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Excerpts from Quarterly Report written by Investment Partners Asset Management – Q2 2013

Did you know that the Federal Reserve has raised interest rates by a quarter of a point five times in 2013? No, they did not actually *announce* this, but the market's perception of future Fed action has had the effect of moving the 10-year note to approximately 2.75%. The price of money is dictated by supply and demand, like anything else. As we have seen though, through quantitative easing, as much as 50% of the demand for mortgage-backed securities and treasury bonds has been artificially created by one buyer – our own central bank. The goal of this policy, in theory, is to peg interest rates at a certain (low) level, and provide the US, and the world, with enough liquidity to stabilize economies. As we have opined over the years, this policy can be effective as long as it is perceived to be somewhat permanent. Interestingly, the Fed has been floating trial balloons to allow the market to get a glimpse of what the actual, unadulterated, market price of bonds would be without $85 billion per month of market intervention. This process of removing such stimulus is called *tapering*. We wonder if tapering is code for being tired of almost single-handedly paving over trillion dollar Federal deficits. Is the Fed probing to find a level at which they can attract another buyer for US paper?

Unfortunately for them, the markets through June spoke loudly that yields in the 2.5-3.0% range did not approximate a level at which the Fed can step away in earnest. While the trade so far has been out of bonds and into certain liquid equities (many of which are historically at extreme valuation levels) we have seen in previous periods where interest rates rise, stocks blow off, and the price of money overtakes the fervor. Bubbles tend to pop, especially when yields on treasuries exceed yields on stocks, as is the case now.

Another offshoot of higher rates (and the associated higher US dollar value) has resulted in some predictable behaviors; a smack-down in commodities (ex-oil), real estate, preferred stocks and other interest rate sensitive asset classes. However, there have been other developments that we view as temporary in nature – what *should* happen given this backdrop. To date, seemingly the more diversified a portfolio, the more lackluster returns on an absolute basis…

What should transpire and what actually will happen underpins the timing of what we believe to be inevitable. The question is… are these developments *imminent?* We strongly assert that markets revert to, and sometimes overshoot, their means after a phase of over extension and/or liquidation. We are undoubtedly awaiting (anxiously) an environment in which the securities we have purchased while in their monetization mode approach their mean valuation from below, rather than chasing the short term hyper-performance we have witnessed in companies whose futures may in fact be bright, but whose stocks, in our opinion, reflect the most perfect of perfect worlds. In fact we posit that the best attribute of some of the high PE companies is their large short positions – exacerbating their already extended upward trends. The Fed, again, has created an environment for risk taking, so it is no surprise that that is what has transpired in large measure….

Our sentiment is further heightened when we witness an inability and/or unwillingness of boards and managements to effectively create value when the courses of action to achieve that goal are, in some cases, glaringly obvious. Maybe the fear of not being greedy enough has overtaken owners of concentrated positions demanding value creation. Our collective efforts may serve as a billboard to other market participants who have ignored cheap and not performing in favor of the rather expensive and (over the short-term) performing stocks.

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