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IN THIS
ISSUE

An analysis
of the fixed
income
market's
prospects.

MEASURING UP

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Prospects for Fixed Income: *How Fixed and How Much Income?*

The equity market's precipitous decline and geopolitical turmoil have prompted many investors to seek the solace of fixed income.

During the past three years, high quality fixed income sectors have generated double-digit returns, in contrast to the double-digit losses sustained by the equity market.

The sharp drop in interest rates has sparked the fixed income market's strength. Interest rates have plummeted to levels that generations of investors have never witnessed. February 2003 U. S. Treasury yields fell to 2.8% for the five-year note and 3.8% for the 10-year bond. February 2003 interest rate levels virtually assure single-digit returns for high quality fixed income for the foreseeable future. This low level of interest rates has profound implications for investors, particularly those with a limited capacity to bear equity risks. Examples of investment pools that generally require high exposures to fixed income are: mature pension plans, funded depreciation accounts of healthcare institutions, reserves of insurance companies, and plant funds of educational institutions. These organizations face difficult choices. Yanni Partners will work with its clients to determine the implications of low interest rates, given clients' unique circumstances. Yanni Partners has analyzed the fixed income market's prospects to help our clients in this endeavor.

Scope of Analysis

We limited our analysis to high quality fixed income. The pursuit of high yields in the fixed income market might induce investors to buy low quality bonds that contain equity-like risks. We restricted the analysis to the high quality sector because investors with a low capacity to bear risk are not able to assume a high degree of credit risk. The U. S. Treasury market serves as a good proxy for the high-grade sector.

The analysis documents the following:

- (a) Historical interest rates across a range of maturities;
- (b) Historical risk and return measures of different maturity groups; and
- (c) Projected returns for different maturity groups given assumed changes in interest rates.

Historical Perspectives and Analysis

The Federal Reserve Board provides historical U. S. Treasury interest rates across a spectrum of maturities starting December 1961. The period from December 1961 to February 2003 encompasses a broad array of economic environments and therefore offers insights into the behavior of interest rates. At beginning of this period, rates were fairly low, reflecting benign inflation. In the mid 1960s, interest rates began a sustained secular ascent, aggravated by the budget pressures from the Vietnam War and later from the inflation fueled by oil shocks in the 1970s. Interest rates peaked in 1981, when the Federal Reserve, led by Paul Volcker, initiated

a pre-emptive strike against inflation by curtailing the growth of the money supply.¹ The Fed accomplished its objective, leading to an extended easing of inflationary pressures.

Figure One plots historical interest rates for three-month, five-year, and 20-year U. S. Treasury instruments from December 1961 to February 2003. Short and intermediate rates have plummeted to 41-year lows.

Figure Two summarizes total returns for U. S. Treasury instruments and domestic equities from December 1961 to December 2002. Equities have out-performed fixed income, albeit with substantially more risk, over the entire 41-year span. The relative stability of fixed income becomes apparent when one examines shorter intervals. An example is the three years ended December 2002 when fixed income substantially outpaced equities. The S&P 500 sustained an annualized loss of -14.6% during these three years, in sharp contrast to the double-digit returns of five-year and longer U. S. Treasury instruments. This defensive property of fixed income documents fixed income's value as an equity hedge in a balanced portfolio.

Another characteristic of fixed income emerges from Figure Two — a maturity premium for maturity sectors up to five years. For example, the three-year U. S. Treasury Note produced an annualized total return of 7.3%, compared to the three-month U. S. Treasury Bill return of 6.1%. The three-year Note generated an annualized maturity premium of 1.2%.

Note:
¹ The yield of the five-year U. S. Treasury note peaked at 16.0% in August 1981. As of February 2003, this instrument yielded only 2.8%.

FIGURE ONE
US Treasury Rates: Dec. 1961 to Feb. 2003



FIGURE TWO
Risk and Return Summary for Equities and Fixed Income: Dec. 1961 to Dec. 2002

	S&P 500	US Treasury Instruments					
		3-MONTH MATURITY	1-YEAR MATURITY	3-YEAR MATURITY	5-YEAR MATURITY	10-YEAR MATURITY	20-YEAR MATURITY
DECEMBER 1961 TO DECEMBER 2002							
Annualized Return	10.0%	6.1%	6.8%	7.3%	7.5%	7.5%	7.4%
Annualized Standard Deviation	15.2%	0.8%	1.9%	4.1%	5.6%	7.7%	9.5%
Maximum Peak to Trough Loss	-44.7%	0.0%	-1.3%	-6.4%	-11.1%	-17.6%	-21.5%
ANNUALIZED TRAILING DECEMBER 2002 RETURNS							
3 Years	-14.6%	3.6%	5.4%	8.7%	10.3%	12.2%	13.9%
5 Years	-0.6%	4.1%	5.3%	7.0%	7.8%	8.4%	8.7%
10 Years	9.3%	4.4%	5.1%	6.3%	7.2%	8.3%	9.5%
20 Years	12.7%	5.7%	6.7%	8.2%	9.0%	10.2%	11.2%

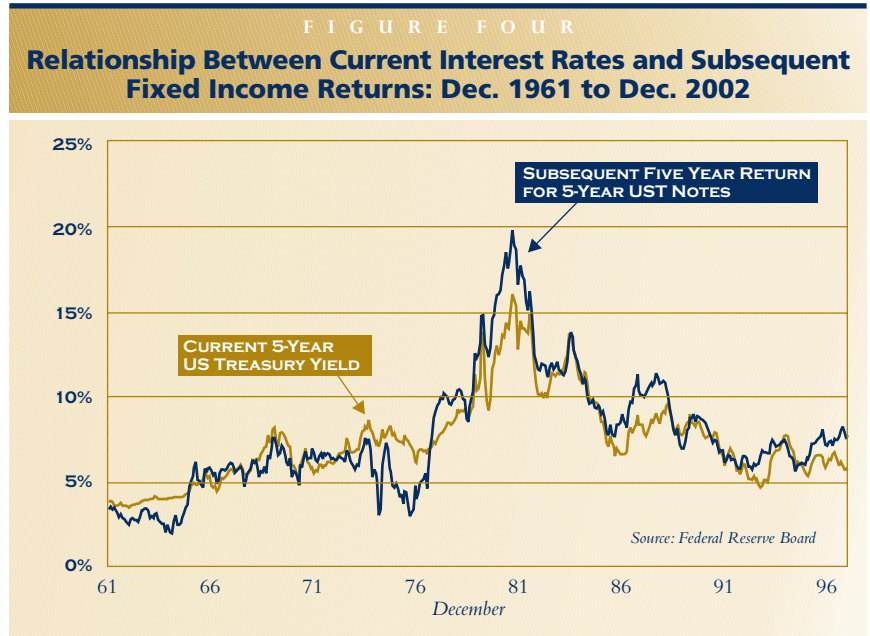
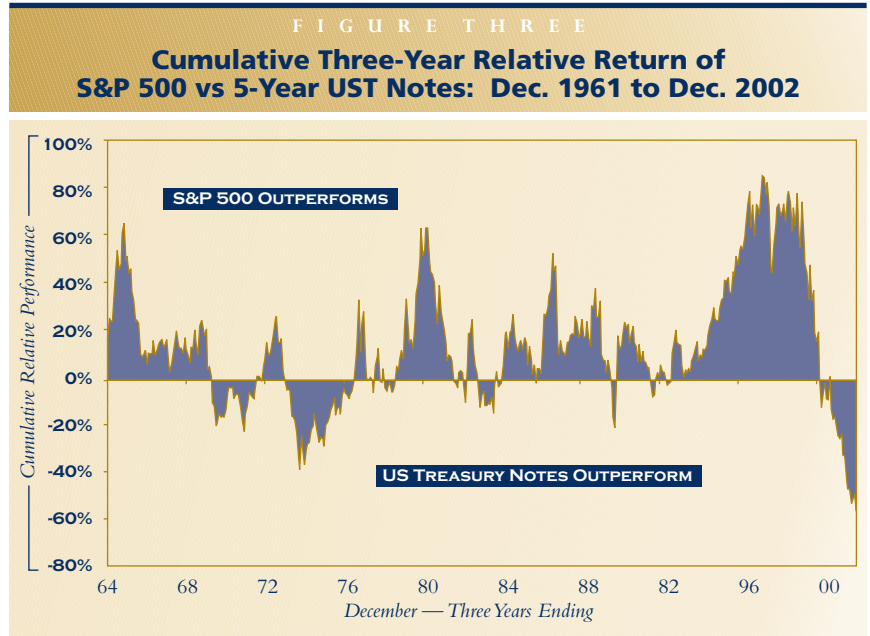
There is no evidence of a maturity premium from these data for instruments with maturities beyond five years. Moreover, maturity sectors beyond five years subjected investors to higher volatility without incremental returns. The relatively unfavorable risk/return pattern beyond five years does not suggest that investors should avoid long-term fixed income instruments. Investors that need to fund long-dated contractual or expected liabilities often require long-maturity instruments to hedge interest rate risks. Long-maturity instruments can play a key role in asset/liability management for certain entities. An investor's fixed income strategy therefore depends on the investor's unique requirements.

The superior performance of fixed income, relative to equities, during the past three years has been unprecedented during the past 41 years. *Figure Three* plots the cumulative three-year rolling returns of equities versus fixed income from December 1961 to December 2002. Equities outpaced fixed income throughout the 1990s.

Future Returns

What do these low interest rates portend for the future? Past interest rates have served as a good barometer for future returns. *Figure Four* plots the close relationship between the current interest rate and fixed income total returns for rolling five-year periods since December 1961. For example, as of December 1984, the five-year U. S. Treasury Note yielded 11.0%. During the ensuing five-year period from December 1984 to December 1989, the five-year U. S. Treasury Note produced an annualized total return of 11.4%.

Current low interest rates virtually assure single-digit fixed income returns for the foreseeable future. This is a mathematical reality. Moreover, low returns are likely to follow regardless of whether interest rates rise or fall. *Figure Five* projects total returns for 5-year, 10-year, and 20-year U. S. Treasury instruments over a five-year investment horizon. *Figure Five* assumes that interest rates change linearly over the investment horizon.



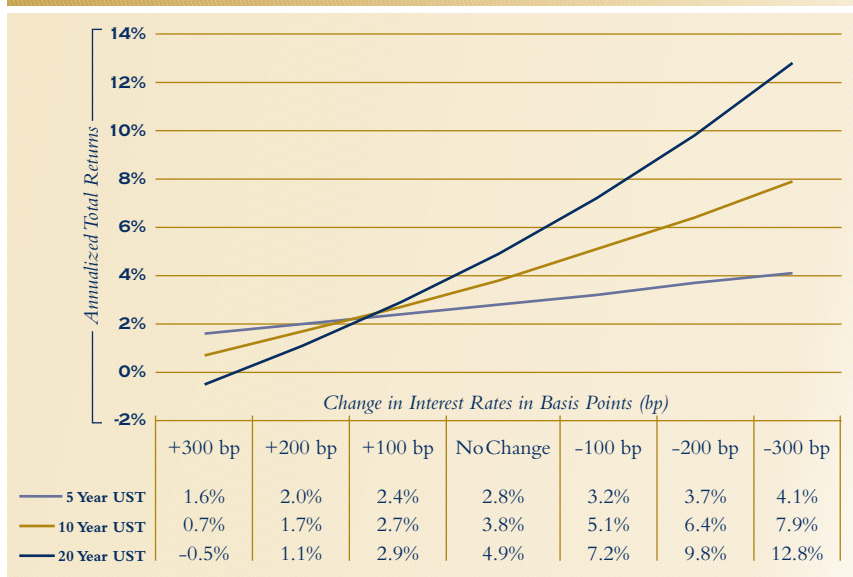
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FIGURE FIVE

Projected Annualized Total Returns of US Treasury Instruments for Five-Year Horizon



Note:

Current 5-Year UST yield is 2.76%. The 300 bp reduction scenario for the 5-Year UST note assumes that yield drops to zero.

Changes in interest rates exert two countervailing effects on total fixed income returns. A rise in rates initially depresses a bond's price, yet it also increases income returns from the reinvestment of coupon income. If the investor holds a bond for a long time, the benefits of higher reinvestment income will more than offset the negative effect of price erosion. The net effect of changes in interest rates on the total return of a fixed income instrument depends on the following factors: magnitude of interest rate change, timing of change, maturity of the instrument, and the investor's holding period.

Summary

The secular decline of interest rates since 1981 has buoyed fixed income returns during the past two decades. Past double-digit rates have provided the foundation for these solid returns. Current rates stand at 41-year lows for most maturity sectors. These low rates virtually assure single digit returns for most maturity sectors for the foreseeable future. Investors who rely on interest income must grapple with the realities of meager returns. Yanni Partners will counsel its clients regarding the appropriate response to these low rates.

Calendar of Events

MAY
19

Yanni Partners
Corporate
Golf Outing

Sewickley Heights
Golf Club
Pittsburgh, PA
May 19, 2003

*Attendance by
invitation only.*

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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