

THE SHERIDAN ROAD MAP



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BETTING ON THE BOND BUBBLE

How much do investors stand to lose when interest rates reverse course?

What's the difference between tulips, the South Sea Company, stocks in the Roaring Twenties, Japan's Nikkei in the '80s, the NASDAQ '90s, the recent housing boom, the current price of gold—and bonds? All of the above except bonds had some measure of euphoria—or “animal spirit,” as some like to say—attached to them. Bonds, on the other hand, have simply been a bastion of safety. However, given the massive amount of investor capital which has flowed into fixed income offerings, what will happen when the music stops and interest rates reverse course? How much could investors lose when rates rise? The answer is, it depends. It depends on the type of bond, their coupon and maturity, their credit quality, how you own them and the degree to which interest rates rise.

Before we dive into these subjects, let's take a step back and discuss our current economic landscape. The health of the economy is a critical factor in determining interest rates and the direction of interest rates has a profound impact on the performance of fixed income issues.

The Challenge of the Fed. The Fed controls our nation's monetary policy through the Federal Open Market Committee (FOMC). The FOMC's mandate is to provide for stable prices and economic growth. Although fiscal policy, which is established by Congress, is a large determinant in economic performance, our focus will be on monetary policy.

The Fed has various tools to accomplish its mandate which include controlling the money supply, setting the discount rate and setting bank reserve requirements, to name a few. However, since the onset of the Great Recession, the Fed has exhausted much of its ammo as interest rates and bank reserve requirements are already at or near zero. Many believe that the Fed's “zero interest rate policy” is designed to push

investors out of cash and into riskier assets. In any event, what arrows are left in the ol' quiver? Not much except expanding the money supply, which brings us to QE2.

The Fed and QE2. St. Louis Fed President James Bullard said in a CNBC interview in mid-2010 that the prospect of long-term deflation is real. Hence, the Fed has been doing everything it can to avoid this. Several months ago, I read a paper written by Fed Chair Bernanke in 1999 while at Princeton. The paper discussed the Japanese deflationary crisis, which has now been entrenched for over 20 years, and what Bernanke would have done to resolve it. As I read, I compared his recommendations to the Bank of Japan and his actions here at home. The list was strikingly similar. Then it hit me—I was reading his playbook. However, there was one item on the list that Bernanke hadn't addressed as of that time: devaluing the dollar. Weakening the dollar creates the illusion that prices are rising. This is because when the dollar is weak, it takes more to buy the same goods and services. A weak dollar also makes imports more expensive—which is inflationary—and attracts foreign capital. The United States depends on foreign capital to buy U.S. government bonds which help finance government spending. Weakening the greenback would also allow us to pay down our debt with cheaper dollars. This is what is referred to as monetizing the debt. QE2 is designed to do exactly that. However, many other nations are also devaluing their currency, and since the value of a currency is measured in relative terms, our dollar has actually been strengthening recently. In any event, inflating the economy and stimulating demand is the Fed's goal and QE2 is the tool.

The Consumer and Demand. The growth of the economy

(continued on page 2)

BETTING ON THE BOND BUBBLE *(continued from page 1)*

is best measured by gross domestic product (GDP). There are four components to GDP: consumer spending, business spending, government spending and net exports. Consumer spending accounts for approximately 67% of GDP.

Consumers took a particularly nasty hit on multiple fronts with the recent financial meltdown as they watched the value of their homes plummet and their financial assets erode. This created a great deal of fear and, to a large extent, the consumer is still on the sidelines. Moreover, nearly 10% are unemployed. Business and industry is another part of GDP and although businesses have cleaned up their balance sheets (except for those holding a glut of high-risk mortgages), their reliance on the consumer cannot be overstated. Also, with demand weak and an uncertain tax environment, businesses have been somewhat reluctant to hire. Government, another component of GDP, has shown no timidity to spend, but we'll leave that for another time. Finally, a weak dollar would boost net exports which would add to GDP.

To boost GDP and avoid a deflationary scenario, the all-important consumer needs to start spending again. However, due to a record number of defaults, lenders have tightened their credit standards. Even though government has been lambasting lenders, should they lower their standards when that's the very thing that got them in trouble? In practice, lenders shouldn't be strong-armed into making loans to high-risk borrowers. In my opinion, a battle is raging between government and the private sector, especially banks. The government is attempting to punish banks by adding to their regulatory burden. The effects of this, however, will be felt by the consumer as banks will simply pass on these additional costs. Another illustration of unintended consequences? You decide.

So the challenge remains how do you stimulate demand and get the consumer back in the game? Inflate prices through a weaker dollar, that's how. If consumers believe that prices will fall, they'll wait to buy. If, on the other hand, they believe prices will rise, they will buy now rather than pay a higher price later. Of course confidence, which is low, plays a major role here. Now that you know my view, let's turn to a couple of bond managers for their analysis.

A Word from a Few Experts. I recently spoke with Ken Volpert, manager of the Vanguard Inflation Protected Bond Fund (VIPSX) and head of the taxable bond group at Vanguard. He believes that interest rates will rise over the next year and GDP will exceed 3% by the last half of 2011. His greatest concern is the fiscal austerity measures being implemented globally and here at home by state and local governments. States have a mandate to balance their budgets and so mandatory cuts appear inevitable. He also believes the U.S. government must address its longer term structural problems, but this author is not optimistic about that. His advice is to shorten maturities to less than five years.

I also sat down with Jeff Tanguis, manager of the Hancock Horizon Strategic Income Bond Fund (HHBAX). Mr. Tanguis

and I discussed the Fed's manipulation of the dollar through QE2 and how interest rates are artificially low. He believes that rates will be higher a year from now, but also expects a general rise over the next several years. His major concerns include a sluggish economy for years to come, high unemployment, and the possibility of stagflation like we saw in the '70s.

With this economic backdrop, let's turn our attention to the topic of fixed income securities.

FIXED INCOME

As I mentioned earlier, investors have flocked to this 'safe' asset class en masse in recent years. Are the best times for bond investors in the past? What are the risks to investors in this asset group?

Duration. In general, duration is a measure of the sensitivity of a bond's price to changes in interest rates and is expressed as a number of years. Although there are several variations, or types of duration, our primary focus will be on Macaulay's Duration.

Macaulay's Duration was named after Frederick Macaulay, who earned a Ph.D. from Columbia University, and measures the weighted average maturity of a bond. Macaulay's Duration may be further defined as the point at which the weighted maturities reach equilibrium. Think of it in terms of a see-saw. The see-saw, which is supported by a fulcrum, will be parallel to the ground when the weight is equally distributed on both sides. A typical bond will have a series of cash flows consisting of principal and interest over its term with the majority of its payment occurring at maturity. Therefore, the duration of a bond without periodic payments will always be higher when compared to a bond with a series of cash flows, assuming their maturities are identical. Let's look at an example. Consider a 10-year zero-coupon bond which is purchased at a discount and matures at par value. Hence, because there are no payments until maturity, its duration would be equivalent to its maturity of 10 years. Now let's assume a 10-year bond with a 6% coupon, paid semi-annually. In this case, the duration would be 7.66 years due to the fact that the investor will receive payments prior to maturity. At the 7.66 year mark, the investor would have received roughly half of his expected payment.

With a slight variation to Macaulay's Duration, Modified Duration can be useful in determining a bond's price sensitivity to changes in interest rates. However, it should not be used with callable bonds due to its imprecision with this type of issue.

Convexity. Convexity reflects the sensitivity of duration to changes in interest rates. A complete discussion is beyond the scope of this article, but I would like to make an important point about bonds with embedded options or call features, and non-callable bonds. As we are fully aware, bond prices move in the opposite direction of interest rates. Although this is true of most bonds, this is not the case with callable bonds. In short, when interest rates fall, the risk of the bond being "called away" increases. Therefore, its price does not rise as it would in the absence of call features. Callable bonds contain negative convexity which may be defined as a characteristic of a bond, when the

BETTING ON THE BOND BUBBLE *(continued from page 2)*

price appreciation is less than the price depreciation, for a large change in interest rates. Negative convexity is an undesirable characteristic.

WHAT HAPPENS WHEN INTEREST RATES RISE?

Which bonds will hold up best when rates rise again? In essence, the longer the duration the greater the price sensitivity. Let's begin by looking at the role a bond coupon plays in a rising rate environment. In Table A, we have three hypothetical bonds with the same maturity. Bond A is a zero coupon issue. Bonds B and C have coupons of 5% and 7%, respectively. As mentioned earlier, a bond without coupon payments (a zero coupon bond) has a duration equal to its term. Again, this is due to the fact that the entirety of the cash payments occurs at maturity. Moreover, because this type of bond has a higher duration, it will experience greater price depreciation when interest rates rise. Conversely, the higher the coupon rate, the shorter the duration, and a lower duration means greater price stability.

TABLE A
THE HARDER THE COUPON, THE GREATER THE CUSHION

Bond	Term (yrs)	Settlement Date	Maturity Date	Annual Coupon Rate	Security Price per \$100 Face	Redemption Value per \$100 Face	# of Annual Pmts	YTM	Duration	How much would the price fall if rates raise by:		
										1.00%	2.00%	3.00%
A	10	1/1/2010	1/1/2020	0.00%	\$70	\$100	2	3.6%	10.00	-10.00%	-20.00%	-30.00%
B	10	1/1/2010	1/1/2020	5.00%	\$100	\$100	2	5.0%	7.99	-7.99%	-15.98%	-23.97%
C	10	1/1/2010	1/1/2020	7.00%	\$100	\$100	2	7.0%	7.35	-7.35%	-14.71%	-22.06%

An additional component affecting the sensitivity of the price of a bond is its maturity date. Basically, the longer the maturity, the greater the price sensitivity. In Table B, there are three hypothetical bonds with differing maturities and identical coupons. Bond D has a maturity of five years, E is a 10-year bond and F matures in 15 years. Note that the longer maturity bonds have a higher duration and greater price sensitivity.

TABLE B
THE LONGER THE MATURITY, THE GREATER THE RISK

Bond	Term (yrs)	Settlement Date	Maturity Date	Annual Coupon Rate	Security Price per \$100 Face	Redemption Value per \$100 Face	# of Annual Pmts	YTM	Duration	How much would the price fall if rates raise by:		
										1.00%	2.00%	3.00%
D	5	1/1/2010	1/1/2015	5.00%	\$100	\$100	2	5.0%	4.49	-4.49%	-8.97%	-13.45%
E	10	1/1/2010	1/1/2020	5.00%	\$100	\$100	2	5.0%	7.99	-7.99%	-15.98%	-23.97%
F	15	1/1/2010	1/1/2025	5.00%	\$100	\$100	2	5.0%	10.73	-10.73%	-21.45%	-32.18%

A working formula for estimating the sensitivity of a bond's price to changes in interest rates is % Change in Price = Duration x Expected Rate Change

It should be mentioned that even though the price of a non-callable bond will tend to fall as interest rates rise, as a bond approaches maturity its price will move toward its redemption value.

CASH IN OR WAIT UNTIL MATURITY?

Another issue facing bond investors today is whether to hold bonds until maturity or sell them early. This is especially relevant as interest rates have plummeted and bond prices have risen. To find our answer, let's look at another set of hypothetical bonds in Table C.

All bonds have the same maturity, but differ in coupon and price. Bond I has a coupon of 5% and is priced at \$115 per bond. If this bond were priced at par (\$100), its yield to maturity

TABLE C

HOLD UNTIL MATURITY OR CASH IN EARLY?

Bond	Term (yrs)	Annual Coupon Rate	Security Price per \$100 Face	Redemption Value per \$100 Face	# of Annual Pmts	YTM
G	10	3.00%	\$103	\$100	2	2.66%
H	10	4.00%	\$108	\$100	2	3.07%
I	10	5.00%	\$115	\$100	2	3.23%

would equal its coupon. However, because interest rates have fallen since it was issued, this bond has experienced price appreciation and is now priced at \$115. Let's assume we are in year four of a 10-year bond. Its YTM over the next six years is 3.23%. At this point, if the investor sells the bond, his return (since issue) would be greater than 5%. Should the investor cash in the bond? It depends. If confidence is high that a return greater than 3.23% can be achieved over the next six years, then the answer is yes. If not, then it would be more prudent to hold the bond until it matures. If the investor holds the bond until it matures, the maximum price he will receive is par (\$100). Therefore, this may be a good time to capture gains.

Packaged Products or Individual Issues? Packaged products would include mutual funds and ETFs. There are a couple of additional risks when you invest in a bond mutual fund. First, there is dilution risk. This is the risk that as interest rates fall, the fund will experience net inflows and the manager will be forced to buy lower coupon issues. Another risk is redemption risk. This can occur when interest rates rise and the fund incurs net outflows as investors depart. The manager would be forced to cash in bonds to meet redemptions.

When is it appropriate to buy individual issues versus mutual funds? If there is sufficient cash and the type of bond is highly liquid, then individual issues may be suitable. With an individual issue there is the possibility of default. Moreover, when buying individual issues, you should buy them in large pieces in case you decide to sell prior to maturity. Even though a bond may be priced above par, say at \$115, a larger bond will likely bring a higher price than a smaller bond when sold.

Credit standards could remain tight for the foreseeable future as lenders work through their glut of foreclosures. This will put downward pressure on home prices which may have an emotional impact on consumer demand and stifle economic growth. Therefore, rates could remain low for a number of years. How does this correlate with the consensus that interest rates will rise over the next 12 months? Since interest rates have been artificially low and will vacillate to some extent, they may indeed rise in the short term, but I would expect a low-rate environment for quite some time. In addition, keep an eye on Europe, our dollar and the steps our government takes to address its long-term structural issues. Long-term structural issues...what do you think the odds are in Vegas on that?

Investing in mutual funds involves risk, including possible loss of principal.

An investment in Exchange Traded Funds (ETFs), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETFs involves additional risks such as not diversified, price volatility, competitive industry pressure, international political and economic developments, possible trading halts, and index trading errors.

DODD-FRANK FALLOUT



While the Dodd-Frank Wall Street Reform and Consumer Protection Act will ultimately result in a benefit to consumers, it is something of an albatross for smaller broker/dealers already faced with the increased regulatory standards and rising costs of today's

financial environment. Some broker-dealers will find it difficult not only to remain in compliance, but to stay in business at all. And many of these firms have been in business with clean records for more than 20 years.

"This is perilous compliance territory," says Lisa Roth, CEO of Keystone Capital Corp., a retail and institutional brokerage in San Diego. "Changing rules result in a lot of misunderstanding and ambiguity. It will take time and a good amount of revision to the new laws until they are logical and fully functional."

Here are some of the specific challenges for broker/dealers posed by Dodd-Frank and other new regulations:

Changing FINRA rulebook. The new regulatory landscape created by FINRA's changing rulebook, which is partly the result of the Bernie Madoff scandal, impedes broker/dealers' ability to remain in compliance. Sometimes even the smallest nuances in the rulebook can have major repercussions for the broker/dealer. In some cases, changes mean that business transactions that were once 100% by the book suddenly are no longer compliant. In several instances, according to Roth, FINRA has assessed the risks associated with particular products after receiving significant customer complaints, and determined industry compliance standards in hindsight. To respond to the changing rules, broker/dealers have to prove the exact timing of particular transactions in order to prove they were compliant under the set of rules in place at the time of the transactions. This is confusing, time-consuming and often expensive for broker/dealers who suddenly are forced to change the way they've been doing legitimate business for many years.

Fiduciary standard. It's no secret that the financial community is divided in its opinion about whether to extend to brokers the fiduciary duty that now applies to investment advisers. Many insurance company broker-dealers may no longer be able to survive if the fiduciary standard is extended to their representatives. This is because many insurance company broker/dealers with captive agents simply do not have the diversity of product lines necessary to comply with a fiduciary standard.

Expanded authority of regulators and agencies. Dodd-Frank expanded the authority of state regulators, raising the threshold for state jurisdiction of investment advisers to assets under management of less than \$100 million, from the previous level of under \$25 million. The issue with expanding state regulatory authority is that states don't have a compliance oversight plan for audits. For broker/dealers with smaller compliance staffs and advisers registered in multiple states, regulating those advisers using different sets of rules is a daunting task.

PCAOB-expanded authority. Dodd-Frank also mandates that all broker-dealers must now be audited by a "PCAOB" (Public Company Accounting and Oversight Board)-registered audit firm, creating yet an additional expense for broker/dealers. Using a PCAOB-registered firm is costly. For smaller firms, this can be the difference between paying \$2,200 and \$10,000 for an annual audit. And for firms in more remote areas of the country, PCAOB-registered auditors can be scarce to non-existent, driving costs up even more.

Increased SIPC assessment fees. In 2009, as a direct result of the Bernie Madoff and other scandals, the Security Investor Protection Corp. (SIPC) increased its assessment fees, implementing a new fee schedule of 0.25% of net operating revenue, a switch from its original \$150 flat fee. Large and small broker/dealers alike have struggled with the exponentially increased fees, especially difficult when first implemented in 2009 when revenues were down. Many companies are in fact still recovering from the initial blow they received in 2009.

Nebulous jurisdiction of investment advisers. With three different alternatives on the table for strengthening oversight of investment advisers, the industry is left somewhat in a lurch. Broker-dealers need to be able to prepare for a single set of laws so that they can put solid and longstanding processes and systems in place to remain in compliance. The current ambiguity makes it extraordinarily difficult for broker/dealers to anticipate whether legitimate actions today can put them out of business tomorrow should the rules change. Keeping up with and ensuring compliance of even just the current regulations can be a full-time job even for a fully staffed compliance team, and many smaller broker-dealers simply do not have that kind of staff.

What's a broker-dealer to do? Large firms may have the luxury of building robust compliance and operations staffs that are equipped to evaluate new policies and implement appropriate procedures in response to changing regulations. Yet smaller firms without that kind of staffing may be unequipped to handle a high volume of regulatory changes, and may suddenly fall out of compliance, without even knowing which rulebook to follow to determine an appropriate solution. Industry trade associations often offer support and education on the issues. Associations such as the Third Party Marketers Association (3PM), the Financial Services Institute (FSI) and the National Association of Independent Broker Dealers (NAIBD) can be extremely helpful allies, and in turn, need solid membership bases behind them to achieve their goals. Broker-dealers need not feel completely alone in navigating through today's difficult and changing environment.

Still, for the smaller broker/dealer, increased regulation and rising fees may make it difficult to stay in business. We are finding that for many, the struggle created by new regulations can tip the risk/reward equation too far off the charts. In some cases, it may mean selling assets and/or becoming an OSJ at a larger firm and transferring the burden of compliance. The changing landscape for broker/dealers means that increasingly, firms may need to evaluate their alternatives.

MORE EMPLOYERS OFFER HELP MEETING RETIREMENT GOALS

Automation, advice are popular ways to help employees with retirement saving

A survey released Wednesday by Aon Hewitt found employers may be trying to save employees from themselves. The human resources consulting firm found 38% of employers are confident that their employees are taking **accountability for their financial futures**, less than the 43% of employers with the same concern in 2010. Furthermore, only 30% of employers say they're confident that their employees are prepared for retirement.

To counter employees' perceived apathy toward retirement, employers are adding features and changing plan designs to encourage savings. Plans offering **automatic enrollment** increased to 57% in 2010, up from just 24% in 2006. Of plans that don't offer automatic enrollment, 36% say they'll probably add it in 2011. Escalation use increased as well; 47% of plans automatically increase employees' contributions, up from 17% in 2006, and 26% say they'll likely add it in 2011. Almost half (49%) offer automatic rebalancing, and one-third are considering adding it this year.

The survey noted that workers who invest in **401(k) plans often have "suboptimal" investing habits**, including a poorly diversified portfolio and inappropriate risk. Fifty-six percent of employers offer online investment guidance, and 36% offer online investment advice and managed accounts. **Target-date funds** are especially popular, offered by 83% of employers. More than one-third of employers offer a **Roth 401(k)**, and 38% of those who do not say they'll add one in 2011. Of the 23% of employers who suspended or reduced matching contributions to retirement accounts in the past two years, 55% say they have already reinstated it; 18% say they will reinstate or increase the match in 2011. Additionally, 11% say they will reinstate or increase the match in 2012.

"Amid the recent market volatility there has been a dramatic difference in outcomes among people who sought out investment assistance versus those who have not," Pamela Hess, director of retirement research at Aon Hewitt, said in a statement. "Employers are seeing the disparity and realize they need to step-up their efforts to ensure workers are saving adequately for retirement and have an investment

strategy. At the same time, companies acknowledge the diverse needs of the workforce and understand that they need to offer a variety of investment advisory tools to meet the various needs and savings habits of their employees."

Employers are also focusing on the **importance of managing income** throughout retirement. Sixty-one percent of employers offer online modeling tools to help employees map their retirement spending. Nineteen percent facilitate annuities either through their own plans or with an outside provider, and 13% plan to add an in-plan retirement income solution in 2011, including managed payout funds, managed accounts with drawdown feature and annuities.

"We expect an increasing number of companies to assess the marketplace and begin adopting new services and products, such as managed payout funds, managed accounts with drawdown feature and in-plan annuities," Hess said.

The costs associated with retirement plans aren't lost on employers, though. Eighty-five percent of companies said they will review their **defined-contribution** operations in 2011, including expenses and revenue sharing. Forty-eight percent said they will review the total plan cost

more often or more thoroughly and 69% said they will increase communication with employees about investments and plan fees.

Three-quarters of **pension plan sponsors** said they don't anticipate any plan changes in 2011, but more employers are planning to freeze or close defined-benefit plans. Sixteen percent of employers say they will freeze accruals in 2011, and 13% of employers who have offered plans to new hires will stop doing so.

Almost two-thirds (65%) of employers offer prescription drug coverage to retirees 65 and older, and file for the **Medicare Part D Retiree Drug Subsidy**. In 2013, though, when the health care reform law eliminates the tax-free nature of the Medicare Part D subsidy, just 53% of companies plan to continue that strategy. Seventy percent of employers said they provide some type of post-retirement medical coverage for current or future retirees.

The principal value of a target date fund is not guaranteed at any time, including at the target date.

By Danielle Andrus • Investment Advisor, March 2011

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