Fixed Income Investment Strategy for 2010
Finding Value in a Low Rate Environment

ECONOMIC/RATE PROJECTIONS

- Recent economic data suggests a **bottom has been reached in the business cycle** and the US economy is now entering the recovery phase.

- Job creation will be far below historical trends during this recovery and the US labor markets will remain depressed. Although it will hit a peak sometime in early 2010, the **unemployment rate will stay high** over the next 18 months; well outside the comfort range of the Fed, thereby limiting the Fed's ability to raise rates.

- It appears most banks have successfully weathered the worst of the financial crisis, but the future is not without pitfalls. **Commercial real estate values will *not* fully recover for several years**. The resulting chronic commercial mortgage loan problems for many banks will force additional writedowns, strain earnings, limit capital accumulation, and crimp economic growth.

- There is a tremendous amount of **slack in the economy** and the gap between actual and potential GDP keeps expanding. (The Congressional Budget Office estimates today's output gap is slightly under $1 trillion.) As long as this *output gap* continues to be relatively large, inflationary pressures will remain quiescent and rates will stay low.

- At least for the foreseeable future, the **Fed does not have to worry about inflation**. Virtually every recent measure of inflation, CPI, PCE, PPI, etc. shows little in the way of nascent price pressure.

- The **weak economy will force the Fed to keep rates low** and nonexistent inflation will make these relatively low investment yields palatable to the market.

- In this low rate environment we expect the **yield curve to remain steeply sloped**. Regardless of what happens in the intermediate to long end of the curve a low fed funds rate will anchor the short end, keeping the slope positive.

GENERAL STRATEGY RECOMMENDATIONS

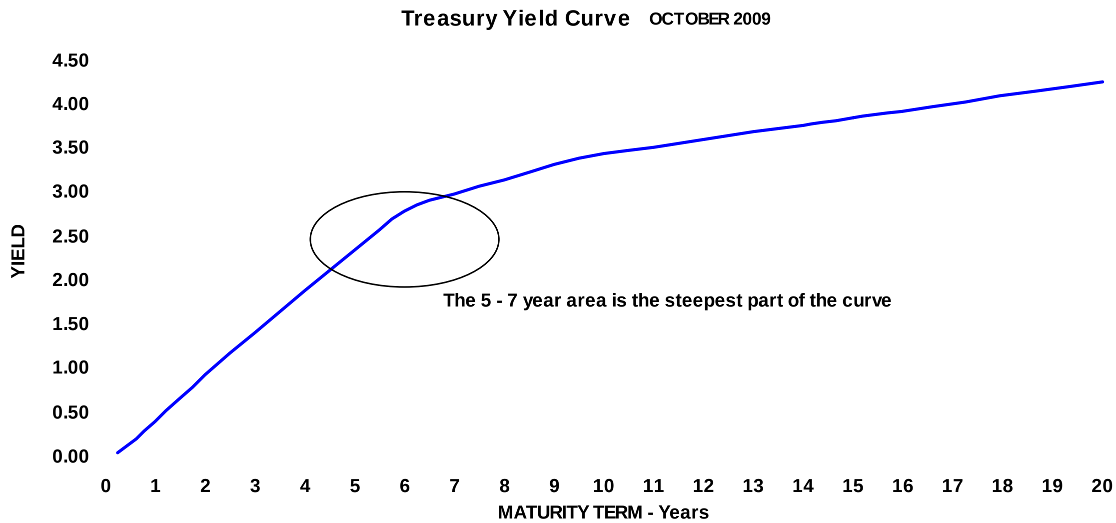
- Low rates and a positive slope to the yield curve, suggest an <u>appropriate risk/reward tradeoff</u> for investors as they extend duration and move out the curve.

- Over the past several months spreads in most sectors have tightened considerably. Nonetheless, we believe there are still <u>attractive opportunities,</u> especially when considered against the backdrop of a low interest rate, low growth scenario. Conversely, a strategy of staying short and adopting a <u>wait and see attitude entails a tremendous opportunity cost.</u>

- At some point in the future we will see economic growth return as the business cycle reasserts itself during the recovery phase – this is inevitable. As this recovery occurs, inflation will undoubtedly become more of a risk to fixed income investors. However, without a robust recovery, <u>inflation will remain relatively benign</u> even in the long run

- Our investment <u>focus is on securities the 5 – 7 year range</u>. This takes advantage of the extremely steep slope in the intermediate part of the curve, providing relatively higher yielding securities, especially compared to the short end. Beyond 7 years, the curve does remain positively sloped, but the degree of steepness begins to decline.

- The steep slope will also provide a <u>better appreciation/return</u> as investments age and roll down the curve.



OPPORTUNITY COSTS

Very often portfolio managers adopt what can charitably be described as a “wait and see” approach to investing. Often the “waiting” part of this equation consists of leaving funds sit idle in low yielding, short term accounts with the intention of investing when rates mover higher. But we view this approach as entailing a great deal of interest rate risk with significant opportunity costs. Investment decision making often comes down to a choice among various alternatives. Evaluating these choices means it is essential to analyze opportunity costs.

The following example illustrates our point. The chart below shows the average yield over a five year time horizon essentially given two choices; invest at the fed funds rate of 0.25% or purchase a 5 year corporate security (maturity = Nov. 2014). In this case a Bank of America (BAC) “A” rated bullet security with a coupon of 5.125% and a yield of 4.50%; the spread is roughly +120 basis points to the 5 year Treasury.

Investment Strategy over a 5 Year horizon (to October 2014) under various rate scenarios

Scenarios:

1. Fed funds rate does not change
2. FF rate increases +0.25% each quarter starting March 2010
3. FF rate increases +0.50% each quarter starting June 2010
4. FF rate increases +1.00% in the next 12 months & then invest in BAC, one year from now at a yield of 5.50%.

	Initial Yield	Ending Yield	Average Yield
BAC Corporate	**4.50%**	**4.50%**	**4.50%**
FF No Chg	0.25%	0.25%	0.25%
FF Rise + 0.25% each quarter starting in March 2010	0.25%	5.00%	2.51%
FF rise +0.50% each quarter starting in June 2010	0.25%	9.25%	4.32%
Invest in BAC @ 5.50% 1 Yr from now. FF up 100 bps next 4 qtrs	0.25%	5.50%	4.37%

- Even if the Fed begins to raise rates in the first quarter of 2010 (which we think is unlikely) and continues to notch up the fed funds rate by +0.25% every quarter, the resulting average yield of the fed funds investment over 5 years is only, 2.50% which is -200 basis points less than the 4.50% yield with the BAC corporate issue.

- We further exaggerated the Fed's actions with a very aggressive and unprecedented tightening. *If* the Fed started to increase rates by *+0.50%* each quarter starting in June 2010, the average yield on fed funds over the next 5 years would still be below that of the BAC, 4.32% versus 4.50%.

- Certainly, the portfolio manager can opt to wait until late 2010 before investing, but even in this situation, putting money to work now provides the best yield. If fed funds rate increases to 1.25% over the next year and in the 4th quarter of 2010, an investment is made at a yield of 5.50% (+100 basis points over today's yield) the average yield (over 5years) under this scenario would only be 4.37%. Even under a rising rate scenario in which rates rise +1.00% and the purchase yield is a full 1.00% higher next year, delaying the purchase does not improve overall return.

TOTAL RATE OF RETURN

The BAC total rates of return are also compelling. Even if rates increase, the total rate of return is still relatively high because of the roll down the curve. The chart below shows the annual total rate of return for rates unchanged and rates up 100 bps for both the BAC and fed funds investment over the next 2 years (through Oct. 2011), and over the next 3 years (through Oct. 2012).

TOTAL RATE OF RETURN (annual)
[Fed funds trade at par, so the total rate of return is simply the coupon/yield.]

	Rates Flat		Rates +100 bps	
	Through Oct 2011	Through Oct 2012	Through Oct 2011	Through Oct 2012
BAC Corporate	5.75%	5.56%	4.40%	5.00%
Fed funds	0.25%	0.25%	1.25%	1.25%

NEXT STAGE IN THE BUSINESS CYCLE

A necessary condition for a return to sustained economic growth is a healthy, well capitalized commercial banking sector. More lending to businesses and consumers is absolutely essential if the US economy is to embark on a sustained, positive growth path. Given the magnitude of the current problems in the banking industry and the acute need to recapitalize (deleverage) we believe it will be some time before banks begin to return to pre-crisis rates of loan growth.

Inevitably, as the business cycle begins its long awaited upswing at some point in the future, the Fed will shift monetary policy and raise the fed funds rate. Presumably, well before the Fed's decision, rates in the longer end of the curve will have moved higher in anticipation of the Fed's decision. Even while this is happening we would expect the curve to remain steeply sloped anchored in the short end by a still-low fed funds rate.

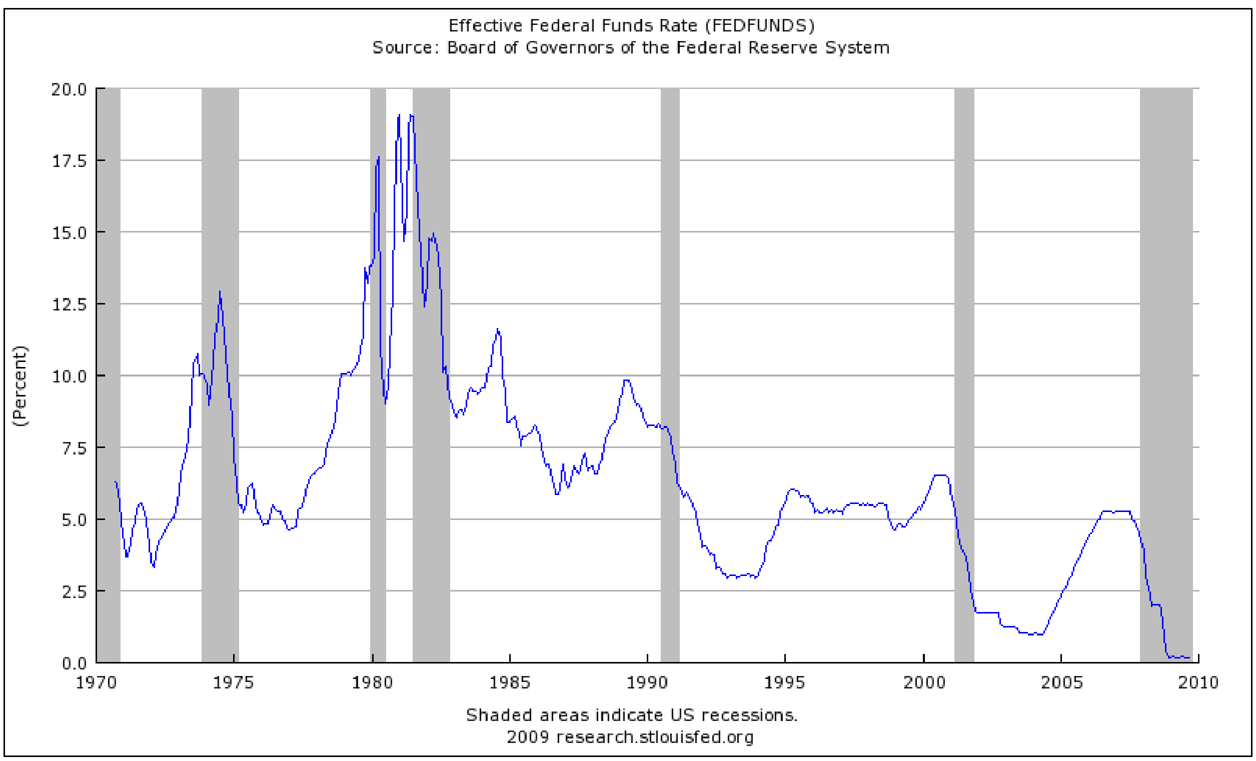
The timing on a Fed move is probably later rather than sooner. We do not expect the Fed to make any changes for at least the next 12 months. (One minor caveat to this is that the Fed *may* opt to increase the fed funds rate to 0.50% for technical reasons, i.e. a slightly greater degree of flexibility in managing the effective fed funds rate; e.g. between 0.25% and 0.50%. However, such a *technical* move would be well publicized and will not be considered a prelude to a major change in policy.) Given the depth of the financial crisis and the need for banks and other financial institutions to rebuild their balance sheets, along with the absence of inflation, we believe it will be some time before the Fed decides to raise rates.

When Monetary Policy Shifts and the Fed Decides to Raise Rates

Whenever the economy has recovered sufficiently that the Fed deems it advisable to shift monetary policy and adopt a tightening stance, any rate increase(s) will be especially measured. Given the depth and breadth of the financial crisis the Fed is extremely concerned about the fragility of today's economy. Consequently, being premature with a rate hike(s) and inadvertently choking off an economic recovery is something the Fed will studiously avoid. In addition, given Bernanke's penchant for transparency, we also think that any change in monetary policy will be communicated well before the Fed acts.

We believe that when the time comes, the Fed will very slowly notch up rates by +0.25% increments and subsequently give themselves a period of time to gauge market/macroeconomic reaction before contemplating the "next" rate hike. This will produce a slow, drawn out series of rate hikes. In addition, the Fed is still fearful of deflation and would be willing to tolerate some degree of inflation, which is viewed as necessary for asset values to improve. Finally the Fed will be concerned about "unwinding" their $2 trillion balance sheet which will also take time.

The chart below shows the historical trends in the fed funds rate over the last 40 years. It should be noted that after each of the last 3 recessions, the fed funds target rate has declined for several years after the end of the recession. Although present circumstances make a decline from here virtually impossible (at 0.25%, the fed funds rate can not decline further) we believe the Fed will nonetheless keep rates very low.



RECOMMENDATIONS

- In this report we used a BAC 5 year corporate note to illustrate our point. However, our general recommendation would include securities with 5 to 7 year maturities and 4 to 6 durations.

- In the corporate sector we especially favor financials, which still provide reasonably wide spreads with good returns despite the fact that there has already been a good deal of tightening recently. Among the specific names we prefer are some of the larger, better credit, generally more liquid names such as JP Morgan, Bank of America, Wells Fargo, Goldman Sachs, Morgan Stanley and PNC. (As the economy recovers and bank balance sheets start to improve, we would expect these names to continue to tighten, providing additional return.)

- In the mortgage/CMO area we believe well structured PACs with a 5 year average life provide the best value. These CMOs are an attractive way to take advantage of roll-down in the intermediate part of the yield curve, typically producing roll-down gains that are superior to 15 and 30 year collateral. For investors concerned with the prospect of slower mortgage prepayments, and resulting risk of average life extension, these CMOs can also to limit extension risk.

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