Changing of the Guard

May Market Review From Your Portfolio Management Team—June 13, 2013

We have been talking about this shift for some time now. In fact, we have made this issue the subject of three of our six Market Updates this year. What are we talking about—the coming end of the great rally in bonds. It's possible that May represented the final straw in the debate. Stocks managed to rally roughly 2% in May, while bonds were down close to 2%, which ranks it as one of the ten worst months since the bond bull market began back in 1981. For the year, investment grade bonds are down 1%, high yield bonds are up 4%, while the S&P 500 index is up 15%.

Yet, amazingly, money flows to bond funds continue to be quite positive. According to the latest data from the Investment Company Institute (ICI), during the first 5 months of the year, domestic stock funds had flows of roughly $12 billion, while bonds of all types (including municipals) had flows of $98 billion. Clearly, investors continue to push a great deal of money into bond funds even as the returns are lagging.

We may be in the early stages of a transition from bonds to some other area of the market. What the next opportunity might be is hard to predict at this point. We will need to watch where the flows of money from investors go. Many analysts believe stocks could be the leaders in the next cycle. Some believe commodities, which led before the 2008 meltdown, could reassert themselves soon. It might be more narrow—such as Technology stocks (similar to the late nineties) or Energy stocks (which were strong before the 2008 collapse). Maybe Financial stocks will rise to the top again.

It was a difficult month for our more conservative strategies that hold a larger allocation to bonds. With bonds down and stocks up, any strategy that held a high allocation to bonds struggled to make money in May. Fortunately, in Conservative Growth, we added a fund that rises in value when interest rates rise (a so-called inverse fund) which has helped offset the losses from the bond funds. We added that fund towards the end of May. In addition, we have been paring back the bond positions and adding to the stock funds. The table below shows the migration we made in Conservative Growth accounts since the start of the year:

Allocation	Jan 1	Jun 1
Stocks	20%	29%
HY Bonds	24%	24%
Quality Bonds	53%	40%
Inverse Bonds	0%	4%
MM	3%	3%

We have not moved more aggressively due to the difficulty that stocks have been having since late May. As of early June, there have been no significant losses in the equity markets, but volatility has returned and high yield bonds are weakening—two early warnings for us to tread carefully.

If, indeed, we are witnessing the final topping process of this secular bull market in bonds that saw yields on 10-year Treasury bonds fall from 15% (in 1981) to less than 2% (earlier this year), what are viable investment options for income-oriented investors? Fortunately, the bond market is quite broad, with an amazing array of options. In a generally rising interest rate environment, we would expect to use short-term bond funds (such as FPA New Income and DWS Short Duration Bond Fund—already in a few portfolios), as well as so-called floating rate funds (such as Franklin Floating Rate Fund and Invesco Floating Rate Fund—already in a few portfolios), and even the inverse funds mentioned above. We would also expect that high yield bond funds could generate decent returns in a rising interest rate environment since their fortunes are tied more with the overall economy rather than with interest rates.

Of course, at times, there is no substitute for money market funds. So, clients in our Income and Income & Growth strategies may see their money market positions increase in the short-term as we rotate out of some of the lagging bond positions, while waiting to identify the next area of opportunity.

Even though it has been a frustrating year for more conservative clients who have been holding a high allocation to bonds, know that we are diligently scanning the horizon for the next opportunity to follow the money.

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