

June 2011

Fixed Income: An All-Season Allocation

Markets seemingly can – and do – ignore rational thoughts for relatively short periods as investors move in droves into and out of certain asset classes. And maybe it is expected that people come to dislike in equal measure those things they favored so much before things turned sour.

Nevertheless, those cyclical moves do nothing to change what are now time-proven truths about asset allocation. It is our job as investment professionals to remind those who rely on us to help them meet their long-term financial goals of those facts. Those who have been in the investment industry for some time recognize that we have seen some unusual moves in the last decade or so.

In fact, it is those cyclical moves that make it all the more important to discuss all the components of asset-allocation strategies. Bonds clearly are out of favor; however, talking about what remains a cornerstone of a well-diversified portfolio is a good idea.

Currently not popular

There clearly are many reasons why investors and advisors may shy away from the topic. First, there is the very real notion that investors – many of whom flooded into the “safe” waters of fixed-income investing in 2009 – saw stocks soar in 2010. Many who had purchased high-yield bonds precisely because of their high interest rates have seen those yields retreat.

Further, there are the headlines. Financial analyst Meredith Whitney, who correctly said in 2007 that major financial institutions would collapse, crushed the municipal-bond market last year when she intimated government bodies across the nation would default on their bonds. The New York Times followed up earlier this year with an article

suggesting politicians were contemplating ways to allow state and local governments to bail out of their debt responsibilities: an idea dismissed by state and local leaders as posturing by national politicians ahead of 2012 elections.

The Federal Reserve is beginning to systematically withdraw the market supports it has provided the domestic economy by way of a second round of quantitative easing (QE2). A chorus of observers has sung loudly the idea that there is no free lunch and the Fed’s actions must necessarily result in hyperinflation and sky-high interest rates that will crush bond investors.

There is also the notion that there may be fixed-income classes with negative returns: something that may appear to be antithetical to investors groomed on the idea – the wrong idea – that bonds are a homogenous, risk-free asset class. Fixed-income investing is now as diverse as equities investing and bonds’ various asset classes have similar year-to-year ups and downs as their stock cousins. (See the annual performance chart – one perhaps more familiar for stocks – on page 7 for a clear look at that phenomenon.)

So, perhaps, it does make sense if some investors ask if investment-grade fixed-income assets still make sense. What doesn’t make sense is not talking about bonds. There are, of course, many reasons to invest in fixed income and we believe those reasons are every bit as valid today as they were two years ago or 10 years or 20 years ago.

We would suggest that now is a critical time to focus on bonds. First, many of the concerns (primarily the “threat” of inflation) currently given for not investing in bonds are, in our view, wrong or are misplaced. Second, we believe there are many good reasons – many of which have to do with the bad

news we read and see on a near-daily basis – to invest in bonds. Third, fixed income remains a critically important keystone of a well-diversified portfolio.

“But what about ...?”

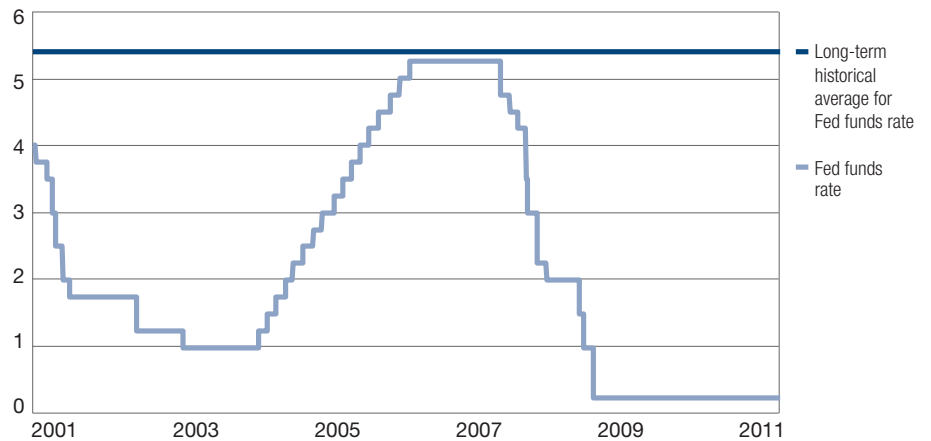
Many investors have a clear recollection of the high double-digit interest rates and inflation of the late 1970s and early 1980s. And it has become apparent in our conversations with financial advisors and their clients that there is a “consensus” view that the U.S. economy faces near-term higher inflation and interest rates. We remind ourselves how often that what everyone “knows to be certain” has turned out to be wrong or, more frequently, the market already has priced itself for that outlook.

The many economic-stimulus efforts (in addition to funding two war efforts and a new federal healthcare system) must be paid for sometime; however, the real question is, When? Increasingly, it doesn't appear to be now.

We have said for more than a year – and we continue to believe – that it's not likely the Federal Reserve will raise interest rates soon. Federal Reserve Chairman Ben Bernanke was a student of the Great Depression. He wants to see the economy grow, of course, but Bernanke and his advisors clearly have a firm grasp on the frailty of the U.S. economic recovery. We believe Fed officials will keep accommodative policies in place as long as they believe they need to until it appears the economy is firmly back on its feet. We will discuss the macroeconomic situation more in the next section.

Nevertheless, it's important to have some perspective on what prospective rate increases may mean. The

Interest-rate moves since 2001



Source: Bloomberg (as of June 15, 2011)

Wall Street economists since 2002 have forecasted higher rates an overwhelming 78 percent of the time (and they were correct about half the time: in 48 of 88 forecasts, or about 55 percent), according to Bloomberg's Monthly Economist Survey for the yield on the 10-year Treasury. Interest rates have trended lower for nearly 30 years, making an increase a popular pick perennially.

long-term average for the Fed funds rate, which was instituted in 1954, is 5.4 percent, according to data from the Federal Reserve Bank of St. Louis. (See the chart above.) A 200 basis-point increase in the overnight rate would still be less than half the historical average. There's no guarantee the Federal Reserve wouldn't increase rates more dramatically but our belief remains that Bernanke and others are more concerned about ensuring the economic recovery is moving along at a solid pace than the (perhaps very) distant rattling of hyperinflation.

Some equity classes have had years in which returns were dozens of percentage points in the red; yet, investors continue to invest in them. There never has been a guarantee that ALL bond asset classes would have positive returns every single year. Certainly, investors are not accustomed to the idea their “safe” investment would lose money but we

would point out that is more of a psychological notion than a financial certainty.

Consider 2009: The Barclays Capital Intermediate Government Index lost money – 0.33 percent – for the year. The S&P 500 Index was up nearly 26.5 percent that year. The Russell 2000 Index was up more than 27 percent. No one likes to lose any money, of course, but a 33 basis-point dip in the fixed-income portion of a portfolio allocated even as simply as among only bonds, large-cap stocks and small-cap stocks is a non-event in the long-term accumulation of wealth. Diversification – some asset classes outperformed while those that weren't correlated underperformed – did exactly what it was designed to do.

Headlines that may favor fixed income

Fixed-income investors may have a right to become concerned when all the news they hear is good news on the macroeconomic front. As we suggested before, that may be when Bernanke & Co. begin raising interest rates. It appears to us that it may be a while before we get to that point.

On a global basis, it is clear that there are still significant sovereign-debt issues in Europe. The budget problems of relatively small countries such as Greece and Portugal, whose economies are a fraction of that of the United States, may seem quaint. However, there is some concern that a default by one of those countries could lead to the classic “falling dominos” of ever-larger countries if no European Union country trusts another to make good on its debt (essentially what pulled the rug out from under Lehman Brothers: its deals relied on all the participants at least implicitly trusting each other). An unstable EU debt environment strengthens the relative position of the large, liquid U.S. Treasury market.

Anti-government uprisings (in addition to the seemingly near-permanent religious tensions) in the Middle East have left that region's political stability in question. Farther to the East, Japan continues to sort out the short- and long-term fallout from the earthquake/tsunami disaster earlier this year that dealt the country a significant blow on every level. Those things, too, may strengthen the U.S. bond market's position.

On the domestic front, the two most important issues are intertwined: employment and housing. Wage inflation often historically has preceded price inflation and interest-rate increases. The nation's employment situation remains shaky. Unemployment numbers had stabilized and appeared to be edging down a bit in the waning months of 2010 and the early part of 2011 but recent data is murky on the true strength of the job market.

Americans – unsure of the employment horizon and unable to tap equity (if, in fact, they are not underwater) in their houses – are paying down debt. Housing prices in many markets are treading water; other markets, though, continue to show decreased prices and sales. Meanwhile, banks aren't lending money but to the most-well-qualified applicants.

The nation's largest banks remain skittish. They, too, are held hostage by the nation's housing market primarily because they fear a continued vicious cycle: If home prices continue to drop, more homeowners who had been paying their mortgages may decide it makes financial sense for them to default. That, in turn, puts downward pressure on area prices and pushes ever more people to the same tipping point.

Bankers currently are more interested in hoarding the cash provided by the Fed's two rounds of quantitative easing to ensure they have enough to cover losses than they are in lending it. All this

– combined with commodity prices that recently have stabilized – leads us unable to envision a hyperinflationary environment any time soon.

What we are suggesting is not all doom and gloom. Consumers still need places to live, food to eat, cars to drive. And many companies – across the capitalization range – have emerged from the recession stronger than ever. We don't know – nor does anyone – where the economy or the markets are heading from here. The stock market historically has proven to “climb a wall of worry;” however, we believe especially the highest-flying portions of the stock market may take a breather as investors assess the current macroeconomic situation.

Not being prepared adequately and ahead of time for any move, which no one can repeatedly predict accurately, in the marketplace – whether the move is up or down, in stocks or bonds – is the surest way NOT to meet one's financial goals.

Conclusion

Confusion and uncertainty have become the buzzwords among many as it relates to how fixed-income investing fits into investors' asset-allocation plans during a period in which the U.S. economy likely faces slower-than-average growth. Eagle believes this environment does nothing to diminish the value of bonds in investors' portfolios but instead perhaps increases the need for the professional management of fixed-income securities.

Many investors now appear to view fixed-income instruments as a yield-only asset class. It is short-sighted – at best – to view bonds strictly through that prism.

Bonds are an integral part of an asset-allocation mix. They historically have produced higher returns than cash while generally exhibiting less volatility than equities. Further, bonds may lower a well-allocated portfolio's overall risk by providing returns that may serve to mitigate negative returns on stocks (or vice versa) should these asset classes move inversely. The key to this is ensuring a bond manager is investing in securities that are not correlated to other asset classes, and particularly the broad stock market.

Many of us love different aspects – the speed, the fuel economy, the stereo – of our cars. But the first thing we all probably do when we put our teens in the driver's seat for the first time isn't to talk about any of those things. Instead, it is to tout the importance of wearing a seat belt.

We say, “Put it on as soon as you get in the car.” We know that the odds of needing a seat belt are pretty slim while backing down a driveway or driving through a neighborhood; further, they do not hinder us from enjoying our ride or prevent us from maybe going just above the speed limit. Instead, we know we put seat belts on before we even put the car in gear is because there rarely is time to put one on when we find ourselves in the very situations where we need them.

We would suggest a prudent fixed-income component remain every bit as important in a well-diversified portfolio as a seat belt is in any car: a must-have.

Fixed Income Markets Focus

An Argument For Diversification

Annual returns for select key indices 1998 - 2010
ranked in order of performance (best to worst)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Long Treasury	16.55%	Treasury Bills 4.73%	Long Treasury 19.88%	Credit 10.40%	Long Treasury 16.20%	High Yield 28.97%	High Yield 10.83%	Long Treasury 6.50%	High Yield 11.85%	Long Treasury 9.81%	Long Treasury 24.03%	High Yield 58.21%	High Yield 15.12%
Short Treasuries	9.60%	High Yield 2.39%	US Govt. Agency 12.18%	Asset Backed 9.81%	Short Treasuries 12.41%	Credit 7.70%	Long Treasury 8.73%	Municipals 3.51%	Mortgages 5.22%	US Govt. Agency 7.92%	US Govt. Agency 9.08%	Asset Backed 24.72%	Long Treasury 9.43%
US Govt. Agency	8.85%	Mortgages 1.86%	Municipals 11.68%	US Govt. Agency 8.31%	US Govt. Agency 11.01%	Municipals 5.31%	Credit 5.14%	Treasury Bills 3.05%	Municipals 4.84%	Mortgages 6.90%	Mortgages 8.34%	Credit 16.04%	Credit 8.47%
Credit	8.57%	Asset Backed 1.81%	Short Treasuries 11.57%	Mortgages 8.22%	Credit 10.52%	Asset Backed 4.01%	Mortgages 4.47%	Short Treasuries 2.93%	Treasury Bills 4.82%	Short Treasuries 5.25%	Short Treasuries 2.85%	Municipals 12.91%	Asset Backed 5.85%
Asset Backed	7.77%	US Govt. Agency -0.94%	Mortgages 11.16%	Short Treasuries 7.73%	Municipals 9.60%	Mortgages 3.07%	Municipals 3.28%	High Yield 2.74%	Short Treasuries 4.74%	Credit 5.11%	Treasury Bills 2.44%	Mortgages 5.89%	Mortgages 5.37%
Mortgages	6.96%	Credit -1.96%	Asset Backed 10.48%	High Yield 5.28%	Mortgages 8.75%	US Govt. Agency 2.59%	US Govt. Agency 3.27%	Mortgages 2.61%	Asset Backed 4.70%	Treasury Bills 5.00%	Municipals -2.47%	US Govt. Agency 1.53%	US Govt. Agency 4.36%
Municipals	6.48%	Municipals -2.06%	Credit 9.39%	Municipals 5.13%	Asset Backed 8.55%	Short Treasuries 2.14%	Asset Backed 2.90%	US Govt. Agency 2.34%	US Govt. Agency 4.37%	Municipals 3.36%	Credit -3.08%	Short Treasuries 0.37%	Municipals 2.38%
Treasury Bills	5.49%	Short Treasuries -2.49%	Treasury Bills 6.29%	Treasury Bills 4.95%	Treasury Bills 1.99%	Treasury Bills 1.22%	Short Treasuries 2.38%	Asset Backed 2.09%	Credit 4.26%	Asset Backed 2.21%	Asset Backed -12.72%	Treasury Bills 0.29%	Short Treasuries 0.29%
High Yield	1.87%	Long Treasury -14.92%	High Yield -5.86%	Long Treasury 3.46%	High Yield -1.41%	Long Treasury 0.66%	Treasury Bills 1.29%	Credit 1.96%	Long Treasury 1.85%	High Yield 1.88%	High Yield -26.16%	Long Treasury -12.92%	Treasury Bills 0.22%

Best ← → Worst

*Source: Barclays. Through Dec. 31, 2010. See descriptions of indices on the next page. Please consider the investment objectives, risks, charges, and expenses of any fund carefully before investing. Contact Eagle at 800.421.4184 or your financial advisor for a prospectus, which contains this and other important information about the funds. Read the prospectus carefully before you invest or send money.

Glossary of Fixed-Income Terms

Basis point – One basis point equals one one-hundredth of a percentage point (i.e., 1 basis point = 0.01 percent). A 200 basis-points (sometimes written as “bps”) increase would equal 2 percentage points.

Fed funds rate – This rate, set by the Federal Open Market Committee, is the interest rate banks charge to loan each other money they have on reserve with the U.S. Treasury. The loans typically are made and paid back between business days; therefore, the Fed funds rate is also known as the “overnight rate.” The Fed funds rate does not directly affect individuals or companies but many loan and/or interest rates are tied to the Fed funds rate.

“Laddering” bonds – This is a passive style of fixed-income investing whereby an individual buys bonds with different maturities. The notion is that by spreading out the maturity dates, one lessens the odds that all the bonds will mature in an interest-rate environment detrimental to an investor who plans to sell entirely or reinvest in the fixed-income market.

Index Descriptions | Index returns do not reflect the deduction of fees, trading costs or other expenses. The index is referred to for informational purposes only; the composition of each Index is different from the composition of the accounts managed by the investment manager. Investors may not make direct investments into any index.

Long Treasury | is represented by the Barclays Capital Long Treasury Index – Comprised of U.S. Treasury securities, publicly issued by the U.S. Treasury. It is limited to securities with final maturities of 10 years or longer. The index calculates total returns for one-month, three-month, twelve-month and ten-year periods and year-to-date.

Credit | is represented by the Barclays Capital U.S. Credit Index – This index is the U.S. Credit component of the US Government/Credit Index. It consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The U.S. Credit Index is the same as the former U.S. Corporate Investment Grade Index, which has been renamed the U.S. Credit Index.

High Yield | is represented by the Barclays Capital U.S. Corporate High Yield Index – An unmanaged index that includes all fixed income securities having a maximum quality rating of Ba1, a minimum amount outstanding of \$150 million, and at least 1 year to maturity.

U.S. Government Agency | is represented by the Barclays Capital U.S. Agency Index – This index is the U.S. Agency component of the US Government/Credit index. It consists of publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, the Resolution Trust Funding Corporation (REFCORP), and the Federal Home Loan Bank System (FHLB). The index includes both callable and non-callable agency securities.

Barclays Capital Intermediate Government Index – The intermediate component of the Barclays Capital Government Index with securities in the maturity range of one year to – but not including – 10 years. It is an unmanaged index. The index represents assets that are subject to risk, including loss of principal.

Barclays Capital Government Index – The Barclays Capital Government Index is comprised of all publicly issued debt securities issues by the U.S. government or its agencies, as well as quasi-federal corporations and corporate or foreign debt guaranteed by the U.S. government, along with all public obligations of the U.S. Treasury. Must be rated investment-grade or higher by at least two of the following: Moody’s, S&P or Fitch; must have at least one year left to maturity; and an outstanding par value of at least \$250 million. Security representation would be those that are publicly issued, dollar-denominated, non-convertible and fixed rate. It is an unmanaged index. The index represents assets that are subject to risk, including loss of principal.

Municipals | are represented by the Barclays Capital Municipal Bond Index – A benchmark index that includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than 2 years) selected from issues larger than \$50 million.

Short Treasuries | are represented by the Barclays Capital Short Treasury Index – This index is the 1-3 yr. component of the U.S. Treasury index. Securities in the Treasury Index (i.e., public obligations of the U.S. Treasury) with a maturity from 1 up to (but not including) 3 years.

Mortgages | are represented by the Barclays Capital Fixed Rate Mortgage Backed Security Index – A benchmark index that includes 15- and 30-year fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal National Mortgage Association (FNMA).

Asset Backed | is represented by the Barclays Capital Asset Backed Index – This index is the ABS component of the US Aggregate Index. The Asset-Backed Securities (ABS) Index has five subsections: Credit and charge cards, Autos, Home equity loans, Utility, Manufactured Housing. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS and the ERISA-eligible B issue.

Treasury Bonds | are represented by the Barclays Capital U.S. Treasury Bill Index – Barclays Capital U.S. Treasury Index is comprised of public obligations of the U.S. Treasury with a remaining maturity of one year or more.



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