Investment Commentary

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Aviance Capital Partners
Focused Asset Management

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Risk sensitivities in the market have been building in 2014

While the overall stock market, as measured by the S&P 500, has performed admirably thus far in 2014, smaller companies are down for the year. Specifically, larger companies have bested smaller companies by an unusually wide margin of 12.9% over last nine months; as of 9/30/14.

Market Index	Description*	Year to Date Total Return (9/30/14)	3rd Quarter Total Return (9/30/14)
Russell Top 200 Index	Mega-Cap – Largest 200 US public companies	8.5%	1.7%
S&P 500	Large-Cap – Largest 500 US public companies	8.3%	1.1%
Russell 2000 Index	Small-Cap – Of the largest 3000 companies, these are bottom 2000	-4.4%	-7.4%

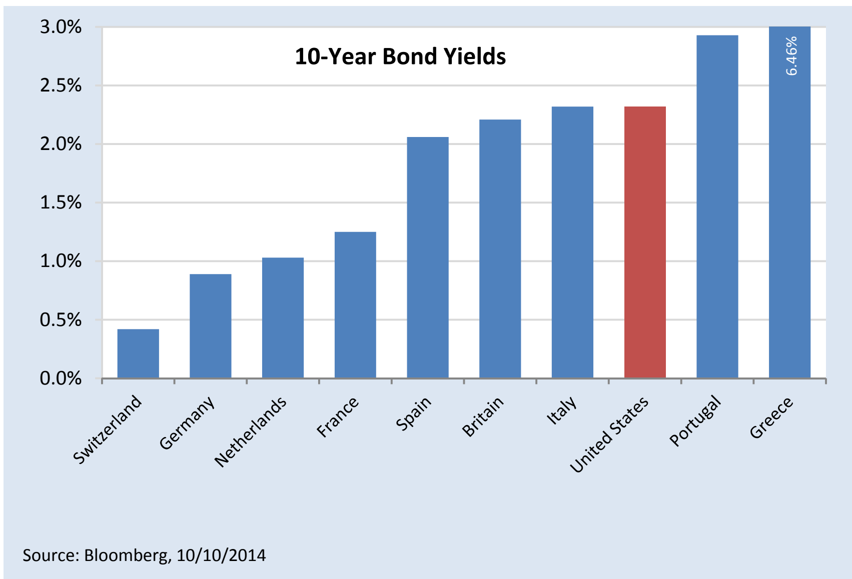
*Descriptions are generalized; precise definitions and compositions are available upon request.

Since smaller companies tend to have higher levels of volatility, they are generally viewed as riskier. Therefore, as small-vs.-large company under-performance has gathered steam, especially over the past three months, it is likely that overall risk sensitivities have increased. This aversion-to-risk theme seems to be expanding to the broader stock market as broad indexes have begun to gyrate widely since the beginning of October.

Why has this aversion to risk picked-up? In any given period of time, there is good news and bad news. It's easy to cite bad news items to explain why the markets are now spooked (Halloween approaching and all). In a broader sense, the common *causation* of increased market sensitivity towards risk, in our view, relates to certainty. Essentially, market participants are less certain of the future – be it Federal Reserve activity, economics, civil and military conflicts, or epidemics.

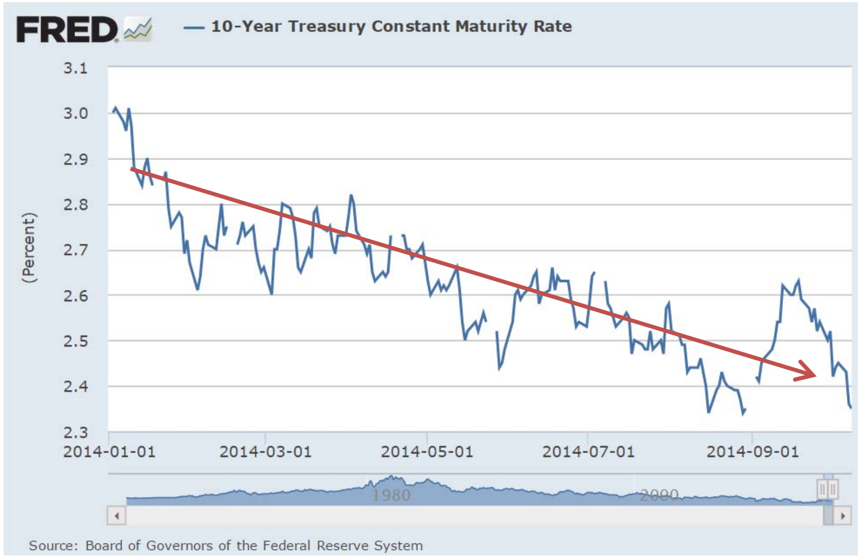
International monies are running into the arms of the U.S. Dollar

With low international bond yields and an uptick in global uncertainty, funds are flowing into the United States – pushing up the value of the U.S. Dollar. A rising dollar is not only consistent with better paying bonds, but an international flight to safety given the perceived economic stability of the U.S.



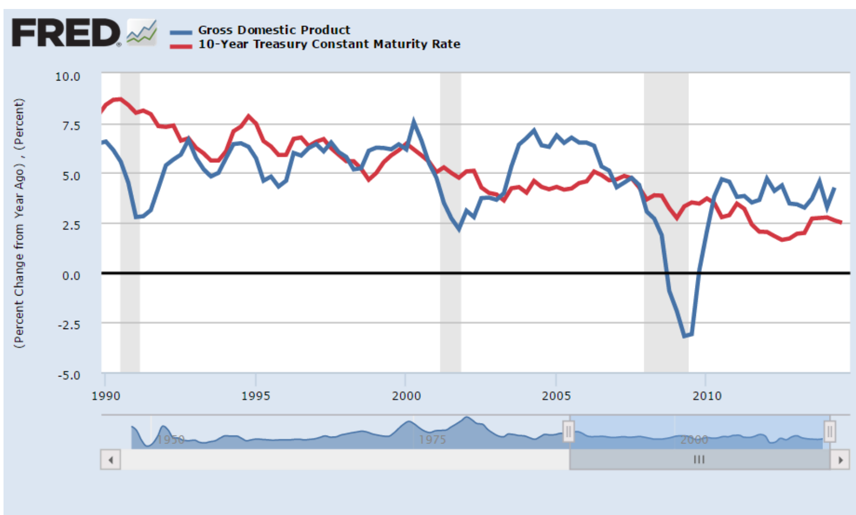
Declining yields are also a sign of rising risk aversion

Consider yields on high-quality bonds, such as 10-Year Treasury Bonds. These rates have fallen in 2014 as a higher demand for bonds pushes up prices and down yields – indicating a move towards the predictable nature of regular coupon payments and pre-determined maturity dates. Specifically, the 10-year Treasury rate has fallen from 3.0% in early January to 2.3% in October. This increase in overall demand for bonds has occurred despite the winding down of bond buying by the Federal Reserve.



Despite the market's rising concerns about risk, we remain favorable on economic growth

Falling bond yields are frequently interpreted to mean lower inflation expectations or slowing economic growth. Yields are a reflection of market sentiment but are hardly a crystal ball. Currently, yields of 2.3% indicate rather low inflation potential and tepid growth potential for the US economy – a view that we do *not* share.



Specifically, our view is that the combination of faster job growth, lower energy costs, and rising confidence will continue to push the economy in the right direction at a faster pace than the past few years. Further with a well-capitalized financial system (i.e. banks) and an abundance of excess banking reserves, we believe lending activity is set to accelerate. Finally, with reasonably strong corporate balance sheets and larger than usual profit margins, businesses appear to have room to accelerate hiring and investing activities.

The bottom line is we see positive signs in the economy with little to get in the way from the banking and business sectors.

Given the backdrop of rising concerns in the market yet decent economic growth, how should investors allocate capital?

Prudently allocating investment capital relies more on longer-term planning based on investor circumstance and less on shorter-term market predictions. This approach tends to be superior in two ways:

- When investors allocate too aggressively into an asset class, there may be times when that asset class performs poorly, and the investor is forced to sell at a bad time – either based on fear or the need for capital.

- A longer-term, strategic approach means funds tend to be rebalanced into more attractive markets – buying into asset classes that have already fallen and selling ones that are inflated.

However, there are occasions when a modest degree of tactical decision making is relevant.

Today, bond yields are lower than what we believe to be normal levels which tend to be closer to total (or "nominal") economic growth for government bonds and higher than inflation expectations. In order for bond rates to rise significantly, the threat of accelerating inflation needs to reside more firmly in our collective conscious. This tends to happen when economic growth picks up and actual inflation is higher than current levels. Consequently, we are looking for these sign posts before making any bold short-term calls on interest rates.

As risk sensitivities remain elevated and stocks wobble, we remain favorable on a bit of spare cash. On the other hand, we remain optimistic on economic growth which should bode well for businesses and earnings growth. Earnings growth and solid stock returns have historically gone hand-in-hand. As a result, we remain in shopping mode as opportunities present themselves.