Building a Fed-resistant Portfolio

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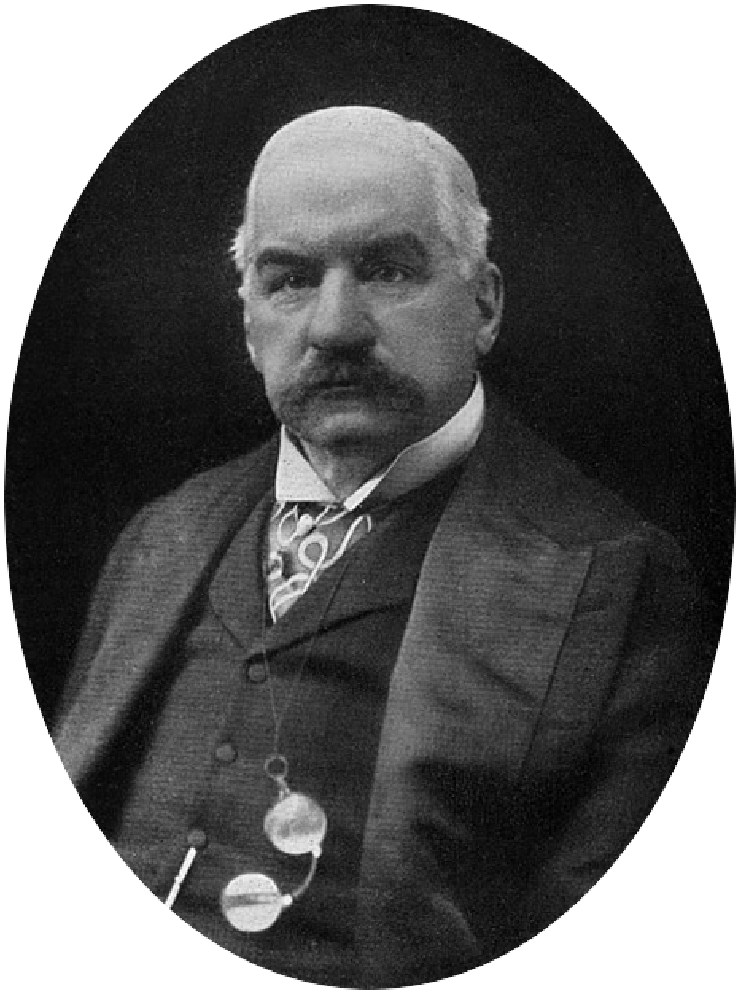
From J.P. to Janet, a brief Fed history



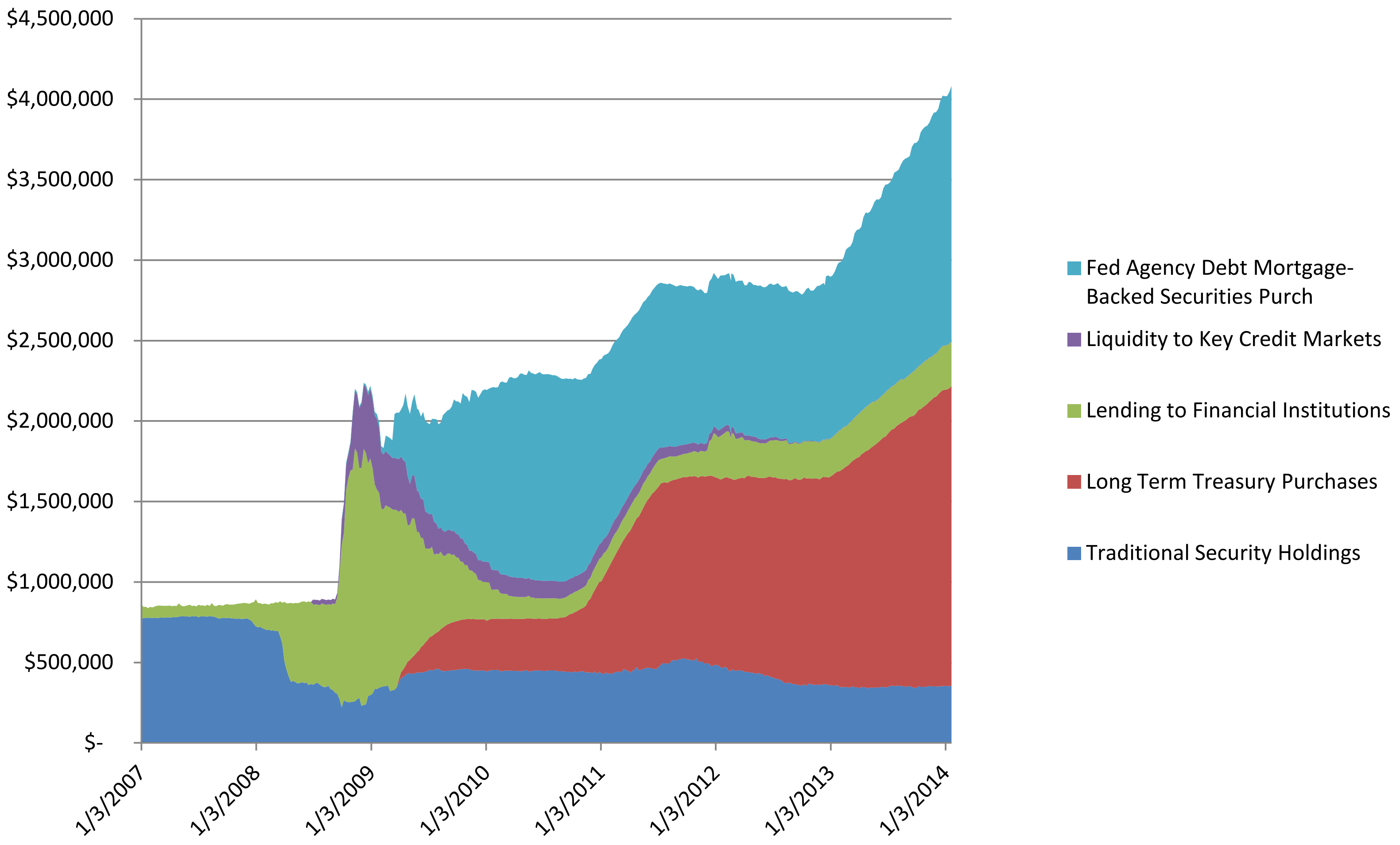
Central bank milestones

- 1791-1811; 1816-1836 and again in 1863
- 1873-1907 the age of financial panics
- 1913: Federal Reserve is born
- 1920: Open Market operations begin
- 1933: Banking overhaul, power to the Fed
- 1951: The Treasury Accord
- 1984-2007: The Great Moderation
- 2008: Financial instability, rediscovered

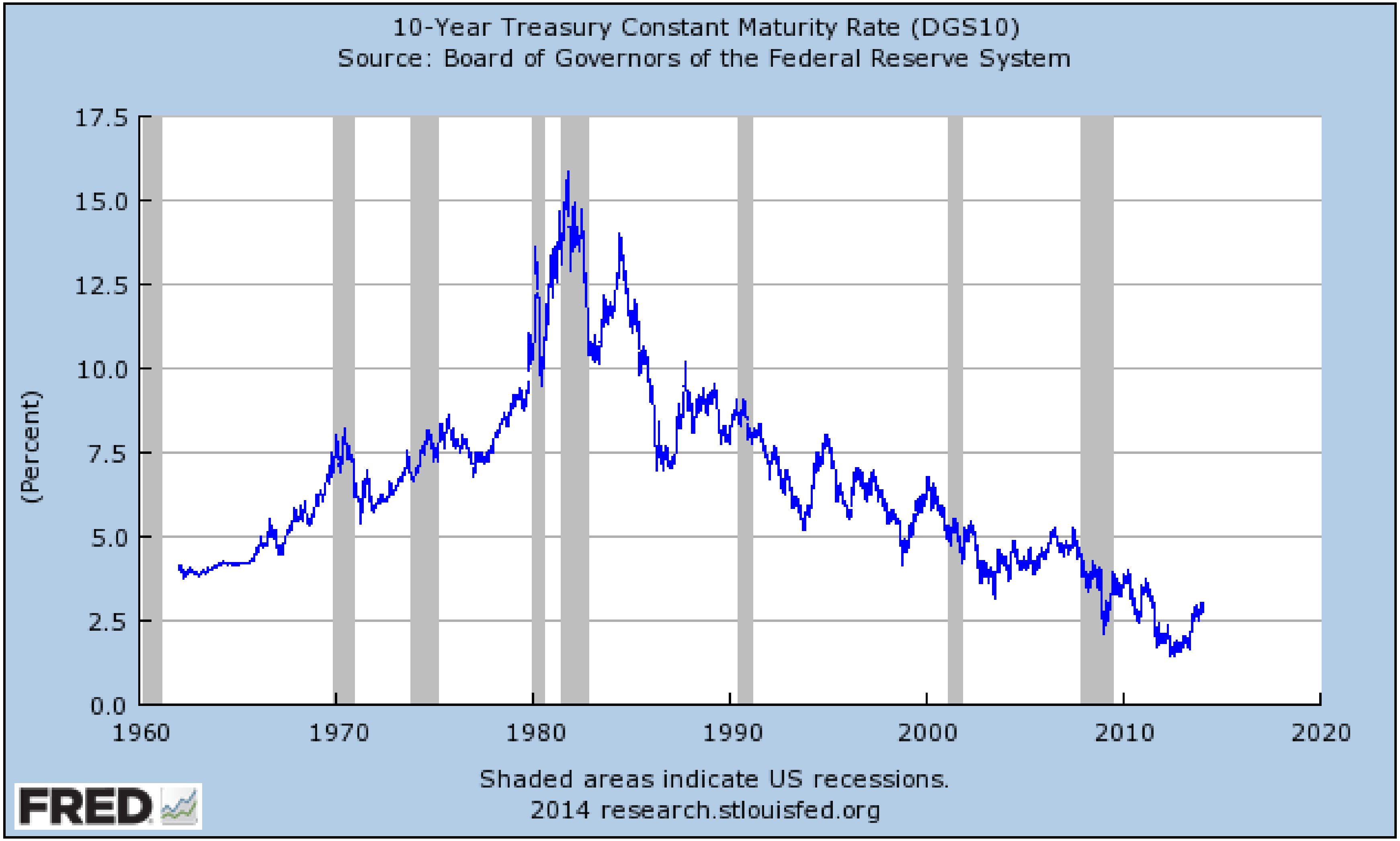
The new tool kit

- Open market operations, federal funds rate (0-0.25% target,)
- Discount rate (0.75% last week)
- Reserve ratio (10% for most, 3% for tiny)
- QE 1, 2, 3 (Fed buying $65 billion each month in MBEs and Treasuries)
- Repos, other liquidity tricks

Fed’s $4 trillion balance sheet

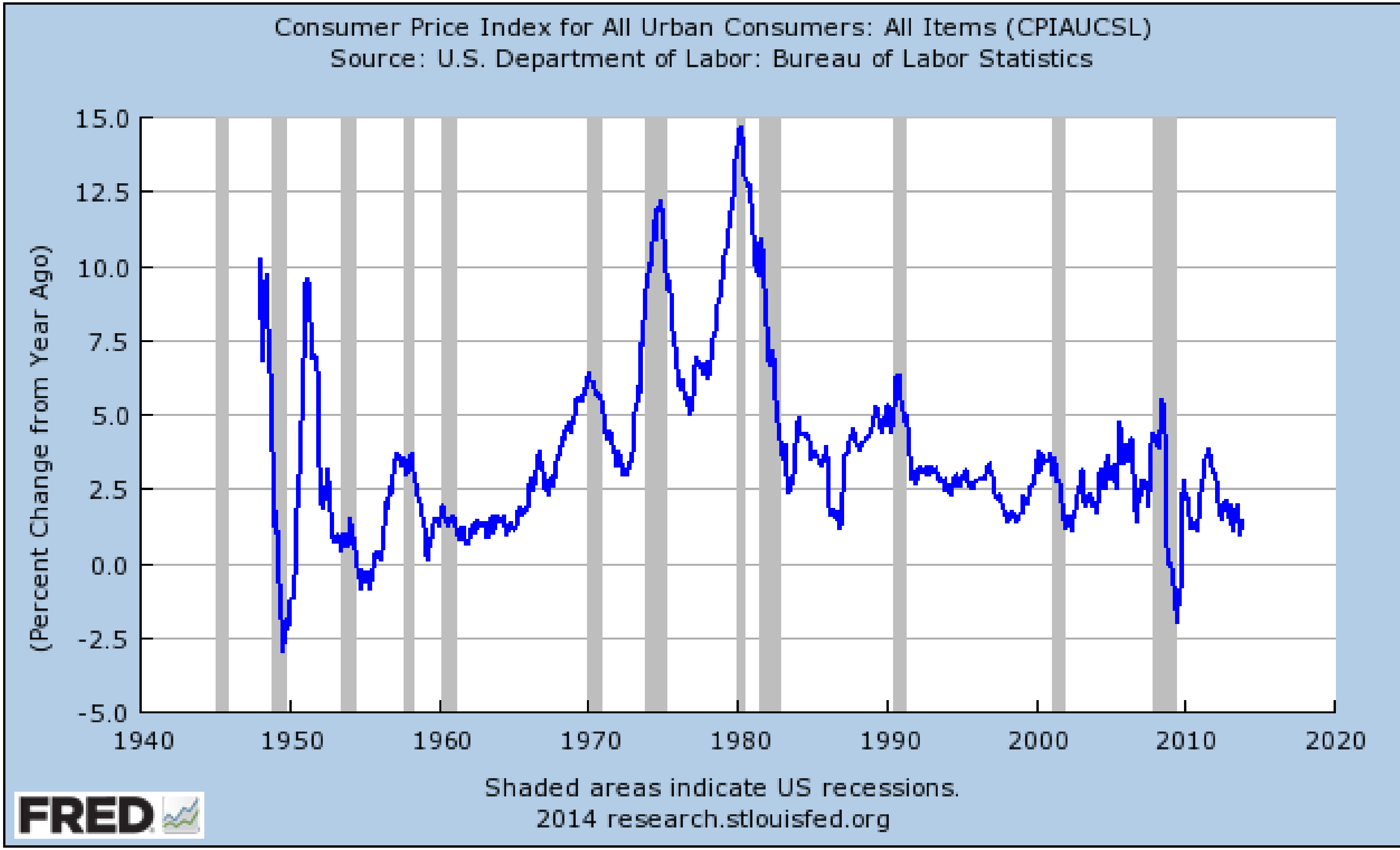


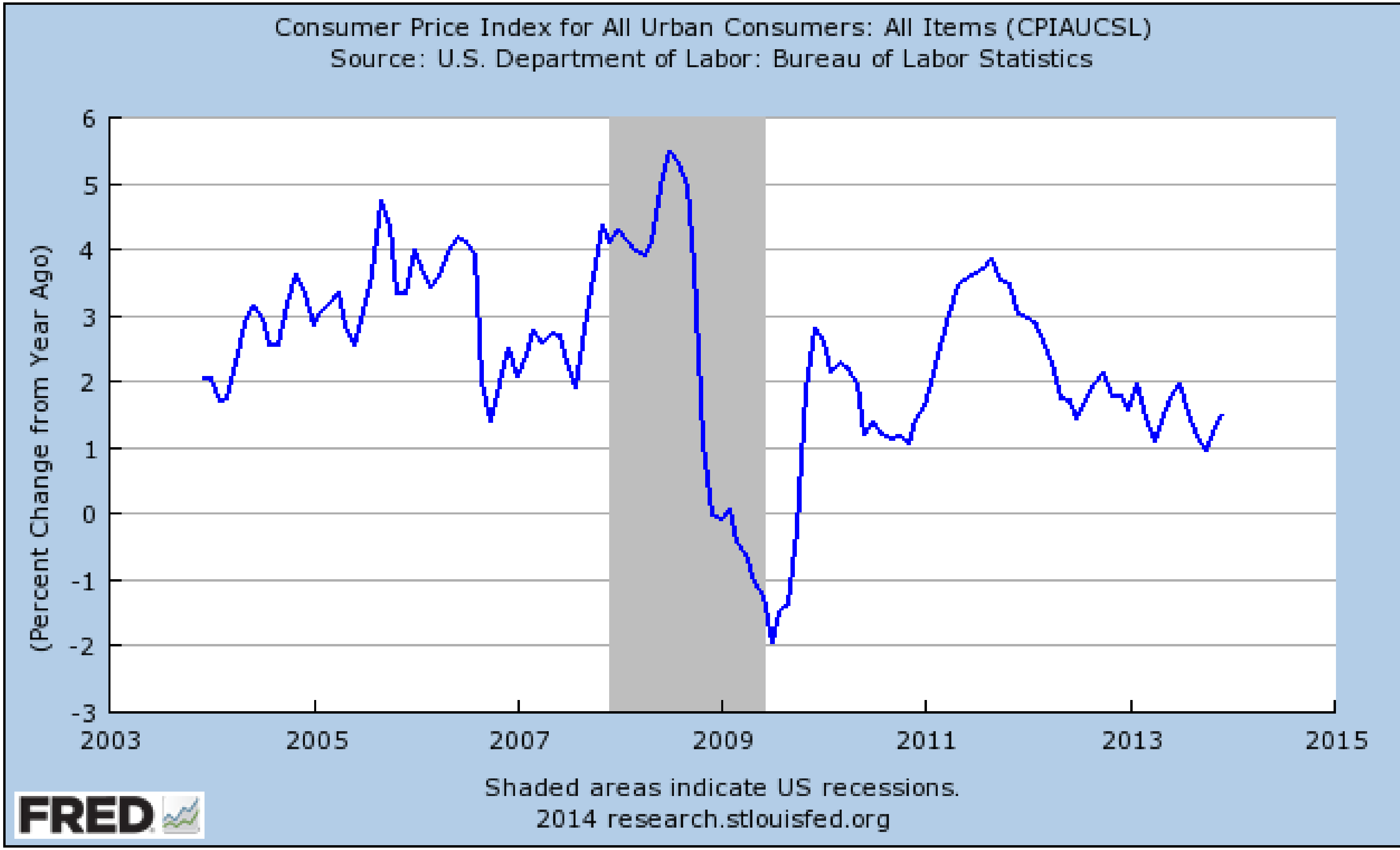
“Past performance …”



Read their lips

- Unemployment “well below” 6.5 percent
- Current inflation higher than 2.5 percent
- Financial stability


Consumer Price Index for All Urban Consumers: All Items (CPIAUCSL)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Percent Change from Year Ago)
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
1940
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
2014 research.stlouisfed.org
FRED


Consumer Price Index for All Urban Consumers: All Items (CPIAUCSL)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Percent Change from Year Ago)
6
5
4
3
2
1
0
-1
-2
-3
2003
2005
2007
2009
2011
2013
2015
Shaded areas indicate US recessions.
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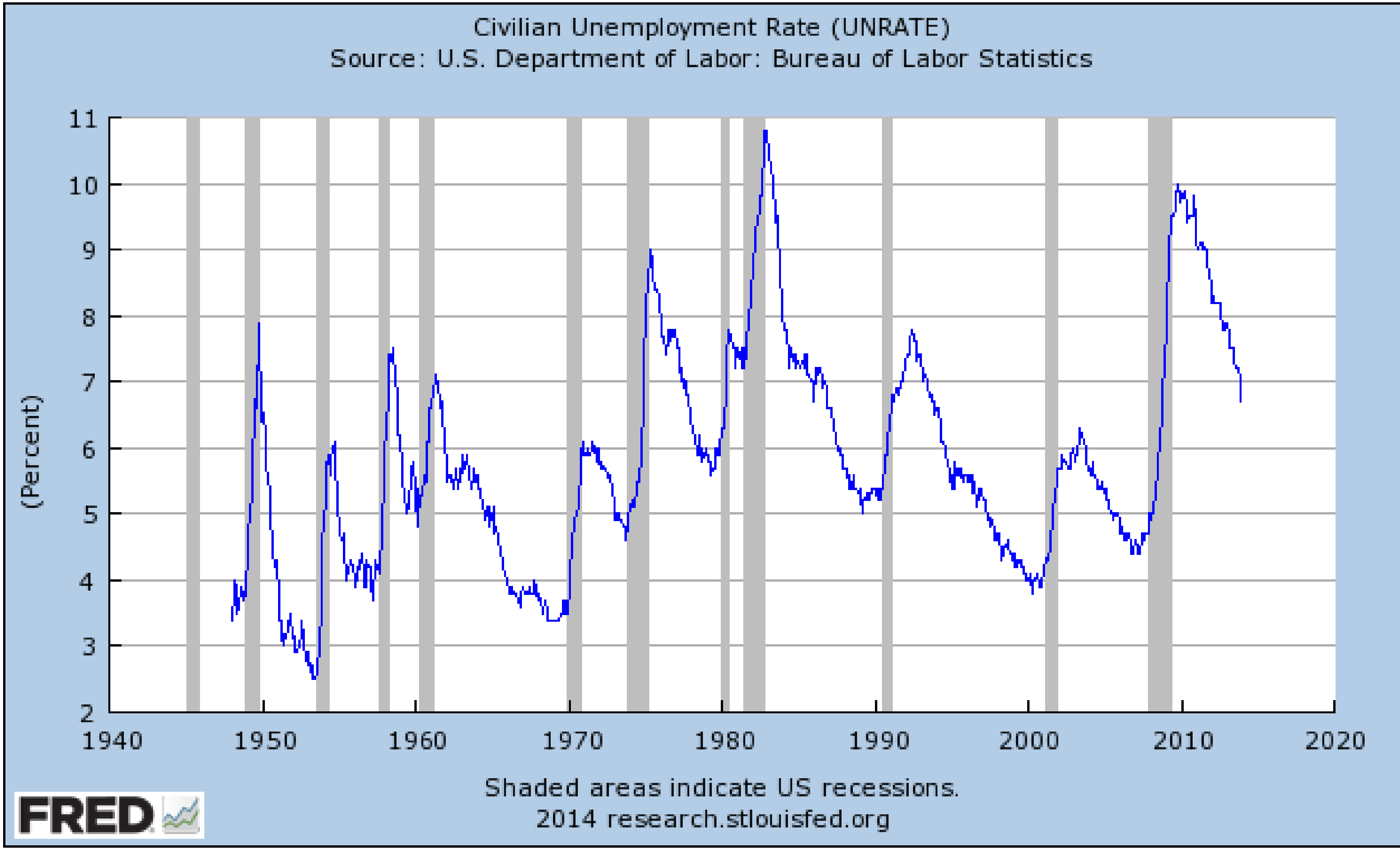

Civilian Unemployment Rate (UNRATE)
Source: U.S. Department of Labor: Bureau of Labor Statistics
(Percent)
11
10
9
8
7
6
5
4
3
2
1940
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
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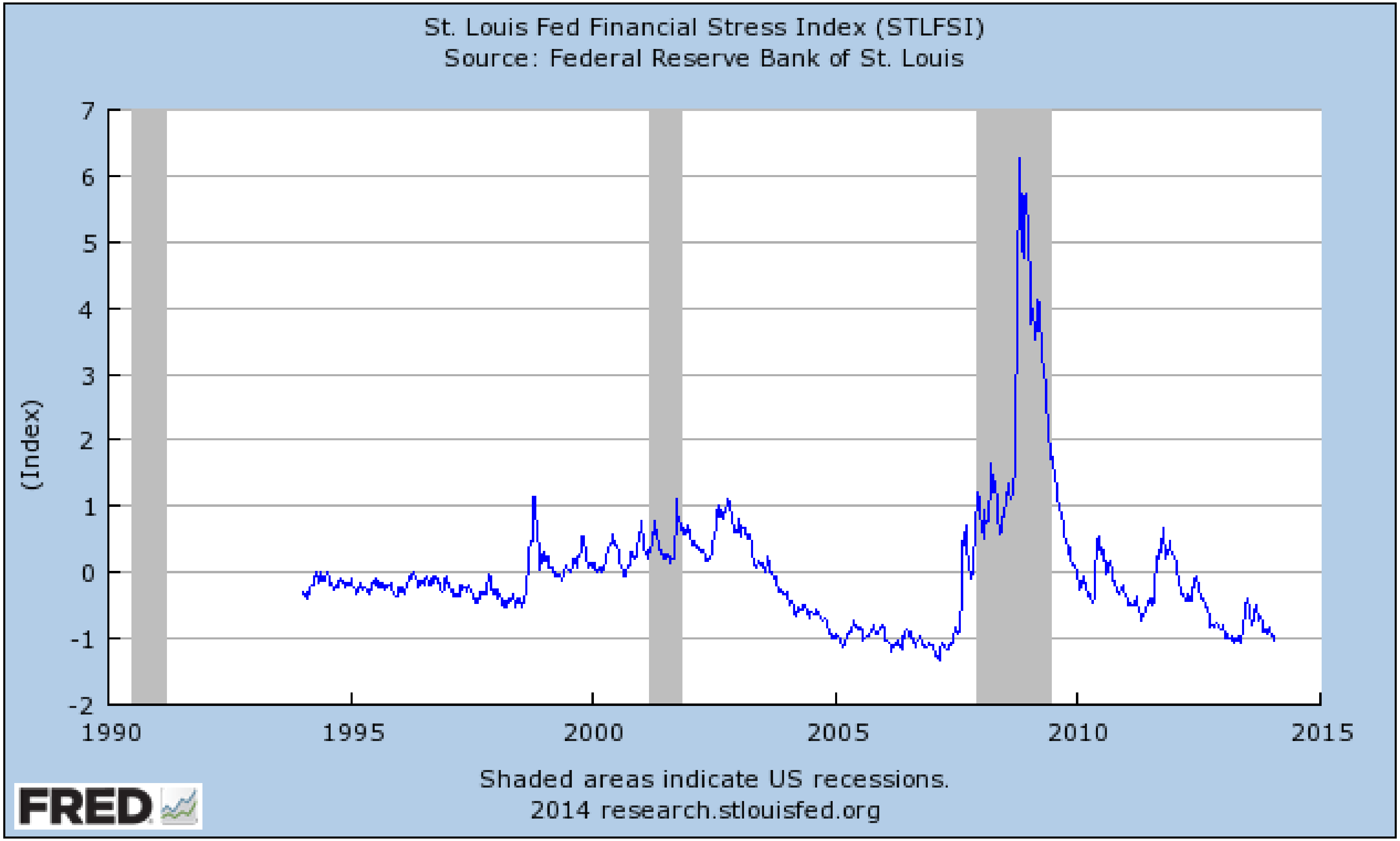
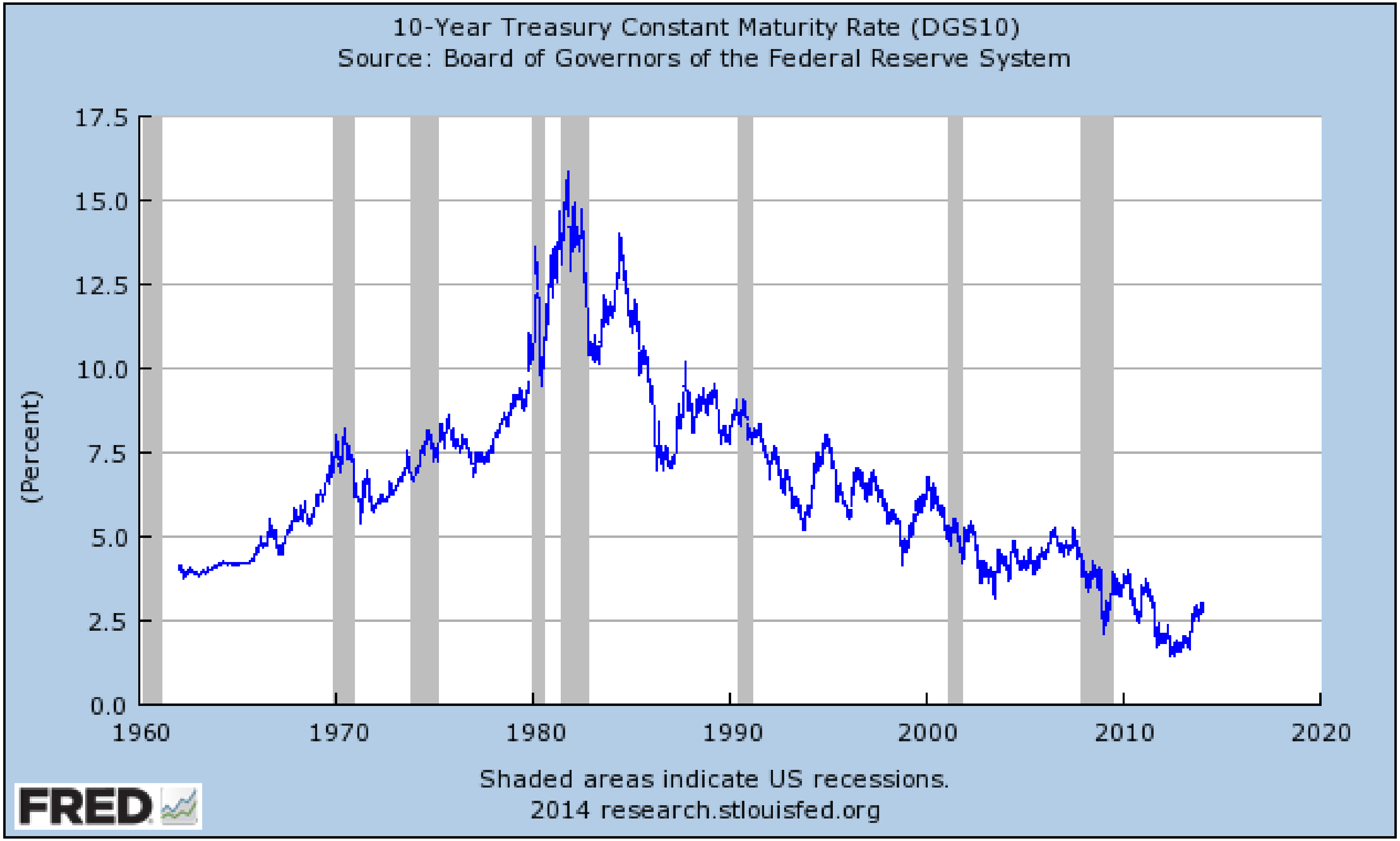
All quiet in the financial system



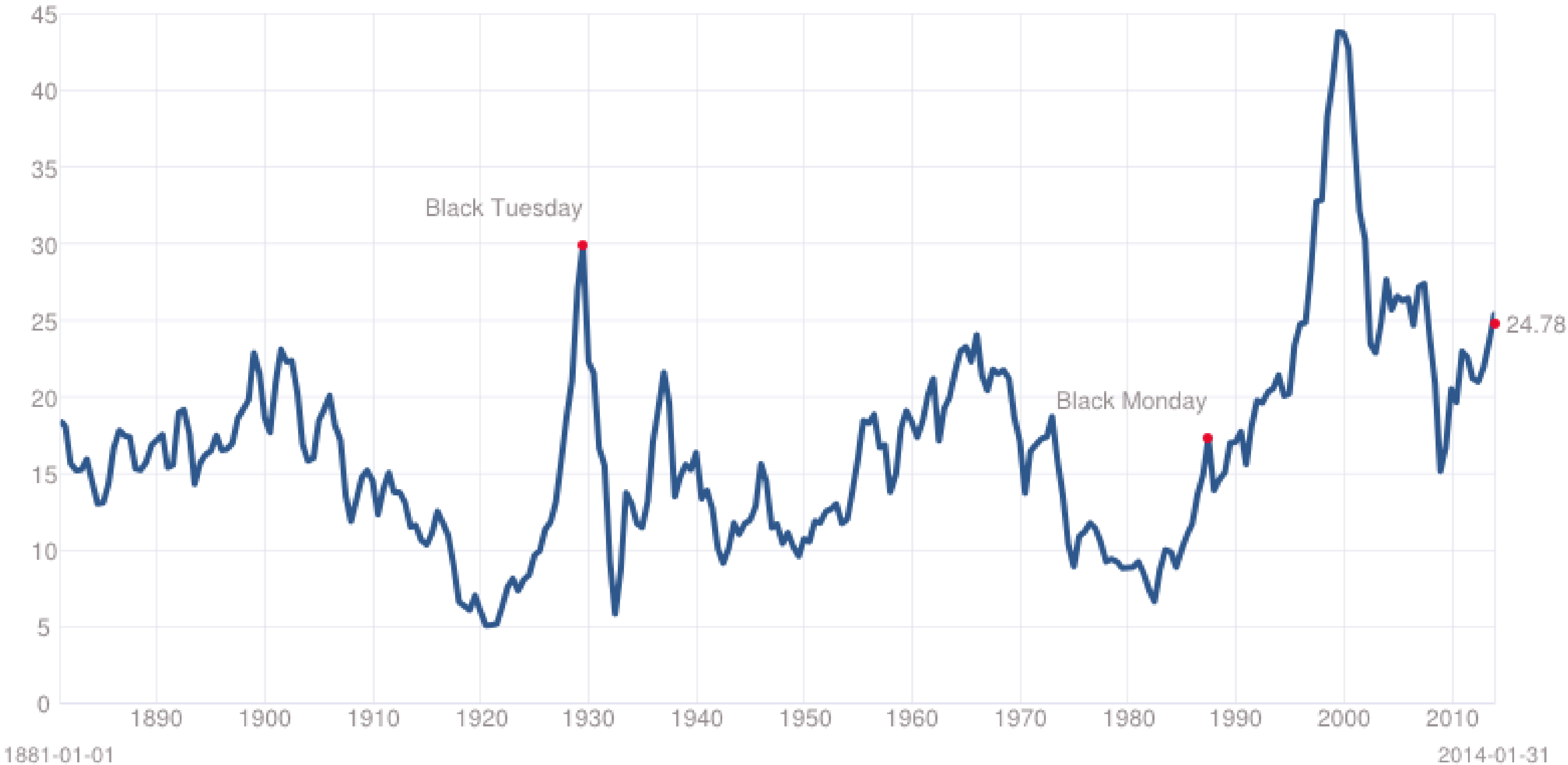
The big question



Why we care about interest rates

- $40 trillion -- total U.S. bond market
- $19 trillion -- total U.S. stock market
- $16.9 trillion -- U.S. GDP

Shiller CAPE flashes yellow



Ebb and Flow

Average calendar-year total return from 1963 through 2012 in years when:

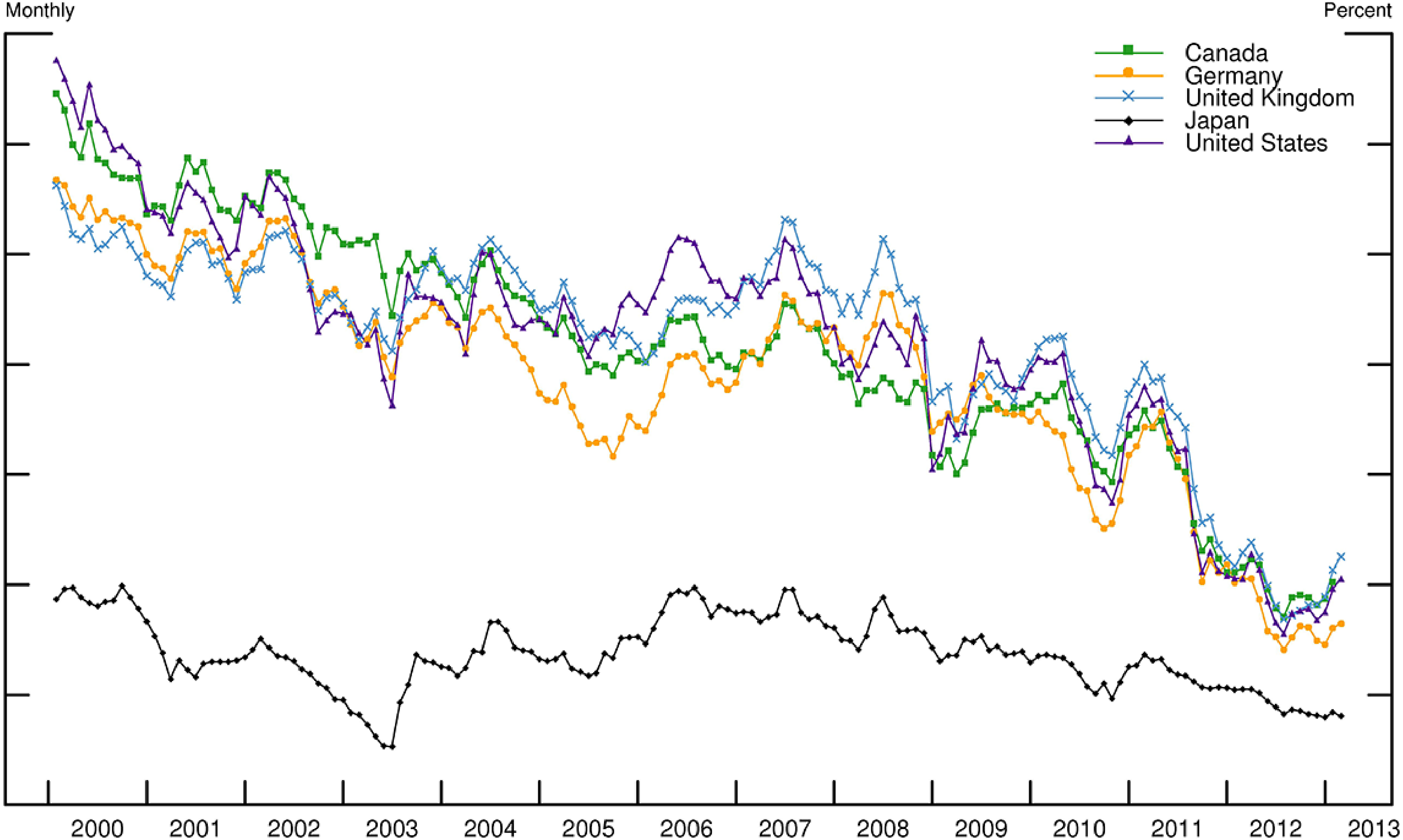
	Large-Company Stocks	Small-Company Stocks	Long-Term Corporate Bonds	Long-Term Government Bonds
Interest rates rose	8.1%	13%	3.0%	2.7%
Interest rates fell	15	19	14	14

Note: Annual change based on average yearly 10-year Treasury yield

Sources: WSJ research; Ibbotson Associates; Federal Reserve

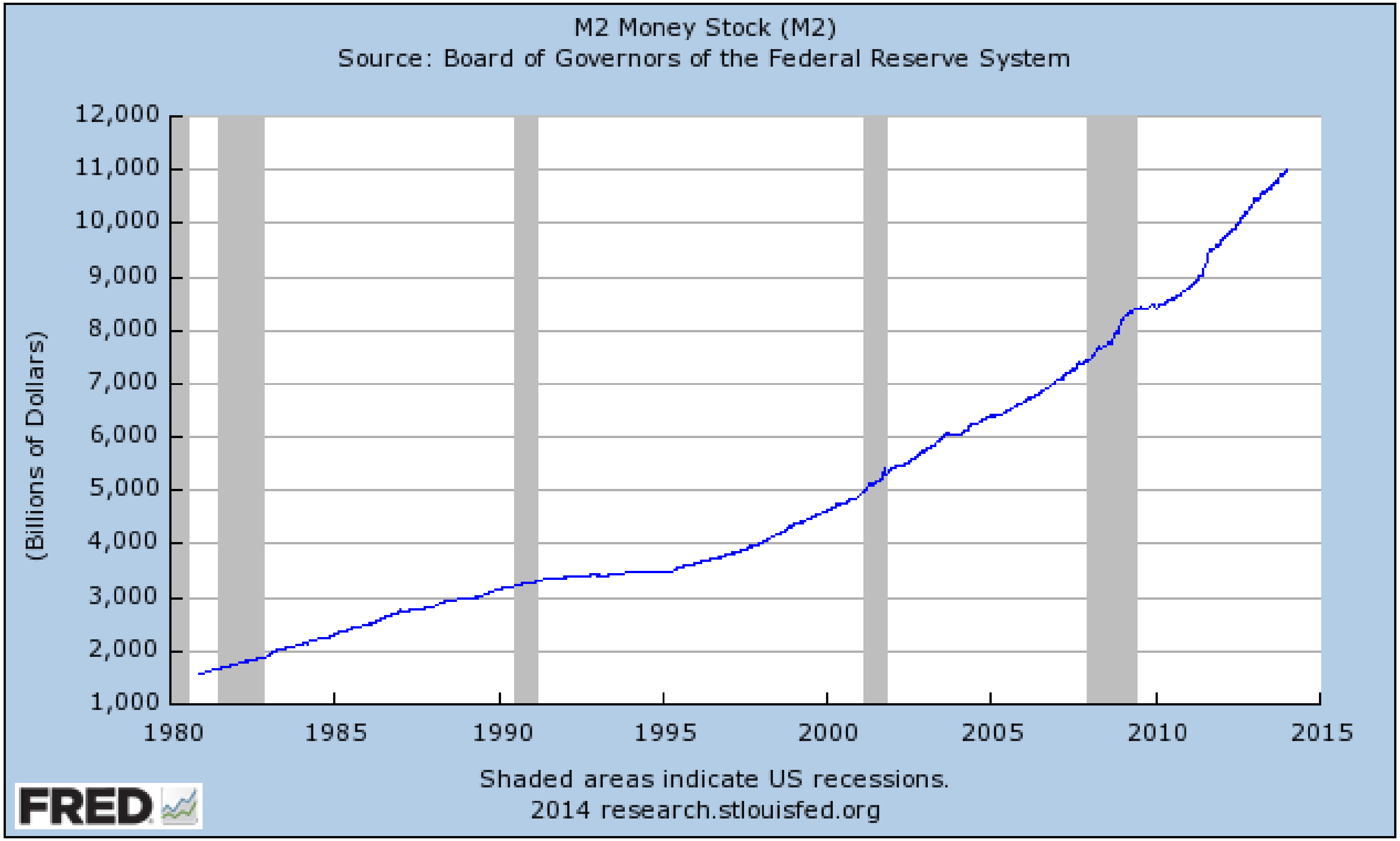
- A 60% stock – 40% bond portfolio lost value from 1928 to 1932, 1936 to 1947 and 1968 to 1982—even before deducting taxes and costs.
- Stocks and bonds tend to lag in rising-rate times

Chart 1. 10-Year Government Bond: Nominal Yield

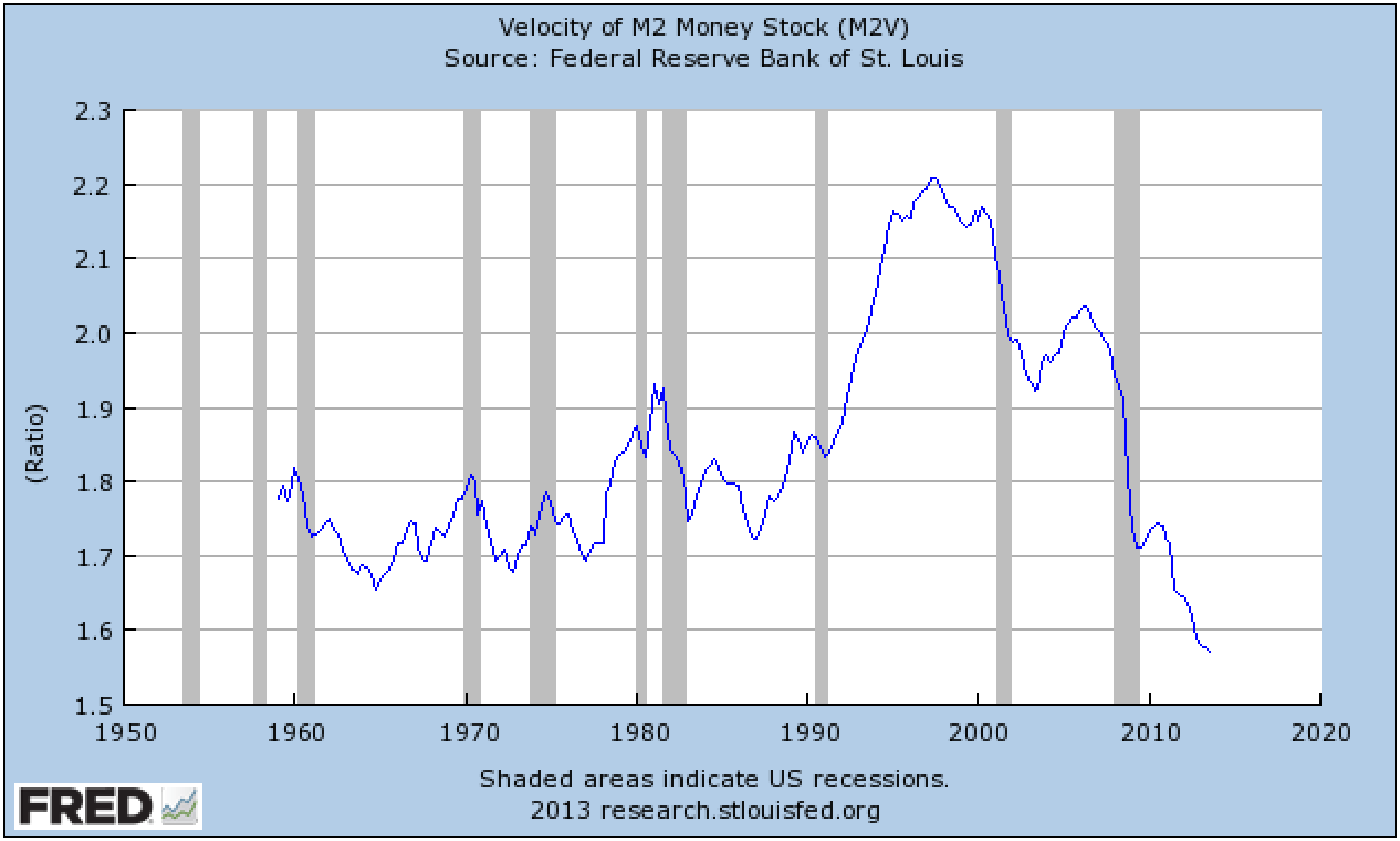


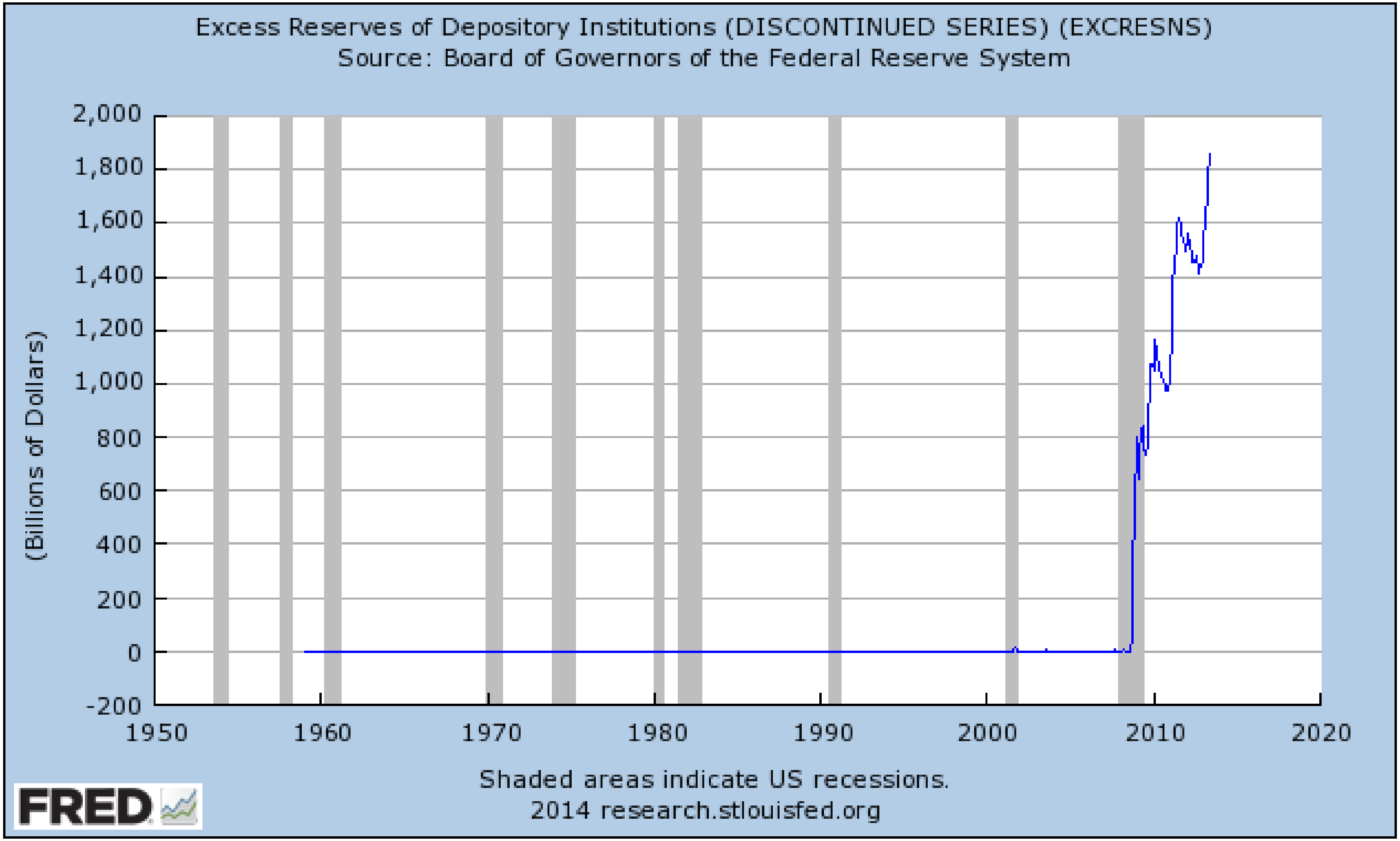
Note: 10-year zero-coupon sovereign bond yields.
Source: Federal Reserve Board staff estimates.

Plenty of money …



… but little demand for it




Excess Reserves of Depository Institutions (DISCONTINUED SERIES) (EXCRESNS)
Source: Board of Governors of the Federal Reserve System
(Billions of Dollars)
2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
-200
1950
1960
1970
1980
1990
2000
2010
2020
Shaded areas indicate US recessions.
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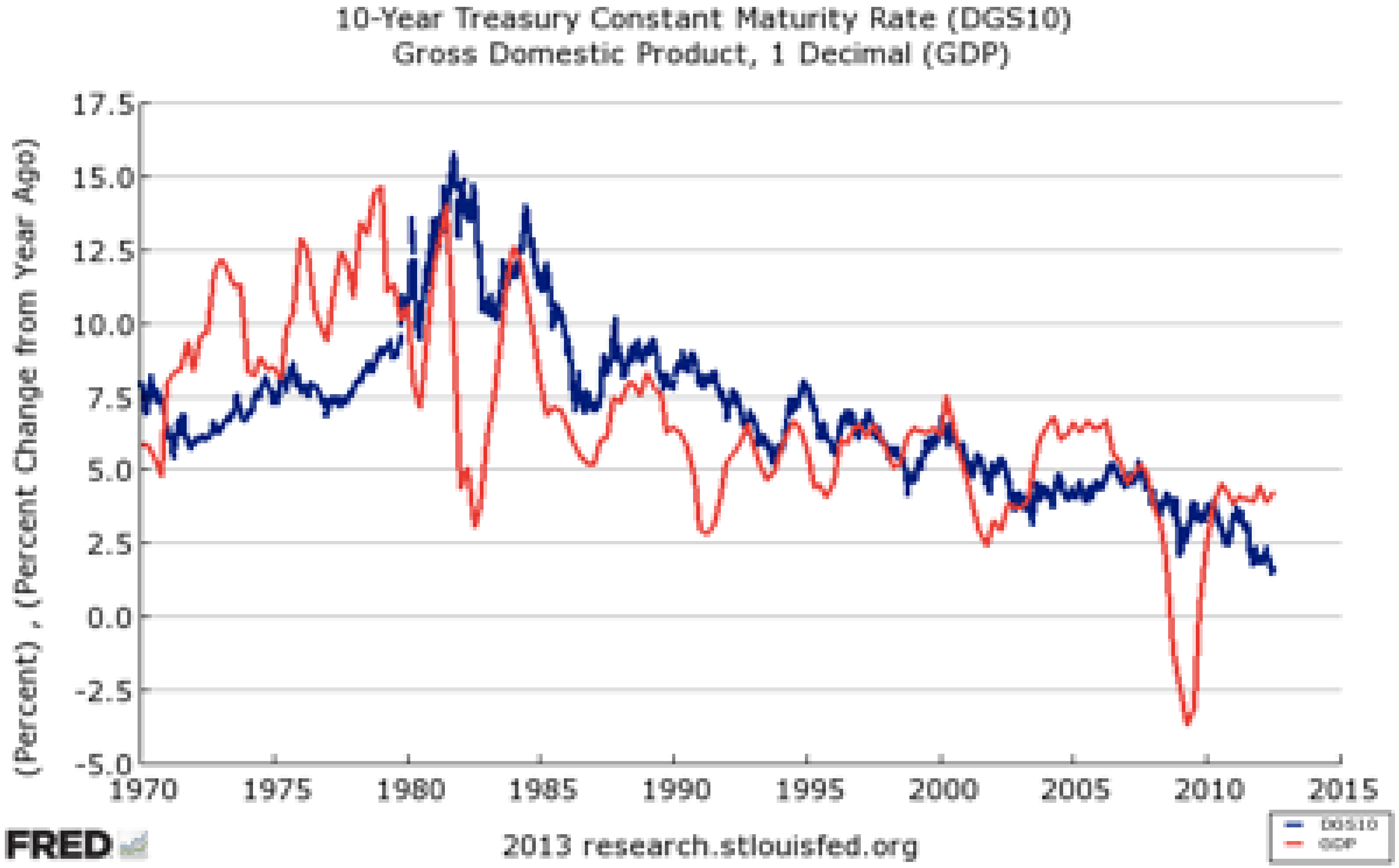
FRED

Case for sitting tight

- Rebalancing pays off over the long haul
- As rates rise, bond incomes will rise, too
- Economic growth helps many stock sectors
- Recently, interest rates have followed GDP closely
- Consider I-bonds, TIPS, direct bond ladders
- Average back into index funds or ETFs, or find good value funds and strap in.



10-Year Treasury Constant Maturity Rate (DGS10)
Gross Domestic Product, 1 Decimal (GDP)
(Percent) , (Percent Change from Year Ago)
17.5
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
FRED
2013 research.stlouisfed.org
DGS10
GDP

Some of the winners

- Wide moat value stocks, mostly U.S.
- Barbell total income funds (Vanguard Wellington (VWELX) and Vanguard Wellesley (VWINX))
- Technology, health care, consumer discretionary, industrials, regional banks, mortgage servicing
- High yield bonds, MLPs, value munis, high yield tax exempts (6%!)

The avoid list

- Emerging market stocks and bonds (except for dollar-denominated bonds)
- Commodities
- Leveraged REITs
- Telecoms, utilities

Bond replacements

- REITs that use cash: Yields 4%, some oversold & trading below NAV. Examples include (O)
- MLPs: Popular, but still yielding 5-7%. ETF example is (AMU)
- Floating rate bank loans: Examples include (FFRHX) and (EVBLX)
- Or let Bill Gross trade bonds for you, with the (BOND) ETF

What Ben Graham would do

- Rebalance toward 40% stocks and 60% bonds, and prepare emotionally for lousy returns
- Markets misprice bonds, too. Plenty of money will be made on bond volatility
- Think of cash (or short bonds) as an option to buy a great, wide moat stock
- Identify great companies or value fund managers and wait. Re-calculate your margin of safety

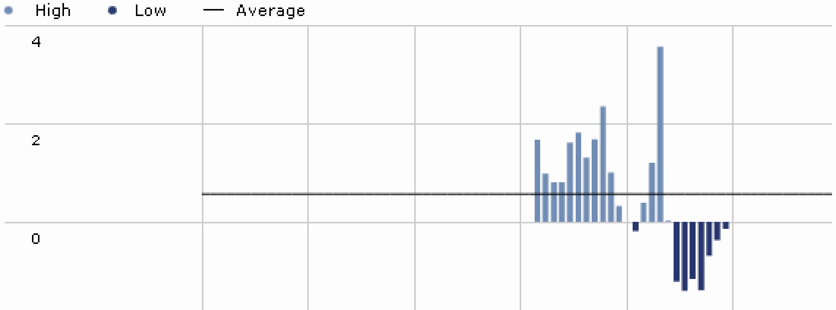
iShares Utilities Bond AMPS

Price % AMPS

5 Years | 10 Years

Monthly Premium/Discount %

High • Low — Average



	2009	2010	2011	2012	2013	YTD
Average Discount	—	—	—	+1.30	-0.12	—
High Discount	—	—	—	+2.35	+3.56	—
Low Discount	—	—	—	+0.31	-1.41	—

Currency is displayed in USD.

The 4% cash solution

- In a tax-free retirement account, the 30-year survivability goes to 59.4% vs. 55% without
- In a taxable account, the chances are even better: 66% with a reserve vs. 60% without

-- Source: Pfeiffer, Salter, & Evensky, The Benefits of a Cash Reserve Strategy in Retirement Distribution Planning (*Journal of Financial Planning)*