

RICHARD C. YOUNG & CO., LTD.
Investment Advisors

Matthew A. Young
President and Chief Executive Officer

www.younginvestments.com

500 5th Avenue South
Naples, Florida 34102
Phone: 239.213.1789
888.456.5444
Fax: 239.213.0770

Offices In Newport, RI

April 15, 2011

Dear Client,

In March, I met at our Naples office with Cato Institute chairman Bob Levy and cofounder and president Ed Crane. The goal was to increase my awareness of Cato's research efforts and to review federal budget policies of the U.S. government. The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato has 13 primary research areas, including finance, banking and monetary policy, government and politics, and international economics and development.

During the seasonal months in Naples, Cato hosts seven invitation-only policy forums. The first forum, which I attended after meeting with Bob and Ed, focused on taming the federal budget. The inaugural Cato Naples briefing featured commentary on the budget from Chris Edwards, director of tax policy studies at Cato, and senior fellow Richard W. Rahn.

Mr. Edwards handed out a chart pack that allowed attendees to fully grasp the urgency of the message. In the chart "Federal Spending by Department," the five largest annual expenditures are (1) defense at \$761 billion, (2) Social Security at \$742 billion, (3) Medicare at \$488 billion, (4) Medicaid at \$276 billion, and (5) net interest at \$207 billion. Below the big five trailed a list of much smaller budget expenditures.

Congress has come up with a nifty scheme to deal with the budget crisis. In a nutshell, the idea is to nickel and dime the smaller budget expenditures and avoid the other five behemoths. It is clear to me, as it is apparently clear to the Cato analysts, that neither the administration nor Congress plans to address what appears to be a crisis. And here is the icing on the cake: net interest, which stands today at #5 on the spending list at \$207 billion, is set on an uphill trajectory that will balloon it into the biggest, most bloated beast of all.

In a March 8 *Washington Times* article, Mr. Rahn wrote about the U.S. government's serious overspending problem:

If the spending and the resulting deficits are not soon stopped, the U.S. economy will become dysfunctional, and our prosperity and freedoms will disappear. Despite the overwhelming evidence that the government is headed for a debt crisis, there are still a

few economists who are saying: “Spend more.” Last week, one of the “spend more” crowd, Mark Zandi of Moody’s, made the absurd claim that the attempt by the Republicans to cut the budget by approximately \$60 billion (or less than 2 percent of total federal spending) would result in 700,000 lost jobs. The Democrats and their media allies, of course, jumped on the opportunity Mr. Zandi gave them as their latest excuse not to reduce spending. Instead, they have proposed cutting the budget by one quarter of 1 percent.

On the monetary side, which Bob, Ed, and I also discussed, the Federal Reserve continues backing up the money truck. There has never been a more accommodative monetary policy in the 235-year history of the United States than there is today. The power of the 0% interest rates and the printing press cannot be overstated. Since the Fed first signaled to the market that round two of quantitative easing was likely, stocks have soared, with the S&P 500 climbing 22% and the speculative Nasdaq advancing 27%. Meanwhile, the dollar index has tumbled 9.1%. The CRB commodities index has gained 26%.

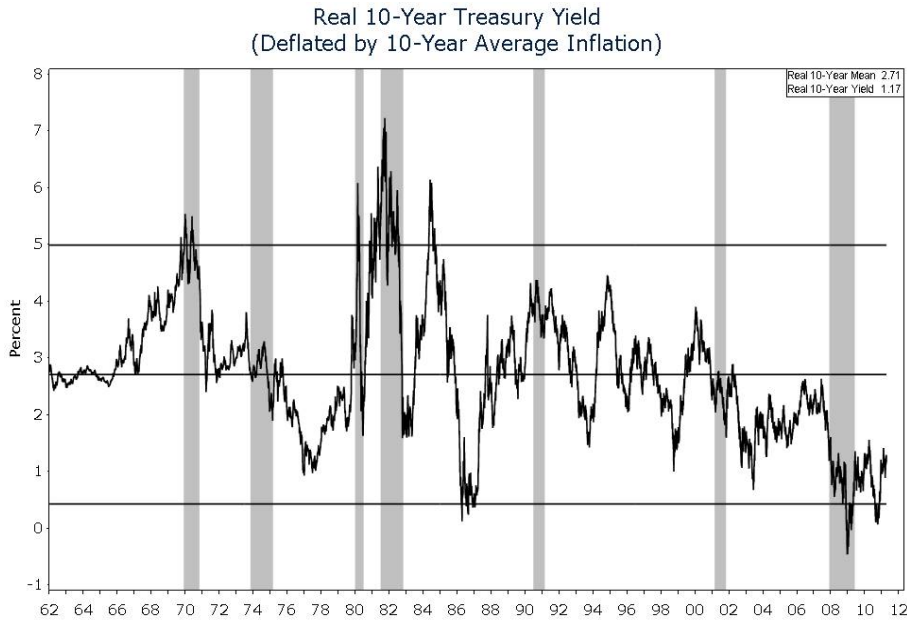
With commodities prices surging and inflation pressures heating up in certain sectors of the economy, the financial press is loaded with articles offering advice on how to protect your portfolio from inflation. One of the more common recommendations is to buy Treasury inflation-protected securities (TIPS). This advice sounds reasonable. If you want to protect your portfolio from inflation, why not buy inflation-protected bonds?

In our view, buying TIPS today to protect your portfolio from inflation would be a mistake. It is not that we are averse to TIPS. In fact, we own a legacy position in TIPS for many of our clients. The problem with TIPS as an inflation hedge is one of price. TIPS yields today are far too low. By example, the yield on the Vanguard Inflation-Protected Securities fund is currently -0.05%. The last time we purchased TIPS for clients, yields were north of 3%.

If you aren’t familiar with TIPS, the yields I am quoting are real yields. TIPS earn a real yield plus compensation for the rate of inflation. So everything else equal, if inflation is 2% over the next 12 months, the Vanguard Inflation-Protected Securities fund should earn 1.95% (-0.05% in real yield plus 2% in inflation compensation).

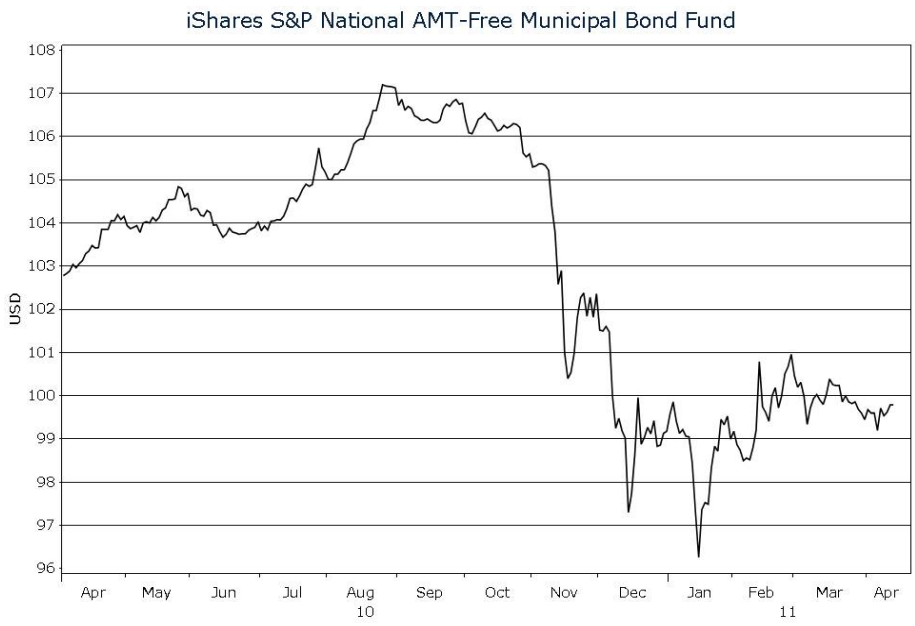
The potential mistake in buying TIPS as an inflation hedge today is that investors cannot separate the inflation-protection component of TIPS from the real-yield component. Even in an inflationary environment, an adverse move in real yields could cause TIPS prices to plunge.

With real yields near historic lows, the probability of an adverse move in real rates is uncomfortably high. Take a look at my real 10-year Treasury yield chart. Here I am simply taking the historical nominal Treasury rate and subtracting the average inflation rate over the previous 10 years. Over the last five decades, the real 10-year Treasury yield has averaged 2.71%. Today, real yields are 0.99% as measured by 10-year TIPS. By historical standards, real yields are low. If real yields rose 1.70% to their historical average, theoretically TIPS prices would plummet 14%.



That -14% price change assumes an instantaneous rise in interest rates, but even if you use more conservative assumptions, the return implications still aren't pretty. If you assume a three-year holding period, a 1.7% rise in real yields, and inflation of 4% annually, 10-year TIPS would return 1.15% annually for the next three years. That's far below the assumed inflation rate of 4% in my example.

Another sector of the fixed-income markets we continue to avoid is municipal bonds. We sold our clients' muni-bond positions in 2009 and early 2010. Our concern was that states and municipalities were facing severe budget pressure that was likely to result in elevated muni defaults. The sales turned out to be timely. Since November of last year, muni bonds have sold off. My chart shows that the iShares National AMT-Free Municipal Bond Fund (MUB) fell 8.8% from October 31 to January 14. The fund has since recovered some of its losses but is still down 6.9% from its high.



We continue to avoid munis for some of the same reasons we sold them in 2009 and 2010. State and municipal budgets are strained. In our view, more defaults are unavoidable. Will defaults reach into the hundreds of billions as some analysts are projecting? I don't know, and neither does anybody else. State and municipal finances are famously opaque. Municipal financial statements, if you can even locate them, are filed with a long lag.

Historically, investors paid little attention to issuer financial statements. Most muni issuers bought AAA ratings by paying for municipal bond insurance. But many of the muni-bond insurers went bust or were severely downgraded in the financial collapse. Insured AAA ratings are no longer prevalent in the muni market. The finances of underlying issuers must be evaluated. That's no easy task when there are tens of thousands of different issuers.

What concerns us most about muni bonds is not so much the prospect of massive defaults. Rather, it is the potential for panic selling. According to *Barron's*, 70% of the investor base in muni bonds is individual investors. The folk who own these bonds don't analyze muni-bond credits full-time. If muni defaults start to pile up, panic selling may ensue. With long muni rates still below 5%, it could be a long way down before value buyers step in to stabilize prices. Who needs the potential volatility at such low yields?

Instead of buying TIPS and municipal bonds we currently favor a short-duration portfolio of GNMA's, individual corporate bonds, and bank loans. Bank loans are a new fixed-income sector we've added to many portfolios.

Bank loans are also referred to as floating-rate loans or leveraged loans. Bank loans are generally made to businesses with below-investment-grade ratings. They are most often secured by collateral of the borrower, such as receivables or inventories. Bank loans are the most senior security in a company's capital structure, ranking ahead of even secured senior debt. That gives bank-loan investors first priority on assets in the event of default. Compared to similarly rated high-yield bonds, bank loans have historically had lower default rates and higher recovery rates. According to Moody's, the long-term average recovery rate of bank loans is 70%, compared to 40% for high-yield bonds.

Bank loans are often issued at a spread of 250–300 basis points to three-month London Interbank Offered Rate (LIBOR). LIBOR is an interbank lending rate that is used as a benchmark for private-sector borrowing rates. The average maturity of bank loans is about four years, but because they are floating-rate instruments, bank loans have a duration of close to zero. When interest rates move up, bank-loan investors get a pay raise. In other words, bank loans have almost no interest-rate sensitivity, although there is credit risk. According to S&P, the current yield to maturity on bank loans is approximately 4.8%.

The total size of the bank-loan market is estimated at about \$515 billion. Bank-loan investors include insurance companies, banks, hedge funds, and mutual funds. This is an institutional asset class. Bank loans aren't securities individual investors can just go out and purchase. You need large sums of capital and adequate support staff to deal with the legal and operational complications of managing a bank-loan portfolio.

To gain exposure to the bank-loan market, we are buying the Fidelity Floating Rate High Income Fund ([FFRHX](#)). FFRHX is a conservatively managed bank-loan fund. The fund manager tends to avoid the most speculative deals in the bank-loan market.

When you consider the current environment, bank loans can make sense. Banks are flush with liquidity. Companies that need to refinance maturing debt should. With risk appetite in the fixed-income markets on the rise, investors will be looking to pick up additional yield in lower-rated securities. An improving economy also points to higher interest rates. Since bank loans are floating-rate instruments, they benefit from rising rates. The 30-day SEC yield on FFRHX is 2.65%. The yield is a bit lower than the average yield in bank loans both because investors must pay an expense ratio, and because the fund favors high-quality credits. The yield is still compelling when compared to a similar-duration three-month T-bill, which offers a yield of only 0.13%.

Given the wildly expansionary and unsustainable fiscal and monetary policies of the U.S. government, we believe the prudent investment course for conservative investors is a defensively constructed allocation. For fixed-income investing, we favor relatively higher-quality bonds with short- and intermediate-term maturities.

On the equity side, we are constructing a globally diversified portfolio featuring securities that pay out decent dividends rather than rely solely on capital appreciation. One of our favored domestic names has been Verizon, with its 5% dividend yield, which has increased in each of the last four years. Also, we have added Canada's Peyto Exploration & Development to many client accounts. Peyto, a low-cost natural gas producer, owns a portfolio of natural gas reserves with an estimated life of 21 years. Peyto shares yield close to 4%.

Have a good month, and as always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Sincerely,



Matthew A. Young
President and Chief Executive Officer.

P.S. We recently acquired bonds from Brazilian oil company Petroleo Brasileiro, or Petrobras. The energy giant, based on market cap, is the eighth-largest company in the world. By the end of this decade, some predict that Petrobras will pass ExxonMobil to become the largest publicly traded oil company in reserves and production. As CEO Sergio Gabrielli explains, "What we can say is that we have a lot of oil. We have an asset base in our own portfolio that, on an organic basis, can grow faster than anyone else."

P.P.S. "Officially reported job growth is better in the last couple of months, but jeez, nonfarm payrolls today are at about the same level as May 2009. That's almost two years with no net gain. And the rotten employment and new home sales readings come on the heels of a mega money-printing campaign at the Fed. What happens when the press shuts down this summer, when QE2 ends, and when the Bernanke-driven Free Money Truck exits the hood? It is an

outrage that the Fed subsidizes Goldman Sachs, while Mr. and Mrs. Goldman, private citizens, hunkered down in a Boca retirement condo, are getting four basis points of T-bill interest on their retirement savings. Are Americans paying any attention to this appalling expropriation? No wonder gold and the Swiss franc are trading at record prices.” Dick Young, April 2011.

P.P.P.S. With the Swiss franc trading near record prices, we recently reduced our position in the currency. Historically, investors have viewed the franc as a safe-haven currency. But, with today’s sovereign debt problems in Europe and reckless money printing by the Fed, the franc has become a go-to currency to hedge against debasements. In our view, the franc has been overbought and over-owned by speculators. We continue to favor the franc on a long-term basis and will look to add to our position again in the future. For additional currency diversification, we have begun taking positions in Swedish holdings. I will profile Sweden and recent purchases next month.

The information contained in this letter is for informational and educational purposes only. It is not intended nor should it be considered investment advice or a recommendation of securities. Please contact our office directly with any questions regarding items appearing in the letter.