Income And Safety In Today’s Investing Environment

Executive Summary

Modern financial theory holds that a small number of investments may offer both the possibility of return, along with almost no risk that investors will lose their money. Historically in the U.S., investors have viewed the 90-day U.S. Treasury bills as this “risk-free” investment for several reasons. These securities are backed by the full faith and credit of the U.S. Treasury. In addition, the market for U.S. Treasuries is one of the largest and most liquid in the world, so investors who want to sell their holdings can typically find a buyer. Finally, the short maturity limits investors’ exposure to potential price drops due to rising interest rates. Using these securities as a benchmark has allowed investors to effectively evaluate the relative risk and rewards of other investments.

Unfortunately, over the past five years, yields on U.S. Treasuries have dropped from just under 5% to well below 1%. Yields have fallen so precipitously that they expose investors to a potential risk that inflation will overtake the income that is being earned. Recently, inflation has been running around 2%, as measured by the Consumer Price Index (CPI), excluding food and energy. As a result, inflation is frequently outpacing the yield on the ten-year U.S. Treasury bond, which has generally been yielding in a range of 1.75% to 2.25%. Rather than providing a risk-free return, in our view, U.S. Treasuries instead offer what might be considered “return-free risk.”

We believe that in order to keep pace with inflation, investors may want to evaluate the use of other types of investments that have historically been considered to be relatively safe. Many of these alternative investments may offer the potential for higher yields than U.S. Treasuries currently provide. Among the options available are certificates of deposit, government-sponsored mortgage-backed securities, private commercial real estate loans, dividend-paying stocks, corporate debt, and some insurance products.
Rethinking risk and safety

With U.S. Treasury bond yields at historically low levels, many investors who traditionally relied on Treasuries are now looking for other investment options that may provide greater yield, yet still may be considered relatively safe.

This requires slightly rethinking the traditional view of risk. Historically, investors may have paid less attention to inflation risk as they evaluated different investments, instead concentrating on credit, liquidity, and other types of risk. However, in light of the minuscule yields currently offered by U.S. Treasuries, investors are advised to consider all types of risk, including inflation risk, when deciding how to allocate their investment dollars. As an example, the 30-day Treasury yielded about 5% in November 2006 versus 0.03% in November 2011. As a result, Treasury bonds expose investors to greater levels of inflation risk than they did five years ago.

Typically, investments that carry higher levels of some types of risk — for instance, corporate debt that is rated below investment grade due to its level of credit risk — provide higher yields. The issuer of the security offers more yield in order to entice investors to take on greater credit risk. Similarly, investors may be rewarded with higher yields for purchasing a longer dated bond from the same institution. While two bonds with differing maturities can carry the same credit rating, those with longer maturities may expose investors to greater levels of interest rate, duration, and market risk.

Today, the principle of higher returns for greater risk still applies. However, because the yields on all maturities of U.S. Treasury bonds have dropped dramatically over the past few years, investors should pay greater attention to inflation risk than they might have in the past, while still considering other types of risk as they determine their investment strategy. With the Treasury curve continuing to flatten and the ten-year Treasury seemingly anchored in a 1.75%-2.25% range, the reach for yield has now taken on a much longer term dimension. Investors may now need to consider adding five or more years of maturity just to pick up an additional 1% in yield.

Factors driving low yields

Several economic forces are converging to hold down yields on U.S. Treasuries. As a starting point, all sectors of the economy, including households and businesses, have engaged in “deleveraging,” or have taken steps to reduce their levels of debt. For instance, according to Federal Reserve statistics, between the second quarters of 2006 and 2011, the average ratio of mortgage and consumer debt payments to disposable personal income per household dropped from 13.78% to 11.09%, and business borrowing declined from $880 billion to $434 billion.

Of course, reducing debt and stockpiling cash may be a prudent step for many households and businesses to take. However, at a macro-economic level, deleveraging can constrain growth. Rather than purchase a new car or invest in equipment — both of which contribute to the growth of the overall economy — households and businesses appear to be using their funds to cover payment obligations on purchases already made.

In contrast to the debt slashing which occurred on the part of many individuals and businesses, the federal debt in the U.S. continues to rise. As of November 2011, the U.S. Treasury calculated the U.S. debt at approximately $15 trillion, which is roughly 99% of the approximately $15.2 trillion in U.S. Gross Domestic Product (GDP). A 2010 report by the

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European Central Bank, “The Impact of High and Growing Government Debt on Economic Growth,” concluded that “Above a 90%-100% of GDP threshold, public debt is, on average, harmful for growth.”

The U.S. Bureau of Economic Analysis reported the economy grew at annual rate of just 2.0% as of the third quarter of 2011. At the same time, according to the Bureau of Labor Statistics, the unemployment rate in the U.S. remains stubbornly high.

The combination of slow growth and higher than average unemployment prompted the Federal Reserve (the Fed) to state in August 2011 that it would leave interest rates at their current level, between 0% and 0.25%, through the middle of 2013. On September 21, 2011, the Fed announced that it would purchase $400 billion of Treasury securities with remaining maturities of between six and 30 years. At the same time, it would sell its holdings of securities with maturities of up to three years. These transactions, which are scheduled to be completed by mid-2012, are intended to “put downward pressure on longer term interest rates and help make broader financial conditions more accommodative,” according to the Fed.

Another reason for the historically low rates appears to come from investors’ desire for potentially safe, quality investments, given the uncertainty in the global economy. Some investors fear an economic slowdown, which could impact the performance of companies and their stock prices. Some worry about the economic strength of other countries. As a result, investor money has been flowing into U.S. Treasuries which are seen as offering safety and quality. The strong demand for these securities drives up their prices and pushes down yields.

**Other investment options**

Given this outlook, we recommend investors consider expanding their pool of potential investments to include securities that are reasonably liquid and may provide higher yields, which could help reduce the levels of inflation risk that Treasuries currently offer. While these investments may offer higher yields, they shouldn’t be considered risk-free substitutes for Treasuries. However, it’s important to weigh all of the potential risks of these securities against the risk of short-term Treasuries, where even slight levels of inflation are likely to exceed yields.

**Certificates of deposit:** One investment strategy that may offer a slight uptick in income, without taking on much higher levels of risk, is to invest in certificates of deposit (CDs) across a range of maturity dates. This is often referred to as a “laddering” strategy.

Assume an investor has $100,000 to invest, and would like the slightly higher income potential that accompanies CDs with longer maturities, but doesn’t want to tie up funds for several years. In addition, the investor would like to take advantage of future rises in interest rates. To achieve these goals, the investor can allocate funds in $25,000 increments across four differing maturity years, essentially purchasing a “ladder” of maturities beginning at one year and ending at five years.

When the first CD comes due in one year, the investor can reinvest in another five-year CD, potentially capturing a higher rate from the longer maturity. Because the investor is one year into this investment strategy, access to the $25,000 two-year CD will occur in just one year.

While CDs are considered safe investments, they do carry some counter-party or institutional risk. If the financial institution behind them runs into trouble, funds may be protected only up to the maximum level of insurance offered by the FDIC. CDs have a maturity date and if money is withdrawn prior to this date, investors may be penalized with a fee.

**Government-sponsored mortgage-backed securities:** One option for investors who would like to remain invested in instruments that are affiliated with the federal government, yet may provide an opportunity for greater yield, is to purchase mortgage-backed securities (MBS) issued by government corporations or entities.
An example of a government corporation is the Government National Mortgage Association (Ginnie Mae). In addition, examples of government-sponsored enterprises (GSEs) include the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), which were created by the U.S. Congress to provide loans to specific groups of borrowers, such as homeowners. While these institutions are linked to the federal government, and their debt has historically been considered by many to be safe, they may not carry a government guarantee, unless one is explicitly stated.

The Government National Mortgage Association (Ginnie Mae) is one example of a government sponsored entity that is backed by the full faith and credit of the U.S. government. Most of the mortgages securitized as Ginnie Mae MBS are those guaranteed by the Federal Housing Administration (FHA). It is generally accepted that the U.S. government will never default on its loan obligations. Similarly, securities backed by Ginnie Mae mortgages have lower yields than other mortgage-backed securities because they are assumed to carry less risk.

On the other hand, GSEs carry the implicit backing of the U.S. government, but they are not direct obligations of the government. For this reason, these mortgage-backed securities may offer a yield premium over Ginnie Mae MBS. However, all government-sponsored mortgage-backed debt carries an identical credit rating to U.S. Treasuries, whether the government guarantee is explicit or implied. The yields provided on these securities are currently substantially higher than those of U.S. Treasuries. Mortgage-backed securities generally yielded 3% more than similar duration Treasury bonds throughout 2011.

Most of the risks associated with government-sponsored mortgage-backed securities revolve around cash flow. This can vary every month as mortgage holders can refinance or pay off their loans early. When rates are declining, borrowers in the pool may refinance, and investors may have difficulty replacing the lost yield in a lower interest rate environment. Conversely, when rates are rising, borrowers may keep their existing loans for an extended period of time, locking the investor into potentially lower yields than what new investments are offering in the higher interest rate environment. In addition, if an investor owns the individual securities, it is possible that the payment received will include a portion of principal. Thus, at maturity there may not be any principal left to invest.

We encourage the use of a fund strategy that reinvests all returns of principal into other mortgage-backed securities. This allows the ability to maintain adequate principal levels while enabling investors to receive yields that change with the current rate environment, potentially reducing interest rate and prepayment risk.

**Private commercial real estate loans:** Investors who are able to accommodate lower levels of liquidity may want to consider investing in a package of private commercial real estate loans. Investors need to be aware that there is the potential for the borrowers to default on the underlying loans. However, as the loans are collateralized by the properties behind them, these investments tend to provide a favorable trade-off between risk and reward, along with the potential for significant income generation in the range of 6%-8%, according to Investors Diversified Realty (IDR), and very low duration risk.

A level of caution is warranted as these securities are typically only available to sophisticated investors as private placements. As a result, investors’ funds are often accessible only on scheduled dates, such as monthly or quarterly.

Because direct real estate investments are illiquid, times of low demand or usage typically depress market values of properties, making exit, or liquidity, opportunities unattractive. However, while liquidity is a benefit to investors during normal periods, periods of technical or mass selling often lead to prices which may be much lower than the actual value of the property.

**Dividend-paying equities:** Quality domestic companies that pay dividends may carry greater market risk, yet can provide a higher rate of income than U.S. Treasuries. This can be seen by examining the dividend yield, which is calculated by dividing the annual amount of dividends the security offers by its share price. While dividend yields of the S&P OEX 100 Index have been gradually increasing over the
last ten years, Treasury yields have been declining. This has created a tipping point where dividend yields are frequently outpacing Treasuries. Between January and August 2011, 243 companies in the S&P 500 increased or began paying dividends, while only four cut their dividends. Many businesses, having cut back on expenses, have accumulated large cash reserves. As well as rewarding shareholders, executives see dividends as an effective tool in generating additional investor interest in their company.

Corporate debt: Corporate debt may offer investors the opportunity for safety along with the potential for solid income generation. A comparison of many companies’ debt-to-revenue ratios with different countries’ debt-to-GDP ratio shows that many companies carry a lower level of debt than the countries in which they’re located. For instance, U.S. companies rated A+ by Standard & Poor’s have an average debt-to-revenue ratio of 42%, which is less than half the current U.S. debt-to-GDP ratio of 99%, according to data from FactSet. While these companies may carry proportionately less debt, their corporate debt could provide higher levels of income.

Corporate bonds do carry some risk that the company behind the issue will default. According to Moody’s Investor Services report, between 1920-2010 the average risk of an investment-grade company defaulting is about 0.15%.

High yield: Investors able to bear a somewhat higher level of volatility may want to consider allocating a small portion of their portfolios to high yield corporate debt, or debt that is below investment grade. High yield corporate debt has been yielding around 8% versus less than 5% for investment grade corporate bonds, according to Bloomberg.

Of course, investing in high yield corporate debt carries a greater risk that the company behind the issue will default. Between 1920-2010, the average risk of a below investment grade company defaulting is about 2.78%, according to a study by Moody’s Investor Services. Investors should consider utilizing an actively managed strategy to increase diversification, which can reduce the impact of any single default in the portfolio.

Insurance products: Investors who would like some assurance that they won’t outlive the income generated by their investments may want to consider instruments like deferred annuities. An annuity is a contract between an individual and an insurance company. The individual agrees to make either a lump sum or series of payments to the insurer, and in exchange, the insurer agrees to make periodic payments to the individual. A deferred annuity, as its name implies, is an annuity contract that delays the income payments until the investor decides to receive them. Earnings on a deferred annuity account are taxed only upon withdrawal, which may provide certain investors with a tax benefit. This type of annuity also provides a death benefit, so the
beneficiary of the annuity is guaranteed the principal and the investment earnings, dependent upon the insurance company’s financial condition at the time of the insured’s death.

While annuities can provide potential safety and peace of mind, this typically comes at a cost. The rates of return, while predictable, tend to be lower than those on other investments. In addition, once you’ve invested in an annuity, those funds generally aren’t available for other uses. One final risk to consider is that should the insurance company become insolvent, the principal would not be guaranteed.

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**Conclusion**

In our opinion, investors should re-evaluate their definitions of risk as the combination of record low interest rates and increasing inflation may gradually decrease the time value of money in portfolios. We believe that investors who are searching for greater income than what is currently available through U.S. Treasuries, yet who are also looking for investments that vary in terms of their risk profiles, have a number of options available to them. These include certificates of deposit, government-sponsored mortgage-backed securities, private commercial real estate loans, dividend-paying equities, corporate debt, and some insurance products.

As investors consider various investment options, it’s important to keep in mind that a carefully designed asset allocation strategy may play a significant role in determining long-term wealth accumulation. Investors may wish to consider a thoughtful plan that accounts for risk and reward preferences. Determining which of these strategies to implement and how much to allocate to each strategy, can be enhanced by consulting the investment professionals in The Private Client Reserve of U.S. Bank. Our portfolio managers have experience with many types of securities and markets, can leverage a broad platform of appropriate investment strategies, as well as access state-of-the art research tools to help inform their investment recommendations.

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**There are a number of options to help achieve income and safety goals.**
**Types of Investment Risk**

An investor’s examination of potential investments should include a thoughtful evaluation of the various types of risk, including liquidity, volatility, and credit or default risk, as well as the risk of diminished yield to inflation.

In investment theory, risk is the likelihood that an investment’s return will differ from expectations. In practice, investors usually concentrate on the risk of a decline in an investment’s price; prices that are higher than expected tend to be viewed positively. Among the types of investment risk are the following:

**Credit or Default Risk:** This risk is the probability that the issuer of a bond is unable to meet its obligations to make principal or interest payments as they come due. If that occurs, the issuer may default on its outstanding debt.

**Duration Risk:** This risk measures the change in the price of a fixed income security resulting from a 1% change in interest rates. Generally, securities with longer maturities are more susceptible to duration risk.

**Inflation Risk:** The risk that rising prices will cause an investor’s future asset values to be worth less than they would be today. Bond investors also can be hurt when inflation leads to higher interest rates, causing the price of their bond holdings to drop.

**Interest Rate Risk:** With bond investments, this risk identifies the likelihood that interest rates overall will rise, leading to a drop in the price of the bonds investors already hold. This risk is particularly acute when yields on Treasury securities are at historic lows. When U.S. Treasuries yield 1%, investors require five years to recoup their initial investment if rates rise 1%. Conversely, when the yield is 5%, investors can recover from a 1% rise in rates in just one year.

**Liquidity Risk:** The risk that a seller of a security is unable to easily find a buyer. This may compel the seller to hold on to a security longer than he or she would prefer, or to significantly drop the price in order to entice buyers. Liquidity risk can also be that funds are tied up for a specific period of time, resulting in an inability to access those funds when needed.

**Market Risk:** The risk that the overall stock or bond market will drop, potentially bringing down the value of individual securities, as well.

**Institution or Counterparty Risk:** This risk contemplates the likelihood that an institution with which an investor is doing business fails to uphold its side of a contract. For example, a financial institution that can’t accommodate an investor’s desire to liquidate his or her account in a timely matter.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. Investment in fixed income debt securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer term debt securities. Investments in asset-backed and mortgage-backed securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Before purchasing a certificate of deposit (CD) investors should understand all terms and carefully read any disclosure statements. CDs have a maturity date and if money is withdrawn prior to this date, investors may be penalized with a fee. Investors should also confirm the interest rate that will be paid and at what interval payment will be made. Investments in real estate securities can be subject to fluctuations in the value of the unerlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties (such as rental defaults). Investments in private equity are illiquid by nature and typically represent a long-term binding commitment. The investments made by private equity funds are not readily marketable and the valuation procedures for these positions are often subjective in nature.

Past performance is not a guarantee of future results. Indexes mentioned are unmanaged and are not available for investment. The S&P 500 Index is a capitalization weighted index of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general. The S&P 100 OEX Index is a market weighted index of 100 stocks from a broad range of industries.

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