F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

VOLUME 12, ISSUE 1

MARCH 2013

MARKET INSIGHT

JOHN V. CARBERRY
PRESIDENT
JCARBERRY@FLPUTNAM.COM

ELLEN FLAHERTY
SR. VICE PRESIDENT,
CHIEF OPERATING OFFICER
EFLAHERTY@FLPUTNAM.COM

SUSANNE STAUFFER
SR. VICE PRESIDENT,
PORTFOLIO MANAGER
SSTAUFFER@FLPUTNAM.COM

ROBERTSON P. BREED, CFA
SR. VICE PRESIDENT,
PORTFOLIO MANAGER
RBREED@FLPUTNAM.COM

STEVEN N. VIOLIN, CFA
SR. VICE PRESIDENT
PORTFOLIO MANAGER
SVIOLIN@FLPUTNAM.COM

D.J. SHAUGHNESSY, CFA
VICE PRESIDENT
PORTFOLIO MANAGER
DSHAUGHNESSY@FLPUTNAM.COM

ANDREW B. WETZEL, CFA
VICE PRESIDENT,
RESEARCH ANALYST
AWETZEL@FLPUTNAM.COM

ROBERT F. TAYLOR, CFA
RESEARCH ANALYST
RTAYLOR@FLPUTNAM.COM

CHRISTIAN D. MCVEY
SR. VICE PRESIDENT,
MARKETING
CMCVEY@FLPUTNAM.COM

WENDY M. BUSH
VICE PRESIDENT,
MARKETING
WBUSH@FLPUTNAM.COM

Taking Stock

By Robertson P. Breed, Senior Vice President

Conventional wisdom suggests that as individuals near retirement they should sell most of their stock holdings and own primarily bonds. This strategy may have worked in an environment when government bonds offered yields of 6% and a 65-year-old retiree could expect to live about ten more years. However, it will not work in today's environment of 1–2% government bond yields and with average life expectancies approaching 85 years.

Similarly, consider institutional investors whose time horizons are essentially infinite. Some are charitable organizations hoping to spend 4% of invested assets annually for their missions. Others are foundations mandated to spend 5% of assets on theirs. While institutions have long recognized the need to maintain a healthy exposure to stocks, today's low bond yields are presenting them with a dilemma: 1-2% bond yields vs. 4-5% annual spending needs. Owning bonds now seems wholly inconsistent with a need to meet both immediate spending requirements and to preserve principal over time – and that's *before* factoring in inflation of 2-3% per year.

This quandary has given rise to the notion that we are about to undergo a "Great Rotation" out of low-yielding bonds and into stocks promising both higher (dividend) yields and the potential for capital appreciation. The thesis contends that as bond investors rotate into stocks, stock prices will rise and bond prices will fall. The logic behind the rotation is that bond yields have fallen so far (i.e., bond prices, which move inversely to bond yields, have *risen* so high) that yields can't possibly fall much further. As a result, it's inevitable that yields will rise, sending bond prices lower in the years ahead. Bond prices will be further pressured by likely reversals in the two main drivers of the recent bond bull market: investors' "flight-to-safety" mentality since the near-systemic meltdown in 2008 and the Federal Reserve's quantitative easing (QE), or bond-buying, program. With the global economy gradually recovering and other major risk factors fading, investors will abandon the safety and low yield of bonds in order to take advantage of reasonable valuations and more attractive total return prospects in stocks. Meanwhile, economic improvement will allow the Fed to curtail its QE program, thus removing the most important pillar of support for the bond market.

That's the crux of the Great Rotation hypothesis. Indeed, this year's flat bond returns coupled with double-digit gains in many stock indices certainly suggest it's plausible. Fund-flows are modestly supportive. Investors plowed $18 billion into stock funds in the first week of 2013, the largest one-week total since June 2008, before the worst of the financial crisis hit. More recently, stock funds have registered ten straight weeks of multi-billion-dollar inflows. Thus far, however, money has continued to flow to bond funds as well, although at a reduced rate. Most of the cash now flowing to stocks appears to be coming out of money market funds. Nonetheless, the large flows into stock funds this quarter represent a significant change in trend since 2008, when investors began consistently pulling money out of stocks and stuffing *$1.1 trillion* into bond funds. As such, we thought it a particularly timely juncture to weigh in on the debate.

In short, we don't know if a Great Rotation will play out exactly as advertised, but we do feel the concept is sound, directionally. It is our belief that we are now past the worst of the era of deleveraging, coupled with sub-par economic growth, financial flare-ups and an absence of business confidence. This has important implications for portfolios:

- It's simply not going to be possible to spend 4-5% of invested assets annually if a significant portion of a portfolio is earning 1-2% per year.
- Bonds are expensive (yields are *extremely* low historically) and therefore carry real risk. Remember, the 10-year Treasury Note now yielding 1.9% yielded *more than 5%* as recently as 2007.
- Losses on bonds are magnified when yields are low. If interest rates rise by just 1%, the average bond issued in 2012 would lose 5.1% of its value. In 2007, when interest rates were higher and maturities shorter, that same 1% increase in rates would have caused just a 1.8% decline in price.
- Stocks, while not cheap, are reasonably valued. The Standard & Poor's 500 stands right where it did 13 years ago. Yet earnings and dividends have doubled since then, reducing the market's valuation from 30- to 15-times trailing 12-month earnings. This makes stocks slightly cheaper today than their long-term average of about 16-times trailing earnings.
- For the first time in decades, many companies are paying dividend yields that are higher than the yields available on their bonds. Better yet, those dividends are *growing* while bonds typically offer a fixed payment stream.
- Sub-par equity returns since 2000 have ingrained a negative outlook into investors' psyches. Investors have not yet fully appreciated many recent positives: an improvement in U.S. employment and confidence; increasing energy independence; a recovery in housing and banking; and a budding manufacturing renaissance driven by low energy prices.

To be clear, despite our obvious preference for stocks, there remains a place for bonds in nearly every investment portfolio. While future returns will likely be muted, bonds make sense by reducing portfolio volatility. Our charge then, is to utilize short-term bonds to reduce volatility just enough to keep clients comfortable with their stock exposures.

Take stock – this one simple decision may largely determine whether or not investors meet their spending and investment objectives over the coming decade and beyond.

2013 Market Diary

	3/31/13	YTD Change*
Dow Jones Industrials	14,578.50	11.90 %
NASDAQ	3,267.52	8.51 %
S&P 500	1,569.19	10.58 %
Russell 2000	951.54	12.38 %
10-Year Treasury Bond Yield	1.85 %	+ 9 b.p.

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices