A Bumpy, But Rewarding Journey

Rich Golinski, CFA  
Principal, Chief Investment Officer

As the world continues to grapple with the aftermath of the recent recession, the economic environment remains uncommonly uncertain. Growth in the United States is quite sluggish, Europe’s recession is deepening, and China’s rapid expansion has begun to slow. On the monetary front, the euro’s fate remains a source of speculation and monetary systems are distorted with short-term interest rates near zero in most of the developed world. Given that there are no quick fixes to many of these challenges, lingering uncertainty is likely to cause continued bouts of high stock market volatility for some time.

With so much discussion of uncertainty and volatility, it is appropriate to ask whether owning stocks within a diversified portfolio continues to make sense. The remainder of this article focuses on a few of the reasons why we believe investors should continue to own stocks. We focus on U.S. stocks, which comprise about three-quarters of our clients’ stock allocations, and discuss reasons why we believe stocks are positioned to generate solid, although not extraordinary, returns.

**Things Change**: Given the many serious challenges we face (the trajectory of Medicare costs is just one example) and the insufficient policy responses to many of these challenges to date, it is easy to understand why some investors are pessimistic about future economic growth and stock market returns. While it would be naive to dismiss these challenges out-of-hand and assume that we will avoid all pain and controversy in resolving them, it is important to recognize that our society usually finds ways to adjust before the worst case scenario occurs. A couple of recent developments show how seemingly intractable problems are being resolved in ways that bode well for investors.

Over the recent past, a number of commentators have predicted increasing problems for the U.S. economy as we send more and more dollars overseas to pay for foreign oil imports. Until a few years ago the trend was disturbing. For example, over the 20-year period ending in 2007, energy imports as a percentage of overall U.S. energy consumption doubled from 15% to 30%. The recent development of new extraction techniques has dramatically changed this situation. With the development of hydraulic fracturing (fracking), previously untapped natural gas and oil fields have now become profitable to drill. As a result, domestic natural gas production has risen significantly over the past few years, and production is expected to continue to increase for many years into the future. The impact has been quite significant - the percentage of U.S. energy consumption attributable to imports declined to 22% in 2010 and is expected to continue to decline to 13% by 2035, according to the U.S. Energy Information Administration.

Another positive development for investors has recently occurred in many municipalities around the country. Over the past few years, it has become increasingly apparent that state and local governments have promised unaffordable retirement pension and health benefits to their workforces. This realization was met in
some quarters with predictions of widespread municipal bond defaults on the premise that municipal leaders would not be willing to confront the ever-rising costs of employee benefits. These dire predictions have turned out to be off-the-mark in many instances. While a few municipalities have filed for bankruptcy over the past couple of years, most have tackled budget shortfalls by cutting expenses and, to a lesser degree, raising taxes. Pension and health benefit challenges remain real and we are monitoring developments in municipal finances closely. Nevertheless, the early signs have been encouraging.

Global Growth Opportunities: Some market analysts cite predictions of slow growth in the U.S. as a reason to expect U.S. stocks to perform poorly. Even if we accept the premise of slower-than-normal domestic growth, U.S. companies are well-positioned to compete for consumers in faster growing countries around the world. With leadership in categories including computers, pharmaceuticals, energy technology, agriculture, and consumer products, U.S. companies are likely to find their products and services in high demand by a growing middle class in emerging countries such as China, India, and Brazil. These opportunities are not limited to large U.S. multinational companies - the build-out of global trade infrastructure has made it easier for even very small companies to sell to foreign consumers.

Valuations: One of the more robust methodologies for gauging whether the stock market is “cheap” or “expensive” is to compare the market’s cyclically-adjusted price-earnings ratio (CAPE) with its long-term average CAPE. CAPE is calculated by dividing the stock market’s current price level by the average of the past ten years of earnings. This averaging approach moderates the impact of the economic cycle which makes CAPE superior to more common methodologies such as price divided by the past twelve months’ earnings. As the graph illustrates, the current S&P 500 CAPE is about 21 versus a post-World War II average of 18. This suggests the stock market is modestly expensive although far from extreme levels. For example, at the end of 1999, the CAPE level of 44 approximated its all-time high – over the subsequent ten-year period ending in 2009, the S&P 500 generated its worst returns for any ten-calendar-year period going back to 1900. The current CAPE level implies average annual returns for U.S. large company stocks in the 6% to 8% range over the next ten years. While this range is below the S&P 500’s average annual return since 1946 of 10.59%, it nevertheless represents an attractive return, especially relative to the low returns available from bonds. Investors have the opportunity to earn even higher stock returns by tilting portfolios towards value and small company stocks – two strategies we employ in our clients’ portfolios.

Maintaining Balance
Given our expectation of continued bouts of high volatility in the stock market, investors should carefully
target portfolio risk levels in order to withstand a large market decline if it were to occur. At the same time, we caution against becoming too conservative. With stocks positioned to provide solid long-term returns, we believe investors who are willing to accept some volatility in their portfolios should be rewarded. For most investors, maintaining a balanced approach, including having a meaningful allocation to stocks, is a very effective strategy for navigating these challenging times and protecting and growing long-term wealth.

Email Rich at rich.golinski@bosinvest.com

Floating Rate Debt

Aaron P. Waxman, CPA, CFP®
Portfolio Manager

Bond yields have reached historic lows in the U.S. and abroad. A ten-year loan to the U.S. government yields less than 2% and the story is the same in foreign markets. “Safe” sovereigns, such as Japan, the U.K. and Germany, all offer sub-2% yields on ten-year loan commitments, an unprecedented environment for bond investors.

With current interest rates at historic lows, variable-rate bonds have deservedly received some attention. Several funds have sprouted up, offering investors the opportunity to own baskets of corporate loans with variable interest rates - the coupon payments “float” up and down over the term of the underlying loan agreements with the principal paid back (or rolled over) at maturity. This is seemingly appealing for investors, understandably concerned that interest rates may soon change course.

Beneath the surface, there’s a bit of fine print. For starters, the floating-rate debt market accessible to investors is generally limited to the low-quality credit spectrum. In other words, underlying loans are not to the healthiest companies such as Johnson & Johnson, Microsoft or Exxon Mobil. Instead, floating-rate funds are packaged portfolios of loans made to smaller and/or riskier corporations (in investment lingo, “junk bonds”). As a result, underlying returns are largely predicated on the performance (business success or failure) of the lower quality companies issuing the debt.

The credit quality issue is best illustrated by historical returns. We compared the Fidelity Floating Rate High Income Fund against the standard industry benchmark for bonds—the Barclays Capital Aggregate Bond Index (“Barcap”)—over the last five calendar years. We also compared the floating-rate (“Bank Loan”) fund averages against the Barcap to broaden the analysis and extend the data (see charts). As the charts show, the volatility on floating-rate debt is significant, falling over 16% in calendar year 2008. Additionally, returns have underperformed the Barcap over the trailing 5-, 10-, and 15-year timeframes.

Over the past fifteen years, investors have not been compensated for the risks associated with owning low-quality floating rate debt. While we would expect some underperformance due to the declining interest rate environment, which is more favorable to fixed-rate bonds, returns on floating-rate bonds have nevertheless been disappointing. This is compounded by the fact that floating-rate funds, on average, carry expense ratios that greatly exceed high quality, fixed-rate alternatives.

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The biggest challenge with floating-rate debt securities is that they behave much like stocks (albeit a deleveraged version), especially when markets are under stress and stocks are falling. This inherently conflicts with our investment strategy in two ways: 1) we seek asset class diversification that achieves lower levels of correlation, not higher; and 2) we expect the bond side of the portfolio to act as the stabilizer of aggregate volatility. In high tide, stocks are sold and replaced with bonds through the portfolio rebalancing process. In low tide, we sell bonds and buy stocks. This process is fundamental to earning competitive rates of return for our clients. In addition, the ratio of stocks to bonds must be carefully calibrated to match the risk tolerance and objectives of each BOS client. When certain bonds behave more like stocks, this delicate balance is at risk of being thrown off-kilter.

Ultimately, in the context of a well-diversified investment portfolio, we believe equities are a better vehicle through which to take on additional risk if and when more risk is appropriate. We will continue to research other bond-related investment opportunities and remain open to any alternatives that can successfully complement a thoughtful investment strategy. As you’ll recall, Colleen Supran took a peak under the hood of Master Limited Partnerships back in the spring 2011 newsletter, and Kevin Dorwin did the same for preferred stocks in the summer 2011 newsletter (both hybrid bond investments). Suffice it to say, we’re looking; but as you might expect, you’ll never catch us buying anything on impulse.

Email Aaron at aaron.waxman@bosinvest.com

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**Raising Financially Responsible Children**

Freda Lam Zietlow, CFA
*Portfolio Manager*

A friend called me in distress one day, seeking advice. The Dow had dropped almost 300 points that day. To my surprise, he did not want to discuss the market or portfolio strategies. Instead, he expressed frustration and helplessness with his children’s out-of-control spending habits and sense of entitlement. While confident and competent in his professional life, he felt clueless talking to his kids about financial responsibility.

Studies have shown that 75% of parents consider it a moral imperative to teach kids about money, but only 36% reportedly know how to do so. That is not surprising as financial matters rank high on the list of difficult topics for families. While in some states children as young as kindergarten are taught about the birds and the bees, money management or personal finances are very rarely covered in standard curriculum. Parents are essentially on their own ensuring financial literacy for their children. The good news is that youngsters are generally eager to learn more about money. According to the 2012 Parents, Kids & Money Survey from T. Rowe Price, many children interviewed (ages 8 to 14) show interest in money matters, particularly about saving and how to make money.

In the book “Raising Financial Fit Kids”, Joline Godfrey listed ten basic money skills that parents should help children acquire (see Table 1). This is admittedly a rather ambitious list, not just for kids, but also for many adults. But, it effectively highlights the different important dimensions of money that we encounter regularly, if not daily.
There are no shortage of books and resources on how to bring up financially-responsible and money-savvy children (a few of these are noted at the end of this article). Similar to many basic life skills, most experts recommend teaching children about money early. We offer some basic suggestions below on how to start a constructive conversation about finances with young children (and grandchildren) and begin equipping them with money management skills.

1. Set, Communicate and Live Your Values

Some parents are uncomfortable talking about money with their children partly because they do not want to reveal how much they have or make. They may also fear that private financial information may be made public by the children, inadvertently or otherwise. However, educating children about finances doesn’t necessarily have to involve disclosing numbers. Communicating the values that are important to you is the key and critical first step to begin talking to your children about money.

Discuss with your spouse and agree on three to five money values that you would like to instill in your children. Examples to consider:

- Do you value experiences over possessions (saving for a nice vacation versus buying the latest gadget)?
- Do you believe in living within (or even below) your means?
- What are your earning and saving goals?
- What is your view on investing and risk taking?
- Do you feel strongly about giving back to the community and philanthropy?

Be consistent and live by your values - children learn from watching their parents. As author Robert Fulgum put it: “Don’t worry that children never listen to you; worry that they are always watching you.”

2. Start an Allowance

An allowance is an excellent tool to teach children the value of money and how to use and manage it. An allowance should not be an entitlement, reward or salary. It is therefore best not to confuse an allowance with money that you give your children for doing chores, at least not initially.

The amount of allowance depends on your household budget. A popular approach is one dollar per year of age per week (e.g. a four-year old would receive $4 per week). Be consistent in the timing of the established payment (e.g. every Friday), the amount and any rules.

Once an allowance is established, teach your children about both saving and spending by suggesting that they divide their allowance into two categories (saving and spending) rather than spending all of it right away. As they become older, consider adding a third bucket for giving and even a fourth bucket for investing or long-term savings (e.g., for an expensive toy). The same split can be applied to money received as gifts. A simple system of labeled envelopes will do the trick. You could also use “compartmentalized” piggy banks with different slots for saving, spending, giving, etc.
3. Seize Everyday Teachable Money Moments

Use everyday moments to teach your children about all aspects of money. A visit to the bank, grocery store, or gas station, whenever you use a credit card or an ATM card, or when you read the financial press - all can provide great teachable moments. Talk to them about what you are doing with money, why and how you make certain decisions about saving, spending and investing.

Spending wisely is just as important as saving. Teach them about budgeting, how to determine the best price for an item and how to prioritize. Importantly, teach them about wants versus needs. This is a basic skill with which many adults struggle. Start early and it will serve them well their entire lives.

4. Learn with your Children - Make it fun!

Children, especially young ones, can lose interest quickly after the curiosity wears off. Try to make the teaching process fun for both you and your kids. Incorporate a game or two into your discussion about money (monopoly, money bingo, coin sorting, etc.). The "Great Piggy Bank Adventure" (http://piggybank.disney.go.com/), for instance, is a fun website that features an online board game that kids or the whole family can play together while learning about setting goals, saving and spending wisely, inflation, asset allocation and diversification.

Other select resources for parents:

- Raising Financially Fit Kids by Joline Godfrey - a great book for parents with specific tasks for teaching kids of various ages (5 to 18)
- Money Doesn’t Grow on Trees by Neale Godfrey
- Silver Spoon Kids: How Successful Parents raise Responsible Children by Eileen Gallo and Jon Gallo
- It’s a Habit, Sammy Rabbit by Sam X. Renick. The author’s website also offers products (books, CD’s, training guides) that teach kids the value of saving (http://www.itsahabit.com/bookandworkbooks.html)

Teaching and training children to be financially responsible and savvy requires persistent effort and commitment. Being a parent of two young children and working full-time, I know firsthand that time is in short supply for parents. I try to remind myself of a quote from O. A. Battista: “The best inheritance a parent can give his children is a few minutes of his time each day.”


Email Freda @ freda.zeitlow@bosinvest.com