Quarterly Newsletter

Arbor
INVESTMENT ADVISORS

OCTOBER 2013

CAPITAL MARKETS UPDATE | Equities rallied in zigzag fashion through the quarter. Over this period, International (+11.6%) and Small Cap U.S. (+10.2%) were the lead performers while Emerging Markets (+5.8%) and Large Cap U.S. delivered solid gains (+5.2%). On a year to date basis, U.S. equities continue to lead their foreign counterparts. Though Fixed Income yields also bounced around, the U.S. bond market achieved modest gains (+0.6%) for the quarter with interest income offsetting slight price declines (see the bond investing article below).

TO TAPER OR NOT TO TAPER: THAT IS THE OBSESSION | Fixed income market volatility has been intense since Fed Chairman Ben Bernanke first intimated in May that the Fed would consider tapering its extraordinary bond purchase program (Quantitative Easing or QE). Bond yields really spiked in June after the Fed suggested it may begin to taper as early as September. Over a seven week period, the yield on the 10-Year Treasury increased over 100 basis points from 1.63% to 2.66% before settling at roughly 2.5% at the end of June. After a docile July, bond yields continued to march higher through August and the first part of September with the 10-Year Treasury yield briefly touching 3%. Once again, stocks and bonds alike sold off over this period as fears of a slowing economy accompanied increasing bond yields.

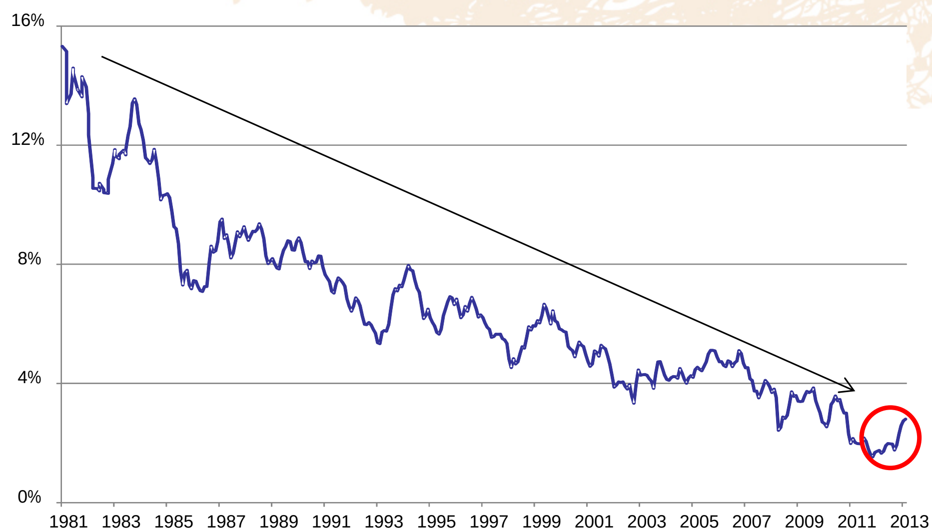
Market apprehension remained intense in anticipation of the Fed's "Taper Announcement" at its September 18th meeting. Chairman Bernanke shocked markets once again as the Fed decided to not taper after all and gave no indications of future timing. Perhaps the Fed had cold feet about the unknown impact on the economy, especially as Congress began posturing for a renewed fight over the budget and the debt ceiling. As Chairman Bernanke's term quickly comes to a close (January, 2014), perhaps the committee preferred to wait for the new chairman before tweaking policy direction.

SOME ADDITIONAL PERSPECTIVE | As long term disciplined investors, it is important that we not try to time the markets and guess which way policy makers will go next. Market pundits and the media are indeed obsessed with taper talk and the future direction of QE. A short five years ago, we didn't even know what QE was. Given the improvement in the federal budget deficit, it makes sense that the Fed plans to decrease its bond purchases. The Fed's QE program currently purchases an annualized amount of $1 trillion in bonds, which not too long ago was the size of the budget deficit. In essence, the Fed has been buying the net new issuance of Treasury debt which has helped keep a lid on bond yields. With the deficit in decline, the Fed would be purchasing large amounts of existing Treasuries in addition to newly issued bonds (and be even more involved in markets with unknown side effects) if it does not scale back its purchases.

In time, QE will indeed be in the rear view mirror and we will be back to more conventional monetary policy announcements such as when the Fed will increase short term rates. Importantly, the Fed has been consistently clear that it has no intention of raising short term rates in the foreseeable future. Most expect short term rates to continue to be pegged at zero for at least two more years. Some more perspective: when the 10-Year Treasury yield touched 3%, the spread above short term rates was among the largest 10% in history. This extraordinary spread occurred at a time when inflation is low and economic growth is tepid. Perhaps this explains the fast retreat in the 10-Year Treasury yield to close the quarter at 2.62%.

The pendulum tends to over-swing in both directions. Market participants with short time horizons invariably overreact, leading to greater volatility. We expect this to continue. History tells us that long term investors are rewarded by maintaining discipline through volatile times. As such, bonds continue to have an important role in investors' portfolios.

10-Year U.S. Treasury Yields
September 1981 – September 2013



Source: federalreserve.gov

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REVIEWING THE ROLE OF BONDS | Arbor's investment philosophy is to view total holdings together as an integrated portfolio and to align the strategy with the client's objectives and with the opportunities and risks in the global investment markets. Under this **total return** approach to investing, each asset has a place as part of the whole. The strategic asset allocation is built based on assumptions of risk, return and correlation with the other assets.

For total return portfolios, bonds provide two primary roles: generate income and counterbalance the volatility of stocks. Today's lower yields provide less income than in times past; however, the stabilizing role of bonds cannot be overstated. One important reason bonds are so much more stable is that the principal and interest payments are *contractual*. Nothing about a stock is contractual—by definition, the stockholder receives what is left over after everyone else is paid. *A bad year in bonds is like a bad week in stocks*.

In the current environment of low interest rates, do bonds still have a role? *Absolutely*. Why? First of all, rising rates are not certain. Bond yields need not rise just because they are low. In the graph on the prior page, the long term trend for 10-Year U.S. Treasury Yields is clearly down. It is unclear whether the recent small hook in the graph is the beginning of a new uptrend. Also, if rates do rise, the interest received on bonds helps offset any market value losses. So even if the outlook is for rising rates, we believe it's important to own bonds for the traditional role of reducing risk while generating income.

STRATEGY GUIDELINES | Over the last several years, perhaps the greatest change we have made within Arbor client portfolios has been in the bond holdings. We recommend several guidelines for the Fixed Income portion of the portfolio.

- **Keep it Short.** Duration is a measure of the interest rate sensitivity of a bond or bond fund. Generally speaking, for every 1% change in the market yield, the bond investment price will change by the amount of duration. For example, a bond investment with a 5 year duration would fall in market value by approximately 5% if interest rates went up by 1%. To guard against rising interest rates, we suggest emphasizing shorter maturities for fixed rate bonds. (Of course yields are lower, but that's generally acceptable, given the trade-off).
- **Diversify Globally.** Yields for non-U.S. sovereign and corporate bonds are generally higher than those of U.S. issues. Our view is that global diversification is compelling, particularly with bond funds which hold multiple issues over a variety of regions, sectors and countries.
- **Hold Inflation Protection.** In addition to traditional government and corporate fixed rate bonds, our portfolios typically include Inflation Linked Bonds or TIPS and Floating Rate Securities (corporate loans that pay a variable interest rate). We may also obtain inflation protection from alternatives such as real estate, commodities and global tactical asset allocation strategies.
- **Consider Alternatives.** Asset managers have spent the last several years developing and refining investment strategies which offer additional diversification to the traditional two-asset class stock/bond approach. One definition of *Alternatives* might be *everything other than stocks or bonds*. At Arbor, we emphasize liquid investments with compelling return opportunities, modest volatility and low correlations with equities and bond duration. Several strategies in our Alternative Toolbox play the role of bond surrogates in the current environment: arbitrage, global macro and unconstrained bond. A managed futures strategy carries higher volatility than these three strategies but offers a higher expected return and can be a great diversifier.

Proper portfolio construction is a mix of science and art. The right blend of assets for each client should take into account the client's individual risk profile and a clear understanding of investment goals.

WELCOME JENNA! | We are pleased to welcome Jenna Craver to Arbor's operations team. Jenna and her husband Scott have two children and live in Lexington. She is a graduate of Appalachian State University and has an MBA from Pfeiffer University. Jenna has over 18 years' experience in financial services and will support operational and client service efforts.