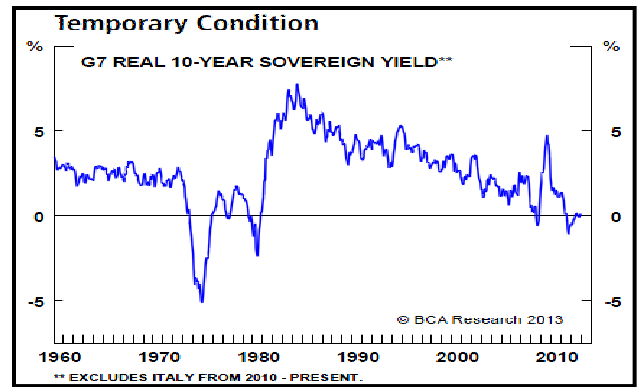


**Introduction** - Without a doubt we live in interesting times. While a calm has descended across the equity markets the last few months as the major U.S. indexes push to new highs, there is palpable anxiety about the bond market. Certainly interest rates have recently hooked higher but the absolute level of rates in much of the developed world remain extraordinarily low and most feel that real interest rates (chart to the right) cannot remain negative indefinitely. We agree with this view, and while timing rate normalization is far from easy, we believe investors should take steps now to prepare for a changing landscape. In this paper we explore what is likely to lead to higher rates in the coming years, the implications for the economy and the stock market, and discuss various strategies we feel could be appropriate in today's environment.

**The Case For Rising Rates** - We would be the first to acknowledge that predicting where interest rates go over the next few months is awfully tricky. While short-term rates are controlled by central bank policy, growth and inflation trends play an important role in setting long-term rates. There is every chance that over the next few months rates may remain stable or even dip as second quarter growth softens due to recent spending and tax policy changes. Rates will also remain anchored for a time given the market's faith in central bankers to continue to pursue their ultra accommodative policies. However, we all have this uneasy feeling that zero interest rate policy and serial asset purchase programs cannot continue forever.

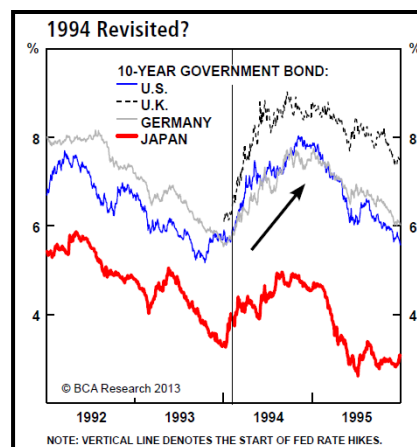
In our mind the critical junction for the bond market will come when investors begin to doubt the Fed's commitment to staying highly accommodative. With the yield on the 10-year Treasury today at roughly 1.95% and CPI inflation slightly over 2%, there is scope for a significant move higher in rates once this mindset changes. We believe we see this regime shift within the time horizon of most investors – say the next 12-to-36 months. The primary force driving the magnitude of the coming bond bear market will be the pace of US job growth. As long as inflation remains tame (more below) trends in the labor market will be key. The Fed's base case scenario is for average monthly payrolls growth this year of around 180,000. If this proves accurate unemployment rates will fall to the Fed's 6.5% target



sometime in 2015. Even before this point, though, the Fed is likely to first scale back and then cease their monthly bond purchases, probably in 2014. While actual rate hikes might have to wait until 2015, the removal of QE3 from the marketplace would have negative implications for government bonds because the Fed would be sending a very strong signal of what's to come. To the extent growth positively surprises due to the building tailwind from housing and the diminishing drag from household and corporate deleveraging, the timing of a change in Fed policy is even closer.

**Looking Back In History** – U.S. government bonds have been in a bull market since 1981. The yield on the 10-year Treasury has fallen from a high of almost 16%, with only intermittent spikes in rates. The most noteworthy is to be found in 1994 (chart below) that resulted in a bond bear market, led to the bankruptcy of Orange County, and inflicted significant pain on fixed income investors.

If we look back to late 1993 the Fed had been on hold for an extended period and lulled bond investors into a false sense of security. However, rising growth and signs of inflation forced the Fed to surprise the market with higher rates. They ultimately hiked rates 3% within a 12 month period and this led to a sharp rise in yields across the yield curve. The 30-year Treasury yield jumped over 1.5% to 7.75% while 10-year bond yields rose by 2.8%. As you can see in the table on the next page, most bond asset classes lost ground. From the trough in yields in September 1993 to the peak in November 1994, 30-year Treasuries lost -16.1% while 10-years fell -8.2%. A couple bond sectors were immune. Short-term Treasuries gained +1.4% and high-yield added +3.2%.



<b>1994 Bond Bear Market</b> <b>9/7/1993 - 11/21/1994</b>	
30-Year Treasury	-16.1%
20-Year Treasury	-11.9%
10-Year Treasury	-8.2%
Barclays Agg Index	-5.3%
1-3 Year Treasury	+1.4%
S&P 500	+1.5%
High-Yield Bonds	+3.2%
<i>Source: Morningstar Direct</i>	

What we must keep in mind when looking at these returns is the starting yield in November 1993. 3-month Treasury bill yields were roughly 3% (compared to 0.09% now) while 10-year bonds yielded a little over 5%. This is important because even though 3-month yields, for example, jumped from 3% to roughly 5.75%, a decent starting yield helped this short-term investment make money over this period. For longer-term bonds even higher starting rates served to mute the losses over a more than year long bear market.

**Far Less Margin of Safety Today** - This last point is important for investors in government bonds today because we have far less margin of safety at today's low interest rates. Even relatively small absolute increases in rates can have a large impact on bond returns. For example, the 10-year Treasury hit a low of 1.40% on July 24<sup>th</sup> 2012 and recently hit a high of 2.06%. While this 0.66% (or 66bps) increase is small, losses rival those seen during 1994 when the 10-year increased 2.8%.

<b>2012 Bond Bear Market</b> <b>7/24/2012 - 3/8/2013</b>	
30-Year Treasury	-12.8%
20-Year Treasury	-11.3%
10-Year Treasury	-5.4%
Barclays Agg Index	-0.5%
1-3 Year Treasury	+0.1%
High-Yield Bonds	+9.2%
S&P 500	+17.6%
<i>Source: Morningstar Direct</i>	

One way to highlight how little margin of safety is priced into government bonds today is to look at breakeven yields for different segments of the market. A breakeven yield tells you how much rates at a particular spot on the yield curve can go up over a one-year period before the capital loss from holding the bond begins to erase the benefit of the bond yield. The table from Bank Credit Analyst below shows the data for various sectors of the bond market both today and back in 1993 prior to that bear market. Today the breakeven yield for the 10-year Treasury is 23bps. This means 10-year yields would only have to go up 23bps for investors in the 10-year bond to start to lose money on a one year time horizon. This cushion was three times higher (75bps) at the low in yields in 1993. Investment grade corporate

bonds offer only a little more protection. The Barclays investment grade corporate bond index will generate negative returns with just a 39bps move-up in yields compared with 102bps in 1993.

<b>Breakeven Yields - Then &amp; Now</b>				
	<b>October 15, 1993</b>		<b>February 26, 2013</b>	
30-Year	5.79%	43bps	3.08%	16bps
10-Year	5.17%	75bps	1.88%	23bps
5-Year	4.57%	130bps	0.76%	20bps
Investment Grade	5.88%	102bps	2.74%	39bps
High-Yield	9.14%	155bps	5.88%	106bps
<i>Source: Bank Credit Analyst</i>				

The story is a little better for lower quality bonds. The high-yield index would have to widen by 106bps to inflict a capital loss, even after allowing for a reasonable level of default losses. Again, this is less than the cushion available in 1993, but the discrepancy is smaller than for higher quality bonds. The bottom line is that government bond investors face the prospect of rising yields at the same time they have very little built in protection.

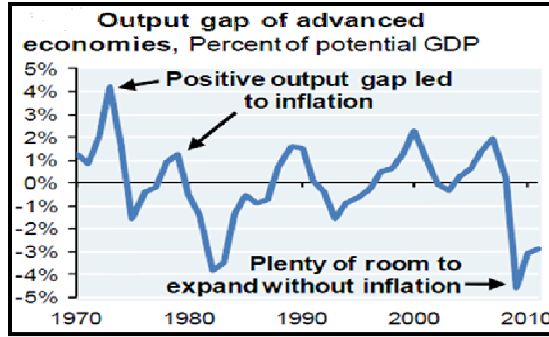
**What Do Higher Rates Mean For the Economy?** - We should take a moment to note that rising rates are not in and of themselves a bad thing. If you look at the 1994 experience for example, the economy stayed out of recession and both equities and high-yield bonds (typically very sensitive to the economic cycle) made money. Of course when taken to an extreme, rising rates can be a serious problem. Just witness what has happened in peripheral Europe as government bond yields have surged and many economies have fallen into a near depression state.

The fundamental cause of rising rates is clearly critical in determining whether the rate move is for good or bad reasons. Examples of good rate moves can be found in the late 1990's as well as the 1993/1994 example referenced before. In late 1998 and 1999 rising rates were attributable to the economic recovery from the Asian financial crisis and the tech boom. Likewise, rising growth and falling defaults in 1993 led to the rate move in 1994. In general we all would probably welcome higher interest rates if it came about because of stronger growth expectations and diminishing fears about deflation.

Conversely, a bad reason for rates to move higher is either inflation or the recent European example whereby investors begin to question the credit quality of the sovereign's debt. For example, rising rates in the late 70's was due to soaring inflation and this weighed on both economic growth and the stock market. This would

be the most prominent example of a bad rate move in the U.S.

Despite the headlines we think there is very little chance of the U.S.'s debt quality coming into question over the next 2-to-3 years. As for inflation, we think the odds favor relatively tame inflation over the same period. The chart above shows the output gap for the advanced economies. What this illustrates is that there is far too much spare capacity in today's mature economies, meaning it is going to be very hard to spark an inflation cycle over the short-term. Certainly if you look out beyond the next couple years you could develop a scenario whereby unemployment rates and other measures of spare capacity move back to more normal levels. Then the inflationary consequences of today's extraordinary monetary policies would become evident. However, over the short-term we think rates are likely to move higher for good reasons rather than bad.



Scott Miner at Guggenheim Partners uses the chart below to make the same point. It shows the correlation between the S&P and 10-Year Treasury Yields. He found that the last 50 years can be divided into three parts:

- 1) When US 10-year bond yields trade below 4%
- 2) When yields are between 4% and 6%; and
- 3) When they exceed 6%.

When rates are below 4% stocks usually do well in a rising rate environment. This is because growth is improving and rates are rising for a good reason. However, when rates are above 6% any increase is likely due to inflation fears, and stocks suffer. We suspect rates are likely to remain below the 6% threshold for some time to come, so we think there is a good window for equity and government bond prices to diverge.

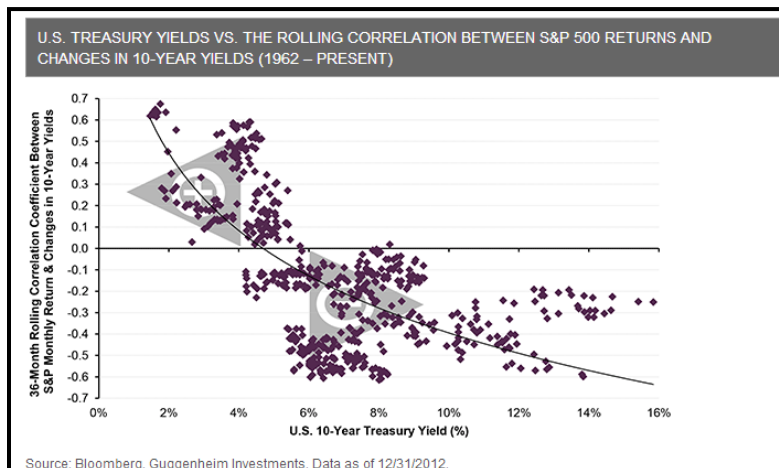
**What Do Higher Rates Mean For Stocks?** - The relationship between changes in bond yields and equity prices is a complicated one and varies over time. Typical valuation models would imply that rising bond yields are bad for equities, all things being equal. Prior to 2000 this relationship worked – rising rates hurt stocks while falling rates helped. Beginning with the bursting of the technology bubble this relationship reversed and really gathered steam in 2008. Falling yields were a sign of economic problems and possible deflation. Stock prices followed bond yields lower.

**Strategies In Today's Market** - So naturally the question turns to what investment strategies make sense if one agrees with the premise that rates are likely to move higher over the coming years?

We would contend that there is a threshold above which rising yields become a problem. However, while rates remain exceptionally low, rising rates are more likely a positive for the equity market than a negative. Our argument is that a rise in bond yields from very low levels would tend to be positive for equities because the rate move is for good reasons. Rising growth expectations and lower perceived systemic risks would be positive reasons for both bond yields and equities to rise. This pattern has been evident in Japan over the past 20 years. Each of the last major rallies in the equity market has been accompanied by rising bond yields as investors have become more optimistic about economic recovery.

- 1) The simplest approach is to manage duration risk. Keep durations short so that if rates rise losses will be kept to a minimum and the investor will have the opportunity to reinvest at higher yields (laddered bond portfolios using either individual bonds or ETFs could also achieve this goal). During the 1994 scenario short-term bonds actually profited. There are a couple disadvantages to this approach today. Starting yields are close to zero so the 1994 experience is unlikely to be repeated, and the yield sacrificed relative to other approaches can be significant. Even so, this is a suitable approach for a portion of an investor's bond allocation.
- 2) Another solution is to trade unwanted interest-rate risk exposure for credit risk. This means overweighting lower quality corporate and mortgage credits.

Breakeven yields for high-yield bonds remains relatively high versus competing fixed income alternatives, implying these bonds have something of a cushion in a rising rate environment. Further, both the 1994 and late 2012 examples show that lower quality corporate bonds can make money in a rising



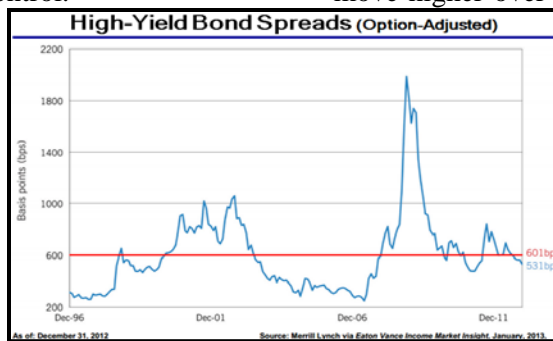
rate environment. And as long as rates move higher because of positive economic surprises, credit spreads should at least remain at current levels. There is actually the possibility that spreads could tighten, because as you can see in the chart below, high-yield spreads remain well above the lows we have seen in prior cycles.

- 3) Another option comes in the form of short-term bank loans. These have characteristics of high-yield bonds in that they are lower quality, but they have the advantage of their yield moving higher as rates rise. Another advantage is they rank higher in the capital structure than traditional high-yield bonds. It is important to note that many bank loans have floors in place so any increase in rates won't filter through to the investor immediately. Also, bank loan investors typically take a yield haircut versus traditional high-yield bonds.

There is course a big caveat in owning riskier securities such as high-yield and bank loans. These investments are tied closely to the economic cycle and have equity like characteristics. Furthermore, during times of stress liquidity can dry up exacerbating losses. Nonetheless, used in moderation, lower quality bonds can serve a useful purpose to hedge against rising rates.

- 4) Annuities can play a role as a bond alternative. While we have tended to take a skeptical view of annuities, there are certain low cost options out there today with guaranteed return/principal protection features that make them interesting fixed income alternatives.
- 5) Alternative assets can be used as fixed income alternatives. While there are numerous alternative strategies, a well constructed basket could generate positive returns in a rising rate environment while at the same time keeping volatility under control.

- 6) Finally, we believe most investors should have some portion of their assets in equities. While the absolute level of equity exposure should vary depending on your circumstances, we think it would be a mistake to abandon equities entirely. We believe that a diversified basket of stocks will



outperform government bonds by a respectable margin over the next few years, especially adjusted for inflation.

**Conclusion** - There is much being written about the bond bubble and the coming Great Rotation from bonds to stocks. The premise of the argument is that money flooded out of equities and into bonds during the financial crisis. The risk is that investors will all exit bonds at the same time, leading to a replay of the 1994 bond meltdown. However, we think that focusing on fund flows misses the point. At all times the total inventory of bonds and equities has to be held by someone – for every seller there is a buyer.

The question is more one of whether or not investors have overpaid for safe havens. We think they have. It does appear that the scramble for safety and the desire for income over capital gains has been overdone, especially now that the economic recovery appears to be on a firmer footing. Any sign that growth is returning to a sustained 3% pace or better will likely cause a significant upward shift in the Treasury rates. Adding to the uncertainty is the fact that there is no precedent for the balance sheet expansion pursued by global central banks the last few years. System-wide distortions are building and no one can know what the unwinding of extraordinary policies will bring. We like the characterization that the path to 'normal' rates could be like pulling a brick across a table with a slinky. For a long time nothing happens and then all of a sudden you have a brick in your lap.

Timing the bottom in rates is impossible. Recent tax and spending changes in Washington could very well lead to a period of soft growth and falling government yields. However, we have strong conviction that yields will move higher over the coming year and that government

bonds are likely to be very disappointing investments over the next 3-to-5 years. Given the strategies available to us we feel we can effectively navigate a rising rate environment in the years to come.

**Charles Blankley, CFA**

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