

KEY RATES ::

Fed Funds Target	0.25%
Discount Rate	0.75%
Prime Rate	3.25%
3-mo LIBOR	0.23%
2-yr Treasury	0.54%
3-yr Treasury	1.05%
5-yr Treasury	1.76%
10-yr Treasury	2.56%
2-yr Swap	0.78%
5-yr Swap	1.93%
10-yr Swap	2.71%
5-yr A Corp Yield	2.27%
5-yr A BQ Muni Yield*	2.51%

* Tax Equivalent Yield

ECONOMIC DATA ::

Q2 GDP Growth	4.2%
August CPI YoY	1.7%
Unemployment Rate	6.1%

UPCOMING EVENTS ::

- Sep 26 - Next Revision to Q2 GDP
- Oct 29 - Expected End of QE

In This Issue

What if You Called The Market Perfectly? Page 2

By: Cliff Reynolds, CFA

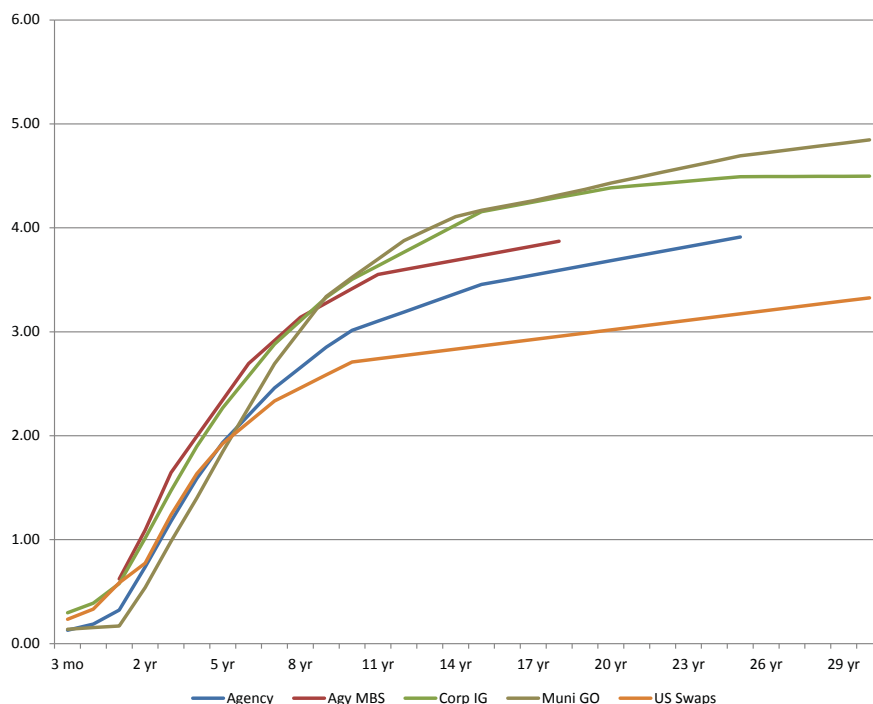
The Impact of Fed Tightening Page 4

By: Ryan Craft, CFA

Why Aren't Interest Rates Higher? Page 6

By: Cliff Reynolds, CFA

Yield Curve



All data as of 9/17/2014

EDITORS ::

Cliff Reynolds, CFA
cr@acrinv.com

Ryan Craft, CFA
rc@acrinv.com

CONTACT US ::

P :: 888.882.0072
636.449.4900

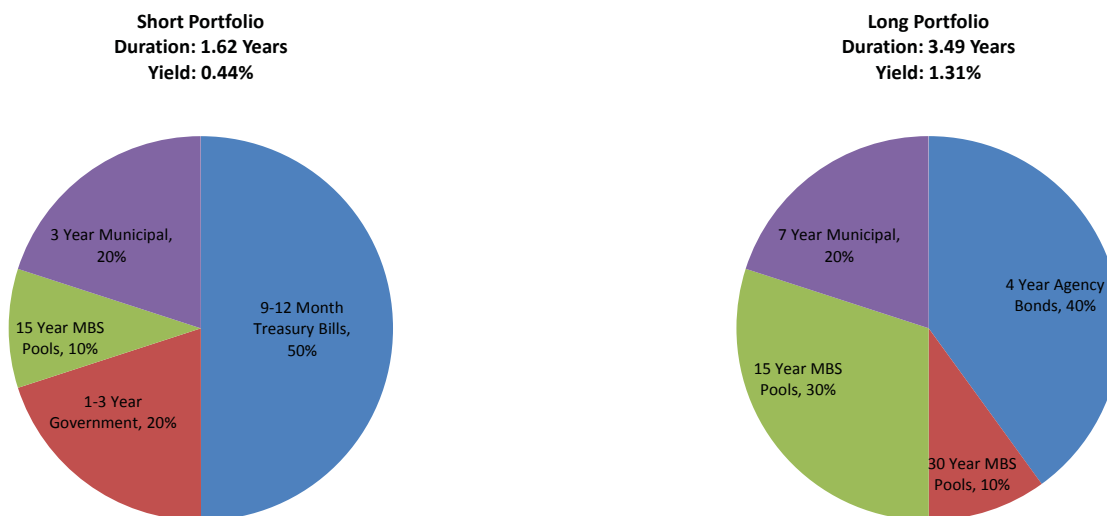
E :: info@acrinv.com
W :: www.acrinv.com



What if You Called The Market Perfectly? | Cliff Reynolds, CFA

It’s an interesting question. The ability to call the tops and bottoms with perfect accuracy is considered the “holy grail” of investing. We spend a great deal of effort talking to clients about the risk of trying to make speculative calls – the risk of being wrong of course.

Just as an exercise I thought it would be neat to imagine what it would be like if we called the bottom in rates in 2012. The closing low for the ten-year Treasury was 1.39% on July 24, 2012. For the ease of calculating returns I compared the performance of two portfolios, (one short and one long), starting on July 31, 2012 through August 31, 2014 – a 25 month period that saw the yield on the ten year yield bounce around between 1.50% and 3.00%.



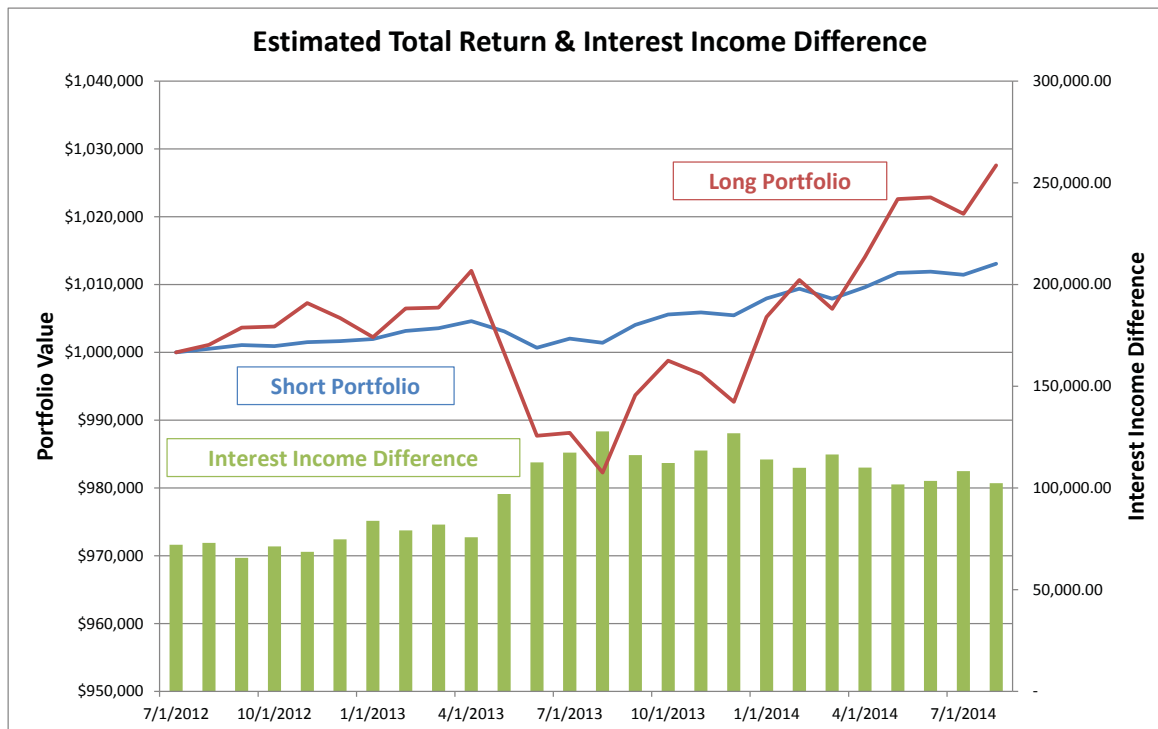
The two portfolios that I created are quite different. Both are well diversified and have the same amount of credit risk, but the short portfolio is positioned to protect against a rise in interest rates with a duration of 1.6 years in 2012 compared to the longer portfolio with a duration of 3.5 years. Because of the shape of the curve at the time, the longer portfolio had a positive yield premium over the shorter portfolio – a signal that the market was demanding extra compensation in exchange for taking additional interest rate risk.

Over the first year yields rose along the intermediate and long parts of the curve. The move in interest rates was much more pronounced in the intermediate part of the curve – causing the curve to steepen further. The drop in market value for the longer portfolio was compounded even more by durations in the mortgage-backed sector extending as refinance activity slowed to a halt.

After one year the decision to go short appears to be a very good one. Total return for the short-term portfolio was only .20%, but compared to -1.19% for the long-term portfolio over the same period things look ok.

But now because of higher yields, the difference in interest income between the two portfolios is larger. Put another way, the additional compensation for holding a portfolio of longer duration assets has grown, (shown by the green bars in graph).

(continued on page 3)



As you can see from the same graph, higher interest income for the longer portfolio has more than made up for the underperformance from the first year. Over the second half of the period we saw some volatility in rates, but most rates currently sit about where they were this time last year, and the total return for the longer portfolio is more than double the performance of the shorter portfolio after 25 months.

The purpose of this isn't to say that the longer portfolio is the most appropriate portfolio for every bank. One thing the graph shows very well is the difference in volatility between the two portfolios. The longer portfolio could create a lot of discomfort for some institutions who aren't willing to see that kind of price volatility - which is understandable considering the effect it can have on tangible equity. In addition to determining if certain risks are appropriate, it's important to also consider whether the compensation for taking on the risk is acceptable.

Like I said at the beginning of this article - we spend a lot of time talking about the risk of being wrong when investors make market calls. But in this case, being right at first didn't turn out to be so good in the long run.

In reality the future is unknown. A rapid move higher in interest rate is still very possible and may move a longer portfolio back underwater. But instead of trying to be tactical with portfolio allocations, a proper investment strategy should focus on modelling more than just the most likely scenario and making sure that the risk in the portfolio is being considered in the context of the overall balance sheet.

The Impact of Fed Tightening | Ryan Craft, CFA

Past performance is not indicative of future results.

That line is perhaps the most used financial disclosure in the investment industry. It's used so often for a reason; because the future is unknown, investors turn to the past for an indication of what is to come. It's in our nature to look for discernable patterns even though that disclaimer is staring us in the face the whole time.

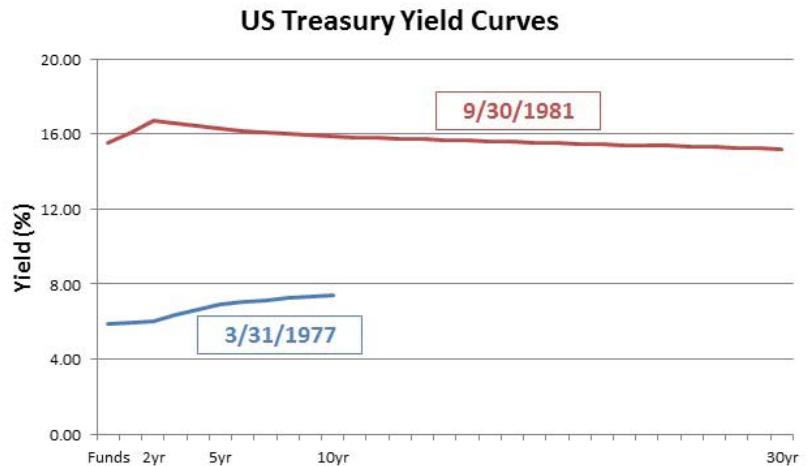
Given the current interest rate environment, it's not much of a stretch to say that the next five years of fixed income performance isn't likely to look much like the last five years. Thankfully we have much more history than just five years.

While no two periods are identical, we can look for some similarities and use them to help frame our expectations and get a better sense for the risks we face as investors. There is no exact replica of today's market that we can use as a crystal ball, but that doesn't mean we can't glean information from the past to help us today.

For bond investors, the single biggest risk on everyone's mind is rising interest rates. With that in mind we identified four periods over the last 40 years where the Federal Reserve raised the target for the Federal Funds rate 300 basis points or more. Using periods that start three months prior the first rate hike and end three months after the last rate hike, we compared the total return of baskets of US Treasuries with varying durations, or levels of interest rate risk.

Of the four periods, the 1977-1981 period was the most extreme tightening campaign – so it shouldn't be surprising that the under-performance of longer-term bonds was the most extreme during this period. It may be hard to tell because of the scale of the graph due to the massive rate shift, but over the period measured the interest rate curve went from a normal steep curve to inverted – usually a good sign for long-term bonds. However, during this period the 962 basis point move higher in Fed Funds was just too much for longer-term bonds to overcome. In this period, an investor would have been much better off staying in cash or shorter bonds compared to longer term bonds.

The most interesting takeaway from this timeframe is the power of reinvestment in a bond portfolio. While many would expect a nearly 1,000 basis point rise in rates to be catastrophic to a bond portfolio, the reinvestment of cash flows at the new higher yields allows the investor to earn back the loss of principal value over time. Even the five year duration index posted a total return of +17.21% over this 4.5 year period, despite 5yr Treasuries going from 6.95% to 16.27%.

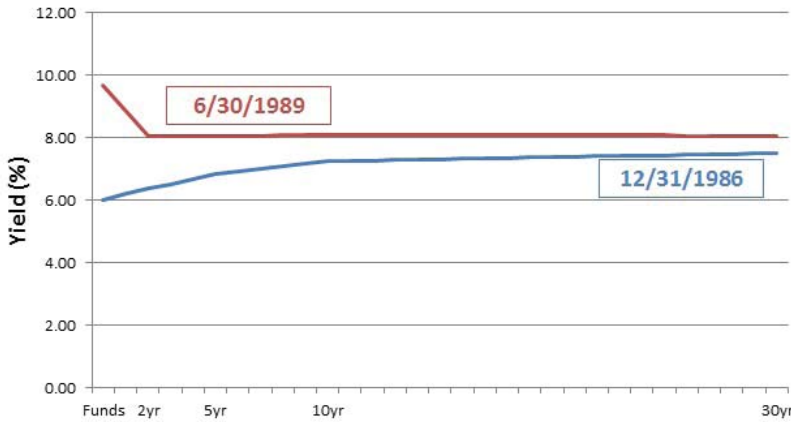


03/31/1977 - 09/30/1981

Index	Approx. Duration	Total Return	Annualized Return	Change in Yield (bps)
Fed Funds	0	65.12%	14.46%	962
Barclays US Intermediate Govt	3	22.01%	4.89%	1023
Barclays US Treasury	5	17.21%	3.82%	933
Barclays US Long Govt	10	-12.62%	-2.80%	842

(continued on page 5)

US Treasury Yield Curves



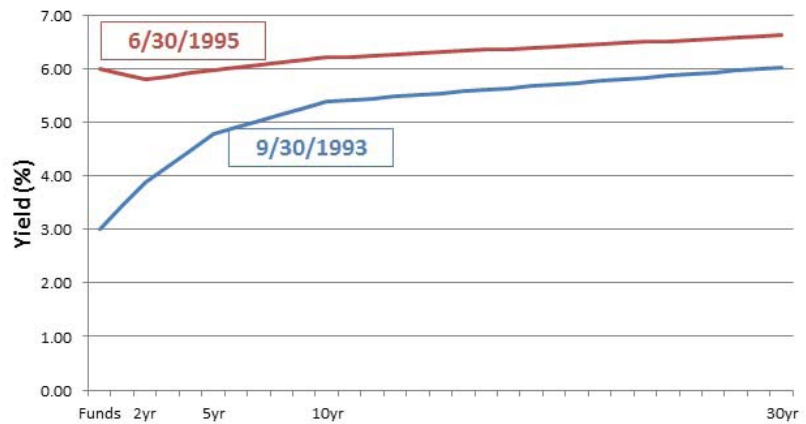
12/31/1986 - 06/30/1989

Index	Approx. Duration	Total Return	Annualized Return	Change in Yield (bps)
Fed Funds	0	21.47%	8.59%	363
Barclays US Intermediate Govt	3	18.77%	7.51%	153
Barclays US Treasury	5	19.31%	7.73%	120
Barclays US Long Govt	10	20.88%	8.36%	85

The next period that we sampled involved a 363 basis point shift in Fed Funds over a two year period. While the shift in rate wasn't as extreme, the time period was shorter – giving the interest income from higher rates less time to make up for the rapid change in price compared to the first period. For this period the change in longer-term interest rates was actually quite small, (ten-year yields were up only 85 basis points compared to 153 and 120 for 3-year and 5-year respectively). While interest rates along the entire curve did move higher, the curve became inverted and total return performance was more or less the same regardless of where one invested along the curve... a result most people wouldn't think was possible in a period where short-term interest rates rose over 300 basis points.

The next period is very similar to the up-rate environment in the late 80's. The rate shift in the short end was very pronounced, (300 bps hike in Fed Funds), but less severe farther out on the curve. The curve became relatively flat, with a kink in rates on the short end of the curve. Long-term bonds underperformed by less than 80 bps, annualized, compared to cash. Again, probably not the performance one would expect considering the abrupt change in short-term rates.

US Treasury Yield Curves



09/30/1993 - 06/30/1995

Index	Approx. Duration	Total Return	Annualized Return	Change in Yield (bps)
Fed Funds	0	8.58%	4.91%	300
Barclays US Intermediate Govt	3	7.29%	4.17%	168
Barclays US Treasury	5	7.08%	4.05%	120
Barclays US Long Govt	10	7.22%	4.13%	82

The most recent period is the best example of how long-term bond performance during a Fed tightening cycle can surprise investors. This was the Greenspan "Measured Pace" period, which saw a 425 basis point change in the Fed Funds rate with hardly any change in longer term interest rates. In fact, ten-year Treasury bonds were the best performing sector for the period as the curve went from being very steep to inverted. Despite this being a period with the Fed raising rates, it was not a rising rate

(continued on page 6)

scenario for all points on the curve. This illustrates the fact that short term and long term interest rates are influenced by different factors.

The common notion is that investors should shorten the duration of their bond portfolios in the face of rising interest rates. The biggest takeaway from this analysis is that this common wisdom has not always been true as higher yields over time will offset losses to principle value. It may be true in the future, but 3 out of 4 of the past cycles have proven it to be less than a given. This is why we continue to recommend to clients to stick with their long term plan rather than gambling on interest rate movements.

I will leave you with one more period, 2009 to the present. Economists have been calling for higher interest rates since the end of 2009. Below is how the markets have performed since that time. Investors who moved towards cash in anticipation of looming Fed rate hikes have sacrificed a lot of return. Making an interest rate call can be a double edged sword.

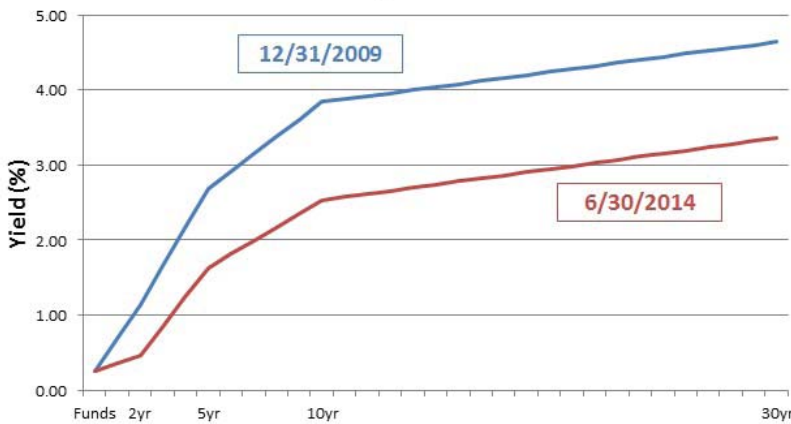
US Treasury Yield Curves



12/31/2003 - 09/29/2006

Index	Approx. Duration	Total Return	Annualized Return	Change in Yield (bps)
Fed Funds	0	8.79%	3.20%	425
Barclays US Intermediate Govt	3	7.10%	2.59%	235
Barclays US Treasury	5	8.92%	3.25%	133
Barclays US Long Govt	10	16.78%	6.11%	38

US Treasury Yield Curves



12/31/2009 - 06/30/2014

Index	Approx. Duration	Total Return	Annualized Return	Change in Yield (bps)
Fed Funds	0	1.15%	0.26%	0
Barclays US Intermediate Govt	3	13.60%	3.02%	-80
Barclays US Treasury	5	18.45%	4.10%	-105
Barclays US Long Govt	10	43.87%	9.75%	-131

In the end it's important to remember that the purposes of a study like this is to help measure risk, not predict what will happen the next time. As the physicist Niels Bohr once said, "Prediction is very difficult, especially when it is about the future." The only certainty is that when the Fed does tighten the scenario will be different than any of the examples we provided here. Then, we will have a fifth example to use next time.

Why Aren't Interest Rates Higher? | Cliff Reynolds, CFA

With a lot of focus being put on the coming end to the Federal Reserve's quantitative easing campaign, this article will delve into some of the other factors impacting interest rates in the US. The Federal Open Market Committee (FOMC) has maintained a steady course ever since Chairman Bernanke first hinted at the end of quantitative easing in the spring of 2013. The "Taper" which is scheduled to complete this October sent ripples across the market – an event we all know as the "Taper Tantrum" – but since then, the FOMC has more or less flown under the radar.

The impending crash in the bond market hasn't come – in fact, bond performance has been quite strong this year with both term risk and credit risk paying off for investors. Interest rates are still very low, but in the context of interest rates around the world our rates appear attractive.

Many fixed income investors, either through onerous capital requirements or outright restrictions, cannot invest in bonds denominated in foreign currencies, but if we use this year as an example it's easy to see that factors impacting bond markets outside the United States can have implications domestically.

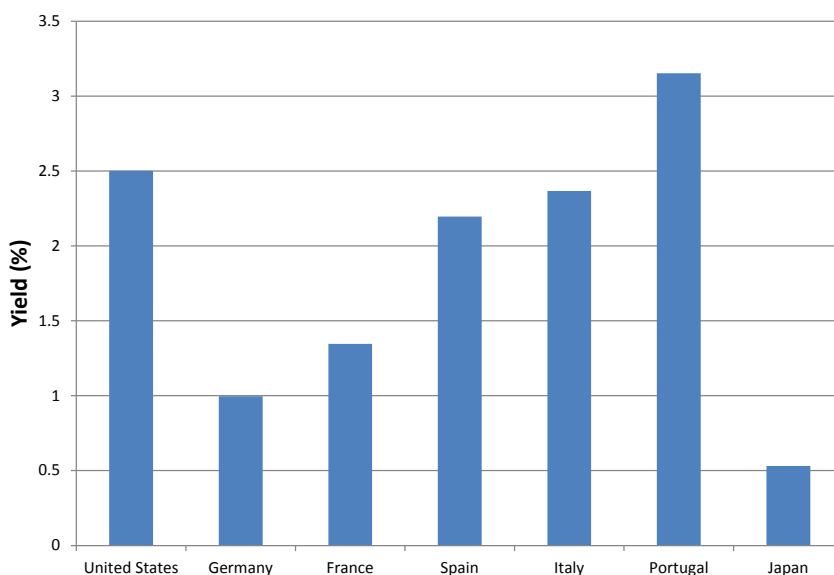
In a way, developed economies around the world are all facing the same struggles. Central banks are responding to weak economic growth and low inflation with asset purchasing programs aimed at lowering interest rates.

In Europe, deficit spending led to unmanageable amount of debt in countries like Greece, Portugal, Spain and Italy. Things came to a head in 2012 and the panic was eventually extinguished with a de facto bailout from Germany, in exchange for structural reforms. While US Treasury bonds were downgraded from AAA by S&P, the credit problem in the Eurozone was much different. This made it that much more difficult for the ECB to lower interest rates, but as you can tell from the graph they have managed to do it.

Japan is a bit different still. While the market isn't pricing any credit risk into the yields on Japanese government bonds, debt to GDP is over 200% and trending higher with a growing debt level and negligent GDP growth over the last 20 years. The Japanese Central Bank is knee deep in a battle with deflation – driving interest rates lower than any country in the world. The Japanese yield curve is a bit of an anomaly, but I thought I would throw it up there anyway.

The majority of focus on interest rates in the United States is centered on domestic factors. US economic growth, monetary policy, inflation and demand for other asset classes like stocks, real estate and commodities have historically had the largest influence on price movements in the fixed income market, but in this era of extremely low interest rates, the global interest rate landscape is clearly impacting bond prices in the US.

Global 10-Year Government Bond Yields



(continued on page 8)

Then why aren't interest rates higher?

It's a question we get a lot. Economic growth is improving – US GDP grew at an annualized rate of 4.2% in the second quarter, personal consumption grew at an annualized rate of 2.5% and inflation is slowly tending upwards – year on year headline inflation measured 2.0% in August. While the Fed is expected to maintain a target rate for Fed Funds below .25% at least through the first few months of 2015, they will be finished adding to their portfolio of longer-term bonds by this October.

While all of these factors have pushed longer-term rates higher, the movement in rates has fallen short of what many thought would materialize. I think low interest rates in other markets carry most of the blame.

I don't want to get too deep into why interest rates in countries like Spain, Italy and Portugal are so low. Yields in those markets have fallen from panic levels, (Portuguese 10-year yields topped out at over 17% in 2012), but few in the market believe that the austerity measures forced on these countries in exchange for bailouts will do much of anything to solve the structural issues that caused the problem in the first place.

The bailouts are pushing yields below their natural levels, driving global investors seeking the proper balance of risk and return into US government bonds. Higher quality European government bonds (Germany and France) are also being pushed lower. The spread between US Treasury bonds and German Bunds has not been this wide since the late 90's – the yield curve in Germany is actually negative all the way out past 3-years.

Interest rates in the United States are still more influenced by domestic economic data than any other factor. If growth and inflation continue to trend higher, interest rates are likely to rise despite of the influence from the global market – but it's still far from a sure bet. Trying to explain why things are the way they are is hard enough – trying to forecast the future is impossible.

The Acropolis Value Proposition

Independent Voice – Acropolis provides independent insight to the Asset Liability Management of financial organizations through effective portfolio management in the context of the entire balance sheet and liquidity needs.

Unbiased – Advice on portfolio management is completely unbiased without influence from outside factors such as trading commissions or dealer inventory. As a fee-only advisor, we are solely beholden to our clients' best interests.

Best Execution – Acropolis offers years of Fixed Income trading expertise and an expansive network of dealers from which to execute trades. This results in buying and selling the most appropriate bonds at the best prices, with no mark-up to our clients.

Specialized Reporting – Our proprietary securities portfolio reports provide detailed data on individual positions with scenario analysis and allocation breakdown.

Fiduciary Duty – As a Registered Investment Advisor, Acropolis is bound to put its clients' interests first. Acropolis takes pride in serving as a fiduciary and took deliberate efforts to become one of fewer than 100 investment advisory firms in the country that are certified as fiduciaries by the Centre for Fiduciary Excellence (CEFEX) (<http://www.cefex.org>).

Notice to Clients: Please remember to contact ACROPOLIS' Investment Management, LLC if there are any material changes to your financial situation or investment objectives or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement as set forth on Part 2 of Form ADV continues to remain available for your review upon request.

Legal Disclaimer: This publication is provided as a service to clients and friends of ACROPOLIS' Investment Management, LLC solely for their own use and information. The information in this publication is not intended to constitute individual investment advice and is not designed to meet your particular financial situation. You should contact an investment professional before deciding to buy, sell, hold or otherwise consider a particular security or investment strategy based on this publication. Information in this publication has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation are not guaranteed and have not been independently verified. The information in this publication may become outdated and we are not obligated to update any information or opinions contained in this publication.