**Investment Strategy Warning for Today's Volatile Markets – September 2011**

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***Summary: This article explores investment portfolio investment strategy considerations warranted in the continuing aberrant global economy and artificial government driven market condition.***

**Introduction**

In today's uncertain environment, all insurance companies and other portfolio managers need increased attention to their investment strategy. Today's central bank engineered artificially low interest rate environment could cause unexpected, and unprecedented, principal losses on traditionally conservative portfolios over the next 3 to 5 years.

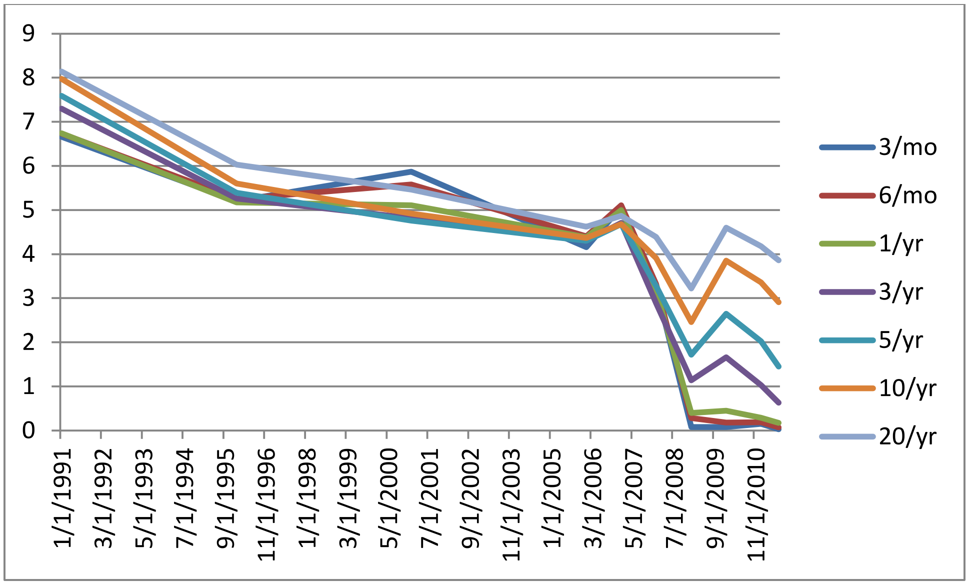
**Modernizing Investment Portfolio Strategy for Today's Economy**

The days of high investment returns on conservatively managed insurance investment portfolios seem long gone. The low interest rate environment of recent years however is no excuse for accepting poor relative portfolio performance, or for taking too much market risk. If you have been fortunate of late to experience meaningful gains in your conservative buckets of your portfolio (note Barclay's Capital High Yield is up 15%, Citigroup World Government Bonds is up 10%, and most investment grade bond funds are up 6% to 7% for the year ending June 30, 2011), do not let that blind you to the dynamics at work impacting your future investment portfolio return; there remains significant risk of market value loss should interest rates start rising particularly if coupled with continuing global economic weakness.

For several years running, many economists have been predicting interest rate yield curve increases for one reason or another that as of September 2011 has not yet manifested.

No one living has experienced such widespread aggressive and prolonged government and central bank intervention keeping interest rates at historic lows. The following 20 year graph depicts the extent of this unusual phenomenon that has driven short-term rates to essentially zero and 10 year rates on US Treasuries to under 2%.

**US Treasury Interest Rate Yields (extracted from the Treasury website)**




This aggressive government monetary policy intervention aims to stimulate economic growth in this extended period of global economic weakness. However the resulting explosion in money supply, particularly in the U.S., gives fuel to the increasing consensus that higher rates will come sooner than 2013 which is the target timeline for keeping short rates near zero according to Federal Reserve Chairman Bernanke. Meaningfully higher interest rates and inflation are inevitable due to this loose monetary policy. A stagflation period could of course reverse recent widespread investment gains for both equities and fixed income investments.

Some portfolio managers are making significant defensive adjustments within client portfolios - shortening average maturities and increasing risk to maintain yields. They may not however be defensive enough as a spike in interest rates could easily cause a decline in principal value of 20% of more in 10 year average maturity portfolios over the next 3 to 5 year horizon.

Looking at the private sector for clues on future yield trends, we are seeing new signs more industries are reviving, suggesting a pulse is returning to the developed industrial economies notwithstanding continuing government mismanagement.

Your investment committee should consider a defensive approach - shortening average maturities to 7 years or less and laddering your portfolio to have periodic maturities to reinvest at the longer end of your portfolio. If interest rates rise the next several years, you would experience increasing average yields on investments while minimizing exposure to declining bond and yield driven investment prices. You can always extend maturities for slightly higher yields later; the probability of long bond yields declining further seems low. Dividend yielding equities of growth companies with strong balance sheets seem particularly attractive right now and increased weighting to such preferred and common equities with growth and dividend increase prospects may be the best approach to preserve principal valuation during the coming inflationary and higher interest rate periods.

**Conclusions**

Where needed, regulators should relaxing investment restrictions to allow all insurance companies and other regulated entities to invest a higher percentage of assets in high quality non-government backed investments during this era of financial regulatory reform initiatives in the US and EU. Regarding managed products, a product prospectus allowing, and at times the actual portfolio having a small percentage of lower grade investment securities, should not disqualify these increasingly valuable and efficient products as allowable investments by insurance companies, government entities and other investment restricted portfolios. For individually managed portfolios, investment grade corporate bonds should be on parity with U.S. government obligations as permissible investments. This would allow portfolio managers to take advantage of yield spreads between governments and investment grade companies with strong balance sheets without compromising principal preservation or liquidity. Additionally, increased allowance of common and preferred equity investments should be considered for portfolios traditionally investing in high quality fixed income investments.

**About the Author:**
Tom Cifelli is Captive Experts Managing Director and Editor. He has over 20 years of legal, accounting, tax and financial expertise. Mr. Cifelli also served as a municipal treasurer managing $100 million in investment restricted fixed income assets and was a founding director of a Municipal Liquid Asset Fund, a managed product targeting restriction laden municipal and school investment portfolios that could not participate in general market managed products. Mr. Cifelli has since served as Chief Financial Officer and General Counsel with private and publicly traded companies. He also served as Managing Director of Investment Banking with a U.S. SEC registered broker-dealer firms.