SPRING 2013

FIDUCIARY PERSPECTIVE

INSIGHTS ON PRIVATE WEALTH MANAGEMENT

REASSESSING RISK IN THE FIXED INCOME MARKET

The mention of bonds tends to conjure up thoughts of safety and reliability, and with good reason. The role they have historically played in portfolio management is to act as a portfolio's proverbial "anchor to windward."

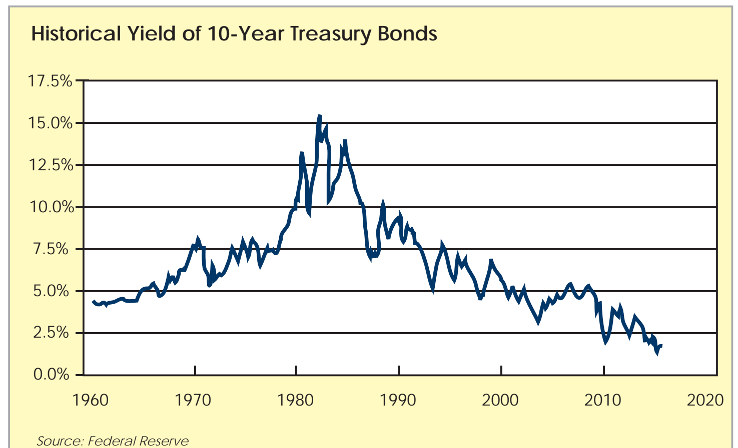
Bonds have been safe and reliable investments for over 30 years, producing good returns with limited volatility. Before addressing both the risks in the current bond market and how Fiduciary Trust is mitigating some of those risks, this article will first outline a few basic facts about bonds.

The main difference between bonds and stocks is that a bond represents a loan, while a stock represents ownership. For example, when investors own a corporate bond, they have loaned a certain amount of money to a particular corporation. Conversely, when investors own stock in a company, they have become part owners of that company.

One defining characteristic of bonds is the inverse relationship that exists between bond prices and the direction of interest rates. As interest rates increase, bond prices decrease, and the longer the bond is, the more that relationship is magnified. For instance, if interest rates rise, the price of a 2-year bond will not fall nearly as much as the price of a 30-year bond. This price sensitivity to changes in interest rates is also known as duration. Duration risk is at the root of investor concerns during this environment of historically low interest rates we now find ourselves in.

Investors tend to flock to bonds as a safe-haven investment during tumultuous and uncertain times. The "Great Recession" of 2008 and 2009 would qualify as one of those periods, as both the U.S. and the rest of the developed world found themselves staring into what looked like a certain financial abyss. To prevent an even more serious global banking and economic crisis, the U.S. Federal Reserve, the European Central Bank and numerous other central banks responded by buying billions of bonds in the open market in an effort to reduce interest rates and stimulate growth. At the same time, volatility in the equity markets caused investors to sell their stocks in favor of bonds. These events disrupted the normal supply/demand relationship and pushed prices of bonds and interest rates beyond what fundamentals would warrant. One side effect is that we now have negative real interest rates, where the current level of inflation is higher than the stated yield of many bonds, including more than 80% of all Treasury bonds. Another consequence is some investors have a fairly large investment in the bond market, but do not really understand the ramifications of that in this low interest rate environment.

The chart below depicts the 10-year Treasury rate going back to the 1960's. In looking at the chart, one can see that for the last thirty years, 10-year rates have consistently trended downward. The inverse relationship that exists between interest rates and bond prices means this decline in rates has resulted in a consistent increase in the price of 10 year Treasuries. This trend is not likely to continue for much longer given the absolute level of rates.



Now that we have talked about the direction of prices when interest rates change, let us next focus on the magnitude of the change and the upside and downside potential. First, we will begin with the upside potential of owning a 10-year Treasury. With the 10-year now yielding 1.94%, it is very unlikely that the rate will fall much lower. The lowest yield registered was 1.55% at the end of September 2012. For illustrative purposes, let us assume that the very unlikely situation of 10-year rates falling to 1% does occur. In this case, the bond would provide a return of approximately 8%. The downside potential, on the other hand, is much more realistic and concerning. If 10-year interest rates were to increase to 4%, which is not out of the realm of possibility, the price of the bond

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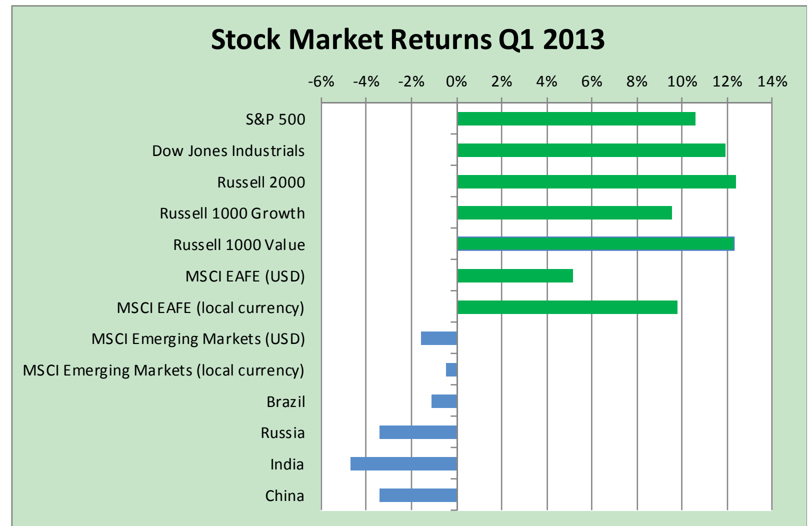
MARKET COMMENTARY

By Michael A. Mullaney
Chief Investment Officer

Q1 2013 RECAP: A "RODNEY DANGERFIELD" RALLY IN STOCKS

Overview

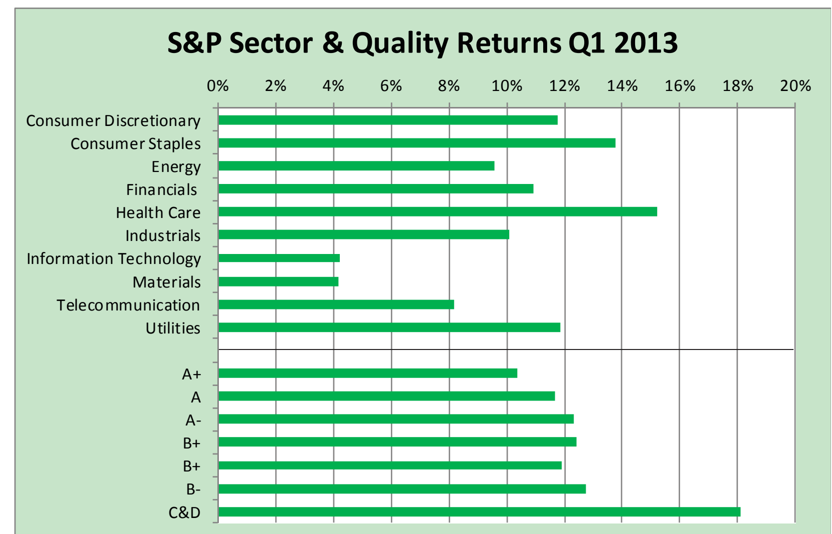
It was an interesting quarter for investors, beginning with an 11th hour congressional compromise on the "Fiscal Cliff" on day one and ending with a record level for the S&P 500 stock index on the last day of trading. In between, there was a plethora of activity across three fronts: economics, geopolitics and markets.



Best Q1 for Dow Jones Industrials since 1998

Economics

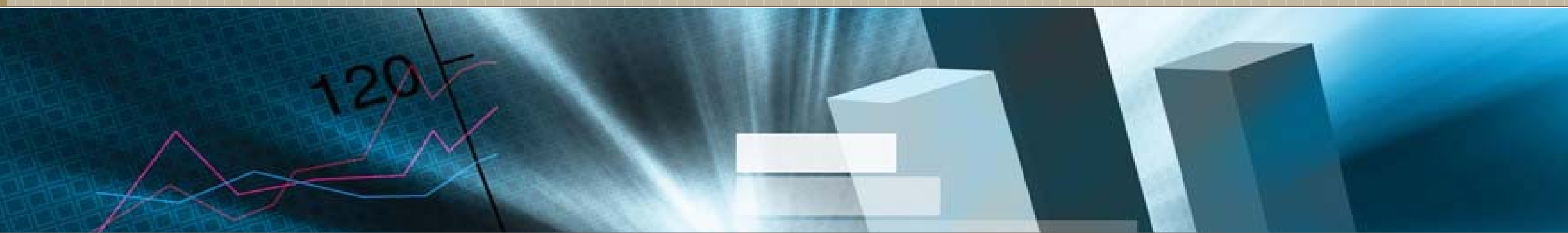
Fourth quarter 2012 U.S. GDP was reported, barely advancing at an anemic 0.4% pace and below consensus expectations. A drop in government spending was the primary culprit, led by a 22% decline in defense spending. Bright spots for the quarter included upticks in both housing and manufacturing. Economists expect the economy to strengthen as the year progresses. Europe continues to be mired in recession, with GDP for the region falling by 2.3% in the fourth quarter. Many emerging market countries posted weaker industrial production figures and elevated inflation statistics.



Unusual combination: Both low quality and defensive sectors did well

Geopolitics

Congress was able to pass the Continuing Resolution, circumventing a government shutdown from debt ceiling limitations. This debate will resume this summer, as a new vote is required by the end of September. The March 1st Sequester came and went without the sky falling. This was probably due to the fact that while the government faces $85 billion in spending cuts, "only" $44 billion is slated for 2013, out of a $3.6 trillion spending budget. On March 20th, the Federal Reserve Board pledged to keep rates near 0% until unemployment falls to 6.5% and/or inflation rises above 2.5%, both of which are not projected to



occur until 2014 or later. The international arena remained troublesome, with Italy failing to elect a new government, a near collapse of Cyprus, the civil war in Syria and renewed saber rattling from North Korea.

Markets

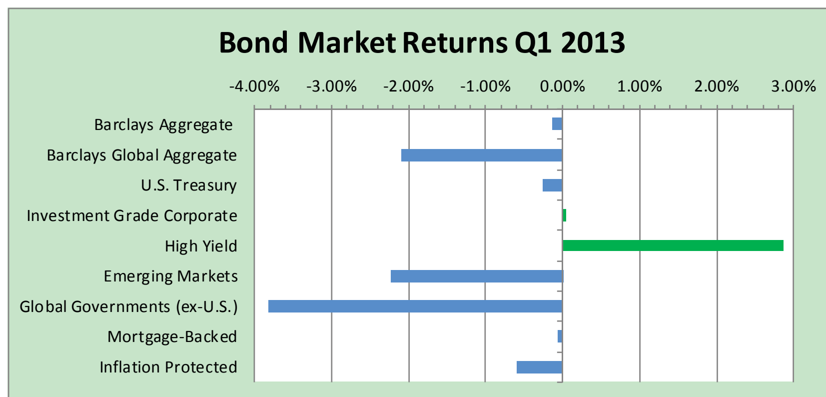
Despite lingering economic and geopolitical concerns, most developed stock markets posted solid-to-significant results for the quarter. While the S&P 500 waited until the last trading day to hit a new record, the Dow Jones Industrials did so on March 5th. At 1565, the S&P is up 135% from its bedeviling low of 666 on March 6th, 2009. Bonds suffered as investors balked at investing at such low interest rates and succumbed to the allure of rising stock prices. A strengthening dollar had a negative impact on both emerging markets and commodities.

Conclusion

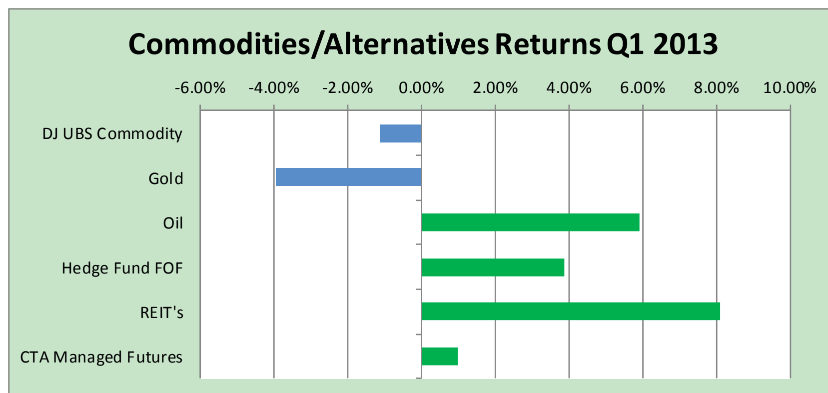
A mistrusted, "can't get no respect" stock market rally.

The Quarter Ahead

It will be interesting to see how the market handles the GDP report for the first quarter, which is expected to show the strongest year-over-year change since 2006, at the same time that corporate earnings are expected to be flat at best. Given the recent strength in the stock market, a correction and/or period of consolidation is widely expected, maybe even hoped for, as many investors are still underweight equities and would like to add exposure at lower prices. Overall conditions for equity prices remain supportive. The adages "Don't Fight the Fed" and "Stock Markets Climb a Wall of Worry" continue to resonate. ■



First quarterly loss for bonds since 2010

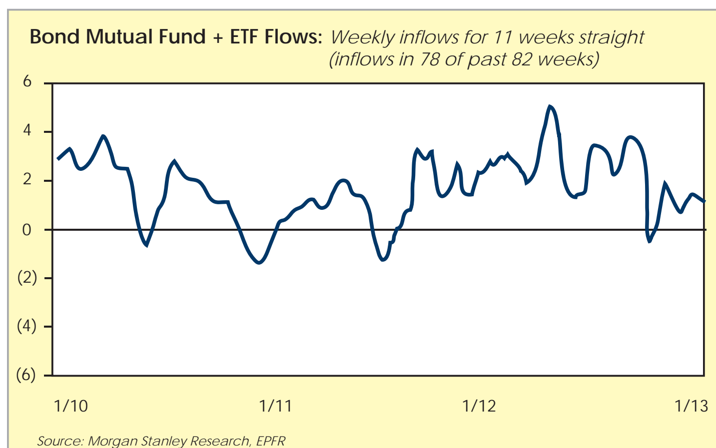


First back-to-back negative quarters for gold since 2008

would fall by approximately 18%. This is not the type of price drop one expects in the part of the portfolio that is intended to add stability. This example illustrates the asymmetrical risks of bond returns going forward and why so many investors are concerned.

With rising rates as the overriding concern of bond investors, you may be asking yourself what could cause that to happen. There are several things that could cause interest rates to rise in the near term. The first of course is the Federal Reserve and what their policy actions are going forward. The Federal Reserve has a dual mandate of keeping inflation low and promoting full employment. At this point, the inflation rate is not concerning, but the level of unemployment certainly is. The Federal Reserve chairman, Ben Bernanke, has said the FOMC will not increase rates until the unemployment rate reaches 6.5% or below. That is not a level we are expected to reach until sometime in 2014, at the earliest.

While the Fed will not likely act to increase interest rates for some time, pure supply/demand dynamics could. The chart below illustrates the elevated flows into the bond market for the past three years. As of the end of March, bonds had positive net cash inflows in 152 of the prior 169 weeks. Many of these investors have not yet moved money out of the bond market, even with equity markets reaching new highs. Once investors perceive the economy is improving and equity markets are stabilizing, they will not feel compelled to own as many bonds, which provide them with very little income and/or return potential. That reduction in demand could trigger widespread selling which would, in turn, depress prices and increase yields. The potential for this scenario to occur is very real and it could happen in the near term.



If the fixed income outlook for 2013 and beyond is a cautious one, then you may be wondering how Fiduciary is protecting your portfolio against these issues. While managing risk across all parts of our clients' portfolios is always a key focus, managing risk within the bond portfolio is especially critical. With the bond portion of a client's portfolio acting to reduce volatility, it is certainly not the place to take on undue risk. That is why Fiduciary has been very active in assessing the potential risks facing the bond market and altering portfolios to mitigate unnecessary volatility.

Reducing overall exposure to bonds has been the primary recommendation coming from our fixed income team. Within the bond holdings, we have reduced risk in several ways, the first of which has been to shorten the duration of our clients' U.S. bond portfolios. We have focused on selling securities longer than five years and moving into shorter securities. In most cases, this has resulted in lower yields; but given the potential for large price depreciation with longer securities, we feel that is a tradeoff well worth making.

Our secondary, but equally important, recommendation has been to only own creditworthy securities. Many corporations, for instance, have very strong balance sheets, a high ability to repay debt, and significantly reduced leverage ratios. With Treasuries yielding close to or, in some cases, less than the rate of inflation, corporate bonds provide more attractive rates of income and return potential in exchange for a very small amount of incremental risk. While emphasizing high quality corporate bonds, we have moved away from more risky "high yield" bonds.

High quality municipal bonds can also be a good place to invest. Balance sheets of municipalities have been strengthening as the housing market heals and employment improves, providing them a higher and more reliable stream of tax revenue. Also, state governments, unlike the federal government, are required to run a balanced budget. That translates into a much lower portion of their income being applied toward debt servicing costs. The recent increase in tax rates for upper income individuals and families has improved demand for municipal bonds.

The international bond market is another area we have been emphasizing in order to insulate portfolios from the risks mentioned above. The non-U.S. debt market accounts for more than one-half of the global bond market. Many international bonds offer more attractive yields, positive total return potential and a reasonably low correlation to U.S. bonds. Unlike domestic fixed income instruments, international bonds also provide the opportunity for attractive returns through currency positioning.

In spite of the clouds on the horizon, bonds do have a place in portfolios. Generally, they reduce the overall volatility of portfolios and provide a good counterbalance to the equity markets. With the proper precautions being taken in your portfolio, the risks mentioned above should be mitigated. We are unlikely to see bonds perform as they have in the past several decades. However, the short duration, high-quality securities we are recommending should provide the anchor to windward characteristics we have come to expect from bonds and provide modest returns. ■

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