Bonds : Why Fixed Income Diversification is important NOW

June 2013

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Bonds in May

May was the beginning of a rocky ride for bond investors and could be indicative of what the rest of 2013 might look like if fears continue with regard to a reduction in economic stimulus. "Tapering" of stimulus activity by the Federal Reserve is an eventuality, however, anything less than a meticulously managed exit could mean a tough time for markets.

QEIII and Central Bank Activity

Since September 2012, the Federal Reserve has been engaged in an economic stimulus policy called Quantitative Easing III (QE III). The QE III policy follows several other stimulus programs including QE I, QE II, and operation twist, all of which are designed to assist in economic recovery post the 2008 financial crisis.

In addition to the Fed, most of the worlds' major central banks have committed to some form of open-ended monetary or fiscal policy as detailed in the table on page 2 following.

However, interest rate reductions and bond purchases have become a routine policy tool with diminishing impact as well as mixed results.

Counterintuitive Results

Unified central bank action has also made traditional portfolio risk management techniques much less effective. Market results, for 2013, have now become somewhat counterintuitive. Big improvements to unemployment, consumer spending and corporate profitability should mean positive market performance, right? Not necessarily. Overly positive economic indicators could, at this time, actually have a negative market impact if sentiment increases that the Fed will taper sooner rather than later and investors feel that the market may not be given enough time to "adjust".

Rates and Rotations

Prolonged periods of low interest rates also present quite an income problem for a host of investors: pension funds, annuities, retirees, and trust beneficiaries who count on portfolio income to meet return goals and requirements. These investors are now forced into traditionally more risky asset classes to reach for the required yield to meet their obligations. This kind of shift to more risky asset classes, some feel, will proliferate into a large "rotation" from bond investments to stock investments.

In addition, prices on longer term bonds will see more of a decrease as rates rise— so, although coupon payments on new bond issues will increase, prices on existing bonds with lower coupon rates will decrease and that can wreak havoc on a portfolio if investors are not able to hold individual bonds to maturity due to cash needs, or if there is exposure to bond mutual funds. We've already seen the beginnings of investors moving from longer to shorter term bonds—termed the "duration rotation" within the fixed income space.

Tapering Timing

At this point, every portfolio manager and hedge fund guru should be focused on the timing of the tapering. The Fed target for unemployment is 6% and inflation at 2%. With Bernanke leaving his position as Chairman of the Fed in January 2014, many suspect he could leave QE III tapering and all its potential for market turbulence to his successor.

Regardless of the timing, it can be dangerous territory when stocks AND bonds are falling simultaneously—there is a potential for overall market instability to develop. A good example is Apple: the stock price on May 3, 2013 was $447.02 and on June 13, 2013 $435.96, a 2.5% decline. For the same time period, Apple bond losses range from 3.7% to 6.2% depending on date of maturity ranging from 10 to 30 years respectively.

Example:

We have illustrated below what your portfolio performance could look like for rest of 2013 starting with $1 million on May 1: Portfolio A shows a 60/40 mix of muni bonds and large cap value stocks with no adjustments through year end (and May performance repeats through December). Portfolio B shows results if May performance repeats monthly to year end and diversification adjustments are made now.

$1 Million Investment: May repeats each month to December 2013				
		Allocation	Return	Results
Portfolio A - Little Diversification & No Adjustments				
Municipal Bonds	60%	$ 600,000	-8.96	$ 546,240
Large Cap Value	40%	$ 400,000	7.84	$ 431,360
		$ 1,000,000	-2.24%	**$ 977,600**
Portfolio B - Diversified and Adjusted for market conditions				
Diversified Bond Portfolio	60%	$ 600,000	-1.07	$ 593,562
Diversified Stock Portfolio	40%	$ 400,000	4.17	$ 416,692
		$ 1,000,000	1.03%	**$ 1,010,253**

See page 2 for asset allocation details of diversified portfolio

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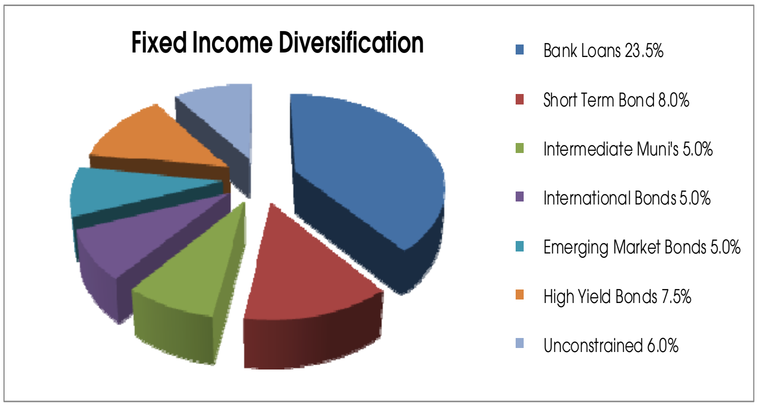

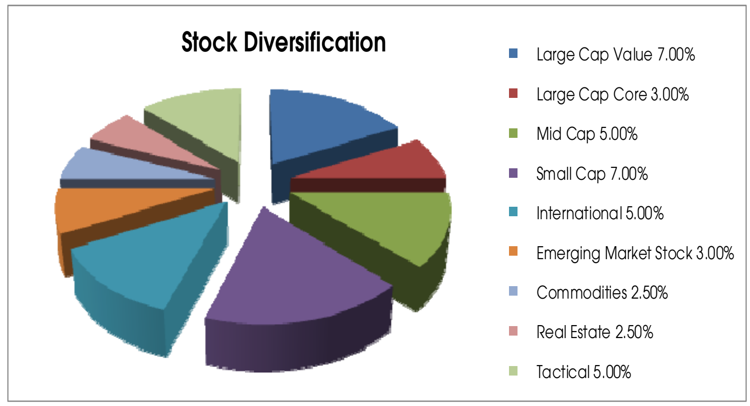

Stimulus Title	Date	Program Description	Goal	Effectiveness
U.S. Quantitative Easing (QE 1)	November 25, 2008	Fed bought $600 Billion in mortgage backed securities (MBS)	Arrest Financial Crisis	Considered Successful. Weakened US Dollar and Strengthened Equity Markets
QE 1 Expansion	March 18, 2009	Fed bought $750 Billion more in MBS and $300 Billion in Treasury Notes	Further recovery from Financial Crisis	
QE 2	November 3, 2010	Fed bought $600 Billion of long dated treasuries	Encourage bank lending, reduce hoarding of money supply, avoid deflation	Criticized for inflationary pressures
Operation Twist	September 21, 2011	Fed bought $400 Billion of 6-30 year bonds and sold maturities < 3 years	Shorten average maturities in the Fed's portfolio, avoid expanding the balance sheet, avoid inflation	Considered Modestly Successful. Trading Partners complain, Equity Markets further strengthen
Operation Twist Extension	June 20, 2012	Added additional $267 Billion	same	
QE 3	September 13, 2012	Fed will buy bonds until the economy recovers	Improve Labor outlook while keeping inflation in check	Little impact so far. Now nicknamed unlimited QE or QE Infinity
China Rate Reductions	June & July 2012	Reduce lending & deposit rates	Reverse sharp economic slowdown or "hard landing" from prior tightening fighting inflation	Mixed, Asian Markets Ralley
Draghi Loans	Q4 2011	3-year loans to banks	avoid sales of bank assets at depressed prices and give time for deleveraging	averted a short term credit crunch
ECB Bond Buying	Q1 2012	LTRO = Longer Term Refinancing Operation	give banks time to recapitalize	markets ralley
ECB and Bank of England Rate Cuts	July 2012	Reduce lending & deposit rates to zero or negative	Combat European Recession, boost stimilus efforts	Illustrates limitations of monetary policy
Japan's Abenomics	December 2012	3 arrow plan: Monetary policy, Fiscal policy and Economic growth post 5 recessions since 1990	Targeting inflation at 2% annual Correction of Yen appreciation	Mixed Results: Stock Market up 60% in the past year and Yen lost 25% of value and Economic Growth at 3.5% for Q1 2013 but reversals of these trends began in June 2013