ITI Financial Management
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Inflation Rate and Typical Spread Suggest Higher Interest Rates Ahead

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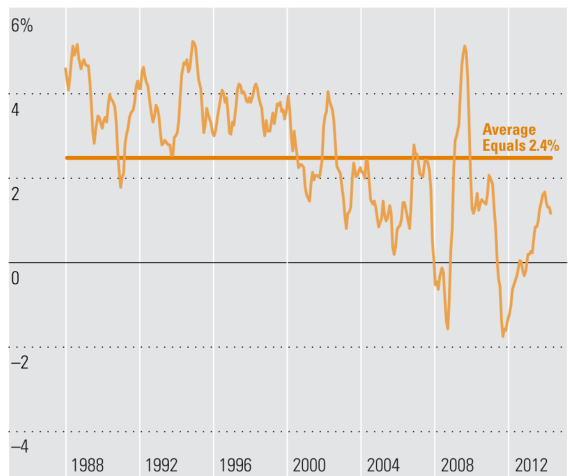
Given that the U.S. Federal Reserve is stepping back some its maneuvers to keep interest rates low, interest rates are expected to increase to more normal levels. Normal means that interest rates are generally dictated by the rate of inflation plus a spread. In the case of the U.S. 10-year Treasury bond, the spread has averaged about 2.4%, though that level has been quite volatile. If one puts that 2.4% spread on top of the current inflation rate of 1.5% (as of Apr. 2014), one could expect an interest rate of 3.9% (compared with 1.8% at the end of 2012 and 2.9% at the end of 2013). Yet, it might take some time to get there. Higher rates are generally bad news for the economy as they tend to slow both housing and auto activity.

10-Year Treasury and CPI Inflation Spread



Source: St. Louis Federal Reserve, updated June 2, 2014. Last data point is for April 2014.

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Advisor Corner

Mr. Kennedy's investment philosophy is the same that he has practiced over the last decade: securities markets are efficient and advisors primarily add value by coordinating the asset allocation for clients based upon risk tolerance, objectives, and time horizons. The firm has constructed 5 models for clients that vary in risk to meet the goals of each client. The firm primarily uses passive mutual funds in each model and uses select actively managed funds for bond, commodity, and real estate exposure. ITI uses several research resources, including many that were used over the last 20 years, to assist with the recommended asset allocation and the appropriate funds to utilize in each model. Mr. Kennedy is an Investment Advisor Representative of ITI Financial Management, LLC.

Investment services are offered through ITI Financial Management, LLC, a registered investment adviser with the state of Missouri

Fight or Flight?

ITI Financial Management/Troy E. Kennedy

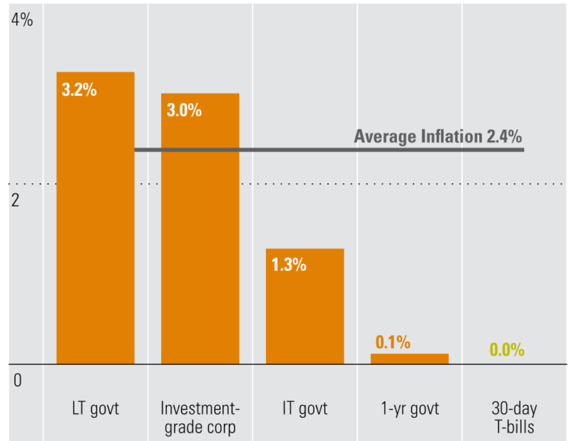
- ITI Financial Management is a fee only, non commissioned registered investment advisory firm headquartered in Springfield, Missouri. We presently manage approximately $65 million for over 175 accounts. In November 2009, Springfield Trust & Investment Company sold to a large out of town bank holding company. After 17 years as a shareholder/executive vice president with Springfield Trust & Investment Company, Troy Kennedy founded ITI Financial Management to continue to provide the highest level of personalized investment management and financial planning services. There are no fees to hire ITI nor are there any fees to terminate the relationship. It is truly a partnership with each client.

The market turmoil of 2008 has caused panicked investors to flee to safety, from stocks and mutual funds to risk-free investments like Treasuries and savings accounts. However, a risk-free portfolio might carry a high price. With their low returns and limited growth potential, some fixed-income investments may leave investors with little return after inflation. Further, by dumping stocks and investing solely in fixed income, investors are not only losing out to inflation, but they are also missing out on an eventual market recovery and growth. Although Treasuries at times provided investors with a safe haven from market volatility, they didn't provide much protection against inflation over the time period analyzed. The image illustrates the current rates for fixed-income instruments with varying maturities, as well as the average inflation rate over the last 10 years. The yields for intermediate- and short-term instruments examined are currently below the average inflation.

Locking investments in Treasuries' current yields might not provide a long-term real return, especially with expectations of a high inflationary environment on the horizon. Too much allocation to conservative investments can cause investors to forfeit long-term growth. An allocation to equity and longer-term bonds could position portfolios to capitalize on an eventual rebound.

Average inflation is annual, from 2004 to 2013. Current yields are for the month of April 2014. Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not eliminate the risk of experiencing investment losses. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest.

Current Yields of Fixed-Income Instruments Versus Trailing 10-Year Inflation



Investment-grade corporate bonds are represented by the Barclays U.S. investment-grade corporate bond index, long-term government bonds by the 20-year U.S. government bond, intermediate government bonds by the 5-year U.S. government bond, 1-year government bonds by the 1-year constant maturity U.S. government bond, Treasury bills by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index.

Bill Gross Speaks at 2014 Morningstar Investment Conference

ITI Financial Management/Troy E. Kennedy

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Interest rates need to rise but must not be extended too far or a bear market may result, says PIMCO founder and CIO Bill Gross.

Speaking at the Morningstar Investment Conference on June 19, Gross outlined details of his firm's "New Neutral" market outlook. The concept focuses in part on the belief that interest rates closer to 0% after inflation are necessary for more stable, if less dramatic, growth than in the past. Currently the real rate (meaning the Fed funds rate minus the rate of inflation) stands at around negative 1.25%, Gross said. "A negative rate for a long period of time hasn't really done much," he said. "The problem is that what it has done is to stimulate financial markets." He said the Fed will have to raise rates "to prevent the bubble popping."

Gross seemed to suggest that higher rates could help the economy, but that raising rates too much could be disastrous. "It was a real rate of only 1% that broke the economy and led to a global recession," he said. "I guess my point is that if the new neutral is closer to 0%, then asset prices are less bubbly," he added. "... They can't survive a 2% real rate."

Gross said the real rate is crucial as it will dictate the performance not only of bonds but of stocks and other asset classes as well. He said that real policy rates have varied from 0% to 8% historically but need to be at the low end now. "In a highly levered economy, the new neutral has to be lower than it's been historically," he said.

He added that keeping the real rate closer to 0% should help keep volatility in check as well, adding, "At 2% you've got bear markets ahead."

Overall Gross said his firm expects 3–4% annual returns for bonds and 4–5% annual returns for stocks in the future.

Gross also expressed concern about the end of the Fed's quantitative easing program, wondering aloud who will buy 30-year Treasuries once the program that has been purchasing so many of them ends. Gross did not directly address the recent high-profile departure of former PIMCO CEO Mohamed El-Erian, but spent his opening remarks discussing how he's been portrayed in the press.

Overall, he said, "I've never been happier at work." He cited the company's new deputy CIO structure and a new building as signs of progress, adding "and if there's a happier kingdom on earth it may be 15 miles up the road ... at Disneyland."

In discussing the idea of investing templates and structures, Gross said that PIMCO's template is based on three components. The first of these he called "bonds plus," combining investments in interest rate futures and swaps ("vehicles that [don't] require very much cash") with short-term corporate notes and floating-rate notes. "In effect we turned our Treasuries into corporate bonds," he said.

The second element is a focus on intermediate-term issues and rolling down the yield curve. Gross says this technique has allowed 5-year Treasuries to equal the performance of 30-year Treasuries over time.

The third element is what he described as "employ[ing] volatility sales"—for example, selling exposure to mortgage-backed securities. He said this approach must be used responsibly and admitted that when markets are volatile it hurts his firm's performance but added "otherwise it's a good business." He compared the practice to what Warren Buffett does at Berkshire-Hathaway, using premiums from his insurance holdings to underwrite riskier bets.

"At PIMCO we're willing to sell that insurance," he said. "We're willing to sleep less [at night] but perform better."

Gross estimated that these three "structural tilts" together add 75-80 basis points per year to fund performance.

Quarterly Market Barometer

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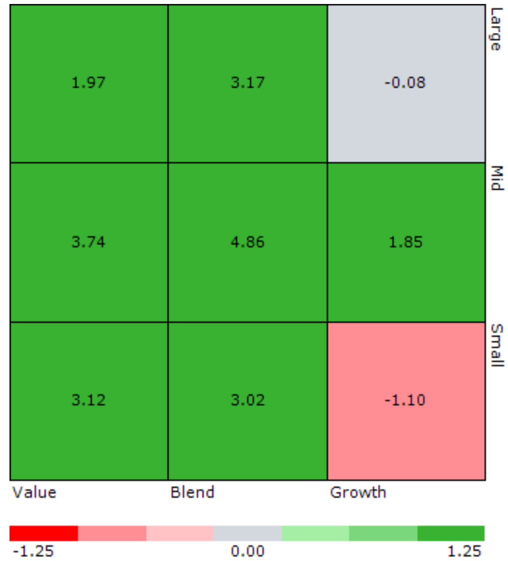
3 Month, ending March 31, 2014. The U.S. Market returned 2.00%.

The Morningstar Market Barometer provides a visualization of the performance of various stock market indexes. The color scale (red for losses and green for gains) allows you to assess which areas of the market performed strongly and which areas showed weakness for the time period analyzed. The nine-square grid represents stocks classified by size (vertical axis) and style (horizontal axis). There are three investment styles for each size category: small, mid and large. Two of the three style categories are “value” and “growth” while the central column represents the core style (neither value nor growth characteristics dominate). Large-caps account for the top 70% of the capitalization; mid-caps represent the next 20%; and small-caps represent the balance.



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