



Yanni Partners
A Division of GBS Investment Consulting, LLC

MEASURING UP

DELIVERING
THE PROMISE

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The Strategic Role of Fixed Income

IN THIS
ISSUE

A look at six
common roles
of fixed-
income
portfolios.

Fixed income can play a pivotal role in the investor's pursuit of investment objectives – helping an organization to achieve its mission.

The fixed-income market, with its broad array of products (maturities, yields) and growing body of analytical techniques, provides investors with a number of practical tools worth considering.

The events of the credit crisis should prompt investors to look deeper into the role of fixed income in their portfolios. In this edition of *Measuring Up*, we explore six common roles of fixed income: diversifying equity allocation (the common role in a traditional 60/40 portfolio), total return (portfolios with majority in fixed income), yield, liquidity, hedging inflation and meeting liabilities (primarily pensions).

The credit crisis of 2007-2008 began with problems related to sub-prime mortgages and ended with the most dramatic spike in credit spreads in more than 35 years. Mid-2007, investors started to raise concerns about the ability of sub-prime mortgage borrowers to repay their debts. The value of those mortgages, which were packaged into large groups of securities and sold to investors, fell sharply in July 2007. Many banks and large financial institutions held large quantities of the sub-prime

mortgages on their balance sheets and quickly found themselves in financial trouble.

In the wake of 2008, some investors have seen their fixed-income investments fluctuate violently. Portfolios that were heavily allocated to spread sectors sustained significant losses last year, failing at a time when investors needed fixed-income investments to diversify equity-related losses. (Spread sectors include corporate bonds, mortgage-backed securities [MBS] and asset-backed securities [ABS].)

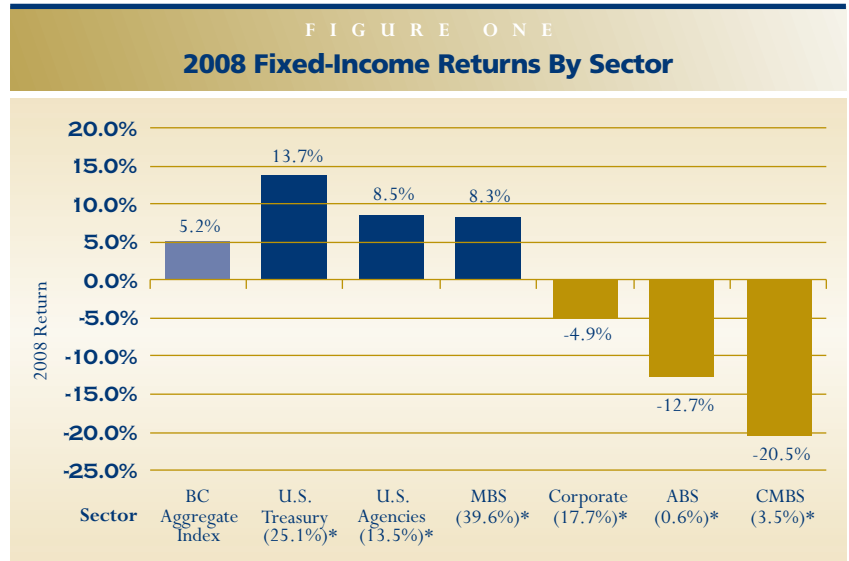
Some of those strategies have rebounded in 2009, as credit spreads returned to more normal levels. Investors also saw the universe of fixed-income managers explode – with managers generating wildly different returns. For example, in 2006, the difference between the return of the 5th and 95th percentile managers in the Yanni Partners Total Fund Fixed Income Universe was less than 1.4%, meaning that 90% of the managers in our universe generated returns within 1 ½ percentage points of one another. In 2008, that spread was 16.6%. The difference between a fixed-income return of +7.5% and -9.1% was quite meaningful for investors that sustained equity losses close to 40%.

Diversifying Portfolios

The most common and familiar role of fixed income is its ability to diversify a portfolio by offsetting the expected volatility of equities and other investments. Broadly diversified fixed-income portfolios consisting of U.S. Treasuries, credit instruments and mortgages have historically been uncorrelated to the gains and losses of equity markets. In a diversifying role, the fixed-income allocation (often 30-50% of the total portfolio) provides a degree of safety and modest, positive returns. The investment-grade fixed-income market, defined by the Barclays Capital (BC) Aggregate Index, did provide protection for investors in 2008, as it rose 5.2% (the S&P 500 Index fell 37.0%). Detail on the BC Aggregate Index return, however, illustrates the significant differences between the individual sectors that constitute that Index.

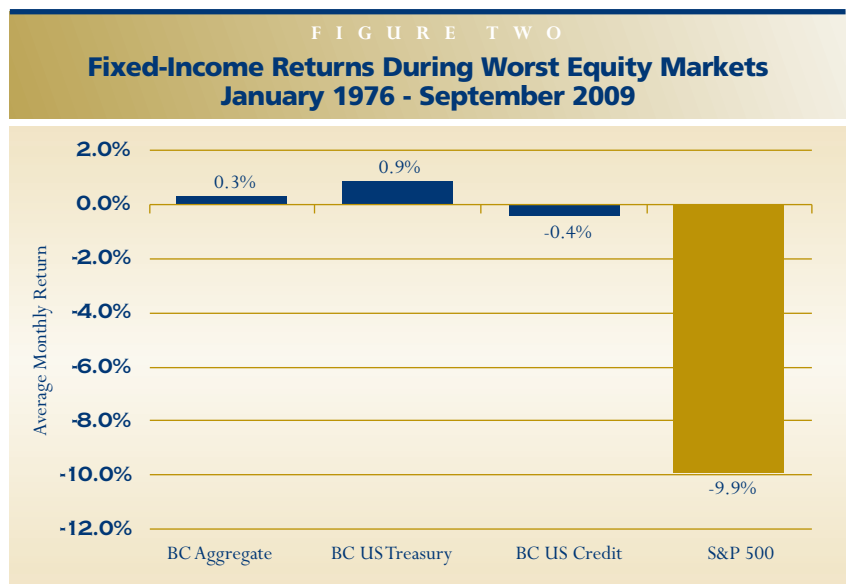
Figure One shows the 2008 calendar-year returns, by sector, of the BC Aggregate Index. U.S. Treasuries performed best, generating a positive return of 13.7%. Mortgage-backed securities (MBS issued by Fannie Mae or Freddie Mac) also protected capital well, gaining 8.3%. The other three sectors (corporate bonds, ABS and commercial MBS), however, failed to protect capital – and sustained losses. This is not new or surprising. U.S. Treasuries are considered to be the minimum-risk asset of choice for most global investors. During times of stress, investors typically sell risky assets (including equities and bonds with credit risk) and rush to purchase assets with minimal risk. This so-called “flight to quality” has historically resulted in higher prices, and therefore positive performance, for U.S. Treasuries during periods when equities have declined.

The “flight to quality” trend may hold an opportunity for investors that use fixed income in a diversifying role. The broad fixed-income market is relatively uncorrelated with equity markets, but the



U.S. Treasury sector has historically shown less correlation with equities than with corporate bonds. (As a reminder, a lower correlation results in better diversification properties.) Investors could choose to hold only U.S. Treasuries in their fixed-income portfolios instead of investing in the broad market. A U.S. Treasury-only allocation provides better liquidity and better protection during times of equity market stress. Figure One illustrates this concept in 2008, but it is not limited to recent experience. Figure Two shows the average monthly returns for the broad fixed-income market,

* Represents the sector's weight in the BC Aggregate Index as of December 31, 2008



U.S. Treasuries and credit instruments from January 1976 to September 2009 during the worst 20 months (representing the worst 5% of all months) for equities. U.S. Treasuries have enhanced portfolio diversification by generating positive returns during times of stress in the equity markets.

The additional downside protection of holding only U.S. Treasuries in the fixed-income portfolio comes at a cost; U.S. Treasuries are likely to underperform spread sector bonds on a stand-alone basis.

U.S. Treasuries generally have a lower yield and a lower total return, reflecting their lower risk. The cost of investing solely in U.S. Treasuries is likely to fluctuate as the characteristics of the fixed-income market, primarily credit spreads, change over time. Credit spreads spiked in late 2008 and remain above long-time averages. As a result, it may not be an opportune time to implement a U.S. Treasury-only strategy. The evolving nature of the fixed-income markets means that investors should monitor current market conditions to ensure they are using the most efficient method for diversifying portfolios that are primarily invested in equities.

Risk-Adjusted Return Strategies

When portfolios are invested more heavily in fixed income than in equities, it might make sense to consider a risk-adjusted return approach. This involves diversifying the fixed-income exposure by sector, maturity and quality. A diversified fixed-income portfolio is less volatile than a concentrated approach (including a U.S. Treasury-only portfolio), as many of the prominent fixed-income sectors are relatively unrelated to one another. Different fixed-income sectors are exposed to common risk factors, including interest rate risk and inflation risk, as well as unique risk factors like credit risk (corporate and ABS) and prepayment risk (MBS). Unique risk factors compound the asymmetrical risk profile of fixed-income securities (an investor can lose up to 100% if the bond issuer defaults), so it is important to limit the exposure to any one issuer. Sectors that

are exposed to different risk factors tend to diversify one another. Broadly diversified exposure to these sectors offers the potential to generate higher returns with less volatility than a more concentrated portfolio could offer.

Yield

Investors that are primarily concerned with yield can invest in a diversified portfolio of spread sector bonds. The spread sectors typically offer higher yields than U.S. Treasuries, albeit with higher risk. Taxable investors searching for yield can consider tax-exempt bonds, including municipal securities, as a source of non-taxable income, pursuant to advice from tax counsel. High-yield securities can enhance the yield of the portfolio overall, but these securities are issued by less stable companies – and are typically subject to a higher level of default risk. In each sector, the search for higher yields must be balanced with strong risk management practices. Investing for yield incurs more risk than a diversifying or total return strategy, so portfolios should be very broadly diversified with respect to the following characteristics: issuer, credit quality, sector, maturity and sensitivity to interest rates.

Liquidity

Fixed-income portfolios can also serve as a source of liquidity for investors. Investing for liquidity can be either a permanent strategy or a temporary initiative designed to accomplish a specific goal. In either circumstance, liquidity-conscious investors should consider debt issued by the U.S. Treasury and other agencies backed by the full faith and credit of the U.S. Government. Those bonds are of the highest quality and generally trade in deep, liquid markets. Significant depth in fixed-income markets ensures that investors can find a buyer willing to pay a competitive price at any time.

Temporary liquidity-driven investors can create a procedure to isolate a portion of the portfolio's assets in order to guarantee their availability for a



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specific project or initiative. For example, a major construction project can be financed by establishing a temporary pool of highly liquid, fixed-income securities to meet the expected costs. The investor would transfer assets into this pool and purchase high-quality bonds in advance of the planned spending.

Hedging Inflation

Inflation poses one of the most significant risks for fixed-income investors. Most bonds pay a fixed coupon and a predetermined principal amount upon maturity. Unexpected rises in inflation diminish real fixed-income returns and can even result in inflation-adjusted losses. U.S. Treasury Inflation Protected Securities (TIPS) are designed to provide a guaranteed real yield if held to maturity. Investors concerned about the potential impact of inflation on fixed-income returns should consider an allocation to TIPS.

Meeting Liabilities

Assets are often set aside to meet future liabilities, such as the future benefit payments that a pension plan owes to retirees. In liability-driven portfolios, it is imperative to establish the objectives and benchmarks for the fixed-income assets. The goals of a liability-driven portfolio are often different from the goals of typical fixed-income investors. While most investors think in terms of risk-

adjusted returns, liability-driven investors must focus on the value of the assets relative to the liabilities. In this context, assets that sustained a 10% loss may be considered successful if the liabilities decreased by 15%. This requires a change in the mindset of the average investor. It is best to document the goals and appropriate benchmarks (which may include the ratio of assets to liabilities) at the outset of such a strategy.

In a pension portfolio, the fixed-income allocation is often invested in long-duration, high-quality corporate bonds. This helps to offset the value of the liabilities, which are typically discounted using a long-duration, high-quality corporate yield curve. As the yield curve changes, the market value of the assets and liabilities should change similarly. The funded ratio of the plan, therefore, will be more stable due to asset/liability matching.

Conclusion

The market environment surrounding the credit crisis of 2008 should be a strong reminder that not all fixed-income strategies are the same. Investors should take this opportunity to evaluate the role of fixed income in their portfolios, and invest accordingly. Yanni Partners, a Division of GBS Investment Consulting, LLC, helps clients to formulate fixed-income strategies to meet their organizational needs.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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