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, even a minor misstep on the Fed's exit could mean a tough time for markets. Both equities and bonds saw large sell-offs in June post communication from the Fed.

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 impaired traditional portfolio risk management techniques. Market results, for 2013, have now become somewhat counterintuitive. Big improvements to unemployment and housing should mean positive market performance, right? Not necessarily. Overly positive economic indicators could, at this time, actually have a negative market impact if the conclusion is less or no QE III and sooner rather than later. We saw this demonstrated last week when the market interpreted Bernanke's statements as more positive than expected, followed by a 2% fall in the S&P500.

Rates and Rotations

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

In addition, prices on longer term bonds will see more of a decrease as rates rise. Coupon rates on new bond issues will increase as all rates rise, but prices on existing bonds with lower coupon rates will decrease. That can hurt a portfolio if bonds cannot be held to maturity or if there is exposure to bond mutual funds. We've already seen a "duration rotation" from longer to shorter term bonds within the bond space and now, toward the end of June, investors are rotating more aggressively out of bond-like investments and into cash.

Tapering Timing

At this point, every portfolio manager and hedge fund guru should be focused on the timing of the tapering. Bernanke is leaving his position as Chairman of the Fed in January 2014, and some still suspect he could also leave QE III tapering along with its potential for more 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. In this environment, flexibility and diversification are increasingly important.

Example:

We have illustrated below what your portfolio performance could look like for rest of 2013 starting with $1 million on May 1 and May performance repeats each month through December:

- Portfolio A shows a 60/40 mix of muni bonds and large cap value stocks with no adjustments through year end
- Portfolio B shows a 60/40 mix with both bond and stock diversification adjustments for current conditions made in early June

$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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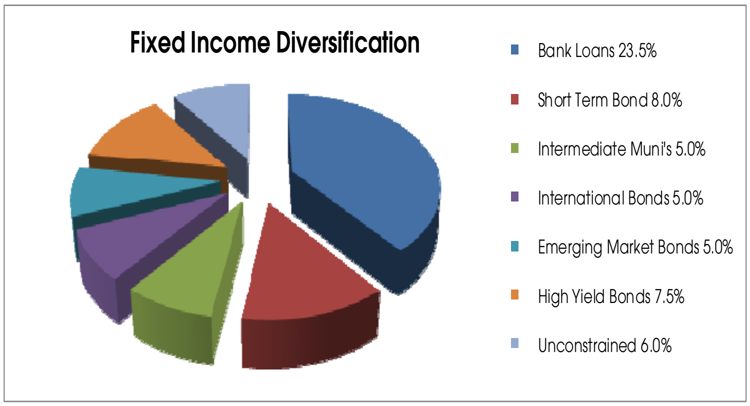

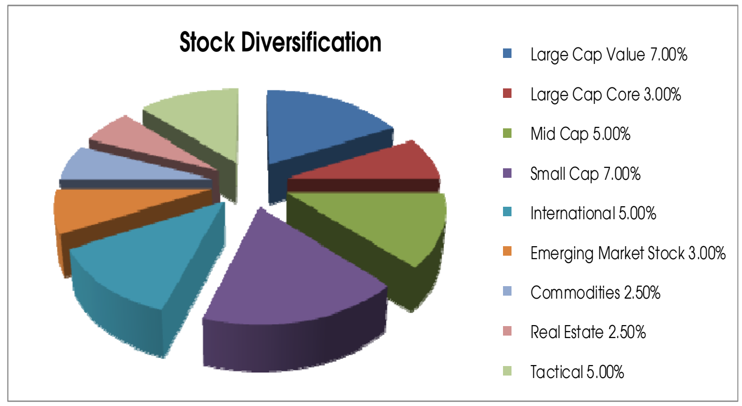

Stimulus Title	Date	Program Description	Goal	Effectiveness
U.S. QE1	November 25, 2008	Fed buys $600bil in MBS	Arrest Financial Crisis	Weaker US Dollar and Stronger Stock Market
QE 1 Expansion	March 18, 2009	Fed buys $750 bil in MBS $300 bil in Treasury Notes	Further recovery from Financial Crisis	
QE 2	November 3, 2010	Fed bought $600bil of long dated treasuries	Encourage bank lending, reduce hoarding of money supply	Criticized for inflationary pressures
Operation Twist	September 21, 2011	Fed bought $400bil of 6-30 year bonds + sold maturities < 3 years	Shorten avg maturities in Fed's portfolio, avoid inflation	Considered Modestly Successful. Trading Partners complain Stonger Stock Market
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 maintaining inflation	Little impact. Now nicknamed unlimited QE or QE Infinity
China Rate Reductions	June & July 2012	Reduce lending & deposit rates	Reverse sharp economic slowdown from prior tightening	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 stimulus efforts	Illustrates limitations of monetary poicy
Japan's Abenomics	December 2012	3 arrow plan: Monetary and 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%, Yen lost 25% value and Economic Growth at 3.5% for Q1 2013 reversals of these trends began June 2013

This analysis is for informational and illustrative purposes only. It reflects performance for May 2013 and quantifies dollar amount changes if identical performance repeats monthly to year end. It is not a market forecast. It does not reflect any specific GenFi strategy. It illustrates values of fixed income securities will change as interest rates fluctuate. Past performance does not assure or guarantee future performance or the success of any investment strategy. Investing in any security involves the risk of loss. Some risks within the bond space include interest rate risk, price volatility, illiquidity, default, and declines in collateral value.

For more further assistance with diversification, allocation or other investment needs please contact Julie Zakarias **jzakarias@generationsffs.com**