Investment Commentary

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Stocks ended October with strong gains despite the Congressional budget impasse that shut down the government for 16 days and led to speculation about the potential for a U.S. default. As has been the case for much of the year, investors seemed more focused on Federal Reserve policy and the likely time frame for winding down quantitative easing. Economic data continue to indicate moderate growth—well below what would be considered a normal economic recovery—and very low inflation, suggesting to investors that the Fed may not begin to scale back its asset purchases until late this year or even 2014. Any expected increase in the federal funds rate has been extended well beyond that. In the interim, the Fed's end-of-month decision to maintain its bond-buying program at current levels was treated as a nonissue by investors. Many companies reported quarterly earnings during October and market reaction was generally positive, also helping to boost stocks.

Among international markets, we've seen a modest rebound in emerging-markets stocks as U.S. interest rate fears have subsided, at least temporarily, and as China has seemed to show an improved economic outlook. Emerging-markets stocks kept pace with U.S. markets in October, though still trail significantly year to date. Developed foreign markets also gained in October amidst modest economic growth and low inflation internationally. In our view, emerging-markets' potential returns are considerably higher than those of both U.S. and foreign developed markets over the next five years. In the near term, we expect the emerging markets to stay volatile as investors (over) react to the direction of interest rates and currencies, we would view any significant sell-off as an opportunity to add to this asset class.

In keeping with a strong month for stocks and risk assets, corporate bonds did well in October, particularly high-yield bonds that tend to somewhat mirror equity market trends.

RESEARCH Q&A

In the context of the recent government shutdown, and the budget and debt-ceiling debacle, what are your thoughts on the potential impact if the United States were to default?

We certainly didn't and still don't see a U.S. Treasury default as a probable event because it is really not in anyone's interest to default. But in the current political climate, it is not a zero probability either. Depending on how a technical default is handled by the Obama administration and the Treasury, and how quickly the situation is resolved, the impact on the financial markets and global economy could be anywhere from a brief negative shock to a sustained and severely negative outcome.

Clearly, the consensus view is that even a technical default that lasts for any meaningful period of time (maybe beyond a few hours or days) could be catastrophic for the markets and the economy because of the role of U.S. Treasurys as the linchpin risk-free asset of the global financial market system. And that catastrophic outcome is exactly why people put a very low probability on a default actually happening, because why would we do that to ourselves?

The recent debt ceiling situation gives us the opportunity to again make the broad point that our response to questions on these types of topics (government shutdowns, debt ceiling debates, the outcomes of elections, the Federal Reserve's next move, etc.) is to note that it is impossible to predict these things with sufficient confidence to justify making an investment bet on that prediction. Moreover, we would have to feel we have information the markets are failing to adequately price in for us to believe we could add value by making decisions based on these factors. In most cases, with issues like this, we are not going to believe that we have superior insight versus what the market is already reflecting and discounting. There may be times when this is not the case and we would take that into account in our decision making. But overall, as long-term investors we don't try to add value predicting short-term outcomes that are inherently very difficult to predict and profit from.

What is relevant for our investment process is that the recent events out of Washington have not changed our fundamental longer-term outlook and the range of scenarios we think are most likely to play out. The debt ceiling debates and government shutdown certainly reinforce our view that we are investing in a time of extreme uncertainty,

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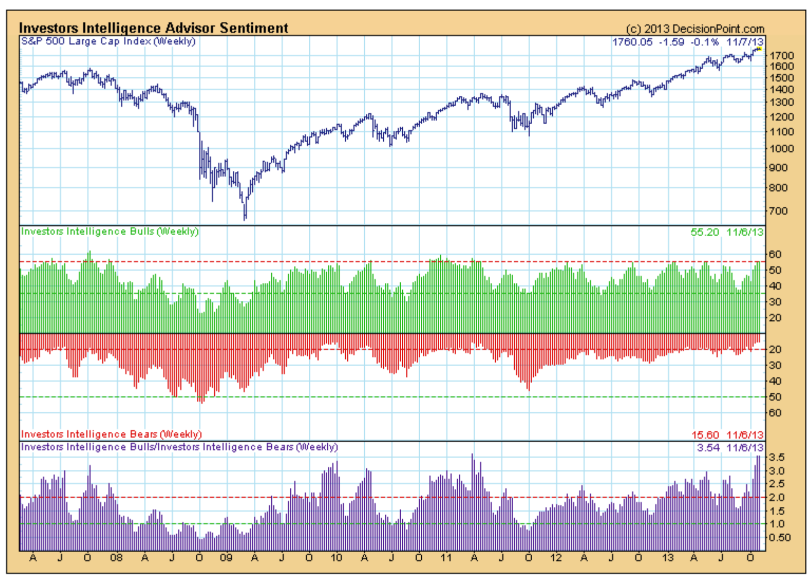
with unprecedented policy actions and political dynamics that only serve to exacerbate the fundamental economic uncertainty stemming from the aftermath of the 2008 debt crisis.

Stock markets have been very strong this year, are there any indicators or charts that you are watching that make you cautious on stocks going forward?

As is usually the case, there are plenty of charts that can be used by the bulls and bears to make their case on the outlook for stocks. That being said, below are a couple of charts that are not being widely discussed in the financial media, but we believe have the potential to weigh on stocks going forward.

The first chart is courtesy of GaveKal Research and highlights the relationship between private payrolls and stock performance. Since this bull market began in March 2009, one of the main driving forces for stock prices has been the strength of the US recovery. The correlation between employment growth and stock performance has been strong, when employment accelerates the stock market has gone up and when it slows stocks have corrected. This high correlation makes sense because the main threat to stocks since the financial crisis has been a relapse into recession or stagnation. However, since July, this relationship has diverged, with payroll growth slowing and stock markets rallying sharply. We expect that the next couple of months will be crucial for the rally, as payroll growth will need to accelerate to justify the move in stocks or stocks will correct to reflect a slower economy. Keep an eye on this relationship...

The second chart is a look at the Investor's Intelligence Advisor Sentiment, which is a survey of leading independent market newsletters and is a good indicator of the current bullish/bearish sentiment in the market. The chart below shows that the ratio of bulls to bears has reached a very high level; in fact, last week's reading has only been exceeded twice going back to 1988. This is a contrary indicator and extremely bullish readings are not a guarantee that prices are going to correct, but the likelihood of a correction is greatly increased.



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With the pension concerns and recent bankruptcies, what is the argument to stay invested in the municipal bond asset class as opposed to investment-grade bonds? Can we really trust the creditworthiness of municipals as being investment grade anymore?

The fiscal health patterns of municipalities are idiosyncratic, not systemic. While municipalities can share similar demographic characteristics, you can observe meaningful differences of fiscal health between neighboring communities.

For example, the neighboring California cities of Stockton and Tracy both benefited from the housing boom, and suffered the same real estate crash. Yet Tracy was able to maintain reserve levels at 50% of their annual budget, while Stockton filed for bankruptcy. This shows how management plays a very important role, which is why assessing fiscal health and management can be key in fundamental analysis. We believe our long history and expertise in evaluating the fundamentals in local markets gives us a competitive advantage in selecting municipal bonds, especially in the Commonwealth of Kentucky.

Overall, most cities are improving their fiscal shape, building reserves, and taking the necessary fiscal steps, including pension reform, which has occurred to some degree in 40 some states. This includes local municipalities, which are starting to benefit from higher property tax revenues as real estate values continue to increase. There are trouble spots, primarily at the local level, but overall we don't think the creditworthiness of municipalities is in question.

As for why we continue to own municipals and not taxable investment-grade bonds in our tax-sensitive client portfolios, our return expectations for munis are similar to our return expectations for taxable bonds. However, on a tax-adjusted basis, munis continue to look relatively attractive.

What are your views on floating-rate loans given the large inflows into the asset class this year?

The strong level of inflows into floating-rate loans is not surprising. Flows into and out of the floating-rate loan funds have been strongly correlated with the anticipated direction of interest rates. For example, in 2011, Wall Street consensus was that the Fed would start to gradually raise rates, creating strong demand for loans. When the Fed announced its plan to leave rates unchanged until 2013, loan funds experienced significant outflows. This year's sharp rise in rates has again created strong demand for floating-rate loan funds. While not surprising, a consequence of this strong demand is that our return expectations have been incrementally lowered. There are two reasons for this. One, strong demand results in higher prices, and less upside. With prices now essentially trading at par, there is little room for price appreciation. Two, floating-rate loans have little in the way of call protection, meaning that in a declining or prolonged low-interest-rate environment, issuers are incentivized to pay off existing debt (typically at par or only a slight premium to par), and reissue new loans at a lower interest rate. Not only that, but in periods of strong demand, issuers are able to negotiate better deal terms in the form of lower LIBOR floors, which weighs on return expectations, as well as less-restrictive covenants. This backdrop has not been game-changing in terms of our return expectations. Valuation sources that we utilize suggest that returns over the next five years in a base case scenario should be roughly 4.5%, which is slightly lower than we previously expected but still attractive relative to other types of fixed-income investments. We continue to believe that loan fundamentals, despite a slight increase in less-favorable deal terms, remain healthy, and that in the event of a strong, unexpected inflationary environment, loans will provide a level of protection for core fixed income portfolios, while also generating a competitive return with other core bond exposure and improving diversification. Should there be a pullback in loan prices, we would consider adding to positions in portfolios that have an appropriate risk tolerance.

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Do you consider real estate investment trusts (REITs) as a good hedge against inflation? What are your current thoughts on the asset class overall?

To make a blanket statement that real estate investment trusts are a great inflation hedge would, in our opinion, be misleading. REITs, or even more broadly, real estate, can provide some level of inflation protection, but the effectiveness will depend on several different considerations, many of which will vary from cycle to cycle.

One consideration is the supply/demand characteristics. One lesson we can learn from the early 1990s is that real estate is not an effective inflation hedge when there is an oversupply of property, which has been the cause of many REIT cycles. High levels of vacancies make it difficult for landlords to raise rents, and in an over-inventoried market during an inflationary period, the cost of managing a property could increase at a faster rate than rents, making it a bad inflationary hedge. In the current real estate cycle, we don't have an oversupply issue. So it's possible that if inflation picked up, landlords could raise rents at a faster clip than expenses, providing some level of inflation protection. Even then, it is going to come down to lease terms by property type and geographic location. Geographically, well-located real estate in high-barrier-to-entry markets will typically have the best inflation protection characteristics. In terms of property type, short-lease durations such as those in hotels are better from an inflation hedge perspective as their rents change daily, while longer leases found in offices or malls have rents that are often locked in for years, making it more difficult to compensate for increasing costs.

There are also interest-rate considerations. The value of a building depends on the interest cost to finance it. Holding all things equal, as interest rates increase, the value of a building will decrease unless the cash flow increases enough to compensate for the increase in borrowing costs. If that's the case, you won't have a good inflation hedge. And to really do this analysis you have to know how much leverage is being used to finance buildings. We would also say that we have seen a lot of volatility with REITs. So REIT performance can be affected as much by general stock market sentiment as it can be by underlying property valuations. Take the recent decline that REITs suffered when interest rates increased. We saw dramatic outflows from income-oriented investments, including REITs, which seemingly had little if anything to do with changing fundamentals.

One last point we would make is that we have not had a high inflationary period since the beginning of the modern REIT era, which roughly began in the early to mid-1990s. Prior to then, the REIT universe was mostly mortgage REITs. So we would caution anyone from hanging your hat on historical studies. Overall, we would say that REITs could be a partial inflation hedge, but again, making a blanket statement about property as an inflation hedge would be misleading.

As for the current REIT environment, our view is that fundamentals are okay, but not great. Analysts we review are seeing some net operating income growth, but it's modest. Valuations are certainly more attractive after the decline that began in May. REITs are up roughly 3% year to date versus 20% for the broader equity market. So from a relative valuation perspective, they are more attractive now then earlier this year. Going forward, if we have a pause in rates, we would not be surprised to see REITs perform well in the short term. We are not adding REITs as a broad tactical asset allocation decision, rather we viewed the recent correction as an opportunity to selectively buy a couple of leading individual REITs that we think are market leaders and possess competitive advantages. If we see further pullbacks in the asset class we may look to increase our exposure.

We appreciate your confidence and look forward to helping you navigate these challenging markets. Please let us know if you have any questions on the above commentary or if there are topics you would like us to address in the future.

– Steve Giacobbe, CFA, CFP®
Chief Investment Officer