

# Capital Market Perspectives

JANUARY 2012

## Capital Market Activity

### Equity Markets

Returns from domestic stock markets ended the quarter generally above long-term averages, as shown in the graph below. On the other hand, returns from international stocks (MSCI EAFE Index) while positive, were weaker reflecting the ongoing uncertainty related to European governments' responses to their financial systems' crises.

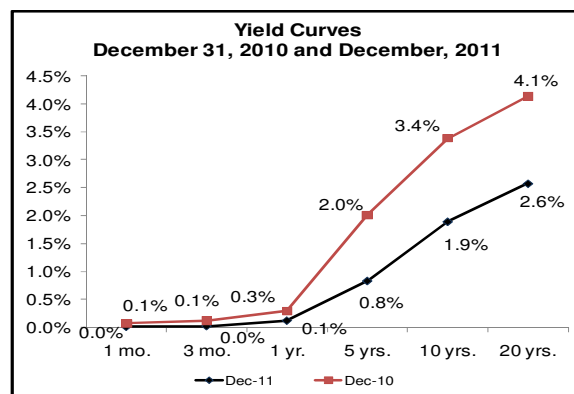
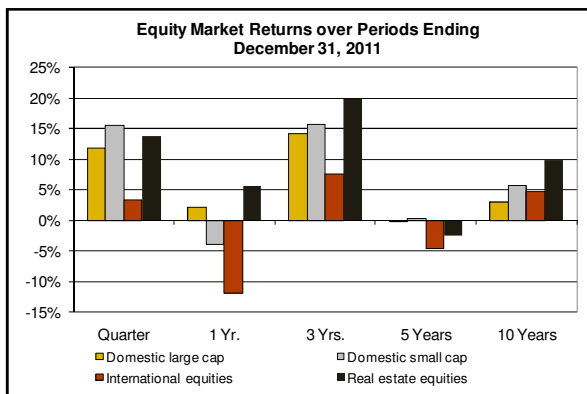
Equity returns in calendar year 2011 were generally weak, all below what can reasonably be expected over the long-run. Our proxy for international stock markets fell over 12% in 2011.

Over the past decade stock returns were not only below long-term expectations, but were also accompanied by significant volatility. Remember the steep fall-off in 2008, and the sharp rebound in 2009 and 2010. This volatility can neither be predicted nor avoided and must be

weathered by maintaining established commitments to several asset classes. Additionally, keep in mind that periods as long as ten years may not be a useful indicator of what's ahead.

### Bond Markets

Yields on U.S. Treasury securities remained at historical lows, producing flat bond returns over the quarter. However, as shown in the graph below, yields on longer maturity securities have fallen dramatically over the past year due to the FED's influence in the bond market with its "Operation Twist." Bond returns behave inversely with changing yields – falling yields produce higher returns and vice-versa. At today's Treasury yields, a return above a 2% inflation rate will happen only if interest rates (yields) fall further. Because it is hard to imagine yields falling much below current levels, the only way to earn a positive return above expected inflation is to take more risk. ♦



## International Markets - Still a Wise Investment

Over the past year, international markets have underperformed domestic markets, which may encourage investors to question the future of international markets. The purpose of this article is to demonstrate why investors should stay committed to these markets.

One year is not long enough to make any conclusions on what to expect in the future. Take a

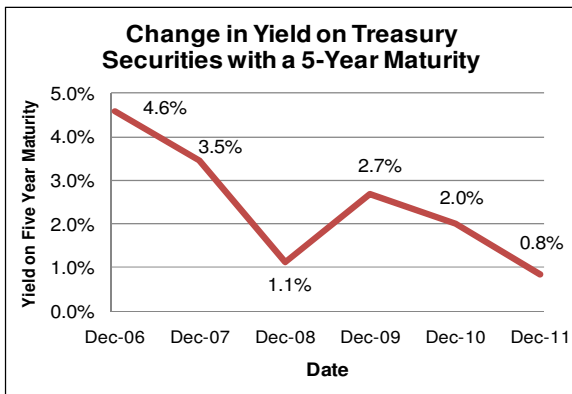
look at the chart at the top of Page 3.

The second reason for maintaining international investments is diversification, which allows investors to reduce risk without having to reduce expected return. This works because, as seen in the past quarter and year, international markets are not always well correlated with domestic

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## Investing in Bonds with Zero Yields

A bond's yield is what its holder will earn if all promised cash flows are paid and the bond is held to maturity. Typically, the cash flows are periodic coupon payments plus the principal payment at maturity. U.S. Treasury bonds are viewed as "risk free" because the cash flows are guaranteed by the U.S. Government. The graph below picks a 5-yr. Treasury Note and shows how its yield has fallen since December 2006:



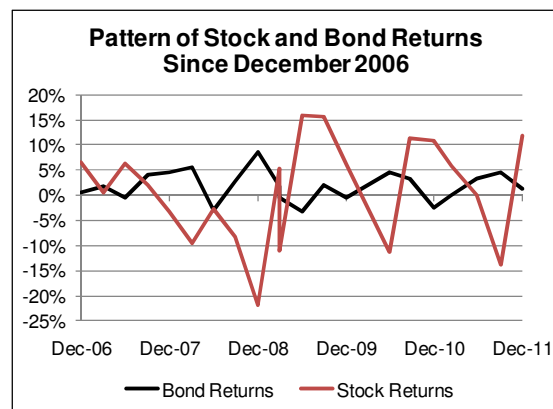
This decline reflects the Federal Reserve System's "Quantitative Easing" and "Operation Twist" programs to keep interest rates low to spur economic growth. Today the after expected inflation yields on Treasury securities are essentially zero, which means the holder will earn no return if held to maturity. This situation begs the question as to why investors would hold a bond with a zero yield. Three reasons come to mind:

1. It is expected return, not yield that's important
2. Bond returns behave differently from stock returns
3. Expected bond returns are still a function of risk

Expected return, not yield is relevant to investors. Yield is not important since at maturity investors will simply reinvest the principal in another bond. Return depends on price change as well as yield. And, if yields are near zero, then it is price change that will determine the return. Price changes are the result of changing yields – if yields fall, prices go up and vice-versa. And, the longer a bond's maturity the greater the impact of a given change in yield will have on its price. So, if yields increase from here, bond

prices will fall, having a distinctively negative effect on return. Therefore, a reason to hold zero-yielding bonds with a short-dated maturity is the expectation that interest rates will increase, resulting in the opportunity to reinvest the proceeds at maturities in a higher interest rate environment and avoiding a negative return.

Another reason to hold zero-yielding bonds is that their return will behave differently from stock returns. Investors do not hold individual securities, but hold portfolios which include both stocks and bonds. Using the 5-yr. Treasury Index published by Citibank as a proxy for bonds and the S&P 500 as a proxy for stocks, the graph below shows how quarterly returns have behaved since December 31, 2006:



Note that the pattern of bond returns is quite different from that of stock returns. The swing in stock returns is not only much greater, they also tend to move in opposite directions. This pattern of returns is the diversification effect of holding bonds, as it reduces the portfolio's risk (volatility of returns) without reducing its average return. This diversification effect is another reason for holding bonds even if the yield is currently zero.

While it is possible to find bonds as well as dividend-paying stocks with positive yields, these securities are not only risky, but also have a pattern of returns that more closely resemble that of stocks. Bonds other than those of the U.S. Treasury carry both credit risk (risk that the cash flows will not be realized as promised) and liquidity risk (risk that the bond will not be able to be sold at reported values). This risk is reflected in a more volatile price that is more

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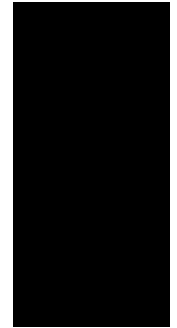
## “Occupy Wall Street,” the “Tea Party” and Capital Market Activity

I am writing to provide a perspective on the “Occupy Wall Street” protests. Readers of a certain age will remember Eric Sevareid, who would from time to time provide comments after Walter Cronkite’s newscasts. I recall one such comment on the student protestors of that day in which he observed, “Students are generally right in what they oppose; wrong in what they propose.” I think this observation is applicable to the Occupy Wall Street people – pay more attention to what they oppose, not what they propose. While many are apt to disagree, the protests of this group are not too different from those of the “Tea Party.” In my view, both groups are essentially protesting a sense of unfairness in how power, both economic and political, is currently distributed. Incidentally, the last time the top 1% had as great a claim on economic income as they do today was at the end of the 1920s.

Much of this economic power has been accumulated by those engaged in our system of allocating capital from those who have it to those who need it. Notwithstanding the size of their claim on economic resources, their track record is, at best, spotty. They have neither produced returns for investors, nor provided capital to productive activities. In the past

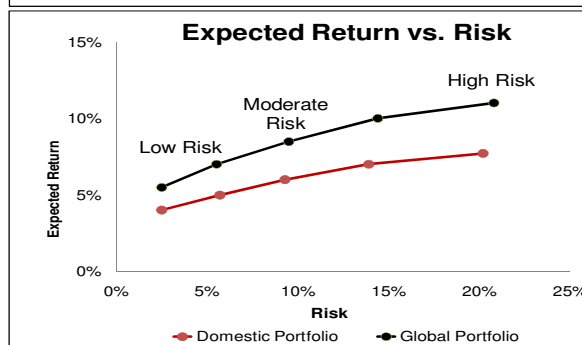
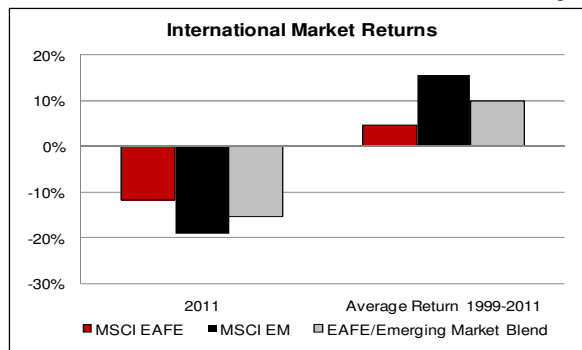
decade returns to investors, even after withstanding significant volatility as evidenced by most market indicators, have been below long-term averages. At the same time, our financial system has allocated capital to activities that produced the dot-com bubble, the real estate bubble and a global financial crisis. There is some debate over the extent to which government is part of the problem, but it seems at the very least to be incapable of improving this record.

A key tenet of market economics is that there must be a downside to risk-taking. That’s been missing lately. Banks that make poor investments are deemed “too big to fail”; traders reap big rewards when they make money, yet pay no cost when they lose it; managements who destroy shareholder value walk away with big bonuses, etc. This, in my view, is an aspect of what both the “Occupy Wall Street” and the “Tea Party” are protesting. There is a lot of common ground between what at first blush seems to be two disparate groups. While we no doubt will have to witness more shouting at one another as we endure a couple more election cycles, let’s look forward to finding this common ground. ♦



## International Markets - Still a Wise Investment... continued from Page 1

markets. In other words, they do not move in the same direction at the same time. This lack of correlation allows for the positive performance of some investments to offset the negative performance of others. The chart at the bottom right gives an example of the risk/reward tradeoff for domestic and international markets over the past ten years. The lines in the chart represent the average returns that a well-developed domestic and a blended domestic/international portfolio will allow for, based on the level of risk taken. The points along the line increase exposures to equities. The chart shows that by adding international markets to a domestic portfolio, average returns increase for the same level or risk. ♦

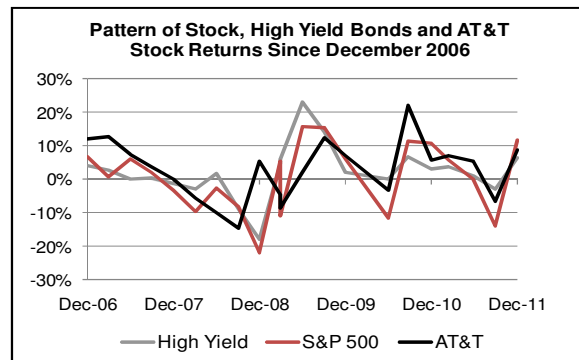


## Investing in Bonds with Zero Yields

consistent with the pattern of stock returns. The graph to the right shows the pattern of returns of a portfolio of bonds with a high level of credit risk, a high dividend paying stock as well as our proxy for stocks (S&P 500). The yield on the Merrill Lynch U.S. High Yield II is 8.29% and the dividend yield on AT&T stock is 6%. However, these yields are clearly not without risk as the past pattern of returns shows.

While it is hard to imagine bond yields remaining at these levels for an extended period, especially as our domestic economy improves, it is still reasonable to hold short-term zero-yielding U.S.

Treasury securities to 1) avoid significantly negative returns when yields rise, 2) maintain the diversification effect of holding bonds, and 3) to avoid the equity-like characteristics of higher yielding investments. ♦



## Market Returns

We show returns over several periods ending December 31, 2011 from indices typically used as proxies for individual markets as well as from diversified portfolios with different risk profiles. Except for international markets, these results are generally as expected. However, always be careful about extrapolating these past results in the future.

Chart I - Returns from Individual Markets

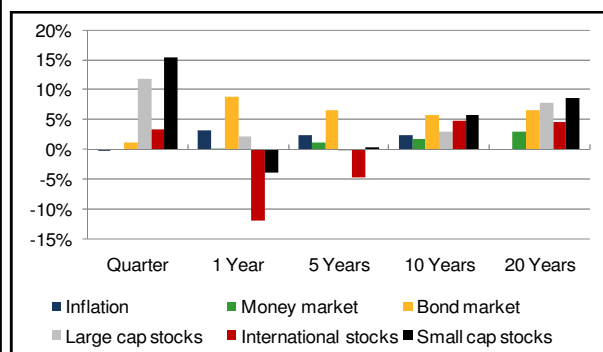
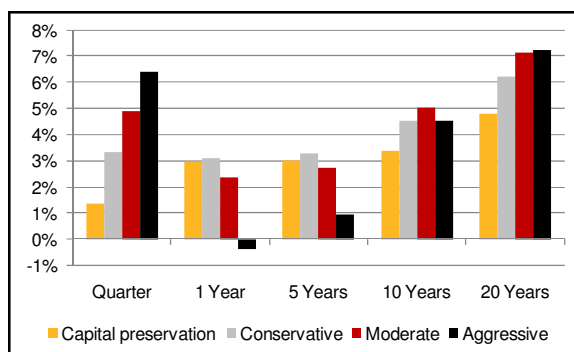


Chart II - Returns from Diversified Portfolios



### We welcome your comments:

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