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MILES Capital UPDATE

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The Tough Questions

As a fiduciary to our clients, one of our most important tasks is to ask the hard questions. Even if they are a little close to home. Such is the case for our fixed income accounts today.

Our clients invest in bonds for a host of reasons, including:

- Predictable current income based on the interest coupon on the bond;
- The certainty of a specified maturity date;
- The opportunity to redeem at par at maturity;
- Lower volatility compared to equities; and
- As a means of reducing the volatility for their portfolios due to their low correlation with stocks.

Bonds have served these aims effectively.

But the bond market has changed in at least two significant ways over the last 30 years. First, the bond market is larger, more complex and global than it was 30 years ago. In the early 1980's the total U.S. bond market was less than $3 trillion. Since then the market has grown to $35 trillion, and we have seen explosive growth in mortgage-related bonds, the creation of asset-backeds, floating rate issues, credit default swaps, cat bonds, inverse-floaters, CLOs and even the infamous CDOs. Municipal bond insurers have disappeared and the credit-worthiness of developed market sovereign debt is in question.

The second major change over the last 30 years is the decline in yields. In 1981 10-year treasury yields exceeded 15 percent. Since then yields have trended lower with few interruptions for three decades. As a result, price appreciation has been boosting bond returns in excess of the stated coupon for much of the last 30 years. The near term implications of lower yields are not lost on anyone – much lower income.

The risk of declining bond values is very real. In part this is because while rates cannot go much lower, they can potentially go much higher. So, a 1 percent rise in interest rates from current levels would reduce the value of a 10-year treasury by roughly 9 percent. That same 1 percent increase results in a 19 percent decline in the value of a 30-year treasury.

This leaves bond investors in a difficult spot. If interest rates stay where they are, they are looking at potentially negative real yields compared to inflation. If – we would say when – rates begin to rise, even modestly, they may experience double-digit losses in the value of their bond portfolios. Such losses are tough to take in a stock portfolio; they are positively unnerving to contemplate in a portfolio of high quality bonds.

David Miles
Chief Executive Officer

What are investors to do in light of this very asymmetric risk/reward scenario for bonds?

Let's start with a realistic understanding of where we are. The near-term future is clear: Fixed income returns will be lower than in the past. The best predictor of the total return of a credit worthy bond is its coupon. If you buy bonds with a 2 percent yield, 2 percent is the expected annual return to maturity. But bond investors have grown accustomed to far better. Over the last 30 years, price appreciation alone has added on average 1.3 percent to the annual total return. One cannot hope for such a result going forward.

Second, it is time to prepare for higher interest rates. As the global economy improves and the Federal Reserve begins to unwind QE 1, QE 2, and the Twist, interest rates will rise. Now more than ever we believe it is important to diversify – not increase – the types of risks in your bond portfolio. Some of the ideas we have been discussing with clients include:

- Reduce Duration: Buying shorter-maturity bonds will help to preserve market value in a rising rate environment.
- Ladder Portfolio Maturities: Laddering portfolios will provide continued reinvestment opportunities as rates rise.
- Consider Higher Allocation to Corporates: Higher yielding bonds have historically performed better in a rising rate environment.
- Add Floating Rate Securities: The income will increase as rate rise, but they pay next to nothing now.

One final point: We suggest revisiting your strategic asset allocation. Asset allocation is appropriately a long-term decision, and we generally – almost without fail – recommend staying the course. But there are times to take a second look. The most common reason to revise asset allocation is a change

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The Tough Questions (continued)

in your investment objectives or risk tolerance. But when relative valuations reach extremes, revisions may be warranted.

Today the relative value of stocks versus bonds has reached an extreme level. The trailing twelve months earnings yield on the S&P 500 is now roughly 7 percent, compared to about a 2 percent yield on the 10-year treasury. To be so far out of alignment indicates that bonds are expensive relative to stocks. Today a diversified portfolio of dividend-growing stocks yields nearly 4 percent. Of course there is no guarantee that stock valuations will not go lower or that bonds will not go higher, and stocks introduce different risks into a portfolio.

There are significant headwinds to the fixed income markets going forward. That is not to say that investors should abandon bonds – far from it. But it is vital to proceed with eyes wide open. At Miles Capital we believe that it is only by asking the hard questions that we create the greatest opportunity for outperformance in a challenging environment.

David W. Miles
Chief Executive Officer

Economy: A Climate of Fear

Market volatility pushed investors to the edge during the quarter as they tried to craft strategies around shifting political winds and central bank policies. Fundamentals have taken a back seat, and fear is front and center.

We can understand the fear. The drama in Europe continues and a resolution will not come quickly. Ratification of legislation to increase the size of the European Financial Stability Facility ("EuroTARP") is an important step to limiting the contagion that threatens to destabilize the European union. But that ratification is not guaranteed. While we believe European leaders will eventually craft the necessary consensus, significant deterioration in the situation could further damage consumer sentiment and send the U.S. back into recession.

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Arguments over the debt ceiling and the subsequent downgrade of the U.S. debt rating to AA+ by S&P have added to the uncertainty weighing on business activity. The Institute of Supply Management manufacturing index declined substantially during the quarter, although both the manufacturing and service indexes remain in expansionary territory. Consumers have held up reasonably well as evidenced by retail sales numbers similar to past post-recessionary environments. But sentiment is low and fragile.

The Federal Reserve remains engaged in accommodative monetary policy, announcing Operation Twist designed to keep longer rates low by increasing the duration of the Fed's portfolio. Declining inflation expectations have allowed the Fed to keep rates low and encourage risk taking. But while the liquidity spigot is open and borrowing rates are historically low, monetary policy alone cannot bring robust growth.

Bottom line, while domestic growth has clearly slowed, our analysis suggests there continues to be sufficient underlying economic activity to keep GDP growth positive and avoid a double-dip recession. Strong growth will not come, however, until uncertainty abates and unemployment declines, which means markets will continue be heavily influenced by politics at home and abroad.

Investment strategies with long-time horizons require patience and perseverance, and an ability to look through the volatility of today's markets. The guidelines established in calmer times anticipate these difficult markets and provide a road map to reaching goals. We appreciate the opportunity to guide you through this environment and look forward to a clearer path.

Equity: Uncertainty Leads to Sharp Correction

Growing economic uncertainty weighed heavily on the equity market during the third quarter. As a result, the S&P 500 declined more than 13 percent, leaving the Index down nearly 9 percent for the year.

In the U.S., the equity market remains volatile, as political impasse has prevented the passage of pro-growth economic policies, weakening consumer and small business confidence. To counteract the pessimism, the Federal Reserve recently

Equity (continued)

announced Operation Twist. While the program may provide a modest benefit to the economy, it does not address the real problem – that short term political motivation is preventing the implementation of meaningful economic reform by leaders in Washington. Overall, it is difficult to predict whether the political gridlock will ease as we approach the election cycle.

In Europe, policymakers continue to struggle, although signs of progress are on the horizon. In recent weeks European leaders have met to discuss an orderly restructuring of Greek debt, which may prevent Greece's troubles from spreading to other countries and minimize bondholder losses. Other plans call for capital infusions into the European banking system, partially offsetting losses on sovereign bonds and bolstering lending, both of which are essential to economic growth. We expect more specific details of these and other initiatives to emerge soon, reducing equity market volatility.

Though policy makers in many emerging market countries are successfully managing inflation and economic growth, China's economy is slowing more than expected. The deceleration, as a result of lower exports to North America and Europe, could lead to additional market volatility in the near term. However, China has the flexibility to fine tune its fiscal and monetary policies in order to maintain economic stability, improving investor confidence.

Given the slowing growth, it makes sense to be cautious about investing in equities in the short term. Nevertheless, a recession does not appear to be imminent, with the U.S. and global economies likely to produce modest economic growth well into next year. Stock valuations have become more attractive and many companies have strong balance sheets. Also, low interest rates are likely to remain through 2012, enhancing future earnings growth.

With negative headlines dominating the news, any positive economic surprises could lead to a sharp upward move in the equity market. And, the U.S. equity market may improve sooner than expected given the limited appreciation and return potential of other asset classes. As of the end of the third quarter, more than 55 percent of S&P 500 companies had a yield greater than that of the 10-year Treasury, implying that purchases of dividend paying stocks could pick up rapidly in the fourth quarter. When stronger signs of global economic improvement emerge, equities will likely be the first asset class to benefit as investors' cautious stance gives way to renewed optimism about future growth.

Fixed Income: The Bumpy Ride Continues....

By many measures, the last quarter was the most volatile experienced in the fixed income markets since the 2008-09 U.S. credit crisis. However, the causes of this instability are very different this time. Most notably, U.S. political gridlock leading to a downgrade of the U.S. debt rating and a lack of credible solutions to the European sovereign debt crisis left market participants with plenty to worry about. That uncertainty along with other factors drove some dramatic moves in the markets during the quarter.

Market participants responded to this elevated uncertainty by buying the most liquid and safest asset in the world, U.S. Treasuries, which drove interest rates to historic lows. Also contributing to lower rates was the announcement of Operation Twist by the Federal Reserve in September. The program to sell short maturity Treasuries and buy longer maturity Treasuries had the effect of reducing longer-term interest rates and thus benefiting borrowers. For example, 30-year mortgage rates fell to 4 percent in September. Interest rates -- as measured by the 10-year Treasury bond -- declined significantly during the quarter, ending near 1.9 percent.

> Interest rates... declined significantly during the quarter....

The secondary effect of this flight to safety was the underperformance of every other sector of the fixed income markets when compared to similar duration U.S. Treasuries. The relative performance of corporate bonds was negative as risk premiums widen out during the quarter. However, in our view, continued strong fundamentals, burgeoning cash balances, and lower valuations make corporate bonds an attractive investment at this time. Mortgage securities tend to underperform as volatility rises and that proved to be the case during the quarter. High quality municipals could not keep pace with Treasury performance but continue to offer value in select sectors.

Many macro risks remain and the markets will continue to respond to news headlines until concrete solutions are implemented. While it may take some time given the magnitude of the issues, eventually the markets will refocus on the economic and fundamental factors that drive long-term performance for investors.

Miles Capital Developments

As an independent firm, Miles Capital's overriding priority is to ensure the needs of our clients are met. Just as we noted in our annual client survey we are committed to continually taking the outstanding investment management and client service that we have become known for, and raising it another notch.

To this end, one of our prime objectives is to attract and retain the highest caliber talent in all aspects of our investment management business. We are pleased to announce that we have recently added an outstanding relationship management professional.

On October 3, 2011, Lori Braunschweig, CFA joined Miles Capital as Senior Client Relationship Manager. Lori serves as the dedicated resource for our institutional clients, and is committed to achieving superior client satisfaction. She earned her Bachelor of Arts in Political Science and History and Masters of Business Administration from Drake University. Lori also earned the right to use the Chartered Financial Analyst designation, and is a member of the CFA Institute and CFA Society of Iowa. Prior to joining Miles Capital, Lori was with the Principal Financial Group for 11 years serving as a Product Specialist for Principal Funds and Relationship Manager for Principal Global Investors.

Lori Braunschweig, Senior Client Relationship Manager

Lori will be introduced to you over the coming months, and her background and experience will be invaluable to the Miles Capital team as we continue to evaluate and refine the services we offer to you, our clients.

We appreciate the continued opportunity to work with you, and look forward to our continued relationship.

We are committed to keeping you updated on the developments at Miles Capital. As always, please contact us at 800-343-7084 if you would like to visit with any of our team members.

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