THE RUDD COMMENTARY

{ FEBRUARY 2011 }

We are excited to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

THE YEAR OF TRANSITION

Our children will surely look back on 2010 as a notable year in American history that will serve as a worthy benchmark for study in many disciplines. Some of the major headlines of the year included a tragedy in Haiti, the oil spill in the Gulf of Mexico, a debt crisis in Europe, and the infamous "flash crash". All of this was followed by an enormous shift of power in the U.S. Congress and a script change in White House policy. From a financial perspective, 2010 was the year of transition and should be contemplated seriously by all and without presumption.

Performance during 2010 was quite strong with most asset classes posting very strong gains. For the year, the stock market was up 15.1% total return as measured by the S&P 500 with developed and emerging foreign stocks posting gains of 8.2% and 19.2% respectively as measured by their respective MSCI indexes. Bonds had another strong year as referenced by their respective Barclays indexes until the fourth quarter when treasuries and municipals experienced a massive sell off sending mutual fund investors rushing for the exits. Corporate bonds performed well for the year gaining 9.0% with high yield up 15.1%. Treasury and municipal bonds got hit in the fourth quarter, losing -2.6% and -4.2% respectively, but were able to finish the year positive at 5.9% and 2.4%. Commodities continued their bull run with the spot price of gold posting its tenth consecutive year of gains up 29%, while agricultural commodities began to move higher toward the end of 2010.

LOOKING FORWARD: MIND THE GAP

The most significant issues in 2011 may not be as visually spectacular as those in 2010. As the economy moves from recovery to expansion, traditional concerns over such things as asset allocation, managing bond duration and a focus on taxes may become secondary to what could have a much more meaningful long-term impact on our portfolios; the powerful economic and political transitions presently underway. As investors make decisions to step back into the market or change their direction, be it in bonds, stocks, or alternative investments, they should pay special attention to these areas of transition or risk losing an appendage during the process. Therefore, I believe investors should mind the following points during 2011.

▪ **Interest Rates:** ***The End of an Era***

One of the most important variables to consider when looking forward will be rising interest rates. Most investors probably don't realize that interest rates have been declining on average for the last 30 years. If this era of falling rates has just ended, which I believe it has, investors should mind how this very important transition will affect their returns. Since 1981, falling rates have promoted a very accommodative environment for bond investors and the economy as a whole by creating an upward bias for bond returns and inexpensive capital for businesses and consumers. In the fourth quarter of 2010, the Fed's latest attempt to hold longer term interest rates artificially low had little effect. The recent sell off in bonds has again reminded us that the market will price loans (even government bonds) according to perceived risk, inflation expectations, supply/demand, and bad government policy. Investors should therefore reacquaint themselves with fixed income investments and how they respond to a rising interest rate environment. Such review will invariably prompt many investors to shorten their bond maturities and look for ways to take advantage of rising rates through investments that have the ability to increase income payouts over time. Investment strategies should also be managed more actively from a credit risk and after-tax total return perspective, which might encourage some investors with larger portfolios to prefer professionally managed individual bond strategies over lower priced alternatives that mirror an index.

▪ **Inflation:** ***A Thief in the Night***

Recently, the deflationary scare has subsided and a renewed focus on inflation has surfaced. According to the Bureau of Labor Statistics, prices rose by only 1.5% during 2010, which is below average and an indication that the Fed may hold short-term interest rates low until businesses begin to hire again. However, the latest monthly figures indicate that we may begin to see prices increase in the very near future. In December, consumer prices increased 0.5% during the month with producer prices increasing 1.1%. While the increases were largely the result of an increase in energy prices, they were still ahead of economist's consensus estimates which it seems caught the bond market by surprise at the time of this writing. While I am not predicting a drastic inflationary increase during 2011, it is important for investors to realize how

THE RUDD COMMENTARY

{ FEBRUARY 2011 }

damaging even modestly high inflation can be to investment portfolios and the economy. The inflationary spike of the 1970s did significant damage to the world economy and had long-term consequences, including the anti-inflationary policies that still loom today. Investors should be aware that inflation does not always appear with all the pomp and circumstance as many market variables, but comes like a thief in the night, eroding the value of interest payments, principle and company profits in a slow, incremental fashion.

▪ **Municipal Bonds:** ***Details that make the Difference***

Municipal bonds have received negative media attention over the past few months due to concerns over enormous budget gaps and rising underfunded liabilities to state and local government employees. Most of these problems have been a result of overly optimistic long-term growth forecasts over the last twenty years for both tax revenue and pension fund returns. Going forward, benefits and services will need to be cut if budgets are to balance and modifications will have to be made to pension plans if retirees are to be paid. Until this rebalancing act is confidently underway, we could see increased municipal defaults, but they should be concentrated among small, unrated securities with limited revenue sources and/or a smaller tax base.

However, despite all the negative noise surrounding the municipal bond market, there are a few key facts to consider that help put these securities in their proper place when compared to other fixed income investments. First, unlike corporate bonds, most municipal bonds are either secured by the taxing power of the issuer on income, sales or property values or backed by a dedicated revenue stream such as net revenues from water/sewer services. Another unique characteristic of municipal bonds is that municipalities are absolutely dependent on individual investor's (as opposed to institutions) willingness to loan them money for virtually every major project they undertake. Finally, it is much more difficult for municipalities to use bond default as a strategic option as corporations sometimes do, and at the time of this writing, states are not able to declare bankruptcy. These subtle, but important differences in municipal bonds create a unique borrower/payer relationship that has lead to a positive position for bondholders in troubled times as we see municipal employees and services cut before bond interest payments. This has translated into a very low percentage of municipal bond defaults when compared to corporate bonds and suggests that municipal bonds remain a good option for investors interested in tax-efficient income and principle security.

A LITTLE LATE TO THE PARTY

In my time in this business, I have witnessed a well known phenomenon that is as constant at the northern star. Very few individual investors on their own have the emotional stamina to weather the ups and downs that come along with market cycles in a capitalist and free market. This is despite the fact that today, investors have access to more information (and most of it is free on the internet) than was available through most brokerage trading desks 15 years ago. The problem here is not a lack of historical information and knowledge, for we can all quote the old adage "buy low, sell high". The challenge lies in our lack of faith. Not faith that a stock "will come back" or that the U.S. will continue to function as a sovereign nation, but the intrinsic faith that our own experience, wisdom and principles are sound and should be applied to our decisions relating to the future. Our inability to stick to a well thought out plan and time tested strategy creates the only business environment where we decide to run away from the attractive opportunities that are truly "on sale" and throw money at speculative investments that are selling at all time highs and are subsequently "too good to be true".

After 18 months of an economic recovery and a stock market that is up 93% from its lows, individual investors are now showing renewed interest in stocks. While we have been there and back again in the stock market over that last decade, dividend paying stocks in quality companies still offer something that bonds don't; the ability to have a rising income that can keep up with inflation. If you have taken a wait and see approach to this recovery, now is a good time to consider owning solid dividend paying companies, but you shouldn't base your near-term expectations on recent returns. The party started 18 months ago and the music has slowed down a bit.

Invest Long and Prosper,

Josh Rudd

The Rudd Company, LLC is an independent investment management & consulting company. We provide objective investment advice and customized asset management services for individuals, family offices, and institutions. We specialize in serving clients with unique tax needs, liquidity concerns, and a desire to make a positive social impact with their investment choices.

If you are interested in our services, and have $1 million or more in investment assets, we welcome you to contact us at (877) 605-7833 for more information.