



# Prepare Now for Rising Rates and Inflation

Less than six months ago, Federal Reserve officials warned us that a downward spiral of deflation and double-dip recession was a real possibility.

Fed Chairman Ben Bernanke used these fears of deflation as an excuse for another round of quantitative easing — shorthand for firing up the money press — launching a \$600 billion Treasury bond-buying spree late in 2010.<sup>1</sup>

With the Fed intent on inflating the US money supply, it didn't take long for investor concerns to shift toward inflation as the next major threat.

With QE2 scheduled to end on June 30, public appetite for printing more money — and all but ensuring inflationary forces win out — has disappeared.

Right now, we see our economy at a crossroads. Has the Fed pumped so much money into the economy that all those dollars are chasing too few goods, forcing prices — and eventually interest rates — higher? Or is the aftermath of the Great Recession too powerful, keeping demand low and deflation on the front burner?

This environment of heightened uncertainty presents a great challenge — and opportunity — for fixed income investors. While most investors are struggling to determine the future direction of inflation and interest rates, you can prepare your portfolio for a move in either direction ... if you know how.

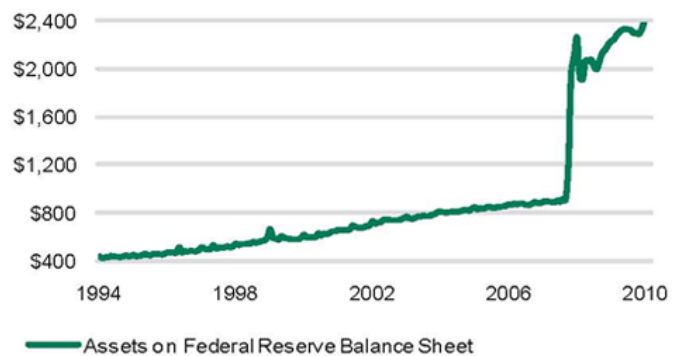
In this special report, prepared by the Banyan Partners investment team, we'll tell you how we are preparing our fixed income clients in one of our most popular investment strategies, Banyan's *Global Fixed Income Strategy*, for the near-term tug-of-war between the forces of deflation and inflation. Plus, we'll detail our longer-term

outlook for interest rates and show you specific steps you should consider to proactively manage your income portfolio in today's environment.

## The Great Recession and Quantitative Easing

During the Great Recession and the financial crisis that triggered it, the US Federal Reserve and Treasury Department introduced extraordinary monetary measures aimed at preventing a deflationary spiral.

### Explosive Growth in Federal Reserve Balance Sheet



Source: American Century Investments: 5/24/11

Through a series of bank liquidity and asset purchase programs, the Fed expanded its balance sheet by more than \$2 trillion. The Fed maintains that these ultra-easy monetary policies were needed to rescue the financial system from a severe capital crunch that could have led to a more severe economic depression.<sup>2</sup>



But today, more than two years after the Great Recession ended, the Fed still maintains a bloated balance sheet. Even as the US economy moves from the initial recovery phase to a relatively more sustained expansion, the Fed continues on a path of easy monetary policy and hasn't indicated that it plans to raise interest rates any time soon.

We believe the Fed plans to maintain an ultra-low target for its benchmark Federal Funds rate (currently 0 to 0.25 percent) for an extended period of time. Its view: With an unemployment rate still above 9 percent, uncomfortably high for this point in the recovery, it needs to promote a stronger growth pace for the economy.<sup>3</sup>

But by keeping stimulative monetary policies in place for too long, the Fed runs the risk of letting inflation expectations get out of hand. In other words, if the Fed doesn't act quickly enough to mop up abundant liquidity, it risks creating a severe inflation problem for the US economy.

This sets the stage for the tug-of-war we are now experiencing between the opposing forces of deflation and inflation. Now let's take a closer look at the case for each ...

## Deflationary Forces

Inflation, as measured by the consumer price index (CPI), remains at a historically low level today while the unemployment rate remains high. Indeed, since 1960, inflation, as measured by the CPI, has averaged 4.1 percent annually and today is running at 3.2 percent. Meanwhile, the US unemployment rate is running more than 9.1 percent currently.<sup>4</sup>

These are the main factors driving the Fed's ultra-easy monetary policies. Here's a closer look at the evidence ...

1. **Lackluster Economic Growth:** After a robust rebound coming out of the recession in 2009, US gross domestic product (GDP) growth slumped to below trend levels again in mid-2010. In fact, GDP growth fell to an annual pace of just 1.8 percent in the first quarter of 2011, down from 3.1 percent in the final quarter of 2010.<sup>5</sup>

Slumping industrial production, consumer sentiment and plenty of excess capacity in the US economy all point to a deflationary force that is restraining GDP growth.

2. **Housing Double Dip:** While the overall economy continues to expand at a sub-par rate, the housing sector continues to be a significant drag on the economy. Existing home sales have slipped to new lows in 2011. And after showing some improvement in 2009 and early 2010, nationwide home prices have rolled over again, falling in nine of the past 10 months through March 2011.<sup>6</sup>

Since home values are such a large component of most Americans' total net worth, the renewed weakness in housing prices represents another major deflationary drag on our economy.

3. **Weak Job Growth, Income:** More than two years after the recession ended, high unemployment and sluggish wage and salary growth remain a big concern. The unemployment rate ticked up to 9.1 percent in May 2011, well above the 5 to 6 percent rate before the recession.<sup>7</sup>

On top of high unemployment, those who still have jobs aren't seeing much improvement in their spending power as real disposable income (after taxes and inflation) continued a flat trend in April.

As a counterpoint to these deflationary drags on growth, there are a number of factors pushing inflation higher.

## Inflationary Forces

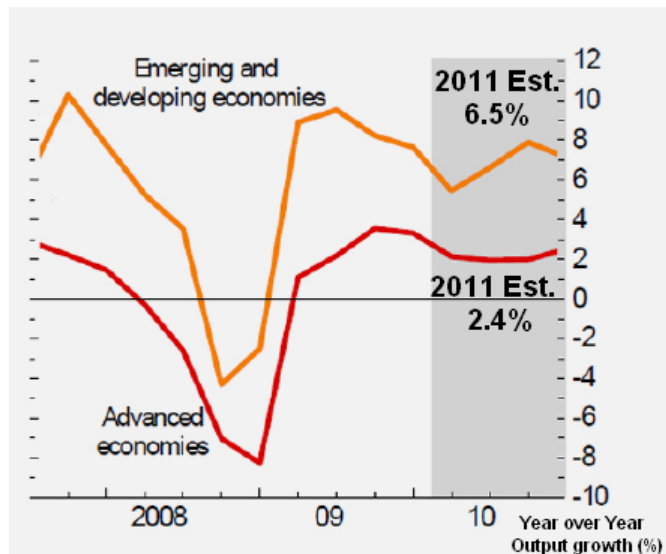
Many professional economists and investors alike are puzzled that the official rate of inflation remains so low in the midst of the Fed's massive balance sheet expansion. However, we all know that the CPI is far from perfect at measuring the true cost of living.

Let's take a look at the evidence suggesting inflation is becoming a more dominant force ...

1. **Robust Growth in Emerging Markets:** While the major developed economies as a group are experiencing below-trend GDP growth of just 2.4 percent this year, emerging markets are enjoying robust expansion. China and India are growing better than 9 percent year-over-year, while Brazil is expanding at a 5 percent annual rate.<sup>8</sup>

This fast-paced growth is inflationary. Inflation has jumped to 5.3 percent in China, and India's inflation rate is running at over 8 percent year-over-year. With wage costs on the rise,

## Stronger Growth Globally



Source: IMF, World Economic Outlook, March 2011

many emerging markets are no longer contributing to global deflation, as they had historically, but may actually be promoting higher inflation — especially in commodity prices.<sup>9</sup>

2. **Commodity Cost Pressure:** Escalating demand for resources is a natural byproduct of rapid growth in the developing world. When combined with supply shortages, commodity prices for everything from food to fuel have been accelerating sharply.

Commodity input costs are classified in the producer price index (PPI), which has been increasing faster than consumer prices — at a rate of 6.8 percent year-over-year.<sup>10</sup>

3. **Uncle Sam Maxed Out:** Perhaps the biggest factor contributing to inflation concerns right now is the explosion in US

government debt combined with the Fed's aggressively easy monetary policy. Standard & Poor's rattled markets recently with a downgrade of the US government's sovereign debt outlook. Research shows that high inflation historically follows periods when debt-to-GDP exceeds 90 percent. And we're perilously close now, with federal debt projected to rise to 84 percent of GDP within the next two years, according to S&P.<sup>11</sup>

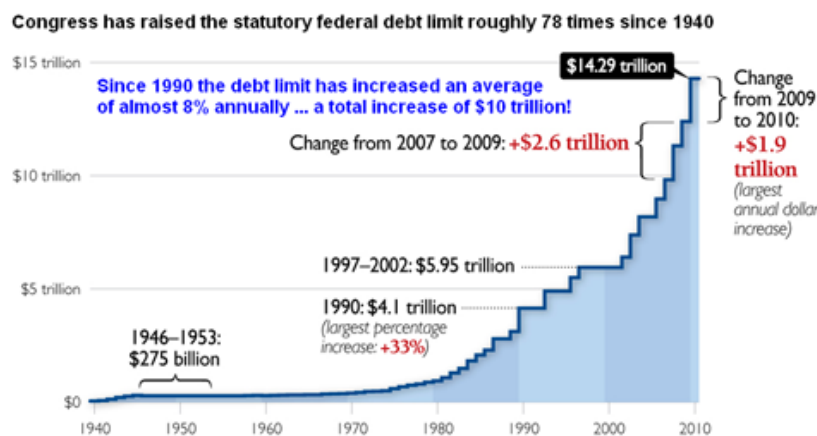
In addition, the dramatic expansion of the Fed's balance sheet has pushed the value of the dollar lower — with the US dollar index losing approximately 16 percent of its value since March 2009. This has the impact of driving up inflation for everything the US imports.<sup>12</sup>

Finally, the US Government officially reached its borrowing limit at the current debt ceiling of \$14.3 trillion in May. While Congress debates solutions, it's almost certain that, in spite of a looming budget deficit of more than \$1.6 trillion this fiscal year, Washington is likely to raise the debt ceiling yet again, just as they have done frequently in the past.<sup>13</sup>

## Safeguarding Your Income Portfolio Against Inflation Uncertainty

We are all aware of the corrosive impact inflation can have on our purchasing power. With so many cross currents in financial markets and the economy today, the threat of future inflation should NOT be underestimated, in our opinion.

### US Debt Limits Over Time ...



Source: Heritage Foundation; White House Office of Management and Budget, 5/18/11

At Banyan Partners, we believe interest rates will eventually move higher from near-record low levels, driven by escalating inflation expectations. It is only a question of timing, in our view.

Remember, bond prices move opposite interest rates, so as inflation moves higher, interest rates will climb, causing your bond holdings



— government and corporate alike to experience a decrease in market value as a result. At the same time, you'll forfeit the opportunity cost of enjoying higher income levels on older bonds as inflation accelerates — a potential double whammy to your wealth. So what's the answer?

Considering the historic inflation rate since 1926 has been about 3 percent, if the inflation rate were to climb to just 5 percent, the purchasing power of \$100,000 would be reduced to only \$70,000 in just seven years. That's a 30 percent loss of capital in purchasing power terms resulting from a relatively small uptick in the inflation rate.<sup>14</sup>

We believe many investors today are just not prepared for these potential hazards. In fact, money has been pouring into fixed income mutual funds — long-term bond funds included — over the past several years, potentially putting investors at greater risk from unexpected inflation.

That's why if you are an income-oriented investor, now may be the right time to take another look at your fixed income holdings and consider the structure, composition and allocation of your portfolio.

## Inflation Hedging Options to Consider

There are a number of strategies for defending against the risks of rising interest rates, inflation and a further slide in the purchasing power of the dollar. Here are just a few you might want to consider for your fixed income portfolio.

**TIPS:** Treasury Inflation-Protected Securities, or TIPS, are bonds that offer principal and interest rate adjustments based on changes in the consumer price index. If held to maturity, you are assured of earning a return above the official inflation rate. However, TIPS prices fluctuate the same as any other bond. This means you will experience up and down price fluctuations and could realize a loss if sold before the maturity date.

For this reason, you'll need to closely follow the interest rate environment. If you aren't planning to hold until maturity, you'll need to carefully monitor TIPS just as you would any other bond.

**International Bond Funds:** A diversified mix of international fixed income funds can give you access to higher yields in other markets and regions of the world. At the same time, foreign bonds provide an automatic currency hedge to help protect you from a

decline in the US dollar.

At times, emerging market economies can offer attractive fixed income opportunities due to rapid growth and a high interest rate climate. Also, some emerging economies are natural resource-based, which can offer an additional defense against inflation. Of course, you'll face some other unique risks investing internationally, including exchange rate fluctuations and unique political risks.

**Shorten Your Duration:** Longer-term bonds — those maturing in 10-years or more, tend to be more sensitive to interest rate fluctuations than shorter-term bonds with durations under five years or so. Thus, they create larger gains or losses when interest rates change. When investing in fixed income mutual funds during a period of rising inflation, you should consider finding a fund with a duration under five years. The average duration of a bond fund portfolio tells you how long it will take (in years) to get repaid your principal.

Of course, the trade-off that comes with a shorter duration may be lower overall yield, or cash flow. But when rates begin to rise, it makes sense to get your money back sooner, giving you the opportunity to reinvest at higher potential yields as they become available. A number of diversified bond funds can offer you a mix of corporate and government bonds (domestic and international) that can deliver yields of 5 to 6 percent with an average duration of five years or fewer.

**Inverse Bond Funds:** A number of specialty funds designed to move up when bond prices decline are available today. And, if used prudently, can provide some protection against the negative impact on the value of your portfolio from declining bond prices and even a falling dollar. However, inverse funds require careful monitoring because tracking errors can, in some cases, result in significant differences between a fund's performance relative to its index. A small allocation to inverse bond funds (or ETFs) as part of a proactively managed portfolio can help reduce the volatility of your fixed income holdings.

## Proactive Money Management: More Important Than Ever During Inflationary Times...

At Banyan Partners, we understand the challenges facing fixed income investors in today's climate. We realize how difficult it can be to earn enough income with interest rates so low.

This is precisely why we designed an innovative income-generating strategy, featuring:

- ➔ **Higher income from a global mix of income-producing securities ...**
- ➔ **Capital appreciation potential from shifting interest rate and currency trends ...**
- ➔ **Hedging strategies designed to protect you against a falling dollar and soaring inflation ...**

At Banyan Partners, our investment team has built its reputation on actively managing investor portfolios with extreme care in volatile markets. We do not follow a “set it and forget it” investment style.

Instead, we follow a proactive, opportunistic approach to managing your money. This includes frequently rebalancing, or repositioning your portfolio, as necessary, with the goal of delivering superior, risk-adjusted returns in all market conditions.

With millions of different bonds to choose from, it can be a daunting task to select the mix of securities that’s just right for you, not to mention the ongoing task of monitoring your investments closely and fine-tuning your portfolio along the way.

You must be keenly aware of shifts in interest rate trends ... economic cycles ... and stay on top of credit rating changes. Choosing the best mix of fixed income securities *AND* maintaining proper diversification in shifting markets can be a challenging task. It’s not for the inexperienced investor.

At Banyan Partners, we are sensitive to this fact. That’s why we use a number of tools, techniques and research to manage our client portfolios. And, we make timely tactical changes for our clients as necessary. This is also why we recommend professional management in today’s uncertain markets: To help ensure you make the right moves with your wealth.

## Professional, Proactive Management Can Make All the Difference

One of the best ways to minimize risk, in our view, is by investing in a broad mix of different types of fixed income securities — both corporate and government — from different regions around the world.

Taking a global perspective to search for the most attractive opportunities both worldwide *AND* here at home is our approach. We look for fixed income funds that can potentially offer you higher current yields without taking dramatically higher risks with your principal.

Market volatility has been on the rise since the credit crisis began in 2007 — and we believe it’s not over yet — not by a long shot. We fully expect new financial shocks ahead, perhaps making it even more difficult for individual investors to navigate turbulent markets on their own.

## One Solution You Should Consider: Global Fixed Income Strategy

Challenging markets require new investment options, and at Banyan Partners, we’re making every effort to provide you with these options.

Protection of principal is our highest priority and the primary goal of **Global Fixed Income** is to produce a cash flow yield that is about 2 percent more than the average yield on a 5-year US Treasury note. For example, if the yield on the 5-year Treasury is 2 percent, our goal is to produce a cash flow yield of 4-to-4.5 percent in this strategy.

How have we been doing with our cash flow goal?

Our **Global Fixed Income** strategy’s cash flow yield stood at 6.2 percent as of June 10 ... or nearly *four-times the current yield on the 5-year Treasury (1.5 percent) today*.<sup>15</sup>

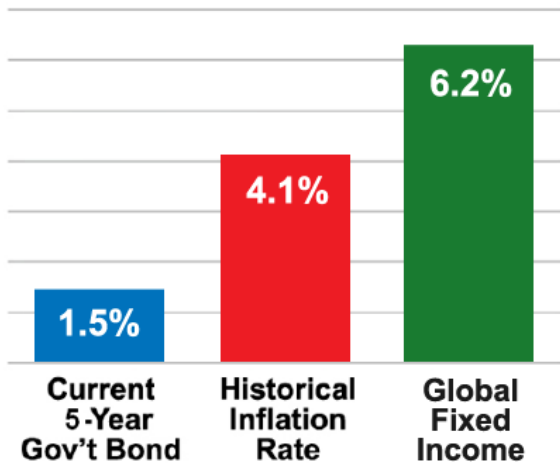
It’s important to point out that this is the *average* 12-month yield of the investments held in the Global Fixed Income portfolio and it’s a moving target that can fluctuate depending on market conditions and changes to our holdings. Although we exceeded our income goal over this period, there is no assurance this will always be the case.

So what about overall performance? The **Global Fixed Income** strategy has produced a total return of 7.64 percent over the past 12 months ending March 31, including both current income plus capital appreciation. Complete performance information is provided at the end of this report.

## Details Behind Our Investment Process ...



## Yield Comparison



Please note: This yield is a forward-looking estimate and is not guaranteed. It is based on yields of holdings in the portfolio as of 6/10/11 and will fluctuate based on portfolio changes and the market. See "Complete Performance" at the end of this report.

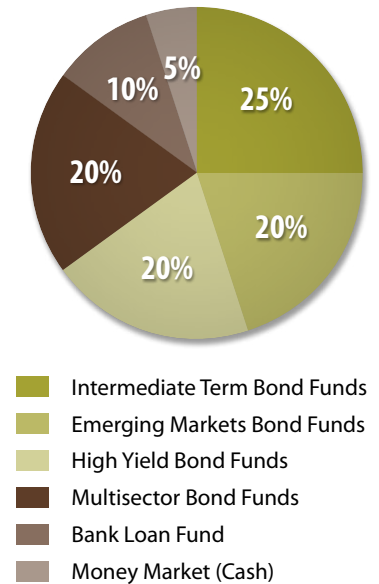
Source: US Treasury, 6/8/11  
Bureau of Labor Statistics, 2010  
Banyan Partners, 6/10/11

reduction and to hedge against the possibility of rising interest rates and inflation or periods of extreme price volatility.

Bottom line: When you use a professional money manager, you don't have to navigate the bond markets alone. You can get all the benefits of bond investing *without* the aggravation. We've designed Global Fixed Income to deliver consistent cash flow and to safeguard your portfolio against unexpected risks.

## Global Fixed Income

Asset Allocation as of 3/31/11



## Benefits You Can Expect from Banyan ...

Our professional investment team at Banyan Partners keeps a watchful eye on changing market conditions, and we are committed to helping investors just like you manage and guard their wealth. As a client in the **Global Fixed Income** strategy, you can expect these important benefits ...

- 1. PROFESSIONAL MANAGEMENT:** We follow global interest rate movements and trends to make the necessary portfolio adjustments for you.
- 2. Access to HIGHER INTEREST RATES** in countries where yields are greater than in the US.
- 3. A BROADLY DIVERSIFIED PORTFOLIO** of income-producing investments that helps to spread credit risk ...
- 4. REGULAR INCOME** — either monthly, quarterly or annually — by check or deposited directly into your account ... the choice is **YOURS**.
- 5. Global DIVERSIFICATION** in currencies other than the

The investment process behind **Global Fixed Income** includes the following key steps:

- ✓ We closely monitor trends in interest rates, currencies and credit conditions around the world. And we make the necessary portfolio adjustments for you based on our extensive research and analysis.
- ✓ Where appropriate, we invest in both domestic and international income-producing securities, paying careful attention to tradeoffs between quality and yield.
- ✓ Your income-focused portfolio may include mutual funds invested in hundreds of bonds from different issuers, which helps reduce your credit and currency risks, while providing the added advantage of potentially higher yields to help meet your cash flow needs.
- ✓ We invest in a mix of mutual funds with different maturities to help reduce your exposure to interest rate risk.
- ✓ Finally, we use inverse mutual funds for the purpose of risk

US dollar to offer you potential protection against further dollar declines.

6. A DYNAMIC APPROACH to managing credit risk and the impact of rising interest rates as well as active monitoring of your portfolio holdings.

Your *Rising Interest Rate Tool Kit* includes all the information you need to get started right away with the ***Banyan Global Fixed Income Strategy***.

**As an added bonus, we offer you a comprehensive, no-obligation investment consultation and portfolio review.**

The Banyan Partners investment team has the experience and

the tools necessary to help you prepare for rising interest rates ... higher inflation ... and a decline in the value of the dollar.

In today's uncertain markets, there has perhaps never been a better time to get a second opinion about your current fixed income strategy — from someone qualified to manage your wealth in fast-moving markets.

Contact us now to take advantage of this exclusive complimentary review of your portfolio — a detailed evaluation of your current fixed income investments. We will take a closer look at each and every security you hold with an eye toward reducing your risk, where possible, and perhaps boosting your current income. And we're happy to provide this service for you absolutely free of charge and with no obligation.

**To get your free portfolio review, call your Banyan Partners Investment Consultant at 800-422-6172 or 561-630-4600 and get started right away!**

<sup>1</sup> Fidelity Investments: The Fed's punch bowl, 4/6/11

<sup>2</sup> Fidelity Investments: What's ahead for bonds?, 5/25/11

<sup>3</sup> Federal Reserve, 4/27/11

<sup>4</sup> Bureau of Labor Statistics, 5/13/11

<sup>5</sup> Econoday: US Economic Recap, 6/3/11

<sup>6</sup> Federal Housing Finance Agency: House

Prices Fall in First Quarter, 5/25/11

<sup>7</sup> Bureau of Labor Statistics: Employment Situation – May 2011, 6/3/11

<sup>8</sup> International Monetary Fund: World Economic Outlook, April 2011

<sup>9</sup> Decision Economics: Global Economic Developments, 5/27/11

<sup>10</sup> Bureau of Labor Statistics, 5/12/11

<sup>11</sup> Fidelity Investments: What's ahead for bonds?, 5/25/11

<sup>12</sup> Bloomberg market data, 6/13/11

<sup>13</sup> Bloomberg: Treasury Bill Rates at Almost Record Low, 5/16/11

<sup>14</sup> FMR Co. MARE, 5/1/09

<sup>15</sup> US Treasury: Daily Treasury Yield Curve Rates, 6/8/11

## IMPORTANT DISCLAIMERS AND DISCLOSURES

The Global Fixed Income Strategy is suitable for investors with a **moderate** risk tolerance looking for a higher level of current income, plus growth. Suitability of the Strategy for 401(k)s and other retirement plans is at the discretion of the plan sponsor or fiduciary. The Strategy does not consider taxable consequences in the pursuit of its investment objectives. Please consult your tax advisor prior to investing in the Strategy.

### Investment Risk

**International investing** presents certain risks not associated with investing solely in the United States. These include, for instance, risks related to fluctuations in the value of the US dollar relative to the values of other currencies, custody arrangements made for foreign securities, political risks, differences in accounting procedures, and the lesser degree of public information required of non-US companies.

**Inverse and leveraged mutual funds** are highly complex financial instruments that may be utilized in pursuit of the Strategy's overall investment objectives. Due to the effects of accurately tracking a particular index, their performance over long periods of time can differ significantly from their stated objectives.

Past performance is not indicative of future returns and, as with any investment program, it is possible to lose money by investing in the Global Fixed Income strategy. There are no guarantees that the Strategy will be able to achieve its stated objectives. Before investing, please read the Firm's ADV Part II and all strategy materials for important disclosure information.

### Important Disclosures

In addition to the management fee charged for participation in the Strategy, transaction costs occasionally may be generated at an additional cost to the client. Banyan Partners does not receive any of these fees. The mutual funds used in the Strategy may impose a minimum holding period to avoid redemption fees. Redemption fees, if levied or triggered, are charged to the client and are received by the mutual fund itself and not Banyan. Mutual fund shares are also subject to expenses that are shared indirectly by all shareholders. Banyan does not receive any special compensation or financial incentive from any mutual fund company in this investment program.

This program's portfolio may be rebalanced as deemed necessary. Rebalancing may generate additional fees to investors in the Program.

<b>Performance</b> <i>(As of March 31, 2011)</i>	1st Qtr Total Return	YTD Total Return	1-Year Total Return	3-Year Annualized Return	5-Year Annualized Return	Since Inception Annualized Return	Since Inception Cumulative Return
<b>Global Fixed Income Strategy*</b>						(10/31/03)	(10/31/03)
Global Fixed Income Strategy Net Returns	2.37%	2.37%	7.64%	4.55%	2.92%	2.71%	21.93%
Global Fixed Income Strategy Gross Returns	2.60%	2.60%	8.62%	5.56%	3.92%	3.73%	31.15%
<i>Barclays Capital Aggregate Bond Index</i>	0.42%	0.42%	5.12%	5.30%	6.03%	5.05%	44.05%

\*Formerly Diversified Income Builder

**Returns:** The Strategy's performance depends on the performance of the mutual funds in which it invests. In turn, the performance of the mutual funds depends on the underlying investments in which they invest. Returns are based on a composite of actual client accounts. Individual client returns may vary. **Net returns** cited include actual management fees, commissions, and other similar fees charged on transactions, and reinvestment of dividends, income and capital gains. **Gross returns** cited exclude management fees are net of actual commissions and other similar fees charged on transactions, and include dividends, income and capital gains.

### Benchmark

The *Barclays Capital Aggregate Bond Index* is a market-value weighted index of taxable investment-grade, fixed-rate debt issues, including government, corporate, asset-backed and mortgage-backed securities. It assumes the reinvestment of dividends and capital gains and excludes management fees, transactions costs and expenses. Although the index represents a portion of the universe from which the portfolio manager may find value, the Strategy may invest in regions and securities that are not included in the benchmark, such as emerging markets, global markets and high-yield bond funds. The Strategy may select funds containing commodities, real estate, currencies, natural resources and precious metals and may also utilize inverse-index funds. **It is not possible to invest in an index.** Index return data source: Bloomberg.



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