Walker & Associates

Second Quarter 2013 *Key Takeaways*

Federal Reserve policy has been a significant force driving market performance over the past few years and this was especially true during the second quarter as investors reacted to comments from Fed policymakers indicating the Fed might begin reducing its bond buying program sooner than had been expected.

Against this backdrop, U.S. stocks suffered losses in June but ended the quarter with gains (though stocks were down from earlier year highs). Core investment-grade bonds fell 2% for their worst quarter since 2004 and other interest-rate sensitive asset classes such as REITs were negative as well. Emerging-markets stocks and bonds lost ground both due to concerns about changes in U.S. monetary policy and potentially slowing growth in many emerging-market economies.

There were two second-quarter market developments we find particularly noteworthy: the spike in Treasury bond yields and the sharp decline in emerging-markets stocks and bonds. While our portfolios were helped (on a relative basis) by the first, they were hurt by the second.

Our longer-term outlook and asset class analysis has had us positioned for a rise in rates (and a decline in bond prices) for a while now, reflected by our underweight to core bonds and overweight to flexible/absolute-return-oriented bond strategies.

We are also underweight equity risk (stocks) overall and while this has been beneficial during the quarter's short-term market declines, we have been hurt by our positions in emerging-markets stocks and emerging-markets local-currency bonds relative to U.S. stocks.

Although we do consider potential shorter-term *risks* in managing our portfolios, we don't try to predict what markets will do over the short-term or position our portfolios for particular short-term outcomes. The events of the past quarter have not materially changed our longer-term asset class views or risk assessments. Consequently, our tactical portfolio positioning has not changed.

With regard to emerging markets, while we believe the recent sell-off is overdone and short-sighted, we remain cognizant of the potential fundamental risks to emerging markets, most notably a sharp slowdown in China or unexpected inflation.

While it can be uncomfortable to see short-term losses in one's portfolio and financial markets falling across the globe, we actually welcome this recent market volatility as it has the potential to create more attractive, if not outright compelling, *long-term* investment opportunities if investors overreact and cause markets to overshoot to the downside as is often the case.

Second Quarter 2013 Investment Commentary

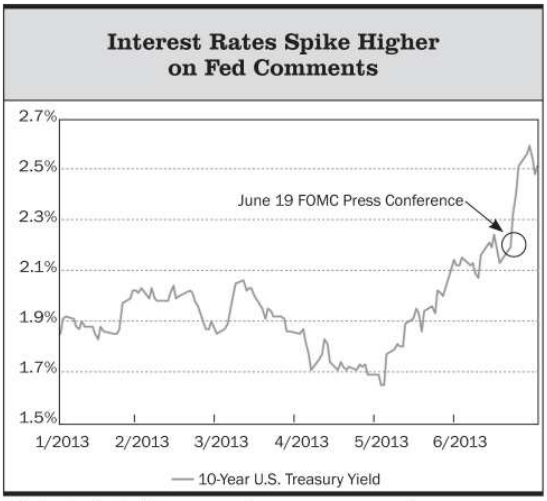
Our commentary will focus on two market developments during the quarter that are noteworthy at both a macro level and given our portfolio positioning: (1) the spike in Treasury bond yields, and (2) the sharp decline in emerging-markets stocks and bonds. Both of these developments had (to varying degrees) the same underlying driver: statements from the Federal Reserve about the future course of monetary policy, and specifically the Fed's plans to begin "tapering" its quantitative easing bond-buying program. This is a theme we've written about a lot recently: the unusually heavy influence of monetary policy on the financial markets in the aftermath of the 2008 financial crisis, and the unusually strong sensitivity of markets to perceived changes to such policy. We've noted how Fed policy—by "repressing" interest rates to all-time lows and aggressively purchasing government and mortgage-backed bonds via quantitative easing—actively encouraged (if not forced) investors to move out on the investment risk spectrum, into higher-yielding but riskier asset classes. In our view, this had helped to boost the U.S. stock market to levels beyond what was justified by the longer-term economic (earnings) fundamentals.

We noted that this behavior could certainly continue in a self-reinforcing cycle as long as the markets believed two things: (1) that the Fed would keep up their stimulative policies and, (2) that such policies were necessarily positive for stocks rather than, say, indicative of the severity of our economic problems. If so, as the markets moved higher more and more short-term-oriented or performance-chasing investors would feel the urge to jump on the stock market bandwagon, propelling the market still higher and further divorcing it from its underlying longer-term economic fundamentals.

That short-term speculative approach is not part of our investment discipline nor is it likely to yield consistent, sustainable success for most investors. That does not mean that we ignore what the Fed is doing, how their policies might change, or what the implications might be for the economy and financial markets. But maintaining an awareness of different possible monetary policy scenarios and outcomes is very different from making portfolio decisions based on the confidence that we know which particular scenario will play out over the short-term *and* that we can get the timing right.

Development #1: Interest Rates Spike Higher

Chairman Ben Bernanke indicated on June 19 that the Fed might begin to taper the pace of monthly bond purchases sooner than expected. Despite Bernanke's best efforts to manage market expectations and communicate that a potential tapering does not mean an actual tightening of monetary policy, investors reacted with alarm to the prospect of a less active Fed. This resulted in a bond market sell-off, with the yield on the 10-year Treasury bond rising from a year-to-date low of 1.63% on May 2 to 2.6% on June 24, its highest level since early August 2011, before ending the quarter at 2.5%. (As a reminder, bond yields rise when prices fall.) U.S. stocks also fell but rebounded fairly quickly.



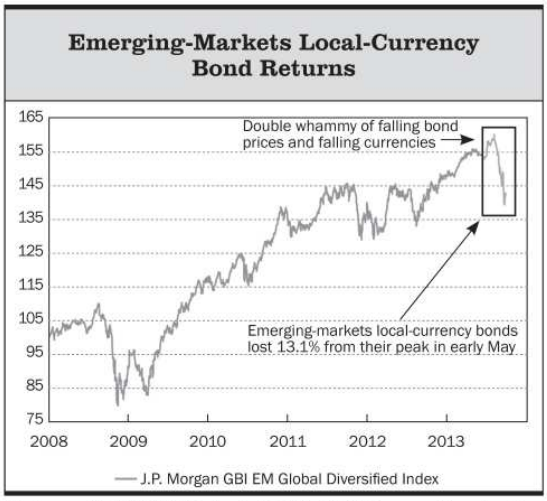
While this looks like a pretty dramatic increase, if you put it in the context of rates of the past 50 years, it is apparent how depressed rates still are relative to history. Data as of 6/30/13. Source: Board of Governors of the Federal Reserve System.

Thirty-year fixed mortgage rates, which are a specific target of QE (quantitative easing), also jumped sharply. Thus, the Fed's optimism about economic growth/recovery, which led Fed policymakers to conclude they could begin ending QE, might in fact become a headwind to that growth. Rising borrowing costs and falling asset prices could short-circuit the economic covery and, in turn, the tapering process. This is just part of the broader challenge the Fed faces as it tries to unwind its unprecedented post-crisis monetary policies without causing any major market or economic tions. At best, we are confident in saying, the "exit" will

be a very bumpy road, with meaningful risks of policy errors and unintended consequences.

Development #2: Emerging-Markets Bonds and Stocks Sharply Declined

The second key development last quarter was the sharp sell-off in emerging-markets stocks and emerging-markets local-currency bonds, and their continued underperformance this year relative to U.S. stocks. While there were numerous drivers of this underperformance, the rise in interest rates in the U.S. and the Fed's tapering announcements were key factors. These developments, along with news that the Japanese central bank was not planning to further expand its own QE program, triggered a general unwinding of the "carry trade," in which investors (mostly short-term traders and hedge funds) borrow the currencies of countries with low-yielding debt and/or depreciating currencies and invest in higher-yielding/appreciating currency investments, such as emerging-markets local-currency bonds. As the carry trade unwound, prices on emerging-markets local-currency bonds dropped, yields rose, and emerging-markets currencies depreciated against the dollar. Thus, emerging-markets local-currency bonds were hit with the double whammy of falling bond prices *and* falling currencies.



Data as of 6/27/13 (Index 1/1/13=100). Source: Morningstar.

In addition to the markets' worries about reduced central bank liquidity, ongoing concerns about a general slowdown in emerging-markets growth and disappointing economic data out of China in particular, as well as fears of a liquidity/credit crunch there, weighed on emerging-markets stocks during the quarter. In contrast, investors seemed to be getting more optimistic about U.S. economic and growth prospects, lending support to the U.S. market.

Portfolio Positioning and our Long-Term Performance Expectations

For the past few years, the fixed-income portion of our balanced portfolios has been positioned for what we expect to be a longer-term trend of rising interest rates. We have been tactically underweight to core bond funds and have a large allocation to more flexible, unconstrained and/or absolute-return-oriented fixed-income funds. We've also held a position in floating-rate loan funds in our most conservative portfolios to further reduce those portfolios' exposure to interest-rate risk.

As a result of this positioning, our fixed-income portfolios held up better than the bond benchmark through the sell-off in the core fixed-income markets. Although our portfolios are underweight to core bond funds due to our expectation for a sustained period of rising rates, we have maintained some exposure to core bonds in our balanced portfolios as a hedge against an economic downturn, deflation, or some unforeseen event that would lead to increased risk aversion among investors and a flight to quality assets (as core U.S. bonds are traditionally perceived to be). Of our two actively managed core bond fund holdings, PIMCO Total Return significantly trailed the benchmark in the second quarter (hurt, for example, by its exposure to emerging-markets bonds and TIPS), while DoubleLine Total Return beat the index. Putting it all together, our overall domestic fixed-income positioning added value again for the quarter versus the benchmark. This has also been the case over the longer-term multi-year periods we've owned these funds.

Turning to the developments in the emerging markets, our positioning was a negative for the quarter. First, we were hurt by the tactical position in emerging-markets local-currency bonds that we hold in our balanced portfolios (initially added to our strategies in 2009). Our emerging-markets local-currency bonds position is being funded from U.S. and international stocks because we view these bonds as having less risk than global equities (although significantly more risk than our other bond funds), but more attractive return prospects from current levels in our base case scenario. In most multi-month periods when emerging-markets local-currency bonds post significant negative returns, we would expect global stocks to perform at least as badly and likely

worse, as has been the case historically. But as noted above, emerging-markets stocks meaningfully underperformed developed stock markets in the second quarter. We don't expect this trend to persist.

Second, although our balanced portfolios are tactically underweight to equity risk *overall*, all of that underweight is coming from an underweight to U.S. and developed international stocks. We have a full allocation to emerging-markets stocks. This was a major headwind to performance given the wide differential in returns for emerging-markets stocks versus U.S. stocks during the quarter.

These two opposing forces combined with other aspects of our positioning, such as our overall equity underweight, resulted in more muted short-term results for our portfolios. However, we view this short-term performance in the context of our longer-term views and objectives for our portfolios.

As we write this, the events of the past quarter have not materially changed our longer-term asset class views or risk assessments. Our underweight to U.S. stocks is not driven by a short-term view of the market, or by a specific concern that interest rates will continue to spike higher in the near-term or that even a moderate but sustained rise in rates should cause a sharp market downturn. Rather, our underweight to U.S. stocks is driven by our analysis that at current levels the market is implicitly discounting too high a growth rate in corporate earnings over the next five years, and therefore is overvalued and likely to deliver subpar returns over that time horizon. U.S. core bonds also look very unattractive over a multi-year horizon. We do think stocks will out-return bonds over the next five years, but core bonds also have much lower downside risk than stocks. For the majority of our clients who are not able or willing to withstand full equity-market risk in their portfolios, we still need to own lower risk (and potentially lower-returning) instruments.

Just as interest rates might continue to spike higher driven by investor sentiment and market momentum, the negative impact on emerging-markets stocks and emerging-markets local-currency bonds could continue as well over the shorter-term. But in this case we think the markets are over-reacting to short-term developments that we don't think take into account the longer-term, positive economic fundamentals and attractive absolute return potential for these emerging-markets asset classes.

Consequently, our tactical portfolio positioning has not changed and we will remain patient for the markets to present us with better return opportunities before we are willing to increase our overall portfolio risk exposure for our clients. To the extent the recent market volatility continues, our analysis of the relative risks and returns may change, and we are evaluating this with respect to emerging-markets asset classes in particular at the moment.

Concluding Comments

While it can be uncomfortable to see short-term losses in one's portfolio and financial markets falling across the globe, we actually welcome this recent market volatility as it has the potential to create more attractive, if not outright compelling, *long-term* investment opportunities if the investing herds over-react and cause markets to overshoot to the downside. We would like nothing more than to see riskier asset classes, such as U.S. stocks, fall back to levels where our analysis indicates they are at least reasonably valued relative to their fundamentals and therefore likely to deliver returns at least commensurate with their risk. We are not there yet.

We are confident, however, that by remaining aware of overall portfolio-level risk and setting allocations accordingly, taking tactical allocations only when highly compelling opportunities are presented to us, and using managers we believe to be highly skilled, we can continue to earn above-average long-term returns while keeping our shorter-term downside risk within our loss thresholds. One consequence of our long-term tactical approach is that we know we will underperform over some shorter-term periods, and even potentially multi-year periods because of market momentum and other short-term factors. But as long as our positioning remains supported by our analysis of the evidence and facts (as we see them), we will remain disciplined and patient in order to allow our investment decisions to ultimately pay off, as we have seen happen repeatedly.

Walker & Associates (7/10/2013)