End of the Bond Bull

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End of the Bond Bull

Against a 30-year backdrop of declining inflation, interest rates have plummeted to less than zero on an inflation-adjusted basis, spawning the longest bull market for fixed income securities on record. During this period, at least three distinct constituencies have carried on a flirtation with leverage: corporate America came first, levering up during the 1970s and 1980s until creditors forced retrenchment after numerous failed Leveraged Buy Outs (LBOs). Individuals were next, amassing mortgage, auto, credit card and student loan debt with seeming abandon until the financial crisis of 2008 forced a hard stop to much of that behavior. The third entity, the U.S. Government, has yet to reign in its balance sheet – though the need to do so is the subject of intense debate and investor concern around the globe.

This paper will outline how the U.S. got to its present state of affairs and profile several different scenarios as to what may happen next. As helpful as it would be to point to a prior period for comparisons and lessons learned, the world has never been faced with the complexity of choices currently at hand, making analysis difficult. Nevertheless, frank discussion of a variety of outcomes and their potential investment and economic implications should help identify areas of opportunity and greatest risk.

Setting the Stage: The Bull is Born

With the benefit of hindsight, we now know that the early 1980s marked a substantial turning point for the U.S. economy. After more than a decade of political trauma, war and economic stagnation during the 1970s, gold reached a record level of $850/ounce, the price of a barrel of oil climbed above $35 (a record up to that date and equivalent to $106 in 2013 dollars), the top marginal income tax bracket registered 70 percent, and interest rates on the 10-year U.S. Treasury bond touched 16 percent.

Then two significant events occurred: in mid-1979, President Jimmy Carter appointed Paul Volcker to head the Federal Reserve and the next year, Ronald Reagan was elected to his first presidential term. Subsequently, President Reagan and Chairman Volcker stood shoulder-to-shoulder to battle inflation and oversee policies that would revive the economic progress experienced during the 1950s and 1960s. President Reagan and Congress worked together to tighten tax loopholes and bring income and capital gains tax rates down sharply. A “peace dividend” began to accrue as troops were brought home from Vietnam and military bases were shuttered.

For his part, Chairman Volcker adopted the mantra of fighting inflation in order to stimulate growth as the Fed’s singularly most important goal, even allowing the country to go into several sharp, albeit short, recessions to prove the point. Commodity prices receded, inflation did indeed subside, manufacturers benefited from significant cost benefit tailwinds and equity prices soared, providing ready liquidity for thousands of business owners. Against this backdrop, a nearly 30-year bull market in fixed income securities was born as yields declined from the mid-teens to low single digits (Chart 1).

Chart 1: 10-Year Treasury Bond Yield

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The Use of Leverage

Another key trend that emerged by the late 1980s was an increased comfort with leverage at the personal, corporate and governmental levels. Credit became substantially easier to obtain while tax policy actually encouraged spending and debt accumulation. Wall Street discovered it could buy and pool loans collateralized by everything from airline assets to mortgages and student and auto loans, thereby unleashing a raft of new underwritings from which to generate fees. Demand for the raw “product” (loans) became insatiable (Chart 2).

What had been anathema during most of the 20th century – the accumulation of personal debt – became a sophisticated way to manage and leverage one’s personal financial affairs, especially as rates declined. Congress, by urging home ownership and allowing for such things as the deductibility of student loan interest expense, implicitly encouraged debt accumulation by an ever-broader audience. Several generations of consumers became accustomed to operating with leverage. Indeed, as declining inflation and globalization began to pressure wage gains, most individuals found they had to deficit-spend just to maintain their standard of living (Chart 3). Consumers became increasingly comfortable with devoting an ever-larger share of their disposable income to servicing mortgage and revolving debt.

Despite lackluster wage gains, the increasing portfolio values brought on by the stock market/tech bubble of 1995-2000 lulled many individuals into a false sense of security related to their ability to absorb a higher debt service level. When that bubble burst, however, Chairman Alan Greenspan led the Fed to push short-term rates to near zero in an effort to prevent broader economic instability. Then, as now, investors fretted that such stimulus would surely lead to inflation as described in a Wall Street Journal article on December 1, 2003: “As investors close the books on 2003 and look out into next year, some are worrying that inflation, which had been banished in the past few years, is poised for a comeback. Were that to happen, it would terrify bond investors and shake up the stock market, while giving a boon to some manufacturers, which finally would be able to raise prices.” With perfect hindsight, we can now see that rather than inducing broad-based inflation, those low rates drove prices higher mostly in one particular asset class – housing – which allowed consumer debt accumulation to go on largely uninterrupted until that bubble burst amidst the credit crisis of 2008.

Businesses, too, found debt an attractive option to lever their economics. A burgeoning pool of institutional buyers, such as pension, foundation/endowment and 401(k) managers, eagerly absorbed the increasing flow of such obligations. Banks – the traditional lender to corporations – were beset by competition from brokers, pension funds and credit unions, putting pressure on standards and pricing throughout the system. By the late 1980s, the widespread use of LBO financing caused a credit crisis and numerous bankruptcies in the corporate sector. It took the better part of a decade for the excesses to be purged from corporate balance sheets. The lessons of that period persist to this day as more conservative U.S. corporations now sit on massive cash balances and run leverage ratios far below historic norms (Chart 4).

Chart 2: United States: Total Credit Market Instruments vs. GDP

![Chart 2](image-url)
Chart 3: Consumer Credit vs. Real Wage Growth

Source: Federal Reserve Bank of St. Louis

Chart 4: Corporate Debt vs. Cash

Source: Federal Reserve Bank of St. Louis
While there have been innumerable attempts to tease apart precisely what set of factors were involved in setting off the latest economic crisis, it is relatively clear that a reliance on short-term funding exacerbated the issue. Investment banks such as Lehman Brothers and Bear Stearns had no long-term debt but relied instead on an array of industry relationships to provide short-term funding. When the counterparties decided against further lending, operations became stressed literally overnight. Credit markets seized, risks skyrocketed as investors of all types ran for the sidelines and a crisis of confidence of epic proportions erupted almost instantaneously. Developed market central bankers realistically had few choices. Key global financial behemoths were too systemically important to allow their failure, so governments absorbed their financial obligations, thus shifting the debt burden to sovereign balance sheets.

In the years since the credit crisis, global regulators have been struggling to put policies and rules in place that will help prevent such events from recurring, casting a continued pall over financial institutions’ willingness to lend. Central bankers, on the other hand, continue to purchase debt in an attempt to push cash into the system and prop up economies. The primary result has been a substantial increase in the Fed’s balance sheet (Chart 5), but more moderate growth than was hoped for and only grudging decreases in the U.S. unemployment rate.

Another result of the Fed’s intervention since the credit crisis began has been a continued decline in interest rates (particularly at the short end) which has allowed the bond bull market to extend itself years beyond what most pundits would have projected. Note, for example, the Fed’s monetary actions relative to the U.S. Fed Funds rate in both the 2000-2002 tech meltdown and the most recent financial crisis (Chart 6). Indeed, real interest rates have occasionally dipped into negative territory over the last 10 years (Chart 7) and even over longer time spans.

**Chart 5: Federal Reserve Balance Sheet**

Source: Federal Reserve Bank of Cleveland
History and Implications for Fixed Income Investors

Throughout the past three decades as interest rates declined, investors in bonds benefited mightily. Fixed income average annual returns have been consistently positive and far above historical norms. Furthermore, bonds outperformed stocks during crucial time periods including, for example, in 2008 when equity markets imploded (Table 1).

This outperformance lured trillions of dollars into fixed income investments – much of it into bond funds (Chart 8). In recent years, the cumulative flow has accelerated, although one could argue that at least some of what went into bond funds came from investors’ cash stores, not equities, as investors searched for yield (Chart 9). As recently as 2006, taxable money market funds yielded 4.5 percent versus 0.01 percent on December 31, 2012. As investors lengthened their maturities in pursuit of yield, the implicit assumption seemed to be that risks were limited when extending only by a small amount. However, the bond market’s downturn in the summer of 2013 (as fixed income investors began to adjust for the notion that the Fed would not keep rates low forever) seems to have put that presumption to a severe test.

As alluded to above, the most recent period is not the only time that the U.S. Federal Reserve’s monetary stimulus carried corollary consequences. When the Fed eased aggressively in the wake of the tech bubble bursting in the early 2000s, the U.S. dollar weakened and investors turned to emerging market debt and equity for better income and growth prospects, a cycle we have clearly seen repeated in recent years (Chart 10). While there are numerous fundamental

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<th>Annual Returns</th>
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<th>2011</th>
<th>2012</th>
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<td>2.1</td>
<td>16.0</td>
<td>1.7</td>
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</table>

Source: WMG Research

Chart 8: Cumulative Bond Fund Flows

Chart 9

[Graph showing cumulative bond, money market, and equity flows from 2007 to 2012.]


Chart 10: Emerging Markets Fund Flows vs. U.S. Dollar

[Graph comparing EM fund inflows to the trade-weighted U.S. dollar index from 2003 to 2012.]

reasons for optimism regarding the long-term prospects for global growth in general, particularly in emerging markets (see Abbot Downing’s Wealth of Nations white paper), we suspect that many yield-hungry investors have migrated to some of these investments without a thorough understanding of their unique risks (e.g., less liquidity during stressful times and geopolitical volatility).

The Coming Meltdown?
In the wake of the Great Recession, developed nations worldwide are in a highly levered state with fragile economies. Populations are aging and promises for health and retirement benefits are coming due even as the numbers of working age citizens shrink. Tax burdens are already high, making that avenue of revenue creation difficult to adopt. Against this backdrop, investor concern about central bankers’ ability to unwind the excess stimulus put into the system over the past five years has reached fever pitch.

It does not help that we have never been in this precise predicament before. Pundits point fretfully to the fact that financial unwinds in other sectors (Savings & Loans, Leveraged Buy Outs and Less Developed Countries, as examples) took much longer to recover from than the fundamentally induced busts of prior decades. Others propose that inflation must be poised to accelerate given the historically vast quantities of liquidity put into the global system. There are many issues at play here and the popular media tends to bundle them together into one giant concern, muddling the discussion even further and leaving investors with nothing concrete to hang onto but fear. In the section that follows, we will discuss the primary issues involved and outline potential outcomes, repercussions and investment implications.

1) The Fed’s Quantitative Easing: How and when will it be tapered or ceased?
Markets around the globe have become obsessively focused on the U.S. Federal Reserve’s bond buying program in recent years. Investors favor what is known over what is not and it is disconcerting to try to discern what happens next.

A stronger economy that can begin to stand on its own means the Fed should be able to stop injecting funds into the system via bond purchases. Though both stock and bond markets reacted negatively to the Fed’s profiling the conditions under which it would start to “taper,” the process should be cheered by investors as it would indicate a more resilient economy was under way. It has never been a question of “if” the Fed would stop as much as “when.” Furthermore, the Fed always has the option to resume purchases if the economy falters. Chart 11 illustrates the beneficial impact that the Fed’s monetary easing has had on the stock market.

2) The Fed’s balance sheet: Will it be unwound and if so, how?
The Federal Government is unlike any other creditor, possessing important advantages that could avert the type of pain extended to other constituencies. For example, the Federal Reserve does not need to mark its balance sheet to market as rates rise nor can it be forced to sell its holdings if it chooses otherwise. It can simply let them mature naturally. Also, the Fed need not be concerned if the value

Chart 11: The Fed, QE and the S&P 500

Source: Federal Reserve Board, Bloomberg Financial LLP, August 9, 2013
of its portfolio declines in a rising rate environment. As long as the U.S. dollar and U.S. government debt obligations are perceived as safe havens during troubled times – admittedly a big if – the Fed is afforded much more breathing room and flexibility than any other creditor. Finally, the Fed has the ability to print money to pay its debts, even if that process has its own significant long-term implications.

Behavioral scientists tell us that, given a choice, individuals will pick near-term pleasure over courses of action that may be uncomfortable near-term but would yield substantially greater long-run benefits. As such, it is not surprising that elected officials, fearing adverse electoral outcomes, have a difficult time making hard choices about spending and debt levels. In addition, despite threats of a government shutdown and a ratings cut, investors continue to buy U.S. government and agency debt, providing little impetus to encourage near-term change. To the extent this remains the case, the U.S. has the flexibility to let its debt decline gradually and naturally.

3) What will happen if an overwhelming number of bond fund investors try to exit at the same time as rates rise? How violent could it get?

The U.S. bond market is gigantic, estimated at more than $40 trillion versus $15 trillion for the U.S. equity market.\(^5\) From the late 1990s until the financial crisis hit, mortgage-backed securities and corporate bonds had much larger representation in the market and in the bond fund indexes than did U.S. Treasury securities (Chart 12).

In our view, nervous bond fund investors could exert a much more destabilizing impact on fixed income markets over the short run than would pressure from outright creditors or overt changes to the Fed’s stimulus programs. As noted earlier, billions of dollars have been invested in fixed income funds of all flavors in recent years – $1.81 trillion in the five years ended 2012 alone. It was not until the second quarter of 2013 that many bond investors witnessed their first negative return, a situation that looks quite similar to what happened to stock fund investors between 1995 and 2000. In that instance, fully half of the investors in stock mutual funds had never seen a decline, having entered those funds in the prior five years. The average annual return that they had come to expect was north of 20 percent.\(^6\)

Should fixed income investors start to panic and withdraw their funds, bond fund managers will be forced to sell to meet redemptions, even if the underlying credits are fundamentally sound. This could push the effective yield on those bonds up until some sort of clearing price is reached. Substantial risk would seem to reside, therefore, in issues that are the most widely owned, particularly those held by popular ETFs and those in the most concentrated positions within the largest funds.

4) What ripple effects for other bond holders would result from a disorderly exit?

To the extent bond fund managers are forced to sell high-quality bonds in order to meet redemptions, other holders of those securities would be forced to mark-to-market

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\(^5\) Source: SIFMA.org. Used with permission.

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their portfolios. This process was part of what exacerbated the 2008-2009 downturn as banks, insurance companies, pensions, and other institutional investors were forced to reflect current prices on their own balance sheets even though they had no intention of selling. In theory, this could damage balance sheets and capital ratios, even though the fundamental situation has not technically changed.

5) Will higher interest rates necessarily lead to higher inflation?

Interest rates have already stayed lower for much longer than anyone had thought possible. Inflation-adjusted rates have been negative for years, depending upon the point in the yield curve. At some point, they may start to tick up and continue to do so, as a number of structural and fundamental factors come into play. How far they move and how fast, will be a function of many different inputs.

Many pundits have long feared that the quantity of money flowing into the system from developed market central bankers was bound to lead to excess inflation. However, easy money alone does not lead directly to price increases; inflation is also a product of velocity (i.e., how quickly money is recirculated). It is further impacted by relative slack in capacity utilization, labor force participation, and competition for scarce resources. Despite the vast increase in global money supply since the 2008 financial meltdown, velocity has dropped sharply (Chart 13).

Even as central bankers have pushed vast quantities of funds into the global monetary system, creditor and lender risk appetites have moderated. Banks have money to lend but are reluctant to do so, given tighter regulatory oversight and looming increased capital requirements that Basel III will bring. Companies have significant cash on their balance sheets, but hesitate spending it on labor, capital expenditures, acquisitions, etc., due to a lack of clarity on a wide range of issues.

Thus, despite the substantial increase in liquidity, headline inflation has remained tame. Moving forward, continued slack in capacity utilization, technological efficiencies in a wide swath of industries and demographics (declining work force participation rates) makes it tough to advance a case for sustained, above average inflation. That said, as already pointed out, the fear of inflation and/or concern about losses in bond holdings could instigate sharp upward moves in fixed income yields which would not necessarily be supported by long-term fundamentals.

With the U.S. economy six to seven years past the start of the credit crisis, personal balance sheets have improved and corporate balance sheets remain in great shape. Even the U.S. balance sheet is improving, thanks to sequestration cuts, stronger-than-expected tax revenues and an economy that is beginning to percolate. The retooling of the U.S. economy (a move toward energy independence), the emergence of more and higher paying STEM (Science, Technology, Engineering and Math) jobs and continued innovation is progressing nicely. Employment trends are stronger, consumer confidence is on the mend and pent-up demand for housing and autos is starting to be fulfilled as echo boomers enter adulthood. In light of global excess physical capacity, continued technological innovation and
the availability of human resources, it is not a given that inflation will necessarily accelerate in lockstep with bonds should yields tick up.

To the extent that loans are tied to floating rate indexes and/or new debt issued, inflation would be pressured to the upside over time, albeit with a lag. A bit of inflation would actually be healthy for many companies, providing some pricing power and allowing for more generous wage growth than has been the case for many years. Financial services companies should benefit in a moderately rising rate environment as the prices they charge for loans can increase faster than the rates they pay on deposits. Furthermore, rising interest rates would better compensate investors for the credit risks they are taking.

It is important to keep in mind that the lofty interest rate and inflation levels of the 1970s and 1980s were not normal by historic standards. The long-term average yield on the 10-year Treasury is in the area of four percent. That said, a move from current levels to four percent would cause substantial deterioration in the price of bonds. If it came quickly, the resultant destruction in investor confidence could prompt a mass exodus from bond funds that could drive rates higher than fundamentals would support.

The flip side of that argument is that yield-starved baby boomers, pension funds, etc., would find those rates attractive and provide buying power. Investors probably would not step in quickly, however, if they think that rates will go even higher.

**Other Considerations**

There are many different variables within global markets and economies that make projecting the outcome of the current situation especially challenging:

- The U.S. dollar and Treasury securities have enjoyed reserve currency and safe-haven status for as long as most current investors can remember. It was not always so. Any crisis of confidence could force the Fed and Congress to institute more balance sheet and spending discipline.

- Bond fund investors have enjoyed steady returns during the past few years. Real capital losses in the future could lead to market volatility that could spill into other asset classes.

- Traditional asset allocation and portfolio construction theory teaches that fixed income plays a stabilizing role. In a rising rate environment, this basic tenet becomes suspect.

- Adequate liquidity in global markets and specific asset classes is not a given, particularly in a short-term crisis when everyone wants to exit at the same time.

Demographics will play a key role in future inflation trends, impacting labor force participation and productivity. As illustrated in Chart 14, current data from the U.S. Census Bureau implies that U.S. population will continue to increase and retain a more youthful proportion than other developed countries. By contrast, Chart 15 shows the projected growth and distribution of China’s population in 2050.

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**Chart 14: U.S. Population 2050**

![Chart 14: U.S. Population 2050](image-url)

Source: United States Census Bureau
**Investment Implications**

Given the complexities and uncertainties presented in this paper, we believe that financial markets will continue to be volatile and unpredictable, particularly over short periods of time. We likewise believe that long-term success is apt to come from investment strategies that incorporate the following: diversification, asset/liability matching, a focus on solid fundamental bottom-up analysis, adherence to sound asset allocation ranges, active tactical adjustments and a willingness to think outside the box to find sources of income, growth and stores of value. The next sections describe recommendations for the major asset classes.

**Fixed Income**

Should investors exit bond funds en masse, fixed income market reactions could be severe. Mass redemption requests would pressure fund managers to sell good credits pushing mark-to-market prices down for all holders. The balance sheets of large holders of such investments, including insurance companies, pension funds and endowment funds, could be impaired even if they owned individual securities that they were not planning to sell. Those investors could see large paper losses notwithstanding the eventual return of principal at maturity for credit-worthy bonds. In the fixed income markets, the psychological overhang of over-levered governments, aging citizens, and seemingly intractable social commitments could well add to the angst.

As we have seen in numerous other market segments, when the initial unwinding is more violent and much deeper than anyone expected at the outset, it often offers interesting long-term opportunities for the diligent investor once the dust settles. Those who own individual securities (especially in laddered maturities where small portions are regularly maturing, providing opportunities for reinvestment) could be well-positioned to benefit from panic-induced dislocations. We have long been recommending that investors shorten duration, own individual bonds whenever possible, have laddered maturities, understand underlying credit risks, match liability and cash flow/maturity schedules, and diversify types of income streams as the means to minimize potential interim volatility. Additionally, employing floating rate and bank loan vehicles offers offsets to rising rates. Investors should also consider carefully the location of their fixed income exposure. Many 401(k) plans only have intermediate or long-term bond fund exposure options. In those cases, investors should consider shifting fixed income exposure to more actively managed portfolios that employ a laddered strategy. And finally, fixed income exposure should be in more actively managed accounts across one’s entire asset allocation structure.

Longer term, high-quality municipal instruments should offer increasingly attractive after-tax income streams, especially in the existing higher tax environment. High-quality corporate bonds should also hold up well in the long run. At some point, as investors become accustomed to higher rates and velocity stabilizes, aging baby boomers may be lured back to fixed income investments to essentially “annuitize” cash flows. This could occur if inflation settled in at lower average rates than initially feared.
**Equities**

If fixed income investments go into a tailspin, it is highly likely that in the short term, equity markets would be negatively impacted as well. We have seen time and time again in recent years that when panic sets in, correlations tighten and fearful investors move to the sidelines first and ask questions later. However, mid- to longer-term equities – especially those with good dividends and the ability to grow payout streams – are well suited to provide attractive inflation-resistant cash flows. Small cap companies in particular are suitable, having historically provided real returns during periods of high inflation. Finally, Master Limited Partnerships and Real Estate Investment Trusts should provide steady income sources as well, assuming the underlying assets are healthy.

**Alternative Investments**

During prior periods of increasing inflation and interest rates, real assets performed well on an inflation-adjusted basis. Complementary strategies such as hedge funds, managed futures and private equity have the ability to participate in unique asset categories (timber, water rights, distressed debt or global real estate) and employ methods (leverage, ability to short) that are not traditionally available to long-only managers.

**In Conclusion**

Predictions for the impending end of the bond bull market have circulated for years. The Fed’s substantial influence on fixed income markets in the wake of the 2008-2009 financial crisis has put off the day of reckoning, and may well have exacerbated the ultimate unwind as investors wait nervously to see what shape it will take. Though the short term could indeed be violent and nerve wracking, it could also present opportunities for nimble fundamental investors.

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**Endnotes**

1. We understand that numerous other sectors – farmers in the 1970s, lesser-developed countries in the early 1980s, and S&Ls in the 1980s and 1990s – have faced similar debt blow ups, but for the purposes of this paper have chosen to focus on these three broader segments.
3. Interestingly, the article that this quote comes from starts with another point of view which illustrates how similar 2003 was to today: “Jim Paulsen, the chief investment officer at Wells Capital Management, ticks off the ingredients needed for a mean batch of inflation. ‘I would flood the system with money far in excess of economic growth, I would take interest rates to the lowest levels possible, I would have the government spend like a banshee, I would drop the value of the dollar, and finally I would take any capacity growth or additional supply growth and stop it,’” he says. As a garnish, he’d add rising commodity prices and a growing trade deficit mixed with some rising trade tensions.” In other words, we are not treading new paths.
4. www.census.gov/compendia/statab/2012/tables/12s1197.xls
6. According to ICI, equity mutual fund ownership increased from 25 percent of the population in 1995 to nearly 50 percent by 2000. At year-end 2000, the five-year average annual return on the S&P 500 was 25 percent.
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