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Zombie Apocolypse

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The Dow and the S&P both reached new record levels last week as stocks reacted to Federal Reserve stimulus and better economic data. The record levels in the indices are not only impressive because of their high levels, but also the slow direct path that they took to get there. However, the slow direct growth in stocks is in-line with the theoretical framework of quantitative easing. In this newsletter we will once again review the Federal Reserve's policy of quantitative easing and why it may be responsible for the slow steady gain in the stock market.

Bond Buying

Once again we will review the policy of Quantitative Easing (QE) and its past results. QE is the Federal Reserve policy of purchasing U.S. government debt from private commercial banks in order to lower interest rates. It is a new policy without historical precedent so the long term effects are still only theoretical, but the short term effects are becoming apparent. By purchasing these bonds, the Federal Reserve is creating additional demand for U.S. treasury bonds, which

↑	S&P 500 Index	
	7.74	0.48%
↑	Dow Jones Industrial Average	
	144.53	0.97%
↑	NASDAQ Composite	
	57.95	1.72%

causes the yield to fall. In other words, since there is a constant enormous buyer of bonds that does not care about rates or return of capital, interest rates will remain low no matter what (barring a major calamity). The consequences of this policy are not limited to government bonds as you can see from the chart below.

What do stocks have to do with Government bonds?

To answer this question, imagine that you are in charge of a large pension fund and you have an obligation to return 5%. When interest

S&P 500 Index over Five Years with Fed Interventions



rates were higher, this was no big problem. Back in 1997 you could buy a 3 month government bond that yields 5.19% and then go golfing, or if you could see the future you were smart enough to buy a 30 year bond for 6.75% and you could still be golfing. Unfortunately, most fiduciaries did not do that and are now faced with a difficult conundrum. They are required to return 5%, but 3 month government bonds now only pay 0.08% and even 30 year bonds only pay 3.04%. That means you will have to get more creative to find those 5% returns.

You decide to look at bonds from strong blue chip companies like GE, but much to your dismay GE bonds that mature in 2042 only get you up to 3.95%, and you are vulnerable not only to changes in interest rate, but you are vulnerable to the long term prospects of GE. So you start looking elsewhere. Maybe a riskier country like Italy...nope you can only get 3.9% on a ten year bond. Since you have to earn at least 5% you start looking to junk bonds and corporations that have high levels of debt that are struggling to make their payments. Jackpot! You find a 6% yield on a junk bond. But now everyone else is on to the same idea, and those yields start coming down to the 5% level. You now start adding stocks to your already precarious junk bond portfolio, but so is everyone else. This is how stock prices, and risk assets in general are inflated by quantitative easing.

Zombie Apocalypse

Systemic risk is the risk that all asset classes will fall together. Systemic risk has both increased and decreased as a result of quantitative easing. To clarify, banks now have more liquid capital thanks to the Federal Reserve so a liquidity crisis has been averted. However, if a bank has a bunch of worthless bonds and bad loans it can stay alive by selling its Mortgage backed securities and treasuries back to the Fed.

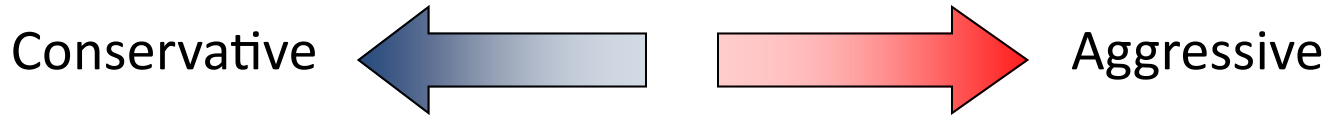
Many banks, particularly European banks with exposure to poor quality sovereign (government) bonds, have become zombies who appear to be alive on the outside, but the credit quality of their bonds are not as good as they appear.

Banks aren't the only zombies in this system though. Think about all the junk bonds that have seen their interest rates come down as a result of the search for yield. Instead of filing for bankruptcy, these companies are able to re-finance their debt at lower and lower rates, and in many cases increase their debt burden thanks to those who are willing to accept more risk for lower and lower yield. Systemic risk is now higher because pension funds and insurance companies are now intertwined with struggling companies that should have gone out of business. The risk event will be triggered when markets lose confidence in the system, or when monetary policy begins to tighten, that is when quantitative easing ends, or shortly thereafter.

Conclusion

To quote Benjamin Graham, "*Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions.*" Business conditions are certainly favorable as even distressed companies can borrow at low interest rates, but greed and a desperate grab for more yield will not end well when those favorable conditions go away. In times of stock market strength, it is wise to give up a small amount of yield for a higher margin of safety. However, identifying what is safe is becoming more challenging.

Strategic Allocation



RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Overweight short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Neutral intermediate term debt, we prefer higher quality corporate bonds to replace treasury exposure.

Neutral Long Term Debt, Long term debt has substantial risk if interest rates rise, but can still help alleviate losses in the event of a stock market selloff.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Neutral Small Capitalization Stocks, we are recommending a neutral holding of smaller companies with strong balance sheets and little need for short term debt financing.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Underweight Large Cap Stocks, We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will look to add to our position in REITs during periods of deflation.

Neutral Commodities, we recommend a neutral holding in commodities to reduce the impacts of future inflation.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are currently holding higher levels of cash.