

PERSPECTIVE

ON FIXED INCOME

Fiduciary
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International



Ron Sanchez, CFA
Director of
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“We believe active, well-researched bond selection and broad diversification will play a critical role in managing fixed income portfolios for 2010.”

Fixed Income Investing in 2010: Diversification Is Key

A year ago, the U.S. economy was mired in deep recession; the feeble housing sector continued to weaken, credit markets were frozen and the job market was deteriorating. Fixed income yield premiums (the yield bonus above Treasury yields) were historically high as investors avoided what they perceived as higher-risk fixed income sectors.

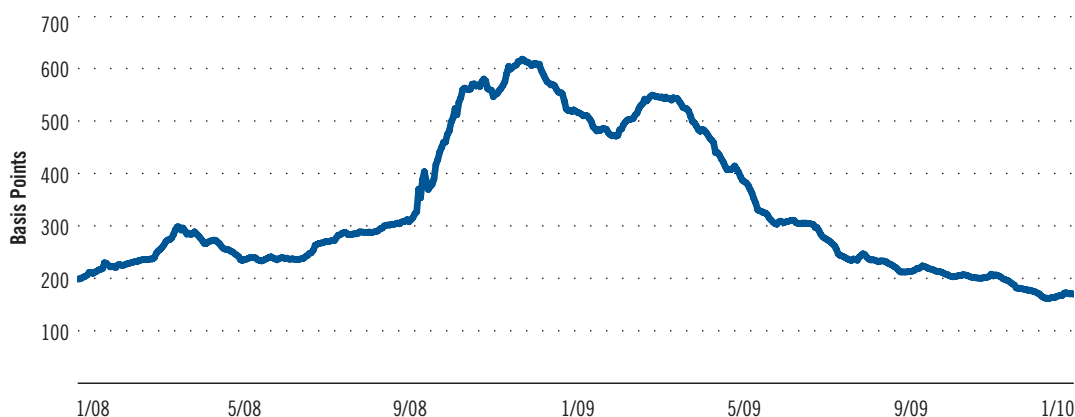
During 2009, risk tolerant investors were able to benefit from the credit sell-off as lower quality issues returned to more normal valuations. Select credit sectors rebounded quite dramatically, which resulted in bond yield premiums sharply declining. In fact, lower quality issues, such as high yield and emerging market sectors, recorded historically high rates of return over the year.

CORPORATE BONDS: IMPROVING FUNDAMENTALS BRING SELECTIVE OPPORTUNITIES

In many ways, 2009 can be defined as a retracement of the stunning price declines in corporate bonds for 2008. We do not expect high yield corporate bonds to provide the same range of returns produced in 2009.

Within the investment grade sector, yield spreads have contracted closer to pre-recession levels, and we believe spreads may continue to tighten slightly throughout the year (Chart 1). However, this will no longer be a broad market phenomenon in our view. We expect credit fundamentals to continue to improve and new issue supply to decrease. We believe this positive backdrop should allow investors to benefit from selective opportunities in the investment grade credit sector.

Chart 1: Investment Grade Corporate Bond Yield Spreads Have Contracted
Investment Grade Corporate Bond Yield Premiums vs. Treasuries



Source: Barclays Capital Credit Index, Option Adjusted Spread.

TREASURIES: DESPITE INCREASES, YIELDS REMAIN HISTORICALLY LOW

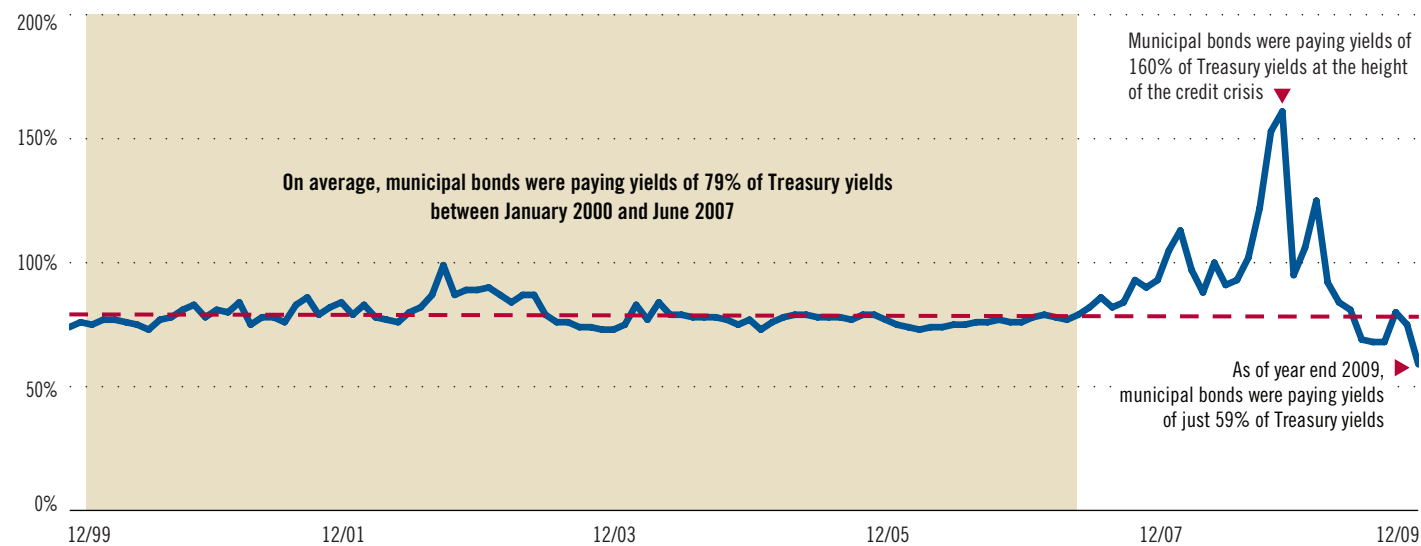
Absolute Treasury yields remain within a historically low range, despite significant increases over the year. We expect 10-year Treasuries to come under modest upward pressure in the coming months.

We do not expect inflation to be a problem in the near term. However, we are watchful of yield increases on longer-term issues because of the amount of debt that will be needed to fund the budget deficit. The Treasury added over \$1.2 trillion in net bond sales in 2009 and is planning on continuing at this pace into 2010. As more debt instruments enter the marketplace, investors' demand may not match the supply and prices could suffer.

MUNICIPAL BONDS: LOW YIELDS AND RICH VALUATIONS PROVOKE A CAUTIOUS VIEW

In 2009, municipal bonds delivered their best annual performance since 1995, even after absolute returns turned negative during the fourth quarter. This strong performance can be attributed to tremendous investor demand fueled by meager, near zero yields on money market funds, and the lower issuance of tax-exempt paper as more taxable municipal bonds were issued via the Build America Bond program. Short- and intermediate-term bond yields ended the year near record 42 year lows (Chart 2).

Chart 2: Municipal Bond Yield Ratios Are Historically Low, Leading to Rich Valuations
 5-Year AAA General Obligation Municipal Bonds vs. the 5-Year Treasury (Before Tax)
 Municipal Yield as a Percentage of Treasury Yield (As of December 31, 2009)



Source: MMD.

1. Center on Budget and Policy Priorities. 1/28/2010.

Municipal credit fundamentals continue to weaken, with states projecting budget gaps of \$194 billion for 2010. With quarterly state tax revenues down 17% year over year, combined budget gaps for the next two years are estimated to total at least \$350 billion.¹ Municipalities will likely need to deal with these budget deficits by cutting public expenditures and by raising taxes.

Until state budgets can recover, and until the low absolute level of yields—and the resulting rich valuations—begin to reverse themselves, we are taking a more cautious view of the tax-exempt sector.

MANAGING FIXED INCOME PORTFOLIOS IN A CREDIT RISK ENVIRONMENT

Our investment thesis is that 2008 was the year of risk aversion, 2009 was about risk appetite, and 2010 will be about risk management. We therefore have a very different view of the bond market than just one year ago, when we found extraordinary value in every sector with the exception of the Treasury market.

We are naturally cautious, as the risks to the downside become more heightened. Our emphasis is on preservation of principal in addition to adopting a rigorous risk management approach. We are more actively diversifying within the tax exempt sector as well as outside of the sector to include corporate credit, agency and other government guaranteed debt.

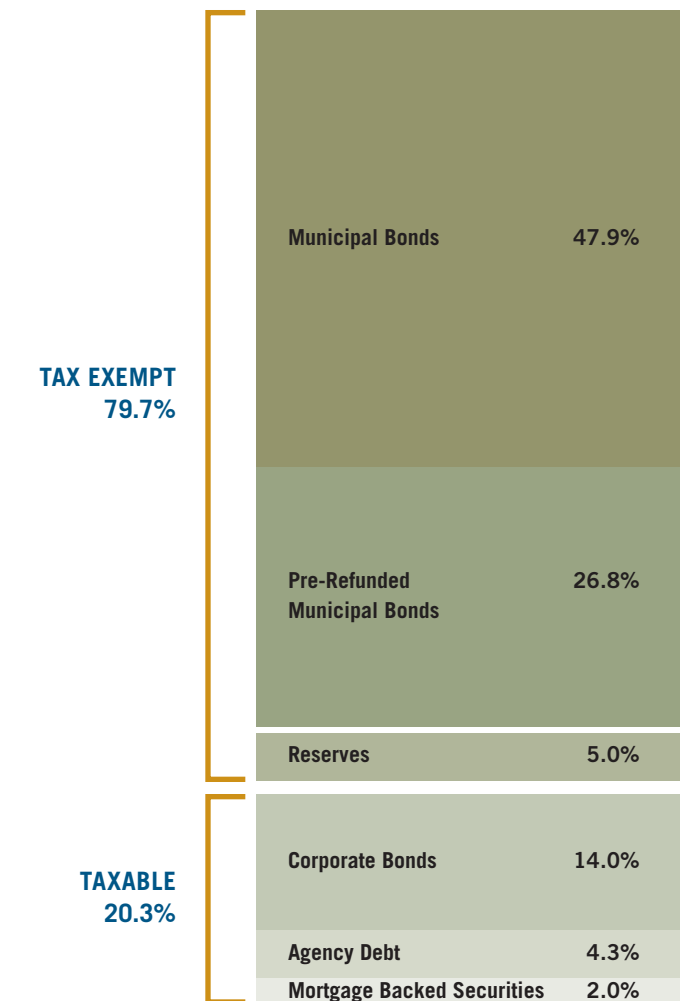
Tax-Exempt Bonds. We have been seeking to increase diversification across tax-exempt securities. We are finding opportunities in pre-refunded municipal bonds (which are secured by the U.S. Treasury, thereby effectively becoming a U.S. government guaranteed tax exempt security), as well as essential services municipal bonds, such as water and sewer authorities, among others. While we are pursuing very selective opportunities across the spectrum of municipal bonds, another area of focus has been callable debt—high grade municipal debt that has maturities no longer than 5 or 6 years, but is callable in the next year or two.

Taxable Bonds. In the corporate sector, we are seeking strong individual names based on credit quality and the potential for spread tightening. As with the tax-exempt sector, we have increased the level of diversification. We are currently underweight mortgage pass-through securities; we believe that the culmination of the Fed's purchase program (scheduled to end in the first quarter of 2010) and historically high valuations make other investment grade sectors more appealing on a risk-return basis.

At this point, we are not in favor of reaching for yield by extending out maturities to the very long end of the yield curve or down the credit quality curve. We strive for below market exposure to risk by maintaining an underweight in longer-term maturities in anticipation of a rising rate environment. Our focus is on short- to intermediate-term maturities and on high quality issues.

Tactical Allocation: Sample Taxable Fixed Income Portfolio

Average Duration is 4 Years with an AA+ Average Credit Quality



Outlook for 2010: Managing Through an Uneven Recovery

We believe that the U.S. may be at the beginning of a new economic cycle. However, we remain mindful that the economy still faces significant headwinds from a very weak labor market and the continued deleveraging of consumers and small businesses, as well as a possible increase in income tax rates, all of which may impede economic growth toward the end of 2010.

We agree with the Fed's assessment that the continued high rates of unemployment and production slack still plaguing multiple industries should help keep inflation rates subdued over the next several quarters. In fact, we expect headline and core inflation data to trend lower during the first half

of 2010. Given this scenario, we anticipate the Fed will keep key interest rates on hold for at least the next two quarters, and perhaps for the entirety of 2010. However, we are mindful of future inflationary concerns which we believe should continue to linger in the background.

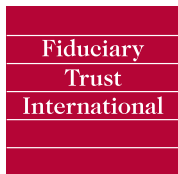
We expect to continue to focus on principal preservation and on lowering the price sensitivity and volatility of our clients' fixed income portfolios. We seek to achieve this through highly-focused security selection and through diversification by industry and issues.

About the Author

Ronald J. Sanchez, CFA, is Director of Fixed Income Strategies and is responsible for the development of fixed income strategies and management of fixed income portfolios for individuals and family groups. He is co-chairman of the firm's Asset Allocation Committee, a member of the Management Committee and is a member of the Franklin Templeton Fixed Income Policy Committee.

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