Mike Rabuffo conference call
Summary notes from the call
August 20, 2013

Current market conditions

1. Positives – improving European economic conditions; 72% of S&P 500 companies have beaten their earnings estimates.

2. Negatives – S&P 500 just suffered largest 1-week loss for the year.

3. Stocks vs. Bonds
   a. A general rule in economics is to sell the "relatively rich" asset and buy the "relatively cheap" asset.
   b. This is what Sechrest is trying to do by reviewing client portfolios, comparing them to their benchmark, and suggesting trades needed to rebalance a portfolio back to the benchmark.
   c. Bonds always mature at par (if held to maturity). Because of this, there is an assurance of where their price will end up. There is no assurance of where the price is supposed to "end up" with stocks. This is one of the reasons why bonds are considered "safer" than stocks.

4. Yield on 10-year Treasuries has gone from 1.67% to 2.83% over the last 3 months (116 basis points increase).
   a. Yield on 2-year Treasuries has only increased by 10 basis points during that same time period.

GWK (Gannett, Welsh & Kotler)

5. $19 billion in assets under management. $16 billion of this in bonds. Most of the bonds are individual bonds.

6. GWK actively manages bonds. Individual bonds can be held to maturity. There are opportunities to sell a bond all the way up until it matures. GWK views their job as deciding which bonds to own for a client and at what point prior to maturity does it make sense to own a bond vs. selling it.
   a. GWK views their job as deciding which types of bonds to buy for a given strategy.

7. GWK is a market maker in the bond market. They buy and sell large quantities of bonds. They're the big fish in the muni market pond.
   a. The analogy Mike used is that they're like BJs or Costco. They buy bonds wholesale, so the price clients are getting for the bonds that end up in their accounts are the best prices out there.
   b. Broker/dealers that have bonds want to give GWK the best prices, because they know GWK is a big buyer.

c. GWK makes its money on the management fee it charges, not on the spread (i.e., the difference between what it pays for a bond and what the client ends up buying the bond at).

8. The more volatility there is in the bond market, the more value GWK feels they can bring to the client.

Fixed income investing in a rising interest rate environment

9. Remember that when you own a bond, you are getting the income ('yield') from the bond. Mike says that most of the return from bonds from the interest income.
   a. Over a 30-year period, approx. 70% of bond returns have come from interest.
   b. Then, this interest is reinvested and you get interest-upon-interest (i.e., compound interest).

10. As page 3 and 4 of Mike's presentation show – rising short-term interest rates do not necessarily lead to negative fixed income returns. Returns are impacted by:
    a. Price return
    b. Income return
    c. Interest upon the original income return (i.e., compounding interest)

    Furthermore, as interest rates rise, now GWK can buy bonds that are paying a higher interest rate. The components of a bond's return in items b. and c. above are now at a higher interest rate.

Detroit bankruptcy and the overall municipal bond market

11. GWK does not own Detroit bonds. They haven't for many years (if at all).

12. What happened to Detroit is no surprise to anyone.
    a. In May 2008, Detroit bonds were downgraded to junk. So it's not like Detroit's bankruptcy came out of nowhere.
    b. Shrinking population base. Shrinking economic base. Large public pension liabilities and commitments.

13. There are over 60,000 municipalities that issue bonds. GWK only owns bonds from around 400 of them.
    a. In this way, GWK has the ability to stay on top of each issuer and understand the nature of the risks of each bond.
    b. GWK does independent credit research on the issuers it owns and avoids distressed issuers.
    c. Furthermore, GWK considers the liquidity of a bond. In other words, if GWK is ultimately going to sell the bond to someone, the buyer may be situated anywhere in the US (or possibly the world).
       - For example, selling a general obligation bond of the Commonwealth of Massachusetts is more marketable (and thus, more liquid) than a Town of Acton bond.

- The potential buyer likely knows nothing about the debt obligations of the Town of Acton but more likely knows about the debt obligations of the Commonwealth of Massachusetts.

14. GWK is focusing on bonds in the 8- to 12-year maturity range. GWK feels that this is where the maximum amount of return is for the appropriate amount of risk being taken.
    a. However, diversification is also important for a bond portfolio, so not all the bonds in an account are necessarily going to be in that range.

15. Municipalities are in better shape the past few years.
    a. Defaults peaked in 2009.
    b. There has been meaningful pension reform – workers (at least newer workers) are having to contribute more to their pensions and health care expenses.
    c. Sales tax revenues are improving as the economy improves.
    d. Income tax revenues are improving as the economy improves.
    e. There are ongoing efforts at continued pension reform.

16. GWK avoids local GO (General Obligation) bonds. Local municipalities have fewer options for raising/generating revenues to service debt relative to state municipalities. There could be future pressure on local GOs because of this.

17. GWK anticipates 3% yield-to-maturity annually in the GWK Muni Strategies for the next 3 years.

<u>Other considerations</u>

18. If you have short-term needs for your cash (i.e., if you need cash within around 3 years):
    a. Be conservative.
    b. Use short-term CDs.
    c. Use short-term bonds.

19. Buy and hold individual bonds vs. actively managing bonds.

    Buying and holding
    a. You're assuming that the best time to get out of the bond is at the maturity date.
    b. You're assuming that the best time to reinvest the proceeds into a new bond is at the original bond's maturity date.
    c. You're ignoring price fluctuations, but you're turning your back on the ability to get price appreciation. Instead, you need to evaluate market conditions and whether you can own a better bond for your portfolio.