Investment Management
& Trust

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Investment Management Update

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Market Outlook

European debt worries and disappointing reports on U.S. manufacturing, job growth, retail sales and real estate indicate economic growth has slowed from the previous quarter, renewing concerns about the possibility of a "double dip" recession. As a result, we saw a global sell-off in equities in the second quarter as investors flocked to the safety of U.S Treasuries. We expect markets will remain volatile as investors look for evidence that the economy is on sustainable footing.

Will ETFs Deliver?

Much is yet to be developed in the area of ETFs, and only time will tell if they'll deliver. See page 1 to learn why—in the face of trading scandals and a financial crisis—their popularity has grown.

Fed Model Focus

The Fed Model is one of the most often used methods in the financial community to predict stock markets returns. What is it and does it work? We take a look on page 3.

Could it Happen Here?

The debt crisis originated in Greece and impacted all of Europe, but could it happen here? On page 4 we explore why differences between the United States and Europe make it unlikely.

Today's Muni Market

The municipal bond market has profoundly changed since 2007. What do you need to know about the current environment? Learn more on page 6.

The Growing World of ETFs

We can count on innovation in the world of investments, and one new product gaining greater attention is exchange-traded funds or ETFs.

Similar to mutual funds, ETFs own "baskets" of securities. However, unlike mutual funds, which price at the end of each trading day and can only be traded once a day, ETFs price instantaneously, trade like stocks and can be bought and sold anytime during trading hours. In addition, while most mutual funds are actively managed, almost all ETFs are passive and designed to mimic a particular index.

Introduced as vehicles designed to track major stock market indices, ETFs now cover a wide variety of equity, fixed income and commodity markets. Growth in recent years has been dramatic. Assets under management in the United States doubled over the past year, and now total close to $800 billion. There are currently over 800 ETFs in the United States alone, with registrations for new ETFs occurring daily. The largest providers are Blackrock, State Street and Vanguard with many new up-and-comers. It is estimated ETF assets could grow to over $1 trillion over the next couple years.

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Why such dramatic growth? Some believe interest started in the early 2000s following the mutual fund trading scandals. Investors began to ask for products with greater transparency and lower fees that allowed for more control through intra-day trading and provided broad diversification. Innovation followed, and ETF demand grew even more after the 2008 financial crisis.

While ETFs got their start tracking the major market indices, now funds not only track the majors like the S&P 500, the Barclays Aggregate Bond and the MSCI-EAFE (international stocks), but a variety of subsets of the various markets. For example, equity investors can use ETFs to pinpoint their allocations to areas such as U.S. small cap, mid cap, and large cap, in either growth or value categories. Further, investments can be made in specific sectors such as technology, healthcare and financials. International equity allocations can be further refined by buying ETFs that are targeted to specific countries such as Brazil, India and China.

The options for bond investors continue to grow as well. Investors can now find a wide variety of funds that track everything from short-to-long term bond indices. Specifically, funds are available that track U.S. Treasuries, mortgages, corporate, high yield, convertible, municipal, foreign developed and emerging market debt. In addition to the passive bond funds available, we are seeing more actively-managed products coming out such as Pimco's new Enhanced Short Maturity Strategy ETF.

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Perhaps the fastest growing ETFs have come in the area of commodities and precious metals. Global demand for materials and investor interest in assets not correlated to the stock markets have been primary drivers of this growth. Investors can invest in energy commodities such as oil and gas, precious metals such as gold and silver and platinum, industrial metals such as copper and aluminum, agricultural commodities such as sugar, grains and livestock, and currencies such as the Euro, the Chinese Renminbe and the Australian Dollar. There are numerous specialized ETFs available as well. And to add a further twist, there are a number of ETFs that investors can use to "leverage" their positions and make bigger bets. It is important to note that investors must use caution when investing in these vehicles.

One event that has taken the luster off of ETFs is the "flash crash" that occurred May 6, 2010, when the Dow Jones Industrials dropped 1,000 points at one point during the trading day before recovering to finish 4% down for the day. While concerns about the downgrade of Greece's debt prompted the drop, computer glitches caused securities to be mispriced and the markets to drop dramatically. ETFs were hit particularly hard. Exchanges reported that over 60% of stocks had their trades canceled that day due to mispricing. Of these stocks, approximately 70% were ETFs, many of which were highly traded and normally liquid funds.

As a result, many believe ETFs have suffered an "image" problem and will need to recover. However, ETF advocates are quick to point out that this was a problem of liquidity and should not be attributed to a problem with ETFs. That is, many ceased to trade when prices became erratic, exacerbating the drop. Many experts believe the computer pricing systems of the exchanges has not kept pace with the growth of ETF volume and that changes need to be made to the exchange rules regarding halting trading when the market drops precipitously during the trading day.

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The Growing World of ETFs Cont.

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Much is yet to be developed in the area of ETFs and time will tell if ETFs really deliver on their promised potential. We expect ETFs will continue to grow in popularity. However, investors need to understand that trading in ETFs is more complicated than with traditional mutual funds, and ETFs are the playground for a number of high frequency traders. Investors should always compare the price of the fund they are buying with the actual value of the underlying assets in the fund to avoid paying a premium. One way is to check the "indicative value" (iNAV), which is published every 15 seconds with the price of the fund share. The iNAV can be obtained by typing a ticker followed by IV on most financial website ticker look-ups; for example type SPY.IV (for the S&P500).

At Bremer, we tend to use ETFs more for special situations than as a general investment philosophy due to our commitment to active management. We do use ETFs as a temporary vehicle for tax harvesting, or as a way to increase exposure to a specific sector for our core equity strategy or for a specific client situation.

Stop, Go, or Yield?

Can the current difference in the ratio between earnings yield and income yield be an indicator for equity markets to move forward?

Simply defined, an earnings yield is the earnings per share for the most recent 12-month period divided by the current market price per share. The earning yield, which is the inverse of the P/E ratio, shows the percentage of each dollar invested in the stock that was earned by the company.

Money managers often compare the earnings yield of a broad market index (such as the S&P 500) to prevailing interest rates, such as the current 10-year Treasury yield. If the earnings yield is less than the rate of the 10-year Treasury yield, stocks as a whole may be considered overvalued. If the earnings yield is higher, stocks may be considered undervalued relative to bonds.

The earnings yield is used by many investment managers to determine optimal asset allocations. Of course, economic theory suggests that investors in equities should demand an extra risk premium of several percentage points above prevailing risk-free rates (such as T-bills) in their earnings yield to compensate them for the higher risk of owning stocks over bonds and other asset classes.

There are many studies for and against the legitimacy of being able to determine whether stocks are cheap or expensive relative to bonds, and it is hard to say whether the predictive nature we saw from 1982-2007 is statistically significant. Stocks only have been valued using forward operating earnings since 1980, so we do not have a long history using this measure.

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The relationship between earnings yield and interest rates was dubbed the Fed Model by Ed Yardeni of Prudential Securities based on the fact that some research at the Federal Reserve in the mid-1990s used similar ideas. But the model goes back much further, and it can be found in various forms in a number of security analysis books. In this sense, the term Fed Model and implied endorsement by the Federal Reserve is misleading.

Looking at the relationship of earnings yield to bond yield during the 1982-2007 time period, we can see that when the ratio went negative significantly (i.e. Earnings Yield ‹ Treasury Yield) in 1987 (-30%) and 2000 (-40%), we had the market extremely overvalued and the market did indeed tumble. We can also see that in 2003, the market was undervalued 80% (Earnings Yield › Treasury Yield) and we saw a four-year rally.

So does the Fed Model always indicate when the stock market is going to make a run or take a dive? The answer is no. We have a recent example to refute the Fed Model. Consider the market in the early throws of the January 2008 downturn. The S&P 500 forward earnings yield (7.69%) was 111% higher than the 10-year Treasury yield (3.64%), suggesting the S&P 500 was significantly undervalued. However, over the next 12 months, the S&P index fell from 1,325.19 points (January 18, 2008) to 805.22 points (January 20, 2009), a drop of more than 39%. It even dropped another 11% to 666 by March 9, 2009.

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The answer is no.

So what is the current earnings yield on the S&P 500? At forecasted EPS of $81 for 2010 and S&P price of 1,022 as of this writing, the earnings yield is approximately 7.92%. The current 10-year U.S. Treasury is yielding just 2.92%. The ratio of earnings yield to Treasury yield is at a very high historical 171%.

Are we going to get what the Fed Model had predicted up until recent years and rally, or are we set for a further decline from the recent highs seen in April of this year? It depends on whether the forward earnings predictions can be achieved. If companies in the S&P 500 can meet that $81 per share earnings number this year and the $95 per share number in 2011, it would appear that the market is indeed inexpensive and thus should move forward in a positive fashion.

The recent market selloff has been caused by concerns about whether or not these earning forecasts can be reached. The earnings yield tanked in 2007 and into 2009, and there is fear that it might fall again. However, one could argue that even if earnings were way off and we achieved only $50 per share EPS in 2011, the earnings yield would still be 67% above the current treasury yield and thus perhaps not an expensive market even under those scenarios. Most would not want to see what the equity market would look like if we did see earnings forecasts get slashed from $95 to this hypothetical $50 level. So, if earnings do go up as expected, the yield relationship ratio as it stands today would predict the equity market to follow.

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What the Heck Happened in Europe?

A look at the European debt crisis

In 2000, the members of the European Union switched to a single currency, the euro, with a single monetary authority, the European Central Bank (ECB). However, each country kept its own fiscal policy and issued its own euro-denominated bonds. A majority of this government debt is issued on the international capital markets and is highly marketable, making it subject to the expectations and fears of investors. The biggest holders of European government debt are European banks.

An old law applies here: "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem." (It's attributed to both John Paul Getty and John Maynard Keynes.) The markets lost confidence in Greece's ability and willingness to repay its debt for three basic reasons:

- The new Greek prime minister disclosed in fall 2009 that Greece had errors in its national accounting, making its deficit much worse than previously believed.
- A very weak tax-collecting system in Greece allowed a large number of people to easily avoid taxes.
- A cascade of pending debt maturities amidst higher borrowing costs further stressed Greece's balance sheet.

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On February 11, 2010, the European Union's members pledged to help Greece if it slashed its budget deficit. However, due to legal challenges and disagreements among countries, specifics on how they would help took months—far longer than markets wanted. On Monday, May 10, 2010, the EU announced a EUR 750 billion euro economic support package.

After an initial relief rally, markets again became skeptical about the nature of the support. The ECB promised to buy up to EUR 750 billion in distressed euro-area debt to defend its currency an creditworthiness. To avoid inflationary pressures, the ECB vowed to "sterilize" any purchases, meaning it will sell Euro-area debt into the market in order to absorb the euros it creates. The markets realized that by agreeing to buy low-quality Greek debt and sell high-quality Euro-area debt, the ECB is lowering the quality of its balance sheet.

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Meanwhile, doubts about other highly indebted countries, such as Portugal, Italy and Spain continue to roil markets. Investors fled European debt for the relative safety of U.S. Treasuries, driving down their yields.

Could it happen here in the U.S.?

There are some important differences between Europe and the United States, making a repeat of the Greek crisis unlikely at this time.

- While Greece's taxes are easy to avoid, the Internal Revenue Service does its job quite well, and it has the power to punish offenders.
- French President Sarkozy threatened to leave the Eurozone unless Germany and ECB agreed to a Greek rescue package. While several American states are in difficult financial shape, no U.S. state is seriously considering secession.
- The Federal Reserve has taken on credit risk with its purchase of assets from Bear Stearns and AIG. However, those assets total $67.3 billion, a huge number, but far less than the ECB's EUR 750 billion commitment.
- Finally, the markets believe the United States and Germany are different from southern Europe. Both countries' government bonds increased in value during the debt crisis.

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Not Your Parents' Muni Bond Market

Today's muni bond market is much different than that of your parents — or even your older siblings.

Many municipal bond investors are unaware of the profound changes in the market since 2007. Some investors ask if a municipal bond is insured, but only 8.5% of munis carried bond insurance in 2009, down from a peak of 55% in 2005, according to Thompson Reuters. Former bond insurance titans are in various states of flux, dealing with mergers, defaults, separation of good and bad assets, and legal and other challenges.

Some investors ask what a municipal bond is rated, but the ratings agencies' business models are under regulatory scrutiny after their failures to accurately rate bonds during the credit crisis. Further, Moody's and Fitch changed their ratings scales in spring 2010 to harmonize them with corporate ratings, while S&P did not, making comparability more difficult.

Bremer Investment Management & Trust looks beyond insurance and ratings. We research individual muni bonds and muni mutual funds for credit risk by analyzing financial statements, studying local and state economic, demographic and housing conditions, understanding the investor type that would buy a given muni bond, and measuring relative value between bonds in the marketplace. The muni mutual funds we use have similar internal research processes.

In his annual letter to shareholders published April 2009, famous investor Warren Buffett warned of a "terrible problem" for municipal bonds in the coming years.

In government testimony on June 2, 2009, and in his annual letter to shareholders published April 2009, famous investor Warren Buffett warned of a "terrible problem" for municipal bonds in the coming years. In summary, public officials may be tempted to default on the bonds, rather than push through needed tax increases or pension cuts.

Buffett's Berkshire Hathway has a business unit that provides insurance for municipal bonds, so he may be "talking his book" somewhat. Furthermore, at Berkshire's May 1, 2009, annual meeting, he admitted, "I don't know how you would tell a state you're going to stiff-arm them with all the bailouts of corporations."

While Buffett acknowledges he is uncertain about muni risk, he makes important points. In particular, his annual letter highlighted that the ability to pay (financial strength) may not always trump the willingness to pay (political situations). Municipalities may find that overly generous pension and health benefits are difficult to cut without "sharing the pain" by defaulting on bond obligations as well. However, "sharing the pain" could include tax increases. The key question is whether a municipality considers immediate access to bond markets more important than cutting the bonds and employee benefits it already owes. This is likely to be a decision that varies by each individual municipality.

At Bremer, we are also analyzing the level of public employee unionization, structure of benefits, amount of government credit enhancement, and climate for raising taxes in each state. With income tax hikes likely in 2011, demand for tax-exempt municipals is likely to remain strong, but it is important to avoid bad credit risks and understand the new environment for municipal bonds.

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