

July 11, 2013

2013 Second Quarter Review
“The Bond Buyer Blues”

The second quarter was a tale of opposites. Stocks generally did well as the S&P500 and NASDAQ Composite continued to rise, ending the quarter up a little over 12% from January 1st through the end of June. Moving in the opposite direction, bond prices fell as the Barclays Treasury Bond Index lost 11.3% of its value and gold, contrary to popular expectations, declined by 23% from the beginning of the year.

For the last few years we have consistently maintained that bonds were not a good place to invest and that we would be much better off with a higher concentration of high-quality, dividend-paying stocks and other income paying investments with growth potential. The traditional individual investment portfolio has consisted of a mix of stocks, bonds, and money market funds. However, our thesis was that rates were so low on the bonds that a small increase in market interest rates could wipe out years of income when the value of the bonds declined to reflect those higher rates. Also, rates were already so low that you really couldn't expect much appreciation since rates could not go much lower than almost zero, but they could go appreciably higher. Therefore, the risk seemed to us to be too great for the possible reward. We judged it to be like picking up nickels in front of a steamroller. You can make some money for a while, but it's probably not worth the possible pain. We expected to be vindicated sooner, but investors continued to pour money into bond funds and the prices held just fine while investments like the 10 year US Treasury bond yielded about 1.6% seemingly forever. Then it happened. In just the two months between the first week of May and the first week of July, the yield on the US 10 year bond rose from 1.6% to over 2.7%. Bond funds like the Pimco 7-15 year Treasury Fund (ticker TENZ) lost 7.5% of their principal value in just 60 days. That represented almost 5 years of income lost back to declining principal value in just two months. In long-term bonds the effect was even worse. The iShares/Barclays Long Term Treasury ETF (ticker TLT) lost 14.5% of its value over the same 8 week period.

The sharp rise in rates was ostensibly attributed to the comments of Federal Reserve Chairman Ben Bernanke when he expressed the obvious necessity of curtailing their “intervention” at some undefined point in the future. The possibility of having the opiate of “QE to Infinity” withdrawn from the addicted markets so alarmed bond investors that they immediately checked out of rehab and headed for the exits. Only fervent and repeated “explanation” by Bernanke and other Federal Reserve members eventually assured investors that the Fed didn't mean to say they'd really pull the plug, they just said that someday...maybe...if everything were just fine, then they might consider doing what has to be done anyway. (Cue “Happy Days Are Here Again!”) So the stock market rallied, but bonds...not so much.

So, we are happy to have avoided having to sing “The Bond Buyer Blues.” Our core positions of high-quality, dividend-paying stocks have generally done well, although we should not expect them to perform like this forever. Corporate profit margins are at all-time highs and could regress in the near term. Gold and other precious metals, however, continued their decline during the second quarter. In fact, the decline has turned into a rout. The price of gold dropped to \$1,250 per ounce from a high near \$1,900 in 2011, and from about \$1,690 per ounce at the beginning of this year. Any exposure to this

quintessential inflation hedge has brought only misery lately. This is true in spite of the fact that inflation is creeping into many consumer items, the purchasing power of the dollar is declining, and the Federal Reserve continues to pump massive amounts of “stimulus” money into the economy. Just six or seven months ago investors were still clamoring for more gold in their portfolios. It was considered a “no brainer” and an obvious protection against the debasing of the dollar caused by the Fed’s massive “quantitative easing” (i.e. money printing). The action in the price of gold is a textbook example of how investing with the crowd in a “no brainer” can entail more risk than is obvious, and often ends badly. Bubbles in the prices of any asset class are fueled by the “no brainer” mentality as investors eventually react to rising prices with still greater confidence that prices will rise further. Eventually, demand is satisfied and prices can start to slip. If sellers panic because there aren’t enough buyers, prices can fall dramatically. It has happened with tulips in 1627 and with houses in 2007. And it will happen again. Part of our job is recognizing and limiting the damage of those bubbles whenever they emerge.

The recent spike in interest rates may have finally popped the “bond bubble” that we have mentioned in the past. If history is any guide, interest rates may start to move up after having declined for over 30 years. (Remember the Paul Volker 1980s with 15% Treasury Bill rates?) That whole tide may have turned. If so, it has several major implications for investments. Higher interest rates have already started to have an effect on housing as mortgage rates have spiked farther and faster than they have in decades (30 year rates up almost 40% to over 4.5% recently). This may materially impact housing starts, since buyers who qualified at 3.5% rates when the construction contract was signed may not qualify at 4.5% when the house is finished. This could cause another dip in housing activity and housing prices. The stock market in general usually reacts negatively to higher interest rates because of the increased borrowing costs for companies as well as the stiffer competition that bonds with higher yields would give stocks in the competition for investment dollars. However, there could be a side-effect that overwhelms the negatives. We may begin to see what we’ve referred to in past letters as “the Great Rotation.” If bond fund investors, seeing their principal decline sharply, start to pull some of those vast assets from that sector and reinvest it in stocks, it could fuel a continued increase in stock prices in spite of mounting negative fundamentals in the economy. “The Great Recession” could well be followed by “the Great Rotation” with investors shifting their allocations from bonds to stocks. As with any complex system, the direction of markets can be determined by variables that are not well understood and are certainly not obvious until later. In the meantime, we will adjust by selling some investments that have become more popular and appear to be near fully valued, and continue our own rotation into what appear to be the better values in the equities markets.

Enclosed you will find your quarterly reports and statements for your review. We also include our annual Form ADV part II to satisfy the recent regulation changes in our industry. As always, please review these at your convenience and give us a call with any questions, comments, or changes in your investment objectives or financial profile. We thank you again for the opportunity to work with you

Sincerely,

Claude R. Carmichael CFA