Investment Options in a Low Yield Environment

Stembrook Investment Commentary – September 2012

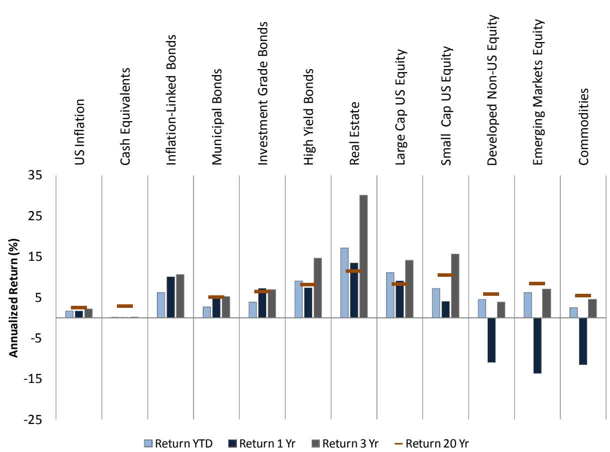
Market Review

The Stealth Market Rally

Markets continue their stealthy recovery. After robust returns in the first quarter, "risk off" trading reflecting fear in market participants began to resurface in the month of May. Fears of contagion in Europe and the threat of Greece leaving the Euro-zone, coupled with a slow-down in US Economic indicators, led to stocks erasing a portion of their gains. After a short pull back, stocks steadily continued their rally in the months of June and July.

The US Equity Markets continue to have a strong year. The S&P 500 is up 11.0% as of the end of July, and the NASDAQ Composite has continued to outperform the broad market with a return of 16.0% so far this year. Another outperformer domestically has been Real Estate Investment Trusts, with a year to date return of 17.1%. Elsewhere, Developed Non-US Equities have underperformed the US Market with a return of 4.6%, year to date, while Emerging Market Equities have delivered a return of 6.2% after a poor performance in 2011, in which the index was down 18.2%.

Chart 1 – Global Market Returns as of 7/31/2012



Source: see endnotes

> The stealth recovery continues, while rates remain low. In this environment, opportunities are available to investors seeking income and appreciation, but pitfalls remain.

The economic landscape in the United States continues to show slow improvement, with a few factors possibly promising to be long-term game changers. Employment remains a significant drag on the economy, with the unemployment rate at 8.3% as of the end of July, down from 9.1% a year ago. The most recent ISM PMI survey for July came in at 49.8%, with a 12-month average of 52.5%, indicating slow and inconsistent, but positive growth. The PMI is a monthly survey that tracks growth in the manufacturing sector and is known to be one of the better measures of short term economic growth. An index reading over 50% indicates growth in the manufacturing economy, while less than 50% is a sign of contraction. Two factors are particularly interesting right now—housing and domestic energy production. The FHFA House Price Index is up 3.6% on a year-over-year basis. This and other housing measures indicate that the worst may be over in this beleaguered sector as inventories continue to clear and show signs of recovery. Increased

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domestic energy production resulting from innovations in drilling and hydraulic fracturing techniques promises to shift the economics of fossil fuel imports to the US. These two dynamics are potential game changers.

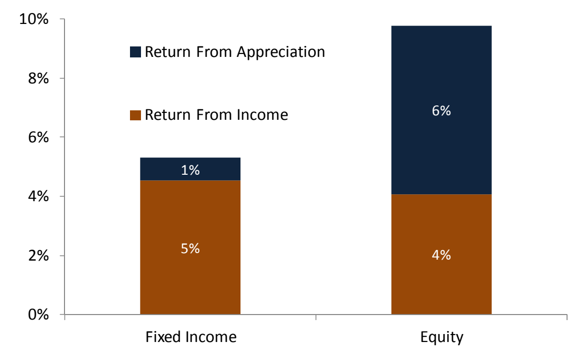
Overall, the economy is moving in the right direction, but not as quickly as market participants had hoped.

A low yield environment continues to serve as a gloomy backdrop to the fixed income markets. In spite of the low returns implied by low yields, bonds have performed astoundingly well year to date. Importantly, they have returned far more than is implied by their very low yields. This performance is mathematically unsustainable. High Yield and Inflation-Linked Bonds have returned 9.1% and 6.2% respectively, so far this year. Municipal Bonds have slowed in momentum with a return of 2.6% versus 3.8% for Investment grade Bonds.

Over the past three years, markets have provided very strong returns, even though it doesn't feel that way. For the three years ended July 31st, US Large Cap Equities are up 49%, High Yield Bonds are up 50%, Inflation-Linked Bonds are up 35%, Municipals are up 16%, and Commodities have gained 14%.

In spite of recent strong performance, equities are attractively priced, with the price/earnings ratio on the MSCI World Index at 14.4 times last year's earnings. However, the potential for short-term volatility remains. The European Union has a long road of recovery ahead and the looming "Fiscal Cliff" in the United States rightfully evokes anxiety in the capital markets. Gridlock in our capital will continue with our elected officials applying game theory to their decisions — the apparent goal being re-election and ideology, not our country's well being. Even with these short-term obstacles, the long-term prospects for equity holders is positive. As noted

Chart 2 – Components of Return—1926—2011



Source: see endnotes

above, housing is showing signs of recovery and is looking like a long-term opportunity for those buying homes or investment properties. We expect the stealth rally to continue in select areas of the financial markets.

Investing in a Low Yield Environment

When we invest for each of our clients, we have a clear and unique goal in mind. That goal may be growing assets for future retirement, funding retirement today, growing assets for future generations, or achieving the stated goals of an endowment or foundation. Keeping our client's goal firmly at the center of our consciousness focuses us on developing specific solutions.

In a low interest rate environment—and the current situation surely qualifies—investing presents a special set of choices and challenges. In this section, we will attempt to outline those challenges, comparing and contrasting a number of choices available to investors today.

How Low Yields Impact You

The current low yield environment takes away a natural option for investors seeking relative safety and reasonable income. Any investment return can be divided into two components, income and capital appreciation (see Chart 2). *Income* is delivered in the form of dividends from equities, coupons from

Chart 3—Performance Characteristics in Various Inflation Environments

Investment Options	Yield (7/31/12)	Environment: Rising Inflation – Rising Growth	Rising Inflation – Falling Growth	Falling Inflation – Rising Growth	Falling Inflation – Falling Growth
Inflation-Linked Bonds		~	++	--	+
Treasury Inflation-Linked Bonds (real yield)	-0.6%				
Nominal Bonds		--	-	~	++
Corporate Bonds	3.1%				
Bank Loans (as of 6/30/12)	6.5%				
Emerging Market Bonds	4.6%				
High Yield Bonds	6.9%				
Mortgage Backed Securities	2.1%				
Equities		~	--	++	~
Dividend Paying Stocks	2.1%				
Real Estate Investment Trusts	3.2%	+	~	+	-
Commodities	0.0%	++	~	+	--
Energy Master Limited Partnerships	6.1%				

Symbols are used to denote the general expected direction of equilibrium returns from major asset classes in various economic environments. Positive (+) and negative (-) signs indicate positive or negative expected performance. The tilde (~) indicates a more ambiguous relationship and thus no clear directional bias.

Source: see endnotes

bonds or payouts from pass-through entities such as Real Estate Investment Trusts or Master Limited Partnerships. *Capital appreciation* comes from the rise in the price of an asset. Stock prices moving higher in response to increased corporate value, or the increase in a bond price due to falling interest rates, are examples of capital appreciation.

A Bird in the Hand

Why is there currently so much focus on income as opposed to appreciation? Income is the proverbial bird in the hand, versus the two in the bush promised by future appreciation. All else equal, income is preferable to appreciation because we receive it now. While appreciation has historically delivered significantly more return to investors, income is sometimes necessary or preferred. With rates so low, yield hungry investors are starving for options.

Investment Alternatives Today

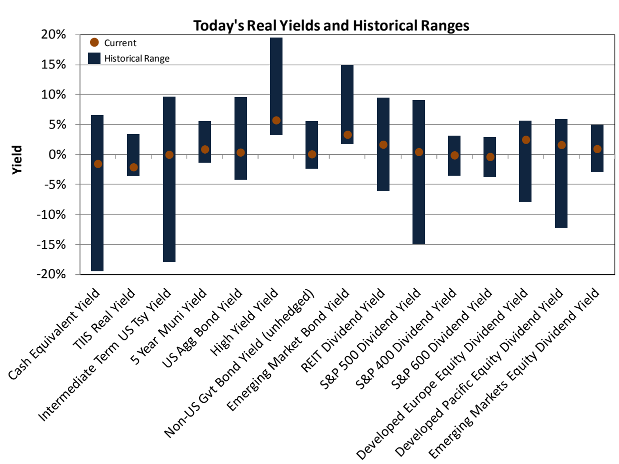
The following is a discussion of various investment options with significant yield components, available today. This list is not all encompassing, but covers many of the choices available to investors.

The list in Chart 3 is organized into 4 groups, with yields shown as of July 31st, 2012. We attempt to anticipate how these investments will behave in various economic and inflation scenarios. Estimating these relationships is not an exact science, but we can make inferences from the underlying factors that drive each investment. Our last Investment Committee meeting was focused on this topic, among others, and The Committee had strong inputs toward identifying these relationships.

In studying Chart 3, the reader will notice that different investments exhibit vastly different behaviors in various market conditions. For example, in a rising inflation-falling growth scenario, Inflation-Linked Bonds should perform very well. In the same environment, equities should perform very poorly. Alternatively, in a rising inflation-rising growth environment, Commodities should do very well while Nominal Bonds should perform quite poorly.

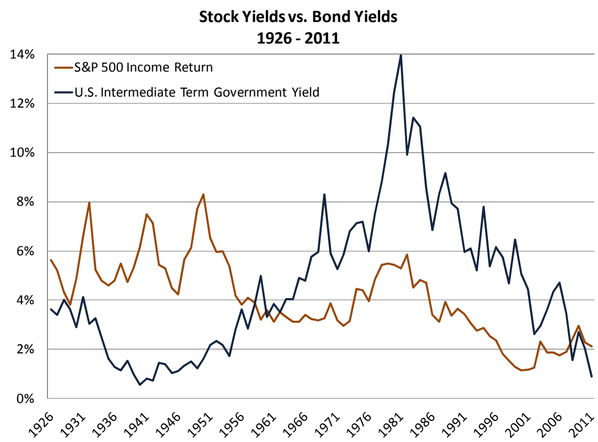
A well constructed portfolio should provide income while also providing strong performance (or protection) in a range of market conditions.

Chart 4 – Inflation Adjusted Yields Across Asset Classes



Source: see endnotes

Chart 5 – Equity Yields versus Bond Yields 1926-2011



Source: see endnotes

The information in Chart 3 is a reminder of an important point, that the level and direction of inflation have a profound impact on your investment success. When selecting investments it is critical to remember that portfolio returns need to meet or exceed the rate of inflation, or the portfolio will be losing ground.

Real Yields

In our last commentary, we introduced a chart that shows yields across various asset classes in the context of historical ranges for each. Chart 4 shows bond and dividend yields adjusted for inflation. The result is the so called "real yield" on each asset class. Currently, real yields on many fixed income investments are zero or negative.

Why Interest Rates are Where They are Today

The 10 year US Treasury Bond is often used as a proxy to measure the general level of interest rates. As of the end of July, the 10 Year Treasury yielded 1.5%. As we've said many times before, this is historically low. Why are rates so low? Why are they not 10% or 15% or 5%? Investment theory tells us that yields change for a number of reasons. Chief among them is supply and demand. As demand increases, prices rise and yields fall (for further explanation see the inset on page 3 of our [April 30, 2012 commentary](#)). Demand is very high today. At the same time, supply of high quality bonds is low.

Why is demand so high? Demand for bonds is strong for a number of reasons. We have just experienced a very uncommon 15 year period where bonds have outperformed stocks by 1.9% per year, which tends to draw the attention of investors. Baby Boomers are beginning to retire in large numbers, which means that more money is being withdrawn from retirement savings. Pensions are also being forced to purchase long-term bonds to match their liabilities, which makes them natural buyers at any price. This generally means that allocations to fixed income move higher. Governments are also working hard to keep rates low, further driving prices up and yields down. Finally, there is a general lack of confidence in financial markets and the global economy, so the historically lower risk asset classes (bonds and cash) are drawing a lot of interest.

All of these factors have driven yields to historic lows and after adjusting for inflation, many of these yields are negative.

Quantitative Ease

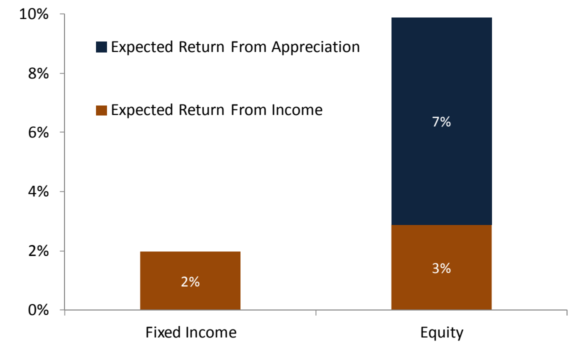
(Not to be confused with Quantitative Easing)

When investors focus on generating cash flow from portfolios during retirement or funding other projects, they can use some intuitive shortcuts to make the planning easier. One such shortcut is to say, "I will withdraw my income and leave my principal untouched." This shortcut allows investors to come up with a reasonable plan without the use of more sophisticated tools. *(The major shortcoming of this approach is a severe narrowing of the sources of return from your investments. For assets that are to be invested for many years, capital appreciation is usually a better source of return for a variety of reasons.)* Though this method is not optimal, it can work in certain circumstances. Nonetheless, the result of this shortcut is a further increase in demand for income producing investments.

Yields on Equities

Demand for income has spilled over into the equity markets, and for the past few years there has been increasing interest in stocks with high dividend yields. When these investments are considered, it is important to understand what a dividend is and how it relates to the overall return to investors.

Chart 6 – Components of Return—Looking Forward



Source: see endnotes

Reinvestment of Profits Versus Distribution of Profits

As an owner of a corporation—holders of common stock are owners—you want management to maximize your return on investment. When companies cash checks from sales, pay their bills and put the remainder in the bank, they have a few choices. They can plow that money back into new investments, they can pay it out to shareholders in the form of dividends or share buybacks, or they can just sit on the cash. If there are projects available with high expected returns (i.e., building a new plant or investing in R&D), then owners want management to keep the profits and reinvest in the company. If these opportunities don't exist, or aren't attractive enough, shareholders will want profits distributed, so they can find attractive investments elsewhere. If keeping cash in the bank will allow them to strengthen their balance sheet and perhaps prepare for troubles ahead, this option might be preferred. This last option may be beneficial in specific circumstances, but, it usually isn't such a good thing for long term growth because cash in the bank is not a fast growing asset.

Shifts in Investor Comfort Level

Prior to the early 1960's, it was considered normal for stocks to pay higher yields than bonds (see Chart 5), in part because stocks are inherently more risky. Later, a different view emerged where investors were more focused on the combined benefit of both dividends and growth in share prices. If companies could reinvest their profits to attain higher growth rates, then investors were willing to forego current income for long-term growth.

Tax Regimes

Taxes also have an impact on how corporations allocate their profits. Dividends have historically been taxed as they are paid out, at the ordinary income tax rate, while appreciation is taxed at the capital gains tax rate only when the security is sold. Until fairly recently, an investor who paid taxes preferred to take his return as a capital gain instead of income, because capital gains were much more favorably taxed. This tax differential led investors to prefer lower dividends in favor of management reinvesting in the company. In an extreme example, an investor in the highest marginal tax bracket in 1952 paid a 92% tax on dividend income. In contrast, appreciation was taxed at 25%. This differential in tax rates made dividends significantly less attractive. In such an environment, investors would think long and hard before asking management to increase their dividends. Today, that is not the case. Qualified Dividends are currently taxed at 15%, which is low by historical measures. However, it is likely that at the end of this year the tax rate on dividends will revert back to 39.6% for investors in the highest tax bracket. If this scenario plays out, dividends will immediately become less attractive to investors.

Management's View of the Future

If management views shares as cheap, they may choose to invest in the existing company through share buybacks. Alternatively, management could simply sit on the cash, holding "dry powder" for future opportunities or to protect against calamity. Legislative uncertainty plays a strong role here. Without a clear view of how the rules will change in the near future, managers are likely to take a wait and see approach. Companies are exhibiting this behavior today, and this is not conducive to long-term growth.

How We are Positioned Today

For investors who can afford to take the risk, we are leaning toward equity over fixed income as relative valuations are very compelling. In general, instead of focusing on income from dividends or coupons, we attempt to maximize total returns (from income and capital appreciation) after inflation is considered.

Where more short-term stability is required, bonds and cash play a necessary role in the portfolio.

After our last research update, we trimmed our position in Municipal Bonds to take profits from our overweight to Municipals versus taxable bonds. We've added to our floating rate Bank Loan positions as they give us high current yields of 6.5%, while their floating rate structure protects against negative returns due to rising interest rates. We continue to own High Yield Bonds in tax-deferred accounts. High Yield valuations are fair at the moment and the significant yield advantage, coupled with moderate protection against rising rates and low current default rates, makes them an attractive alternative. We

An Aside

An interesting moment that marks, for me, a turning point in the move to a paperless world. For almost 20 years now, I have kept an old fashioned wire bound notebook where I record notable facts, figures, insights, etc. that I encounter in my research. Things like, "beginning in the late 1980's condo prices in Boston fell by as much as 50% in some areas over several years...it took more than 10 years for condo prices to return to their 80's peak." (WSJ 8/18/05). I re-read the notebook every quarter as part of our deep dive into the fundamental research that drives our portfolio decisions. Over the past few years, our office has moved to an *almost* paperless environment where tablets (read iPads) have almost totally replaced paper. We use an app called Goodreader that allows us to open documents, take notes on them, and save them or discard them. This has eliminated the printing of hundreds of pages of research reports on a daily basis.

This past quarter-end, when I was reading a portion of my notebook that was written in particularly small text, I instinctively put my thumb and forefinger together, lowered them onto the page and moved them apart in a gesture that, if I was reading on the iPad, would have zoomed me in, so I could read it a little easier. That gesture has become normal behavior. It then occurred to me that the day had come when reading in the electronic world was truly easier and more pleasurable than reading in the paper world. I'm not throwing out my books, but it's fascinating to contemplate how this improvement in the electronic realm will change lives and investments in the future. Thus far, our exposure to Apple, Inc. and other technology leaders through our portfolio investments have capitalized on this change, but I suspect there are many more investment opportunities ahead.

have trimmed our positions in Treasury Inflation-Linked Bonds and hold none in taxable portfolios as they have dramatically outperformed Nominal Treasuries and Corporates, TIPS now have a negative real yield, meaning that investors are paying the government to hold their money after inflation is accounted for. We still hold an overweight in Corporates versus Treasuries (which also presently have negative real yields). This position has paid off well and we continue to like the relative valuation metrics.

In equities, we continue to hold a minimal position in Real Estate Investment Trusts. We have not benefited from their recent performance, but we are comfortable limiting our exposure to this sector. REITs have exhibited very strong recent performance, and valuation metrics are currently quite high making them unattractive in our modeling framework. This view is held in spite of our positive view of real estate. Price matters, and the prices on REIT's look high to us. We continue to hold an overweight allocation to US Equities, though we are rebalancing to our current targets in Non-US and Emerging Market Equities, in light of their valuation metrics and corporate strength, along with the inflation and growth diversification inherent in non-US investments. This will be a long-term investment, as these markets are sure to be quite choppy in the short- to intermediate-term. Instability will continue in Europe as leaders grapple with the daunting task of bailing out Greece, protecting against further contagion, and quelling civic discontent in both the north ("we don't want to pay any more") and the south ("we don't want any more austerity"). We continue to hold our overweight in the technology sector, which has returned 7% per year versus 1% for the S&P 500 over the past 5 years.

We recently trimmed our commodities exposure after strong gains, but continue to maintain a significant position here given the diversification properties, long-term inflation protections and exposure to economic growth.

We don't tend to talk in the near-term very often, but election years tend to have specific short-term influences on capital markets. According to Ned Davis Research[1], "The second half of election years have tended to be positive for stocks. In 16 of the last 21 third quarters during election years the S&P 500 has gained. Of the five exceptions, the incumbent party has lost four times (1932, 1960, 2000, 2008). Whether the third-quarter rally continues into a year-end rally has been related to whether the incumbent party has won or lost." These statistics don't provide any guarantees but given the historical odds, and current expectations for the election's outcome, a strong finish to the year looks more likely than on average.

Investment Planning

For investors, your goals have a primary impact on investment decisions. Whether an individual preparing for retirement or a trustee on the board of an endowment, your goals will lead you to invest in a specific way.

The foundation of every one of our client's investment strategy is their Stembrook Strategic Investment Plan. This plan takes into consideration your current portfolio, your expected saving and spending and various scenarios for market returns. Please contact me if something has changed significantly with your unique state of affairs so that we may adjust your plan accordingly.

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

Sincerely,

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Endnotes

Chart 1: 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 UBS Commodity (Total Return) Index.

Chart 2: S&P 500 TR: Ibbotson Associates 1926 - 2006, Thomson Reuters 2007 - Present, S&P 500 Income Return - Ibbotson 1926 - 2004, Thomson Reuters 2005 - Present, U.S. IT Gvt TR - Ibbotson 1926 - 2000, Barclays Capital Interm Government Index 2001 - Present, U.S. IT Gvt Yld (Ibbotson 1926 - 2003), Federal Reserve (5Yr TSY Yield) 2004 - Present, Stembrook Research

Chart 3: Dividend Paying Stocks: Vanguard Dividend Appreciation ETF (VIG), Treasury Inflation-Linked Bonds: US 10 Year Inflation Linked Treasury, Corporate Bonds: Dow Jones 5 Year Corporate Index, Bank Loans: S&P/LSTA U.S. Leveraged Loan 100 Index, EM Bonds: Citi Yield Book ESBI Index, High Yield Bonds: Barclays U.S. Corporate High Yield Index, Mortgage Backed Securities: Barclays Capital U.S. Mortgage Backed Securities Index, Real Estate Investment Trusts: FTSE NAREIT– All Equity REITS, Energy Master Limited Partnerships: Cushing 30 MLP Index

Relationships represented in this table were provided by Jennifer J. Wagner, CFA, Director of Traditional Assets at Interventure Capital Group. Jennifer is a member of Stembrook's Investment Committee. These relationships were discussed at length at Stembrook's August Investment Committee meeting.

Chart 4: Sources: Cash Equivalents (since December 1945): Ibbotson, Federal Reserve Bank, Thomson Reuters, TIIS (since March 1997): Citi Yield Book, Federal Reserve Bank, Intermediate Term US Treasury Yield (since December 1945): Ibbotson, Federal Reserve Bank, 5 Year Municipal Bond Yield (since March 1988): Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, US Aggregate Bond Yield (since March 1976): Barclays Capital, High Yield (since December 1984): BofA Merrill Lynch, Barclays Capital, Non-US Government Bond Yield (since December 1984): Barclays Capital, Citi Yield Book, Emerging Market Bond Yield (since December 1991): Bloomberg, Barclays Capital, Citi Yield Book, REIT (since March 1972): NAREIT all Equity, S&P 500 (since December 1956): Standard & Poor's, BARRA, S&P 400 (since June 1991): Standard & Poor's, BARRA, S&P 600 (since December 1993): Standard & Poor's, BARRA, Developed Europe Equity (since December 1974), MSCI Europe, Standard & Poor's Europe 350, Developed Pacific Equity (since December 1974): MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, Emerging Markets (since December 1998): MSCI Emerging Markets

Chart 5: S&P 500 TR Ibbotson 1926 - 2006, Thomson Reuters 2007 - Present, S&P 500 Income Return - Ibbotson 1926 - 2004, Thomson Reuters 2005 - Present, U.S. IT Gvt TR - Ibbotson 1926 - 2000, Barclays Capital Interm Government Index 2001 - Present, U.S. IT Gvt Yld Ibbotson 1926 - 2003, Federal Reserve 5Yr TSY Yield 2004 - Present, Stembrook Research

Chart 6: Stembrook Research. Expected returns are stated for US Broad Market Bonds and Global Developed Equities.

(1): Ned Davis Research, Market Digest, July 2012, p6.

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