DIVERSIFIED TRUST

COMPREHENSIVE WEALTH MANAGEMENT

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FIRST QUARTER 2013

how safe is the "safe" component in your portfolio?

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During the past six years, investors have withdrawn a little more than $400 billion from equity mutual funds while contributing more than $1.2 trillion to bond funds, both on a net basis. Some of this massive shift is attributable to the fact that baby boomers are approaching retirement which calls for increased emphasis in their portfolios on income generation and relative stability. But, the trauma of the economic and stock market collapse of 2007-09 is also certainly a factor as many investors have sought to insulate their portfolios from another potential economic or market shock. This trend has not been limited to individual investors as demonstrated by the fact that pension funds cut their equity exposure in recent years from 60% to 38% while increasing their fixed income weighting from 28% to 41%. Most important, this shift toward fixed income has occurred during what may turn out to be the final stage of a long and powerful bull market in bonds.

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In September of 1981, the yield to maturity on the 10 year US Treasury Bond was 15.84% as compared to 1.76% on the last day of 2012. This decrease in interest rates resulted in an annualized return on a broad index of bonds over the thirty-one year period of 10.1%, which is almost twice the long term average and just shy of the 11% earned by stocks. By any measure, this was a stunning period for bond investors.

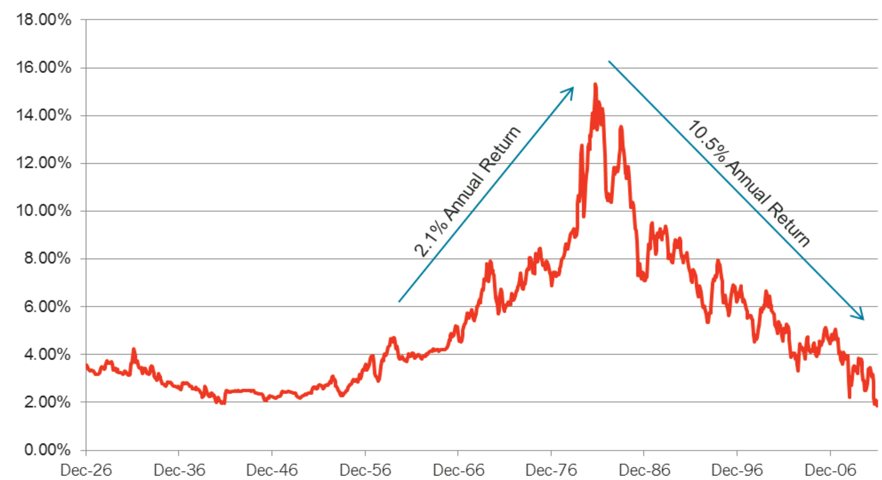
We have no confidence in our ability to forecast interest rates, so we won't join the ranks of those who suggest that rates "just have to go up sooner or later." But, it is important to understand that the risk: reward relationship for bonds has changed which compels us to think carefully about the role that bonds play in portfolios.

The Role of Bonds

Historically, bonds have represented an important component of most balanced portfolios because of the following important characteristics:

- They generated a cash yield significantly above the dividends provided by stocks.
- They generated a total rate of return that exceeded inflation by about 2% per annum thereby contributing to the overall real return on the portfolio.
- They were not highly correlated with stocks which means they provided a diversification benefit.
- They experienced volatility that was approximately one third that of stocks. When combined with the fact that they have a specific maturity date, this suggests they represented the "safe" component of the portfolio.

Bull Market in Bonds



It is important to spend a moment on the concept of safety because surveys of mutual fund investors suggest that many of those who have piled into bond funds do not understand that their investment is subject to price risk. Yes, if you purchase an individual bond and hold it to maturity, then you are guaranteed to receive a return of principal. This is one of the primary reasons that we manage separate municipal bond portfolios for our taxable clients.

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But, if you invest in an actively managed bond fund, the price of the fund will fluctuate because of the impact of changes in interest rates on the underlying bonds held in the fund. Of course, the manager of the fund may make changes in the portfolio that will dampen the impact of changes in interest rates. But, even so, since there is no ultimate maturity date for the fund, the amount that will be realized should you choose to redeem the fund is therefore highly uncertain. And, as we will see in a moment, the changes in price can be significant.

What Has Changed?

How has the world changed? First of all, the dividend yield on the S&P 500 is now 2%, emerging market stocks yield about 2.3%, and large capitalization European stocks yield about 3.6%. Therefore, depending upon the actual blend, a globally diversified equity portfolio yields about 2.5% or so which compares with the yield on the 10 year US Treasury Bond which is now 1.9%. So, for the first time in many years, stocks provide more current income than intermediate Treasury Bonds. Who would've thunk it? Second, the consensus forecast for inflation for the next ten years is 2.5% which means that purchasing a ten year US Treasury bond yielding 1.9% should result in an annual loss in purchasing power of .6% (1.9%-2.5%) So, combining a current return that is less than the dividend yield on stocks with the likelihood of a negative real return, the return side of the risk : return equation certainly does not look very appealing.

What about risk? I won't bore you with a dissertation on the mathematics of bond investing, but take my word for it that the sensitivity of the price of a bond to changes in interest rates increases as interest rates decline. In other words, as interest rates decline, bonds become more susceptible to a rise in interest rates. Simply stated, they carry more risk. At current low levels of interest rates, the duration of a ten year US Treasury Bond is just under 9 which means that a 1% rise in interest rates will result in a 9% decrease in the price of the bond. To make this point more vivid, let me remind you that the yield on the ten year US Treasury Bond just prior to the first sign of economic and market problems in mid-2007 was 5%. Should interest rates return to those levels immediately, the price of a ten year bond would decline by approximately 25%. Now, that is risk in my book! And to further emphasize the point, the duration of the thirty year US Treasury Bond is approximately 19 which suggests that a 1% rise in interest rates would result in a price decrease of 19%. Wow!

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A famous economist said, ''there are only two kinds of interest rates forecasters: those who don't know where interest rates are going, and those who don't know that they don't know where they are going. '' So, we are not forecasting a dramatic rise in interest rates, but I hope that the last couple of paragraphs make it clear that good old US Treasury bonds are not very attractive from either a risk or return perspective. But, most of our clients continue to be well-served by having a portion of their portfolio dedicated to generating income with relative safety. So, we will always maintain an allocation to core fixed income. But, ideally, we would like to diversify our portfolios by finding strategies that have some of the characteristics of bonds but are subject to less interest rate risk. So, what are we doing to construct portfolios that meet those objectives?

Fixed Income Strategy

Changes in our clients' portfolios take place at four levels. First, our Investment Strategy Group develops a recommended or model portfolio that is then modified to meet the specific needs of each client. Based on our view of the investment world, we make moderate shifts in recommended weightings, although these changes tend to be evolutionary in nature. Second, we make more tactical, opportunistic shifts in those weightings in response to significant changes in the economic outlook and relative valuation. Third, within each of our Common Trust Funds, we make changes in strategies, weightings, and managers. Finally, the managers we employ in each Fund buy and sell individual securities based on their investment philosophy and current outlook. As a result of the changing risk/reward dynamics of bonds, we have made important shifts in our fixed income strategy at each of these levels.

Let's begin with the first two levels which represent our high level allocations. While we have not changed the overall recommended fixed income weighting significantly, its components have evolved considerably. In early 2009, the entire weighting consisted of investment grade bonds (Short Duration plus Core Bonds) whereas we are now recommending 60% in those two categories and 40% in our Credit Opportunity Fund.

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The Credit Opportunity Fund takes moderate credit risk (Average quality rating of BBB-) but has a yield of 4.7% and duration of only 2.2 years. In other words, it has an attractive current return with very modest exposure to rising interest rates.

In addition, we recently added an allocation to a consumer lending program that makes 3-5 year small loans to individual borrowers with relatively high credit scores. The borrower pays both interest and principal monthly so the loans have a relatively short average life which means that they are not exposed to rising interest rates. Most important, the strategy is expected to generate a current return of 7-9% net of expected credit losses. Once again, this is an example of taking modest credit risk in order to generate very attractive returns. And, when combined with the allocation to the Credit Opportunity Fund that was discussed above, this strategy has resulted in a marked decrease in the overall sensitivity of our clients' bond portfolios to rising interest rates. Similarly, we have shortened the duration of our taxable clients' municipal bond portfolios from 5.2 to 3.6 years in order to accomplish the same objective.

Finally, we recommend several strategies that have risk: return characteristics that fall somewhere between stocks and bonds. For example, Master Limited Partnerships are publicly traded vehicles that invest in energy infrastructure, principally pipelines. While they trade in the equity markets and therefore carry downside risk, they generate a current return of approximately 6% and the possibility of appreciation. In other words, they have the income characteristics of bonds (in the good old days of higher interest rates) but are exposed more to equity risk than interest rate fluctuations. Similarly, most of our portfolios have an allocation to Multi Strategy Mutual Funds or Hedge Fund of Funds that are designed to capture a portion of the upside in stocks with volatility that is more similar to that of bonds.

As previously mentioned, we have also responded to changes in the risk and return characteristics of bonds by making significant shifts within our Common Trust Funds. For example, in our Credit Opportunity Fund, we now have a 40% allocation to Senior Floating Rate Bank Loans. The interest rate on these securities is tied to market rates which means that they actually benefit from rising interest rates. Similarly, we have approximately a 10% allocation to short term high yield bonds that once again provide an attractive return and modest interest rate exposure in return for taking some credit risk.

The final layer of management is the selection of individual securities by the underlying managers in our Common Trust Funds. Our managers are obviously aware of the changing characteristics of bonds that were discussed above and have adjusted their holdings accordingly. In particular, they maintain minimal holdings of US Treasury securities and have instead focused on high grade corporate and asset backed securities that offer returns that materially exceed those of Treasury Securities. For example, a broad universe of investment grade corporate bonds currently provides a yield that exceeds that of Treasuries of comparable maturity by approximately 1.4%.

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Balanced Portfolios in the New World

For many years, a "balanced" portfolio was exemplified by the traditional blend of 60% stocks and 40% bonds. Stocks were viewed as the return generators for the portfolio and bonds provided current income and a relatively safe haven. The next couple of steps in the evolutionary process involved international diversification and an initial foray into "non-traditional" assets such as real estate, private equity, and hedge funds. We think we are now at a point where another evolutionary step is required. Today, plain vanilla bonds such as US Treasury Securities do not generate particularly attractive levels of income and they will not represent a safe haven should interest rates rise significantly. Because we do not make "all or nothing" decisions, we will continue to maintain an allocation to core fixed income, but we are making significant shifts to other categories that provide more income and modest interest rate exposure. Of course, there is no free lunch so these categories still entail risk. But, the key point is that they bear different risks. Hopefully, by diversifying risks, the "safe" portion of the portfolio will fulfill its traditional role of income generation and relative stability. ■

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