DSA Communiqué

February 2013

Looking back at 2012 and forward to 2013

By now you probably have had an opportunity to review your portfolio performance for 2012. We were quite pleased to see most client returns for 2012 solidly in double digits and, for our long-term clients, we noted that trailing 10-year performance numbers were approaching 7% annually which we think is quite remarkable given the market crash of 2007-08, when the S&P 500 dropped over 47% from its 2007 peak to its 2009 bottom. However, hidden in the good numbers was what we think is cause for concern as we look forward to 2013 and perhaps, a bit beyond.

Our concern was confirmed when we attended the “Advanced Personal Financial Planning” conference sponsored by the American Institute of CPAs in January. One recurring theme among advisors and expert speakers at the conference is the widely held expectation that interest rates are likely to rise sometime over the course of the next year or two as the economy continues to slowly recover from the Great Recession. A second theme which also confirmed our own thinking is that we are likely to see better performance from international fixed income securities relative to U.S. fixed income securities.

This issue of our Communiqué is focused on strategic changes we will be implementing in the fixed income asset class for our client portfolios in order to address these concerns and opportunities.

Bond Prices and Interest Rates

While we do not expect to see rates increase dramatically in the near term, we do expect to see rates rise in the future if only because rates are so low now that the odds favor increases over decreases. Since we do not believe that we or anyone else can predict exactly when rates will rise, strategically it is far better to be early in adopting this defensive stance rather than late. In order to better protect your fixed income investments from rising rates (interest rate risk) we will be reducing

what is known as the "duration" of the bond funds we own. For your fixed income investments, we feel that it is just as important to focus on return ***of*** your principal as it is to focus on return ***on*** your principal.

Duration is actually a relatively simple mathematical calculation that measures the expected change in the price of a bond (or bond portfolio) in response to a given change in interest rates. When interest rates rise, bond prices fall, and vice versa. Since the coupon rate of a conventional bond does not change after the bond is issued, when interest rates go up the bond price goes down. For example, if a new bond with a 3% coupon rate is issued at a time when the average market rate for similar bonds is 3%, the bond will sell at par ($1,000). If you own that bond and rates later rise to 4%, the bond will sell for less than par – it will sell at a price such that the 3% coupon ($30) allows the purchaser of your bond to earn a 4% rate of return.

The longer the term of the bond, the more the price will drop to compensate for the number of years of "missed interest." As a result, the longer the maturity, the bigger the price change, the higher the duration and the greater the loss. Longer term bonds thus have higher durations than shorter term bonds. For bond funds, duration is simply the average duration of all the bonds owned by the fund.

For us to effect this change and reduce duration we plan on replacing Loomis Sayles Bond with BlackRock Low Duration Bond (in tax deferred accounts and for low tax bracket clients) and replacing Schwab Tax-Free Bond Fund with Wells Fargo Advantage Short-Term Muni Bond (used for high tax bracket clients in taxable accounts). We expect to be making these adjustments sometime over the course of the next thirty to sixty days.

International Bonds

We also are making a change this year in the mix of our asset allocation targets for U.S. and international bonds. After extensive research, we have concluded that allocating a higher portion of the fixed income allocation to international bond funds will not only likely enhance returns but, at the same time reduce volatility because the correlation between U.S. equities and international bonds (including emerging market bond funds) is lower than between U.S. equities and U.S. bonds. As part of our effort to reduce the correlation between (international) fixed income and U.S. equities we are also making a slight shift adding to our emerging market fixed income allocation and slightly reducing the exposure to developed market fixed income securities.

Our prior allocation guidelines targeted approximately 80% of the total bond allocation to U.S. bonds and 20% to international bonds. Our new targets allocate approximately 70% of the total bond allocation to U.S. bonds and 30% to international bonds. We selected this mix of U.S. and international bond funds because it should reduce the level of risk per unit of return from the former 80/20 mix.

For more information on our investment strategy or, if you have any questions on the issues raised in this Communiqué, please do not hesitate to call us.

Later this month...

We are presently in the process of preparing your year-end tax reports and expect to be mailing these reports by the third week of February. The year-end report package will include a detailed summary of realized gains and losses, deductible account expenses and other information that will be helpful to you in assembling your 2012 income tax data.

Referrals

Please take a moment to recommend us or share contact information for an individual, family or a business colleague you think could benefit from working with us. Be assured that we will regard your friends, family and business colleagues with the highest level of consideration.

Contact Us

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