The Pendulum Swings: Paying More for Less in the Bond Market
Stembrook Investment Commentary – September, 2010

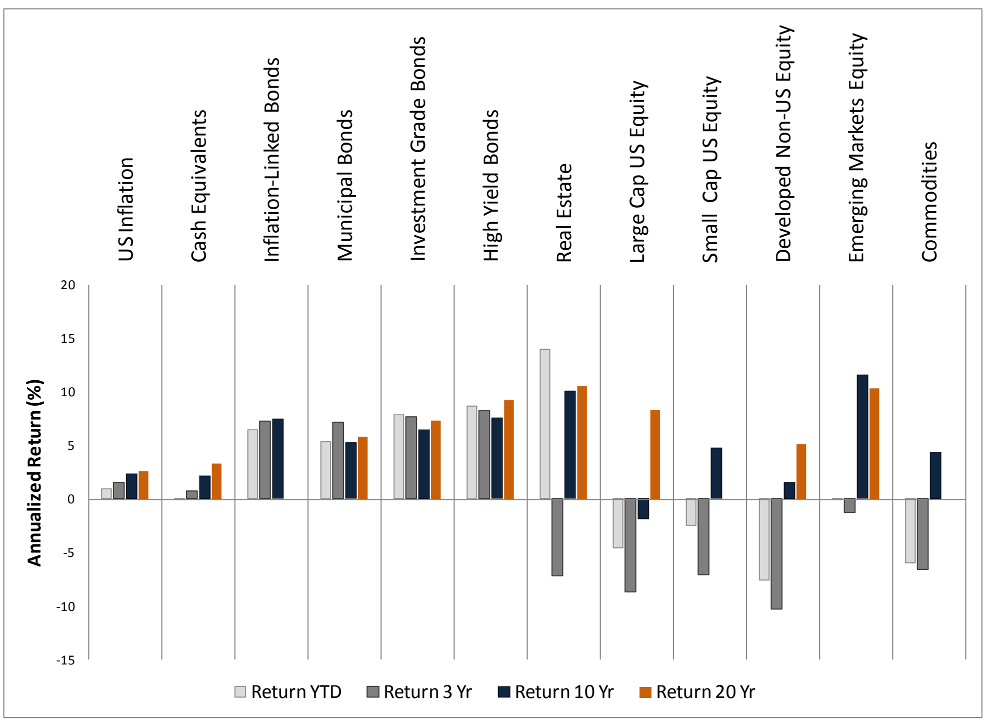
There are two dramatic and notable phenomena occurring in economics and finance today and both are impacting your investments. One is the shift in valuations between stocks and bonds and the other is the country's current mortgage dilemma.

> "Since January of 2007, mutual fund investors have added $695 billion to bond funds while withdrawing more than $155 billion from stock funds"

Stock and Bond Valuations

Low current equity valuations tend to lead to higher future returns and vice versa – see Chart 2. Ten years ago, in June of 2000, the price/earnings – or P/E ratio – on the S&P 500 was 26. Very high by any measure. It would stand to reason that the return of US equities over the following ten years would be below average. In fact, it was well below average at minus 1.6% per year through June of 2010. As we look ahead to the next ten years, US stocks are currently valued with a P/E of roughly 14. Slightly below their historical mean. If history is any guide, the prospects for future returns are significantly higher today than they were ten years ago.

Chart 1 – Global Market Returns as of 8/31/2010



Source: Thomson Reuters, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index.

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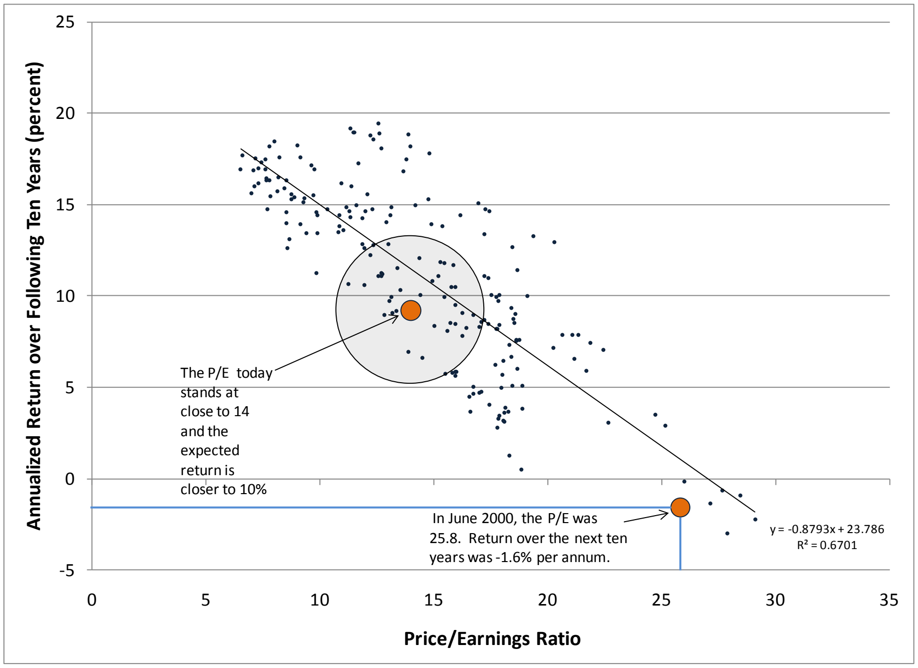
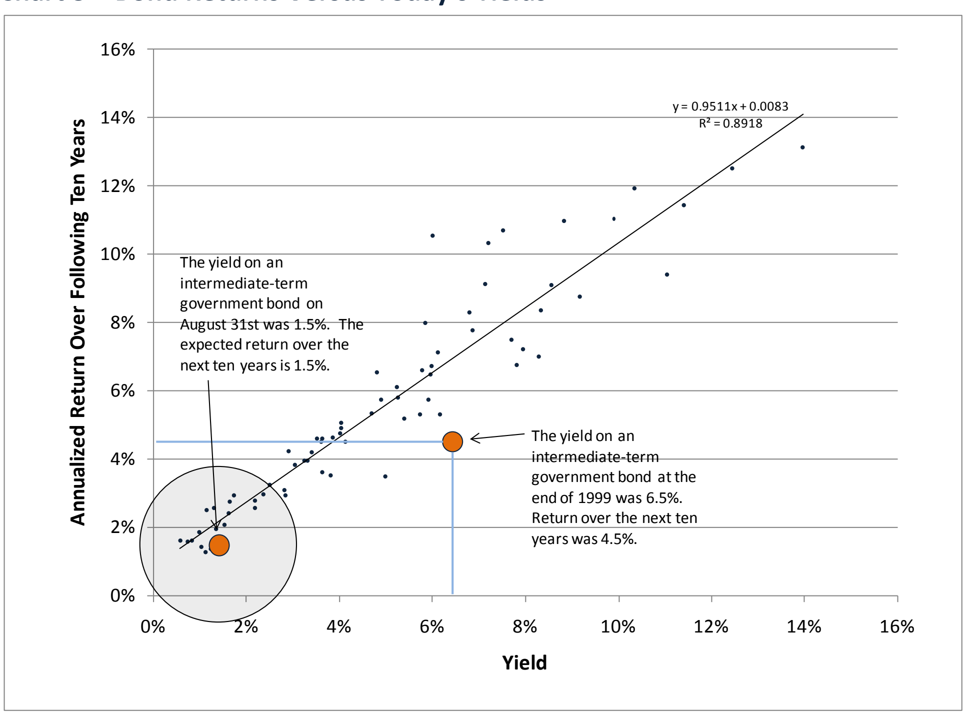
Chart 2 – Stock Returns Versus Current Valuations



Source: Standard & Poors, Stembrook Research. Data from 1/1946 through June 2010.

On the other side of the coin are bonds. These are traditionally lower risk assets. One nice thing about bonds is that predicting their returns is generally an easier process than for stocks. Why? Because every day the market provides us with a yield-to-maturity. The yield-to-maturity is the bond's yield based on today's prices, if held to maturity. Chart 3 shows the relationship between bond yields and future bond returns. The higher the yield, the higher the expected return. Today, yields are at historically low levels. This implies that returns for bonds over the coming ten years should be historically low. There is an echo of history in this observation. In 2000, we had *stock* valuations indicating historically low future returns. Today, *bond* yields are indicating the same. The pendulum has swung and investors are reacting. As Chart 4 shows, mutual fund investors are pouring money into bond funds

Chart 3 – Bond Returns Versus Today's Yields



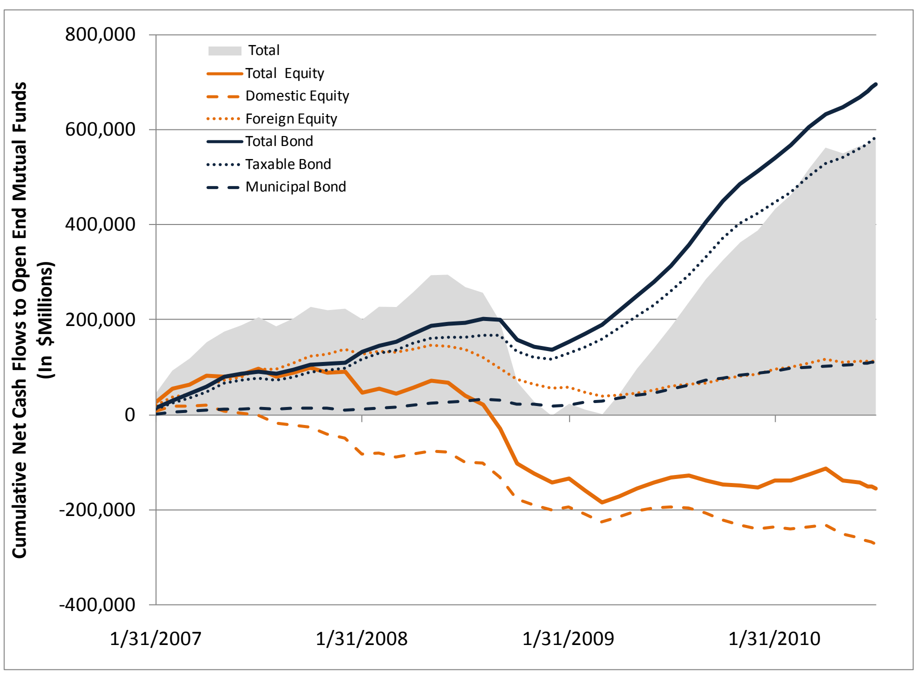
Source: Ibbotson Associates, Federal Reserve, Stembrook Research.
Research based on annual yields and returns on intermediate term US Treasury bonds from 1926 through 2009.

at a swift pace. Since January of 2007, investors have added $695 billion to bond funds while withdrawing more than $155 billion from stock funds. The crowds have voted overwhelmingly on the side of bonds. Based on a number of factors, we believe stocks offer significantly higher return potential in the coming ten years. Large US corporations have strong profitability, cash on hand and currently have access to cheap and abundant capital. In response to this information, we have increased our allocations to equities over the past few months. We have also reduced exposure to bond ETF's, which have been trading at premiums to their underlying Net Asset Value due to significant investor demand.

Everything is not OK

The above argument paints a fairly rosy picture for investors who are willing to take risk and have the investment horizon to prudently do so. However, the global economy has a number of hurdles to get past. In my introduction, I noted the stresses in the mortgage market as a second significant phenomena in today's financial markets. We all know the story of how we got here (see our prior commentary titled, "An Eye Towards the Future" for more details). What is of concern now, is that the US housing market has a significant and prolonged adjustment period ahead of it. As we analyzed the research data this quarter, one startling figure jumped off the page. The number of mortgage delinquencies, that is homeowners that are behind on their payments, is litterally off the charts - see Chart 5. With inventories of unsold homes at exceptional levels and jobless numbers nearing 10%, the direction for housing prices in the near term seems to be flat to down. In the long run, housing prices will reach a healthy equilibrium point. Unfortunately, the transition from bubble peak to equilibrium price has been and will be difficult. In this reagard, I believe time will be the ultimate salve that heals our housing wounds.

Chart 4 – Investments in Mutual Funds January 2007 - July 2010



Source: Investment Company Institute, Stembrook Asset Management

Note: Net New Cash Flows to Hybrid Funds are omitted, but remained largely unchanged over the period.

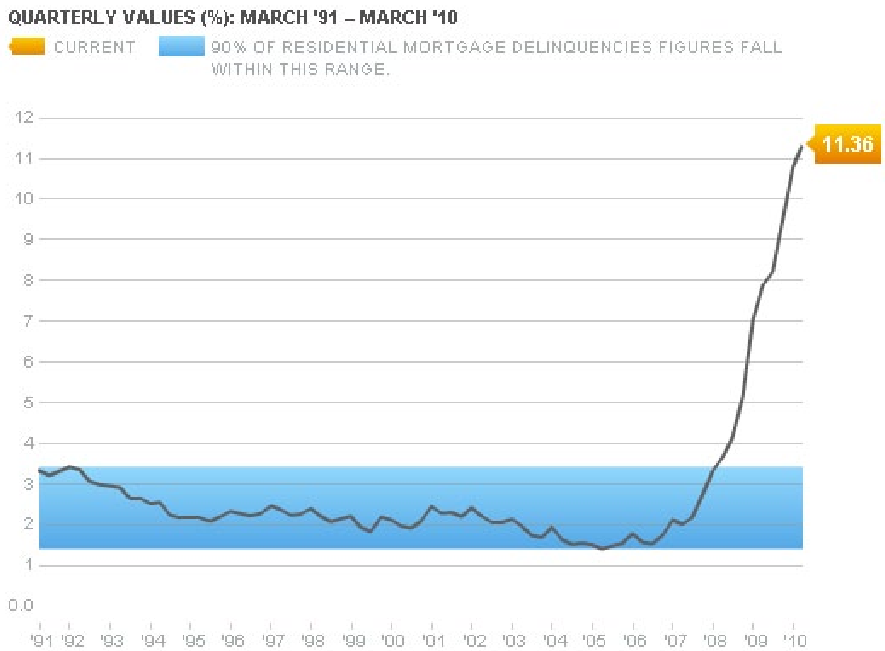
This is significant because we as US Citizens are the owners of many of these mortgages and unlike other components of the federal stimulus effort, there is a fair chance that we won't be paid back on the money we've lent. This will likely increase the federal deficit and could put upward pressure on bond yields - and downward pressure on bond prices.

One bright spot is that the Federal Reserve has engineered very low mortgage rates. If you have not done so lately, there is a good chance that refinancing your mortgage is a sound idea.

When, Not If

I think the odds are very good that an economic recovery will happen and that stocks will outperform bonds over the next ten years. The question in my mind is when, not if. That is forever the dilemma that equity investors face. In the shadow of short-term uncertainty, investors need to purchase the investment with the fundamentals that point to higher returns down the road. For those with the time horizon and financial wherewithal to do so, that is what we are doing with our portfolios today.

Chart 5 – Mortgage Delinquencies



Source: Russell Investments

Relative Valuations - How we are positioning the balance of our portfolios

Large cap stocks in the US are currently more attractive on a valuation basis than small caps. We have reflected this observation in client portfolios.

In what now seems like a distant memory, the European debt crisis has grown quiet, for the time being. During the height of the crisis, we increased our exposure to international investments as the Euro approached parity with other currencies. We've since reduced that exposure somewhat, after almost ten percent outperformance of international equities versus the S&P 500.

Active Management

We continue to believe that active management, or seeking to outperform a target benchmark can add value in select areas of the asset allocation spectrum. We have recently increased our exposure to funds of this nature. Note that our average fund fees still stand well below the industry norm. At this writing, the average fee paid on our portfolio funds is 0.4% versus and industry average of 1.2%[i]

Value Orientation
We continue with our value orientation based on historical data displaying significant outperformance of value stocks over growth stocks. These stocks also currently exhibit the higher dividend yields and lower valuations that fit well with our investment thesis.

International Small Cap
We have added an international small cap value manager to our portfolio. This fund has the potential to capture the growth of small companies in developed and emerging economies outside of the US.

Tax Efficiency
One of the benefits of the recent downturn is that many funds now have embedded tax losses in their portfolios. This means that as these funds realize gains in the future, they can offset those gains with accumulated tax losses and not pass them on to its investors. We will benefit from having purchased a number of funds with embedded losses, thus improving our future after-tax returns.

Times are difficult and almost every business owner and store operator I speak with tells me that things are, "not like they used to be." However, this is the time when opportunities can present themselves to patient and vigilant investors.

We will keep you up to date on our progress and look forward to speaking with you soon.

As always, I welcome your comments and questions, and appreciate your continued confidence in our investment advice and management.

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[i] Source: Average Mutual Fund Fees – Mutual Fund Fees Around the World. HBS Finance Working Paper No. 901023, July 2007.