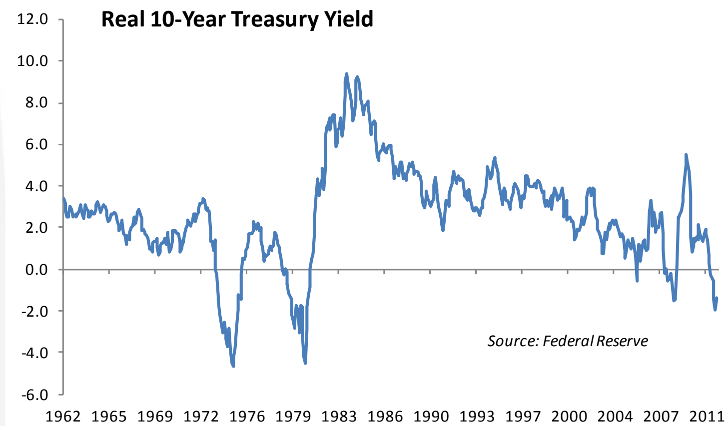
With the dramatic decline in interest rates, fixed income investors are faced with lower expected returns which may not keep pace with the rate of inflation. This article discusses the current investment environment for fixed income, and describes the benefits of using Winthrop Capital Management's Ultra Short fixed income strategy, in conjunction with other broad market strategies, to reduce risk and maintain the weighted average yield of the fixed income portion of the portfolio.

The Negative Real Interest Rate Environment

In the wake of the Financial Crisis of 2008, the Federal Reserve has orchestrated monetary policies which have pushed interest rates in the United States near historically low levels across the yield curve. We expect the Federal Reserve will continue to pursue these aggressive monetary policies that will likely maintain interest rates at these low levels through 2014, as long as the rate of inflation remains subdued.



The rate of inflation last year was near 2.3% measured by the Consumer Price Index (CPI). The result is that investors are earning a *negative real rate of return* investing in US Treasury securities all the way up to the 10 year Treasury.

After Federal Reserve Chairman Paul Volker helped direct monetary policies that ultimately broke the high rates of inflation in the early 1980s, interest rates have been declining ever since. As a result, the US bond market has experienced a sustained rally over the past 30 years. The yield on the 10 year UST was 16% in 1982; today that yield is near 1.9%. However, we believe that the thirty-year rally in bonds is nearing its end.

Following the Financial Crisis of 2008, the monetary policies of the Federal Reserve today are now designed to maintain interest rates at low levels helping the economy move toward sustained growth, and allowing the financial system to re-build capital levels and the capital markets to continue to function. The traditional monetary policy tools of the Federal Reserve including manipulating the money supply, altering the Fed Funds Rate and changing the discount rate are no longer effective in altering economic growth. However, the asset purchase programs, known as *quantitative easing*, have proven very effective in maintaining interest rates at the desired low levels.

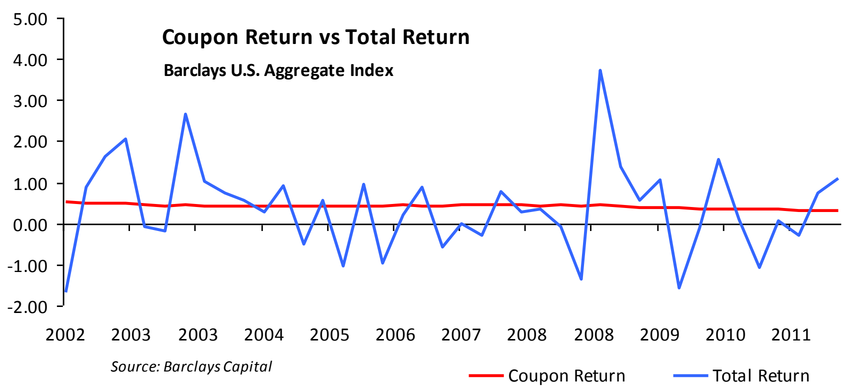
We expect that one of the consequences of these policies is that fixed income investors are not adequately compensated for the risks they are taking in certain parts of the bond market. While we do not see a catalyst for rising interest rates in the near future, we believe that investors should consider the role of fixed income in the asset allocation and portfolio risk allocation.

The Analysis of Fixed Income Total Returns

The total return of a bond over an investment horizon, known as the holding period return (HPR), is measured by the coupon income plus any price (P) appreciation or depreciation.

$$HPR_n = \frac{Income + (P_{n+1} - P_n)}{P_n}$$

Over the past ten years, the quarterly coupon return (the contribution that coupon provides to the total return) of the Barclays U.S. Aggregate Index has declined from 0.512% for the quarter ending March 29, 2002 to 0.308% for the quarter ending December 31, 2011 (Exhibit 1). Over the same time period, the average quarterly total return of the Barclays Aggregate Index was 0.379%. The chart below illustrates the stability of the portion of the coupon return compared to the total return of the Barclays U.S. Aggregate Index over quarterly time periods over the past ten years.



With the Federal Reserve successfully manipulating interest rates to their lowest levels, looking forward we expect that any capital appreciation as a percentage of fixed income total return will be substantially less than prior years. In addition, with coupons of publicly traded fixed income securities trending lower over the past ten years, we would expect overall total returns for US Treasury securities in the future to be lower as well.

As a result, investment strategies that emphasize stable coupon income and protection of principal will likely lead to better investment performance than traditional broad market strategies relying on price movements.

WCM Ultra Short Fixed Income Strategy

Winthrop Capital Management's Ultra Short Fixed Income Strategy is managed as a Separately Managed Account and invests in securities with maturities of less than three years. This strategy emphasizes the credit sectors including municipal bonds and corporate bonds. Generally, we do not invest in structured securities since we are measuring and managing credit risk not prepayment risk. As a guiding principal, we invest in securities that we believe have strong credit characteristics including solid free cash flow, high levels of cash, undrawn lines of credit and business models that work. We choose to not be unsecured lenders to issuers in the airline, restaurant, nursing home, assisted living, gaming, and steel industries since we believe the business models are challenged in today's economy.

The benefits of our separately managed account strategy over mutual funds or Exchange Traded Funds with short duration investment objectives generally include faster portfolio duration decay, quicker roll down the yield curve and a better managed target duration and yield.

Over the past three years, a 50/50 blend of Winthrop Capital Management's Ultra Short Fixed Income Investment Strategy, combined with the Barclay's US Aggregate Index fixed income strategy produced a lower cumulative return with less risk (measured by the standard deviation of returns). And, with the dramatic move in lower interest rates over the past three years, introducing the Ultra Short Fixed Income Strategy alongside a Barclay's US Aggregate broad market strategies allowed the portfolio to maintain the base level of income of the portfolio while significantly reducing the price volatility of the fixed income portion of the portfolio thru dramatic shortening of duration.

	Barclays US Aggregate	WCM Ultra Short	50/50 Blend
Cumulative Return	15.130%	3.658%	9.278%
Standard Deviation	0.823	0.628	0.652
Yield to Worst (%)	2.236	2.570	2.403
Modified Duration (Years)	4.95	0.79	2.87

The quarterly coupon return of the Barclay's US Aggregate has fallen consistently from 0.5% in 2008 to 0.3% for the fourth quarter of 2011. As the coupon return declines, the contribution to return from changes in price becomes greater. In other words, a 50 basis points move in interest rates when the ten year US Treasury yields 4.0%, has less of an impact on total return than the same shift in rates when the ten year US Treasury yields 1.86%. Thus, we expect the biggest determinant of fixed income returns over the next decade to be the shift in interest rates. Investors can protect portfolios from heightened volatility by shortening the overall duration while maintaining the average yield to worst date. In a rising interest rate environment, maturing securities can be reinvested into securities with higher yields which improve the overall portfolio yield.

In addition, blending the Ultra Short Fixed Income Strategy with the portfolio cash position provides a higher expected return with only a modest increase in volatility.

Total Return Comparison

Date	Barclays U.S. Aggregate (%)	WCM Ultra Short (%)	50/50 (%)
10/30/09	0.494	-0.020	0.237
11/30/09	1.294	0.100	0.697
12/31/09	-1.564	0.310	-0.627
1/29/10	1.528	0.130	0.829
2/26/10	0.373	0.100	0.237
3/31/10	-0.123	-0.020	-0.071
4/30/10	1.041	0.010	0.525
5/31/10	0.841	0.300	0.571
6/30/10	1.568	0.200	0.884
7/30/10	1.067	0.270	0.669
8/31/10	1.287	0.310	0.798
9/30/10	0.107	0.090	0.098
10/29/10	0.356	0.040	0.198
11/30/10	-0.575	0.320	-0.127
12/31/10	-1.078	0.170	-0.454
1/31/11	0.116	0.100	0.108
2/28/11	0.250	0.060	0.155
3/31/11	0.055	0.270	0.163
4/29/11	1.270	0.270	0.770
5/31/11	1.305	-0.140	0.583
6/30/11	-0.293	0.290	-0.001
7/29/11	1.587	-0.400	0.593
8/31/11	1.461	-0.040	0.711
9/30/11	0.727	0.460	0.594
10/31/11	0.108	-0.090	0.009
11/30/11	-0.087	0.370	0.142
12/30/11	1.099	0.140	0.620

Exhibit 1
Barclays U.S. Aggregate Index

Value Date	Number Issues (Returns)	Returns Modified Adjusted US Duration	QTD Price Return (%)	QTD Coupon Return (%)	QTD Other Return (%)	QTD Total Return (%)
3/29/02	6,786	4.535	-2.146	0.512	-0.029	-1.663
6/28/02	6,873	4.232	0.386	0.504	-0.025	0.865
9/30/02	6,862	3.753	1.188	0.482	-0.051	1.620
12/31/02	6,918	3.729	1.661	0.474	-0.070	2.065
3/31/03	7,148	3.768	-0.454	0.453	-0.077	-0.077
6/30/03	7,472	3.855	-0.549	0.430	-0.079	-0.199
9/30/03	7,471	4.251	2.270	0.436	-0.059	2.647
12/31/03	6,703	4.437	0.613	0.432	-0.028	1.018
3/31/04	6,827	4.238	0.365	0.419	-0.034	0.750
6/30/04	6,976	4.718	0.156	0.425	-0.016	0.565
9/30/04	5,686	4.383	-0.118	0.411	-0.022	0.271
12/31/04	5,794	4.268	0.523	0.415	-0.018	0.920
3/31/05	5,933	4.424	-0.918	0.415	-0.011	-0.514
6/30/05	5,979	4.084	0.151	0.407	-0.013	0.545
9/30/05	6,262	4.358	-1.427	0.407	-0.011	-1.031
12/30/05	6,434	4.498	0.521	0.425	0.003	0.950
3/31/06	6,610	4.607	-1.411	0.428	0.002	-0.981
6/30/06	6,824	4.731	-0.240	0.438	0.014	0.212
9/29/06	6,938	4.554	0.439	0.434	0.006	0.878
12/29/06	7,134	4.419	-1.015	0.434	0.001	-0.581
3/30/07	7,248	4.546	-0.437	0.438	0.002	0.003
6/29/07	8,899	4.615	-0.745	0.442	0.008	-0.296
9/28/07	9,093	4.535	0.309	0.443	0.007	0.758
12/31/07	9,193	4.334	-0.156	0.438	-0.001	0.281
3/31/08	9,175	4.307	-0.081	0.432	-0.010	0.341
6/30/08	9,457	4.619	-0.513	0.435	-0.002	-0.080
9/30/08	9,420	4.408	-1.771	0.428	0.000	-1.343
12/31/08	9,168	3.666	3.296	0.440	-0.005	3.731
3/31/09	9,003	3.629	0.996	0.420	-0.026	1.390
6/30/09	8,866	4.190	0.207	0.398	-0.037	0.568
9/30/09	8,717	4.345	0.696	0.382	-0.027	1.051
12/31/09	8,413	4.482	-1.893	0.367	-0.038	-1.564
3/31/10	8,257	4.546	-0.428	0.361	-0.055	-0.123
6/30/10	8,211	4.209	1.266	0.349	-0.047	1.568
9/30/10	8,249	4.560	-0.171	0.330	-0.052	0.107
12/31/10	8,216	4.855	-1.350	0.328	-0.056	-1.078
3/31/11	8,001	5.006	-0.245	0.332	-0.032	0.055
6/30/11	7,979	5.096	-0.586	0.323	-0.030	-0.293
9/30/11	7,844	4.861	0.457	0.312	-0.042	0.727
12/30/11	7,854	4.877	0.843	0.308	-0.051	1.099