December 2012

Monthly Investment Commentary

Commonwealth Bank & Trust Company

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Despite a post-election stock market slide and uncertainty caused by ongoing budget negotiations in Washington, investor sentiment improved in late November and the resulting market rally pushed stocks into the black for the month. Both large- and small-cap U.S. stocks returned around 0.5%, while mid-caps gained 1.6%. Growth did better than value across all market caps. International markets also finished November in positive territory. As worries about a Eurozone breakup lessened, both the broad international and regional European benchmarks gained around 2.5% for the month, and emerging-markets stocks rose 1.3%. Year to date, U.S. and international stock returns are in the low to mid-teens.

Domestic investment-grade bonds edged up 0.2% in November while developed foreign bonds slipped 0.1%. Emerging-markets local-currency bonds also continued their positive year, rising 1.4% in November, bringing their year-to-date return close to 15%.

THE ELECTIONS ARE BEHIND US, BUT CHALLENGES REMAIN

We don't spend a lot of time making short-term predictions about the economy and political outcomes. Frankly, we are skeptical that any investor(s) can consistently get them right and therefore question how much value it adds to the investment process and results. Instead, we focus our time on trying to understand how a range of outcomes—macro, political, or otherwise—can impact our investment strategies. To that point, the recent election and the fiscal cliff negotiations may take attention away from the underlying longer-term problems the global economy faces, but those deeper problems will remain the driver of how things unfold in the years ahead. In other words, we are less concerned with the media's focus on the coming debt ceiling, than we are about the debt itself. It is our belief that high debt levels and other structural issues in the developed world will dominate the economic landscape and be a key focus of our investment and risk management strategies over the next five years.

Issues like Europe's debt struggles, our longer-term fiscal issues, and a potentially sharp slowdown in growth in China create risks that can shake markets at any time. Moreover, we are challenged to find positive counterpoints to the structural challenges we see impacting economic growth. A fiscal cliff agreement, for example, may replace a painful short-term dose of budgetary medicine with a more measured and economically better tolerated regimen. However, any solution by definition will have to reduce the dangerous gap between revenues and spending that is being plugged with ever increasing amounts of debt, and this will create economic headwinds likely to suppress growth for a number of years to come. The same holds true for Europe; there is no game-changing solution that replaces the difficult adjustments that must occur. So it's not an issue of whether there will be painful economic consequences, it's an issue of when, what form they will take, how well managed they will be, and whether a very negative outcome can be avoided—and, equally important, the extent to which financial asset markets are discounting (i.e., pricing in) the potential range of outcomes.

Against this backdrop, the most plausible positive case is one where in the years ahead policymakers manage to avoid a crisis, allowing us to muddle along with modest economic growth (ideally) until things gradually get better, and eventually (perhaps later in this decade) we return to a more historically normal growth rate. We believe we can still earn decent returns in that subpar growth environment, by pro-actively implementing strategies that are well suited for this type of environment. Examples of strategies that we have regularly discussed are: high-quality and global dividend paying equities, alternative strategies and asset classes, unconstrained bonds and tactical asset allocation to capitalize on short-term market volatility. A major obstacle facing us and all investors is how to handle the lower expected returns from bonds, which often comprise a significant portion of traditional portfolios.

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THE RISK-RETURN EQUATION FOR BONDS

Earning an acceptable rate of return on bonds the next five years will be a challenge. Therefore, the bond portion of portfolios will demand special attention because yields across most fixed-income sectors are exceedingly low, and, in many cases, are at historically low levels. High-quality bonds (such as Treasurys) may provide protection during sharp stock-market downturns as investors flock to "safety." However, with interest rates at record lows, the ability of Treasurys to provide positive returns is limited. The only way to increase the protective value of bonds in such an environment is to extend duration, which is another way of saying "take on more interest-rate risk," to achieve higher returns as rates fall. However, with rates so low, there is significant likelihood that rates will instead rise over our five-year investment horizon, and this will hurt bond prices. Investors are thus forced to choose between trying to protect against a severe recession and stock-market declines, and protecting against rising rates.

Our general approach has been to reduce exposure to core bonds—the kind that provide the most recession protection—in favor of higher-yielding, shorter-duration, global and/or unconstrained strategies that have less risk if rates rise and that should generate better returns along the way. In fact, we are highly confident that over a full five-year span we will earn higher returns from these strategies versus the core bond index (Barclays Aggregate) in almost any scenario, even while they would temporarily underperform the benchmark in a fear-driven market selloff.

In thinking about the impact of this tradeoff on portfolio risk, it's helpful to consider risk in the context of time. Some of the non-core bond strategies may provide less short-term protection, during a "risk-off" market, but we are confident that over a period of quarters instead of days or months, this will even out as market confidence comes back. In other words, some of the bond strategies we are utilizing might not rally in a bear market, and might even suffer modest losses in the shorter term, but it will be temporary rather than permanent. It's important for investors to understand that tradeoff so they know what to expect in a difficult market.

THE FISCAL CLIFF, TAXES, AND MUNI BONDS

The fiscal cliff negotiations have brought taxes to the forefront of people's minds, and we want to update readers on our thinking about the municipal bond asset class. Most of our comments address the national municipal market, and may be different than what you'd expect based on the headlines in the media.

At a high level, our objectives for the bond portion of our tax-sensitive portfolios are the same as for our tax-exempt portfolios. We are trying to improve returns while not entirely trading off the modest risk-management benefit we get from high-quality core bonds. Muni bonds carry generally the same challenges and problems as their taxable counterparts. Yields are dismally low, but in a fear-driven market they would likely rally to some extent along with Treasurys, so their role in providing ballast to a portfolio is similar to that of high-quality, core taxable bonds. With taxable equivalent yields very low, we expect returns to be very low over the next five years (2-3%) and likely to lag some of the taxable strategies and managers we are using. This has been the situation for a while, and as a result, we may recommend using some of our preferred flexible and absolute-return-oriented bond funds—alongside muni funds—in our tax-sensitive portfolios.

To improve our fixed income returns we are generally willing to accept greater credit risk and less short-term downside protection in exchange for protecting against what could be a more painful, rising interest-rate scenario (interest rate risk). In other words, there appears to be an asymmetric risk/reward scenario among most fixed-income asset classes. The upside is limited because of the absolute low level of rates, while there could be significant downside should rates rise. Another option for managing muni bonds' interest-rate risk is to shift from intermediate-term munis to short-term munis. However, short-term muni yields are paltry. For example, the one-

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to three-year segment of the muni market is yielding 0.5%, compared to 1.6% for an average 10-year muni bond of higher quality. Meanwhile, going farther out the muni yield curve and investing in longer-maturity bonds does get us higher yields, but doing so further increases risk from rising rates. We believe the intermediate part of the muni curve, where we are currently positioned, currently offers the best risk-reward tradeoff. In both taxable and tax-sensitive strategies we are very cognizant of downside loss thresholds and take these into account in our overall portfolio allocations, including our exposure to credit and interest-rate risk.

STRONGER DEMAND FROM EXPECTED TAX INCREASES MAY BE OVERBLOWN

Supply and demand forces also play a role in determining muni returns. Since the muni market collapse in late 2008, due to concerns over substantial defaults, strong investor demand has pushed muni returns higher by more than 25%. We suspect much of the potential demand tailwind that contributed to this rally has already played out. Individual investors typically account for roughly two-thirds of the muni market, and we expect that most high-tax-bracket investors already hold munis. Therefore, an increase from 35% to 39.6% in the top bracket isn't likely to result in a significant swing to munis and increase demand for tax-exempt bonds. So where has the recent demand come from?

One source has been taxable investors making a tactical play by crossing into the muni market as yields in certain parts of the taxable fixed-income markets (such as high-quality corporate bonds) have been less attractive than munis even on a pretax basis. Some of that is from taxable mutual funds, including PIMCO and others. Some of these "crossover" investors are investing in the longer-dated, higher-duration maturities, and in the riskier high-yield segment of the muni market, which has rallied strongly, but seems quite vulnerable to a pullback that could be made more painful if and when this shorter-term money rushes for the exits.

On the supply side of the supply-demand equation, net new municipal bond issuance has been minimal, with the majority being municipalities refinancing at lower rates. With a lack of new bonds in the muni market, existing demand also contributed to bond prices rising and yields dropping to record lows.

STATE AND LOCAL GOVERNMENT FISCAL PROBLEMS HAVE IMPROVED

We are likely to continue to read about fiscal problems at the state and local level, including threats of defaults, union strife, pension abuse and reform, etc. This headline risk could contribute to periodic weakness in the muni market, and, as noted above, could contribute to "hot money" heading for the exits. But this isn't a driver of our thinking, as there have also been encouraging signs relating to generally improving fundamentals.

While municipalities are not clear of their fiscal challenges, they have made progress in improving their fiscal credibility. We have seen many examples of higher taxes, pension reforms, public sector layoffs, and significant spending cuts (several hundred billion in expenses have been cut at the state level over the past three years) that are to varying degrees helping municipal government's correct gaps between what they take in and what they spend.

WHERE DOES THAT LEAVE US IN TERMS OF OWNING MUNIS?

We make investment decisions at the asset-class level based on a longer time-frame, usually five years, and factoring in multiple macroeconomic scenarios. Based on this time-frame, we view munis as neutral to slightly overvalued and expect low single digit total returns. As discussed above, we think it may make sense for municipal bond investors to consider supplementing their portfolios with taxable bond strategies that have higher expected total returns. As with core taxable bonds, what little yield you get with munis comes with risk of price declines if and when we see rates moves higher. Although, like core taxable bonds, if we see fear drive

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stocks lower, munis are likely to follow Treasurys higher in a flight to quality. In summary, the recent drop in municipal bond yields, including Kentucky, has us less optimistic about the asset class. That being said, we are confident that our investment team can continue to add value to returns thru our bond selection and portfolio management strategies. If you have any questions about the municipal bonds in your portfolio and/or any of the strategies discussed, please do not hesitate to contact us.

– CB&T Investment Team (6/12)

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