Forecast number one: the stock market will continue in its upward trend for at least two to three more years. I don't think we'll see the kinds of year-over-year gains we've experienced the past several years, but I believe the stock market will continue to rise in value. There are certainly pros and cons in the economy, but overall, the balance seems to be positive enough for stocks to sustain their rally.

Forecast number two: interest rates will rise, starting this year. The Fed has made it pretty clear that it will start increasing short-term rates soon. Back when Alan Greenspan was the Fed chief, you had to read the tea leaves to figure out what he was going to do. However, under Ben Bernanke and Janet Yellen, the Fed has been more transparent. I'm inclined to take them at their word that rates will rise.

The Fed only sets short-term interest rates, so there are some saying that longer-term rates will remain low. This is certainly possible, but since 1975 short-term Fed Funds rates and the yield on the ten-year Treasury note have had a correlation of 92%. It may take a few months for longer-term bonds to react, but I believe that by year end, we'll see higher interest rates across the yield curve.

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Forecast number three: volatility will increase. This is the most important of my forecasts, and really the reason I'm writing this article. It is highly unusual for the stock market to be as sanguine as it has been the past six years. It will not continue. Returns will be more muted, and the roller coaster ride will resume. Buckle up. I expect to see at least a 10%, and possibly a 15% drop in the stock market this year.

That is not to say that stocks are going to crash, or that we should sell out of them, or that doomsday is nigh. As my first forecast indicated, I think stocks will continue to rise. However, going forward, the rise will not be linear. It will be bumpy. This can create opportunities, but it also can be uncomfortable.

All of our clients have investment and asset allocation plans that are designed specifically for them. They are set up for long-term growth, but also to provide some downside risk control for the market declines. So, when the market bounces around, or declines, don't panic. The economy will continue to function, businesses will continue to earn profits, and market declines will invariably be offset by future recoveries. Markets rise and fall, and we need to start getting ready for some of the latter.

Valuation

As the stock market continues to rise, we thought it would make sense to revisit our previous discussion of valuation. Stock market valuation has been a topic of concern, and debate, for some time now. Robert Shiller, the Nobel Prize winning professor from Yale has been talking about his favorite valuation metric, the cyclically-adjusted price/earnings ratio, and believes it indicates significant overvaluation in the stock market. The fact that Robert Shiller has correctly warned of past market crises, only fuels the media frenzy around his current opinions.

However, there are other valuation metrics that show the market is not overheating. Valuations appear fair by most measures, but even somewhat undervalued by others. Another famous finance professor, Jeremy Siegel believes fair value for the Dow Jones Industrial Average is currently 20,000, which is still quite a bit higher than today's level.

My own take on it is that there is no true way to know if the market is overvalued, and it really doesn't matter anyway.

Back in 1996, when I was working on Wall Street, the strategists and economists with the most experience were warning that P/E ratios were stretched, and the market was likely due for a fall. Indeed, the stock market was trading at valuation levels that it had never seen before. It was clear to just about everyone that the market was truly overvalued.

However, even with decades of experience and reams of solid research to back their views, these Wall Street veterans were dead wrong in their conclusions. The stock market continued to rise at a very rapid pace for four more years. When it did finally correct in 2000, the decline was very severe, but even with a drop of roughly 50%, the market never retraced all the way back to 1996 levels.

Calling market peaks and troughs, using valuation or any other metric, is a tough game to play. Today's market may be frothy, or not. We'll never know until well after the fact. So, rather than try to second guess the market, we'd rather implement a long-term plan that tunes out the short-term fluctuations, but positions our portfolios for long-term growth.

Portfolio Review

Stock market returns in the first quarter of 2015 reversed many of the trends of 2014. Where large-cap stocks performed strongly last year, they began 2015 with a poor showing. Indeed, the S&P 500 earned only 0.3% for the first three months of this year.

Small-cap and mid-cap stocks earned relatively modest returns last year, compared to the S&P 500, but are up considerably so far this year. Given the stock market volatility in the first quarter, it is surprising that smaller stocks are outperforming. Usually riskier stocks perform worse during

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Portfolio Review

periods of high volatility, when investors gravitate toward higher-quality investments. Still, smaller stocks likely appeared more attractive than their large-cap brethren, as valuation levels were similar across the size spectrum. This is particularly true since smaller stocks generally have stronger growth prospects.

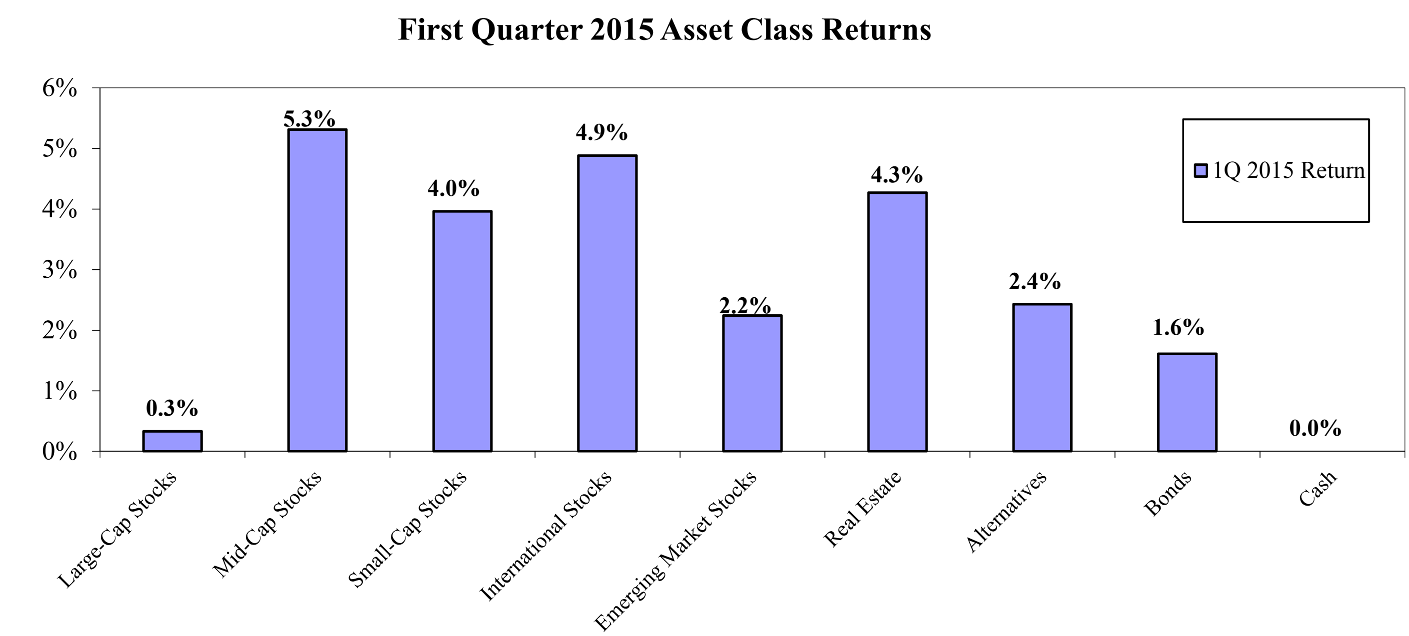
International stocks also rebounded nicely this year. After posting losses last year, both the developed and emerging markets earned decent returns in the first quarter. In local currency, international stocks performed even better. Developed market stocks earned over 10.0%, but as the U.S. dollar continued to rise versus foreign currencies, the returns were watered down for U.S. investors. With the dollar trading at lofty levels, overseas stock market valuations looking attractive, and monetary stimulus in foreign markets, now is likely a terrific time to be investing in international stocks.

Real estate was the one constant between 2014 and 2015. Real estate investment trusts (REITs) continued their rally into the New Year, and posted a gain of 4.3%. While this rally has been impressive, we continue to believe that publicly-traded REITs are due for a correction, probably beginning later this year when the Fed is likely to raise short-term interest rates. Forecasting market swings is all but impossible, but REITs tend to be sensitive to interest rate swings, and they are trading at valuation levels as high as they have ever been. Certainly the risk of poor future performance is elevated.

Alternative investments posted solid returns, earning 2.4% in the quarter, as measured by the Hedge Fund Research Fund Weighted Composite Index. Our alternative investments have been very encouraging the past nine months, both in terms of returns and risk control. As stock market volatility ramps up, we expect them to further augment risk-adjusted returns.

Bond returns were decent in the first quarter. If interest rates rise later this year, bond prices would come down. However, an orderly interest rate rise wouldn't necessarily be problematic for long-term bond investors. In fact, we would like to see interest rates return to more normal levels so that bond investors are compensated more appropriately for the risk they are taking on.

Overall, the first quarter wasn't a bad period for investors with diversified portfolios. Last year diversification was a detriment, as only those invested in large-cap, domestic stocks earned solid returns. Fortunately, so far this year the tools of solid portfolio construction seem to be back in vogue.



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.

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about the change of seasons and the natural transition from winter to spring, but my mind drifted to hopes that I was going to be transformed from an out-of-shape slob into more of a Greek Adonis. It turns out that doesn't happen with just one class.

The particular type of Yoga we enjoyed was Vinyasa, which I believe is an ancient Sanskrit word for "ouch". It involved uncomfortable bending, twisting, stretching, and reaching. The class was incredibly rigorous, and surprisingly to me, involved a lot of strength that I clearly did not possess. About 20 minutes in, I wasn't sure I could take any more. Then, after a long stretch of poses that I executed poorly, we were instructed to do "Child's Pose". This involved laying down on the floor, which I found I was actually quite good at. Downward Dog, Gentle Warrior, Sun A (not to be confused with Sun B), and the rest I wasn't so great at, but I was a natural at Child's Pose.

So, while I didn't quite realize enlightenment during my class, I did realize some new things:

1. I am very out of shape.
2. Sitting in a windowless office beneath fluorescent lights for ten hours each day is not healthy.
3. Even very fit, attractive women in tight Yoga apparel start to emit off-putting odors when they exercise in extreme heat.
4. The mental and spiritual benefits of Yoga must kick in after you have been at it for a while. I mostly just felt anguish.

When the class was finally over, the instructor walked around to offer words of encouragement to everyone. I appreciated the sentiment, but found it hard to get up to speak with her. I was still engaged in Child's Pose.

Compliance Corner

The nature of our business requires us to obtain sensitive personal and financial information from our clients. As a registered investment adviser with the United States Securities and Exchange Commission (SEC), we must adopt policies and procedures to protect this nonpublic, personal information. Our policy mandates that ACM employees are prohibited from disclosing nonpublic, personal information to any person or entity outside of our firm, except as authorized by our clients or an appropriate regulatory institution. We also take all reasonable measures to ensure secure transfer and/or disposal of documents containing sensitive information about our clients.

Along the lines of confidentiality, we have invested quite a bit in data security in the past year. Our CFO, Chris Cebula, has a background in auditing and experience with technology. He has significantly enhanced our systems to provide additional safeguards against hacking, viruses, and other nasty IT issues. At this point, we believe our system is more robust than most of our larger competitors.

Additionally, registered investment advisors are required to file Form ADV with the SEC or state securities regulators on an annual basis. A copy of our updated Form ADV is available at any time upon request. A copy of this brochure is also available on our website. Please let us know if you would like us to send you a copy.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and free of conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

Armbruster CAPITAL MANAGEMENT, INC.

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