BONDS VS. EQUITIES – The Continued Tug-of-War

First Quarter Market Review From Your Portfolio Management Team—April 16, 2013

The Great Rotation out of bonds into equities has been one of the most anticipated financial events of recent time. With the strong start to 2013 for equities, one would think that investors have been bailing out of bonds by the truckload. But while the appetite for riskier assets did accelerate in the first quarter, we did not see a corresponding decline in the demand for "safe haven" assets.

According to a Reuters poll of leading investment houses in March, allocations to equities in the U.S. rose to a four-month high of 41.3%, while allocations to bonds also picked up to 52.3%. Another report by TrimTabs revealed that during the first quarter, equity and exchange-traded funds (ETFs) saw a nine-year high of inflows, $52 billion, contrasted with $87 billion of outflows last year. Fixed-income funds took in $65.7 billion, the highest inflow since the same period in 2006. So far, the Great Rotation appears to not be coming from bonds, but actually, from cash positions, which stand at their lowest level since January 2011.

Bonds and equities seem to be telling two different stories: a longer period of sluggish growth versus a more robust recovery. Bonds tend to get the real story right more often than stocks. That's not to say that equities haven't been giving it their best shot in this tug-of-war with the S&P 500 recently surpassing its October 2007 intra-day high.

On the next page, we review the five broad strategies that FSA manages. Keep in mind that your specific portfolio may differ to some degree from the averages, as our portfolios are individually managed.

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Portfolio Review

Conservative Growth
*Current Money Market Allocation: 2%**
During the quarter, we decreased our allocation to certain bond funds in order to move more into stocks funds, while maintaining a 20% allocation to high yield bonds. In the first quarter, Conservative Growth accounts were up 1.5%, on average.

Core Equity
*Current Money Market Allocation: 2%**
In February, we added an inverse high yield bond position due to the loss of upward momentum in the market, while maintaining a 65% exposure to equities. In the first quarter, Core Equity accounts were up over 7%, on average.

Tactical Growth
*Current Money Market Allocation: 5%**
We cut back our allocation to European stocks (The Netherlands), while adding a Japanese equity position and increasing consumer products. We also added an inverse high yield bond position due to the loss of upward momentum in the market. In the first quarter, Tactical Growth accounts were up over 5%, on average.

Income & Growth
*Current Money Market Allocation: 5%**
We increased our allocation to equity income funds and added bond funds that would be less affected by rising interest rates. In the first quarter, Income & Growth accounts were up over 1%, on average.

Income
*Current Money Market Allocation: 5%**
During the quarter, we adjusted the mix of bond funds a bit, increasing our floating rate exposure and adding a new multisector fund. In the first quarter, Income accounts were up less than 1%, on average – not a bad result, given that the typical bond funds were flat.

*These allocations represent the money market levels of our various strategies, including trades through March 31, 2013. Performance numbers for FSA portfolios represent composite results. A complete Performance History of all FSA strategies in available upon request.

A Look Ahead

The U.S. equity market has largely shrugged off worries as if they no longer exist: renewed fear in the Euro zone caused by the Cyprus crisis, sluggish economic growth here in the U.S. and an upcoming earnings season that stands to disappoint. The main reason these concerns appear to be having less of an impact is the belief that the U.S. is in better shape relative to the rest of the world. Our economic recovery might be slow, but it's stable against a backdrop of accommodative monetary policy and turmoil over the European debit crisis. Japan's recently-announced aggressive monetary easing has helped to fuel the hope that central bank policies will continue to provide support for liquidity in capital markets.

FSA has been participating in the stock market moves by keeping cash levels low and moving more into equities across the board. With the major indices back at 2007 highs, the question for many investors is, "What now?" Will the market continue its trek upward or will the 2007 highs act as resistance and keep equities from marching further ahead? Trying to predict which road the market will take is a fruitless endeavor. Rather, it is better to be nimble enough to follow the market once its path becomes clear.

What does this mean? We stand poised to shift bond assets to stocks should the recent stock market trend continue up or bond prices turn down. No matter which asset class wins out in the current tug-of-war, we will be diligent with FSA safety nets firmly in place.

We wish everyone a happy spring!

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