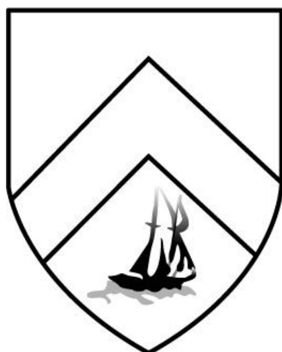

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Mast Report ***Making the Important Decisions***

INVESTMENT STRATEGY

APRIL 28, 2017

The advised investment strategy in this Report applies to investment assets that are not expected to be needed within three years and for long-term investors with balanced portfolios.

An investment strategy essentially deals with whether or not, and the degree to which an investor should take risk. Addressing this requires several things. What are the sources of risk? What risky asset classes could be used? And, what rates of return are expected on the asset classes, based on prevailing market information, primarily prices and yields?

For the majority of investors, most of their investment assets are held in fixed income securities, in stocks, or in cash equivalents, such as short-term Treasury bills and short-term bank CD's. There are essentially two sources of risk that investors can take in the attempt to earn higher rates of return than that on cash equivalents. The first is duration risk. This is the risk associated with owning longer maturity/duration assets that have essentially no credit, spread, or equity risk. U.S. Treasuries with durations longer than short-term Treasury bills are the primary and most important asset class that has only duration risk. The second source of risk, as just suggested, is credit risk, or other yield spread risk, and the risk of owning equities.

The process used herein measures future expected rates of return that markets are providing on major classes of assets. Then to use these expected returns to judge if and to the degree it makes sense to take risks in light of prevailing and anticipated conditions. Let's begin with prevailing and anticipated conditions.

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The prevailing environment is reflected in the performance of U.S. stocks and the 30-year Treasury bond since March 13th. Since that date, the S&P 500 Index has risen by a small 0.45%, while the price of the 30-year Treasury bond was up a more sizable 4.77%. For the month of April, the S&P 500 returned 1.03%, compared to a return of 1.58% for the 30-year Treasury bond.

Stronger rates of return on the 30-year Treasury bond reflect sluggish first quarter growth in the U.S. economy, especially for consumer spending, lower oil prices that are dampening any acceleration in headline inflation rate, and skepticism and doubt of the impact of President Trump's policies on the economy and financial markets.

These factors might have driven stock prices lower. However, stocks have benefitted from rebounding corporate earnings, expectations for further strong increases in earnings over the remainder of this year, and continuing increases in dividends on stocks. Also, Mr. Trump's recently released proposals for federal taxes

look to be positive for the economy, businesses, and investors, of course depending on one's perspective. Specifics on his proposals, including their possible impact on the federal budget deficit are needed. Regardless, nearly all Democrats will be opposed, and some fiscal conservatives could also be opposed if deficits are likely to rise significantly. Mr. Trump's actions and proposals to reduce regulatory burdens should also be positive for the economy and stocks, again with the much of the same opposition.

As for the economy, the pace of growth should accelerate from the first quarter's meager 0.70% annualized increase in real GDP. This will largely depend on better growth in consumer spending, as this is a major question mark. Growth in real GDP persists at just under 2% over longer periods, and getting that up to even 2.5% is going to be a significant challenge. As has been my belief over at least the past seven years, one should not get too optimistic, or too pessimistic on the U.S. economy.

INVESTMENT STRATEGY

Given the prevailing environment and expectations, what investment strategy is advised, in light of current readings on key metrics?

Starting with duration risk, the two key metrics are the term premium and expected real rates of return on the 30-year Treasury bond. The term premium is measured by the difference between the yield on the 30-year Treasury bond (currently 2.95%) and the yield on the 3-month Treasury bill (currently 0.78%). The difference, or the term premium, is 217 basis points. This is somewhat larger than the mean term premium since April 1953 of 179 basis points. This argues for maintaining a somewhat longer duration in fixed income assets, as opposed to holding cash. One important factor that has a bearing on this is the Federal Reserve's projection that it will raise its target for the federal funds rate from the current 0.75%-1.00% to 1.25%-1.50% by the end of this year, with an additional three 25 basis point increases in 2018. Also, the Fed has begun to discuss plans for reducing its holdings of intermediate and longer maturity Treasuries. These factors could put upward pressure on Treasury yields, but remember, current yields reflect prevailing expectations on the Fed's comment, plans, and actions.

The second metric regarding duration risk is the real yield on long-term Treasuries, currently 0.89%, based on the long TIPS yield. The current yield remains well below the mean long TIPS yield of 2.13% since April 1998, when TIPS were first issued. However, long TIPS yields will remain below this historical average, given continued modest economic growth and only gradual increases in the Fed's target for the federal funds rate. But even with this, the current long TIPS yield of 0.89% is unattractive.

My judgment is not to be too quick to significantly shorten average durations in fixed income assets, but not to hold a longer duration than the current 5.9 year duration of the Bloomberg Barclays Aggregate Bond Index.

The second broad type of risk is credit risk, or other spread risk, and equity risk. Credit and other yield spread risk are inherent in fixed income securities other than Treasuries. The major fixed income asset classes with these types of risk are corporate bonds, mortgage-backed securities, and debt issued by state and local government entities (municipal bonds). Prevailing yields to maturity reflect market expectations for future rates of return. Prevailing yield spreads can be compared to historical norms, which along with assessments of current conditions, provide the basis for assessing the attractiveness of the various fixed income asset classes.

The general economic environment continues to be modestly positive for corporate bonds, and this environment would likely improve with tax cuts and reduced regulatory burdens. Strong gains in corporate earnings since mid 2016 and those projected through at least the end of this year are also positive for corporate bonds. But of course these assessments are already reflected in prevailing spreads.

The Merrill Lynch All Corporates Index is used to assess U.S. investment grade corporate bonds. The yield on this index as of April 27th, the latest available, was 3.25%, compared to a yield of 2.03% on comparable maturity Treasuries (approximately 6 years). The spread of 122 basis points is modestly below the median spread of 151 basis points since August 1998.

The Merrill Lynch High Yield Index is used to assess below investment grade U.S. corporate bonds. The yield on this index is currently 5.65%, compared to a yield of 1.87% on comparable maturity Treasuries (approximately 5 years). The spread of 378 basis points is a good deal below the median spread of 545 basis points since August 1998.

These narrower than average historical spreads on corporate bonds reflect the significant degree to which future superior returns on corporate bonds are dependent on a positive environment. Corporate bonds are expensive, if assessed only on prevailing yield spreads. The environment, especially the continued strong gains in corporate earnings, is sufficient to continue to maintain positions in corporate bonds. But prevailing narrow spreads indicate that corporate bonds will only modestly outperform Treasuries, even in a positive environment. These reservations are enough to advise conservative investors who have a relative low risk tolerance to hold little or no position in below investment grade corporate bonds.

The S&P Mortgage-Backed Securities Index is used to assess this sector of the U.S. fixed income index. This index is comprised of mortgages guaranteed by federal government agencies, so they effectively have no credit risk. But they do have risk associated with the negative convexity of mortgages. So, yields on the S&P Mortgage-Backed Securities Index are higher than comparable maturity Treasuries (approximately 5 years). The prevailing yield on the S&P Mortgage-Backed Index is 2.71%, compared to a 1.83% yield on the 5-year Treasury note. The spread of 88 basis points is considerably narrower than the 116 basis point mean spread since March 2009. As the mortgages in the index are guaranteed, the performance of mortgage-backed securities compared to Treasuries is not going to benefit much from a positive economic environment.

My assessment of mortgage-backed securities is that they provide diversification and are high quality. But if Treasury yields decline, some higher rate mortgages will be refinanced and returns on mortgage-backed securities will not get as much benefit from falling yields as do comparable maturity Treasuries. This is reflected in changes in yields. Since the end of 2016, the yield on the 5-year Treasury note has declined by 12 basis points from 1.95% to 1.83%, but the yield on the S&P Mortgage-Backed Securities Index has fallen by only 6 basis points from 2.77% to 2.71%. As a result of this relatively smaller drop in yield, along with the negative convexity of mortgages, the year-to-date return on the S&P Mortgage-Backed Securities Index was 1.00%, compared to a total return of 1.61% on the 5-year Treasury note.

The S&P AMT Free National Municipal Bond Index is used to assess municipal bonds. The prevailing yield on this index is 3.01%, compared to a 2.28% yield on the 10-year Treasury note. The resulting spread of 0.73 basis points is slightly narrower than the mean spread of 84 basis points since September 2007. Prior to 2007, municipal bond yields were generally lower than Treasury yields, due to interest on most munis being exempt from federal taxes. For nearly a decade, municipal bond yields have been higher than Treasury yields. As a generalization, this makes municipal bonds attractive for taxable asset of higher income individuals.

Reflecting recent and prevailing narrower than normal spreads on municipal bonds, the year-to-date total return on the S&P National Municipal Bond Index (1.96%) has slightly trailed the 2.12% return on the 10-year Treasury note. But if one's federal income rate was above about 10%, municipal bonds would have provided a higher after tax return. The prevailing yield spread, although below average, is sufficient to advise holding municipal bonds instead of Treasuries within taxable assets of those in higher federal income tax brackets. This could change if federal income tax rates are significantly lowered, which would reduce the after tax attraction of municipal bonds. But it is far from certain that this will occur.

The last source of risk is equity risk, which is most significantly associated with common stocks. The prevailing environment continues to be modestly positive for stocks. While relatively modest economic growth is likely to persist, corporate earnings are rebounding and dividend continue to rise at a mid single-digit pace. Reflecting this, stocks remain overvalued compared to historical norms for stocks. The expected long-term real rate of return on the S&P 500 Index is currently 4.09%. The median expected long-term real return since 1959 has been 5.33%. This indicates that stocks continue to be overvalued compared to their own past history. This assessment and conclusion is essentially the same as that based on price/earnings

ratios. This has led many investors and experts to conclude that stocks have been and remain unattractive, and as a result, will decline.

The problem with this conclusion is that the assessment of stocks is based on a comparison to past normal valuation levels on stocks. The assessment is incomplete, as stocks need to be assessed and compared to prevailing expected returns on other assets, particularly to long-term Treasury bonds. This comparison enables one to specifically measure the expected long-term equity premium, that is, the expected additional long-term return from stocks compared to long-term Treasury bonds, which essentially have no risk other than duration risk. The expected long-term equity risk premium is measured by the difference between the expected real long-term rate of return on the S&P 500 Index (currently 4.09%) and the long-term TIPS yield (currently 0.89%). The resulting equity risk premium of 3.20% compares to a median risk premium of 3.12% since 1959. Yes, a good deal of this is the result of a low and Fed repressed long TIPS yields. But this is the environment we are investing in. Stocks are not significantly attractive, but they are relatively attractive to holding cash, to Treasuries, and to other fixed income assets. I continue to advise holding significant positions in common stocks in portfolios, while cautioning that stocks are unlikely to provide strong rates of return, only better ones than most alternatives.

Finally, preferred stocks offer some attraction, especially as a source of investment income. Preferred stocks have longer durations, and their yields are best compared yields on the 30-year Treasury bond. The prevailing yield on the S&P Preferred Stock Index is 6.23%, compared to a yield of 2.95% on the 30-year Treasury bond. The resulting spread of 327 basis points is modestly lower than the mean spread of 345 basis points since October 2005. The current spread, while not overly attractive, is adequate to own some preferred stocks as a source of income.

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