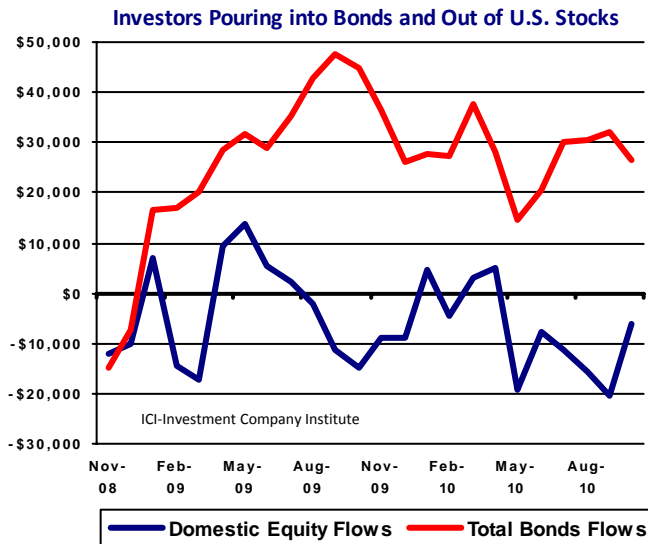


Are All of those Bond Buyers Right??

Investors continue to favor bond funds, pouring in record amounts while money continues to flow out of U.S. stock funds. Continued concern about housing and unemployment has many seeking a safe haven. **But are bonds and bond funds as safe as many investors**



think?

Unless you have been investing or remember the markets from 30 years ago it is not likely you have ever experienced a long term downtrend in bond prices or uptrend in interest rates. Since 1981 when interest rates peaked they have generally dropped, a big plus for bond owners as bond prices generally move in the opposite direction of interest rates. The Director of Research at Fielder Research and Management said recently:

“The past three decades have been a secular trend of declining interest rates and declining cost of capital. No one under the age of 53 has experienced a world with rising cost of capital”

Ten year U.S. Treasury bonds now yield slightly over 2.5% and corporations are issuing debt at extremely low yields. IBM, Microsoft and EBAY are just a few examples of strong companies borrowing in the debt market because their cost of funds is so incredibly low. For example, EBAY recently issued \$400 million in three-year notes at 0.875%—a lower rate than the German government can muster! With rates this low investors who need income are struggling to find a strategy by which they will meet their income needs.

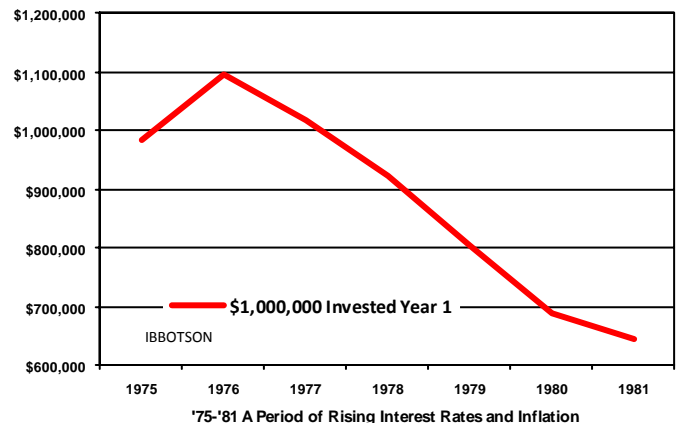
This is a noteworthy phenomenon today, especially as significant investment monies have been moving into bonds and bond funds at a time when rates are at record low levels. For many years, as rates fell, bond investors benefited from capital gains as bond prices rose. At current low interest rates, returns from capital gains and yields have limited upside and potential for loss. As a matter of fact bond investors face the possibility of great losses if they hold longer maturity bonds when rates rise. From the period 1975 to 1982 investors lost significant amounts of money as real (net of inflation) bond returns fell when interest rates rose. (See chart next column)

INVESTORS ARE ASKING What Should We do now?

Unfortunately the answer to this question is not easy, but doing nothing or making the wrong adjustment could hurt your portfolio's performance even more. The answer is not the same for everyone. Those who need income but have little time to recover in case of (stock or bond) market volatility, must look at the risks and opportunity differently than those who can weather volatility with time.

Investors experiencing low yields in money markets and other fixed income investments are seeking alternatives. Besides bonds, some investors have considered dividend paying common stocks because in some cases they yield more than bonds. Stocks of companies make no guarantee and are not backed by company assets like bonds, but some very healthy companies are paying attractive dividends when compared to other fixed income investments. The question remains: If concerns about market risk abate, will investors seek the dividend and potential of Blue Chip U.S. stocks?

Long Term Bond Investors should be Cautious US Gov't Long Term Bonds - Inflation Adjusted



As of yet buyers have not made the move as investors have been net sellers of U.S. stock funds. The only really growing area in stock funds is in foreign emerging markets, not likely the core holding for conservative investors. Recent industry analysis sees an opportunity here: Recent quotes from Research firm GMO:

“While historically, high quality stocks – those companies exhibiting high, consistent ROE and low debt – have traded at a significant premium to the market, valuations today are cheap. Quality stocks represent one of the few areas within the U.S. equity market that is trading below its fair value, and the portfolio's U.S. exposure will continue to tilt toward quality.”

Fortunately the fact that big quality stocks have been ignored is a positive for investors. Despite the recent rise in the market the valuations and yields on some selected “Balance Sheet Behemoths” are attractive. Corporate earnings have recovered from the drop in earnings during the recession, and it is a good time to begin averaging into stocks with attractive valuations and healthy yields. We would be happy discuss our strategy further with you.

Steve Wenstrup and Jim Tillar, CFA