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Quantitative Easing: How Unconventional Monetary Policy Affects Your Portfolio

Quantitative Easing, commonly referred to as QE, is the employment of unconventional monetary policy to depress interest rates with the dual-objective of: (1) increasing the money supply to stimulate economic growth, and (2) preventing deflation (i.e., driving measured inflation). The aggressive series of bond purchases comprising Quantitative Easing serves to depress interest rates, making the return on Treasury securities and other safer investment options uncomfortably low. This forces investors to chase yield in riskier investments such as high-yield and equities. We believe the combination of QE and a lack of investor exposure to equities is a predominant force driving the market higher.

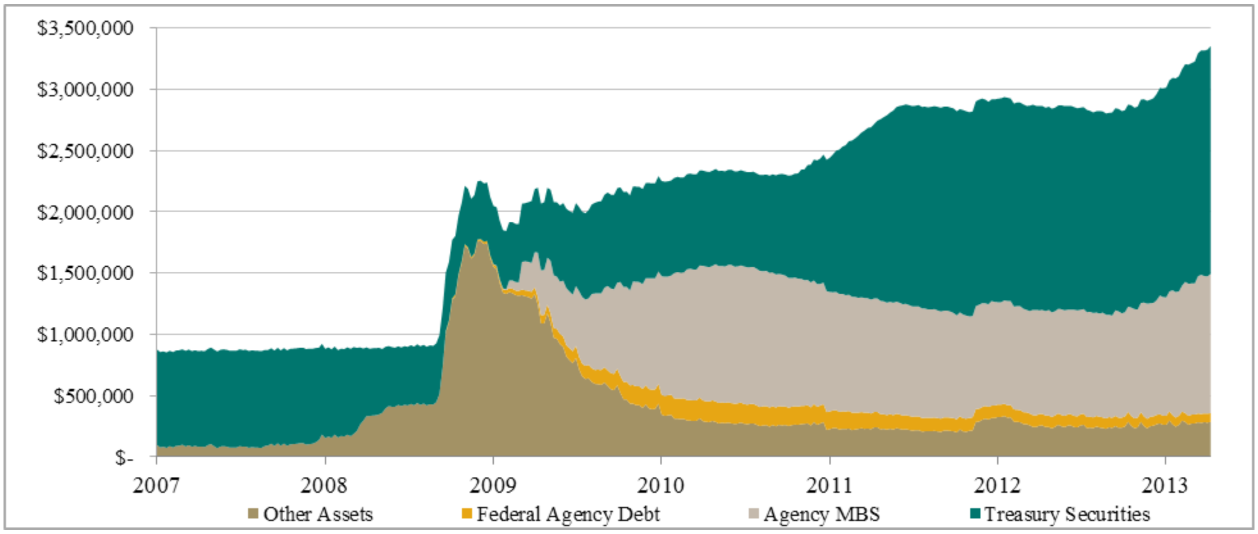
There have been a number of programs instituted to stimulate the economy. All of them are slightly different. Below is a table summarizing the actions taken by the Federal Open Market Committee (FOMC) in response to the turmoil of the "Great Recession" that began in 2008.

Table I: Summary of Federal Reserve's Recent Open Market Operations[i]

Name	Date Range	Total Amount	Securities Purchased
QE1	Dec. 2008 – Mar. 2010	$175 mil.	GSE Direct Obligations
	Jan. 2009 – Mar. 2010	$1.25 tril.	GSE-Backed MBS
	Mar. 2009 – Oct. 2009	$300 bil.	Longer-Term Treasury Securities
QE2	Nov. 2010 – June 2011	$600 bil.	Longer-Term Treasury Securities
"Operation Twist"	Sept. 2011 – June 2012	$400 bil.	Treasury Securities
	June 2012 – Dec. 2012	$267 bil.	Treasury Securities
QE3	Sept. 2012 – "Infinity"	$40 bil./mo.	Agency MBS
"QE Infinity"	Jan. 2013 – "Infinity"	$45 bil./mo.	Longer-Term Treasury Securities

"Operation Twist" is the plan to purchase longer-term Treasury Securities and sell an equal amount of shorter-term Treasury Securities to put downward pressure on longer-term interest rates. "QE Infinity" is the Fed's attempt to tie monetary policy to an improvement in economic data that has heretofore been minimal. Infinity suggests that the FOMC will support the program until unemployment drops to 6.5%. The cumulative impact of the multiple rounds of quantitative easing is startling. The chart below shows the growth in the Federal Reserve's Balance Sheet since 2007. It has required this unprecedented amount of stimulus to revive the equity market.

Chart I: Federal Reserve Balance Sheet

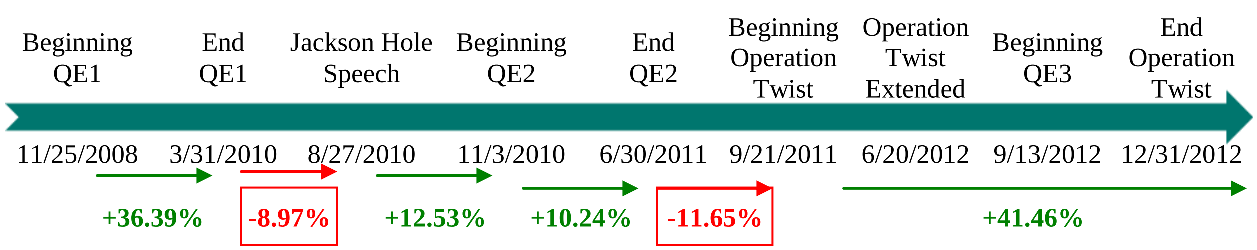


Source: Board of Governors of the Federal Reserve System

Despite the aforementioned, unprecedented stimulus, the response of many economic metrics has been muted, while the equity market recovery has been impressive. We believe there is a clear, direct relationship between market performance and quantitative easing. It is difficult to separate market performance driven by true economic recovery versus what we refer to as quantitative smoke and mirrors.

Below is a timeline of the series of quantitative easing measures employed by the Fed, accompanied by the associated market performance. This simplistic depiction supports our supposition that the equity market may not be able to maintain momentum without the benefit of extremely accommodative monetary policy. Each time a round of QE ends, the market declines. This is why there is so much skittishness in the news about how and when the Fed will reduce QE.

Chart II: Timeline of Key Monetary Policy Dates and S&P 500 Performance



Source: FactSet Research Systems, Inc.

Constructing a Low Risk Portfolio

We are often asked our recommendation for creating a low-risk, conservative portfolio that generates a robust yield. The answer is that those two attributes can no longer co-exist and for a portfolio to keep up with inflation, you must take a certain amount of risk. Expectations for conservative portfolios need to be realistically low. Interest rate movement is a very real risk for conservative investors. In our opinion successful portfolio construction has never been more difficult. Our dual objective of principal preservation with necessary growth to meet objectives and exceed inflation requires us to vigilantly explore unique investment strategies to grow portfolios and achieve the volatility control conservative investors have become accustomed to and demand. The best investors can hope for from a low-risk portfolio of high-grade bonds is slightly over 2%. Below is a table showing the current yields on typical low risk assets relative to the historical average.

Table II: Yields on Typical "Low-Risk" Assets

Name	Current Yield[ii]	Historical Average[iii] (1980-2013)
US Treasury Constant Maturity – 3 Month	0.05%	4.56%
US Benchmark Bond – 10 Year	2.02%	6.76%
Barclays US Aggregate – Corporate Investment Grade	2.79%	5.22%
Germany Benchmark Bond – 10 Year	1.40%	5.77%

Source: FactSet Research Systems, Inc.

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[i] Board of Governors of the Federal Reserve System, Open Market Operations: "Credit and Liquidity Programs and the Balance Sheet," http://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm
[ii] As of Market Close – May 23rd, 2013
[iii] Vincent McCarthy, "Central Bank Policy & Portfolio Construction," *CFA Institute Magazine – May/June 2013*