

Stocks started the new year on a sour note, with the large-cap Vanguard 500 Index Fund falling 3.6% for the month, and Russell mid- and small-cap benchmarks dropping 3.4% and 3.7%, respectively. Foreign stocks fared worse, with the Vanguard Total International Stock Index Fund falling 5.1% and emerging-market equities losing 6.3%. Domestic fixed-income did better as the intermediate-term, investment-grade Vanguard Total Bond Market Index Fund gained a solid 1.6% for the month, the Barclays 7-Year Municipal Bond Index rose 0.9%, and high-yield bonds returned 1.5%. Although there is much media chatter about the significance of the month of January for predicting the rest of the year for stocks, –“as January goes, so goes the rest of the year,” the so-called January barometer, the statistics behind this thesis are not at all convincing and are of no value for determining our investment strategies.

In this month’s commentary, we address several subjects which have been at the forefront of our recent thinking.

Volatility is Back

After a nine month run in which stocks enjoyed a strong rebound, we hit a rough patch in mid January and the market has pulled back about 7%, as of this writing in mid February. The primary culprits for the sell-off are (1) the fiscal crises in Greece, Spain, Portugal and Ireland that the European Economic Union is working through; (2) the ongoing political uncertainty in the U.S. over fiscal and monetary policy; and (3) concerns about China’s slowing economy and their trade relations with the U.S. These issues are significant but we believe they will get sorted out in benign fashion and will not derail the economic recovery that is underway. Based on our view and the views of several of the fund managers and

economists we respect, we believe the current market pullback is normal (at least not unusual) and probably presents a buying opportunity for longer term oriented investors. We know it isn’t easy to go through these periods of market weakness, and we encourage investors to look beyond the immediate and volatile time frame.

Domestic Bonds: Getting Risky?

There has been a lot of demand for fixed income (as evidenced by record-setting mutual fund inflows). This brings up the question as to whether bonds are now over-priced. We are comfortable with the current fixed-income allocation in our client portfolios. By way of historical perspective, going back 30 years, the worst rolling 12-month loss for the Barclays Aggregate Bond index was 9% (for the 12 months ending February and March 1980). The next worst 12-month periods were the 5% losses for the periods ending June and July 1981. Over longer periods, the downsides are less severe. The worst three-year annualized loss for the investment-grade bond index was 2%, also ending in March 1980. Those were all periods where rates rose sharply in a short period of time, although they were also periods where the starting yields were much higher than they are today, which provided more cushion against falling bond prices.

While we don’t think there is a great deal of risk in bonds in general, this does not mean we think they are attractive or undervalued. To the contrary, based on our assessment of the scenarios that are most likely to play out, we think the returns to the broad investment-grade bond index will be subpar over the next five years relative to historical bond returns.

Specifically, given the low current yields and the likelihood of higher interest rates at some point during our five-year horizon, our estimate is that

potential returns for investment-grade bonds over the next five years will be in the 1% to 3% range, annualized. That compares to an 8% average annual return for the Barclays index over the past 34 years. That certainly meets the definition of a subpar return. Although the five-year total return is likely to be at least marginally positive, there is also a risk of losing money in investment-grade bonds over shorter periods during that stretch.

In terms of a really bad worst-case 12-month return scenario, if we assume 10-year Treasury yields are two percent higher a year from now (at around a 5.8% yield), and that the Barclays Aggregate Bond index's yield spread over Treasuries increases somewhat, our analysis suggests that the index would have a total return loss of around 10%. We think the odds of that scenario playing out are quite low, but not too low to discount entirely.

These risks are a driving reason that we have invested a significant portion of our bond holdings in funds that have flexibility to make adjustments in a rising-interest-rate environment or give us exposure that can mitigate the impact of rising inflation and/or a falling dollar. In addition, we have added an "absolute return" bond fund, Eaton Vance Global Macro Absolute Return, to our balanced portfolios. Its focus is to generate positive returns in the 5-8% range, even in rising rate environments.

Revisiting Risk Tolerance

We don't recommend shifting portfolio strategies on a short term basis. That said, purely from a timing standpoint, given the sharp rebound in the market last year, this probably isn't a bad time to shift to a more conservative model for clients who genuinely do have a lower risk tolerance—as revealed by their reaction to the market crash in 2008—than they thought prior to 2008. However, we have already addressed this issue during 2008 and 2009 on an individual basis with many of our clients and, of course; we will continue to do so going forward in our client meetings and discussions.

In any case, trying to shift strategies on a short-term, market-timing basis is something we believe is unwise, because our ability to outperform over a long-term investment time horizon is based on our ability to make longer-term decisions with confidence. We don't think there is a basis for believing that shorter-term decisions being made at the same time can be expected to add value because the short term is inherently difficult to predict with any confidence. And if such portfolio shifts are done repeatedly it reflects a lack of discipline and raises the risk of whipsaw, which goes against what we bring to the table in the first place.

Quoteworthy

"Greece was the Cradle of Democracy. Democracy is a great concept. The problem is that it is easily corrupted by politicians who give the voters whatever they want no matter what it costs. That way, the politicians get more of what they want, namely, the votes to remain in office. To avoid angering taxpayers, the politicians must fund their spending largess by issuing government debt. Among the voters that politicians seem to favor most are public employees and retirees.....Let me be clear: I am a big fan of Democracy. It is my favorite form of government. The problem is that it tends to be corrupted by the best politicians money can buy. To fix the problem, we need some checks and balances in the relationship between politicians and unions representing public workers. This is an issue that the current global sovereign debt crisis is bringing to a head right now in many countries around the world. Today, in the Cradle of Democracy, many civil servants are on strike and protesting the Greek government's plans to cut their pay."

**—Dr. Ed Yardeni, Economist Baron
CEO, Baron Funds**

**—Mark Schwartz, CFS, CRPC®
President, TriCapital Advisors**