"What the Stock Market Giveth, the Bond Market Taketh Away."

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Whispers of a Fed tapering sent the bond market into a tailspin. In what may have been the most anticipated sell-off in bond market history, many firms (including our own) predicted the move as much as two years ago. The takeaway is this: Bonds have benefited from a tailwind for the past 30 years. From the day I entered the business in 1981 and 30-year AAA tax-free bonds were yielding 13.5%, until May of this year, interest rates have been in a steady decline, virtually uninterrupted. When you begin with a high coupon and add declining interest rates, it makes long-term performance look pretty darn good. The opposite is now true; we're starting with a low coupon, which means less cash flow, and when you add in rising interest rates, you can easily offset the income component with price depreciation. The bond party is over. Bonds, unlike stocks, are mathematical; they can't go up forever. In fact, the 30-year US Treasury bond is down 15% since May; Treasuries were supposed to be perceived as safe, right? Wrong!

So, what do we do when the "perceived safe" option isn't working? For those who have been reading my quarterly letter, you know that dividend-paying stocks have been a favorite asset class of mine for some time. The yield on many good quality stocks meets or exceeds bond yields, and dividends over time have tended to rise, a good inflation hedge over long investment periods. There are other options as well, alternative income sources such as Master Limited Partnerships (MLPs) or Real Estate Investment Trusts (REITs). Wells Fargo Advisors has published a great piece entitled "Rethinking Your Income Strategy." If you would like a copy, please let me know.

Despite the generally negative tone on interest rates, we still believe that certain fixed income investments, such as municipal bonds, may be a good value. Tax rates are likely to move higher, making the tax-exempt feature increasingly valuable. Finally, we continue to believe that we are in a cyclical bull market for stocks, even though most of the gains that we predicted for the full year are already in hand. Fall will likely bring back increased volatility with a number of headline items that are sure to rattle the investing public, such as Fed tapering, the budget ceiling debate, the Syria conflict, a new Fed chairman, and a German chancellor vote among them. The long-term message remains unchanged: Funds will seek out the best areas of return which, in my opinion, continues to be the stock market. The US economy is recovering, as is Europe, albeit slowly. One final note: The sell-off in emerging markets combined with the rally in domestic markets have created a significant

value gap. It may be time to nibble at the emerging market stocks and debt while prices are down.

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Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.
Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than original cost upon redemption or maturity.
Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).
Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.
Dividends are not guaranteed and are subject to change or elimination.
Tax-free bonds may be free from federal taxes however still subject to state and local taxes. The S&P AAA rating means a bond has the highest quality debt with minimal credit risk.

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