GREENWOOD REPORT

FIVE YEARS LATER

The month of September marked the five year anniversary of a seminal event in the modern history of financial markets: the failure of Lehman Brothers, the largest bankruptcy in the history of the United States. While a lot has changed, much stays the same: uncertainty still exists in the financial markets, the word "crisis" remains on the tip of our tongues, and the nation is polarized – some say paralyzed – as the result of political theater. Further, **Greenwood Gearhart's investment strategy has stayed as consistent over the last five years as it did the previous twenty-five**. Our competitive advantage of a long-term time horizon coupled with the perspective and experience that comes with navigating thirty years of markets, proves once again to be effective in times of crisis. By consistently implementing our process, we exploit temporary asset mispricings and profit generously as the economy improves. The returns we've achieved for our clients' portfolios are gratifying.

The continued dysfunction in Washington prompts some clients to inquire as to whether our strategy might or should change. Our response echoes Benjamin Graham, the founder of value investing: "*We use the market to serve us, not instruct us*." When unfavorable scenarios in Washington create volatility, we opportunistically invest in companies that become available at more favorable prices. **We do not, however, respond with a knee-jerk reaction**. As we counseled in 2008 and 2009: "*The end of the world only comes once, so invest accordingly*." A default by the government of the United States of America, the most powerful, wealthiest nation in the world, and the issuer of the world's reserve currency[1], would be Financial Armageddon. No doubt, *some* damage has been done to our national credit as a result of this political theater; however markets are not behaving as if a default will occur. Should global lenders to the United States **expect** a lapse in interest payments, frenzy will ensue, prompting a major selloff in Treasury securities, a massive spike in interest rates, and financial panic. Congress knows this and the President knows this. A short-term solution was crafted. Until a longer-term solution is reached however, expect volatile markets driven by fearful investors. Eventually, cooler heads, like yours and ours, will prevail.

September also marked the five year anniversary of Mary Ann inviting Brock to join her as part of Greenwood & Associates, now Greenwood Gearhart Inc. Though this and the Lehman event were merely a coincidence, Brock has spent much of the last five years convincing Mary Ann that her hiring decision didn't spark a global financial crisis!

Levity aside, we believe this partnership has been a successful venture for the firm and, most importantly, for our clients. Throughout the last five years, we've proudly referred to Greenwood Gearhart as "G^2" or "G-Squared". This symbol is intended to represent the power of two and the compounding benefits that arise from like-minded investors working together with a common goal of helping clients achieve their financial independence. But Greenwood Gearhart is more than just

[1] For more information see: "The Future of the US Dollar", October 2009. GreenwoodGearhart.com.

two people; it is our highly capable and professional team that keeps the wheels turning and the business thriving while providing a high-level of client service. This year we will celebrate long-term employment anniversaries for Linda Batson (Vice President, Administration – 26 years), Denise Anderson (Director, Client Services – 17 years), Hal Marshall (Information Technology Manager – 13 years) and Mark Castleman (Director of Retirement Plan Services, 9 years). In fact, all of our team members have at least five years with Greenwood Gearhart Inc. (Robert Greenwood and Spencer Kirkland – 6 years) and over 75 years of combined experience at the firm. If you count Mary Ann and Brock, we have spent a collective century with one firm in one location. **When it comes to helping people manage their financial affairs, continuity and consistency are essential**. There is no doubt that Greenwood Gearhart has staying power! In addition, we regularly have interns on a short-term basis (one to two years). This long standing practice has allowed us access to the best and brightest from the University of Arkansas Walton College of Business. Our current intern, David Pierce, is no exception. We appreciate the loyalty and service of our great team and are excited about our future.

REMEMBERING LEHMAN

The failure of Lehman Brothers had unintended consequences unforeseen by our government's leaders at the time. For example, had Treasury Secretary Hank Paulson anticipated the ripple effects that occurred with Lehman's failure, he might have acted differently. This singular event made a bad economic situation exponentially worse. The collapse of Bear Stearns followed. Credit seized-up; Merrill Lynch, AIG, Citigroup, Morgan Stanley, Bank of America and even Paulson's former employer, Goldman Sachs, had to receive lifelines from private investors and/or the U.S. government to bolster their financial position and save the financial industry. The cascading effect was unprecedented and required **new and unconventional tools;** the government flooded the economy with liquidity and kept the recession from becoming a depression. As Ben Bernanke, the Chairman of the Federal Reserve, admitted to us in a room of other investors in October of 2008, the Fed had to "**experiment**" to solve this crisis.

THE EXPERIMENT

To understand the **new and unconventional** tools, a review of the **conventional** means by which monetary policy is applied is helpful. The Federal Reserve is in charge of implementing monetary policy through the manipulation of money, credit, and interest rates to influence the level of economic activity. The goal of monetary policy is maximum employment, stable prices, and economic growth. Historically, there are four conventional tools that the Federal Reserve uses to achieve these mandates.

1) **Open Market Operations**: the purchase and sale of U.S. Treasury and agency securities to increase or decrease the availability of capital (money supply).

2) **Discount Mechanism**: raising or lowering the discount rate that depository institutions are charged on loans from regional Fed banks.

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

3) **Reserve Requirements**: increasing or decreasing the amount of funds that a depository institution must reserve against specified deposit liabilities to tighten or loosen lending.

4) **Moral Suasion**: the jawboning tool; when the Fed Chairman speaks, the markets listen.

For example, in past periods, when the economy got ahead of itself and inflation was on the rise, the Fed could influence short-term interest rates to temper growth and keep the economy from overheating. In opposite scenarios (like the past five years) the Fed would attempt to stimulate the economy with accommodative policy. Unfortunately, **conventional** tools were insufficient to fully combat the credit crisis and, because rates can't be lower than zero, **other means** were needed.

These **other means** took the form of a number of key programs that, when implemented together helped alleviate the financial crisis. These **additional** programs are summarized here:

5) **Interest Rate on Excess Reserves (2008)**: A new tool, representing the true risk-free rate of interest paid by the Fed *directly* to a financial institution on excess reserves. This rate is set by the Federal Reserve Board as opposed to the Federal Open Market Committee.

6) **Access to the Discount Window for Non-bank Financial Institutions (2008)**: A safety valve in relieving credit and liquidity pressures during times of systemic stress. (e.g. Goldman Sachs and Morgan Stanley converted to banks for the express purpose of accessing the window.)

7) **Troubled Asset Relief Program (TARP) (2008)**: Referred to as "the bailout", the Treasury purchased $700 billion of distressed assets from troubled financial institutions.

8) **Recovery and Reinvestment Act (2009)**: Referred to as "the stimulus", intended to create jobs with $831 billion worth of "shovel-ready" projects.

9) **Payroll Tax Holiday (2010)**: A two-year, two percent cut in payroll taxes.

10) **Operation Twist (2012)**: To put downward pressure on long-term rates, the Fed swapped short-term Treasuries for long-term Treasuries.

11) **Forward Guidance:** Fed "signals" future policy in an attempt to smooth market reaction.

12) **Other Programs**: TALF (re-securitization of asset-backed securities like student loans), PPIP (public and private funds used to purchase distressed assets), the FDIC insurance limit increase to $250,000, etc.

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

13) **QE or "quantitative easing."** Of all the aforementioned programs, quantitative easing is the one that remain in effect today and prompts important **questions and concerns** looking forward.

QUANTITATIVE EASING

The Fed used QE 1, 2, and 3 to increase the money supply substantially, thereby liquefying the economy with cheap capital to stimulate growth. The programs were implemented by buying large amounts of financial assets from commercial banks and other private institutions. While similar, QE is different from conventional Open Market Operations as it involves purchasing a broader assortment of assets in much larger quantities.

QE1: Starting in November 2008 (**Dow 9,325**) the Federal Reserve began buying $600 billion of Treasuries and Mortgage Backed Securities (MBS) in an effort to stimulate the economy. By March of 2009, (**Dow intraday low of 6,470**), the Fed's balance sheet had grown to $1.75 trillion before reaching $2.1 trillion in June of 2010 (**Dow 9,774**). As the securities began maturing, the balance sheet contracted and the Fed, in August of 2010, (**Dow 10,014**) embarked on a program to buy approximately $30 billion of Treasury notes **each month**.

QE2: In November of 2010 (**Dow 11,006**), the Fed announced a second round of QE to further stimulate growth, combat perceived deflation, and avoid a Japan-like scenario. This program involved buying $600 billion of Treasuries only.

QE3: In September of 2012 (**Dow 13,437**) the Fed launched a new $40 billion per month program to purchase additional Treasuries and MBS. In December, the program was increased to $85 billion with no end date.

Today: Most recently, in June of this year (**Dow 14,909**) Chairman Bernanke announced the decision to "**taper**" QE purchases if economic data continued to improve. The taper was effectively signaling the parameters for an exit strategy for QE. Markets expected tapering to begin in September, dropping purchases from $85 billion to perhaps $65 billion per month. However, Bernanke delayed, preferring to wait for additional data, to avoid compounding the debt ceiling issue, and to involve his successor, Janet Yellen in the process.

Prior to the recession, the Federal Reserve held nearly $800 billion of Treasury securities on its balance sheet. It held $0 in MBS. Today the Fed's balance sheet totals nearly $3.8 trillion consisting of over $2 trillion in Treasury securities and $1.3 trillion in MBS.

CONCERNS WITH QE

There is no doubt that quantitative easing has played a part in the success of the economic recovery. Clearly the value of the stock market helps convey this notion. But some have **concerns that QE was inadequate** as displayed by a still stubbornly high unemployment rate (7.2%). Additionally, many frustrated workers have dropped out of the labor force altogether indicating an even larger pool of unemployed Americans. Others argue that the economy has been "propped-up"

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

by artificial means and will tumble when the Fed begins to exit in earnest and the "free money" disappears. Still others believe "runaway inflation", a collapse of the dollar, higher interest rates, austerity, or a combination of each is on the horizon.

THE EXIT

The aforementioned concerns are understandable. Just as the Fed was "experimenting" as they inflated the money supply and bought new assets from new bank entities, it may be an experiment to deflate it. The methodical nature with which the Fed historically conducts its business will be even more important going forward given the unconventional and unprecedented actions they have undertaken. Further, we acknowledge our country's issues extend well beyond monetary policy and into the fiscal realm where we are carrying record levels of debt and continue to carry annual budget deficits which increase the national debt. While solutions are for another commentary, we have real problems that deserve real attention.

Considering all these issues, **we believe the Fed's exit from QE will be more orderly than many anticipate** for the following reasons:

1) The Fed's policy of buying assets to push down long-term rates could not last forever. Institutional investors are aware and have been **anticipating the "taper"** for some time.

2) This anticipation is reflected in the fact that 10-year **interest rates have already more than doubled** from 1.39% on July 24, 2012 to 2.99% on September 5, 2013. We believe short-term rates will likely remain low and the yield curve will moderately steepen as economic expansion strengthens.

3) QE3, the last of the three programs, has **not been as simulative** in the U.S. as anticipated. One possible reason could be that the Fed's Treasury purchases are from foreign sellers, whereas MBS purchases would be from domestic sellers.

4) Thus, **the impact of tapering may be muted** in the United States if *Treasury* purchases *primarily* affect foreign economies while *MBS* purchases *only* affect the domestic economy. It is possible that QE3 has been a factor in the recovery of Europe, Asia, and Emerging Market economies.

5) Prior to the recession, the Fed held about 10% of all outstanding U.S. debt. Today, even after increasing its balance sheet substantially through QE, the Fed still holds 10% of all debt, a function of the Treasury's new debt issuance over the last five years.

6) For "runaway" inflation to occur, there must be a shortage of resources – either labor, capital or natural resources. The current environment reflects ample supply and technology reflects increased mobility of each. **With an abundance of resources, one would not anticipate inflation to run rampant**.

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702

7) Excess capital resources should diminish incrementally as QE is tapered. However, an orderly drawdown, augmented by the natural maturity of the underlying securities, would be superior to the Fed implementing an immediate and strong restrictive monetary policy.

8) While the economy has been flooded with new money, the expenditure response on new goods and services, lending, and investing, has been muted. Caution has trumped the propensity to spend. This phenomenon, referred to as a **liquidity trap**[2], means the new money (liquidity) is trapped by financial intermediaries who are unwilling to lend. **Without lending, the money is not multiplied into the economy, doesn't stimulate, and doesn't threaten inflation**.

9) Factors number 6, 7, and 8 support **continued low interest rates**. Rates can and will likely rise but even the result of a 1% increase will still mean historically low rates.

10) Janet Yellen, President Obama's nominee to replace Ben Bernanke, is a positive selection. She is a highly accomplished academic with real-world experience under multiple presidential administrations. She is a measured, thoughtful, tough leader and is well-versed in monetary policy. She is also considered a "Dove" preferring to err on the side of accommodative policies that support economic growth and full employment.

11) Finally, with cash paying near zero percent and the interest rate risk inherent in bonds, **equities remain the best relative value for long-term investors**. Although equity values have recovered substantially since the crisis lows, "Mr. Market" is still offering bargains for patient investors.

G. Brock Gearhart, CFA
President

Mary Ann Greenwood, Ph.D., CFA
Chairman

October 22, 2013

[2] For more information see: "Addressing the Double Dip Question", September 2010. GreenwoodGearhart.com.

26 EAST CENTER, POST OFFICE BOX 4278 ● (479) 521-5353 ● FAYETTEVILLE, ARKANSAS 72702