YOSEMITE CAPITAL MANAGEMENT

Third Quarter 2013 - COMMENTARY

It is the nature of financial markets to be subject to sharp price fluctuations, to be buffeted by events, and often to be emotionally trying. Successful investing involves the disciplined and patient execution of a long-term strategy, especially when it is emotionally difficult. That is usually the time the opportunities are the greatest. – Bill Miller

We have long counseled that investors will do quite well over time when they adhere to a well-devised long term investment plan. Long term data demonstrates that ***the most significant driver of a portfolio's ultimate returns and volatility is the broad investment allocation to stocks and bonds***. A good long term plan begins with this allocation and depends on the discipline to adhere to the plan no matter how the financial markets behave. Such a plan should be revised infrequently, usually only upon a significant change in an investor's circumstances, and never simply as a reaction to the financial markets.

The second most important driver of a portfolio's ultimate returns and volatility is tactical asset allocations (allocations to sub-asset classes within the broad asset classes). While noticeable, the effect is actually relatively minor.

For the vast majority of investors, everything else, including ***security selection, short-term trading, and market timing, is almost irrelevant*** and in many cases subtracts from portfolio performance. Most amateur investors and far too many so-called professional investors over-emphasize selecting securities by trying to pick the "right" stocks or bonds, or engaging in continuous short-term trading, or attempting major market timing by going all in or all out from one asset class or another. This happens in large part because it feels sexy to have activity, no doubt aided by bombardments of stories or advertisements or Wall Street institutions seducing them with promises of wealth through either a get-rich-quick mentality or a way to avoid market declines.

> Of course, simple statistics dictate that there will be some investors who are successful by using approaches that are detrimental to the vast majority. If a million people flip a coin twenty times about ten of them will get all heads or tails, but that does not automatically make them experts worthy of following or seeking advice. The failure to understand the statistics behind certain activities, the significance of luck, and the role of emotion entices many to pursue certain activities they otherwise would not.

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As a result of a summer of discontent in the fixed income area, many have questions about the role of bonds in the future, specifically whether a period of rising interest rates suggests doom for a portfolio that contains bonds. The short answer is absolutely not. A long term plan's broad asset allocation to bonds should not change simply because one believes interest rates have begun a secular rise due to the fact that ***bonds are not a monolithic investment category*** where the question of owning them is a binary yes or no.

A look at the dynamics of the fixed income market explains why. Any investment has two components of return to an investor: income and capital appreciation.

> Sometimes the income portion is zero (commodities, zero coupon bonds, a subset of common stocks, etc.) or very small (as with another subset of common stocks), in which case the investment is made with the goal of capital appreciation.
>
> Sometimes the income and capital appreciation are more balanced (yet another subset of common stocks, REITs, etc.) in which case capital appreciation is generally more muted.
>
> And sometimes income is the primary component of return while capital appreciation is expected to be relatively small, as with most fixed income securities most of the time.

During secular periods of rising interest rates, as last happened in the United States from 1950 through 1981, the income portion of returns for fixed income securities was easy to obtain while capital appreciation and maintaining purchasing power was difficult due to rising inflation. This was especially true in the last six or seven years of that period when inflation rose significantly and quite abnormally into double digits.

Conversely, during secular periods of falling interest rates, such as that period from 1981 until perhaps very recently in the United States, the income portion of returns became more difficult to obtain while capital appreciation became unusually easy.

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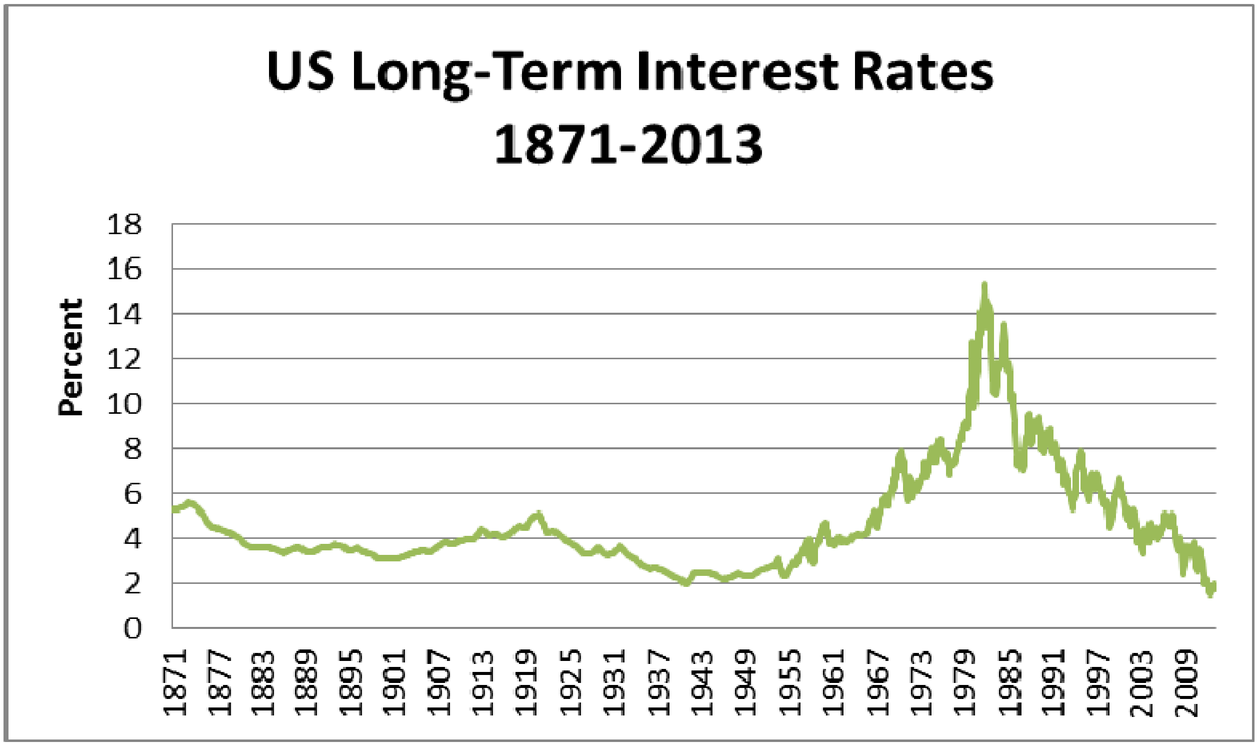
Exhibit 1, U.S. Long-Term Interest Rates, 1871-2013



Source: Robert Shiller (http://www.econ.yale.edu/~shiller/data.htm) via Forbes.com, July 15, 2013

Thus, bond strategies should be very different during a secular rise of interest rates versus a secular decline of interest rates. Specifically, generating rising income becomes the emphasis and capital appreciation becomes minor if at all. Usually the strategy involves lowering the duration (a measure of bond sensitivity to interest rate changes), primarily by shortening the maturity of bonds so that when they come due the principal is reinvested into higher-yielding bonds. As interest rates rise, the new bonds provide more income. This should greatly please all those pundits who have bitterly complained and whined and moaned about low income from investments. And as long as serious inflation does not rear its ugly head, maintaining purchasing power does not have to be an overwhelming feat.

Therefore, investors should still maintain their broad exposure to bonds and only adjust their tactical strategy.

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This leads to the question of the secular environment for bonds, in particular if interest rates have finally begun their long-anticipated increase. Simple math argues that interest rates cannot decline below zero, so by definition rates are more likely to increase than decrease. But that argument does not necessarily mean rates must rise dramatically or even immediately since rates can stay in a low range for a fairly long time. This happened in the United States during the late 1940's to the mid 1950's.

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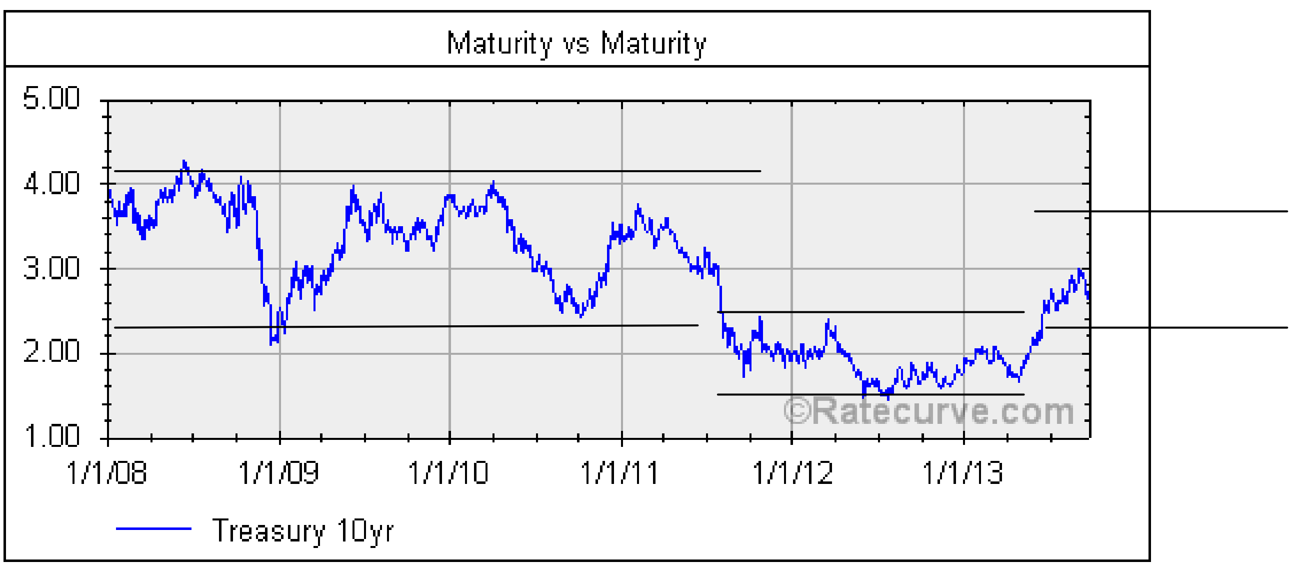
As with any historical comparisons of the economy or the financial markets, rarely if ever do circumstances replay in a precise manner. But ***our assessment that the fundamental drivers of interest rates, economic growth and inflation, are expected to remain below historical trends*** (as we have explained in past Commentaries which are at http://www.YosemiteCapital.com/News-Commentary) ***is the primary reason we believe interest rates could stay relatively low for perhaps a couple more years***.

> Note that if economic growth was to improve, this situation could drive interest rates higher simply due to more demand for credit which would not be a bad development. Rising inflation would be the reason for a more sinister rise in interest rates that, depending on the severity, could cause concern for the economy and the financial markets because of the inherent potential to get out of control.

Guessing future interest rates and when they will change is notoriously difficult. We might be able to get in the ballpark of a range, with the point being to gauge reasonable limits. In that regard, we perceive that the key 10-year U.S. Treasury rate is likely to stay mostly in a range of 2¼% to 3¾% for at least the next year or two. For reference, during the time between the flare-up of the Euro crisis in the summer of 2011 and the FOMC meeting in June, the range was about 1½% to 2½%.

Exhibit 2, 10-Year U.S. Treasury Interest Rate and Ranges



Source: BondsOnLine.com

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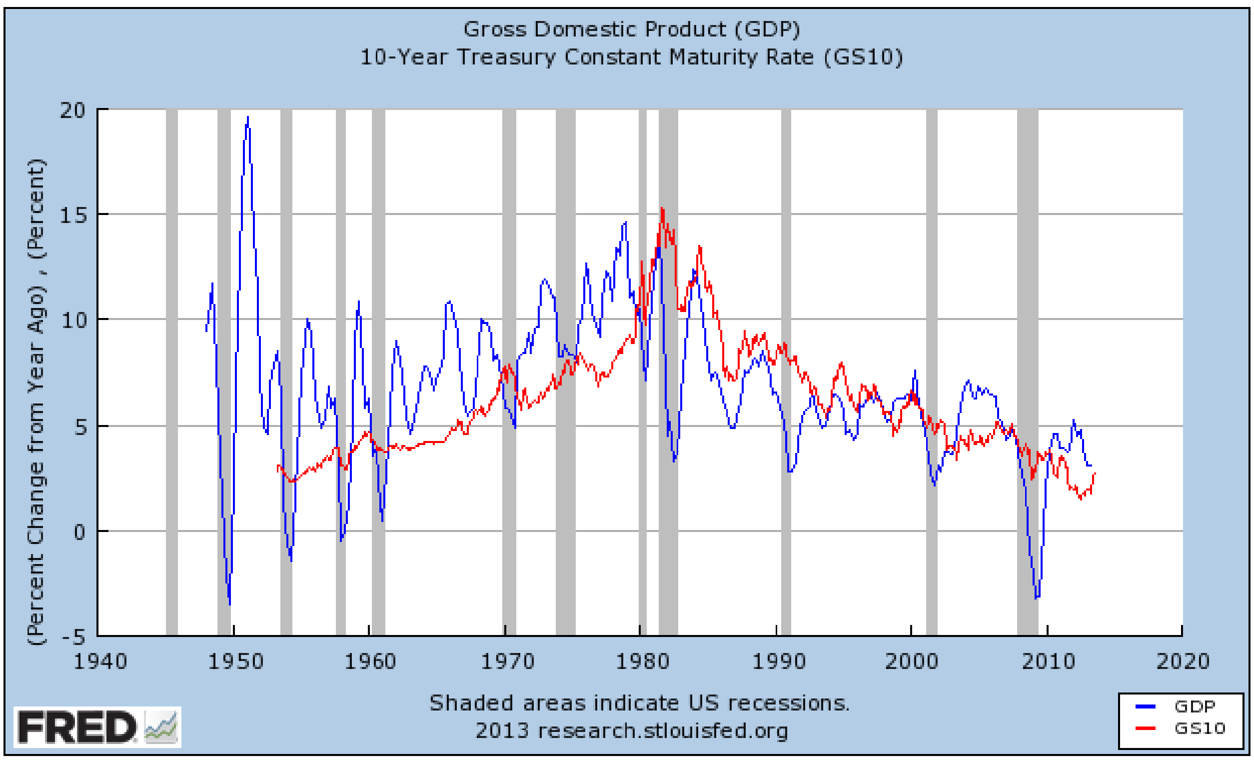
Two general ideas support these possible limits.

First, this interest rate crudely tracks nominal GDP, which equals real GDP plus inflation. The U.S. economy has struggled to maintain real GDP growth around a pace of 2% per year and inflation has generally been below 1½%. All but the misanthropic would like to see the economy grow faster, and we would not be surprised if future domestic growth were somewhat stronger than the recent past. However, it would take a great deal of things to go right for real GDP to achieve a CONSISTANT pace much higher than even 2½% and current evidence suggests this is not happening yet. At the same time, a sluggish economy remains vulnerable to setbacks such as a geo-political incident (which is ALWAYS a risk even in the best of times), a pullback in consumer sentiment, and any number of other developments that could cause economic activity to occur at a very low pace with even occasional negative numbers.

Exhibit 3, Nominal GDP vs. 10-Year U.S. Treasury Interest Rate



Source: St. Louis Fed

Second and perhaps more importantly, the 10-year U.S. Treasury rate rarely extends beyond 400 basis points (4%) of the Federal Funds Rate, which the Federal Reserve controls and is currently near 0%. The Fed has explicitly stated they are not likely to raise this metric until specific economic data is attained, which by their own projections may not occur until mid-2015. Therefore, an environment of slow to moderate growth argues for a lower spread, which could cap the 10-year U.S. Treasury rate around 3½%.

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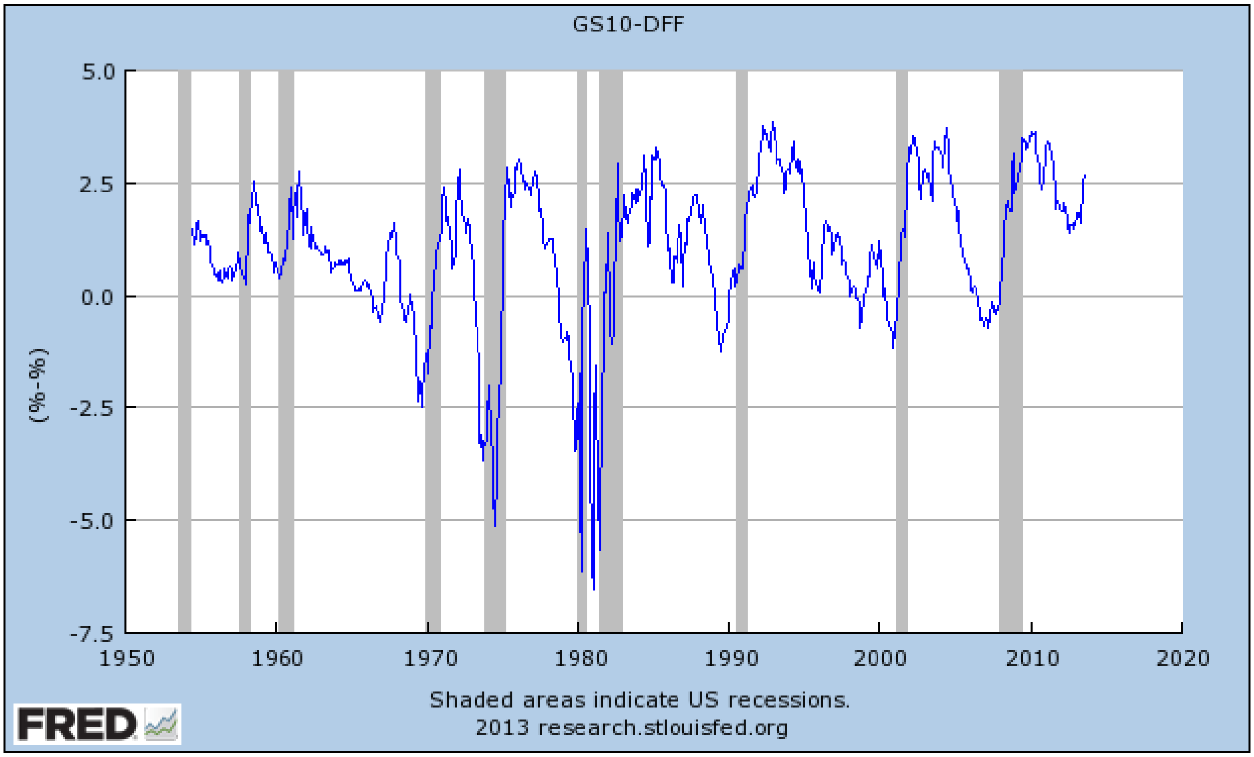
Exhibit 4, 10-Year U.S. Treasury Interest Rate minus Fed Funds Rate



Source: St. Louis Fed

Much has been made about the recent backup in bond yields as a result of the Fed reminding everyone that their asset purchases will not go on forever. When the 10-year U.S. Treasury rate increased to as much as 3%, many thought this was only the beginning of a long increase in interest rates and a bear market in bonds. We strongly disagree.

When Ben Bernanke, Chairman of the Federal Reserve, indicated in May the Fed MIGHT dial back the amount of asset purchases by the end of the year IF economic data permits, many people sold bonds all at once which jolted interest rates higher. In true financial market fashion, many panicked and illiquidity led to a short-term disruption to the supply-demand balance for credit that moved rates even further than otherwise warranted. And interest rates higher than required by normal demand will naturally retard economic activity. Consequently, all eyes are on the housing market to see if there is a negative response to higher mortgage rates as an early clue of this possibility. If most of the traders and investors who were taking excessive risk have moved out of the market, and certainly if economic activity remains slow, interest rates could very well settle down.

Thus, interest rates have simply adjusted to a slightly higher range than before. In the absence of a systemic shock, we perceive a scenario of a rapid rise into double digits that would decimate the bond market (and very likely the stock market too) is very unlikely.

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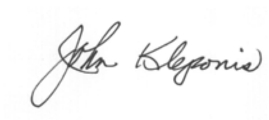
To summarize:

A long term investment plan should remain in place

Bonds should continue to be a part of most long term investment plans, though ***tactical adjustments*** within that allocation may be warranted

Interest rates may settle to a higher range than before, but they are not likely to advance significantly because ***slow economic growth and subdued inflation is likely to continue***

As always, please contact us if you have any questions.



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