Normalization—The Process Begins

One of Webster’s attempts to help define ‘normal’ is conforming to a type, standard, or regular pattern. When things in the world become irregular or off balance we begin a process to restore normalcy. And much like happiness, contentment or any other state of being, we are never in the optimum state for very long. We live most of our lives in some relative degree of normal or happy and spend most of our time and efforts attaining an allusive and ever-changing target.

Human behavior is generally what contributes to the unsettled aspect of normal. Just when balance is achieved, we are motivated to reach too far in one direction or another. In the business and financial markets, fear and greed are pretty strong contributors. Disequilibrium is further exacerbated by poor allocation of resources, bad management, errors in policy making, etc.

In our opinion, the financial markets beginning the first week of May took some major steps toward normalization in the interest rate environment and the bond market. We all know that The Financial Crisis resulted in unprecedented government action and policy making that entered unchartered territories. The result of these actions has been historically low interest rates. And not only have the rates been absolutely low (nominal rates), they have been extraordinarily low relative to inflation (real rates).

Since 1958 the real rate yield spread (difference between rates) between the ten-year treasury rate and the inflation rate has been on average approximately 2.55% or 255 basis points. For example, since 1958 ten-year treasury nominal yields have averaged 6.42% and inflation has averaged 3.87%. At the end of April 2013 the difference in the yield spread for real rates was negligible; e.g. ten-year at 1.60% and inflation at 1.40% equals .20 or 20 basis points.

The real rate yield spread difference of .20% or 20 basis points versus the historical average of 2.55% is far from normal. And in our opinion this anomaly has been the result of artificial stimulants via government printing presses and policy making. It was only a matter of time before the historical relationship was restored. In the two months beginning May of 2013 the bond markets began pushing interest rates higher. As of this writing, the yield on the ten-year treasury rose from 1.60% in April to
an early July high of 2.725%. Assuming a current inflation rate of 1.40%, the real return on the ten-year treasury has gone from .20% (1.60% - 1.40%) to 1.325% (2.725% - 1.40%).

If the average or normal real rate is to be achieved in the current low inflation rate environment, the ten-year treasury would have to rise an additional 1.23% to a yield of 3.95%. It is our opinion that the real return yield spread of 2.55% will be achieved again. Predicting the timing and amount of change in interest rates and the bond markets is as difficult a task as predicting the short-term moves in the stock markets. However, it appears that the process has begun to return some relative normalcy to the bond markets with the recent move up in rates and there is probably more to come at some future point in time.

So what does the ‘bond bubble’ and the move higher in interest rates mean for bonds and your portfolio? Bonds like stocks have two primary sources of return. One is the change in price of the instrument. And the second contributor to return is income that is paid. With stocks dividends are the income portion and in bonds interest is the income return.

A primary difference between bonds and stocks is that bonds have a finite life to them (maturity date). There is a point in time where the issuer of a bond has made a specific promise to repay you the par value of the bond. With common stocks the promise to repay you does not exist. With stocks the future value of your repayment (price) is determined on any given day by the market.

Generally speaking, investors view bonds as a more secure investment than stocks due to the promise of repayment and the generally fixed nature of the interest paid. With such assurances what is all the nervousness about the ‘bond bubble’ and its effect on investor’s capital?

Bonds do get priced each day in the market. The prices are a reflection of how much longer the bond has to maturity (the payoff), the credit quality of the issuer (the ability to repay) and the changes in interest rates in the daily market. The table below illustrates how bonds in a variety of maturity and quality change in price with a rise and fall in interest rates of 1%.

<table>
<thead>
<tr>
<th>Bond</th>
<th>1% rise in rates</th>
<th>1% fall in rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-year treasury</td>
<td>-2.0</td>
<td>0.7%</td>
</tr>
<tr>
<td>5-year treasury</td>
<td>-4.9%</td>
<td>4.90%</td>
</tr>
<tr>
<td>10-year treasury</td>
<td>-9.3%</td>
<td>9.3%</td>
</tr>
<tr>
<td>30-year treasury</td>
<td>-20%</td>
<td>20%</td>
</tr>
<tr>
<td>US High Yield</td>
<td>-4.4%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Emerg Mkt Debt</td>
<td>-5.9%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Municipals</td>
<td>-6.6%</td>
<td>6.6%</td>
</tr>
</tbody>
</table>

There are two things to take away from the table above. The longer the maturity the more price movement the bond has to a change in rates. And secondly, the lower the credit quality the more price changes relative to interest rates. The sig-
significant price change risk in the above scenarios is changes of -9.3% and -20% which are found in treasuries with maturities of 10 and 30 years.

When the ‘bond bubble’ is mentioned in our minds it is applicable to two things. First since the crisis there has been a significant amount of capital reallocated by investors from stocks to bonds and other yield investments; e.g. preferred stocks, real estate investment trusts, etc. Investors sought out bonds for their perceived safety as they were moving away from stocks resulting from their fears associated with the falling stock market. Second, it is focused on the treasury market, the growing balance sheet of the US treasury and the low real yields referenced above.

Bubbles typically result in asset prices which are extraordinarily high relative to normal fair values and collapse as liquidity dries up as sellers out number buyers by large numbers. In recent weeks, sellers in the bond market were more prolific than buyers thus resulting in lower prices and higher yields. However, liquidity was not an issue and the markets transacted their fund flows in an orderly fashion.

We have been aware of these characteristics in the bond markets and their possible resulting scenarios. Our strategy over the last 5 years was initially to take advantage of the dislocation in the markets and add to mortgage-backed bonds, buy higher yielding multi-sector funds, add to global bonds and add to actively managed funds. These have been productive moves. Over the past year we have begun to make changes to moderate duration risk in the portfolios. In some cases our active managers have been implementing these changes in their portfolios and in some instances we have reallocated assets to managers whose objectives are more focused on capital preservation. In a period like the last few weeks it is nearly impossible to escape total return losses in the bond market. Our objectives have been to limit losses and position capital where duration and credit quality risk are moderated. Bonds will be fighting the headwinds of rising interest rates for many years to come. However, with proper management they remain a core piece of an investor’s portfolio where more stable principal and predictable income is the objective. Additionally, the good news is that as a bond investor new capital put to work today is receiving a higher rate of return on the interest payment.

CURRENT INVESTMENT STRATEGY

The actions in the bond markets and the move up in interest rates did not result in changes to our strategy. In the year leading up to these changes we did actively review the risk in our fixed income portfolios and made some decisions to moderate duration risk. We have been more diversified in our fixed income portfolios than any time in our history and continue to find this valuable. We continue to look for opportunities to manage income in portfolios and to provide good risk-adjusted returns in the process.
The US equity market had one of its longest least volatile periods in history leading into the second quarter of 2013. All ‘Goldilock’ periods must come to an end and this latest one ended with the circumstances of the move up in interest rates beginning in May. The S&P 500 moved from a high of 1685 in late May to a low of 1560 in late June resulting in a 7% move down from peak to trough.

When we first entered our profession in 1983 we were dealing with two generational issues. One was that a number of our clients who were children of the depression never forgot it. They knew what it was like to do without and they would protect anything they had to keep from going there again. Secondly, the stock market indexes had been flat for nearly 15 years and few investors were willing buyers of stocks. The environment was also characterized by very high interest rates which competed directly with investor funds.

The Financial Crisis did a lot to change the psyche of investor’s relative to the stock market and real estate and losses of capital. In our opinion, it is probably something that is long-term and generational in nature. The stock market move down in the Financial Crisis was extraordinary and the circumstances surrounding it were systemically centered. Fear was the highest on the ‘Richter’ scale we have experienced in our career.

Fear in life can be healthy and prudent. The fear of a burning fire to the touch is healthy. It will keep you from being burned. However, the fear of fire itself would be unhealthy because it would prevent you from cooking food which is a healthy thing. Or experiencing a bone-in rib-eye which is very, very good!

Experiencing loss in investing is a normal experience. Investments go up and down in value. As we have said many times before the ultimate goal in experiencing losses are to limit both significant and permanent losses, with an emphasis on permanent losses. Permanent losses afford you no chance of recovery.

The fear of losing money is healthy if it helps us make thoughtful and prudent decisions that mitigate losses and in particular permanent losses. It keeps us from being burned. Fear is unhealthy if it paralyzes you from making any investment decisions or if it contributes to decisions that result in permanent losses of capital. Since 1980, the S&P 500 has had positive annual calendar returns in 25 of 33 periods. However, the average intra-year loss experienced during this period was -14.70%! The median loss was -9.0%. So on average, as investors we should expect the equity portion of our portfolio to lose at some point every year a decline represented by these numbers. Temporary loss is inevitable when investing in the stock market. Fear of this inevitable loss is probably unhealthy.

We realize the significance of the capital we manage and the fears associated with the security it provides. The Financial Crisis and its effects will be with this generation in many ways for years to come. The crisis called into action many changes which are having a positive effect; e.g. lower financ-
ing costs, lower total debt in the corporate and personal sectors, improved balance sheets in both sectors, improved capital structures in banking, heightened sense of the risk of over leverage, etc. We continue to see improvement in the economic environment, albeit slow and measured.

We continued to remain investors with a long-term perspective, value-orientation and a global perspective. The US markets and economy have led the globe in the Financial Crisis recovery. This was evidenced by US stock markets leading international and emerging market stocks in 2009, 2010 and 2011. As we evaluate the equity investment opportunities today, we continue to favor the US large cap stocks in the investment universe. We like their current valuations, their ability to compete in a growing global GDP for customers and their brand and geographic moats that help mitigate competition.

We also continue to find growing interest in the values being created outside the US. The opportunities are being created out of a lull in their associated economies and extreme political issues, but securities continue to look cheaper and more attractive to value buyers. Most notably, we have seen growing interest in our manager’s portfolios in developed Europe and Japan. Though 2012 was the first year in four that EAFE outperformed the S&P 500, international stocks have led domestic stocks in return for 7 of the last 10 years.

Note from the valuations below that the emerging markets and international equities are selling for cheaper valuations with higher current dividend yields than US stocks. Additionally, both the international and the emerging markets are selling at forward price to earnings ratios that are below their 10-year average.

## THE ABULS, BONE & ELLER EQUITY ALLOCATION AS OF JUNE 29, 2013:

<table>
<thead>
<tr>
<th>MARKET</th>
<th>CURRENT FORWARD PE</th>
<th>10-YEAR FORWARD PE</th>
<th>CURRENT DIVIDEND YIELD</th>
</tr>
</thead>
<tbody>
<tr>
<td>World (ACWI)</td>
<td>12.9</td>
<td>13.3</td>
<td>2.7</td>
</tr>
<tr>
<td>International (EAFE)</td>
<td>12.5</td>
<td>13.0</td>
<td>3.4%</td>
</tr>
<tr>
<td>US (S&amp;P)</td>
<td>14.2</td>
<td>14.2</td>
<td>2.0%</td>
</tr>
<tr>
<td>Emerging Markets (EM)</td>
<td>9.8</td>
<td>10.8</td>
<td>3.0</td>
</tr>
</tbody>
</table>
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Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Investments are subject to market risk, including possible loss of principal. Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US. Alternative investment strategies involve greater risks and are only appropriate for the most sophisticated, knowledgeable and wealthiest of investors. High-yield bonds are not suitable for all investors. When appropriate, these bonds should only comprise a modest portion of your portfolio.

The S&P 500 is an unmanaged index of 500 widely held stocks. The MSCI Emerging Markets Index is designed to measure equity market performance in global emerging markets. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. Barclays Capital U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. The MSCI EAFE (Europe, Australia, Far East) index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. It is not possible to invest directly in an index.

The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability. (P/E) is the price of the stock divided by its earnings per share. The MSCI ACWI ex US Index is an equity index based upon a broad based world ex-US composite market.

Past performance does not guarantee future results. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs and tax considerations. If included these costs would reduce an investor’s return. As federal and state tax rules are subject to frequent changes, you should consult with a qualified tax advisor prior to making any investment decision. Raymond James does not provide legal or tax advice on these or any other transactions.