TRUST

INVESTMENT PERSPECTIVES

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Just How Safe Are Bonds?

Ask most any investor if stocks or bonds are the safer asset class and the reply will come back almost automatically: "Bonds". Historically, that is correct. And over the last few decades, bond returns have not only been much smoother than equity returns, but have also outperformed equities for significant periods of time (for example, the entire 30 year period ending September 2011).

After such a long period where investors did not seem to be getting rewarded for taking on the extra risk of stocks, it's no surprise that retail investors were continuing to invest heavily in fixed income funds into 2013. This occured even as the stock market had more than doubled from its March 2009 lows.

However, the rapid rise in interest rates beginning in the spring and continuing into the summer has left returns on bonds negative for the year. The Barclay's U.S. Aggregate Government and Credit Index, a broad index of U.S. corporate and government bonds, was down 1.9 percent through September 30. Investors whose fixed income portfolios were concentrated in longer maturity bonds have lost 10 percent or more. The yield on the benchmark 10-year U.S. Treasury bond has increased more than one percentage point from its 2013 low of 1.6 percent in May to as high as 3.0 percent in early September. This is a modest move in nominal terms, but a very large move in percentage terms.

While not as severe as the stock market's decline in 2008, the decline in bonds came as a surprise to some investors accustomed to steady increases from that portion of their portfolio. With rates still low on a historical basis, the question on the minds of investors and financial market participants alike is: where do rates (and, by extension, fixed income returns) go from here?

Any discussion of interest rates must begin with an acknowledgement that actions of the Federal Reserve (Fed) have created a distorted interest rate market. In normal times, government bonds provide a "benchmark" interest rate, off of which other types of debt are priced. For example, a corporate borrower such as General Electric (GE) issues bonds at interest rates that reflect the rate of a risk-free U.S. Treasury plus a "spread" to reflect the default risk of the borrower. If the 10-year treasury is at 5 percent, GE's 10-year bonds might trade at 6 percent, with the extra one percent compensating investors for default risk. (While there are actually many other factors

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Zac Reynolds
Vice President

MARKET RECAP

Equity markets worldwide have been strong over the past year. The third quarter saw international stocks outpacing U.S. stocks.

	Third Quarter	YTD	Past 12 Months
Dow Jones	2.1%	17.6%	15.6%
S&P 500	5.2%	19.8%	19.3%
EAFE (Int'l)	11.6%	16.1%	23.8%

VIEWPOINT

A Message from the Desk of Tom Wilkins

Looking back over the past few months, I once again realize that some things in life move fast and other things move slow. Whatever the pace may be, living life with gratitude and moving forward is a must.

An important part of moving forward as a company is to employ the right people. Our goal has always been to select truly exceptional individuals who are committed to cultivating strong relationships and to managing our client's wealth for generations. At the end of the day, we insist that each employee be someone our clients would enjoy working with.

Moving at a faster pace this quarter, TCO has added some great new employees to our team. Coming in with a strong investment and insurance background, Michael Hopper joined our Compliance department in the Tulsa office. And our ever growing Oklahoma City office added Scott Cravens and Katherine Chandler to the Real Estate group. Scott and Katherine bring valuable experience in the management of commercial real estate.

Always moving forward, several of our employees have achieved new professional designations. Demonstrating expertise in the areas of trust and the wealth advisory profession, the Certified Trust and Investment Advisor (CTFA) designation was earned by Jennifer May, Shawn Crisp and Stacey Curtis. In addition, Shawn has earned the designation of Certified Financial Planner (CFP). Congratulations to all on a job well done!

To conclude and to continue with the moving theme, our growth in the Oklahoma City market has enabled us to relocate our office. We are still located in the same building in the Waterford, just moving downstairs to a larger suite #160. For those in the area, feel free to stop by for a cup of coffee and a tour.

Thomas W. Wilkins *Chairman, President & Chief Executive Officer*

that can affect interest rate spreads, default risk is one of the most important).

After the financial crisis that began in 2008, the Federal Reserve instituted a series of extraordinary measures to help prop up the economy. In addition to reducing the Fed Funds rate to near zero, the Fed also began buying tens of billions of dollars a month in treasury and government agency bonds. The intended effect of these "quantitative easing" (QE) programs was to lower the cost of borrowing for individuals and corporations by reducing benchmark rates.

At least with respect to interest rates, the Fed's plan seems to have worked. When QE1 began in November 2008, 10-year U.S. Treasury yields were over 4 percent. Just a couple of months before QE3 began in the fall of 2012, the same 10-year rate hit an all-time low of 1.43 percent. Because bond prices rise as interest rates fall, bond investors were rewarded with price increases on the market values of their bonds in addition to recieving coupon payments.

Think about the coupon return as a "cushion" against rising rates. As the chart on page 3 shows, in years like 1980 and 1981, coupon rates were high enough to offset the negative price return from rising rates. This left investors with a net positive return. With the exception of 1994, 1999, and this year, coupon returns have helped investors achieve positive overall returns, as shown on the chart.

As interest rates decline, investors have a much smaller cushion and must rely more on price return. As interest rates fell from 2009 to 2012, price return made up a significant percentage of the total positive return for fixed income. The problem becomes obvious when you look at the year-to-date return for 2013 – coupon rates are so low that it takes very little in the way of interest rate increases to send the overall fixed income return negative.

This leads us back to the question that matters most – what does this artificially low interest rate environment mean for bond returns going forward? And how can investors help protect themselves against rising rates?

One important protection investors can build into their portfolio is keeping duration lower when expecting a rising interest rate environment. Duration is a measure of sensitivity to interest rate changes. In general, the shorter the amount of time to maturity, the shorter the duration of a bond.

The reason shorter duration portfolios are more protected from an increase in interest rates is that less time has to pass before bonds mature and the proceeds are available to invest at new, higher interest rates. The tradeoff for the increased safety of lower duration is less income in the short term, as longer maturity bonds generally pay higher interest rates.

Over the past few months at Trust Company of Oklahoma, we have been proactively reducing duration to better position bond portfolios for what we believe will continue to be a rising rate environment over the next several years.

Another way investors can

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reduce sensitivity to rising interest rates is to invest in segments of the fixed income market that may benefit from factors other than coupon payments and decreases in interest rates.

For example, high yield bonds (also called "junk" bonds) are debt issued by companies rated below investment grade by Standard and Poors, Fitch, or Moody's. These companies pay higher interest rates because the market judges them to have higher default risk, and investors must be compensated for taking on that additional risk.

Companies that issue high yield bonds are generally quite sensitive to economic conditions. In a recession, default risk can increase significantly, resulting in negative returns. However, good economic conditions lowers default risk and can lead to high returns on high yield debt. Over the last five years, for example, high yield bonds have returned more than 11 percent per year as the economy recovered from the financial crisis.

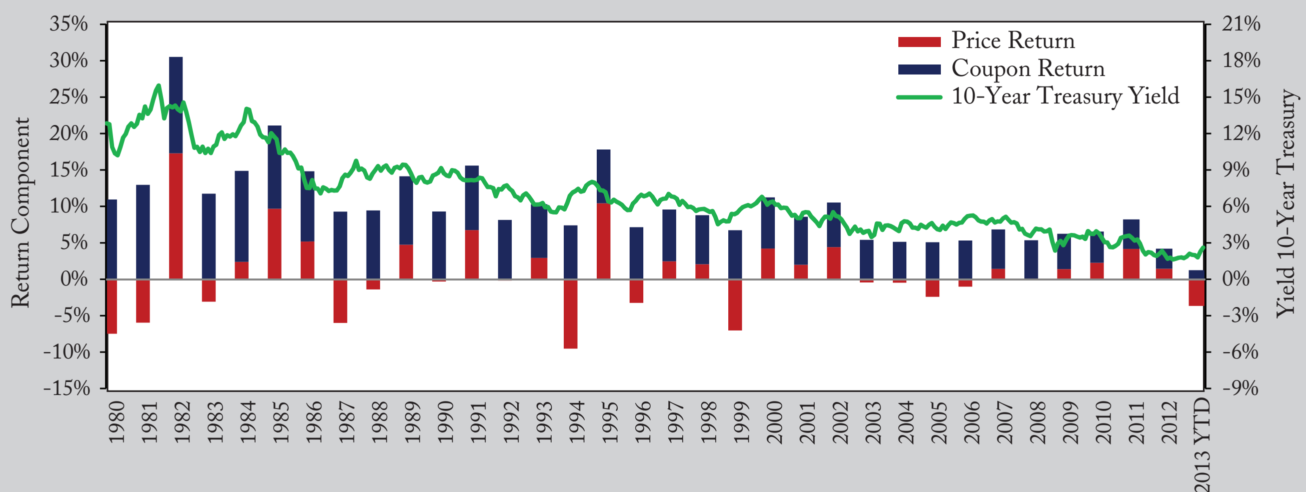
Because high yield bonds have sources of returns other than interest rates alone, they provide diversification benefits to a fixed income portfolio. The same is true of other fixed income asset classes such as international bonds, Treasury Inflation Protected Securities (TIPS), investment grade corporate bonds, and municipal bonds where appropriate for taxable investors. While changes in interest rates are still going to be the most important factor in fixed income returns, combining all of these asset classes in a portfolio provides multiple sources of return, which lowers risk and can enhance return.

But even with a well-diversified, lower duration portfolio, investors must be prepared for returns over the next 10 years that are lower than fixed income returns have been over the last 10 years. Given where yields are now and the fact that interest rates are unlikely to go below zero, it's almost mathematically impossible for bonds to repeat their better than 5 percent per year performance. Exactly what the returns will be is impossible to know with certainty. Pimco's Bill Gross, known as the "Bond King," and manager of the world's largest fixed income fund, is on record saying investors should expect annualized fixed income returns at best in the 3 to 4 percent range. Others have predicted even lower returns.

Here at Trust Company of Oklahoma, we agree that interest rates will rise over the next few years. However, there is some good news. First, while the rise in interest rates will hurt the market value of bonds, investors will begin seeing an increase in income from their portfolios. And given the rise in rates this year, some of the pain of declining bond prices has already been felt.

Secondly, the Federal Reserve has made it clear that they will continue to try to keep rates low for an extended period, reducing the probability of rates jumping sharply higher from here. In fact, the Fed surprised the market in September by announcing that they would continue buying bonds at a pace of $85 billion per month. The news that there would be no "tapering" of purchases sent interest rates lower and bond prices higher.

In conclusion, fixed income investors have enjoyed a nearly uninterrupted 30-year bull market as 10-year treasury rates declined from double digits in the early 1980s to less than 2 percent earlier this year. That performance is unlikely to be repeated in our lifetimes. However, we believe careful control over duration and diversified sources of returns within fixed income portfolios will serve clients well in the interest rate environment to come.



Don't Let Your Digital Assets Evaporate Into the Cloud

Stop for a minute and make a quick mental list of your assets. You probably immediately thought of some of the following: your home, heirlooms, automobiles, jewelry, bank accounts, stock accounts, and mineral interests. These are the types of assets that one normally considers when designing an estate plan (e.g., will, trust) in the event of death or in the event of incapacity (a durable power of attorney).

But have you considered estate or management planning for your digital assets? At first, you might think you have no need for digital asset planning, but consider the following:

- Do you receive financial statements, bills, or other information via email which your fiduciary (successor trustee, personal representative, guardian or attorney-in-fact) will need?

- Should your fiduciary close or maintain your social networking accounts such as LinkedIn, Twitter, Facebook?

- Do you have a website or blog from which you derive financial value? Should the site be maintained or can it be sold?

- Do you have photographs or other sentimentally valuable materials stored on cloud software or multimedia websites? Who can access them?

- Do you have downloaded books or music?

First, does your fiduciary have the necessary knowledge and authority to access your digital assets? Most digital assets require a username and password to access them. Consider keeping an updated list of usernames and corresponding passwords with your governing document (e.g., will, trust, or power of attorney) or explaining in your governing document where your fiduciary might find such information. Additionally, if your fiduciary is not technologically savvy, you may want to consider naming a separate or additional "Digital Asset Fiduciary." You might consider this in other circumstances as discussed below.

Your fiduciary will also need authority to access your digital assets. Oklahoma is a frontrunner in this area as one of only six states with a law that provides certain fiduciaries with the power to access and control certain digital asset accounts. However, Oklahoma's statutory authorization applies only to personal representatives, so other fiduciaries will need the governing document to provide explicit authorization. And if you want your Oklahoma personal representative to have more direction, you might provide more explanation in your will. For example, the governing document might use language adapted from Oklahoma's statute and/or the National Conference of Commissioners on Uniform State Laws' draft Fiduciary Access to Digital Assets Act to state:

It's 2013… Do you know where your family photo album is?

Fiduciary shall be authorized to take control of, conduct, continue, or terminate any accounts on any websites and any electronic devices, to the extent permitted under a terms-of-service agreement. Fiduciary shall be authorized and may maintain ongoing access to digital property, assets, and accounts. Digital property, assets, and accounts include but are not limited to information created, generated, sent, communicated, received, or stored by electronic means on a digital service or digital device.

But be careful! Generally, before creating a digital asset, you must agree to a terms-of-service agreement. If you're like most people, you don't read these agreements but just check the box stating something like "I agree to the terms of the terms-of-service agreement" so you can go ahead and get started. This agreement likely addresses whether someone else like your fiduciary can access and/or maintain the account. For example, pursuant to the applicable terms-of-service agreements, a fiduciary cannot access your Facebook or Apple (think iTunes) accounts. A fiduciary may seek written approval from the provider, but the provider is not required to deliver such approval, and a court generally cannot compel the provider to do so.

Thus, despite the authorization provided by statute or your governing document, a fiduciary who maintains or accesses a digital asset without the provider's written approval might be guilty of violating federal criminal law. This could carry a hefty financial penalty and/or imprisonment. While a surviving spouse or child might disregard such penalty as too remote, it is unlikely a corporate fiduciary will attempt such access without the provider's prior written approval. This might

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be another good reason to have a family member serve as a separate Digital Asset Fiduciary.

Further, certain digital assets like iTunes and Kindle downloads are licensed for use only by the person purchasing them. That person does not “own” those assets to sell, give, or pass down to others, but rather merely has a license that expires upon the purchaser’s death. Thus, unlike past generations who could pass down their library collections, whether or not valuable, future generations may lose out on being able to listen to a parent’s or grandparent’s favorite songs or read a favorite book, unless, of course, the future generation also purchases the electronic copy of the song or book title.

To avoid this result, some estate planners are implementing a “digital asset trust” or other entity which purchases and holds the licenses of the electronic downloads. Because an entity doesn’t die like a person, the license arguably continues in perpetuity, or at least several generations, and the entity’s beneficiaries or members can continue to enjoy these digital assets as long as they remain beneficiaries or members through the use of trust or corporate law.

Don’t be surprised if your governing document doesn’t currently address digital assets. As you can imagine, this is a pretty new concept and the law is just now taking steps to catch up. As mentioned before, Oklahoma is one of only six states to even begin addressing it statutorily.

That said, you may want to revisit your estate and management plans to include digital asset planning.

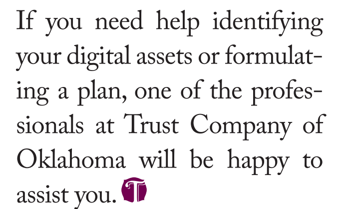
- Do you need to name a separate Digital Asset Fiduciary, and if so, who should it be?

- How will your fiduciary access your digital assets?

- Does your governing document provide your fiduciary with the power to access your digital assets?

- Are you and your fiduciary both comfortable with him/her accessing your digital assets?

- Do you need or want a digital asset trust?



If you need help identifying your digital assets or formulating a plan, one of the professionals at Trust Company of Oklahoma will be happy to assist you.

Melissa Taylor
Vice President

SPOTLIGHT

Easter Seals Oklahoma

More than 56 million Americans have a disability. This accounts for approximately 19 percent of the population. Easter Seals Oklahoma is the leading nonprofit provider of services for individuals with developmental disabilities and is committed to bridging the gap for the increasing number of Oklahomans in need of services.

For more than 88 years, Easter Seals Oklahoma has offered help and hope to children and adults with disabilities. Through therapy, training, education and support services, our organization creates life-changing solutions that enable people with disabilities to live, learn, work, and play alongside their family and friends.

For example, our adult day center provides special care for adults who are unable to care for themselves over extended periods of time. The center offers a protective group setting enabling participants to maintain or improve their ability to remain independent. The program provides various activities such as music therapy, arts and crafts and current event discussions to stimulate their minds, promote social interaction and support high levels of function.

Easter Seals Oklahoma also has an onsite Child Development Center which offers early intervention and childhood learning programs. A new peer integration program has been developed to increase early intervention. In addition, consultation services are available for parents and teachers who need additional support and training regarding developmental disabilities.

Our organization provides direct financial assistance for children needing therapy, as well as a variety of rehabilitative equipment which is necessary for a child’s development. We also offer onsite medical rehabilitation for behavioral, occupational and speech therapies.

It is our mission at Easter Seals Oklahoma to enhance the quality of life for children and adults with developmental disabilities so they may live with equality, dignity and independence. Thanks to the support of our communities, we are able to fulfill our mission.

For more information on our Easter Seals Oklahoma’s programs and services or to find out how you can help, please visit ***eastersealsok.org*** *or call* ***405-239-2525.***

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