



January 5, 2012

Dear Clients and Friends:

For those in our industry, there is no better time of the year than the end of the year. If you have done well, it is a time of reflection on the reasons for your clients' good fortune. If not, a fresh calendar beckons and hope springs eternal! For clients of Reams Asset Management, 2011 was a good year in what was a very challenging environment, with many of our peers struggling. Being of solid Midwestern stock, we are not ones to dwell on past success, but besting our coastal competition is something that never gets old. Enough of the past. In the land of "what have you done for me lately," let's spend some time on what we are now doing on your behalf.

As you may recall, we are not fans of making specific forecasts. We have pilloried the Federal Reserve for their seeming inability to forecast last week's weather. We can add to the list several well-known investors who have succumbed to the siren song of certainty regarding higher interest rates. Instead, in our investment process we look for knowable risks, determine potential outcomes (both positive and negative), and ask ourselves if our clients are being adequately compensated for assuming these risks. More recently, these risks have included the now familiar issues of Europe and our own country's destabilizing fiscal and monetary policies, with the shockingly low level of interest rates serving as the icing on a very unappetizing cake. It is the confluence of the European issue (it's not really a crisis as it has been with us for over three years now) and its concomitant risk aversion, along with the pernicious policy of the Federal Reserve and its aggressive debt monetization, that has combined to present investors in fixed income with one of the highest risk environments we have ever known. We are faced with an investment landscape that demands a fresh approach to the role of fixed income in an overall portfolio.

This risk, in our opinion, does not refer to a Lehman-like event which most investors seem to inordinately fear. Rather, we are referring to an inability to meet one of the most primary investment objectives ... to maintain and, hopefully, grow your current purchasing power. All asset pools exist to fund a future need or liability which is likely to be more expensive in the future than it is today. Yet, those investing in the vast majority of the high grade fixed income universe are ceding almost any chance of meeting this most fundamental goal with negative real interest rates in Treasury securities out to 10 years and near negative real rates in many non-Treasury high quality securities. It is often forgotten that 80% of the Barclays Aggregate Index is comprised of Treasury and agency securities. The adjusted nominal yield on this index stands at about 2%. The real yield will likely be much lower or, perhaps, negative. Matching the index going forward will not likely lead to success.

As Mark Twain has been credited with saying, "History does not repeat itself, but it does rhyme." Misguided Fed policy gave us negative real rates in the 1970s and, eventually, higher rates (both nominal and real). This is what keeps tripping up those calling for higher rates. They compare the 1970s with current Fed policy and expect some kind of replay. Those old enough to remember back then ... yes, I remember ... may be especially vulnerable to expectations of surging interest rates and rapidly declining bond prices. This is where the rhyming part comes in. The negative real rates are the only thing we now have in common with the 1970s. Rather than surging interest rates, we may experience very low rates for a very long time. Rather than losing a lot very quickly, we may lose a little each year for many years without fully realizing the long-term damage. The strategy required for this environment will be very different than simply waiting for higher rates. The cost of that approach is likely to be far too high.

We must understand the vice-like grip the Fed has on short rates and how their aggressive purchases of long-dated securities have created a shortage of investable assets. The Fed has distorted the pricing function in the U.S. Treasury and government related market. This market now represents a strange class of investments known as return-free risk, and we believe it should be almost entirely avoided as it contains significant risk with almost no chance of achieving positive real returns over the long term. Facing this landscape, it is important that investors consider the appropriateness of a benchmark largely comprised of these types of securities. As a result, your portfolio will look different than your benchmark as we move into 2012.

Events in Europe and our own political arena have combined to offer an opportunity to invest in assets that are not U.S. Treasuries but offer compelling value and may make it possible to achieve a positive real return. This will not be easy and the road may have some potholes, but we feel that it is a road that should be taken. Investors should extend their horizons beyond the next month or quarter. We must embrace volatility as our friend and harbinger of opportunity. There is likely to be short-term discomfort but just as chance favors the prepared mind, we believe volatility favors the prepared investor. We are prepared.

As always, we never lose sight of the fact that if it were not for you we would not be able to do that which we so thoroughly enjoy. We look forward to continuing to serve you in, what will no doubt be, challenging and difficult times ahead. A member of our investment team will be in contact with you early in the New Year so that we may find a time to answer any questions that you may have and more fully explain our strategy for dealing with the current environment.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark M. Egan". The signature is fluid and cursive, with a long horizontal stroke at the end.

Mark M. Egan, CFA, CPA  
Managing Director

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