



Quarterly Market Outlook & Strategy Letter

Third Quarter of 2014

October 2014

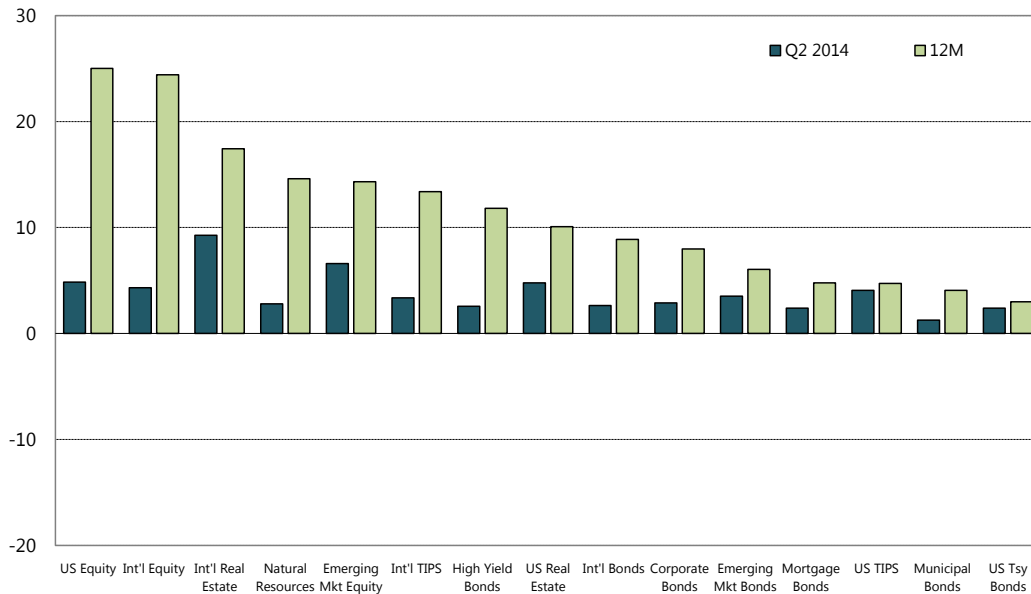
Executive Summary

- As in Q1, most market segments delivered solid returns last quarter. Gains were especially large in sectors that are most sensitive to the global business cycle—and which lagged behind other markets in 2013. Despite weak growth in the first quarter, investors have been buoyed by signs of improving economic conditions in the US, Japan and China. To a significant extent, the improvement owes to continued monetary support from the world’s central banks.
- While we are pleased with our clients’ investment results in these robust markets, we are mindful that valuations across many asset classes are stretched, while volatility is abnormally low. This benign environment cannot and will not continue. Thus, we will be rebalancing our clients’ allocations back to target over the next 6-12 months.
- Long-term wealth creation depends on how much one is able to save over the course of a lifetime, and how much one is able to earn on those savings. The three drivers of investment returns are: (a) the distribution of investment capital across different market segments, which offer varying combinations of return and risk; (b) the tax liability that accrues on those investments; and (c) management fees and trading costs. The selection of individual investment vehicles is critically important, for it influences each of those three drivers of return.
- The investment landscape is constantly evolving, and the options available to retail investors are far more plentiful than they were 20 years ago. Even small investors can achieve portfolios that are far more broadly diversified, with greater return potential, and at lower cost, than in the past. Nevertheless, the plethora of modern investment options can be overwhelming.
- It is impossible to determine what individual funds to select without a clear roadmap in the form of a strategic portfolio allocation. Various asset classes reflect securities’ distinct risk characteristics—with macroeconomic and issuer risks being the defining features. However, the alignment between risk factors and asset classes is imperfect; many macro risks are prevalent across multiple asset classes. In this context, it is imperative to keep track not only of asset-class and issuer-specific risks in the portfolio, but the aggregate macro risks they entail.
- We select investments to fulfill our clients’ allocation targets with the goal of maximum diversification across and within asset classes; an optimal balance of passive vs. actively-managed investments; and minimal tax liability, manager fees, and trading costs.
- Our approach to selecting a high-yield municipal bond manager illustrates the process.

Market Overview

As in Q1, most market segments delivered solid returns last quarter. Gains were especially large sectors that are most sensitive to the global business cycle—and which lagged behind other markets in 2013. Emerging market equity and debt, natural resource stocks, and international real estate led the way, although US and foreign developed equity markets continued to post sizable gains (Figure 1). Despite weak growth in the first quarter of the year, investors have been buoyed in recent months by signs of improving economic conditions in the US, Japan and China. To a significant extent, the current (and prospective) economic improvement owes to continued supportive monetary conditions by the world’s central banks. It appears the global economy is on the brink of the synchronized economic rebound that we have been anticipating since last year—although the sluggish European recovery and mixed signals from the Japanese economy remain significant risks.

Figure 1. Benchmark Asset Class Returns



Source: Bloomberg

While we are pleased with our clients’ investment results in these robust markets, we are mindful that valuations across many asset classes are stretched, while volatility is abnormally low. This benign environment cannot and will not continue; global liquidity will tighten as growth improves. Thus, we anticipate rebalancing our clients’ allocations to some of the best-performing sectors (US equity, US real estate and high-yield bonds, for example) back to target over the next 6-12 months.

Portfolio 101: How to Select Suitable Investment Vehicles

Long-term wealth creation depends on how much one is able to save over the course of a lifetime, and how much one is able to earn on those savings—that is, one’s investment return. The three drivers of investment returns are: (a) the distribution of investment capital across different market segments, which offer varying combinations of return and risk; (b) the tax liability that accrues on those investments; and (c) management fees and trading costs. The first determines how much you make on your investment, while the second and third determine how much you are able to keep. The selection of individual investment vehicles is critically important, for it influences each of those three drivers of return. Every potential investment entails a specific mix of risk and return, exposure to tax liability, management fees, and trading costs. Identifying the optimal combination of investments involves weighing the benefits vs. costs for each potential investment, and understanding how they might work together to produce a sensible portfolio.

The investment landscape is constantly evolving, and the options available to retail investors are far more plentiful than they were 20 years ago. The emergence of mutual funds and exchange-traded funds (ETFs) has made it far easier for individual investors to gain access to a wide variety of investment opportunities in a cost-effective manner.¹ By pooling large numbers of small investors, these publicly-traded investment vehicles enable individuals to own a fractional share of the equity or debt of a large number of issuers (i.e., companies and public sector entities around the world). Thus, even small investors can achieve portfolios that are far more broadly diversified, with greater return potential, than in the past.

Moreover, management fees and trading commissions have fallen dramatically over the past two decades as a result of deregulation and heightened competition. Whereas in the late 1980s, the average stock trading commission was \$45, that cost has fallen as low as \$7/trade today. Thanks to Vanguard and other large-scale index fund providers, small investors can gain exposure to the broad US stock market for as little as 0.1% of the assets invested (the annual expense ratio). SEC regulations have promoted greater transparency in how investment managers report fees and charges, as well as the potential tax liability on their investments. Even so, the plethora of modern investment options can be overwhelming; at the end of 2011, some 14,000 mutual funds were available to US investors, representing assets of \$13 trillion. The Investment Company Institute estimates that, globally, \$25 trillion is now invested in mutual funds. Given the dizzying array of opportunities, it is important for one to start with a clear understanding of one’s investment objectives. These determine the portfolio’s overall asset allocation—the scaffolding of the investment strategy—which is then fulfilled with a selection of individual funds that meet the requirements of each asset class.

¹ A mutual fund is a pool of investment capital in which individual investors own shares. It is priced daily, based on the value of the assets it holds, at the end of each trading day. ETFs are also pooled vehicles, but are traded on exchanges like individual securities. ETFs are priced continuously, throughout the trading day.

The Starting Point: A Well-Defined Asset Allocation

Among the questions every investor must address in designing a sensible plan are:

- How much risk (volatility or potential capital loss) can he or she comfortably assume?
- When will the investor need to start drawing money from the portfolio, and how much will be required annually to meet household spending needs?
- How much of the portfolio should be kept in cash to meet potential contingencies?
- Given the likely spending rate, what yield and/or target return is required?
- Is the target return achievable given market conditions and the investor’s risk tolerance?
- How will the investor’s tax situation influence the after-tax rate of return on the portfolio?

The below table illustrates the array of investment opportunities available in the global financial markets. The broad asset classes are meant to capture distinct *macroeconomic risk factors* and the return premiums associated with them. By contrast, the sub-asset classes capture various *issuer-specific risk factors*. These asset classes offer varying combinations of risk and return, and perform differently from one another over the course of the business cycle. Since they do not move in lock-step, combining them into a portfolio achieves a better balance of risk and return for the investor.

Broad Asset Classes Capture Various Macro Risks

	Equity	Fixed Income	Real Assets/Inflation Hedges	Alternatives (Opportunistic)	Cash & Liquid Instruments
Sub-Asset	U.S.	US Treasury notes	US inflation-linked bonds	High yield/distressed debt	Taxable money market funds
Classes	International	US Treasury bonds	International inflation-linked bonds	Special situations	Municipal money markets
Capture	Emerging Market	Mortgage bonds	Natural resources	Hedge funds	CDs
Various		Municipal bonds	Domestic real estate	Private equity	Cash
Issuer		Corporate bonds	International real estate		
Risks		International bonds			
		EM sovereign bonds			

The optimal combination of asset classes for each investor depends on his/her objectives. Equity assets tend to produce high but volatile investment returns, most of which come through capital appreciation. By contrast, bonds tend to produce lower, but more consistent returns over time, most of which come from income. Investors who draw regularly from their investment portfolios and who need (or prefer) consistent returns will generally have a larger share of fixed income in their asset mix. They may be willing to sacrifice a higher return for greater portfolio stability—but must ensure their assets are sufficient to last through retirement. Taxes are another important factor to consider. Most investment income is taxed at ordinary rates, rather than the lower long-term capital gain rates. Tax policy increases the attractiveness of equity assets to wealthy investors who are comfortable with the greater volatility they entail.

It is impossible to determine what individual funds to select without a clear roadmap in the form of a strategic asset allocation. We have written elsewhere about what is involved in moving from investment goals to an allocation plan, and will not elaborate here. Once that plan is established, we select investments to fulfill our clients' targets that achieve maximum diversification across and within asset classes, with an optimal balance of passive vs. actively-managed investments—all while minimizing tax liability, manager fees, and trading costs.

Diversification Within and Across Asset Classes

As noted above, investments are grouped into various asset classes according to their distinctive risk characteristics—with macroeconomic and issuer risks being the defining features. However, as the matrix below illustrates, the alignment between risk factors and asset classes is quite imperfect; many macro risks are prevalent across multiple asset classes. Moreover, the compensation investors receive for bearing those risks also varies by asset class. In order to gain broad exposure to the global investment opportunity set, and to capitalize fully on the various risk premiums available to investors, it is important to diversify portfolios both *across* and *within* asset classes.

Prevalence of Various Macro Risk Factors Across Asset Classes

	Equity	Fixed Income	Real Assets	Alternatives	Nature of Factor Risk Premium
Equity Risk Premia					
Market risk premium	X		X	X	Premium to compensate investors for the greater volatility and unlimited downside of equity ownership vs. the safest ("risk free") assets
Value risk premium	X		X	X	Premium to compensate investors for the risk that a low-priced asset is cheap due to weakening fundamentals, rather than market conditions
Size risk premium	X		X	X	Premium to compensate investors for the heightened risk that a small firm will fail amid turbulent economic/market conditions
Profitability risk premium	X		X	X	Premium to compensate investors for inconsistency or uncertainty in a company's earnings stream
Fixed Income Risk Premia					
Interest rate (duration) risk premium		X	X	X	Premium to compensate investors for the greater sensitivity of long-term bond prices to interest rate fluctuations
Convexity risk premium		X	X	X	Premium to compensate investors in callable bonds for the risk that the issuer will pre-pay, thus reducing income as interest rates fall
Credit risk premium		X	X	X	Premium to compensate investors for the risk that the issuer will default on the bond
Currency Risk Premium	X	X	X	X	Premium to compensate investors in foreign securities for fluctuations and potential losses from currency movements
Inflation Risk Premium	X		X	X	Premium to compensate investors for uncertainty about the future worth of an investment amid high and/or rising inflation
Liquidity Risk Premium	X	X	X	X	Premium to compensate investors for their inability to redeem an investment at the time and/or price of their choosing

What this means, for example, is that our clients stand to benefit from exposure to the small cap premium not only in the US equity market, but also in the foreign equity markets. Similarly, they will earn higher risk-adjusted returns by investing not only in high-quality mortgage-backed bonds guaranteed by the US Treasury, but also those that are lower in the credit spectrum but which offer a compensating yield.

In this context, it is imperative to keep track not only of asset-class and issuer-specific risks in the portfolio, but the aggregate macro risks they entail. Let us consider the fixed income asset classes in greater detail: Most bonds, which pay out a fixed coupon, do not provide an inflation risk premium (floating-rate bonds are an exception). Rising inflation erodes the purchasing power of coupon income. Worse, it pushes up interest rates, which depresses bond prices and creates a capital loss for investors who may have to sell their bonds. The longer the maturity of a bond, the greater is the impact of rising interest rates on its price. Long-term bonds typically offer a higher yield than short-term bonds, as compensation to investors for bearing this interest rate risk.

Many governments now issue bonds whose principal value is indexed to inflation. In the US, these are known as Treasury Inflation Protected Securities (TIPS), while overseas they are known as “linkers”. The prices of these bonds transparently reflect the market’s perception of future inflation risk—and the premium investors currently demand for accepting that risk. The existence of an inflation risk premium in these bonds leads us to group them with other “real assets”, which tend to hold their value in the face of inflation. However, apart from the inflation premium, these bonds have very different attributes than other “real assets,” and are therefore a useful way to diversify the portfolio’s inflation hedges—and mitigate losses elsewhere in the bond portfolio.

Both mortgage-backed bonds (securities that are backed by pools of residential mortgages) and callable municipal bonds (whose issuer has the option of early repayment) are exposed to “convexity” risk. When interest rates fall, it is attractive for families to refinance their mortgages at lower rates, and for local governments to redeem their high-interest debt by issuing new bonds. As a result, the yield on these investments declines at an increasing rate as interest rates fall. Both mortgage-backed bonds and callable municipal bonds offer a premium to compensate investors for convexity risk. This premium income mitigates the sensitivity of the bond’s price to higher interest rates. In effect, the investor accepts greater convexity risk in exchange for lesser duration risk.

All bonds are subject to some form of credit risk. Traditionally, government-issued bonds have been considered the safest—all but free of default risk. After all, if a government starts running out of money, it can use its legal authority to raise taxes and thus meet its obligations. As a last resort, it can pressure the central bank to print money and use the funds to buy government debt. The resulting inflation may be considered an indirect form of default, insofar as it erodes the *real* value of the bonds, as described above. However, outright default was considered a remote possibility—until the S&P downgrade of US Treasury debt in 2011, and the European sovereign debt crisis that followed in 2012. Clearly, government bonds issued by even the wealthiest countries are subject to some credit risk.

In selecting an investment vehicle, we must therefore consider not only its exposure to various macroeconomic and issuer-specific risks, but also how those risks might compound or neutralize other exposures already embedded in the portfolio. Ideally, one would also evaluate whether the risk premium on offer—relative to alternative investments—provides adequate compensation for the risks inherent in that investment. Realistically, such assessments are hindered by perpetual uncertainty about a continually changing economic and market environment. The best remedy for rampant uncertainty is, in our view, to diversify portfolios as broadly as possible, to keep track of the resulting risk exposures, and to tilt the portfolio toward or away from those exposures only when market pricing has moved far out of line with perceived risks.

Balancing Passive and Active Management: When, Where and How

Macroeconomic and issuer-specific risks are constantly in flux. The latter are, to a large extent, idiosyncratic, and can be minimized by holding a sufficiently diversified portfolio of securities. The changing fortunes of a single company, municipality, or country (unless that country is the US) are unlikely to derail a well-designed portfolio. Moreover, several decades of research has demonstrated the futility of trying to “beat the market” by selecting individual securities that seem likely to deliver superior performance. Periods of exceptional returns are fleeting, and the long-term gains from security selection in liquid markets rarely exceed the cost in terms of trading fees and tax liability. For most publicly-traded securities, broadly-diversified passive investment vehicles are the most cost-effective approach. That said, in markets that are new, illiquid and/or generally lacking in transparency, the opportunities for a manager to improve returns through active security selection are greater. Passive investment vehicles in these markets may be limited or costly, so actively managed funds may be the best option.

Unlike issuer risk, macroeconomic risks in a portfolio tend to be far more concentrated, and thus more difficult to diversify away. Even a well-designed portfolio can suffer large losses if there is a shock to one or more risk factors (i.e., an inflation surprise, a rapid rise in interest rates, a sudden slowing of economic growth, and/or meaningful currency depreciation). The chance of loss is greatest when risk premiums have become compressed and no longer adequately compensate investors for changing economic conditions. The case for actively managing a portfolio’s macro risk profile, by dynamically adjusting its target asset allocation, rests on the magnitude of these non-diversifiable risks.

Of course, the same critique that has been leveled against active security selection can be applied to active asset allocation. Indeed, the potential adverse impact on a portfolio of mismanaging its macro exposures is considerably larger than with ill-advised security selection, given the greater concentration of risk. In effect, asset allocation decisions become binary (i.e., stocks vs. bonds, risk-on vs. risk-off) when they are most needed—i.e., when animal spirits get out of control. Fortunately, research suggests that dynamic asset allocation based on valuation principles can be effective over the long-term; asset classes that are highly valued tend to have lower future returns, and vice versa. Mean-reversion of asset prices toward fair value typically occurs over multi-year cycles, creating opportunities for patient investors.

Acting on that knowledge is nevertheless difficult, given the unique challenges associated with macro investing. The concentration of risk, and the unpredictability of markets' return to fair value, creates disincentives for professional investors to tackle mispricings that may be obvious to everyone. Storied value investor Jeremy Grantham recounted a 1999 survey he conducted of professional money managers, in which *"more than 99% of the analysts and portfolio managers of the great, and not so great, investment houses believed that there would indeed be a major bear market."* Nevertheless, few found themselves able to do anything to protect their clients' portfolios. On the contrary, *"Their spokespeople, with a handful of honorable exceptions, reassured clients that there was no need to worry."*²

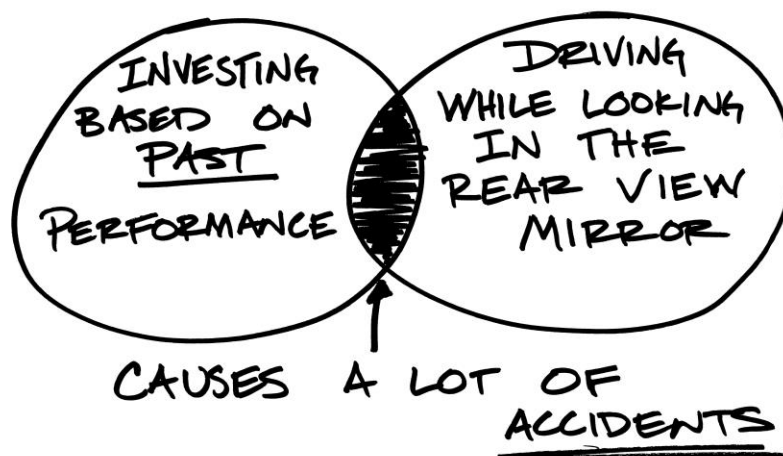
As Grantham explains, a manager of individual securities can apply his approach to a large number of potential investment opportunities. Although some won't turn out well, others will—success is a question of batting averages. If the manager is often wrong, or simply mediocre, it can take years for that signal to emerge from the noise of markets. By contrast, asset allocation decisions are, by their nature, highly conspicuous, and thus pose career risk to professional investors. The longer it takes for assets to return to fair value, the more conspicuous the "mistake" becomes. This dynamic reflects a self-fulfilling prophecy: professional investors won't tackle a major market mispricing without help from other investors—but if others were willing to do it, that mispricing would never emerge, or would soon be gone.

Easy or not, value-oriented management of a portfolio's macro risks is essential. After all, diversification is of limited value if one simply spreads investment capital across an array of overvalued investments. All such investments will suffer when interest rates rise, liquidity dries up, or growth suddenly stalls, as the events of 2008-09 showed only too well. The keys to success as a value investor are a good sense of timing, and a commitment to maximize more subtle opportunities for portfolio return while avoiding sectors that are clearly (and increasingly) overvalued. Working with individuals (such as Grantham's sister), who are less susceptible than professional investors to the pressures of peer and benchmark performance chasing, is invaluable. In this regard, we at KPF Global are extremely fortunate: our clients are focused squarely on the long-term security of their retirement assets, and are quite sensible.

In sum, active management of a portfolio's target asset allocation may be appropriate when macro risk exposures are highly concentrated, and when it is clear that market pricing provides inadequate compensation to investors for growing economic and financial risks. Active management at the security level may also be appropriate in markets that are relatively new, illiquid or non-transparent—as in the mortgage, municipal and high-yield bond sectors, the emerging equity and debt markets, and amid distressed market conditions. Finally, it may be sensible to hire an active manager when multiple factor risks are present within a sector—and when those risks interact powerfully with issuer-specific factors.

² Grantham, Jeremy and Ben Inker, "My Sister's Pension Assets and Agency Problems (The Tension Between Protecting Your Job or Your Clients' Money)" GMO Quarterly Letter, 4/18/12.

Finding experienced investment managers, who are skilled in identifying and capitalizing on market opportunities, while managing the associated risks, can be quite difficult. The most commonly-used screening criteria, past performance, is perhaps the least useful. That's because investment results may reflect skill or luck, and it is often hard to discern which matters most. Frequently, managers (consciously or unconsciously) exploit one or more of the risk premiums described above. The resulting portfolio tilts may boost returns, but increase latent risks to the portfolio. Others deploy leverage in subtle ways so as to improve performance—at the expense of portfolio safety. Past returns convey little information when market opportunities and risks are ever changing; it's like driving with both eyes focused on the rear-view mirror. It is far more sensible to consider the *consistency* of a manager's investment results, the coherence and integrity of his or her investment process, and the correspondence between that process and its results, given the market context. In other words, did the strategy perform as advertised, given prevailing market conditions?



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Combining passive and active investments, while relying on managers with diverse skill sets, is a source of portfolio diversification. Management of the most concentrated risk factors should be shared, whenever possible. No single investor has all the answers, and no strategy performs well in all markets.

Minimizing Taxes, Fees and Costs

Obviously, the attractiveness of a particular strategy or manager can only be evaluated relative to its cost. Investment costs may be direct or indirect, and include potential tax liability and management fees, as well as sales and trading commissions. Active investment strategies are always more expensive than passive approaches, since they entail greater capital gains, higher management fees, and larger trading costs. Therefore, one must ask whether logic and experience suggest that the excess return that an active manager believes he or she can achieve is likely to be sufficient to compensate for the extra cost. This is a practical question, not a faith-based decision. However, it is useful to remember that while excess returns are often fleeting, taxes and fees are forever!

Taxes

Investment tax liability can be managed at the security (or fund) level, the account level, or the portfolio level. The biggest contributor to capital gains tax liability is turnover: short-term capital gains, which are taxed at ordinary income rates, are especially costly. Active strategies, which generate more turnover, have a higher pre-tax performance bar to clear—in order to produce an acceptable *after-tax* return.

Tax liability can also be reduced through the careful assignment of investments to various investment accounts, depending on their tax status. After-tax returns are generally improved by locating heavily taxed assets (i.e., those that generate high returns that come mostly in the form of income) in tax-deferred accounts, while keeping those that are taxed more lightly (i.e., those that generate lower returns, or returns that come mostly in the form of capital appreciation) in taxable accounts.

All distributions from IRA and 401K accounts are taxed as ordinary income, regardless of whether the investment return was generated by income or by capital gains. Since capital gains tax rates are usually lower than income tax rates, it is disadvantageous to place passive equity investments in an IRA or 401K account. Tax-exempt municipal bonds should always be located in taxable accounts; tax-deferred money should be allocated to investments that can benefit from the deferral.

Tax-deferred accounts are also useful for handling portfolio reallocations, since rebalancing decisions can be made with no tax consequences. Thus, it is unwise to locate all of one's equity assets in taxable accounts, nor all of one's fixed income in tax-deferred accounts.

Fees and Trading Costs

To maximize an investor's total return, one should select investment vehicles that achieve the desired diversification, and manage key macro risks, while minimizing the fees and trading costs. Never is it advisable to buy a fund with a front-end load (sales commission); back-end loads sometimes pay for themselves if they discourage investor turnover in illiquid markets. Some advisors accept "referral" or "placement" fees from managers whose funds they purchase. These are fancy names for kickbacks, and should be avoided at all costs. More often than not, referral fees are a sign that the fund's reputation is inadequate to attract investors. The advisor must be paid to play—a blatant conflict of interest.

High reported returns are no guarantee of future performance. Consider the following example: an investor can choose between two mutual funds for a \$100 investment. Fund A is expected to provide an annual return of 10%, while Fund B offers the prospect of a 12% return. Most investors who don't read the fine print would be inclined to pick Fund B. If they do, it could take five years for the value of their investment to catch up to Fund A—despite returning an extra 2% each year (or 1.5% after expenses). If an investor plans to hold the fund for a very long time—and if its performance is consistently superior—it might make sense to purchase fund B. Yet how often does that happen?

Fund A	Fund B
Expected return of 10%	Expected return of 12%
Expense ratio of 0.5%	Expense ratio of 1.0%
No loads	Front-end load of 5.5%

	Fund A	Fund B
Starting Value	\$100	\$100
Year 1	\$100	\$95
Year 2	\$110	\$105
Year 3	\$120	\$116
Year 4	\$131	\$129
Year 5	\$144	\$144

Putting It All Together

Selecting and combining investment vehicles into a well-diversified portfolio is a complex task. Knowledge and experience are useful—but the process still involves as much art as science. Even for experienced investors, it can be difficult to prioritize all of the relevant considerations, given ongoing uncertainty about the economic environment, the likely performance of various investments amid changing conditions, and the potential interaction among strategies. To the extent that investors (i.e., clients) are focused on long-term results, it is easier to design a strategy that produces the desired outcome. However, market volatility is discomfiting to most people, and can disrupt the best laid plans. Hence it is important to consider a variety of contingencies, and make one’s selections accordingly. The decision process can best be illustrated with a case study of our selection of a high-yield muni manager:

The first question asked was: Does an asset of that type belong in our clients’ portfolios? In other words:

- *Would it contribute to portfolio diversification?* Yes, insofar as the fund offered a combination of credit, duration, convexity, liquidity and issuer risks in one package
- *Should the investment be actively managed?* Definitely, given multiple risk factors interacting with issuer risks. Moreover, the sector is both illiquid and lacks price transparency
- *Does the risk premium provide adequate compensation for the risks?* The tax-equivalent yield on high-yield muni funds is in the 7.5%-8.5% range, well above yields on investment grade municipal and high-yield corporate debt (4-5% for comparable maturities). However, the default rate (at roughly 8%) is also higher than for regular munis (1-2%) and high yield corporates (5-6%). Whether the yield premium is adequate depends on the time frame over which defaults might occur, and the investor’s time horizon. State and local government fundamentals are improving, the economy is expanding, and we believe that monetary policy will not be tightened so quickly as to derail the expansion—pushing default risk out over a 3-5 year horizon

- *Will the investment mitigate or heighten existing portfolio risks?* Our portfolios have too few munis (due to lack of supply in the investment grade market) and are light on interest rate risk. We have greater credit exposure, but shifted to a higher-quality high-yield fund early in 2013. Adding an intermediate-duration high-yield muni fund, sized appropriately, should not pose a problem
- *Will the investment improve the after-tax return profile of portfolios?* Certainly, since these are tax-exempt securities
- *Can we find a skilled manager at reasonable cost?* As the table below shows, several experienced high-yield muni managers have produced consistent risk-adjusted returns from managing high-yield municipal credit and duration risk. Their fees are moderate given the average yield on the asset class. In determining which manager is best for our clients, we will put a premium on turnover and fund redemptions during illiquid markets
- *What are the principal risks to the strategy?* Clearly, liquidity is an overriding concern given the inherent illiquidity of the asset class, in conjunction with the current business cycle conjuncture (i.e., faster economic growth will prompt a tightening of US monetary policy). Convexity is less of a concern as the credit status of these borrowers makes it less likely they will be able to redeem and reissue debt
- *Implications of these risks:* Start with a small allocation, with room to add if the fund demonstrates its ability to manage credit & duration risk in a tightening liquidity environment. Choose a manager that offers a shorter duration profile and/or higher credit quality; trim other sources of duration and credit risk in the portfolio
- *Implementation:* Allocate to taxable accounts of clients that have available cash, so as not to incur unnecessary capital gains tax. Trim duration- and credit-sensitive investments in their tax deferred accounts

High Yield Municipal Bond Funds

Fund Symbol	Fund Name	Gross Expense Ratio	Dividend Yield	Sharpe Ratio	Annualized Standard Deviation	5 Year Annualized Return	10 Year Annualized Return	Duration	Average Credit Quality
NHMRX	Nuveen HY Muni	0.65	5.95	1.7	6.9	12.6	4.7	10.81	BB
PRFHX	T Rowe Price Tax-Free HY	0.67	4.31	1.6	5.4	9.4	5.5	6.15	BB
AMHIX	American High-Income Muni	0.69	4.40	1.8	4.9	9.1	5.0	8.20	BB
WYMHX	Ivy Muni High-Income	0.69	4.88	1.4	5.1	9.3	6.3	9.30	BB
GHYIX	Goldman High-Yield Muni	0.58	4.87	1.4	6.5	10.3	4.3	N/A	N/A
ABHYX	Am. Century HY Muni	0.60	4.28	1.5	4.9	8.6	4.4	8.04	BB
MMHYX	MFS Muni High Income	0.72	4.97	1.5	5.6	9.0	5.6	9.15	BB
FRHIX	Franklin HY Tax-Free	0.65	4.63	1.2	5.6	7.9	5.4	N/A	BBB
DVHIX	Delaware Nat'l HY Muni	0.74	4.50	1.5	5.9	10.3	#N/A	6.90	BB

KPF Global Portfolio Strategy

We made no major changes to our investment strategy of the past quarter. It has been a good market for risk assets, such as emerging markets and commodities. In 2013 we increased our clients' allocations to these sectors, which we believed were attractively valued. Holding these positions last summer was difficult; however we are committed to these investments over the long term, and are pleased to see them come to fruition.

We recently raised our client's municipal bond targets, but found fulfilling the target allocations to be challenging. Municipal bond issuance has declined with the improvement in state & local government finance, meaning there are fewer bonds available to purchase. At the same time, the attractiveness of these bonds to investors has increased with the tax law changes of 2013.

For clients with substantial municipal bond allocations (i.e., more than \$250k), we continue to maintain and replenish their ladders, while evaluating several separate account managers. For smaller clients, we have refreshed our investment grade municipal fund screens and find that the Vanguard Intermediate-Term Tax Exempt fund remains a solid choice. We will be supplementing these investments with Vanguard's Short-Term Tax-Exempt fund, as well as T Rowe Price's Tax-Free High-Yield Fund.