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Mast Investment Advisors LLC

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

INVESTMENT STRATEGY

MAY 31, 2017

The advised investment strategy in this Report is directed at long-term investors with balanced portfolios and applies to assets of those investors that are not expected to be needed within the next three years.

Long-term investing essentially deals with degree to which an investor should take risk in the pursuit of earning higher rates of return. This requires using information from financial markets to measure expected rates of return on major classes of financial assets, notably equities and fixed income. With this information, one can then assess how attractive, or unattractive market expected rates are, given one's assessment of the prevailing investment environment.

ECONOMIC ENVRIONMENT

As reviewed in the recent 5/26/2017 Report, the environment for equities and corporate bonds remains positive. Economic growth in the U.S. has picked up since the end of the first quarter. Developed economies in Europe and Asia are improving. Still, growth will likely remain modest in developed economies due to aging populations, related slow growth in labor forces, weak productivity gains, and difficulties and resistance to governments' implementing pro growth policies. Corporate earnings began to rebound in the second half of last year and this is expected to persist. Dividends continue to rise at mid single digit rates in the U.S. Although monetary policies have ceased to become even more accommodative, a shift to less accommodative policies is occurring quite gradually and is being well signaled by central banks. Investors clearly seem to prefer this to the alternatives of either more rapid tightening or further moves to negative interest rates in Europe and Japan. Inflation rates have so far remained low as the pace of economic growth improves.

Of course, this sanguine environment has driven prices of riskier financial assets higher, which has lowered their expected long-term rates of return and the premiums of those expected rates of returns compared to those on low risk assets. In most cases, lower risk premiums and narrower yield spreads to government bonds on fixed income asset classes have begun to moderate rates of return over the past three months. This indicates that the generally positive environment for riskier asset classes is not translating into higher rates of return to the degree it was three to six months ago. This is because expected rates of return have become less appealing.

CURRENT INVESTMENT STRATEGY

The process used to develop an investment strategy address specific sources of investment risk. The majority of returns for balanced portfolios of long-term investors, above those that would be earned by savings in cash equivalents, come from a few major sources of risk. There are two major sources of risk, and associated additional returns, within fixed income assets - duration risk and credit or other forms of spread risk.

Duration risk is assessed by two measures. The first is the term structure of yields on Treasury securities across the range of maturities. The measure used herein is the yield spread between the 30-year Treasury bond and the 3-month Treasury bill, or the term premium. At the end of May, the yield on the 30-year Treasury bond was 2.85% and the yield on the 3-month Treasury bond was 0.93%, or a term premium of 1.92 percentage points (192 basis points). Since 1953, the mean term premium has been 179 basis points, so the current term premium is only slightly above its historical average. The term premium has declined substantially since mid December of last year. On December 16th the yield on the 30-year Treasury bond was 3.19%, and the 3-month Treasury bill yield was 0.50%, resulting in a term premium of 268 basis points. The reward of owning duration is considerable less now than it was five and a half months ago.

The second measure for assessing duration risk is the real yield on long maturity Treasury bonds. This is measured by the yield on the long Treasury Inflation Protected Security, or TIPS, which was 0.90% at the end of May. Since TIPS were first issued in April 1998, the long TIPS yield has averaged 2.13%. Not coincidently, the average TIPS yield since April 1998 and the annualized rate of growth in the U.S. economy measured by real GDP since 1998 are quite similar. The prevailing rate of growth in the economy, as measured by the year-over-year rate of change in a 4-quarter average of real GDP, was 1.57% in the first quarter of this year and has started to improve, with more improvement towards 2.5% expected over the remainder of this year. On December 16th of last year the long TIPS yield was 1.18%. So, the long TIPS yield has declined as growth has begun to improve. The prevailing long TIPS yield of 0.90% is unattractive in my assessment. The Federal Reserve is expected to continue to gradually raise its target for the federal funds rate. Yields on short-term Treasury bills will move higher with the federal funds rate, which would further reduce the term premium, if long Treasury yields did not rise. For these reasons, I would advise investors to hold an average maturity and duration within fixed income assets that is modestly shorter than the Bloomberg Barclays Aggregate Bond Index (maturity of 8.05 years and duration of 5.86 years). If the average maturity and duration of fixed income assets in the one's portfolio is shorter than that of the Barclays Aggregate, I advise against lengthening maturities and durations at this time.

The second source of additional return in fixed income assets is to own fixed income assets that offer higher yields than comparable maturity Treasuries. The three major categories are corporate bonds, mortgage-backed securities, and debt issued by state and local governments, or municipal bonds.

The assessment of corporate bonds includes bonds with investment grade credit ratings and those with below investment grade ratings. The analysis is based on two Merrill Lynch corporate bond indices - the Merrill Lynch All Corporates Index (all U.S. investment grade corporate bonds) and the Merrill Lynch High Yield Index (U.S. corporate bonds with below investment grade credit ratings).

At the end of May the yield in the All Corporates Index as 3.18% and the yield on similar maturity Treasuries (approximately 6 years) was 1.99%, or a yield spread of 119 basis points. The median spread since August 1998 has been 151 basis points. The current positive environment is clearly reflected in well below historical median spreads. Over the past six months, the All Corporates Index has returned 4.27%, a little more than two percentage points higher than the 2.17% return on like maturity Treasuries. But the return differential has narrowed. Over the past three months the All Corporates Index returned 2.05%, compared to 1.58% for like maturity Treasuries. My advice is to maintain positions in investment grade corporate bonds so long as prevailing conditions remain positive and spreads do not narrow considerably further. Close monitoring returns on the All Corporates Index to like maturity Treasuries is needed, especially to see if investment grade corporate bonds start to underperform Treasuries.

Conditions for below investment grade corporate bonds are similar, but somewhat more nervous. High yield corporate bonds turned in spectacular rates of return over the past year, with the High Yield Index returning 15.17%, compared to a mere 0.26% for like maturity Treasuries (approximately 5 years). However, yield spreads have narrowed dramatically, again a reflection of the positive environment. At the end of May the yield on the High Yield Index was 5.57%, compared to a yield of 1.83% on like maturity Treasuries, for a spread of 374 basis points. This is well below the median spread of 545 basis points since August 1998. The impact of narrowing spreads is reflected in recent performance. Over the past three months the High Yield Index returned 1.82%, not much better than the 1.37% return on like maturity Treasuries and slightly less than the 2.05% return on the All Corporates Index.

My advice for investors with a relatively low capacity for bearing investment risk is to own at most only a small percentage of fixed income assets in corporate bonds with below investment grade credit rating. I advise all investors not to add to positions in high yield corporate bonds.

The analysis of mortgage-backed securities (MBS) is based on the S&P Mortgage-Backed Securities Index. The mortgage-backed securities in this index are guaranteed by agencies of the federal government and have an AAA rating. As such, their higher yields compared to like maturity/duration Treasuries are not primarily the result of greater credit risk, but to negative convexity. At the end of May the yield on the S&P MBS Index was 2.60%. This 5-year Treasury note has a similar duration as the MBS Index. The yield on the 5-year Treasury note at the end of May was 1.77%. The resulting spread of 83 basis points compared to a mean spread of 116 basis points since March 2009. Over the past six months the mean spread has been 86 basis points, or 30 basis points lower than its mean spread over longer periods. As would have been expected under these conditions, the S&P MBS Index has returned 1.53% over the past six months, slightly below the 1.95% return on the 5-year Treasury note. With prevailing spreads well below historical norms, mortgage-backed securities offer little attraction to bear their risks. Modest holdings for portfolio diversification would be primary attraction for mortgage-backed securities.

The analysis of debt issued by state and local governments is based on the S&P National Municipal Bond Index. At the end of May the yield on the National Muni Index was 2.86%, compared to a yield on the 10-year Treasury note of 2.19%. The resulting yield spread of 67 basis points compares to a mean spread of 84 basis points since September 2007. The yield spread on the National Muni Index was 118 basis points at the end of July of last year when the yield on the 10-year Treasury note was 1.46%, close to its all time low in early July 2016. Since the end of July 2016, the total return on the 10-year Treasury note was -5.27%, while the National Muni Index's return was -0.38%, almost 5 percentage points better than the 10-year note. But as the yield spread on the National Mini Index has narrowed, its performance compared to the 10-year Treasury note has also narrowed. Over the past three months through the end of May, the National Muni Index returned 2.38%, compared to a return of 2.01% for the 10-year Treasury note. The prevailing yield spread of 67 basis points is not attractive enough for municipal bonds to materially outperform Treasury securities. However, their exempt status from federal income taxes for interest paid on most municipal bonds is sufficient to make them attractive for taxable assets of most investors.

The analysis of U.S. common stocks is based on the S&P 500 Index. The metric used to assess the S&P 500 is the expected real long-term rate of return derived from a ratio of operating earnings per share to the S&P 500 price index. The expected real long-term rate of return on the S&P is compared to the long TIPS yield to compute the expected long-term equity risk premium.

At the end of May the expected real long-term rate of return on the S&P 500 was 4.00%, well below its historical median of 5.33% since 1959. The prevailing well below historical median expected real long-term rate of return on the S&P 500 Index indicates the degree to which the positive environment is reflected in stock prices. But as noted above, real yields on long-term Treasury bond are also well below historical norms. With the long TIPS yield at 0.90%, the expected long-term equity risk premium was 3.10% at the end of May. This is essentially identical to its long-term median of 3.12% since 1959.

While yield spreads on corporate bonds, mortgage-backed securities, and municipal bonds are all narrower than historical norms, the expected long-term equity risk premium is relatively attractive at its near to historical average level. In an environment of low yields on fixed income securities and low expected real long-term rates of return on stocks, investors should expect and plan for below historical real rates of return on their investment portfolios. The relative attraction of stocks compared to fixed income alternatives means that investors should continue to maintain above allocations to stocks in their portfolios. The major risk to stocks, and also to corporate bonds, especially below investment grade corporate bonds, is that the positive economic and corporate earnings environment will not meet investors' prevailing expectations. This obviously requires close attention.

Lastly, preferred stocks are a source of investment income and should be assessed as a possible alternative to long maturity Treasury bonds. Obviously, preferred stocks are riskier than long maturity Treasuries, so they provide higher yields than long-term Treasury bonds to compensate for their higher risk. Analysis of preferred stocks is based on the S&P Preferred Stock Index. The yield on the Preferred Stock Index was 6.28% at the end of May, and the yield on the 30-year Treasury bond was 2.85%. The resulting spread of 343 basis points compares to a mean spread of 345 basis points since October 2005. So, the current spread is just about average.

At the end of August of last year, the spread on the S&P Preferred Stock Index to the 30-year Treasury bond was a much wider 414 basis points. At that time the yield on the 30-year Treasury bond was only 2.29%. Since then through the end of May, the 30-year Treasury bond returned -10.73%, while the S&P Preferred Stock Index returned a considerably better 1.99%. But as its yield spread on the Preferred Stock Index has narrowed, so too has its performance compared to the 30-year Treasury bond. Over the past three months the S&P Preferred Stock Index has returned 2.30%, somewhat less than the 3.40% return on the 30-year Treasury bond. With the current yield spread on the Preferred Stock Index close to its historical mean, rates of return on preferred stocks should exceed those on 30-year Treasury bonds by just about enough to compensate for their higher risk. Recall, however, that preferred stocks have considerable duration risk, as do long maturity Treasury bonds, and taking above average duration risk at present is not advised. As such, modest portfolio positions in preferred stocks are advised.

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