INVESTMENT STRATEGY
OCTOBER 2010

During the past three months, equity market volatility has continued as various experts chime in on the health of the economy. During this period of elevated rhetoric, investors, fearing the unlikely worst case scenario, have withdrawn large amounts of money from the equity markets. Where has this money gone? To fixed income instruments, as investor appetite for bonds continues unabated.

It has now been a year since we first suggested that fixed income investments were becoming overpriced and unattractive. Nevertheless, money has continued to pour into these investments at record levels. According to the Investment Company Institute, in the first seven months of 2010, investors withdrew $33.1 billion from domestic stock mutual funds and poured $185.3 billion into bond mutual funds. The current level of interest in bond mutual funds resembles the popularity of stock ownership in the late 1990s. This is quite clear when you compare the $480 million that flowed into fixed-income funds during the two years ending in June 2010, with the $497 million put into equity funds from 1999 to 2000.

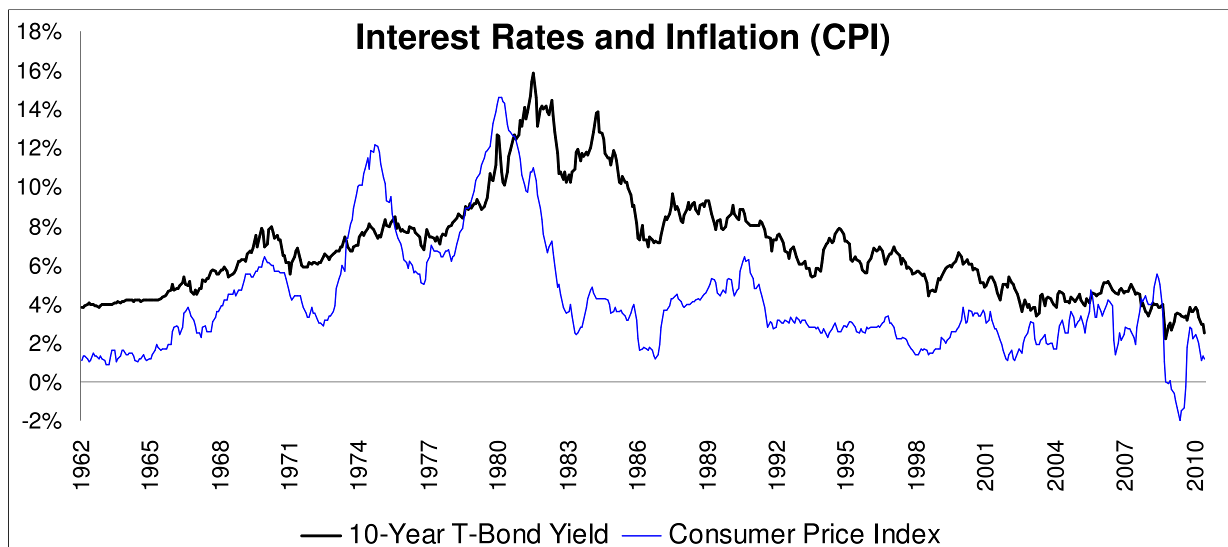
The massive flow of investor funds into fixed income investments since the start of the bear market two years ago is driven by a unique set of circumstances. Poor equity returns over the past decade coupled with increased market volatility have given a large segment of investors an irrational fear of stocks. Some have even said that they will never own stocks again. As a result, many investors have moved heavily into fixed income investments, causing bond prices to rise. The momentum of these price increases cause short-term investors to jump on board, driving prices unsustainably higher and, simultaneously pushing interest rates to record lows. The following facts are but a few of the many warning signs that the bond market may have moved beyond rational levels:

- The last time interest rates were this low was in 1955.
- The 10 lowest-yielding U.S. corporate bond issuances in history were sold in the past 14 months.
- In just nine months, 2010 has already set an annual record with $172 billion in lower-quality junk bonds issued.

Yet investors remain unconcerned since they assume bonds are safe – as long as the borrower does not fall into distress. However, this view ignores the effects of rising inflation and interest rates. Investors ignore these perils because they are intangible ideas that have not substantially affected bond values since the 1960s and 1970s. A close parallel is the assumption a few years ago that house prices can only go up – after all, there had not been a meaningful decline in housing prices in more than a generation.

The following chart reveals the declining yields in 10-year Treasury Bonds and the tepid level of inflation investors have faced since the mid 1980s. The chart also reveals the devastating effects of rising inflation and bond yields in the 1960s & 70s. As an example, let's take a $100,000 twenty-year U.S. Treasury bond with a 4% coupon. For simplicity, let's also assume an annual inflation rate of 3% for the next twenty years. You would receive $4,000 of annual income from the bond with certainty. However, the real risk stems from what you are able to do with that $4,000 over time – your purchasing power. Thanks to inflation, the real

purchasing power of that $4,000 in twenty years would only be $2,215. Put another way, if your annual food bill is currently $4,000, in twenty years that same amount of food will cost you $7,224 thanks to twenty years of inflation at 3%. Given those numbers, you would be quite hungry if you did not plan for some growth in your income. Even worse, your $100,000 in principal would only be worth $55,368 in real purchasing power terms. If these numbers concern you, imagine the effect on your purchasing power if inflation averaged 6.4%, as it did from 1966-1985.



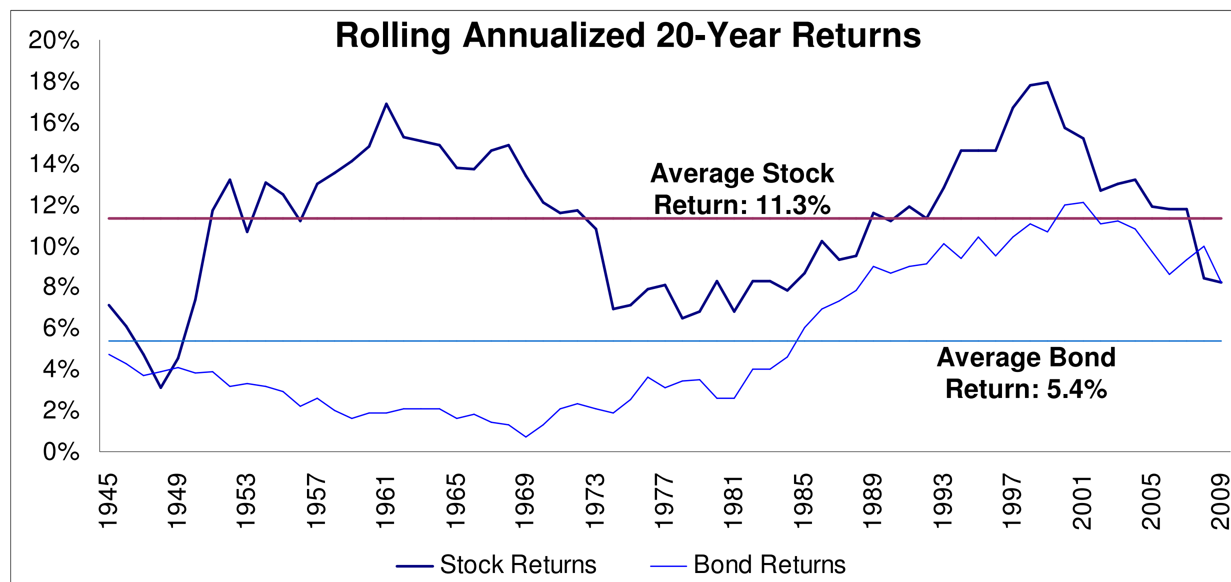
Source: Ibbotson SBBI 2010 Classic Yearbook.

Our expectation is for inflation in the coming years to approximate at least 3%, or roughly in line with the recent experience. However, the risk to our forecast is clearly toward inflation over 3% rather than under 3%, given questions about long-term energy and food supplies and large worldwide budget deficits. Higher inflation would translate into higher interest rates and lower bond prices. Historically, inflation has been the path most governments have used to reduce the real costs of their deficits and debt burdens. Therefore, the potential upside in bond prices appears quite limited while the downside could potentially be disastrous – not a recipe for long-term investment success.

So which investments have a smaller downside with the possibility of a large upside? The stocks of high quality, dividend-paying, multinational corporations appear to best meet these criteria. These companies offer significant upside due to their exposure to high growth emerging markets, but continue to be valued at levels not seen in twenty years. These low values, coupled with significant dividend yields, reduce the downside risk. In fact, many of these stocks yield greater levels of income than the bonds currently favored by many investors. As an example, our average all-equity portfolio yields between 2.8% to 3.3% annually from dividends. Meanwhile, 10-year Treasury bonds currently yield approximately 2.5%, high-quality corporate bonds yield 1% to 4%, and lower quality junk bonds yield only 5% to 7%.

Additionally, while bond payments remain fixed over the life of the investment, dividend income typically grows along with, if not ahead of, the rate of inflation – protecting your purchasing power over time.

As seen in the following chart, there have only been three 20-year periods from 1926 to 2009 where the total return on bonds exceeded the total return on large company stocks. Two of those periods just occurred in the periods ending in 2008 and 2009. The last time this happened (the 20-year period from 1929 to 1948), equities went on to average 14.9% per year over the subsequent 20-year period, while bonds only returned 1.3%. The same trend holds true when looking at 15- and 10-year annualized returns.



Source: Ibbotson SBBI 2010 Classic Yearbook. Returns presented are total returns, which include dividends.

So what do we recommend? For clients that hold fixed income assets outside of our management, we encourage you to not overweight fixed income assets and to avoid trading down in quality to gain a little extra yield. Unfortunately, we are seeing many investors move heavily into this asset class at precisely the wrong time. In our managed portfolios, fixed income will remain important for many clients. However, over the past year we have slowly transitioned away from longer maturity fixed income, where appropriate, to lower our overall exposure to the negative effects of rising interest rates. We have accomplished this by reinvesting the proceeds from called or matured bonds into shorter maturity bonds or into higher yielding stocks. These changes should help protect clients from short-term changes in interest rates and the long-term negative effects from the destructive powers of inflation.

Truly yours,

Keating Investment Counselors, Inc.