Strategy Quarterly

Fourth Quarter 2013

Executive Summary

❑ The combination of loose monetary policy and expansionary fiscal policy has resulted in a strong rebound of cyclically-sensitive sectors of the economy such as housing and autos with accompanying spillover effects to industries that benefit from it such as home appliances and furniture.

❑ However, more recently, government spending has declined and taxes have increased, as the budget policy shifted to austerity. In addition, the continuous support provided by the Fed's purchases of mortgage-related bonds may soon come to an end – as telegraphed by Mr. Bernanke.

❑ A gradual curtailing of the QE program is not equivalent to a restrictive policy; it is just a needed step toward restoring a more normalized monetary policy environment.

❑ Based on a number of data points, we think that the economy is more resilient than investors believe. Strength in the housing market, healthy corporate balance sheets, the restoration of individuals' finances, a stronger banking system and availability of credit form a solid fundamental backdrop for further economic expansion, in our view.

❑ We remind investors that a well-structured portfolio that includes bonds is still a sound long-term approach. While bonds may be going through a period of poor performance, the reality is that asset classes perform differently in the various phases of the business cycle.

❑ It is important to remember that the main role of bonds in a diversified portfolio is to preserve capital, cushion equity market volatility, and generate income. Many investors who are shifting into stocks that are "bond substitutes" are unknowingly increasing the risk of their portfolio by changing their asset allocation.

❑ We reiterate some of our prior strategies to mitigate bond market risk: a short duration bias, accepting credit risk over interest rate risk, and diversifying into other sectors of the fixed income market to help smooth volatility.

CYPRESS TRUST COMPANY

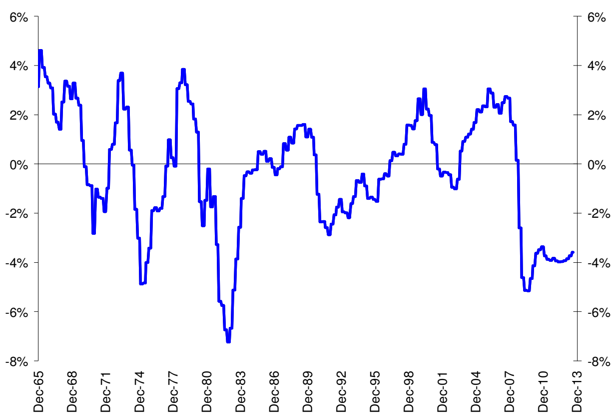
Massimo Santicchia
Chief Investment Officer
Cypress Trust Company
Massimo.Santicchia@CypressTrust.com

Ryan Kuyawa, CFA
Vice President, Senior Portfolio Manager
Cypress Trust Company
Ryan.Kuyawa@CypressTrust.com

The U.S. Economy: Where Do We Go From Here?

Over four years have passed since the end of the 2008 recession. Since then the economy has registered 13 consecutive quarters of positive growth, yet overall growth has been quite weak and significant slack remains in the system. In this regard, it is emblematic that the current estimated output gap – the difference between actual and potential GDP growth - is about -3%, a level historically associated with deep recessions.

Chart 1. U.S. Output Gap



Source: OECD

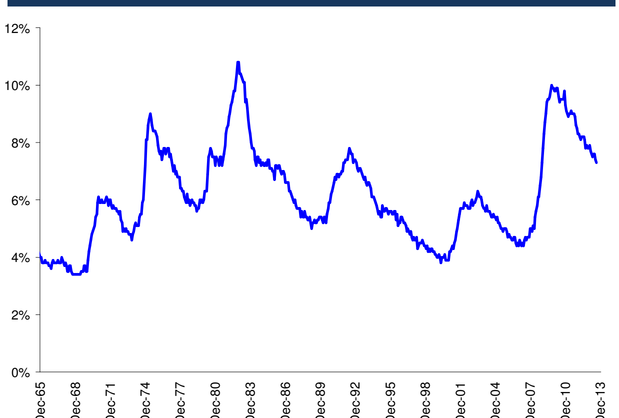
On the positive side, job gains have been solid over the past year, with an average of 200,000 jobs added monthly and unemployment falling below 7.5% from a peak of 10% in 2010.

There is no doubt that this economic recovery has been strongly supported by a Fed policy that has pushed both short and long-term rates to record low levels. The Fed has accomplished this via both conventional (by setting and keeping short-term rates low) and "unconventional" (by executing large-scale purchases of long-term treasury and mortgage securities to push long-rates low) monetary stimulus programs. Another form of unconventional policy enacted by the Fed is the "forward guidance." The Fed pledged it would keep the funds rate near zero until unemployment falls to 6.5%. This reassures people that short-term rates will stay low and makes them willing to pay more for longer-dated securities, which in turn, drives down longer-term rates.

Such decisive and prolonged accommodative policy has resulted in a strong rebound of interest-sensitive sectors of the economy such as housing and autos with accompanying spillover effects to industries that benefit from it, such as home appliances and furniture.

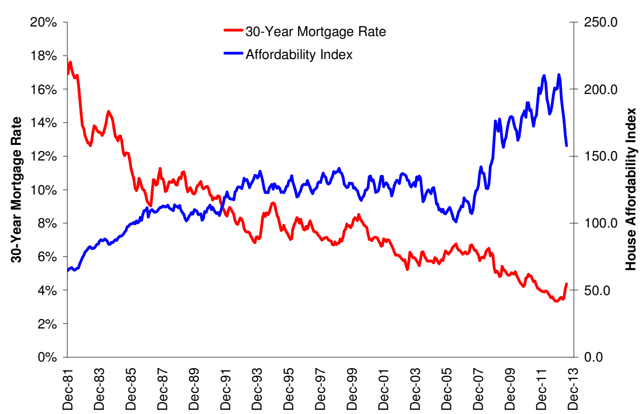
Even with the recent spike, mortgage rates are still well below their long-term historical average, which, in combination with high home affordability levels, suggests that the housing market has legs.

Chart 2. Civilian Unemployment Rate



Source: U.S. Department of Labor

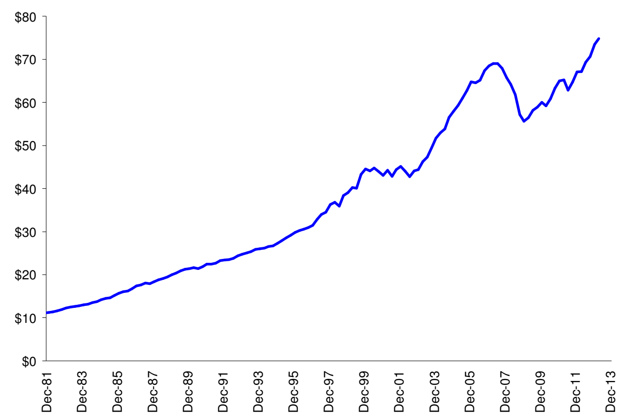
Chart 3. House Affordability Index



Source: National Association of Realtors, Freddie Mac.

In the meantime the equity markets have advanced over 150% since the March 2009 bottom contributing to a corresponding increase in the net worth of U.S. households which stands today at a new all-time high.

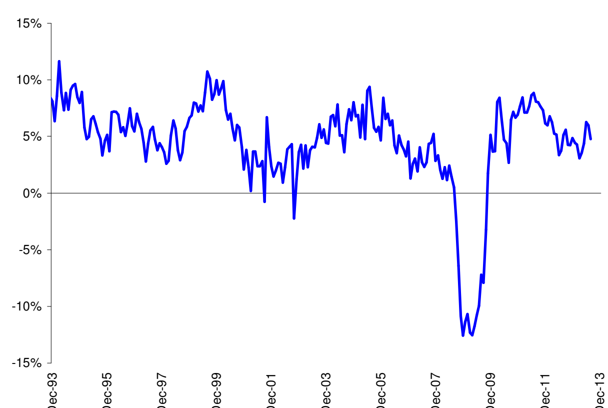
Chart 4. Household Net Worth (Trillions of Dollars)



Source: Board of Governors of the Federal Reserve System

The combination of higher real estate prices and soaring equity markets has also improved consumer confidence through the “wealth effect,” the increase in spending that accompanies an increase in perceived wealth. This in turn, has resulted in good gains in retail sales.

Chart 5. Retail Sales: Total (Excluding Food Services)

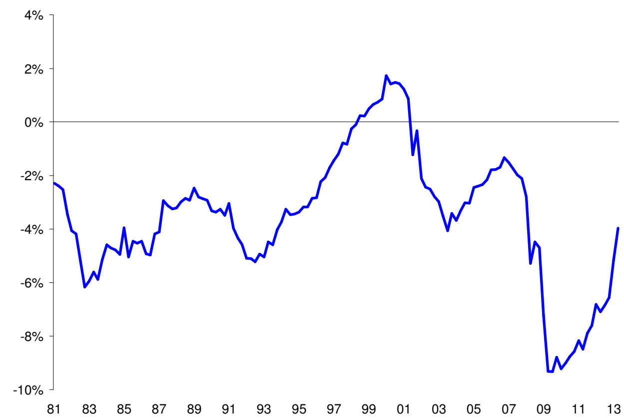


Source: Board of Governors of the Federal Reserve System

During the recession, fiscal policy provided a lift to the economy through federal tax and spending support.

However, more recently, government spending has declined and taxes have increased, as the budget policy shifted from expansionary to austerity (see Chart 6).

Chart 6. Budget Deficit as Percent of GDP



Source: Bureau of Economic Analysis

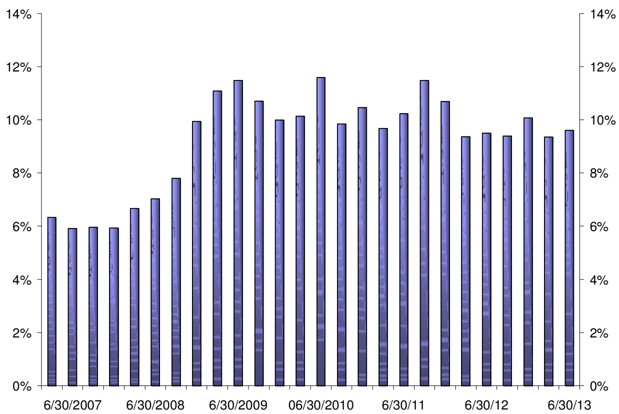
In addition, the continuous support provided by the Fed’s purchases of mortgage-related bonds may soon come to an end – as telegraphed by Mr. Bernanke. In fact, we expect the Federal Reserve to begin tapering its quantitative easing program by the end of the year, which, in conjunction with budget austerity, may present risks to the nascent economic recovery.

A gradual curtailing of the QE program is not equivalent to a restrictive policy, it is just a needed step toward restoring a more normalized monetary policy environment.

We would like to emphasize that historically the Fed’s monetary policy stance has been mainly characterized by the level and direction of the Fed funds rate. More importantly, our research shows that the direction of short-term rates is a significant driver of equities and bond performance. (Please see Business Cycle and Asset Returns on pages 6-7.) Today we have a Fed funds rate basically at zero and the Fed’s pledge not to raise it until unemployment falls to a targeted level. These are hardly restrictive monetary conditions. We believe monetary policy will remain accommodative throughout 2014 and expect the first hike to take place in mid-2015.

Then the real question is: Is there enough economic and business strength to continue toward the path of economic recovery and expansion? Based on a number of data points, we think that the economy is more resilient than investors believe. Besides the strength in the housing market, there are other positive signs that foreshadow a continued recovery. One of them is corporations' pent-up demand for capital expenditures. Cash on corporate balance sheets has recently reached a new record high of $1.14 trillions (Chart 7).

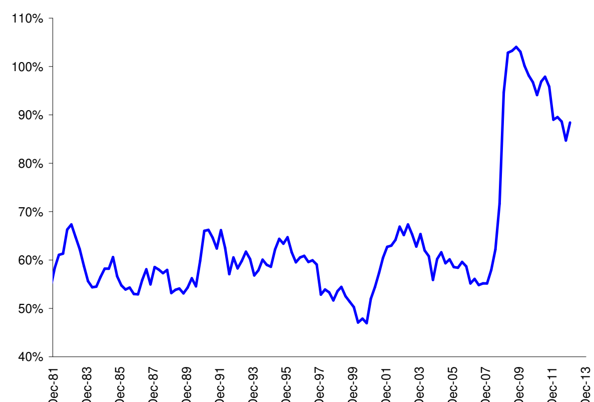
Chart 7. Cash-to Market Value – S&P 500



Source: S&P Dow Jones Indices

This cash has been partly returned to shareholders via dividends and share buybacks. However, capital expenditures have not kept up with cash flow generation, as Chart 8 shows.

Chart 8. Cash Flows-to-Investment Ratio

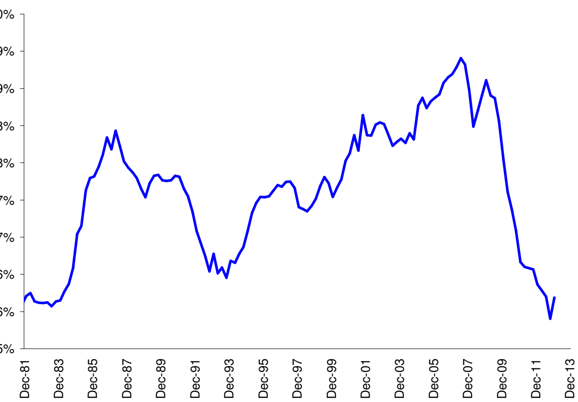


Source: U.S. Department of Commerce

We expect these strong cash flows eventually to be re-deployed towards capital spending, with concomitant benefits for the whole economy.

An additional positive development that has gone somewhat unnoticed is the deleveraging that has taken place at the household level. Figure 9 shows the remarkable improvement in the debt-to-disposable income of individuals after the 2008 downfall. The household service burden is currently at a historical low – this should be supportive of consumer spending.

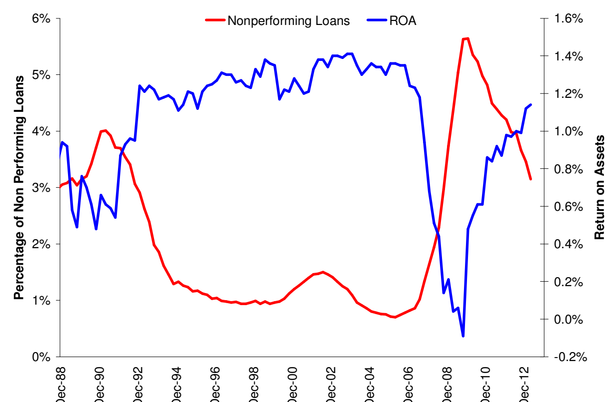
Chart 9. Household Financial Obligations



Source: Board of Governors of the Federal Reserve System

At the same time the banking system appears to have considerably improved its profitability as a steady decline in non-performing loans has been accompanied by a sharp recovery in return on assets (Chart 10).

Chart 10. Banks: ROA and Nonperforming Loans

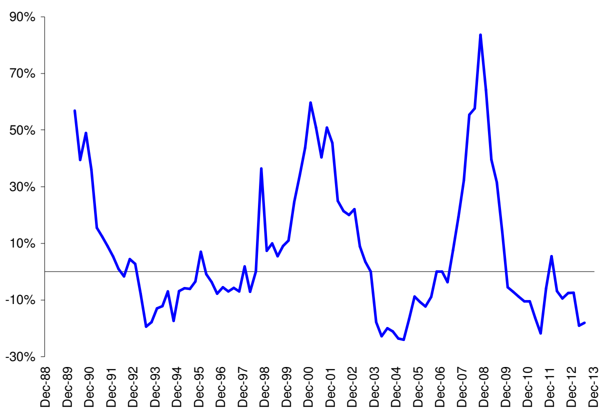


Source: Federal Financial Institutions Examination Council

Better capitalized, more profitable banks have greater ability and willingness to make loans. As Chart 11 shows, banks are becoming more willing to lend.

In summary, healthy corporate balance sheets, the restoration of individuals' finances, a stronger banking system and availability of credit form a solid fundamental backdrop for further economic expansion.

Chart 11. Banks Tightening Lending Standards



Source: Board of Governors of the Federal Reserve System

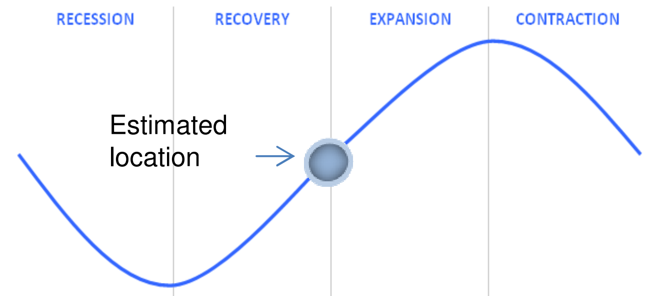
Where are We in The Cycle?

This is one question investors ask frequently – and correctly so. First, it is an always relevant question: the ever evolving cycle articulates the evolution of the economy through time. Second, and more importantly, as we discuss in the "blue box" piece on pages 6-7, various asset classes perform differently throughout the business cycle.

Therefore, from a portfolio positioning standpoint, it is helpful to determine what stage the cycle is in at any point in time. Although it is very difficult, if not impossible, to pin point the exact location on the cycle curve, an estimation of it can be made based on a number of economic and market indicators.

We estimate that we are in a transition region between recovery and expansion (see Figure 12). Many of the indicators we track such as output gap, unemployment, GDP growth, interest rates and bond yield spreads, currently display values in a range historically associated with recoveries.

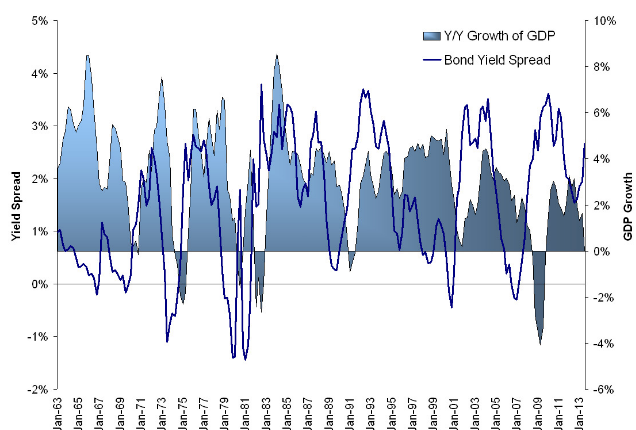
Chart 12. Business Cycle Model



Source: Crest Investment Partners

Most importantly, forward-looking indicators such as the spread between the 10-Year Treasury Bond and the 3-Month Treasury Bill currently point to accelerating growth over the next few quarters (see Figure 13). We particularly keep an eye on this indicator given its track record in predicting future recessions and the overall future economic activity. Between August 2012 and August 2013, the spread has increased by over 100 basis points to about 2.7%. Spreads above 2% have historically predicted robust growth over the next four quarters.[1]

Chart 13. 10Yr-3M Bond Spreads and GDP Growth



Source: Federal Reserve, BEA

Expansionary monetary policy can lead to a steeper yield curve by jointly inducing a decline in the short rate and an increase in the long rate reflecting higher future economic activity. An upward (downward) sloping yield curve indicates that future short-term interest rates are expected to rise (fall). Hence, given that short-term interest rates are typically pro-cyclical, a positive (negative) term spread signals a future business cycle expansion (recession).

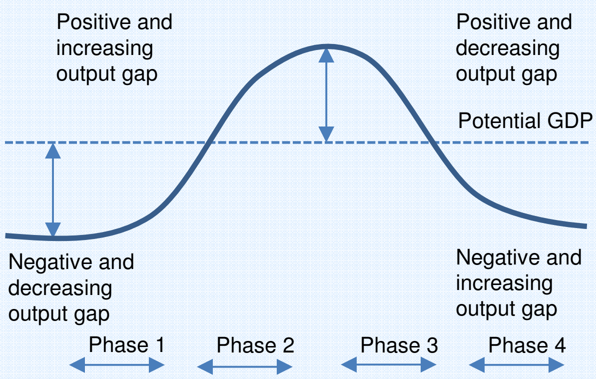
[1] Estrella and Mishkin, "The Yield Curve as a Predictor of U.S. Recessions," http://www.newyorkfed.org/research/current_issues/ci2-7.pdf and: Estrella and Hardouvelis, "The Term Structure as a Predictor of Real Economic Activity," Journal of Finance, 46:2 (June, 1991).

Business Cycle and Asset Returns

Analysis of the economic cycle is of great importance for monitoring economic output and explaining price and wage inflation. It provides essential information for shaping economic and monetary policy of central authorities. From an investor standpoint, we require an analytical framework to make investment decisions. Specifically, we need to define and characterize the distinctive phases of the business cycle in relation to its economic drivers. The framework needs to be rooted into fundamental economic analysis, exhibit consistent linkages to the performance of various asset classes, and be empirically testable. The departure point for assessing the dynamics of the business cycle is the long-run sustainable real growth rate of the economy. The availability and growth of capital and labor determine the long-term potential growth rate of the economy – the potential real GDP. The existence of a maximum level of growth is due to natural and institutional constraints.

If actual GDP rises and remains above potential output, inflation tends to increase as demand for factors of production exceeds supply. This is because of the limited supply of workers, capital equipment, and natural resources, along with the limits of our technology and productivity. Thus, the output gap - deviation in GDP growth from potential - indicates disequilibrium within the economy and it can be either non-sustainable (positive output gap is inflationary) or suboptimal (negative output gap is deflationary). The magnitude of the output gap and its direction (increasing or decreasing) has implications for inflation, monetary policy and overall direction of the economy. The output gap's magnitude and direction define the four phases of the growth cycle. Each phase is characterized by distinct trends in the corporate earnings cycle, inflation, credit cycle and monetary policy. More importantly, the four phases of the cycle systematically affect the relative performance of various asset classes.

Output Gap Cycle and Average Performance of Various Asset Classes



Source: Adapted from Jon G.Taylor (1998)

	Phase 1 Negative & Decreasing Output Gap	Phase 2 Positive & Increasing Output Gap	Phase 3 Positive & Decreasing Output Gap	Phase 4 Negative & Increasing Output Gap
S&P 500	15.1%	12.8%	-2.7%	9.1%
Intermediate Bonds	7.2%	6.1%	5.6%	12.5%
Long-term Bonds	8.8%	8.7%	1.9%	13.4%
US SmallCaps	20.5%	11.8%	-2.8%	13.1%
MSCI EAFE	11.3%	25.2%	-11.8%	4.3%
S&P GSCI	6.0%	17.3%	20.4%	-2.2%
Cash	3.9%	4.9%	6.6%	6.7%
Balanced Portfolio	11.8%	10.8%	0.3%	11.8%
Number of quarters	62	46	28	38

Source: Crest Investment Partners

Phase 1. Expansion to Potential (negative and decreasing output gap). In phase 1, the economy is moving from the bottom of the cyclical trough towards a level of economic activity consistent with the sustainable noninflationary growth trajectory of the economy. This phase is often characterized by a resurgence of growth led by inventory accumulation, business investment and recovery in housing. Given that rising demand can be met with existing capacity, corporate margins expand and drive strong earnings growth. Monetary policy remains accommodative as underutilized capacity keeps inflation muted. In this phase, equities and particularly small-caps do very well with historical average compounded returns of 15% and 20%, respectively. Bonds perform well too, as inflation continues to fall on high spare capacity and despite increase in activity. Cash yields are low due to expansive monetary policy.

Phase 2. Growth Expansion above Potential (positive and increasing output gap). During this phase, the economy moves above its sustainable noninflationary growth path. Capacity constraints and labor shortages drive inflationary pressure. In the commodity markets the supply is constrained by existing capacity limits while demand accelerates along with economic growth. The Federal Reserve, in an attempt to stem inflation, intervenes by increasing the interest rate and reducing liquidity. The emergence of capacity constraints drive investment in capital equipment as corporations try to keep up with demand. In this phase stocks continue to do well even as the Fed starts tightening, at least initially, on business momentum and positive sentiment. In this phase, typically, capital investments increase as companies try to keep up with surging demand. International equities are the best performing asset class on strong exports and as investors benefit from weakness in the U.S. Dollar. Commodities perform well due to positive demand/supply dynamics.

Phase 3. Contracting Growth from non-sustainable levels (positive and decreasing output gap). During this phase, a flat to inverted yield curve reflects restrictive monetary policy and signals economic weakness ahead. Inventories tend to build up suddenly as sales growth drops. The sudden downturn in interest-sensitive sectors such as housing and capital expenditures will eventually lead the economy down. This phase is typified by a decline in activity from its peak and represents the worst time for equities as restrictive monetary policy enacted to contain inflation is now tipping the economy into recession. Commodities perform exceptionally well on still constrained capacity. Bonds do well on weakening growth as investors exit the equity markets in search of safety.

Phase 4. Contracting Growth below potential (negative and increasing output gap). Despite increasingly accommodative monetary policy, credit is scarce which together with inventory imbalances and declines in business capital investment cause growth to fall. The resulting impact on employment and consumer and business confidence precipitates a generalized slowdown. Inventory correction is a major factor at this juncture which, once completed, sets up the next expansion. In this phase equities, at the beginning fall, then rebound strongly in response to excess liquidity injected by the Fed and improving demand on more favorable inventory trends. Recessions are unequivocally good for bonds. During this phase, deterioration of growth prompts a decline in short term rates as the Fed tries to revive the economy.

Conclusion and Implications

We have presented an established framework to analyze the business cycle. Such approach is based on the output gap – the difference between potential and actual GDP growth. The sign and the direction of the output gap determine four distinct phases of the business cycle. Our research confirmed and quantified the linkages between business cycle and asset classes performance. These linkages appear to be consistent over several business and market cycles over the 1970-2013 period.

As we apply this framework to the current economic situation, various economic and financial data seem to support the evidence that we are somewhere between Phase I (recovery) and Phase II (expansion) of the growth cycle. Although slowly, the economy is moving in the right direction and we believe we may well be in the midst of an extended cyclical recovery. The spread between the 10-year Treasury Bond and the 3-month T-Bill falls within a range historically associated with recovery periods. In addition, other indicators of economic activity such as the PMI and the housing market seem to point to future positive growth over the next few quarters.

Monetary policy remains extraordinarily accommodative with historically low rates and Fed support through the continuous purchase of longer-dated U.S. Treasuries and MBS at the pace of $45bn and $40bn per month. Even if the Fed will be tapering its monthly asset purchases, we don’t expect it to raise interest rates until 2015 and even then we would expect an unusual slow tightening.

The research here presented shows that historically during these two phases, equities outperform bonds and cash. Within equities, smaller capitalization and cyclical issues tend to perform better than the market average. If our estimate of the cycle stage is correct and barring any exogenous shock (political turmoil, oil crisis, etc.), we would expect these market segments to lead over the next six months.

We caution investors against engaging in market timing and always advise them to formulate and adhere to an asset allocation policy that reflects their risk profile and time horizon. This also means that investors should not abandon bonds in reaction to their recent negative returns caused by a spike in rates.

As we discuss in the fixed income section “Why Own Bonds?” we remind investors that a well-structured portfolio that includes bonds is still a sound long-term approach. While bonds may be going through a period of poor performance, the reality is that asset classes perform differently in the various phases of the cycle. It is important to remember that the main role of bonds in a diversified portfolio is capital preservation and income generation.

As our empirical research shows, a balanced portfolio of 50% equities, 40% bonds and 10% cash, has produced respectable returns with acceptable volatility over the period under study.

Footnotes

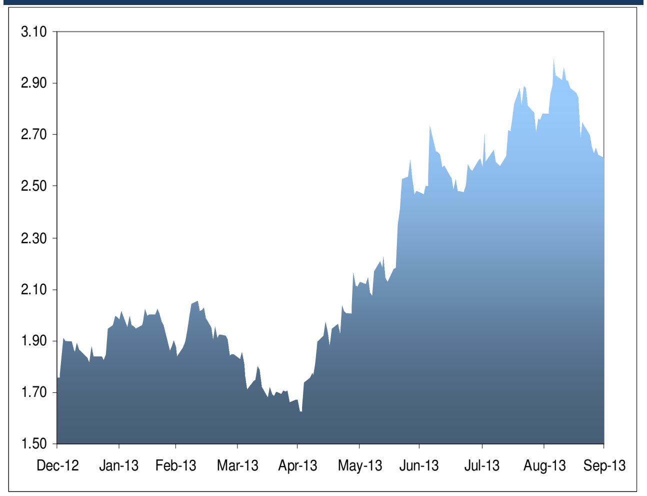
The Cycle chart is adapted from Jon G. Taylor, “Investment Timing and The Business Cycle”, 1998, Wiley Finance.

The table reports the results of our analysis conducted over the 1970-2013 period. We calculated annualized geometric returns for each period of the growth cycle by applying the chain-lined method to quarterly total returns of various asset classes. For intermediate and long-term government bonds and for small cap stocks we used the Ibbotson series. We used the 3-month treasury bill as a proxy for cash. The balanced portfolio is made of 50% equities, 40% long-term bonds and 10% cash. EAFA returns are dollar-denominated.

Credit Markets: "Why Own Bonds?"

With the recent rise in interest rates, investors may now be asking themselves, "Why Do I Own Bonds?" After all, the recent move in interest rates has been very punitive for bondholders.

Chart 14. The Rise in Rates: 10 Year Treasury Yield



Source: Bloomberg

In 2013 investors experienced the unexpected in the bond market - losses. Depending upon the credit product (government, corporate, municipal, etc.) the total return has been somewhere between a loss of 2 to 7% through the end of the 3rd quarter of 2013 and it is highly likely bonds will end up being money losers in 2013**.** After years of solid gains this is likely to come as a shock to many investors who thought the good times would never end. In times like this it is important not to dwell too much on past performance. Instead, investors should remind themselves of the *role* that bonds play in their investment portfolio and overall asset allocation.

Cushion to Stock Market Volatility

The first role that bonds play is to cushion investors from volatility in the equity markets. Historically, bonds have been pretty effective in acting as a cushion. In the example below, we look at particularly volatile periods in the equity market over the past 25 years that often coincided with bear markets. We measured volatility by looking at sharp rises in the VIX Index which is a generally accepted measure of the volatility of the S&P 500 implied by S&P 500 options that are traded on the Chicago Board of Trade.

Chart 15. Periods of Equity Market Volatility & Stock & Bond Returns- Last 25 Years

Time Period	**% Change in VIX Index**	**S&P 500 Total Return**	**Barclays Aggregate Total Return**
7/16/98-10/8/98	181%	-18.7%	3.8%
3/27/02-08/1/02	154%	-22.3%	5.0%
2/14/07-3/17/08	211%	-10.3%	8.6%
8/28/08-11/20/08	448%	-41.8%	-1.8%
4/20/10-5/20/10	191%	-11.1%	1.8%
4/21/11-8/8/11	227%	-15.8%	4.5%

Source: Bloomberg, Cypress Trust

The Barclays Aggregate Index is the bond market equivalent of the S&P 500 Index. In only one of those periods, during the height of the credit crisis, did bonds have a negative return; yet, a return of negative 1.8% for bonds was far outpaced by the negative 41.8% for equities. Clearly, it has paid to own bonds when the equity market has sold off. Bear markets often occur quickly and dramatically and cause the investor a lot of pain. Having an allocation to bonds can help ease the pain.

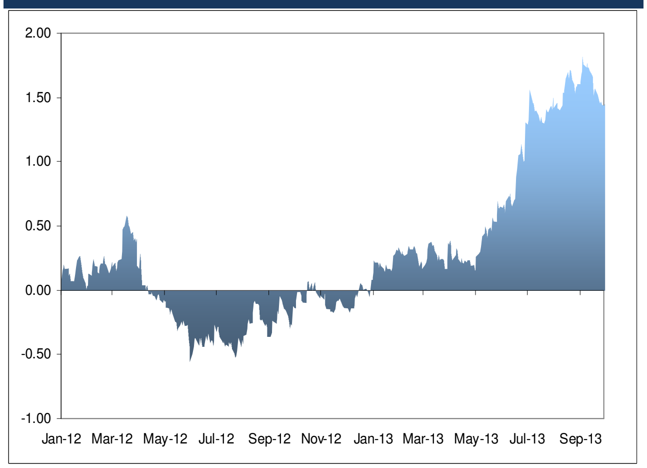
A Stable Source of Income

Bonds also offer an inherent advantage over stocks - a contractually guaranteed stream of income in the form of coupon payments. Dividends, for all their merits, are paid at the discretion of management and can be reduced or eliminated at any time. Coupon payments are contractually required and missing a coupon payment would be an event of default for any borrower, corporate or otherwise.

Therefore, interest payments are just about at the top of the list of bills to be paid by a company, municipality, or government. When talking about a corporation, creditors (i.e., bondholders) have a priority claim on the earnings stream of a business as interest and principal repayment come before dividends to shareholders. This income source can be a great stabilizer, and in addition to providing income helps to account for the lower risk profile of bonds over stocks. This is a key point we will expand on later when discussing substitutes for income.

Furthermore, the recent rise in interest rates has been driven not by inflation concerns but by the perception of an improving economic picture which is leading the Federal Reserve to reduce monetary stimulus (bond buying). The difference is important to understand. If the rise in rates was coming from higher inflation this would be very detrimental to bondholders as inflation eats away at the value of bonds as the income stream is fixed. The challenge of negative real yields (inflation rates that exceed bond yields) which has been a continual theme of ours is less of a risk now than it has been in some time. As the chart below indicates, for much of the past year real yields have been negative or infinitesimal. With the recent rise in rates, real yields are now solidly positive and trending upward, a good sign for bondholders.

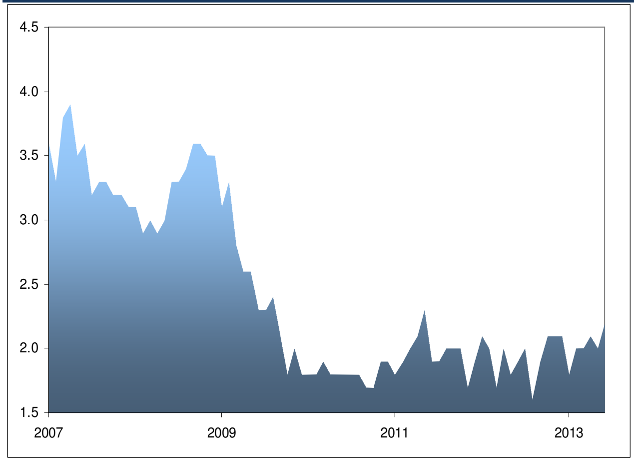
Chart 16. Real Yield (10 Yr. Treasury less CPI)



Source: Bloomberg, Cypress Trust

As we have written in the past, we do not believe inflation is a concern. Wage growth remains low which is a critical component to drive higher inflation, and in our opinion there are few catalysts for wage growth. Chart 17 is the Average Hourly Earnings of All U.S. Employees as calculated by the Bureau of Labor Statistics. Since the financial crisis of ’08/’09 wage growth has never fully recovered to pre-crisis levels. Economic growth and corporate profitability is not yet robust enough to trickle down to the employee level in the form of wage growth which is a necessary condition for inflation.

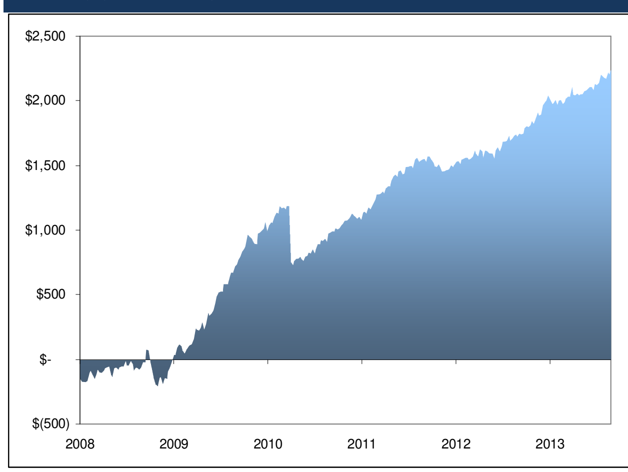
Chart 17. U.S. Average Hourly Earnings- All Employees



Source: Bureau of Labor Statistics, Bloomberg

It is crucial to remember that inflation is also a function of demand and not just money supply. Economic growth is still insufficient to increase the velocity of money, which is a measure of the frequency with which money is spent on new goods and services (Nominal GDP/ Money Supply). Lastly, lending remains weak as banks continue to hold surplus liquidity.

Chart 18. U.S. Bank Surplus Liquidity (Deposits less Loans) (in billions)



Source: Bloomberg

What *Not* To Do

As the bond market sputters and investors see interest rates rising we think it is vital that investors not fall for some common mistakes such as:

1) Thinking tactically instead of strategically.

2) Abandoning the asset allocation approach.

3) Reaching for yield and the "bond substitute."

Thinking Tactically Instead of Strategically

A common misperception in the investment community amongst both professionals and non-professionals is the idea that one can switch between asset classes to "time the market." We firmly disagree with this approach as the evidence is plentiful that market timing is a loser's game. The market timing approach increases transaction costs and taxes at the expense of poorer performance. It requires the investor to dramatically increase the number of investment decisions to be made which dramatically increases the opportunity for mistakes. The market rarely gives advance notice of a correction to allow investors to make the necessary changes. We steadfastly adhere to the approach of setting a strategic investment objective based upon client risk/return requirements. This leads us into the second common mistake, abandoning your asset allocation.

Abandoning Your Asset Allocation

While bonds may be going through a period of poor performance, the reality is that all asset classes go through periods of poor performance. If there was an asset class that never had bad performance then everyone would be in it. It simply does not exist. It is important to look at your investment strategy from an asset allocation perspective. For many investors, bonds are part of a balanced objective (50/50 stocks and bonds, 60/40, etc.). We encourage investors to think in terms of the total return of their portfolio. Viewed in isolation bonds can seem inappropriate at times.

However, we would reiterate the cushion they provide to equity market volatility, as highlighted in Chart 15. It is natural for investors to want an asset allocation approach where all asset classes are outperforming. The problem with that logic is that asset classes that all go up together, all go down together!

While rising interest rates make for a challenging environment for bonds they are indicative of an improving economic outlook which is often beneficial for stocks. We encourage investors to think in terms of the total return on their portfolio. Periods of particularly sharp rises in rates have been met with solid equity market returns.

Chart 19. Episodes of Sharp Rises in the 10-yr. Treasury Yield

Time Period	Starting Yield	Ending Yield	Change in Yields (bps)
9/30/93-12/30/94	5.38%	7.82%	244
9/30/98-12/31/99	4.42%	6.44%	202
6/30/03-6/30/06	3.51%	5.13%	162
12/31/08-12/31/09	2.22%	3.83%	161
9/30/10-3/31/11	2.50%	3.47%	97
11/16/12-Current	1.58%	2.95%	137

Source: Bloomberg, Cypress Trust

Confirmation of the importance of asset allocation and the total portfolio return mindset that investors should employ is the performance of the equity market during periods of rising rates as shown in Chart 20. While bond returns were in the negative to mid-single digit area, stock market returns far outweighed bond returns. The two asset classes, stocks and bonds, often have a low correlation among one another. They complement each other within the context of an asset allocation mix; that is why it is so important to maintain your asset allocation setting and not alter it based upon the ever changing winds of the market. When the stock market sells off you are going to want to own those bonds.

Chart 20. When One Doesn't Work the Other Should: Stock & Bond Performance During Sharp Rises in Rates

Time Period	S&P 500 Total Return	Barclays Aggregate Total Return
9/30/93-12/30/94	3.7%	-2.9%
9/30/98-12/31/99	46.8%	-0.5%
6/30/03-6/30/06	37.5%	6.3%
12/31/08-12/31/09	26.5%	5.9%
9/30/10-3/31/11	17.3%	-0.9%
11/16/12-Current	25.1%	-3.5%

Source: Bloomberg, Cypress Trust

Investors should consider changing their asset allocation setting only if material changes occur. For example, if there is a change in investment time horizon or a long lasting change in investment objective or in risk tolerance. The key phrase in the last sentence is "long lasting" - changes to an asset allocation mix should have a permanency to them.

Reaching for Yield and the "Bond Substitute"

With rates so low it is understandably tempting to reach for yield. Within the bond market the main way that this is done is by purchasing lower quality bonds which offer higher yields. We have been the proponent of taking credit risk over interest rate risk in this environment with this caveat: Taking credit risk should be done within the investment grade bond market, not the high yield market. For certain investment objectives an allocation to high yield bonds is appropriate; however, it should be included only as part of an overall strategy to diversify across an array of fixed income sectors. We prefer this to be done within the context of an exchange traded fund structure or ETF where exposure to individual credits is significantly minimized.

The reach for yield risk that we are more concerned with is the "bond substitute" argument whereby investors shift out of lower income-producing bonds and into higher dividend paying stocks. The rationale is that the stocks offer a higher level of income, the dividend is reasonably safe, and is therefore a good "bond substitute."

To illustrate in stark terms just how different stocks perform from bonds under stress let us look at the performance of two sectors that are often associated with the "bond substitute" argument, Telecommunications and Utilities. Both sectors offer some of the higher dividend yields found in the market and can be considered lower risk due to their relatively stable revenue streams which are backed by essential services - electricity, in the case of utilities, and telecommunications services, in the case of the telecommunications industry, which is vital for basic communication within a society.

Instead of picking on a specific company, let's use the iShares US Telecommunication ETF and iShares US Utilities ETF as proxies for the respective industries to compare their performance through the financial crisis of late '08/ early '09 to corporate investment grade debt. We see dramatic differences in performance.

Telecommunications lost 38% more in value than bonds did and utilities did only modestly better, losing 34.5% more than bonds. You can argue against a small sample size and data mining, but we still believe the underlying lesson is that at the end of the day, stocks are stocks and bonds are bonds. As outlined earlier, they have different characteristics and carry different risk profiles. Many investors who are shifting into stocks as "bond substitutes" are unknowingly increasing the risk of their portfolio by changing their asset allocation.

Chart 21. Beware the "Bond Substitute": Utilities & Telecomm Sectors vs. Bonds During the Financial Crisis

The Financial Crisis	Telecomm Sector	Utilities Sector	iBoxx $ Liquid Inv. Grade Index
8/15/08-3/9/09	-42.7%	-39.1%	-4.6%

Source: Bloomberg, Cypress Trust

Conclusion

In conclusion, we would reiterate that in times of turbulence for bonds investors should remember the primary role of bonds in their portfolio: as a cushion to stock market volatility and therefore as a portfolio stabilizer, and as a stable source of income. Thinking tactically instead of strategically, abandoning your asset allocation mix, and falling for "bond substitutes" are all typical investor mistakes to be avoided.

As we have been stressing for over a year, bond investors should lower their return expectations. 2013 is highly likely to see losses in bonds for most investors. We have been advocating the following in our approach to bond investment to mitigate market risks:

- Keep a shorter duration portfolio.
- Selectively take credit risk within investment grade credits. We much prefer credit risk to interest rate risk.
- Diversify into non-U.S. interest rate based credit products.
- Invest in high premium priced "cushion" bonds as their high coupons will soften the blow of rate increases.
- Think more broadly about bond investments – diversify into other areas of the bond market to smooth out volatility.
- Consider greater use of exchange-traded funds (ETFs) as their structure of broadly diversified holdings and continuously maturing bonds will allow for improved diversification and reinvestment at higher rates.

Massimo Santicchia is the Chief Investment Officer for Cypress Capital Group, Cypress Trust Company and Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages his own custom equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as portfolio manager of JNL/S&P 4 funds and co-managed JNL/S&P Managed and Disciplined funds.

Ryan Kuyawa, CFA is a Portfolio Manager & Fixed Income Trader for Cypress Trust Company and Cypress Capital Group. He is responsible for security selection and research, yield curve positioning, and directing the firm's fixed income strategy. In addition, he performs equity research, manages client portfolios, and helps shape the overall investment outlook. Ryan has over 10 years experience in the financial industry working as a senior credit analyst for Fidelity Federal Bank & Trust in West Palm Beach, Florida and as an Equity Analyst and Equity & Fixed Income Trader for Northstar Capital Management in Palm Beach Gardens, Florida. Ryan has earned the right to use the Chartered Financial Analyst designation (CFA).