

THE EAST END FINANCIAL GROUP

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Dear

Over the last few days our office has received numerous phone calls from clients asking why their May statements show a loss in market value even as the stock market has continued to rally. The answer is the "bond bubble" which we have discussed with you in meetings and via our quarterly newsletters over the past 18 months.

Since most of our accounts have heavy fixed income exposure (usually 50+%), any increase, or in this case perceived increase, in interest rates will have a negative effect on bond prices. This is called the inverse relationship between interest rates and bond prices. Rates go up, bond prices go down and vice versa. Last October we began to be proactive with protecting bond values in anticipation of rising rates. In our meetings we discussed the bond bubble issue and began to take steps to protect principal values in the bond funds we use in our portfolios.

Some of the techniques used were increasing the credit quality of the bond portfolios and, most importantly, reducing the duration of the portfolio. Duration is a key factor in analyzing bond portfolios since it is a measurement of how much effect an increase in rates will have on the price of bonds. For example, a duration of 4 means that a 1% move in rates will result in a 4% loss of principal value in a bond portfolio. We cut the duration of most portfolios in half in anticipation of rate increases.

We also shifted money out of traditional fixed income to alternative programs using market neutral funds with Pimco and John Hancock and, on larger portfolios, the Hilton Income Strategy using alternative fixed income investments in MLPs, REITs and preferred stocks as well as traditional bonds.

Being well ahead of the curve on this has helped to greatly reduce the effect of a slight rise in Treasury rates the last month and, more importantly, the perception that the federal reserve will ease its quantitative easing program forcing rates upward.

This preemptive action on our part has insulated our portfolios to a great degree against the effects of the bond sell off. I've enclosed a copy of an article from the business section of the New York Times from Saturday, June 8th, that reviews the effect of the rate move. Long Treasury bonds lost 6.8% in May with many top funds losing 5 – 10% for the month.

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We have charted many of our prominent bond funds from May 1st through June 7th to measure the effect of the sell-off. Our typical funds, i.e. Pimco Total Return, Loomis Sayles Bond and Vanguard Intermediate Term Corporate bond, lost 1.7% to 3.08% respectively or about 35% of a typical long bond fund. *Source: All market data provided by Yahoo Finance.*

Please understand it is impossible to completely eliminate interest rate risk if you own bonds; you can only reduce the risk by shortening duration and increasing quality. It is also critical to review why you own bonds in your portfolios.

Bonds are poor investments in an inflationary environment. There is little upside growth potential in bond funds. They serve two basic purposes in a portfolio – first, bonds provide consistent income either monthly in funds or semi-annually in individual bonds. If you want income, especially in retirement, you must have a portion of your portfolio in bonds. Secondly, bonds will provide a cushion against volatility in a portfolio, reducing what we term beta in a portfolio. Bonds will normally reduce overall losses in a portfolio during a period of equity sell-offs, i. e. corrections.

While there is never an assurance of avoiding investment losses, the purpose of diversification is to put together a mixture of assets classes to reduce volatility and provide predictable rates of return over a period of many years.

Please take some time to read the Times article we've enclosed. We have expected this correction in bond prices for well over a year but when it finally happens, it can be shocking to the investor. This volatility in bond prices will continue. Please feel free to call us to discuss this in more depth.

Best regards,

John J. Kosinski

John J. Kosinski, CLU, ChFC, MSFS
President

JJK:ml
Encl.

A Bond Market Plunge That Baffles the Experts

As if it wasn't bad enough for the millions of Americans scraping by on paltry interest payments, now they face another threat: the loss of principal on their bonds and other fixed-income assets.

The month of May, and this first week of June, were terrible for many fixed-income investors who have spent the last few years reaching for higher yields.

JAMES B. STEWART

COMMON SENSE

If there was an index for fixed income with the status of the Dow Jones industrial average or Standard & Poor's 500 index for stocks, the carnage in fixed-income markets would have been a big story and we'd all be talking about a bear market in bonds.

Consider the damage: mutual funds that invest in long-term United States Treasury bonds lost an average 6.8 percent in May, according to Morningstar, with the loss in principal wiping out years of interest payments. But that's not the worst-hit sector. Higher-yielding bonds and fixed-income securities, to which investors have turned in droves in recent years, have suffered even more, especially mortgage-backed securities and emerging market debt, as well as just about anything that uses borrowing to increase returns.

Many individual securities and funds were hit much harder

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A Bond Market Plunge That Seeped Into Stocks Baffles the Experts

From First Business Page

than the averages.

Vanguard's Extended Duration Treasury Index fund was down more than 6 percent in the last month. In the mortgage area, Annaly Capital Management, a popular real estate investment trust that invests in mortgages, fell 8.7 percent, and an iShares mortgage exchange-traded fund lost 10.4 percent. Pimco's Corporate Opportunity Fund, which is managed by the star analyst Bill Gross and which invests in a mix of corporate bonds and mortgage-backed securities and uses some borrowing, lost nearly 13.4 percent. Annualized, such declines are off the charts.

"There are many closed-end bond funds and mortgage funds that were just annihilated in May," said Anthony Baruffi, a senior portfolio manager at SNW Asset Management in Seattle, which specializes in fixed-income assets.

This week, the bond markets' jitters spilled into the stock market, with major indexes gyrating around the globe. The Dow Jones industrial average dropped more than 200 points on Wednesday, only to bounce back Thursday and Friday.

High-dividend stocks, which many bond investors also looked to in their quest for income, were pummeled. Shares of Procter & Gamble dropped more than 6 percent the last week in May.

The severity of the market reaction shows how skittish investors have become about ultralow interest rates. Bond prices fall when interest rates rise, with longer-maturity, higher-yielding and riskier bonds the hardest hit — the very assets that the Federal Reserve's ultralow interest rate policy has encouraged income-seeking investors to embrace.

Fixed-income funds are where investors have traditionally looked for safety and low volatility, unlike stocks, and such precipitous moves are rare. To put this in perspective, the recent plunge in prices of fixed-income securities had analysts reaching back to 1994, when the Fed began raising rates and 10-year Treasury rates rose two and a half percentage points. That year, Orange County, Calif., had to declare bankruptcy after its bond port-

folio plunged in value.

The sudden recent moves in the markets have left many experts scratching their heads, because, on the face of things, not much has changed in the overall economic outlook. This week's employment number — American employers added 175,000 new jobs in May — was the average rate for the last year, suggesting slow but steady growth in the economy. Other measures released in May, like consumer confidence, consumer spending, and personal income, were generally positive, but nothing to suggest any imminent surge in economic growth.

"Last week's sell-off was very indiscriminate," said Jonathan A. Beinler, chief investment officer for global fixed income and liquidity at Goldman Sachs Asset Management. Added Mr. Baruffi, "I was surprised at how severe the market reaction was."

After all, the Fed hasn't actually raised rates, as it did without any advance warning in 1994. But all it took this time was the merest hint from the Fed's chairman, Ben S. Bernanke, that the Fed's quantitative easing policy might be tapering off sooner than expected.

In the latest round, the Fed announced last December that it would buy billions of dollars of long-term Treasury bonds as well as mortgage-backed securities in an attempt to keep longer-term rates low. With the federal funds rate at 0.25 percent, it has already lowered short-term rates about as far as they can go. The question for investors since then has been: How long will the Fed keep rates so low?

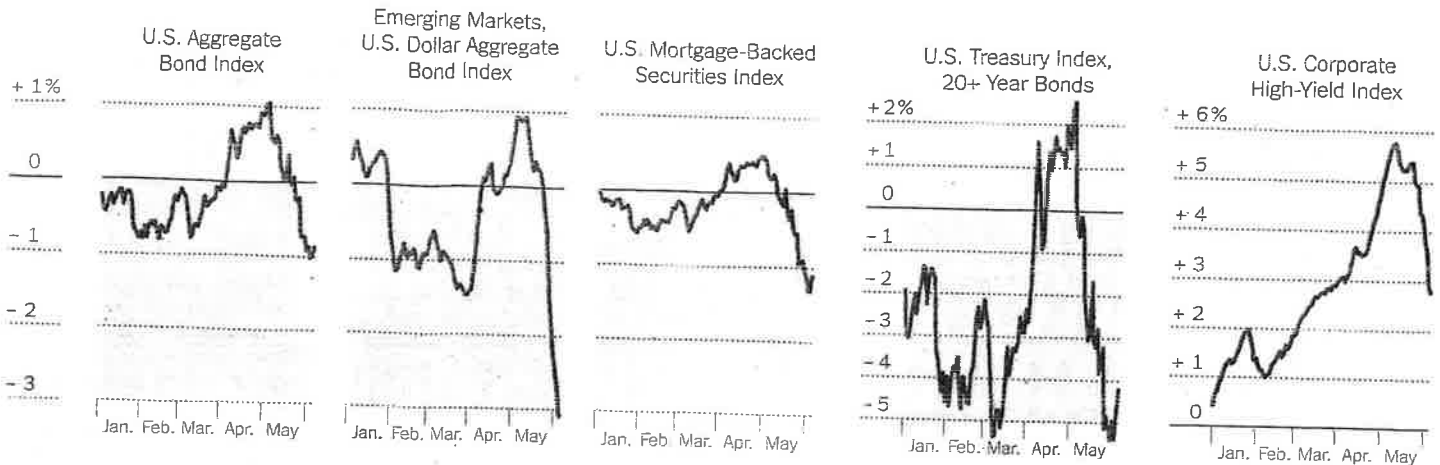
Maybe not much longer. "We've been talking about the fact that eventually this interest rate cycle has to come to an end for the better part of six-plus months," Gary D. Cohn, president and chief operating officer of Goldman Sachs, told me this week. "People need to be reminded of the inverse correlation between interest rates and bond prices. The moves in interest rates may seem small, but they're pretty powerful. There can be a dramatic impact on prices."

The sell-off in fixed income began slowly on May 10, an otherwise uneventful day with no obvious catalyst for any change in sentiment. It picked up steam

Bond Market Turmoil

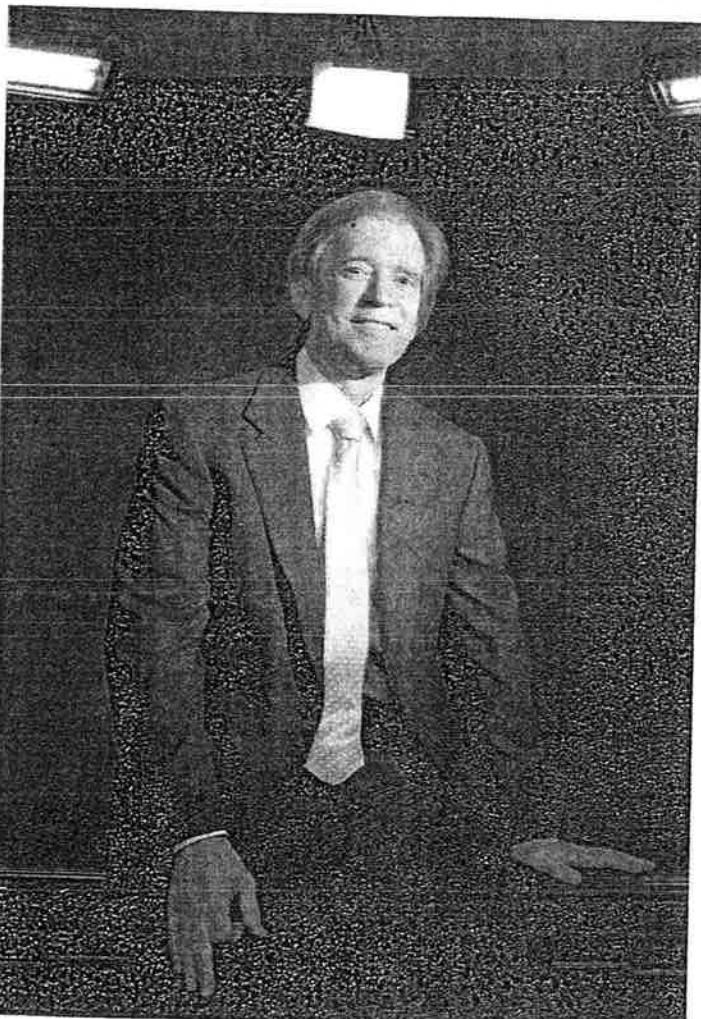
A sell-off in fixed-income securities began in May, on fears that the Federal Reserve might start tapering off its purchases of Treasury bonds and mortgage-backed securities earlier than expected.

Total return on selected Barclays fixed-income indexes through June 6, 2013



Source: Barclays

THE NEW YORK TIMES



STEPHANIE DIANT FOR THE NEW YORK TIMES

Bill Gross, a founder of Pimco. The investment firm's Corporate Opportunity Fund was down more than 13 percent in May.

when Fed sources didn't step forward to calm markets. Then, in comments to Congress on May 22, Mr. Bernanke said, "We could in the next few meetings take a step down in our pace of pur-

chases."

That set off alarm bells, in contrast with his prepared text, which gave no suggestion that the Fed's policy would change so soon. And then, the minutes of

the Fed's May meeting suggested that some Fed governors were prepared to start tapering off bond purchases as soon as the Fed's next meeting, which will be June 18 and 19. Near-panic selling in some markets ensued.

"When you get a fundamental shift in interest rates, which doesn't happen very often, the initial move is always pretty dramatic," Mr. Cohn said. "It's a move from a lower rate world to a higher rate world, and people try to get ahead of it."

Mr. Beininger added: "The concern is that the Fed is taking away the punch bowl and taking liquidity out of the market. The increase in liquidity has been a big driver of these markets, and as the market gets its head around these things, it follows that those markets will weaken."

That said, "The magnitude of the moves was extreme in some cases," Mr. Beininger said. "It wasn't based on fundamentals, and may have been a liquidity-driven event, with hedge funds" selling when prices fell to target levels.

Whether or not the current sell-off continues, the plunge has startled investors who may not have realized how much risk was embedded in their portfolios. "The only thing I guarantee for sure is that someday we will have high interest rates again," Mr. Cohn said.

"It may take 50 years, but rates are going to go higher. We have an entire generation of investors who have never experienced a rising rate environment."

Mr. Beininger said investors need to reconsider their traditional fixed-income allocations, nearly all of which carry interest rate risk. "It's an asset class with a negative expected return with-

out any other positive offsetting properties. So why have it as a part of your portfolio?"

He said the simplest and safest approach is simply to park funds in a low-volatility money market fund and accept near-zero returns. There are also floating-rate funds, which invest in floating-rate bank and corporate loans as a way to protect against rising interest rates, at least in theory. But there has been a recent rush into these funds, and the risks may not be clear to investors. Their track records are relatively brief, and it's not clear how they'd react in another financial crisis.

Hedging by taking short positions in interest rate futures is too expensive and complicated for most individual investors, and so-called inverse funds, which use leverage and take short positions, are too speculative for many investors.

There are also so-called unconstrained bond funds, like Goldman's Strategic Income Fund, of which Mr. Beininger is a manager. His fund uses hedging strategies to minimize interest rate risk and can seek opportunities around the globe. (He says he thinks emerging market debt is undervalued.) But returns on such funds depend on the skills of their managers.

"I've been hearing from a lot of worried baby boomers," Mr. Baruffi said. He recommends a cautious approach, which means accepting low returns for now in return for safety. "People need to be patient," he said. "This is no time to reach for yield. What people need is a bomb shelter. There's no return on those, but if the market continues to drop, you'll be happy and you can invest at lower prices."