Fourth Quarter 2010

Becker Capital Management, Inc.

Perspectives

Value Driven

A Bargain with the Devil

by Marian Kessler

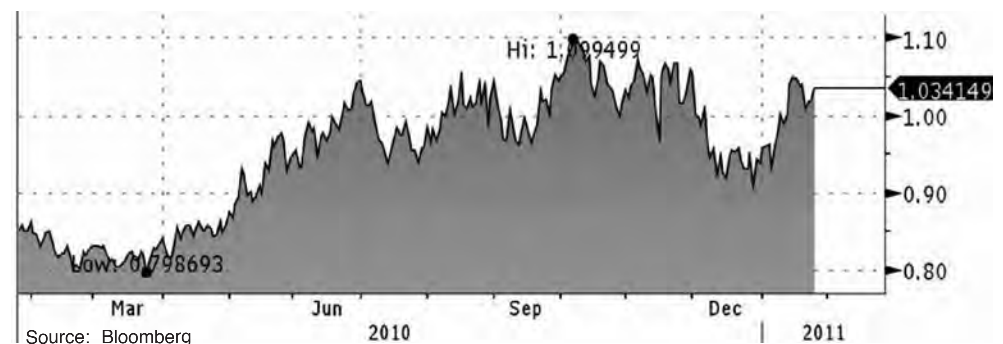
In early November of 2010, the Federal Reserve announced it would purchase up to $900 billion of longer term Treasury bonds and other securities in the open market – a tactic known as "quantitative easing." The Federal Reserve believes this most recent round of stimulus will increase demand for Treasuries, drive down interest rates, stimulate corporate and consumer borrowing, invigorate economic growth and employ a greater number of the unemployed and underemployed. Dubbed "QE2", this latest easing followed hard on the heels of the Fed's repurchase of nearly $1.8 trillion of Treasuries and mortgage-backed securities since early 2009 in response to the serious lack of liquidity in the credit markets in late 2008.

In the last two and a half years, the Federal Reserve's balance sheet has grown more than 220% as it printed money to combat housing and financial asset deflation, recession and rapidly rising unemployment. It is this expansive monetary policy – created and perpetuated by the Fed – that Thomas Hoenig, President of the Federal Reserve Bank of Kansas City, has called a "bargain with the devil." This bargain however, applies only to the Federal government. In sharp contrast to the Federal Reserve's ability to print money, individual states must seek to live within their means. Balancing state budgets is proving extremely difficult this year, as the promises made in more prosperous times far outweigh the current income of states such as Illinois and California. In recent weeks, municipal debt spreads have widened modestly to Treasury debt. States will have to make difficult and unpopular choices this year relative to taxes and spending. On the other hand, the Federal government may be able to postpone, for the time being, its burgeoning debt problem.

Mr. Hoenig has been the lone dissenter on the Federal Open Market Committee (the FOMC sets interest rate policy), voting consistently against the low-and-lower interest rate policy advocated by Chairman Bernanke. He has expressed concern that current low interest rate/accommodative money policy is at best a short term fix, with serious potential for adverse unintended consequences. Continually stoking the printing presses, he states, risks runaway inflation and a further devalued dollar. Flawed monetary policy can also lay the foundation for future asset bubbles and possibly even greater systemic risk than experienced in 2008. Many economic and financial market pundits have made the argument the Fed contributed to the dot-com and the housing bubbles with aggressive liquidity infusions and falling interest rates. How likely is the creation of a new bubble – a bond bubble - given the government's aggressive monetary response to the Great Recession?

The government can continue to print money until the bond market says it can't. Fixed income investors respond quickly to perceived inflationary forces by demanding higher interest rates on longer term bonds and mortgages. The FOMC sets only very short term interest rates – the level of longer rates and the steepness of the yield curve are a function of investors' inflation expectations and supply relative to demand, among other variables. But, since the QE2 was implemented last fall, the financial response has not been consistent with the theoretic objective. Since November 3, 2010 – the date of the QE2 announcement – interest rates have risen, not fallen as the Fed had expected. The yield on the 10 year Treasury has backed up 80 basis points, from 2.60% to 3.40%, making borrowing more, not less costly. Crude, gold and the dollar have all appreciated in value – all seemingly counter to intent and to historic precedent.

Ratio of 10-year Municipal Yields to 10-year Treasury Yields



Source: Bloomberg

One explanation of this seemingly contradictory market response to QE2 is the possibility that the Fed's monetary largesse has been successful in stanching deflation. The economy is once again reflating – housing and commodity prices have stabilized or are rising following the bursting of the housing/credit bubble. Global economies indicate slow, uneven but sustainable recovery. The US government's printing presses may be able to slow their torrid pace.

In our opinion, ample supply and rising yields render fixed income securities relatively unattractive investments in 2011.

Bond popularity soared following 2008's financial meltdown. An astonishing $645 billion net, on a $1.7 trillion base, poured into US fixed income funds from 2008 through year end 2010, 50% more than in the previous 10 years as Treasuries were perceived to be "safer" than stocks, real estate or credit derivatives. Investor appetite for bonds mirrored the government's expanding supply. That is, until the QE2 was announced. Treasury bond popularity seems to be waning as borrowing costs rise and prices fall. It may be dawning on bond buyers that Treasuries may be vulnerable to an expanding money supply, ever-increasing government debt and rising inflation/interest rates. For example, a 30 year Treasury bond paying a $50 coupon annually is worth $1000 when long term rates are 5%. However, if long rates rise to 6%, the bond is worth only $860. If rates rise to 7%, the bond's value falls to $750 – a 25% loss. It's been a long time since inflation or interest rates ticked up. Perhaps investors are beginning to think it prudent to broaden their asset allocation.

State Defaults?

The Federal Government has the unique ability to meet its immediate obligations, support credit markets and encourage economic activity by printing money, the potential negative ramifications of which have been noted by Mr. Hoenig and many others. States however, do not share the federal government's balance sheet flexibility. With the exception of Vermont, all US states have a constitutional, statutory or judicial mandate to balance their budget. These budgets have become difficult to balance as the recession caused municipal revenues to decline and governments were loathe to cut expenditures. In addition, many municipalities have promised pension benefits to employees, that have not been fully funded. In the last two years, states have collectively spent a half trillion more than they have collected in taxes. According to a 2002 study by the Pew Center on the States, the states have set aside $2.35 trillion to cover future pension obligations currrently valued at $3.35 trillion. This estimated $1 trillion deficit, if not addressed, may become harder to fund over time further constraining municipal budgets.

Because future obligations were based on rosy economic assumptions, most states are facing growing budget deficits in the next several years. Several states, including California and Illinois, have credit default swap spreads that are implying near-junk status; CDS spreads have been widening in recent weeks as political impasses have stonewalled budget discussions. In response, the credit obligations of states and municipalities have declined in price and demand while the cost of borrowing money has risen. Illinois, one of the most critically under funded states, has a $26 billion general fund budget and current tax revenue of only $13 billion, due to the impact of the recession as well as lack of financial discipline.

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The possibility of state and municipal default is remote but not unprecedented. In the 1840's, eight states and the territory of Florida defaulted on their state debt. In 1841, as defaults escalated due to aggressive public infrastructure spending, investors here and abroad dumped states' bonds, pushing yields above 12% in early 1841 to 30% one year later. And in 1843, Congress set a precedent that still stands today; it rejected an elaborate bailout that was deemed to encourage "recklessness and extravagance" in state budget planning. States were forced to raise taxes. Property taxes in Indiana and Ohio, for example, went up eightfold in the first half of the decade. Most of the bankrupt states eventually paid off their debts and enacted stringent laws which encouraged fiscal discipline.

Today's state/municipal financial crisis is much more complex than it was 170 years ago. There were no state entitlement programs and no inviolate health and retirement packages. Drastic measures will almost certainly be embraced to whittle away current state deficits. Just last week, Illinois passed legislation that raises taxes by 66% over the next four years. Personal income taxes will rise from 3% to 5% and corporate taxes from 4.8% to 7%. Illinois' tax bill to its citizens will increase by nearly $6B. It is possible other burdened states may follow suit – higher taxes, spending reductions and growing pressure on policymakers to limit or reduce sacrosanct but underfunded retirement and health benefits. It is impossible to know how the future will unfold. We suspect however, there will be wider reaching discussions about how states will cope with the aforementioned $1 trillion unfunded retirement liability. It is illegal for states to declare bankruptcy. However, discussions will likely escalate regarding options states possess to reduce future public obligations. Don't be surprised if the financial problems of states and municipalities continue to make front page news.

Ultimately, state defaults appear highly unlikely. Despite the negative publicity, the municipal bond market is stable and calm – normal yield spreads on municipal bonds relative to risk-free Treasuries corroborate this view. However, legislated and judicial default options will probably continue to be argued by academics, policymakers and others. The threat of state or municipal bankruptcy could be used as a tool to negotiate future public retirement and health benefits. Such discussion could provide an interesting and opportune market to the low-risk seeking muni investor if prices on low risk, voter sanctioned and revenue pledged bonds fall due to the threat of credit problems of a small section of the public finance market.

The majority of municipal credits are low risk. At $2.86 trillion in size, the municipal market is large and diverse. There are more than 90,000 issuers, the majority of which issued general obligation and revenue bonds with specific tax and revenue pledges to pay the debt service on the bond. It is possible some issuers will be forced to restructure due to the excessive appetite for debt and the assumption of infinite prosperity that characterized the mid 2000s. In the long run, being forced to live within their means is positive for states, municipalities and their investors. And hopefully federal monetary policy will navigate the cross currents of stimulus and inflation, thus allowing the Fed to concentrate on its express mandates – price controls and a full employment economy. ❦

Becker Value Equity Fund (BVEFX) ★★★★ Overall Morningstar Rating™ Out of 1,120 Large Cap Value Funds

As of December 31, 2010	1 Year	3 Years	5 Years	Since Inception 11/3/03
BVEFX	**12.17%**	**-0.36%**	**3.29%**	**6.62%**
Russell 1000 Value[1]	15.51%	-4.42%	1.28%	5.11%
S&P 500[2]	15.06%	-2.85%	2.29%	4.63%

The Total Gross Expense Ratio of the Fund as disclosed in the most recent prospectus is 1.24%, and the net expense ratio after contractual fee waivers is 1.00%. The advisor has contracted with the Fund to cap certain operating expenses at 0.95% plus Fees and Expenses of Acquired Funds of 0.05%.

Peer Ranking as of December 31, 2010

	1 Year	3 Years	5 Years
Percentile Ranking %	69th	8th	17th
Number of Funds in Peer Group	1,240	1,120	956

Performance figures shown are past performance and are not a guarantee of future results. Due to market volatility, fund performance may fluctuate substantially over the short-term and current performance may differ from that shown. The value of the Fund's shares and their return will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data current to the most recent month end may be obtained by calling 800-551-3998. Periods over one year are annualized.

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other important information about the Fund and may be obtained by calling 800-551-3998. Read it carefully before you invest.

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[1] Russell 1000 Value Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The performance of the index does not reflect deductions for fees, expenses or taxes. Index is not available for purchase.

[2] The S&P 500 is an unmanaged index which includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Index is not available for purchase.

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