

# PROFESSIONAL FIXED-INCOME MANAGEMENT

*A Strategy for Changing Markets*

## EXECUTIVE SUMMARY

- The bond market has evolved in the past 30 years and become increasingly complex and volatile.
- Many investors are choosing professionals to manage their fixed-income portfolios to help them navigate the fixed-income markets.
- A professionally managed fixed-income portfolio offers several advantages including: access to bonds that are not readily available to individuals, block-trading price advantages, opportunities to capture capital gains and strategic positioning of the account according to the market environment.

Today's fixed-income investor can choose from a diverse universe that encompasses much more than the traditional staples of U.S. Treasury bills, long-term municipal bonds and corporate bonds.

In fact, today's market includes a whole host of fixed-income options that have emerged to satisfy a greater variety of needs.

While the fixed-income market offers greater opportunities, it has also become more challenging as exemplified by recent turmoil within the credit markets. Investors face an overwhelming array of complex fixed-income choices, which are not always suitable for every investor. This multitude of alternatives can create confusion, making it difficult for investors to determine what best fulfills their specific financial needs.

For many investors, professional management, whether through a separately managed account or a well-managed mutual fund, is the best choice to successfully navigate the fixed-income options and satisfy the two needs that remain constant: capital preservation and income.

### **Bond Fundamentals**

A bond represents a loan from an investor to a government institution, a corporation, a bank or a municipality. Essentially, an investor is lending money to the issuer for a specified period and expects the issuer to pay back the face value, or **par value**, on the date of maturity. Until that date, the borrower must send the investor an interest payment, called **a coupon**, usually twice a year. The coupon amount is based on the current interest rate and the estimated risk of the loan. The more risk the borrower asks an investor to take, the more interest the borrower must pay. A bond's **yield** is the amount of annual income paid by the bond divided by the bond's current price.

By purchasing a bond, an investor has locked in

set payments for a specific period of time, creating a fixed cash flow. The borrower, in turn, commits to return the principal at the end of the loan agreement. The strength of that commitment, however, depends on the creditworthiness of the bond issuer.

### **Increased Complexity**

Of course, there is much more to the bond market than the basics mentioned. Wall Street seemingly has the capacity to create ever newer products and some investors have been willing to blindly commit capital without thorough analysis. With the expansion of offerings in recent years, the fixed-income arena has become more intricate and unpredictable and it continues to become more complicated. Today's bond market also reflects more "event risk," including leveraged buyouts, stock buybacks, subprime mortgages and illiquidity in the credit markets.

Few individual investors have the patience, experience or expertise to actively monitor the numerous bonds available. And fewer still have the resources to analyze the interconnecting factors — such as issuer credit risk, maturity, price, face value, coupon rate, yield and market risk — that affect bond investing.

### **Interest-Rate Volatility**

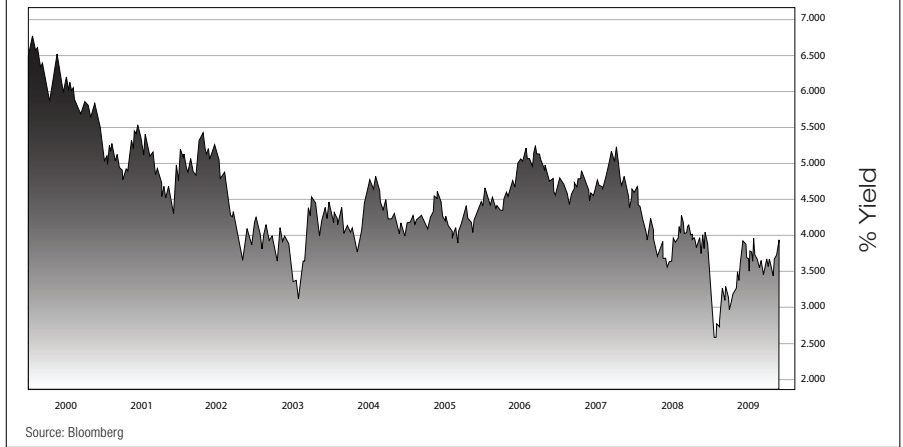
Because bonds and interest rates have an inverse relationship, the value of a bond will decline in a rising-interest-rate environment or increase in a lower-interest-rate environment. Closely monitoring

interest rates is essential for any fixed-income portfolio or mutual fund because it affects the volatility and value of a bond.

From 1960 to 1965, average yields of AAA-rated long-term corporate bonds ranged from a low of 4.26 percent to a high of 4.49 percent, a difference of just 0.23 percentage points (Source: EMB Limited. U.S. Treasuries were not available in the early 1960s. Corporate AAA bonds are used for comparison). But from 2000 through 2009, yields for U.S. Treasuries ranged from 2.13 percent to 6.77 percent, a difference of 4.64 percentage points (see Chart 1).

To further illustrate this point, from October 1993 to October 1996, the 30-year Treasury bond index had a greater standard deviation than the S&P 500 stock index. (Standard deviation is a commonly used statistical measure of volatility. The higher the

Chart 1: Changes in U.S. Treasury Yields



standard deviation, the more volatile the price of the security.) This is surprising because stocks have historically been much more volatile than bonds.

### More Types of Securities

In the mid-1960s, fixed-income securities were limited to U.S. Treasury bills, long-term municipal bonds and corporate bonds. These long-term bonds were usually offered with a maturity of 20 years, while T-bills were loans of one year or less. Intermediate-term bonds were rarely available and the 30-year Treasury bond was not introduced until the late '70s.

These narrow choices did not serve the needs of all borrowers and lenders, so fixed-income issuers created a broader range of securities with different maturities, characteristics and risk/reward profiles. Now, corporations and government institutions are able to borrow more money for expansion, while investors with differing financial requirements can better match their needs with specific fixed-income securities.

Today's market offers a mix of government bonds, including agencies, Ginnie Maes (Government National Mortgage Association) and other mortgage-backed securities, high-yield corporate

Chart 2: Then and Now

#### 1965

- Long-term corporate bonds
- U.S. Treasury bills
- Long-term municipal bonds

#### 2010

- |   |  |
|---|--|
| ■ Long-, intermediate- and short-term bonds: <ul style="list-style-type: none"> <li>• Government</li> <li>• Corporate</li> <li>• Municipal</li> </ul> | ■ Futures                                |
| ■ Ginnie Maes   | ■ Options                                |
| ■ High-yield bonds  | ■ Derivatives                            |
| ■ Zero coupon bonds   | ■ Collateralized debt obligations (CDOs) |
| ■ Collateralized mortgage obligations (CMOs)  | ■ Collateralized loan obligations (CLOs) |
|   | ■ Credit default swaps (CDS)             |

Source: Bloomberg

bonds, zero-coupon bonds, futures, options, derivatives and many other fixed-income securities (see Chart 2).

### Sector Relationships

Like equities, fixed-income securities are organized into sectors, or groupings, such as long-term municipal bonds or short-term corporate bonds. Similarly, bond sectors cycle in and out of favor, and prices fluctuate with demand. Generally, in-demand sectors move up in price, while others lose value (see Chart 3). Portfolio managers actively monitor sector and sub-sector performance in an effort to produce positive long-term results.

### Credit Ratings

When the credit quality of a bond changes, so does its value. The credit rating indicates the level of risk that a bond will default prior to its maturity. Even if the bond doesn't default, its value can rise and fall based on investors' concerns. Therefore, it is important to assess the financial stability of companies and municipalities to make informed investment decisions.

Rating agencies (Fitch, Moody's and Standard & Poor's) increasingly are changing the credit ratings of corporate bonds in response to a more competitive environment and rapidly changing industry dynamics. In 1981, there were 30 non-financial AAA-rated companies. Today, there are just four (as of Dec. 31, 2009). Now, more than ever, it is essential to understand and monitor credit ratings without relying solely on the ratings agencies to determine the worthiness of the bond.

Knowledgeable managers evaluate the underlying credit of the bonds for themselves and do not rely on the rating or insurance to buy a bond. In today's world, rating a bond has become increasingly difficult and requires skills not unlike that of an

Chart 3: Best Performing Bond Sector\*

|                                      |                              |                              |                              |                                |
|--------------------------------------|------------------------------|------------------------------|------------------------------|--------------------------------|
| 1990<br>Intermediate-Term Government | 1991<br>High-Yield Corporate | 1992<br>High-Yield Corporate | 1993<br>Long-Term Government | 1994<br>Intermediate Municipal |
| 1995<br>Long-Term Government         | 1996<br>High-Yield Corporate | 1997<br>Long-Term Government | 1998<br>Long-Term Government | 1999<br>Treasury Bills         |
| 2000<br>Long-Term Government         | 2001<br>Credit               | 2002<br>Long-Term Government | 2003<br>High-Yield Corporate | 2004<br>High-Yield Corporate   |
| 2005<br>Long-Term Government         | 2006<br>High-Yield Corporate | 2007<br>Long-Term Government | 2008<br>Long-Term Government | 2009<br>High-Yield Corporate   |

Source: Barclays Capital indices. Past performance is no guarantee of future results.

\* Based on total returns.

equity analyst. Professional managers leverage their knowledge and technology to research the creditworthiness of bond issues and evaluate market information prior to making investment decisions.

### Investment Strategies

As the market changes, investors opt for different strategies to help them meet their goals and avoid unwanted risk. A passive strategy involves buying and holding bonds until maturity, while a managed strategy may involve hiring a manager (either directly or through a mutual fund) who actively adjusts portfolios to reflect changes in the market.

**Passive Strategy** | The most popular passive strategy involves laddering maturities so that bonds come due at regular intervals. For example, a conservative ladder might include bonds ranging from one to five years in maturity. A more aggressive ladder might include five-, seven-, 10-, 15- and 30-year maturities. In most cases, a longer maturity bond pays more interest to compensate the investor for committing the principal for a longer period of time. However, these bonds are more volatile and have greater interest-rate risk.

Each time a bond matures, the principal is reinvested in new issues at prevailing interest rates. In other words, a passive strategy does not make any adjustments to reduce risk or to take advantage of opportunities presented by changes in the market.

**Managed Strategy** | Investors also have the option of working with a knowledgeable, professional fixed-income manager to monitor their portfolio or mutual fund holdings. Professional managers strive to balance interest-rate fluctuations with security and sector selection. They know when to be defensive and when to be opportunistic. Their goal is to actively mitigate exposure to market risk and protect the safety of the principal.

A professional manager seeks to position a portfolio or fund according to the risks and opportunities in the fixed-income market. Investors benefit from certain advantages, which often are unavailable to them through a passive strategy, including:

- Adjustment of maturities
- Analysis of sector valuations
- Extensive credit research
- Identification of inefficiently priced bonds
- Opportunity to capture capital gains
- Management of call risk
- Block-trading capacity and price advantages
- Access to bonds not readily available to individuals
- Liquidity
- Diversification

Portfolio managers may choose to shorten or lengthen the maturity of the portfolio depending on their market outlooks. The managers can adjust maturities to capture additional returns by extending maturity if they consider yields attractive. Conversely, they may opt to shorten maturities to preserve principal if the risk/reward trade-off seems poor.

A managed strategy or actively managed fixed-income fund also considers the relative value of different fixed-income sectors. If corporate bonds are offering historically high returns compared to Treasuries, a portfolio manager may purchase more corporate bonds to capitalize on this opportunity. If two-year municipal bonds are offering higher-than-normal returns in relation to longer-term issues, a portfolio manager may purchase these bonds and wait for longer-term issues to offer higher yields.

As mentioned previously, portfolio managers conduct extensive credit research to determine the ability of the issuer to repay the debt. While government securities are backed by the United States government, corporations and municipalities have varying degrees of credit-worthiness. In evaluating the credit of corporate and municipal bonds, managers analyze the financial data available as well as ratings agencies' research.

Portfolio managers have access to excellent opportunities that the individual investor rarely has the chance to buy. Some of these bonds are under-researched and, as a result, are inefficiently priced. These bonds may have special features — sinking funds, call features, put options, etc. — that make them more attractive to managers who can direct the appropriate times to buy and sell.

A managed strategy also can offer the flexibility to capture capital gains. A portfolio can capture capital gains by selling a bond before it matures to realize a profit. This capital gain may result from a decrease in interest rates, an improvement in credit quality or the elimination of a previous price inefficiency. A passive strategy that holds bonds to maturity cannot take advantage of these capital-gain opportunities.

An active portfolio manager also monitors call risk. A bond with a call feature allows the issuer to

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redeem or repurchase the loan prior to maturity, usually at a slightly higher price than the bond's par value. A portfolio manager who believes it is an appropriate time to extend maturities will avoid bonds that have an impending call date. However, bonds with call features can be an advantage if used to shorten the overall maturity of a portfolio in a rising-interest-rate environment.

Active bond managers may run multiple portfolios – which could include a mutual fund – and may purchase a bond for numerous accounts in one transaction. Block trading for multiple clients typically allows a portfolio manager to pay less for each individual bond. This savings helps offset the cost and allows the manager to move bonds quickly and efficiently. An active portfolio manager also has access to a much broader range of bonds because he regularly does business with a large group of buyers and sellers.

### **Role of a Professional Manager**

An increasingly complex and unpredictable bond market has done little to diminish investors' enduring need for financial stability and income. A separately managed fixed-income account or investment-grade bond fund may stand among the best ways to meet those needs.

An involved manager understands how to create opportunity from increased volatility, greater uncertainty and inefficiency in bond markets.

Portfolio managers understand the complex interconnections among issuer creditworthiness, maturity, price, face value, coupon rate, yield and myriad other factors that affect bond investing. And they use their expertise and access to better technology to research the creditworthiness of bond issues and evaluate market information prior to making investment decisions.

A professionally managed portfolio is designed to reflect investors' needs with respect to sector allocation, interest-rate exposure, yield-curve structure and credit quality. One advantage of a separately managed account is that the manager can consider an individual investor's specific risk tolerance and investment time horizon in an effort to achieve his or her individual financial goals.

The flexibility to reposition holdings in response to changing market conditions ranks highly among the many advantages offered by active managers, whether through separately managed accounts or dedicated fixed-income mutual funds. Unlike passive laddering strategies, an active approach adds value by skillfully adjusting the portfolio in light of interest-rate trends, changes in the yield curve, economic forecasts, Federal Reserve policy and sector valuations.

In addition, active managers predominantly focus their efforts on research and investment. They have access to data not generally available to individual investors. As the market evolves, advances in technology will bring enhanced efficiency in market trading and professional experience will become increasingly relevant as more options become available. Professional managers will be able to focus more of their skills and resources in an effort to add the most value for their clients.

### **In Conclusion**

We believe fixed-income vehicles should remain an important part of an investor's asset-allocation mix and a transparent, investment-grade bond fund or an actively managed separately managed account may be a particularly good choice for many investors.

Like any investment decision, it is important for investors to determine which strategy is the most appropriate for their needs. Professional fixed-

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income management is an excellent choice for those who seek institutionally desired bonds at better prices, the opportunity to capture capital gains and the ability to strategically restructure a portfolio as market conditions change.

Many investors consider bonds to be “risk-free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk-and-return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital. Bonds, if held to maturity, provide a fixed rate of return and a fixed principal value. Bond funds fluctuate and shares, when redeemed, may be worth less than their original cost. Clients should consult their tax advisors before making any tax-related investment decisions.

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