Full Circle
FINANCIAL INC.

March, 2013

Dear Valued Clients,

When last I wrote to you, I addressed the underlying reason why equities have so terribly underperformed relative to what we experienced in the previous 18 years (1982-2000). Excessive valuations and frothy buying of securities can skew portfolio performance in very harmful ways. As the last piece, illustrated excessive valuation will ultimately lead to a readjustment to a more reasonable valuation of the securities.

Over the last 6 years, the flow of money has been a torrent, of safe haven seeking investor refugees, into the comparative safety of bonds. Stung by the paltry equity performance and the seemingly unending losses in our portfolios, combined with the endless doom and gloom narrative from countless numbers of sources, these securities have provided positive returns. The most fearful, have put their money in a mattress, otherwise known of as a short term GIC. There you have gotten returns in the 1-3% range, which after taxes and inflation means you lost money. Of course when someone looked at their statements the “not as bad as” argument may have ensued. As an advisor, I have recommended this strategy of placing a portion of your investments in bonds and cash. For the most part, it has done what it should do, provide steady returns, with much lower volatility and perhaps a full measure of peace. Any survey of the investment returns would show over the last 6 + years a very nice gain, which felt good.

Like everything in investing, all good things come to an end. The same over-bought excessive valuation that affected equities can just as easily affect bonds, real estate or any asset for that matter. In my last letter, I talked about the number of bubbles which have formed and burst in the last decade or so. To refresh, Tech Stocks and Housing should come to mind. They typically form when the past performance illustrated a consistent positive result and momentum builds to the point where the underlying numbers no longer are relevant to the buying decision. Justification for these purchases generally follow several lines of reasoning; “this time it’s different”, or “there is a new paradigm” or there is some documented extrapolation of demand, or last, but not least, “this asset has gone up for a long time and will continue. Those who have missed out on the initial positive returns do not want to miss out again. The motivator can be driven by greed or fear. The investment effect is the same, demand exceeds supply and the price goes up.

In a conversation I had recently with a money manager, he opined that Ben Bernanke US Federal Reserve Board Chairman was driving investors up the risk curve. The Federal Reserve through their monetary stimulus actions have driven down interest rates and more importantly the return you should expect as investors for the long-term commitments you are making when buying bonds. Make no mistake, without this action; the effects of the financial crisis of 2008/2009 would have been disastrous. As a result there has been a massive move to safety. In this period of time the Investor mindsets have evolved from Risk Awareness through Risk Aversion to Risk Avoidance (Cap. Int’l). The Excessive Fear Trade can be just as ruinous as the Excessive Greed Trade. Consequently, I believe we have another bubble forming: Bonds. The world is awash in low interest rate debt.

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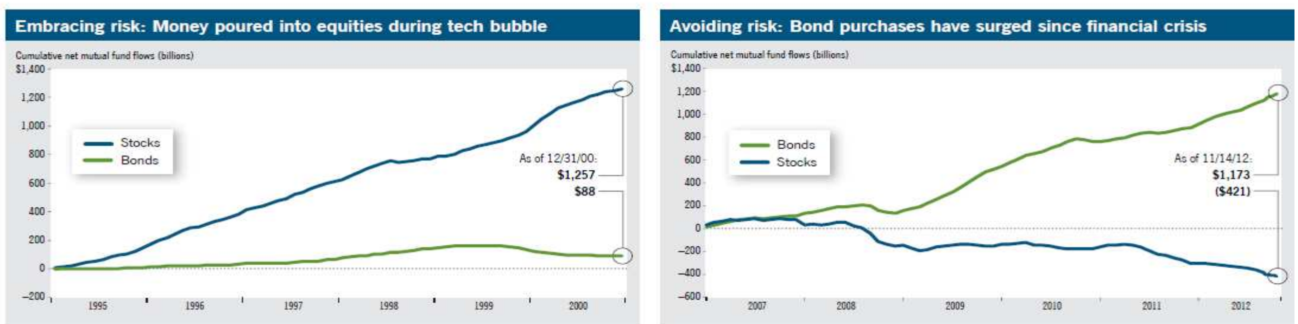
Debt, which has been driven, up in price and down in yield. Yields, which are in some cases so low that the return is actually negative. There are trillions of dollars of government bonds and investment grade corporate debt, which barely equal inflation as a return on investment. US Treasuries in 2009 had a coupon of 2.78% for 30 years. Does anybody think that 2.78% for 30 years would represent good value for 30 years worth of investment commitment? And yet the investment flows into bonds in all their iterations has been overwhelming. As the following graph will illustrate the amount of money that has been invested in bonds since 2008 approximately mirrors the amount of money, which went into Tech Stocks at the end of the 90's and early 2000. Do I have to remind you of how that one ended.

From one extreme to another

The pendulum has swung from manic to panic



Sources: Strategas Research Partners and Investment Company Institute. Data represent flows into mutual funds. Stocks reflect flows into domestic capital appreciation and total return funds as well as world equity funds. Bonds reflect flows into both taxable and tax-exempt funds, including corporate, high-yield, world, government, strategic income and municipal bond funds (both state and national).

I would like to thank the investment folks at Capital International for these graphs and the permission to pass them along to you as well as the above reference to the Risk. They are one of the truly good global investment companies available today. This said; please do not infer that Capital International is making a market call on bonds. This is just a factual representation of investment flows.

If there is something which causes me concern, this is it. I can think of positive and non-tumultuous ways this can be unwound. Experience tells me otherwise. I will not outline how I think this will unfold. My immediate concern is that percentages of the investment community, looking at the metrics on low risk bonds, will conclude there is no return available. They will, as I am now, advocate for change. Thus will start the move. As the bi-line for this letter states, "I'd rather be early and wrong, than right but late! The following recommendation is not something I have arrived at in the blink of an eye. I've wrestled with your concerns over risk and your need for consistent return. I think the following prescription will prove beneficial. I would like to materially reduce fixed income positions. I would like to cut in half the exposures you have at a minimum. For those of you who are retired and relying upon your portfolios for current income, my sense would be to seek out Dividend Funds and continued exposure to High Yield Debt with an emphasis on Emerging Market Debt. Also I would like to take a position in Convertible Debt. This latter product is essentially a Corporate Bond Fund with the right to convert the corporate bond to stock with the company, at an agreed upon price. Lastly, I would like to increase both US and Global Equity positions including Emerging Markets. By definition, this will result in a decrease in my recommended exposure to Canada.

As I wrote in my last letter, equity values on a P/E basis have contracted to the point where they represent reasonable historical value. On a relative risk basis, I think they are less risky than bonds. Further, a good well run and profitable company is producing a dividend yield similar to or better than a corresponding bond and the taxation on dividends is lower than on bonds. Thus, the net after tax return is better.

I hope this letter has been helpful. **These moves will take a fair amount of time and I cannot make any change to your portfolio without your approval. If you agree, please don't hesitate to write or call. I will endeavor to contact you in as timely a way as possible.**

As always, thank you for your trust in my advice.

Sincerely, Kevin

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