

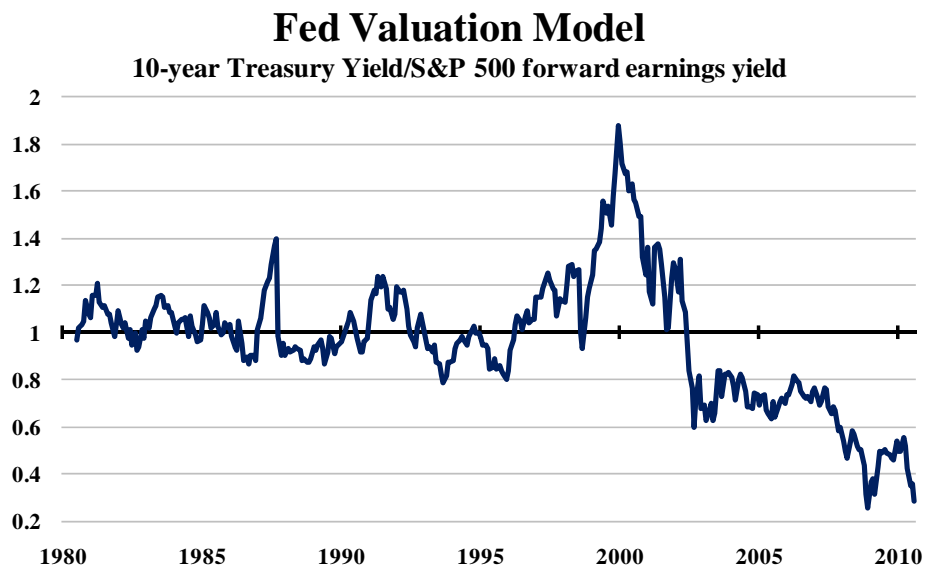


Stock/Bond ‘Gut Check’ – Reduce Bonds, Accumulate Stocks

- Sooner or later we believe interest rates will rise and bonds will enter a bear market. Our best guess is that investors have time to reposition portfolios as the bear market is unlikely while growth is sluggish and the Fed is buying bonds. That said, we think portfolios need a plan for this eventuality, both to protect principal and to maintain income. With the risk-free rate close to zero, we think tough choices are now required such as:
 1. *Credit risk or interest rate risk?* RiverFront’s Fixed Income team calculates that bond investors would incur a principal loss of approximately 12% if 10-year Treasury yields rise to 4% (last seen this April). This would wipe out the next five years of income (assuming a 2.5% yield). Among bonds, we like credit risk rather than interest rate risk and thus a combination of higher yielding corporate bonds and low yielding short maturity ‘cash-like’ bonds. (See *Fixed Income View*, “High Yield Bonds – An Alternative to the Bubble” 9/23/10)
 2. *Volatility of principal or volatility of income?* Many high-quality stocks yield more than 5- and 10-year Treasuries and even their own 5- and 10-year corporate bonds. This suggests to us that from both a total return and an income stream perspective, stocks will be better investments: “by seeking [principal] stability investors must accept high income volatility over time. By contrast, a diversified portfolio of stocks has the potential to provide a relatively secure and growing source of income” (*Strategic View* 9/15 *The Bond Bubble: Are Your Portfolio’s “Safe” Assets Safe?*).
 3. *Deflation protection or inflation protection?* Treasuries have traditionally offered the best protection against deflation, but the insurance is expensive in our view, especially since the Fed is committed to preventing deflation from occurring. We believe inflation is the greater concern, especially a few years from now when banks and individuals will have likely repaired their balance sheets. The best protection from inflation has historically been assets such as stocks, real estate, and commodities that participate in the economy and that can benefit from rising prices, earnings, and dividends.

The valuation case for stocks over bonds is as overwhelming today (in favor of stocks) as it was for bonds in 2000. The so called ‘Fed Model’ compares the yield on 10-year Treasuries to the earnings yield on stocks (see chart on right). The earnings yield is simply earnings/price, and the assumption of the model is that they should be about the same. The Fed Model was a favorite tool of former Fed chairman Greenspan, as it worked well as a relative valuation guide in the 1980s and early 1990s. However, the relationship has not worked since the late 1990s. In 2000, bonds were yielding about 6.5%, about twice as

much as stocks, implying that stocks were overvalued. Today the situation is reversed – the 10-year Treasury bond yield is 2.6% and the S&P 500’s earnings yield is about 6.4%. For us the message is that Treasury bonds are expensive rather than that stocks are cheap. While much less useful as a tactical guide, we believe the Fed Model is still useful at

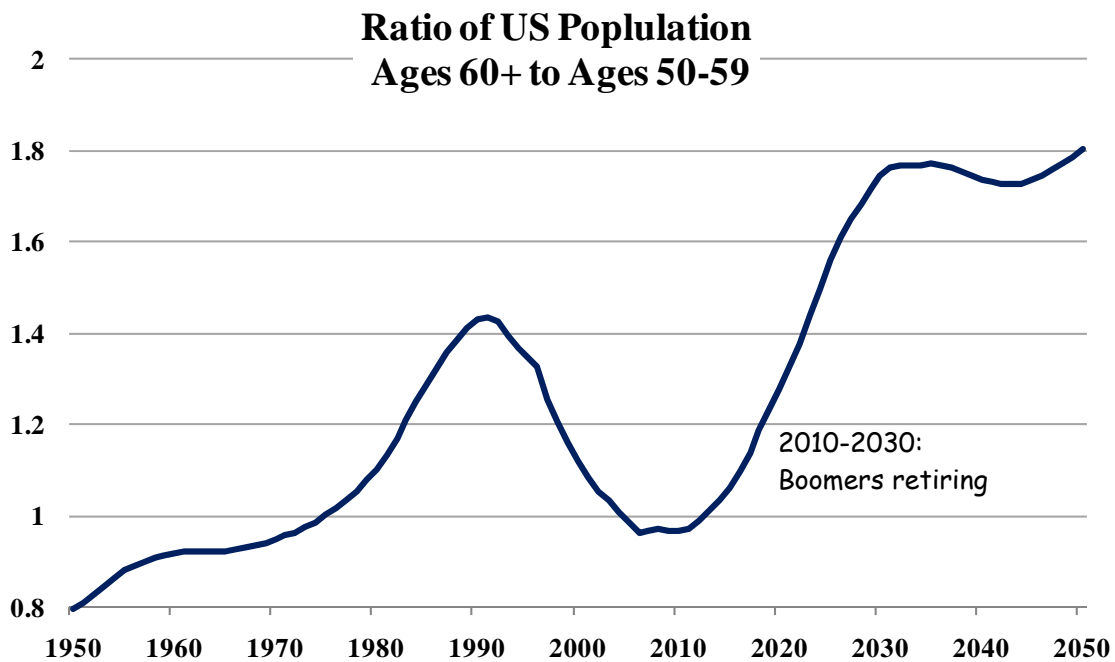


Source: Ned Davis Research, RiverFront

extremes and explains RiverFront's defensive bond portfolio and ongoing belief that stocks and other risk assets will outperform longer dated bonds in the coming years.

- The S&P 500 broke above 1140 last week, a level we had identified as significant overhead resistance. Last Friday's 2% stock rally included another technical plus – slightly above-average trading volume. We regard these technical positives as confirmation of our view that the cyclical bull market is still intact and that the probability of a retest of the bottom of the 'box' at around 1000 has lessened. In our view, following the 10% rally from its August lows, the S&P 500 will pull back slightly and attempt to find support around its 200-day moving average (currently just above 1117) or below that around 1090. A successful test of either of these potential support levels would suggest a rally up to 1220, the top of our box. A positive resolution to the 2011 earnings growth outlook will be required to break above the top of the box, in our view.

The Weekly Chart: Boomers' need for income will grow as they retire



Source: US Census Bureau, RiverFront

The 'Boomers' And Their Need For Income

The baby boom generation usually seems to overpay for assets that are associated with each stage of their lifecycle: growth stocks in the 1990s when the boomers were in their 40s and 50s, vacation homes in the 2000s and now -- fixed income. The ratio of 60+ to 50 year olds has already started to accelerate, and this trend will persist for two decades, as illustrated in the chart above. This will provide support for all kinds of income investments, but we believe retiring boomers will eventually discover the advantages of compounding dividend growth. We believe investors are already overpaying for high quality fixed income and thus recommend buying high quality dividend stocks now before boomers drive up prices.

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