STRATEGIC WEALTH PARTNERS LLC

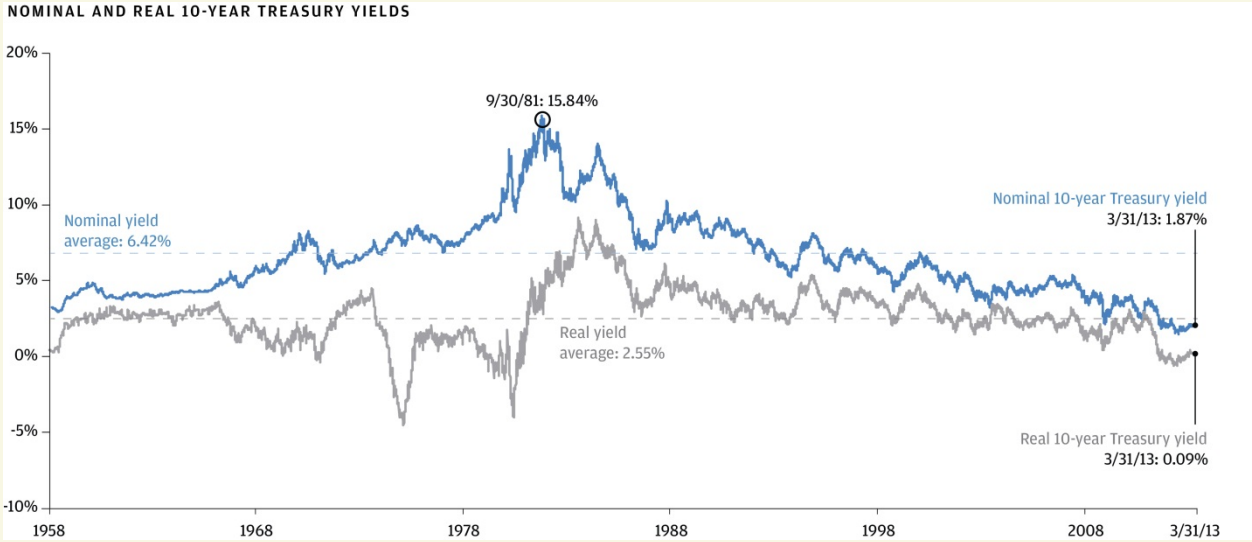
Insightful planning. Objective advice.

Spring 2013

Predicting interest rates has always proved difficult for those who dared, and this is especially so in recent years. The Federal Reserve has pumped trillions of dollars into the US economy via "quantitative easing" and other strategies, in an effort to stabilize the financial system and provide a climate for economic recovery. The cumulative effect of these policies has dramatically, albeit artificially, lowered interest rates. From an investor's perspective, "don't fight the Fed" has been the mantra since the Great Recession – in other words, one shouldn't invest contrary to the Fed's current policies.

At the same time, however, the overwhelming consensus among investors is that rates will eventually rise, thereby causing bond prices to fall and total returns on fixed income strategies to suffer. This seems to be a sensible assumption with the 10-year US Treasury reaching all-time lows last July and *negative* yields after accounting for inflation (known as "real" yields).

The following chart plainly illustrates how far rates have fallen over the past thirty years. Investors have enjoyed well above-average bond returns for decades; unfortunately, however, since much of that return was from price increases as rates declined, it is now mathematically impossible to achieve those same returns going forward.



Source: Federal Reserve, BLS, J.P. Morgan Asset Management. Note: For illustrative purposes only. Past performance is not indicative of future returns. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core inflation for that month except for March 2013, where real yields are calculated by subtracting out February 2013 year-over-year core inflation. Data as of 3/31/13.

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Factor in an improving US economy (albeit at a glacial pace), a rising stock market (which looks more attractive to investors and competes for dollars), solid corporate balance sheets, a healthier banking system, and signs of a housing recovery, and the rising rate theory seems inevitable. Eventually, the Fed's current accommodative policies will come to an end. But even before the Fed takes action, we may be witnessing the rising-rate hypothesis playing-out before our eyes. Since the 10-year Treasury yield bottomed last summer, market forces have pushed yields up more than 20% to a recent 1.70%.[1]

The timing of and speed at which nominal rates will change is unknown. Consistent with our philosophy regarding equities, we don't claim to have a crystal ball that shows the direction of the fixed income markets. We find that those who do are wrong more often than they are right. Our philosophy for client portfolios is anchored on managing risk and developing appropriate asset allocations to achieve clients' goals. Our research has shown that volatility patterns are far more reliable than return patterns, and we can use this to our clients' advantage.

With that in mind, we cannot abandon fixed income despite apparent signs that the 30-year bull market may be coming to an end. Fixed income provides essential diversification and helps reduce overall portfolio volatility. Bonds as a whole, measured by the Barclays Capital U.S. Aggregate Index, have historically provided a modest standard deviation (which is one common measure of risk) when compared to most other asset classes.[2] Interestingly, this typically holds true even during rising rate environments.

However, investors must remember that rising rates *can* subject bonds to greater than normal volatility. And despite common perceptions, bonds and bond funds *are not* risk-free. Two primary risks affect a bond's value: credit (default) risk and interest rate risk. As noted above, rising rates will cause the value of a bond to fall.

The challenge we face is constructing portfolios with the potential to deliver needed returns – especially for those clients who depend on their portfolio to provide cash flow – without assuming unwanted volatility. This has dared certain investors to chase yield – usually by investing in lower quality bonds and/or longer maturity strategies. Either of these could prove dangerous if rates rise or the economy falters. So what is SWP's approach to combating a potential rising rate environment? Simply put, we pay close attention to both credit quality and maturities. And as with other components of a portfolio, we diversify.

By carefully controlling interest-rate sensitivity, we believe our chosen managers can provide critically important insulation from the drastic price fluctuations that can result from rising interest rates. However, this conservative approach is also likely to produce lower returns. As a consequence, our target return for most fixed income strategies is quite modest at present.

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[1] Yahoo!Finance
[2] Zephyr StyleADVISOR

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Realizing this may not suit all clients' needs, we continue to utilize alternative investment strategies where appropriate. As featured in our last newsletter, the goal of these strategies is to provide meaningful returns in excess of inflation (greater than bonds, less than stocks) with some downside protection (greater volatility than bonds, but less than stocks). Many of the alternative strategies we employ can react nimbly to a variety of economic and market forces.

Diversification is the second pillar of our fixed income strategy. SWP diversifies fixed income investments into subcategories that offer differing risk-return potential. Besides the usual diversification by type of issuer (government, municipal, corporate, etc.), we categorize and diversify fixed income strategies according to our assessment of risk. Portfolios are then implemented both strategically and tactically by trusted management companies that possess deep research staffs and fixed income expertise.

In concert, we believe conservative duration and diversification strategies may be the key to mitigating risks and reducing volatility. While our approach will likely mean that fixed income returns will be muted going forward (especially compared to the last few decades), we believe that caution is appropriate. These are new times with new challenges; however, we will continue to work our hardest to find new opportunities for our clients.

As always, but especially in light of the current environment, please contact us with any questions and/or if your risk tolerance has changed and requires adjustments to your portfolio(s).

From all of us at Strategic Wealth Partners, it is a privilege to serve you.

Sincerely,

Strategic Wealth Partners

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