

DSA Communiqué

July 2013

Bond Prices and Interest Rates ... a continuing discussion

In our February Communiqué, we reviewed the reasoning behind the changes in our fixed income investments designed to shorten the maturity of our overall fixed income investments. Although we were not surprised by the comments from Ben Bernanke on May 21 we were surprised by the sudden impact on the bond market: the 10-year Treasury moved from 1.61% at the beginning of May to 2.50% by the end of June. As interest rates rose, bond prices moved down resulting in losses in most categories of bond funds. For the quarter ended 6/30 the Barclays Capital Intermediate Bond Index lost 1.63% and for the year ended 6/30 the Index was virtually flat with a return of -0.12%. Interestingly, the high yield market fared better with 6 month and 12 month returns for the Barclays Capital High Yield Index posting positive returns of 1.42% and 9.49%, respectively. This is attributable to the fact that lower quality bonds are much more sensitive to credit risk than interest rate risk and tend to be more highly correlated with equity returns than bond returns.

Where do we go from here?

With interest rates low, albeit a bit higher than they were just a couple of months ago, many investors are in search of higher yields. We have read articles suggesting preferred stocks, utility stocks, higher dividend stocks or increasing exposure to REITs. These investments, along with a multitude of other options, do offer opportunities for higher yields but each comes with its own particular risk and must be evaluated within the context of your overall portfolio.

Yields on preferred stocks are substantially higher than those on common stocks as well as most bonds. The iShares S&P U.S. Preferred Stock Index currently has a yield of 5.8%. By comparison, the yield on the iShares Core Total U.S. Bond Market ETF is currently 2.45% and the S&P 500 has a dividend yield of about 2.25%. So far so good...BUT, let's not forget the risks. Preferred stocks typically have very long maturities and many are issued in perpetuity, with no maturity at all. If rates go up, and from all indications, that's the direction they will be heading, the holder of the preferred shares will be left holding a security that may pay less than the market rate for many years or, in perpetuity, effectively reducing

the value of the investment. In addition, although preferred “shares” sound like an equity investment, most preferred shares have a fixed dividend meaning that company growth has a minimal impact on the preferred share price so the appreciation potential is very limited.

So how about those utilities? The SPDR Utility ETF has a dividend yield of 3.9% nearly 1.5% higher than the current yield on the 10-year Treasury. However, the recent performance of the utility sector in the last few months has been poor – down nearly 5% compared to the S&P 500 which is up a little over 5%. The culprit in the current demise of utilities appears to be the same one that pumped the sector up for the earlier part of the year: Treasury yields. If yields continue to rise, as seems most likely, utilities will returns will likely continue to decline along with declining bond prices. Utility stocks generally get most of their return from dividends rather than appreciation in value so if the stock is declining the “high” dividend could easily be wiped out.

High dividend stocks/funds and REITs also carry with the rewards certain risks. Yield is only one aspect of dividend investing – you need to consider consistency as well. The highest yielding dividend stocks/funds might not have the consistency of returns that you think you are getting. Many companies – as well as investors – have caught the dividend fever. With interest rates near record lows it has been prime season for dividends. However, let’s not forget the past. Just five years ago dozens of companies were forced to reduce or eliminate their dividends as profits evaporated and, a stock or fund that reduces the dividend payout is particularly susceptible to market price declines. REITs, which we own in virtually all client accounts, are certainly an asset class that we like but we recognize the specific risks that go along with the rewards and have set what we believe are appropriate allocations for every client. Increasing the allocation to REITs changes the dynamics of your portfolio and, instead of reducing risk, it is likely to increase the overall risk of any given portfolio.

So where do we go from here? We would suggest that maintaining your already well-diversified portfolio and rebalancing to target allocations as the market moves your actual allocation is the best way to achieve the best “total return” over the long-run. Given that it is virtually impossible to accurately predict short-run fluctuations in the economic activity and interest rates, the best defense against the “unknown unknowns” in the investment universe is to continue to diversify across and within asset categories.

Some new names in your portfolio

We've recently started to make some changes in international equity holdings as we routinely rebalance accounts. These changes were precipitated by the fact that two of our preferred small and mid-cap ("smid cap") equity funds have grown to the point where they are now large cap funds and no longer provide us the exposure to small and mid-cap stocks that we want in our portfolios, so we replaced both funds with funds that are invested in small and mid-cap foreign stocks. Mutual Global Discovery is being replaced by Goldman Sachs International Small Cap Insights Institutional (smid value fund) and Blackrock International Opportunities is being replaced by Aberdeen Global Small Cap Institutional (smid growth fund).

Both of the new international funds are "institutional" class funds, meaning they either have a \$1,000,000 minimum investment or they are sold only to institutional investors. Institutional share classes provide a performance advantage because they have the lowest expense ratio of all share classes offered. Both funds are rated "5 stars" by Morningstar based on their last three years' performance. Of course, past performance is not predictive of future performance, and the future may not follow the past, but both funds have experienced managers and excellent track records. Both funds are managed by fund companies with a very large asset base and long history of success.

Goldman Sachs International Small Cap Insights Institutional Fund

Like all of Goldman's "Insights" fund offerings (10 in all), this fund is run based on quantitative models that base fund purchases on quantitative valuation and momentum metrics. The quantitative model is grounded in fundamental research and uses an economically intuitive approach that employs quantitative models to analyze securities on a daily basis. Fundamental factors fall into six broad criteria: valuation, profitability, quality of earnings, management, momentum and investor sentiment. The fund has compiled an impressive record, with fund performance ranked in the top 23%, 3% and 4% for the past one-, three- and five-year periods compared to its peers.

Aberdeen Global Small Cap Institutional Fund

Scotland based Aberdeen Global is globally diversified with 90% of investments outside of the U.S. Aberdeen's Morningstar 5-star fund historical performance is ranked at first percentile (last 3 years) and fourth percentile (last 5 years) compared to its peers. Aberdeen avoids "star managers" and uses a team approach to managing the portfolio. One integrated management team draws on first-hand fundamental research by their own analysts; little attention is paid to consensus opinion or benchmarks. The fund has a proven track record of successful global investing in small cap stocks through a number of market cycles.

What's happening at DSA

This issue of Communiqué announces some exciting news at Droms Strauss. As we have continued to grow and enhance the level of services we can provide to you, we have added a sixth full-time professional to our firm. Anthony Gennaoui joined us effective May 15th. Anthony brings over ten years of experience to Droms Strauss, first with Deutsche Bank and more recently with The Hartford, as an "advisor to advisors." "In my prior positions, I was providing investment and asset allocation advice to other advisors but was missing contact with clients," says Anthony. "At Droms Strauss, I can take advantage of my knowledge of the investment universe and provide conflict-free advice to our clients. My only goal for our clients is that they achieve their objectives in the most effective and efficient way."

Anthony is a graduate of Miami University of Ohio with a BS in finance and has completed graduate level coursework at the University of Chicago. He was a Regional Vice President/Advisor Consultant for Deutsche Bank (2003-2011) and The Hartford (2011-2013), working with financial advisors at many of the largest wealth management firms in the country. His role was to provide financial advisors with global market insight as well as "best practices" in wealth management in the areas of asset allocation and investment opportunities.

We welcome your questions, comments and feedback; please contact us at any time. Our goal is to provide you and every DSA client the highest level of service.

Sincerely,

Bill and Steve

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.

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