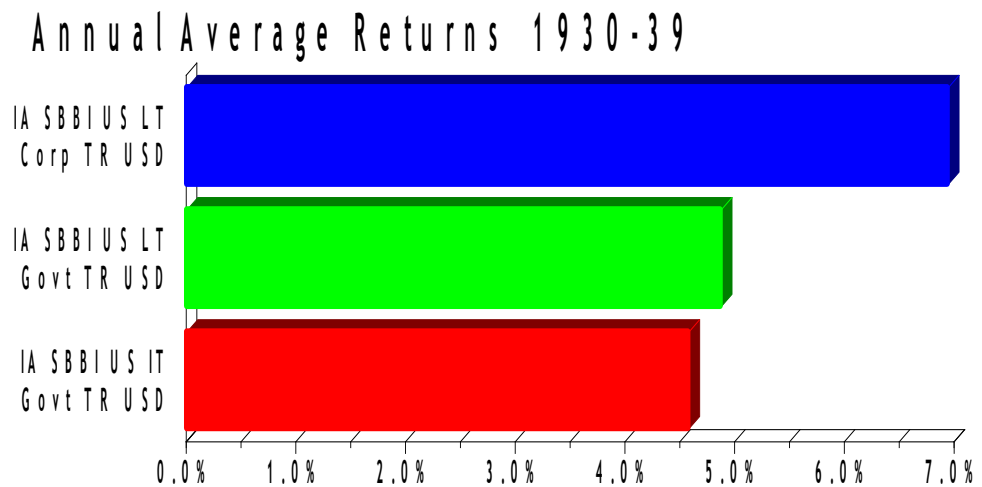




And the Winner Is...

As investors rush into U.S. Treasuries in response to a weakening economy that may portend the onset of deflation, this begs the question whether there is a superior deflationary hedge. History can be instructive in this regard. During the Great Depression of the 1930's, a decade where prices fell at an average annual rate of 2.1%, the winning investment was not Treasuries - it was high grade corporate bonds. As illustrated in the following chart, high grade corporate bonds (in blue) achieved an annual return of almost 7% while long-term and intermediate-term U.S. government bonds (in green and red) had annual returns of 4.9% and 4.6% respectively.

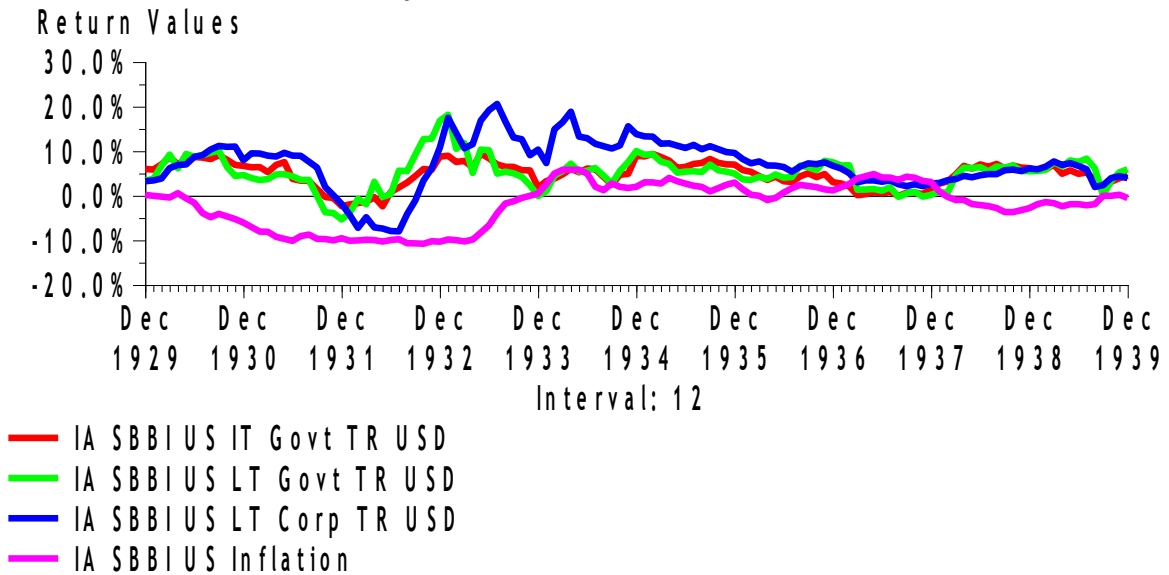


Source: Ibbotson Associates S&P. Corporate bond returns are computed from the Standard & Poor's High-Grade Corporate Composite.

High grade corporate bonds outperformed both intermediate and long-term government bonds in six of the ten years in the decade. As illustrated in the graph on the following page, which depicts 12-month rolling returns for all three bond types as well as the annual inflation rate (in pink), corporate bonds (in blue) really only underperformed materially during the heart of the contraction in 1931 and 1932. Even in the severe recession of 1937-38 that triggered a second deflationary cycle, corporate bond performance remained positive.

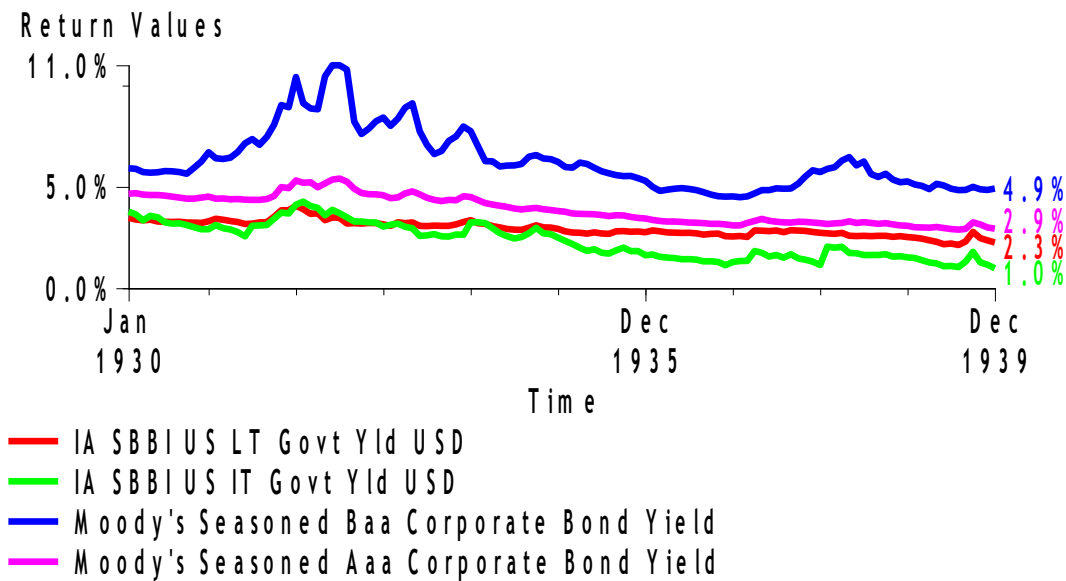


Rolling 12-Month Returns



The performance of high grade corporate bonds traces to two factors. First, as illustrated in the following chart, bond yields fell dramatically over the decade as deflation took hold. This drove up bond prices.

U.S. Bond Yields 1930-39





More importantly, although bond defaults by companies skyrocketed during the 1930's, the extraordinarily high default rates occurred in speculative bonds. For example, in 1933 speculative bonds suffered a 15.4% default rate. In comparison, investment grade bonds had a 0.8% default rate, well above normal but comparatively modest. Appendix I at the end of this Commentary sets out the percentage default rates by credit rating for each year during the 1930's.

In the most dismal economic decade of the century, defaults of high grade bonds, those rated Aaa and Aa, were negligible. Not one Aaa bond defaulted and Aa bonds had a 0.30% annual default rate. Even bonds at the lower end of the investment grade, rated A and Baa, averaged respective annual default rates of 0.59% and 1.13%. In retrospect, it appears that investors, seized by fear, overestimated the risk of default and those prepared to venture out of Treasuries were handsomely compensated.

So far, default rates for 2008 and 2009 suggest that the default experience for quality bonds, although elevated, will be much less severe than the 1930's (see Appendix II at the end of this Commentary). Even today's bears are not forecasting a second downturn as severe as the recession of 1938 when nominal GDP plummeted 6.3% from the prior year. In fact, a recent Standard & Poor's reportⁱ estimated the forward looking one year default rate for U.S. bonds at just 0.075%.

The Congressional Budget Office forecasts that the U.S. government will incur nearly 10 trillion dollars in additional deficits from 2011 to 2020. Annual budget deficits are not expected to fall below 4% of GDP and will be growing toward the end of the decade as ever-rising interest payments take their toll. In contrast, according to a recent Standard & Poor's reportⁱⁱ, cash and short-term investments for non-financial S&P 500 companies have grown over 40% over the past two years to nearly a trillion dollars, equivalent to 40.1% of corporate debt.

Investors looking for a deflationary hedge should not simply run to Treasuries. The winner in the 1930's was high grade bonds - they just might offer that same opportunity today.

June 30, 2010

www.tacitacapital.com



Appendix I

Annual Issuer-Weighted Corporate Default Rates by Credit Rating 1930-39

Year	Aaa	Aa	A	Baa	Investment Grade	Speculative Grade
1930	0.000	0.000	0.000	0.421	0.159	2.131
1931	0.000	0.000	0.281	1.039	0.490	7.845
1932	0.000	0.677	0.873	0.898	0.780	10.811
1933	0.000	0.000	0.266	1.808	0.806	15.391
1934	0.000	0.610	0.348	0.817	0.578	5.929
1935	0.000	0.000	1.345	1.899	1.253	6.09
1936	0.000	0.803	0.510	0.344	0.465	2.736
1937	0.000	0.000	0.545	1.101	0.661	2.595
1938	0.000	0.870	1.719	1.988	1.579	2.593
1939	0.000	0.000	0.000	0.950	0.402	1.751
Average	0.000	0.296	0.5887	1.127	0.717	5.787

Source: Moody's Investor Services, *Corporate Defaults and Recovery Rates, 1920-2009*

Appendix II

Annual Issuer-Weighted Corporate Default Rates by Credit Rating 2008-2009

Year	Aaa	Aa	A	Baa	Investment Grade	Speculative Grade
2008	0.000	0.557	0.370	0.474	0.430	4.371
2009	0.000	0.000	0.183	0.771	0.340	12.972

Source: Moody's Investor Services, *Corporate Defaults and Recovery Rates, 1920-2009*



Tacita Capital Inc. (“Tacita”) is a private, independent family office and investment counselling firm that specializes in providing integrated wealth advisory and portfolio management services to families of affluence. We understand the challenges of affluence and apply the leading research and best practices of top financial academics and industry practitioners in assisting our clients reach their goals.

Tacita research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it and is not intended to replace individually tailored investment advice. The asset classes/securities/instruments/strategies discussed may not be suitable for all investors and certain investors may not be eligible to purchase or participate in some or all of them. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Tacita recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor.

Tacita research is prepared for informational purposes. Neither the information nor any opinion expressed constitutes a solicitation by Tacita for the purchase or sale of any securities or financial products. This research is not intended to provide tax, legal, or accounting advice and readers are advised to seek out qualified professionals that provide advice on these issues for their individual circumstances.

Tacita research is based on public information. Tacita makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to inform any parties when opinions, estimates or information in Tacita research changes.

All investments involve risk including loss of principal. The value of and income from investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Management fees and expenses are associated with investing.

ⁱ Standard & Poor’s, *Market Intellect: Probability Of Default For S&P 500 Index Debt Plummets With Growing Corporate And Economic Stability*, <http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245212657884>

ⁱⁱ Standard & Poor’s, *Market Intellect: Could U.S. Corporate Cash And Debt Levels Foreshadow A European Shopping Spree?*, <http://www.standardandpoors.com/products-services/articles/en/us/?assetID=1245214635566>