Fixed Income Investment Strategy

September 3, 2009

So far this quarter, we've experienced a moderate decline in interest rates and a contraction in spreads across all the risk sectors including investment grade corporate bonds, mortgage backed securities, asset backed securities and municipal bonds. As a result, overall yields in the fixed income market are within sight of their pre-2008 financial crisis levels. The performance across all fixed income sectors has been strong. As examples, the year-to-date returns of the Barclays MBS index and the Barclays U.S. Credit Index though August was 4.45% and 12.90% respectively.

There is currently an active debate about the potential for an increase in the rate of inflation and interest rates once the Fed starts to pull liquidity our of the system and the economy shows a sustained recovery. This debate has resulted in a significant push into the front end of the yield curve where investors believe a better risk/reward exists. Whereas an investor could earn a yield of 4.0% investing in A rated corporate bonds one year ago, today that yield is a skimpy 2.35%. We believe the government's initiatives to improve liquidity over the past year have been successful; however, the consequence has been lower rates which don't necessarily coincide with the risk inherent in the market.

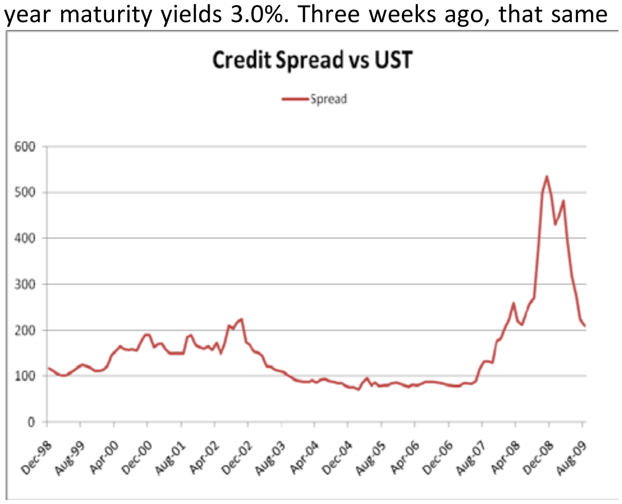
Structured securities, including mortgage backed securities, have experienced similarly strong performance on a year-to-date basis. Prepayment activity, orchestrated by the Fed's "quantitative easing" initiatives, has increased during the summer as home owners refinance their mortgage in a lower interest rate environment. The result is a slight shortening in the durations of pools with 5.5% and higher coupons.

Fixed Income Investment Strategy for the Third Quarter

There are generally three types of fixed income investors: those that are investing to earn a targeted yield or income stream, those that are trying to earn a return relative to a performance benchmark, and those that are trying to match cash flows from their investment portfolio with a stream of liability cash flows. With that in mind, we summarize our thoughts on fixed income investing for the remainder of 2009.

1. Sit it out.

Today an A rated corporate bond with a five year maturity yields 3.0%. Three weeks ago, that same issuer traded to yield almost 4.0%. Clearly, the decline in yield is a function of a decline in interest rates as well as tighter spreads. In the context of this market, one strategy is to simply wait for spreads to widen, interest rates to rise, and overall yields to increase. An investor who is trying to achieve a yield target, for example 4%, with a duration of 3.0 years, may choose to simply wait for interest rates to return to 4%. With the average money market fund yielding 0.5%, there is a 250 basis cost to this strategy assuming that interest rates remain stable over the three month horizon. But, we know that never happens.



Source: Barclays Capital

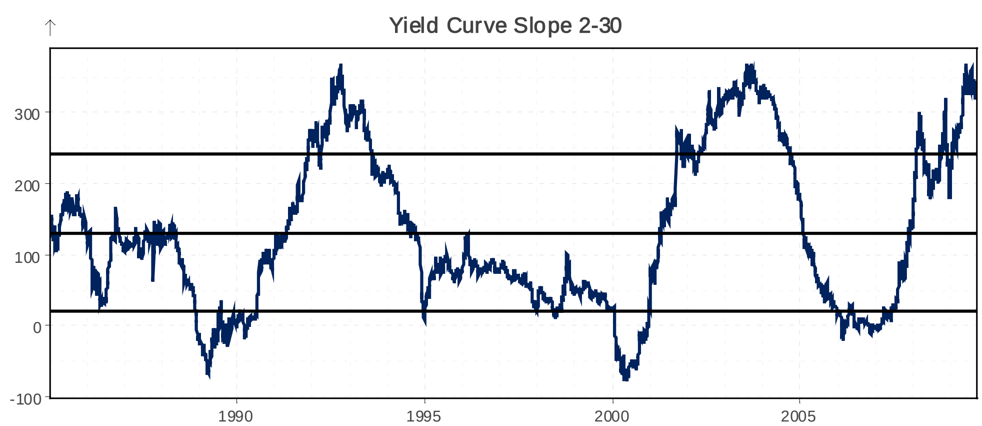
In general, credit spreads still have room to tighten further to reach 1998 to 2007 levels. However, that assumes the liquidity programs under Greenspan remain in place. Currently, with interest rates at zero percent, that is still the case.

2. Move up in quality.

There is a time to invest lower in quality and pick up incremental yield and there is a time to move up in quality and preserve capital while reducing risk. Usually, whenever spreads tighten, we advocate moving up in quality. The best performing sector so far this year has been the BBB rated credit sector which was up 23.47% on a year-to-date basis through August 31st. When markets dislocate like they did in the fall of 2008, the weakest credits tend to underperform. As markets improve, inevitably the weakest sectors out perform the broad fixed income market. For the most part, we believe the lower quality trade has run its course. To invest lower in quality in order to continue to achieve a yield maintenance strategy will inevitably result in underperformance if spreads widen.

3. Invest in the shorter part of the yield curve.

The yield on the 10 year US Treasury has increased from 2.24% at the beginning of the year to 3.40% at the end of August. Similarly, the yield on the five year US Treasury increased from 1.43% to 2.34% over the same period. As the bond market wrestles with the potential for higher interest rates, we are advocates of investing in the short portion of the yield curve. We're fond of saying that "*You can only take what the market is willing to give you.*" Right now, the bond market is providing investors with low yields, tight spreads and adequate liquidity. In general, a one year A rated corporate bond provides a yield of 1.5%, while a two year bond of similar quality yields 2.0%. Over the next year, we believe that interest rates will creep higher as the US government simultaneously reduces its capital support while still placing over $2 trillion in funding needs. As the economy shows signs of recovery, we expect the Fed will unwind the massive liquidity programs which will result in a flattening in the yield curve similar to the 1993 – 1995 period.



Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
—	Left	2-30 Slope	343.052	-78.282	05/16/2000	369.232	10/05/1992	130.812	110.177	4.634

Source: Barclays Capital