SOME CHANGES HERE & THE CASE FOR CAUTION

LUKE LANIER MARRIES ... TO LIVE UNDER MILITARY RULE

Over the past few years, many of you have become acquainted with Luke Lanier and have grown accustomed to his conscientious care (I could hear it from my office). As of July 5th, Luke is a married man. He and his bride, Rachel, are currently roaming the western U.S. Instead of returning to North Carolina, however, they plan to relocate to Thailand later this month and to then remain there for the foreseeable future ... where they'll *both* live under military rule as Thailand revamps its political system and constitution for what I count to be the 12th time since 1932.

Once in Thailand, Rachel intends to teach English while studying for a post-graduate degree in education. Luke will continue to assist here on a part-time basis through a virtual private network while pursuing a Ph.D. in economics. Luke is also mid-way through the Chartered Financial Analyst program, but it remains to be seen how much time he'll have to devote to those studies.

Whereas Luke used to handle a variety of administrative duties around here, Luke will now focus on digesting research opinions, developing investment ideas, and assisting with the portfolio management process. I expect Luke to be in position to log in to his office PC sometime in August.

You'll be able to email Luke as usual, but if you receive emails into any device that chimes, be aware that any responses you receive from him are likely to arrive in the middle of your western hemisphere night.

Luke is among the smartest, most thoughtful people I know and I have always held him in the highest regard. I already miss him, but I am gratified that technology will allow him to work here from way over there. Hopefully, Thailand's military regime (the "junta") will continue to allow Internet access to the west.

WELCOME JOSEPH HOITELA

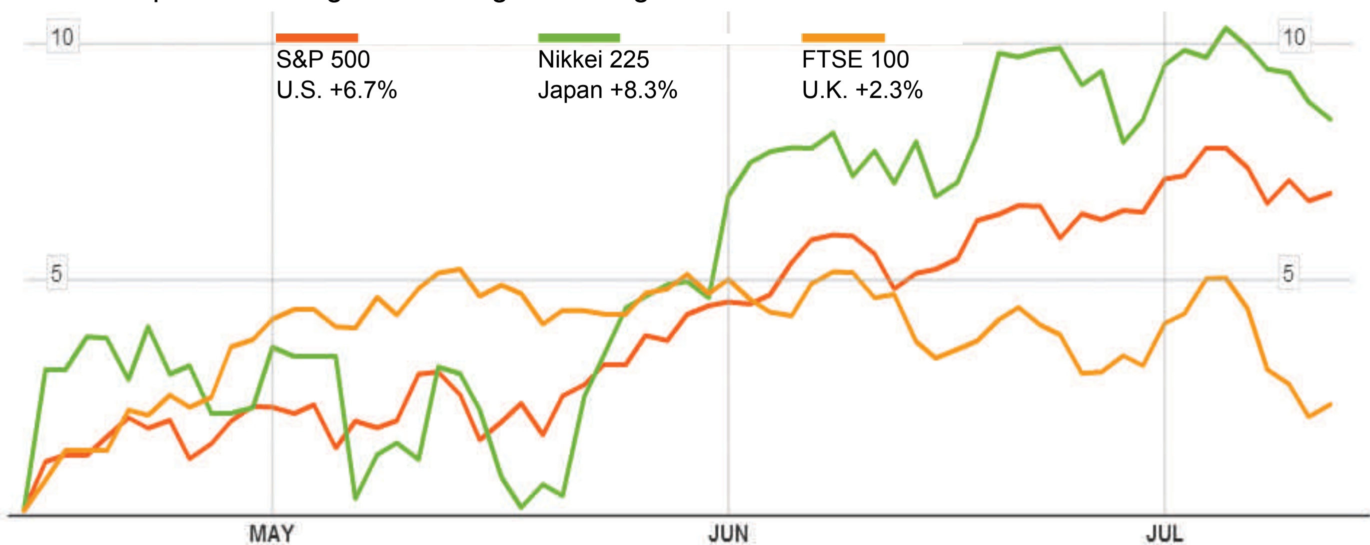
I have occasionally quipped to Luke that, between the two of us, I may have the lesser mind. It's a good thing I'm not overly insecure because it seems as though I may have caught lightning in a bottle for a second time. Coming to us in June, Joseph Hoitela arrived with a deep interest in the realm of finance. Like Luke, Joseph has an exceptionally disciplined mind that has allowed him to excel in technical fields such as economics, accounting, chemistry and mathematics.

Upon winning the position here, Joseph immediately enrolled in the Chartered Financial Analyst program. According to Wikipedia, the CFA credential is widely considered to be the most difficult test on Wall Street. Of the approximately one million people who have attempted the CFA program since 1963, only about 16% of them have received charters. Joseph plans to sit for the level I exam this December. Based on what I already know about his intellect and work ethic, I expect Joseph to be in the minority that gets invited to sit for the level II exam, next year.

As an aside, I am happy to report that I have found unexpected delight in being able to boss people around who are probably sharper than I.

EQUITIES BEHAVE PROPERLY

In my last note, I suggested that the outlook for equities seemed to be at least decent due to continued central bank support, comparatively high dividend and earnings yields, and the World Bank's increasingly constructive view of global economic activity through 2016. As shown below, the returns afforded to equity investors over the past three months have probably been more generous than most professional guessers might have figured.



I also suggested that equities were relatively more attractive than bonds and other debt instruments. Before I discuss the performance of bonds and the like, I'd like to remind you that, for all but the most monied investors, prudence seems to dictate that some portion of one's portfolio be invested in a manner that is less associated with the vagaries of the stock market. Because interest rates on cash and cash equivalents remain low, a substantial portion of the assets we oversee is invested in various types of debt, despite the fact that debt securities may be relatively less attractive than equities.

SOME CLARITY FROM THE FED

Bond values are highly influenced by central bank policy, so it makes sense to summarize the Federal Reserve's latest thinking before discussing bonds. A year ago, investors were wondering when the Fed might begin reducing the amount of stimulus ("tapering" in media parlance) it was pumping into the U.S. economy. Peek at the graph that appears on the following page. Those vertical bars represent the amount of stimulus the Fed has been injecting into the economy each month over the past year, or so.

Prior to 2014, the Fed had been pumping $85 billion worth of additional reserves into the U.S. economy each month in an effort to drive economic activity, reduce the unemployment rate, and to support the housing recovery. As you can see, the Fed began tapering its stimulus injections in January of this year from about $85 billion per month to a still substantial $75 billion per month. By May, the Fed had reduced its monthly injections to $45 billion.

Once the Fed began reducing its stimulus injections, investors naturally wondered when the injections might cease altogether. In truth, investors are really more anxious to know when the Fed might actually begin *removing* stimulus from the economy ... so they can know when to begin removing *their* own capital from the markets. The question of when the Fed is likely to halt its stimulus program is really just an intermediate question. However, the Fed answered that question a few days ago. The answer is "October," as long as the economy stays "on track."

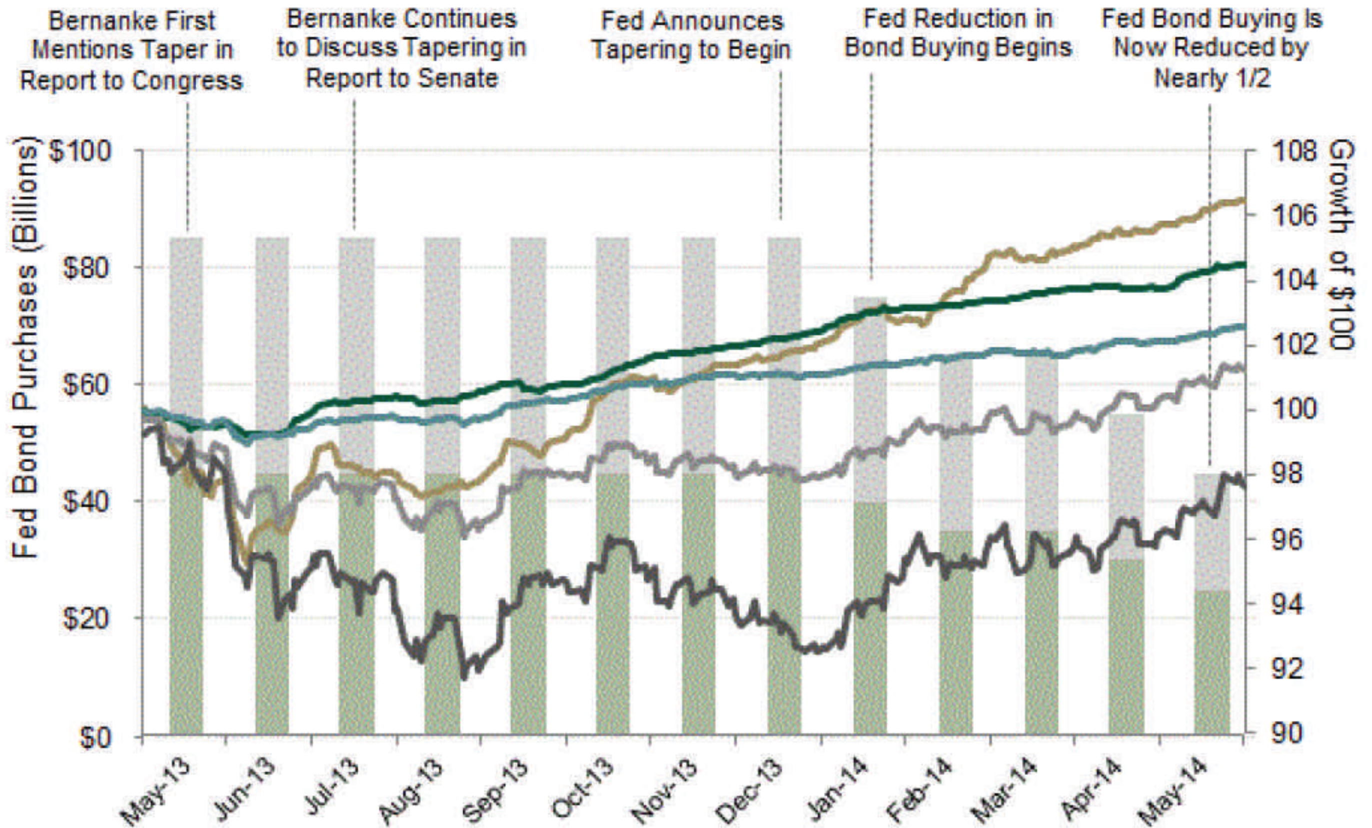
BEAR RACING, BAD DIRECTIONS, AND FRAGILE INVESTOR PSYCHOLOGY

In the last paragraph, you might have surmised that investors would be tempted to remove their capital from the capital markets as soon as they detect any noise about the Fed doing the same. In actuality, it is likely that more proactive investors will be tempted to begin withdrawing capital from the markets somewhat *beforehand*.

Recall the old saw about two campers fleeing a bear. At some point, each realizes that he need not necessarily run as fast as possible, just a bit faster than the other guy. While investors certainly enjoy positive returns, the prospect of risking substantial, already gotten gains makes less sense as expected incremental returns wane. To the extent investors become increasingly twitchy, that same psychological force will undoubtedly cause many investors to prepare for a race to the exits.

Unfortunately, this puts us in a position not too unlike the lost motorist who, after asking a local for directions, hears, "I'm going that way, so just follow me and turn right 10 to 15 miles before I do."

Growth of a $100 investment, May 22, 2013 -- May 22, 2014



Fed Stimulus

- U.S. Agency MBS Purchases
- U.S. Treasury Purchases

		Return
—	U.S. High Yield Bonds[1]	6.50%
—	U.S. Bank Loans[2]	4.51%
—	Short U.S. Corporates[3]	2.56%
—	Barclays U.S. Aggregate[4]	1.23%
—	10-Year U.S. Treasury[5]	-2.37%

Source: Morningstar, Credit Suisse, and Federal Reserve.
[1] Represented by the Credit Suisse High Yield Index
[2] Represented by the Credit Suisse Leveraged Loan Index
[3] Represented by the BofA Merrill Lynch 1-3 Year U.S. Corporate BBB-Rated Index
[4] Represented by the Barclays U.S. Aggregate Bond Index
[5] Represented by the BofA Merrill Lynch 10-Year U.S. Treasury Index

I'm not in favor of trying to time the markets outright, e.g., being either "all in" or "all out," because market timers, as a whole, have lousy track records. Historically, however, the correlation between stimulus injections and rising asset prices has been undeniably positive. To the extent the Fed begins reversing its stimulus efforts, it seems reasonable to assume asset prices may relax, at least until investors adjust. Therefore, I think it may make sense for us to maintain equity allocations that are at the lower end of each client's predetermined range at some as-of-yet undefined point.

PICKING OUR SPOTS IN THE BOND MARKET

Generally speaking, as the expected returns from a given asset class decline, security selection within that asset class becomes more important to anyone who hopes to outperform the asset class as a whole. This is why gamblers have an incentive to specify their bets anytime the total pot amounts to less than the sum of the individual bets. The larger the house's cut of the winnings, the greater the incentive for gamblers to specify their bets rather than to diversify them. Although I am not suggesting that bonds and other debt instruments will generate negative average returns for investors as steadily or as severely as race tracks, lotteries, and casinos do for gamblers, I do expect interest rates to rise and I would like to avoid dissipating capital our clients already have.

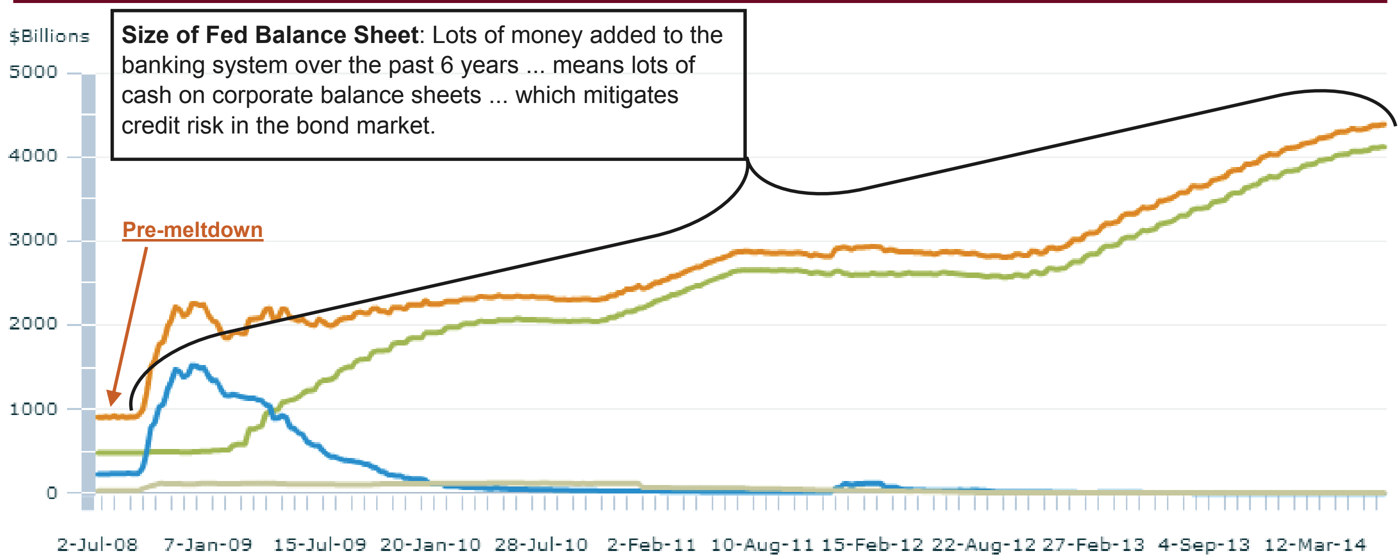
If you look at the legend beneath the graph to the left, you'll see that the returns associated with various components of the domestic bond market have varied quite a bit over the past year, or so.

The Barclay's U.S. Aggregate index is a good place to start this discussion because this index is a good barometer of the performance of the overall bond market within the U.S. As such, it captures the returns from Treasury and government agency securities, mortgage-backed securities, investment-grade corporate bonds, as well as some foreign bonds that trade domestically.

As you can see, the bond market as a whole has generated a paltry return over the past year, so I'm pleased to report that our bond portfolios have not and do not at all emulate this index. Most of our bond portfolios are likely to have only minor exposure to U.S. Treasury securities, if any.

Instead, we have favored and continue to favor short-term corporate and municipal securities of medium and, especially, lower credit quality. We favor short-term instruments because we wish to mitigate whatever damage a future rise in interest rates might unleash. (Remember that bond values tend to vary inversely with the level of interest rates.)

We favor lower credit quality instruments to regain some or all of the yield we must necessarily forego to avoid the interest-rate risk associated with intermediate and longer-term securities.



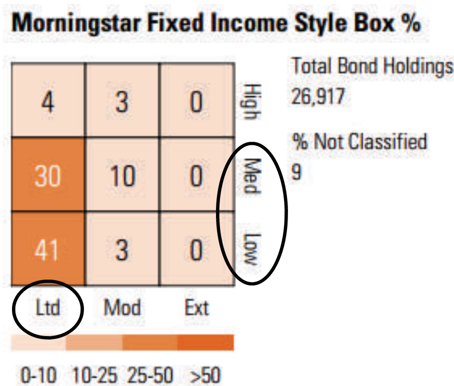
We also favor them because we do not believe there is very much credit risk in the system right now. This is so because the Fed has pumped an additional 3½ trillion dollars into the U.S. banking system over the past six years, as shown above.

The grid on the bottom of page four depicts the return afforded to those who invested in short-term, U.S. corporate bonds, but that figure does not capture the returns from lower credit quality bonds, which we favor even more. If it had, the return figure would have been higher.

We have also been maintaining significant exposure to floating rate securities, the returns of which are fairly well captured on page four by the "U.S. Bank Loans" index. Floating-rate bank loans represent loans banks have made to borrowers, not money banks have borrowed from investors. Because the interest payments generated by floating-rate bank loans fluctuate with the general level of short-term interest rates, bank loans have tended to hold their value well during periods of rising rates.

However, floating-rate bank loans tend to be too small to garner credit ratings from credit rating agencies. To err on the side of caution, investors have traditionally lumped bank loans in with other low-quality credit instruments. It's worth noting, however, that bank loans are often supported by underlying collateral such as receivables, inventory, and fixed assets which ought to provide some additional comfort in cases where issuers default.

As we review portfolios, we rely upon software that maps each client's holdings. Many of our clients' bond portfolios might look something like shown on the following page.



Interest Rate Risk	Bonds	% Not Available
Avg Eff Maturity	4.84	22.20
Avg Eff Duration	2.39	0.95
Avg Wtd Coupon	4.93	1.49

The fixed-income style box tells us, in percentage terms, how capital is allocated according to term and credit quality. In this example, the client's debt holdings are tilted toward limited-term, lower-quality issues. Even though all of this client's debt holdings are held indirectly through various types of funds, our software looks inside each fund in an attempt to assess every issue (all 26,917 of them, in this case). In this example, the software is unable to classify 9% of those 26,917 issues, but it gives us a good read on the other 91%.

The average effective duration figure provides us with an approximation of the interest-rate sensitivity of the debt instruments within this client's portfolio. For minute changes in the general level of interest rates, we would expect the market value of the debt issues within this portfolio to vary in the *opposite* direction by a factor of 2.39. For example, if the general level of interest rates were to increase by .01%, the market value of the bonds in this portfolio might decline by about .0239% (usually less). We're comfortable with this level of interest-rate risk in this environment.

THE BOTTOM LINE ON BONDS

Fed Chairwoman Janet Yellen has already speculated that the Fed might begin raising short-term rates within six months of ending its stimulus program. If the Fed were to end its stimulus program in October as it has already indicated, it might then make its first move to increase short-term interest rates next April. By nature, markets are forward-looking, so it is plausible that interest rates, stress hormones, and other forms of angst could rise well before then.

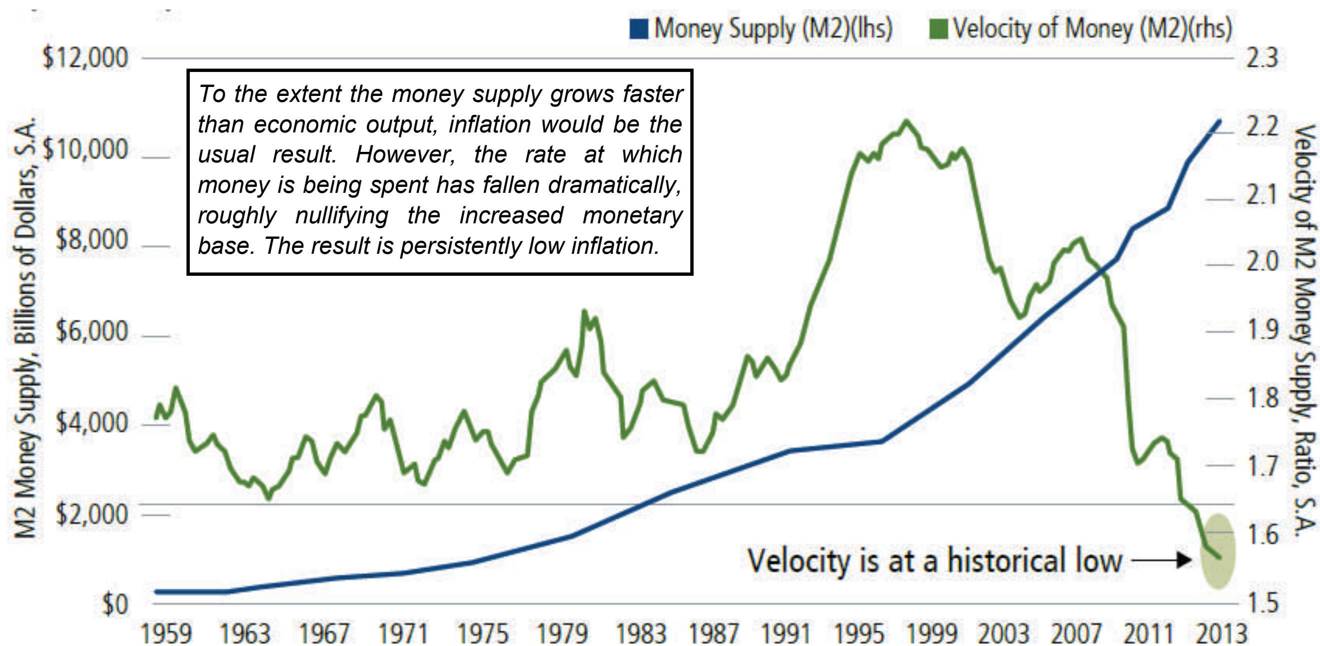
Given that the Fed's plan to raise interest rates is dependent on continued improvements in the economy, it is not unrealistic to expect economic growth to strengthen and for corporate earnings to continue to advance during this period. I would expect such an environment to continue to favor the types of credit instruments in which we're already invested.

AS FOR EQUITIES ... IT DEPENDS

Any conjecture about the likely performance of equities is necessarily messy. On a basic level, one could argue that an eventual rise in interest rates will present a headwind to equity values on the grounds that a rise in interest rates tends to cause the values of most assets (not options, I know) to decline in value. It could also be argued that as rates rise, investors who had been temporarily satisfying their appetites for income by holding dividend-paying equities will abandon them as soon as their relative yield advantage disappears.

However, the Fed is not likely to end or reverse its stimulus efforts unless and until it is convinced that the U.S. economy can withstand the negative effects. And, even when the Fed does begin the process, which might not happen in a large way for a very long time, there will still be such a huge chunk of excess reserves sloshing around the banking system that even a modest increase in lending activity could support asset prices and/or push them higher.

Recall this graph from my last commentary. That blue line represent a lot of potential firepower. As such, I liken it to a puddle of lighter fluid sitting near a fire. The bottom line is that outcome of the marshmallows will depend very much as to whether that lighter fluid evaporates, or ignites.



— Glenn Wessel