
THINK GLOBAL, INVEST LOCAL

How the world's economic outlook affects your investments, and how you can benefit

Financial Managers Society – Boston Chapter

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Chief Investment Officer

Eastern Bank Wealth Management

October 28, 2014

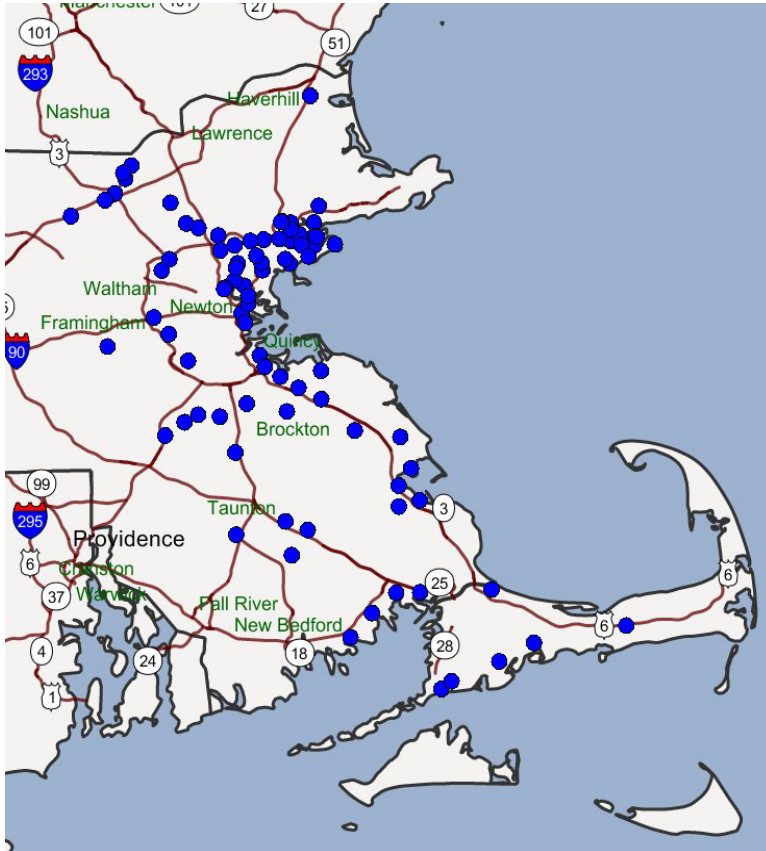


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EASTERN BANK



- Largest mutually-owned U.S. commercial bank, with \$9 billion in assets
 - Headquartered in Boston with operation centers in Lynn and Middleborough
 - Over 90 branches stretching from Newburyport to Hyannis
 - Offer a full range of financial products for consumers, businesses, governments, and not-for-profit organizations



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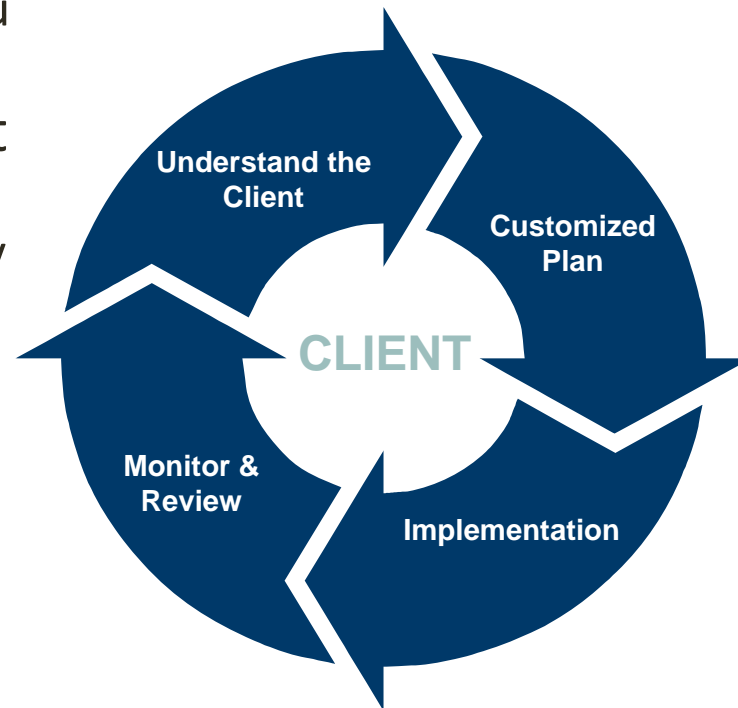
EASTERN BANK WEALTH MANAGEMENT

- Headquartered in Boston with offices in Norwell, Brockton, and Saugus
- Manage \$1.8 billion in individual & institutional client assets
- Team of 49, comprising Account Officers, Trust Officers, Financial Planning, Investment, and Operational Officers
- Fiduciary and Investment Team Credentials
 - 13 Certified Financial Planners
 - 2 Chartered Financial Analysts
 - 3 Masters of Business Administration
 - 4 Juris Doctor
 - 6 Certified Trust and Financial Advisors
 - 2 Chartered Retirement Planning Counselors



THE EASTERN BANK DIFFERENCE

- Comprehensive individualized service
 - Dedicated account officer provides a consultative approach
- Building a plan
 - Align your resources to help you meet your financial objectives
- Investment risk management
 - We help you evaluate and control your portfolio's volatility
- Investment philosophy
 - We guide your process to determine strategic deployment
 - We evaluate market conditions to make tactical decisions



MICHAEL A. TYLER, CFA

- Chief Investment Officer, Eastern Bank Wealth Management
- Former Partner at Wellington Management in Boston
 - Built and led telecom investment practice
 - Managed \$400 million in mutual funds
- Founder/CEO of investment boutique
 - Guided institutional clients on corporate takeovers and managed hedge fund
- Harvard MBA, Princeton BA

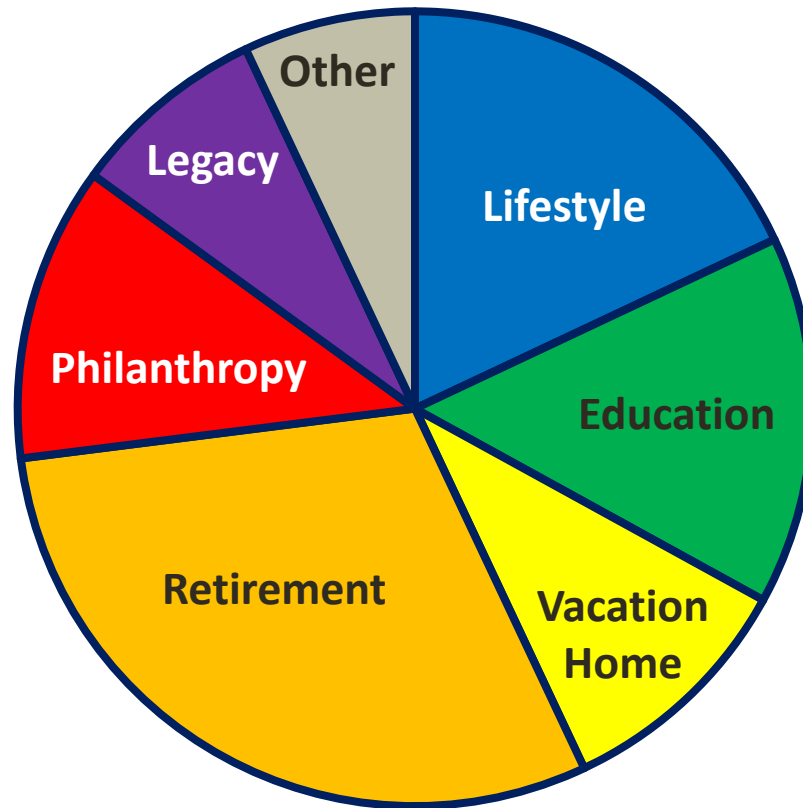


AGENDA

- A philosophy of investing
 - Guiding principles
 - Strategic asset allocation
- Think global
- Invest local
- Q & A

GUIDING PRINCIPLES

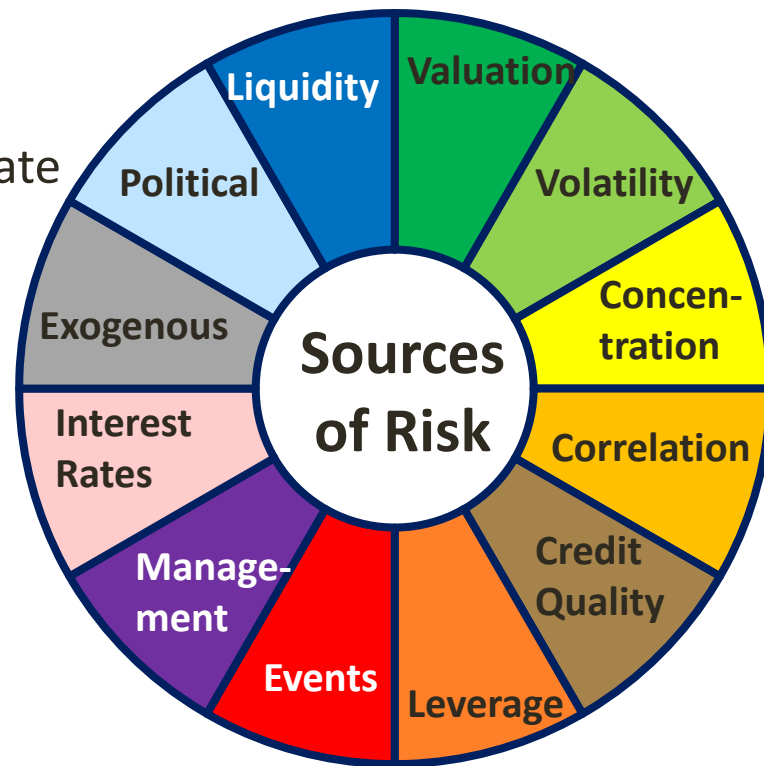
- Money is a tool: What do you want to accomplish with it?
 - Timing of cash flows
 - Preserving future options
 - Investing vs. hoarding
- Your hypothetical pie chart uniquely reflects *your* personal values and goals



Hypothetical Example

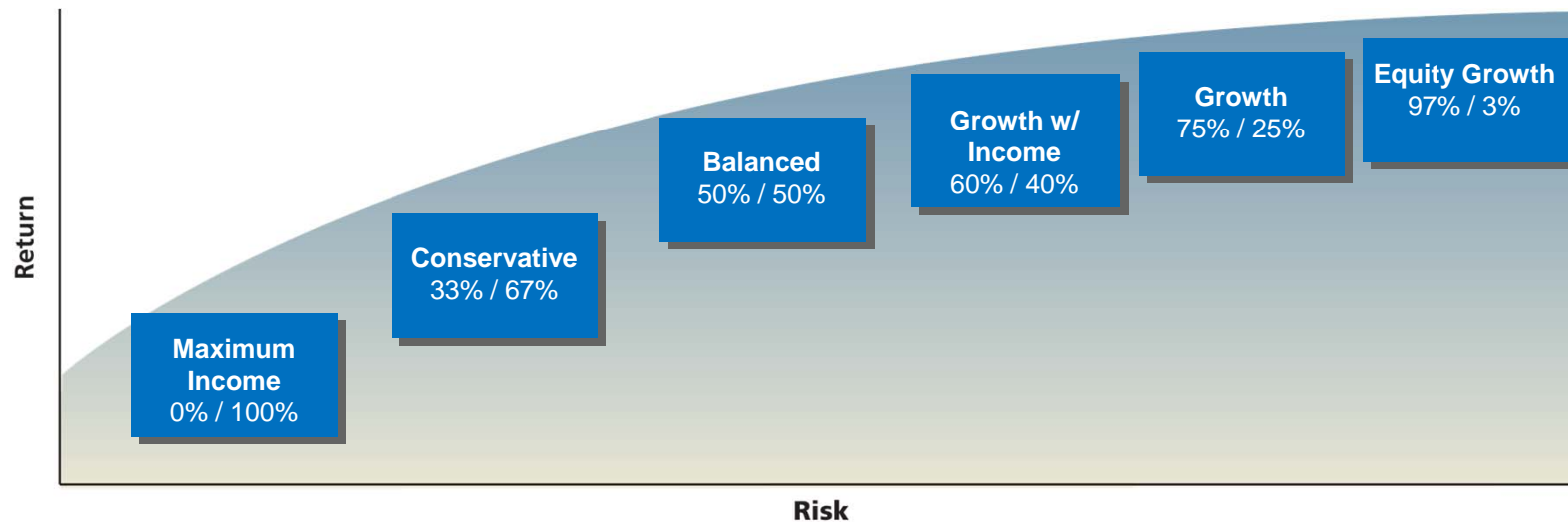
GUIDING PRINCIPLES

- Managing risk is more important than seeking returns
 - Don't *avoid* risk
 - Don't *embrace* risk
 - Do *manage* risk to create successful results
- Returns come from multiple sources
 - Growth
 - Income
 - Tax efficiency
 - Liquidity
 - Global diversification



Source: Adapted from Wells Fargo

BALANCING RISK AND RETURN



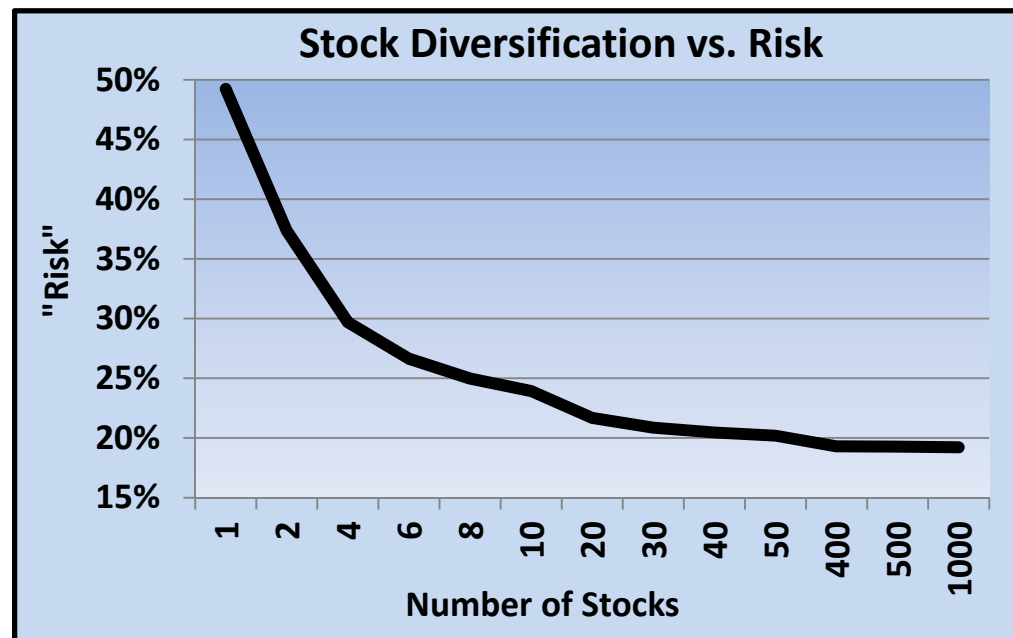
- This chart illustrates only equity and fixed-income
 - The principle applies to all asset classes
- Inefficient investing occurs when portfolios take incremental risk that is not associated with incremental return

STRATEGIC ASSET ALLOCATION

- Choices among asset classes are far greater contributors to return (and risk) than choices within asset classes
 - Strategic asset allocation reflects your long-term needs
 - Select a target “neutral” allocation among asset classes
 - Rebalance periodically back to neutral or to a tactical tilt
- Tactical allocation refers to periodic shifts of asset classes
 - Economic and market factors are key inputs
 - Wise tactical allocation produces returns that are higher and more stable than “stock jockey” speculation
- Risk = volatility; it works both ways

BENEFITS OF DIVERSIFICATION

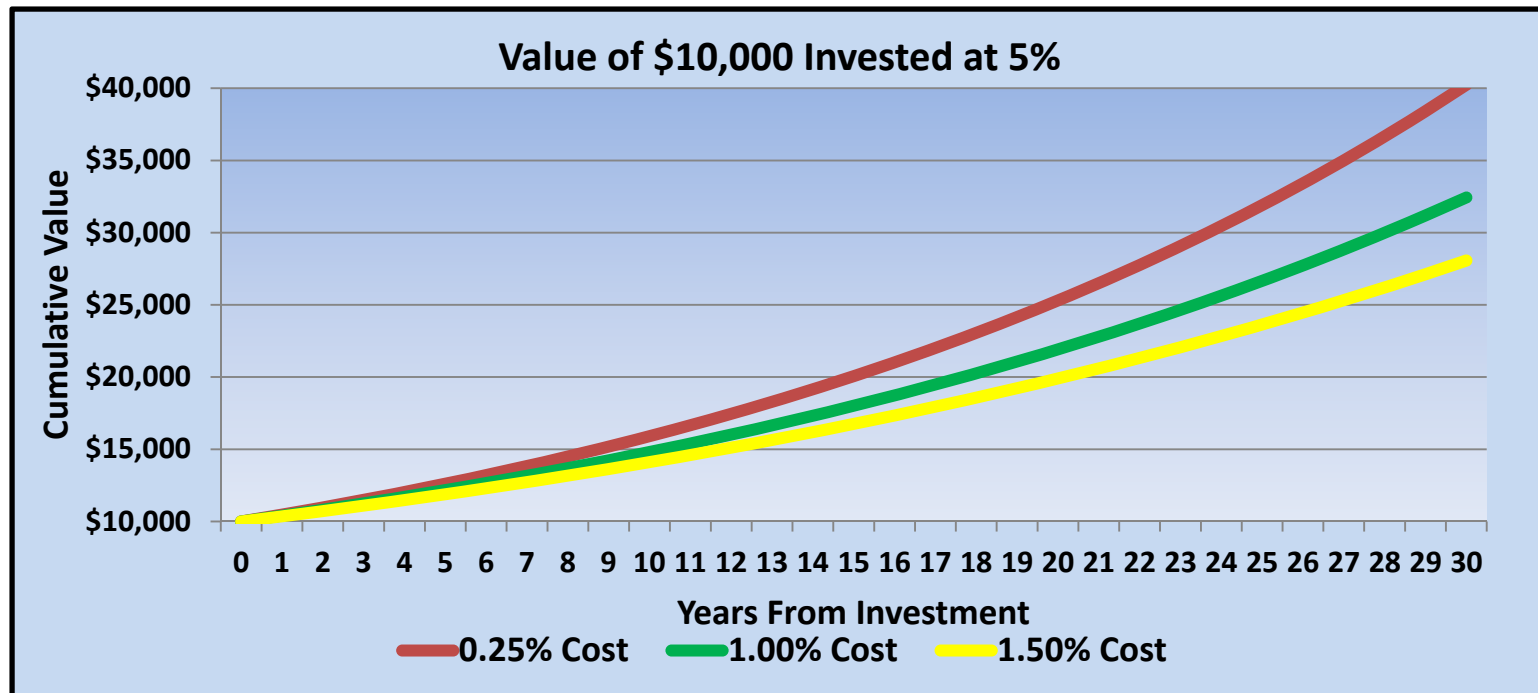
- Adding names *does* reduce risk, without reducing return
 - Risk is defined as standard deviation of return, i.e. volatility
- After about 20 names, marginal benefit diminishes
 - For funds, the same principle applies, but with even fewer names needed to optimize a portfolio



Source: E. J. Elton and M. J. Gruber, "Risk Reduction and Portfolio Size: An Analytic Solution," *Journal of Business* 50 (October 1977), pp. 415-37

THE IMPORTANCE OF COSTS

- Choosing a lower-cost fund can have a dramatic effect on portfolio performance



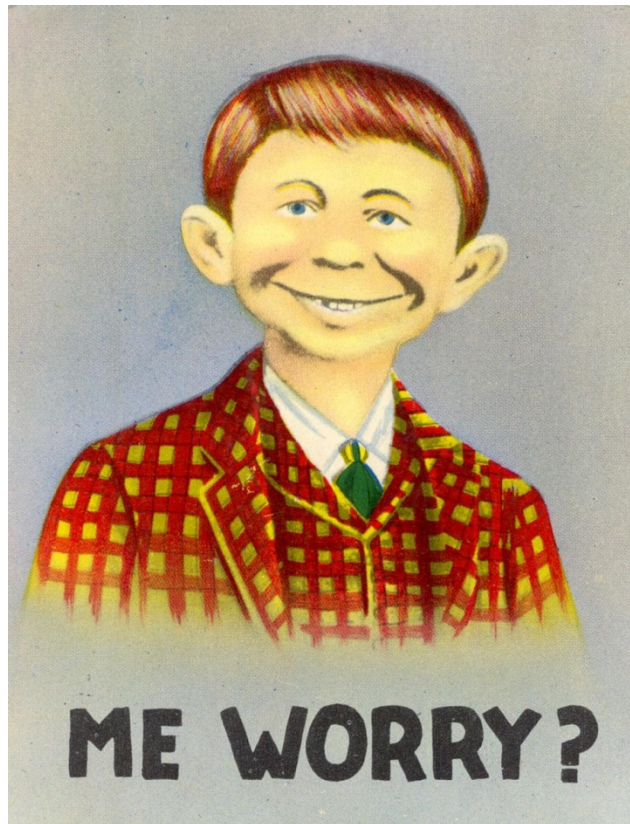
FUND MANAGER OVERSIGHT

- A dog shouldn't quack, and a duck shouldn't bark
- *Style drift* refers to a fund manager's deviation from the mandate imposed by the client
- *Personnel moves* are important to understand
- *Transparency* is necessary to assess the manager's process

AGENDA

- A philosophy of investing
- **Think global**
 - International issues
 - The U.S. economy
- Invest local
- Q & A

TAKING A GLOBAL VIEW



- What happens *there* matters *here*
 - War and peace have multiple effects
 - Foreign demand for American products affects our economy
 - Foreign interest rates affect the U.S. dollar and our interest rates
 - Costs of labor and materials affect global competitors in many industries
 - Availability and price of key inputs affect prices and demand here

A WORLD IN CONFLICT

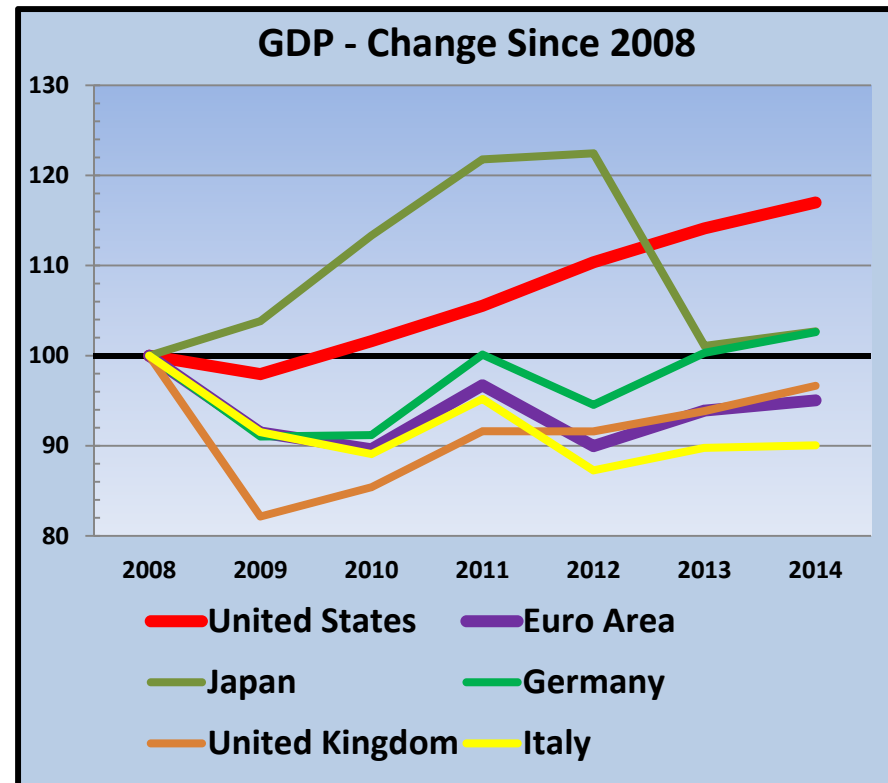


A WORLD IN CONFLICT

- Hot spots are all over the world
 - Ukraine vs. Russia
 - Islamic State (ISIS) vs. the West
 - Hamas (Gaza) vs. Israel
 - China vs. Vietnam
 - A nuclear Iran?
- Causes are varied
 - Economics, politics, religion, culture, ethnicity, etc.
- Impact on markets varies, too

DIVERGING ECONOMIC PATHS

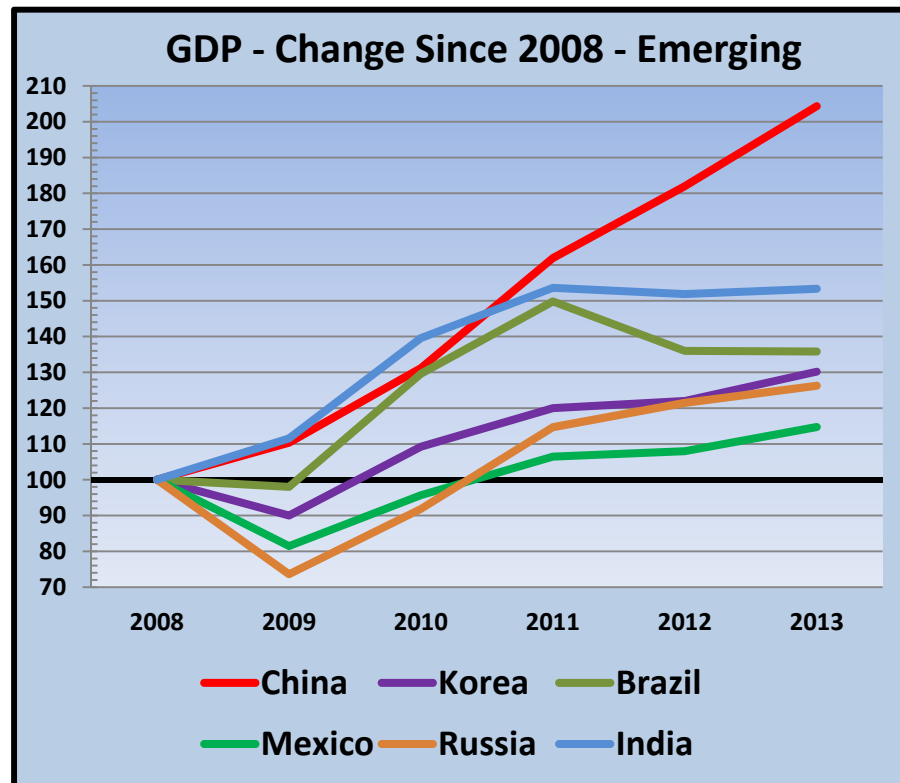
- Economic patterns usually differ across national borders
- In 2008, all “developed markets” converged
 - To varying degrees, all suffered concurrent severe recessions
- Recoveries have been sharply divergent
 - The U.S. has outpaced all other major developed economies



Source: World Bank

EMERGING MARKETS

- Emerging markets grow faster, but fundamentals vary
- Resiliency and vigor depend on diversified sources of growth
 - Consumer-driven markets suffered in 2009 but rebounded more strongly
 - Resource-based markets lagged those propelled by capital investment
- China learned from our pre-recession mistakes



Source: World Bank



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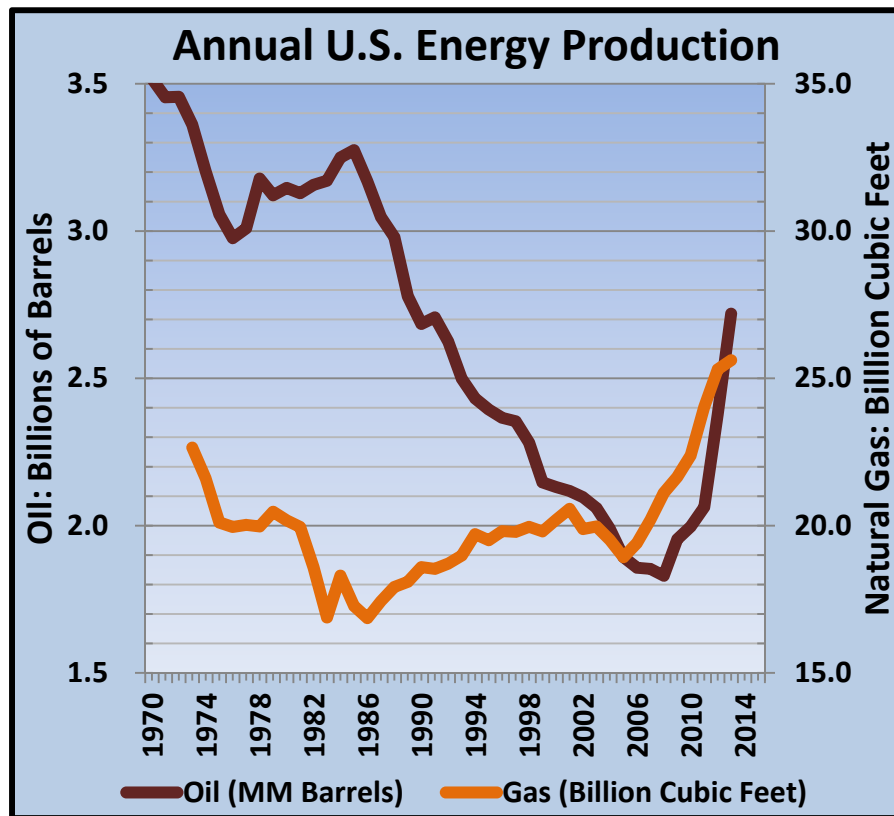
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GLOBAL FACTORS: ENERGY PRICES

- Weak demand due to slowing emerging markets, stagnation in Europe, and large-scale conservation
- Rising supply due to booming U.S. production
- Global events – Ukraine/Russia, Iran, Iraq, etc. – can have big short-term effects, but economics set long-term prices



INFLATION: OIL & GAS PRODUCTION



Source: U.S. Energy Information Administration

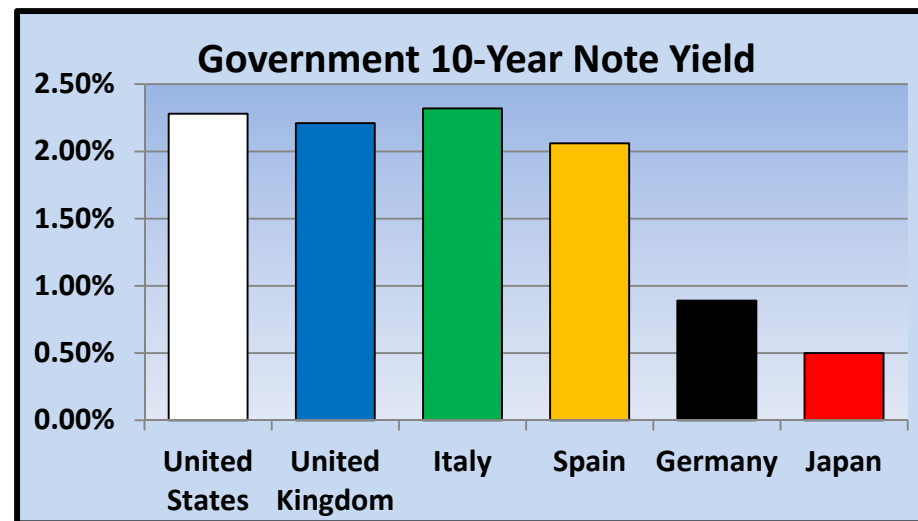
- U.S. oil & gas production is at 25-year highs
 - Fracking opens new fields that weren't previously economic
- U.S. will become the world's largest producer – and possibly an exporter

ENERGY: LOCAL VS. GLOBAL ISSUES

- Lower crude oil prices don't always mean we pay less
- Oil is easy to transport but bulky to store
 - California's gas prices are high partly because the state has inadequate terminal capacity to offload Midwest shale oil
- Gas is extremely difficult to transport
 - Despite abundant supply, New England suffers from inadequate pipeline capacity to deliver natural gas to electric utilities
- Electricity cannot be stored effectively
- Closure of Vermont Yankee and Salem Harbor raises prices
 - Eliminating these generation plants reduces capacity long before planned gas pipelines are brought online

GLOBAL FACTORS: INTEREST RATES

- Accelerating U.S. economy normally leads to inflation and higher rates; the Fed is talking tougher but not yet acting
- ECB policy includes monetary stimulus, pressuring rates
- Global tensions often lead to “flight to safety”



Source: Bloomberg

INTEREST RATES: U.S. VS. GLOBAL ISSUES

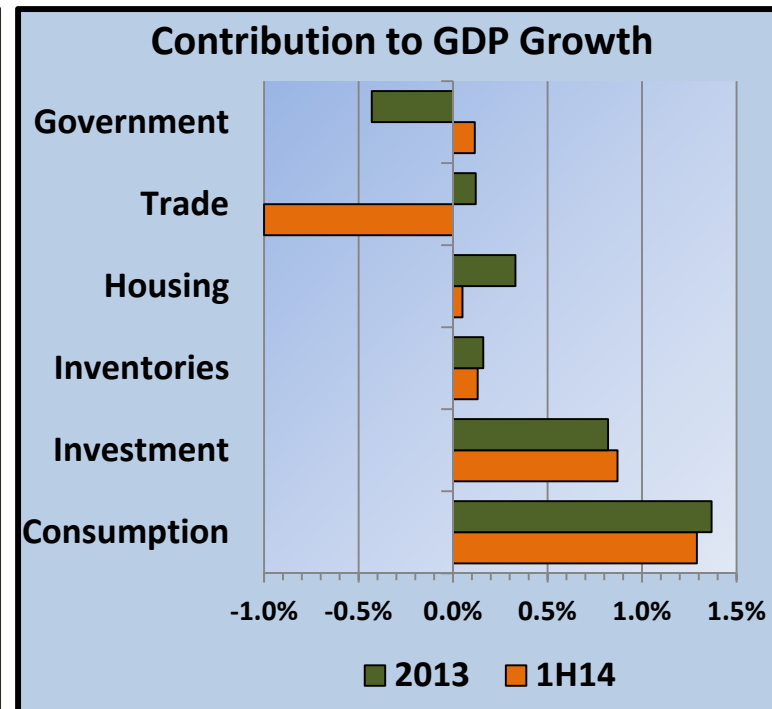
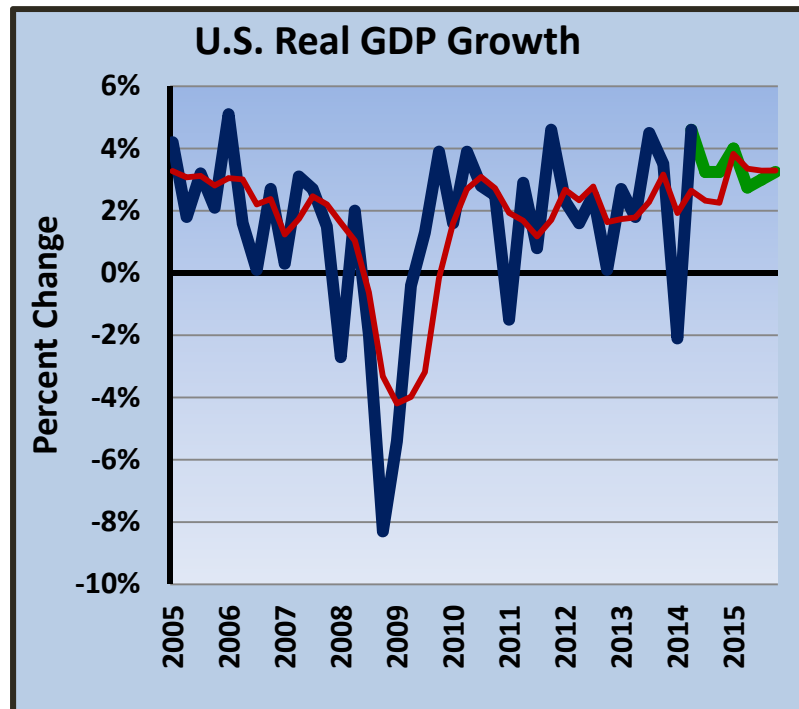
- Interest rates are caught in a transnational tug-of-war
- Global factors are pushing interest rates down
 - Flight to safety when foreign tensions rise
 - Foreign bonds are either more expensive or lower quality
 - Stronger U.S. dollar will attract more foreign capital (i.e., buyers)
- Local (U.S.) factors are pushing interest rates up
 - Fed will finish its monthly bond purchases just as the Treasury begins to ramp up seasonal new issuance
 - Fed wants to avoid overheating stock and bond markets
 - Economy is growing and beginning to accelerate

AGENDA

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- **Think global**
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 - The U.S. economy
- Invest local
- Q & A

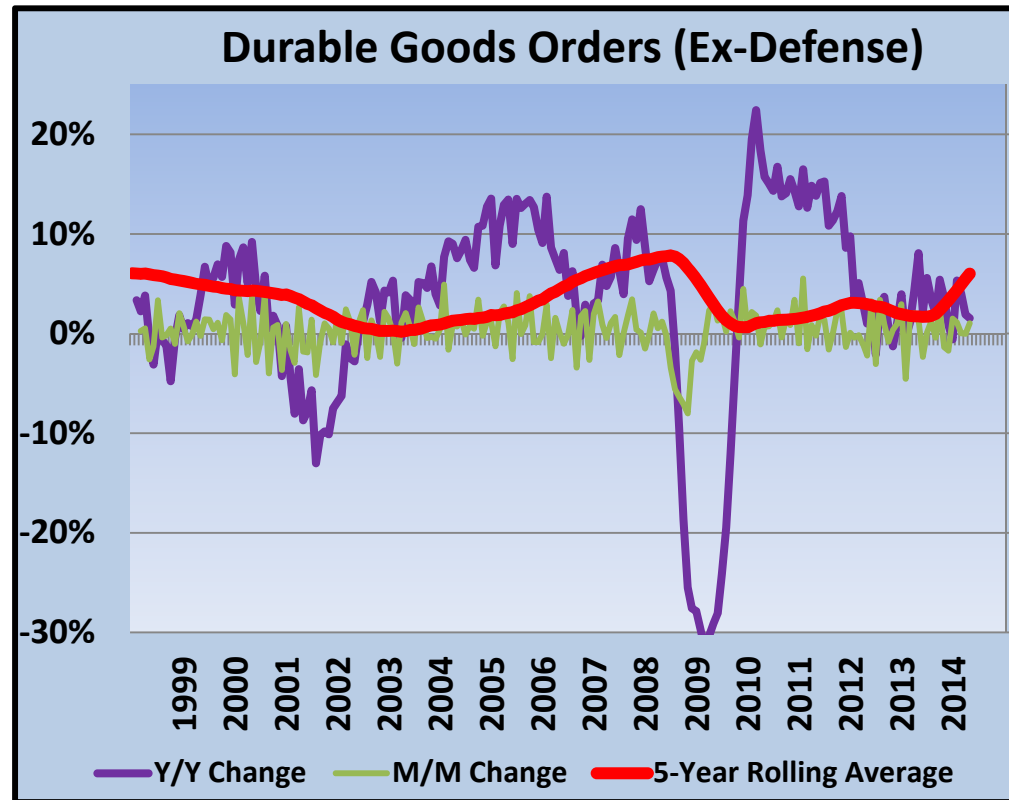
U.S. ECONOMY: SLOW IMPROVEMENT

- GDP shrank in Q1, revived in Q2: What happened?



Source: Commerce Department, Bureau of Economic Analysis

PENT-UP DEMAND: DURABLE GOODS

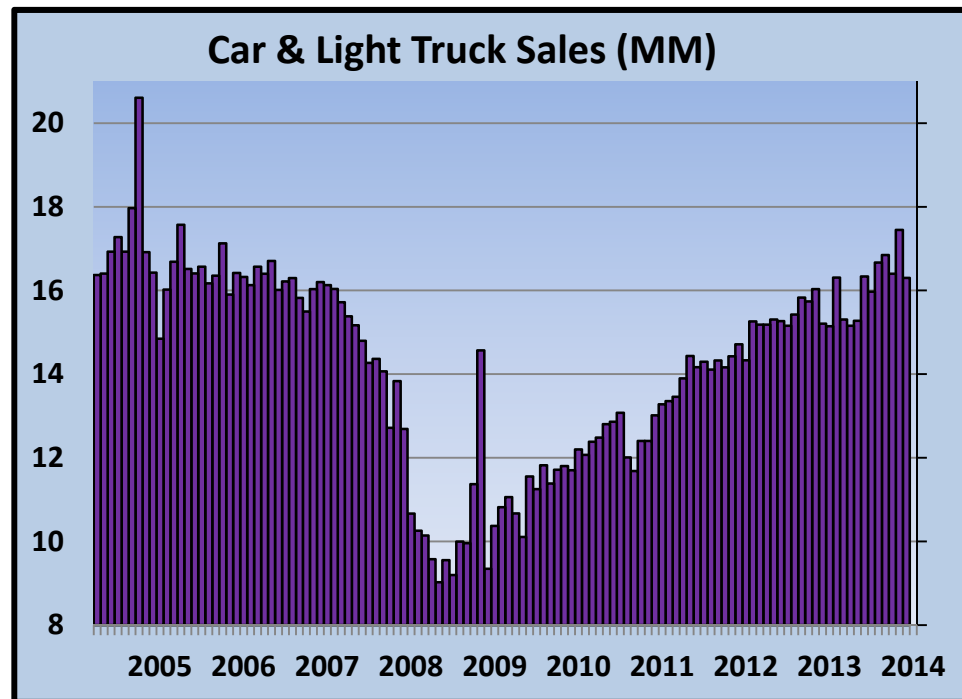


Source: U.S. Census Bureau

- Businesses and households have been making do with old products
 - With credit tight and fear rampant, purchases of long-lived assets stalled
 - Pent-up need for replacements and upgrades will spur new investment

PENT-UP DEMAND: CARS & TRUCKS

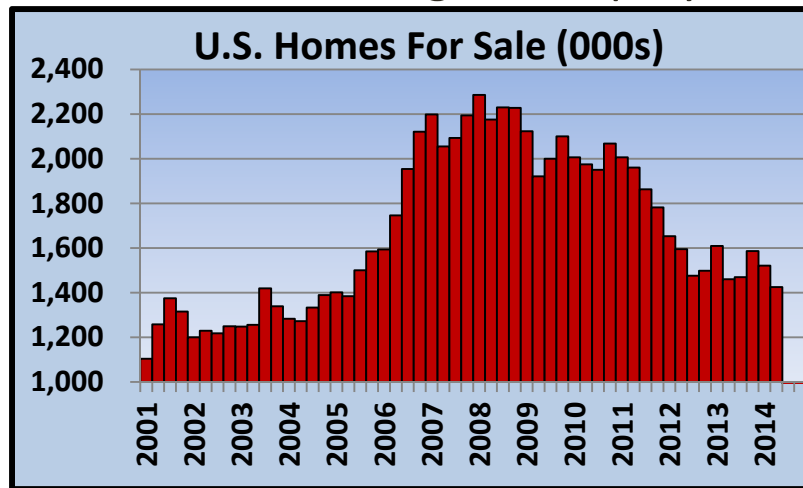
- The average car on the road in the U.S. today is 11.4 years old – the oldest in American history
 - The average truck is 9.6 years old – also the oldest in American history
 - Better quality is partly the reason
 - People & businesses delayed major expenditures due to economic fears



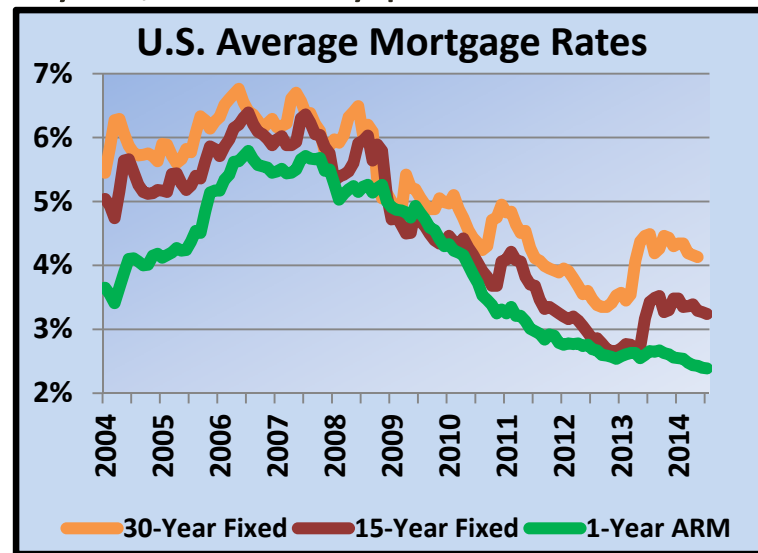
Source: Commerce Department, Bureau of Economic Analysis

HOUSING MARKET: SUPPLY

- Inventory is shrinking
 - Almost no new construction for years after 2008 downturn
 - Banks have worked through most foreclosures
 - Prices are affordable for more buyers, but many potential sellers still have negative equity



Source: U.S. Census Bureau



Source: Freddie Mac



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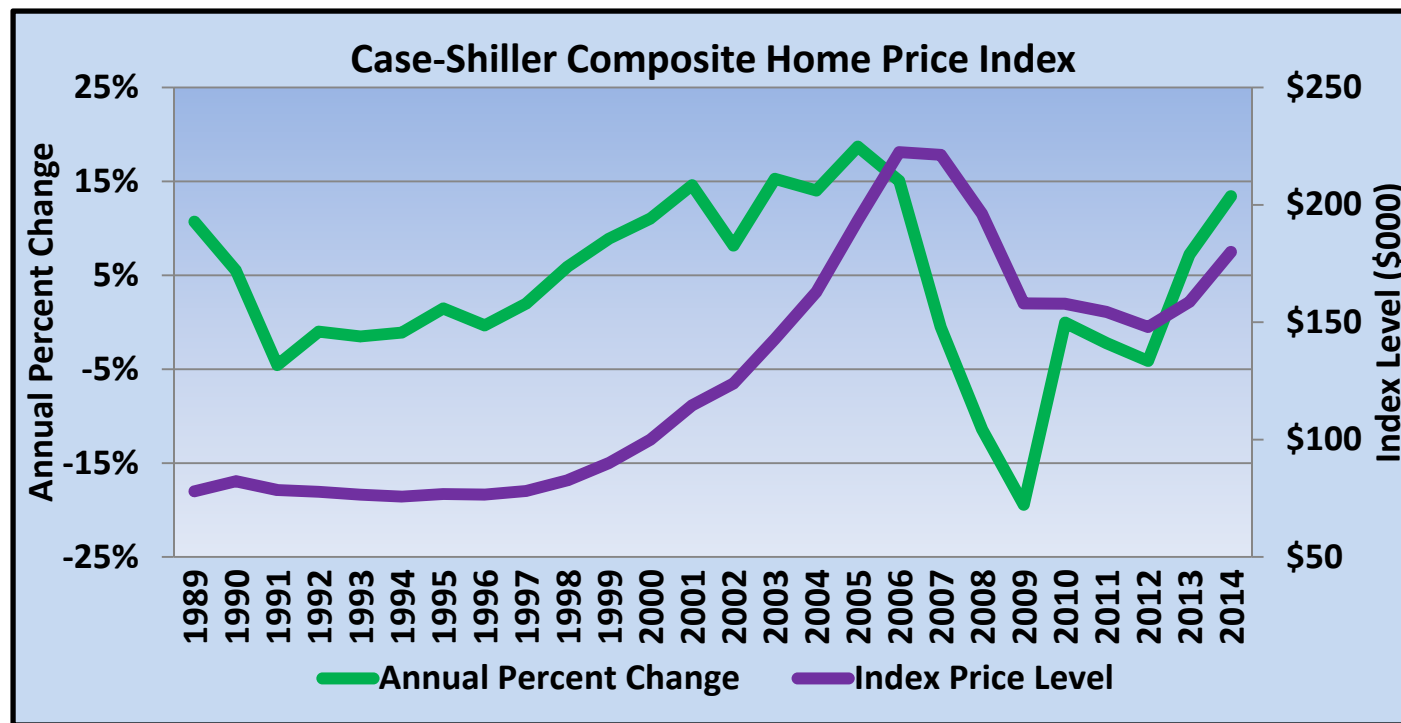
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HOUSING MARKET: PRICE RECOVERY

- Falling inventory and cheap money produce rising prices
 - But homes are still well below their pre-crash peak



Source: Standard & Poors / Case Shiller



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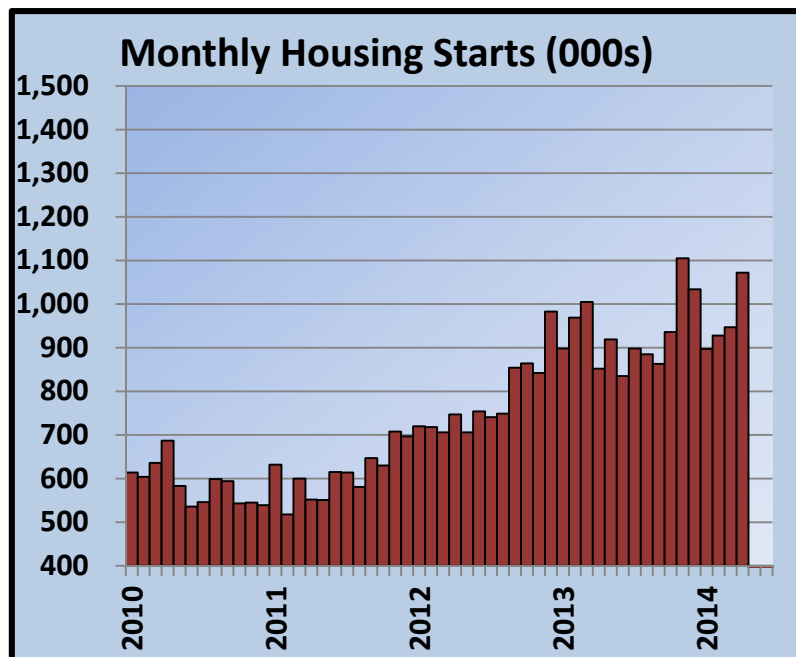
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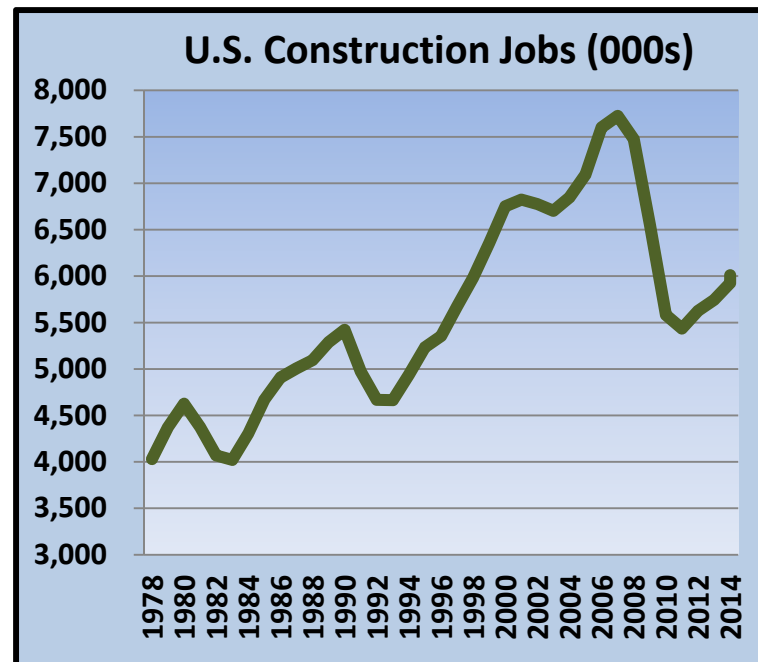
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HOUSING MARKET: A NEW CYCLE

- Current pace of construction is still too low to sustain economic growth; but jobs gains are still occurring



Source: U.S. Census Bureau



Source: Bureau of Labor Statistics



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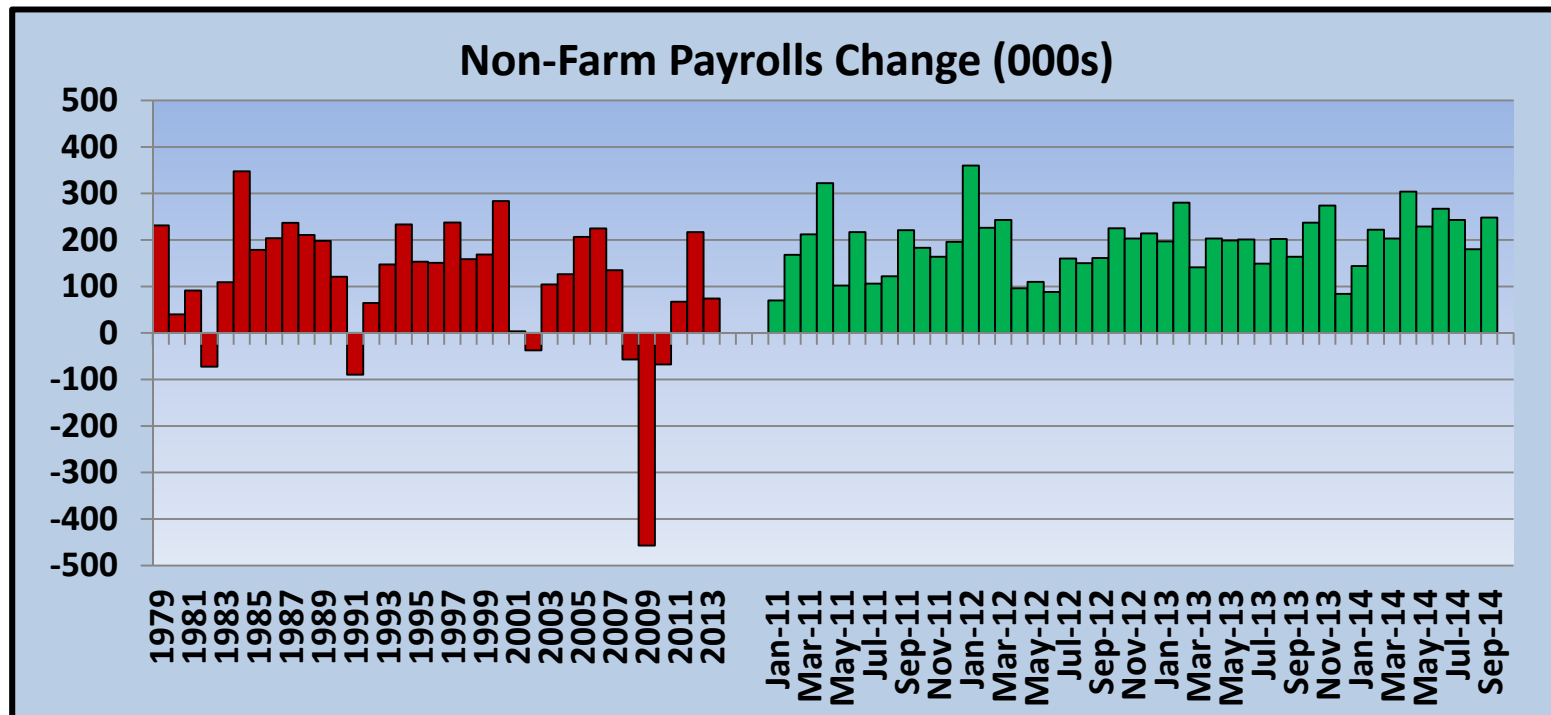
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JOBS: EMPLOYMENT TRENDS

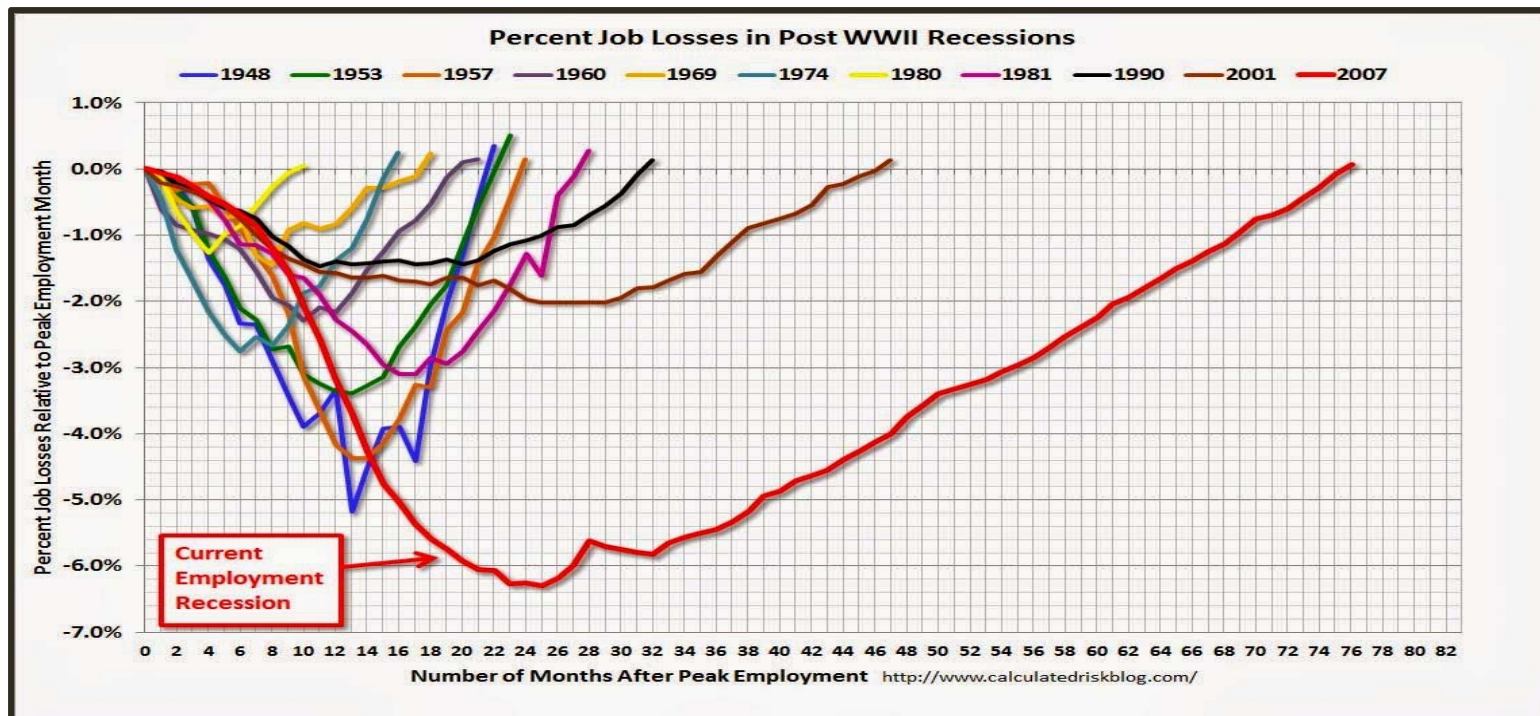
- Payrolls have been rising (too slowly) for three years



Source: Bureau of Labor Statistics

JOBS: A LONG, DEEP CYCLE

- This was the deepest and longest period of job losses since the Great Depression



Source: Calculated Risk Blog



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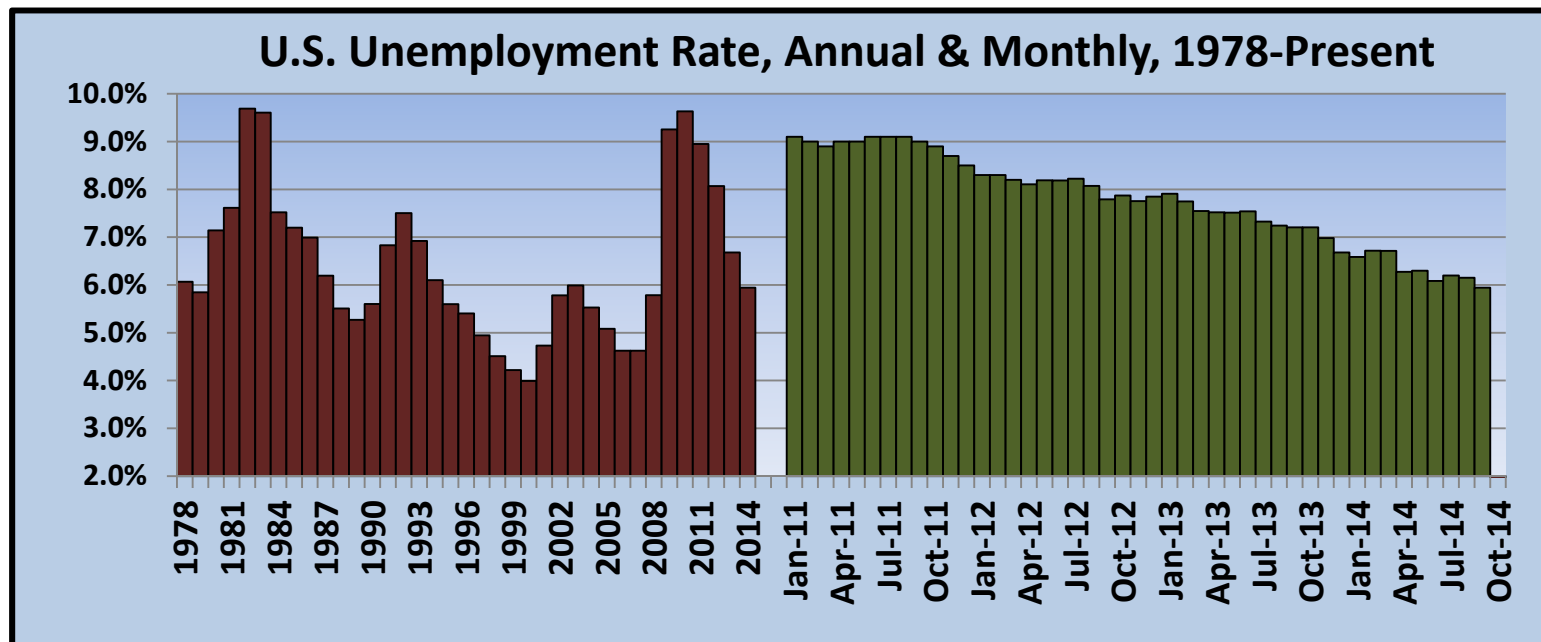
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JOBS: EMPLOYMENT TRENDS

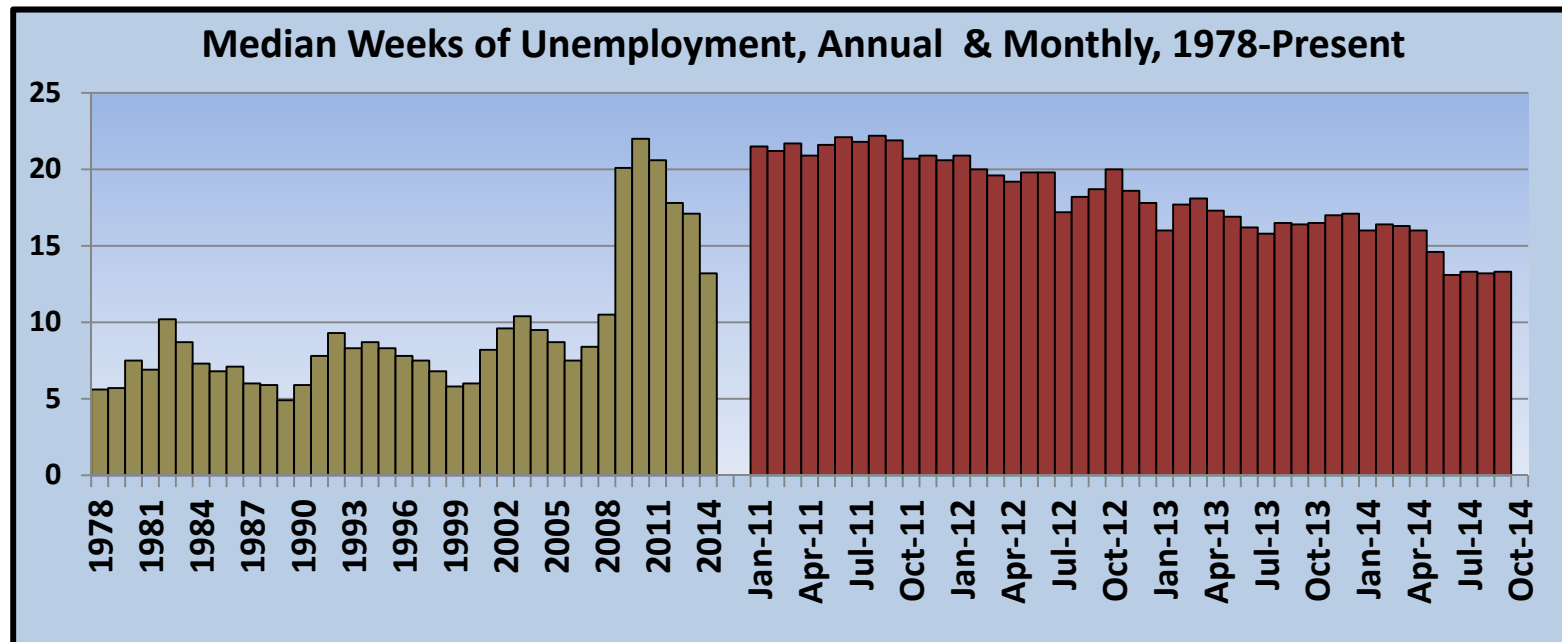
- Unemployment is consistently down since 2009
 - Absolute level remains far too high



Source: Bureau of Labor Statistics

JOBS: LONG-TERM UNEMPLOYMENT

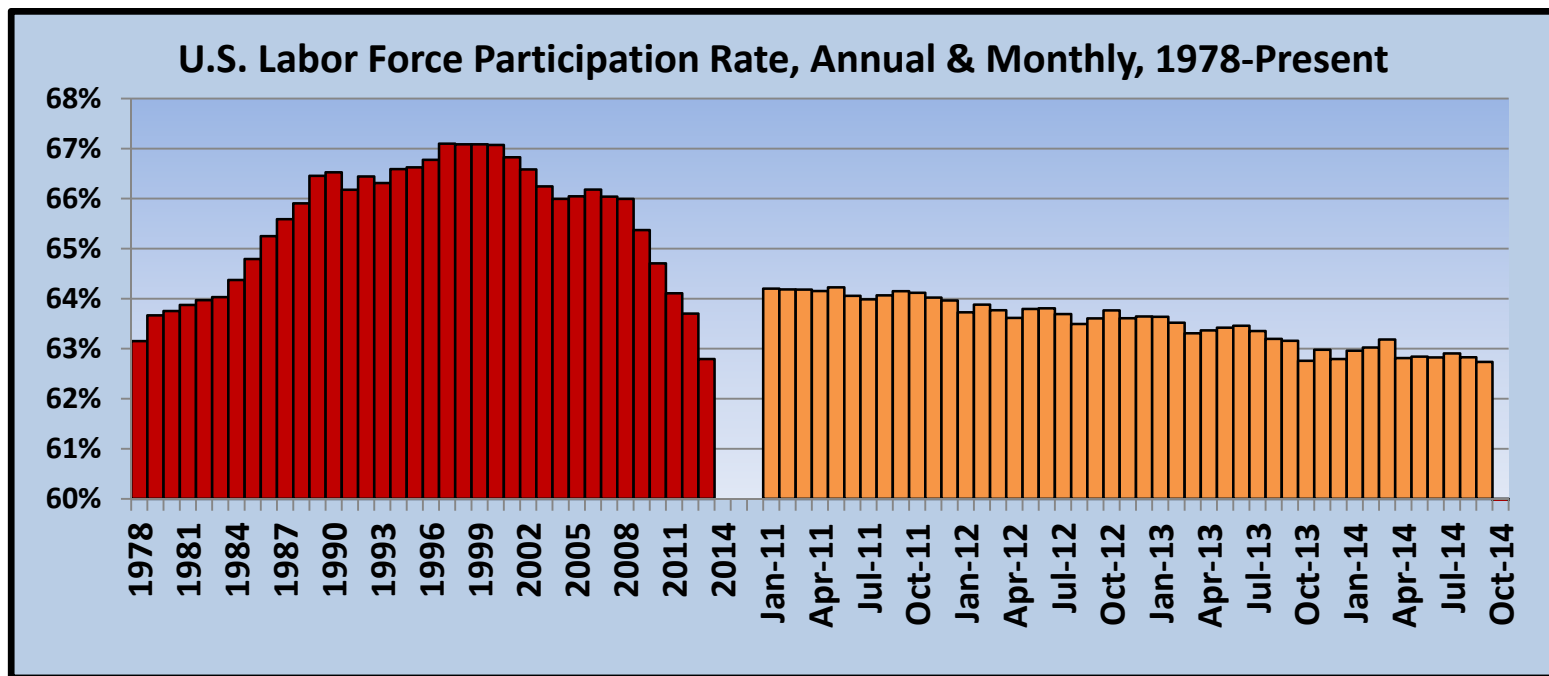
- Slow growth in jobs, combined with high unemployment, means people are taking much longer to find new jobs



Source: Bureau of Labor Statistics

JOBS: HIDDEN UNEMPLOYMENT

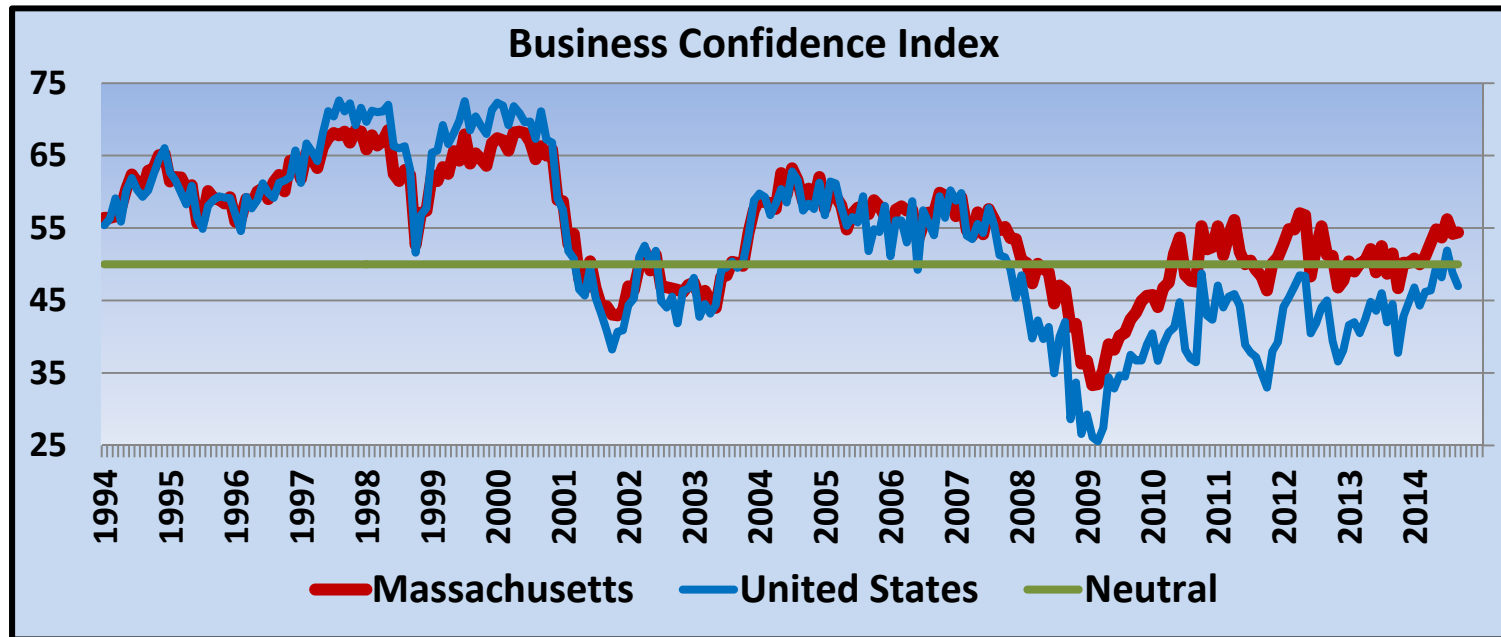
- Labor force participation rate has dropped sharply
 - Retiring baby boomers; frustrated job-seekers; slower in-migration



Source: Bureau of Labor Statistics

MASSACHUSETTS: BUSINESS OUTLOOK

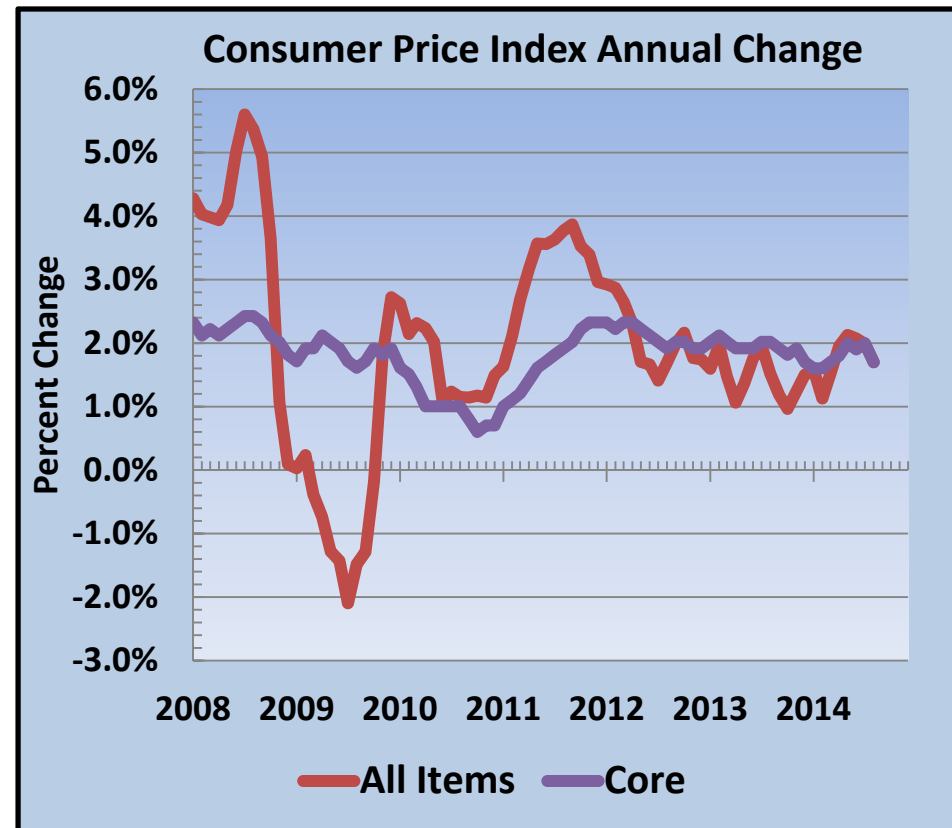
- Companies don't yet expect a strong economy
 - Without more confidence, they won't boost payrolls much
 - Bay State companies are more resilient than elsewhere in the U.S.



Source: Associated Industries of Massachusetts

INFLATION: NOT AN ISSUE ... YET

- Slack labor market and weak demand restrain CPI
- No pressure from commodities like energy or materials
- Rising money supply, housing prices, and stock prices are concerns



Source: Bureau of Labor Statistics

AGENDA

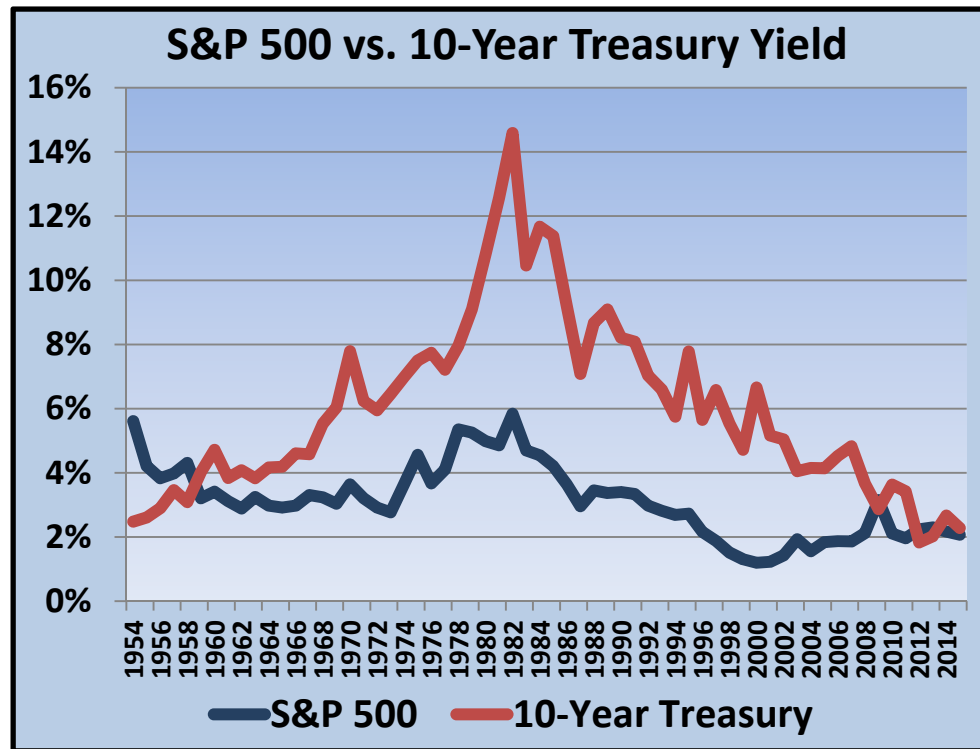
- A philosophy of investing
- Think global
- **Invest local**
 - Tactical asset allocation
 - Bonds
 - Stocks
- Q & A

U.S. MARKETS OVERVIEW

- U.S. equities have hit all-time highs
 - Trading is becoming more volatile – a sign of change coming?
 - Values are reasonable, despite higher prices
 - Quick dips in the past two years were minor, only ~5%
- Bond markets react to anticipated Fed actions
 - Long-term bonds were hurt badly last year by anticipated tapering
 - Bonds recovered in early 2014, as rates dropped again
- Hedge funds and alternative assets still lag
 - Hedging market risk detracts from performance when prices rise
 - Commodities & precious metals crushed by poor sentiment

ASSET ALLOCATION: STOCKS VS. BONDS

- Equities historically yield less than bonds



Source: FactSet

- Bonds have no upside beyond par value at maturity
- Equity prices grow with earnings and inflation, providing price gains in addition to yield
- Despite the bull market, at current interest rates and dividend yields, equities are *still* cheaper than bonds



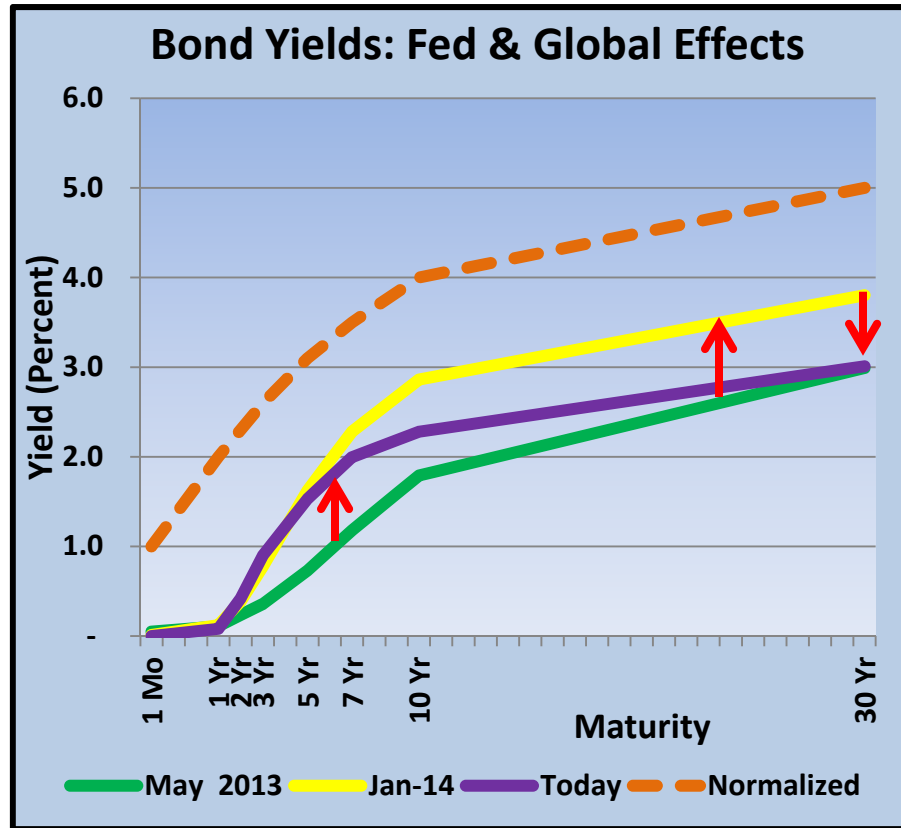
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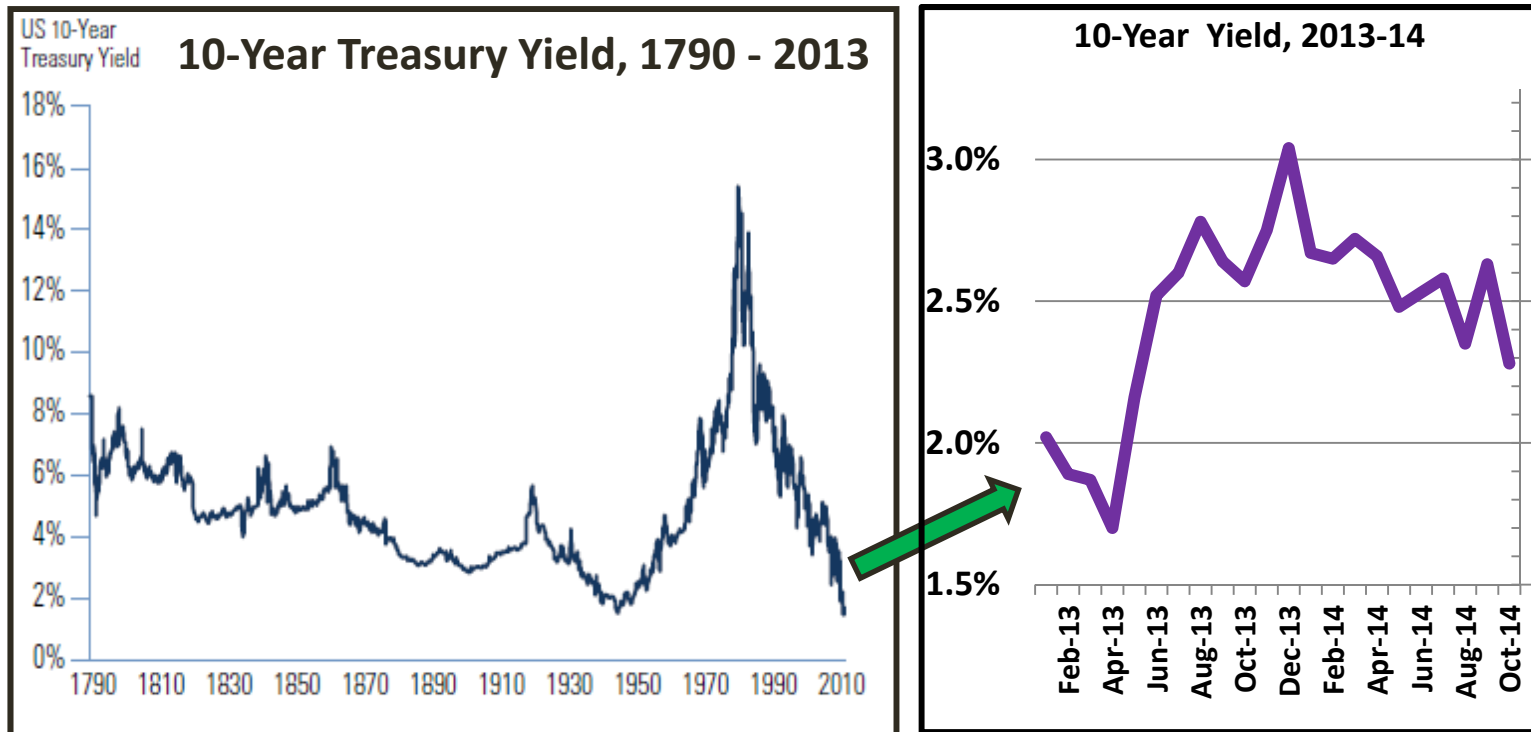
THE YIELD CURVE: TUG-OF-WAR



Source: FactSet

- Short-term interest rates: Money is free
 - Markets increasingly anticipate Fed action to raise rates
- Long-term rates jumped last year, then fell back
 - Spike up reflected anticipation of Fed's tapering program
 - Global rates pushing U.S. rates down today

SNAPSHOT: 10-YEAR TREASURY NOTE



Source: Goldman Sachs, FactSet



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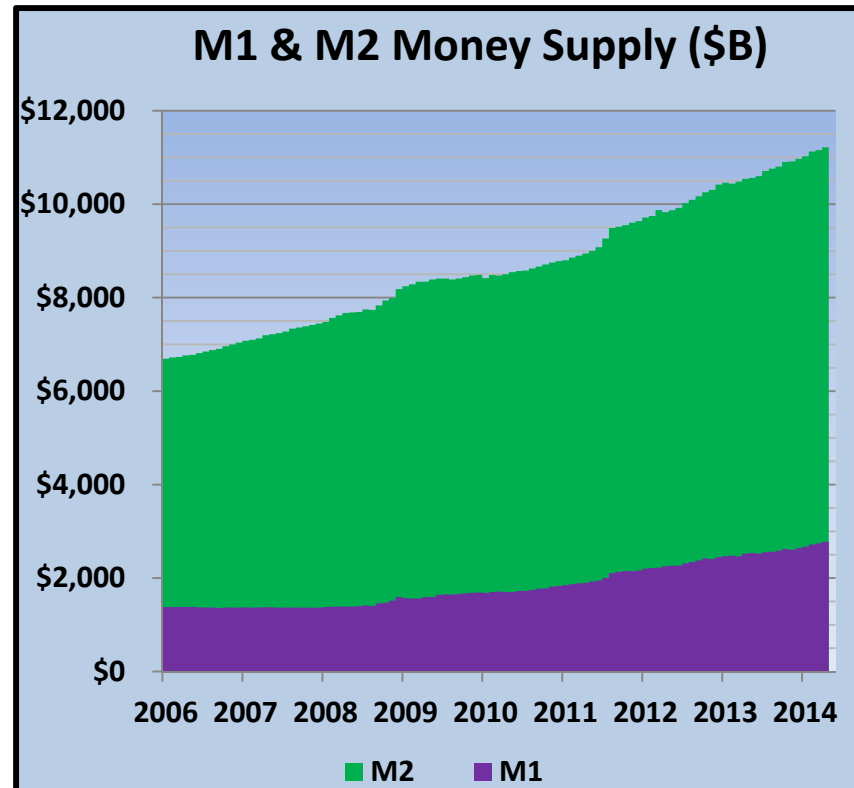
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FEDERAL RESERVE: CHANGING COURSE

- What did Quantitative Easing accomplish?
 - Fed's policy has suppressed long-term interest rates by 1%-2%
 - Program has “printed” a lot of money, but it's not in circulation
- The Fed is changing course
 - Tapering is essentially complete: QE is finished
 - Beginning to prepare for higher short-term interest rates
 - Considering “repos,” capital requirements, and other tools
- New objective: Rein in credit bubble before it happens

FEDERAL RESERVE: MONEY SUPPLY

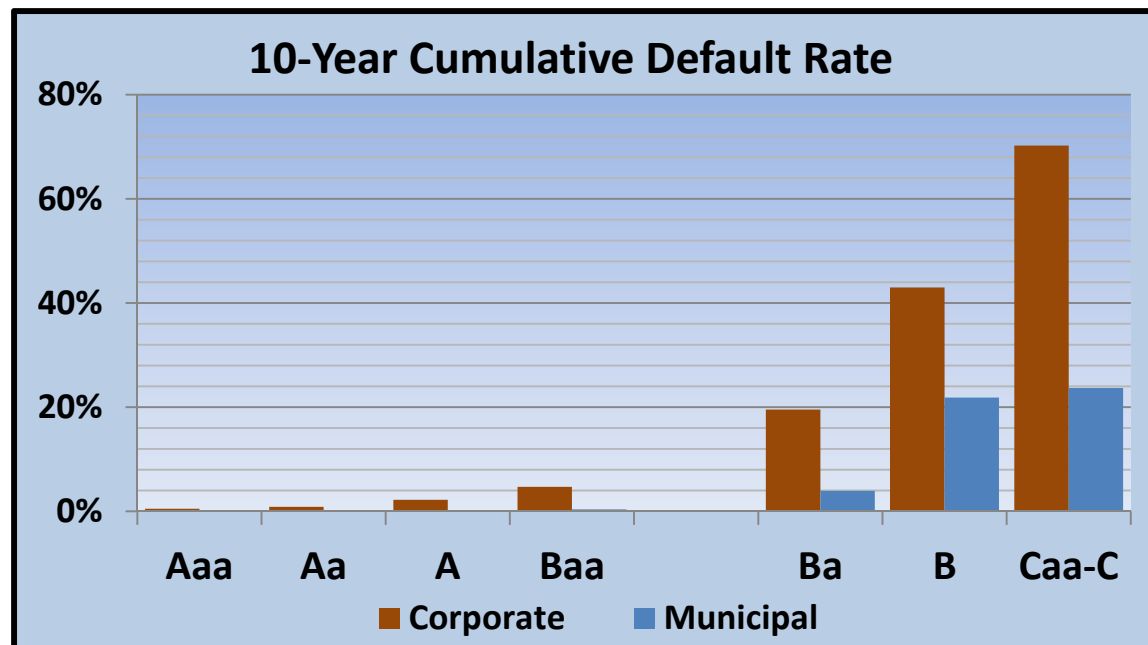
- Fed's bond purchases have had the effect of "printing money"
 - But this money is mostly sitting still at the Fed, as banks have not invested it to create loans
 - Money actually in circulation is up only 2%
 - When the "velocity" of money is so low, inflation is not a threat



Source: Federal Reserve

STUPID BOND TRICKS: CREDIT RISK

- Higher yield implies higher risk of default or downgrade
 - Within any bond category, it is not a linear relationship



Source: Moodys

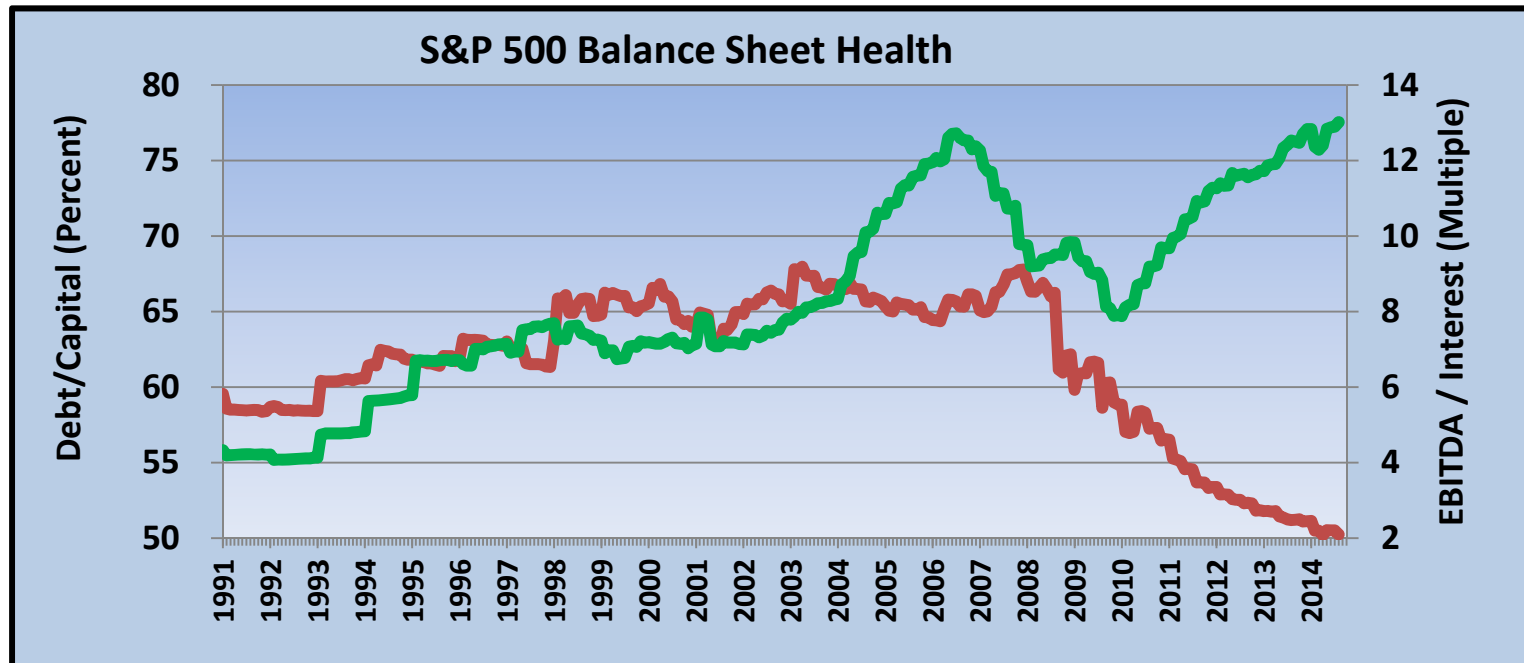
STUPID BOND TRICKS: DURATION RISK

- All bonds carry some interest-rate risk
 - Bonds with longer maturities and smaller coupons have much higher *duration* (interest-rate, or price) risk
 - Long-term bond fund investors suffered a rude shock last year

\$1,000 Par	Yield	Duration	Par	+1.0%	+2.0%	+3.0%
30-Year Bond	3.5%	18.5	\$1,000	\$840	\$710	\$610
10-Year Note	2.5%	8.8	\$1,000	\$920	\$840	\$770
2-Year Note	0.4%	2.0	\$1,000	\$980	\$960	\$940
Source: Bloomberg, Eastern Bank. Prices assume parallel shift at all maturities on yield curve						

EQUITIES: HEALTHY BALANCE SHEETS

- Profits have recovered, and interest coverage is superb



Source: FactSet

- So maybe companies will feel more confident hiring?



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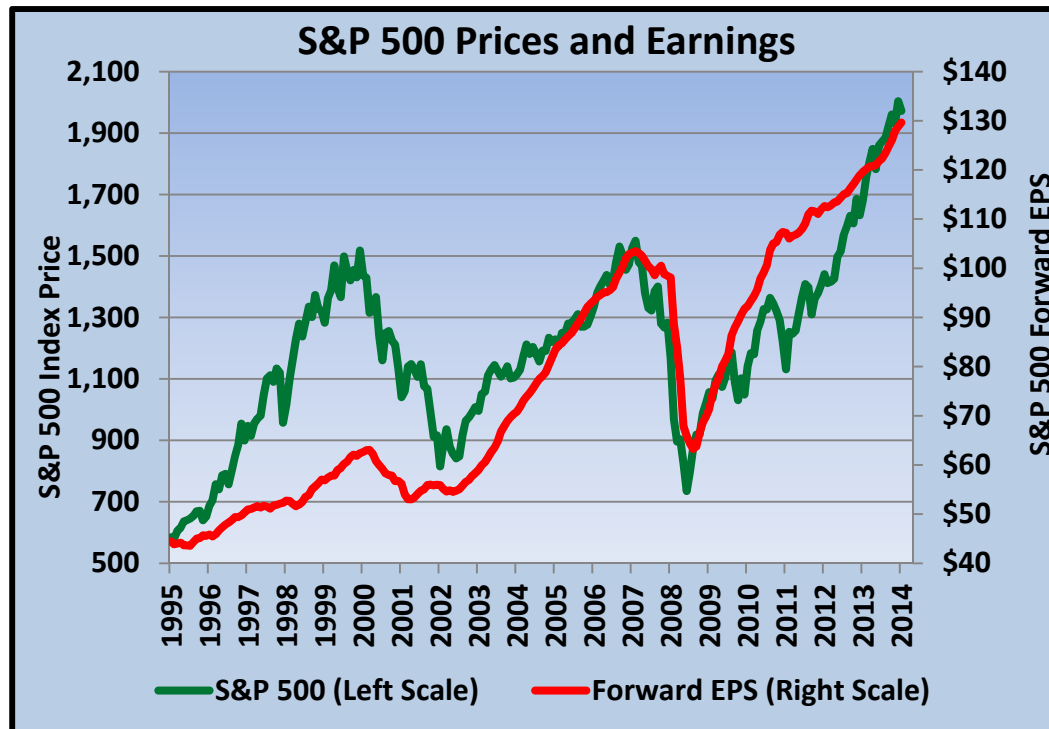
EQUITIES: PRICE VERSUS VALUE



- Is \$20,000 a good price for a car? It depends on the car
- How about \$2,000 for the S&P 500? It depends on earnings

EQUITY VALUATIONS

- P/E multiples are not high by historical norms



Source: FactSet

- P/Es can rise further as interest rates normalize
 - Equities do well as interest rates rise to normal levels

EQUITIES: SOME YELLOW FLAGS

- U.S. dollar is rising against most other currencies
 - Rising U.S. interest rates contrast with falling European rates
 - Stronger dollar is a headwind for U.S. exporters
- Weak demand in foreign markets could stifle U.S. earnings
- Profit margins are already close to peak levels
 - Shortage of skilled workers could create wage pressures
- Merger boom often signifies the end of a bull market
 - Weakness in small-cap stocks also could be worrisome

INVESTMENT RECOMMENDATIONS

- U.S. economic picture is positive but not without risk
- U.S. equities are attractively priced compared with bonds
 - But the rest of 2014 could be bumpy
- Debt is expensive but may not get cheap anytime soon
 - High-yield debt is more attractive than investment-grade
 - Laddered portfolios provide protection
- Stay away from hedge funds, private equity, venture capital

AGENDA

- A philosophy of investing
- Think global
- Invest local
- Q & A

QUESTIONS & ANSWERS

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