



YANNI
PARTNERS

MEASURING UP

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DELIVERING
THE PROMISE

Living with Low Interest Rates

Focus on Fixed Income

IN THIS
ISSUE

Evaluating the risk and return characteristics of fixed income.

In our Spring 2003 *Measuring Up*, *Prospects for Fixed Income*, we examined the implications of low interest rates. We concluded that, “Current [February 2003] low interest rates virtually assure single-digit fixed income returns for the foreseeable future... regardless of whether interest rates rise or fall.”

In this issue, we extend our Spring 2003 analysis, providing additional perspectives for evaluating the risk and return characteristics of fixed income and the implications of portfolio tactics designed to enhance fixed income returns.

Background

The Spring 2003 *Measuring Up* reported prevailing (February 2003) levels of interest rates. The analysis focused on the U.S. Treasury market as a representative proxy for the overall high-grade domestic fixed income market. As of February 2003, representative rates were 2.8% for the five-year note and 3.8% for the 10-year bond.

As of September 2004, rates remained close to February 2003 levels: 3.3% for the five-year note and 4.1% for the 10-year bond. Current rates hover only slightly above the February 2003 levels. The persistence of low rates limits prospective returns to levels commensurate with current yields.

The Spring 2003 *Measuring Up* documented the close correlation between current yields and prospective returns. We have updated these relationships in *Figure One*. *Figure One* plots historical five-year U.S. Treasury yields since December 1961 and the

FIGURE ONE

Relationship Between Current Interest Rates and Subsequent Fixed Income Returns: Dec. 1961 - Aug. 2004



total return of the five-year U.S. Treasury note for the next five years on a rolling basis. Historical evidence suggests that current interest rates tend to predict future returns.

The outlook for modest fixed income returns raises the following questions:

- Should investors continue to hold fixed income?
- Is it likely that prospective real returns (after the effects of inflation) might differ from prospective nominal returns?
- How can an investor boost returns of the fixed income portfolio? What are the risks of tactics to enhance potential fixed income returns?

Rationale for Fixed Income

Faced with such a modest outlook for returns and the possibility of rising interest rates, many investors approach fixed income with skepticism. Yanni Partners contends that fixed income remains a viable asset class when considered from a total portfolio perspective. Many investors must reconcile the competing demands of long-term capital growth and the need for stability. In traditional portfolios, equities have fueled the long term growth of capital, while fixed income has served as the source of liquidity, income and stability.

Figure Two documents the fixed income market's historical propensity to buffer the portfolio against equity losses. *Figure Two* compares the performance of various fixed income indices relative to equities during severe market declines from August 1987 through September 2002. The two high-quality fixed income series are the seven-year U.S. Treasury note and the Lehman Brothers Aggregate Index. The below investment-grade fixed income series is the CSFB HighYield Index. This analysis highlights four periods of major equity declines. High quality fixed income has provided modest to substantial returns during equity market downturns. Below investment-grade fixed income suffered moderate losses during these equity market downturns. The below investment-grade fixed income losses reflect the substantial degree of credit (equity) risk inherent to this fixed income sector. High quality fixed income has overwhelmed low quality fixed income as an equity hedge during past periods of

FIGURE TWO

Cumulative Returns of Fixed Income Quality Sectors Periods of Equity Market Declines

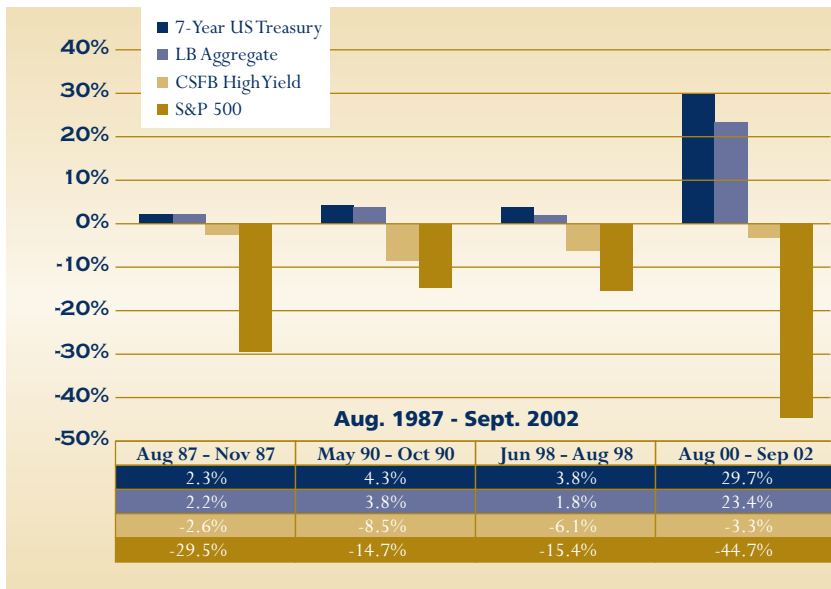


FIGURE THREE

Nominal and Real Intermediate US Treasury Returns Five-Year Trailing Results: Dec. 1925 - Dec. 2003



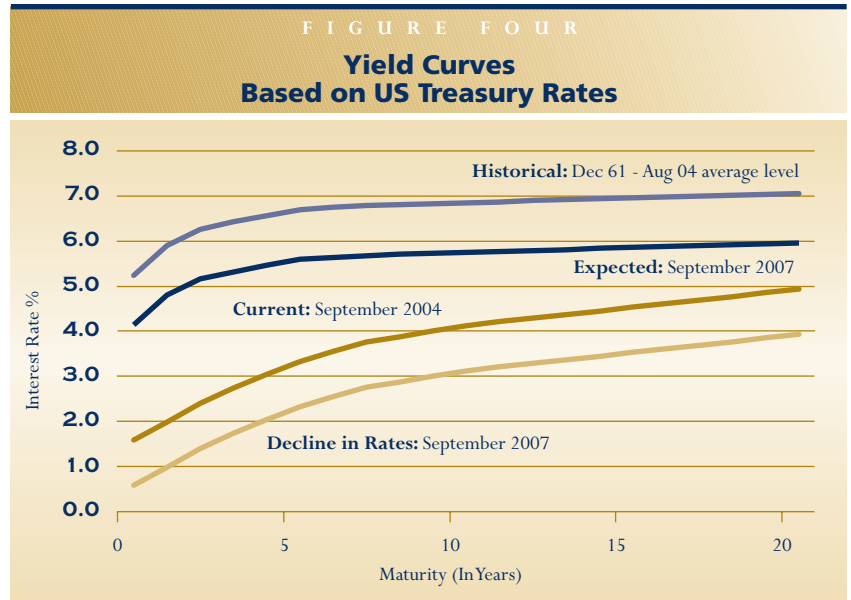
equity market stress. This analysis reinforces the importance of high quality fixed income for total portfolio risk control purposes.

Prospects for Real Returns

Real (inflation adjusted) fixed income returns could deviate significantly from nominal returns in the event of material levels of inflation or deflation. *Figure Three* compares five-year rolling nominal and real returns for intermediate U.S. Treasury notes from December 1925 to December 2003. The analysis begins in 1925 to incorporate the last period in U.S. history of deflation. Deflation occurred during the early 1930s. High quality fixed income (particularly the U.S. Treasury sector) hedged deflation well because of the fixed nominal cash flows. During the 1930s, real returns of high quality fixed income instruments significantly outpaced nominal returns due to declines in the overall price level of the economy. Fixed income sustained real losses in the late 1940s and during the 1970s, when the U.S. economy experienced bouts of increasing inflation. Although many economists expect relative stability in the price level for the foreseeable future, one cannot rule out the risks of severe inflation or deflation. Future real returns might therefore differ from the modest nominal fixed income returns that current yields suggest.

Tactics to Boost Returns: Benefits and Risks

The U.S. Treasury yield curve is relatively steep as of September 2004. The one-year instrument is yielding approximately 2.0%; the 10-year instrument is yielding 4.1%. The investor can clearly enhance current yield by extending the portfolio's average maturity (duration). The tradeoff is additional risk as longer maturities subject investors to potential price declines. Does the incremental yield from longer maturity instruments compensate investors for the risk of potential price declines? *Figure Four* plots historical, current and prospective yield curves to address this risk and return analysis. The historical yield curve encompasses the period



from December 1961 to August 2004. *Figure Four* shows two potential yield curves: (a) a higher yield curve based on Gianni Partners' capital market assumptions, and (b) a lower yield curve assuming a parallel downward shift of 1.00% (100 basis points). These two prospective yield curves assume that interest rates move evenly during the next three years.

FIGURE FIVE
**Annualized Returns of
US Treasury Instruments**

US Treasury Maturity	Five-Year Horizon		
	1 Year	5 Year	10 Year
Rates Increase	3.5%	3.0%	2.8%
Rates Remain Constant	2.0%	3.3%	4.1%
Rates Decline	1.5%	3.5%	5.2%

Figure Five displays future returns for three U.S. Treasury maturity categories during the next five years based on three yield curve scenarios: an expected increase, no change and a decline.

The analysis suggests that the five-year U.S. Treasury note balances risk and return prospects given the potential for various shifts in interest rates. The ten-year instrument offers incremental yield with the risk of significant price erosion. In summary, the market does not appear to offer a compelling incentive to increase duration.

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Yanni Partners

310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302

FIGURE SIX

Long-Term Corporate Credit Spreads December 1961 - August 2004

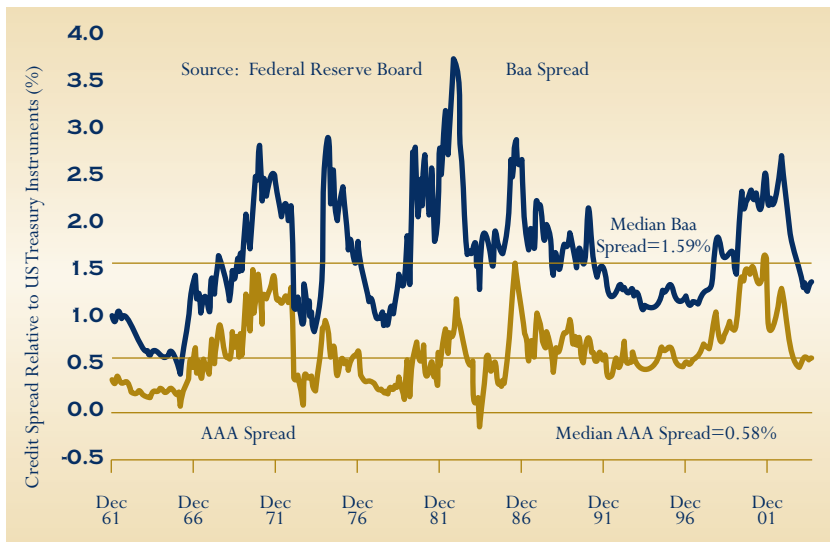


Figure Six plots credit spreads of high-grade (AAA) and medium-grade (Baa) long-term corporate bonds relative to long-term U.S. Treasury instruments from December 1961 to August 2004. Credit spreads have fluctuated significantly over time. The recent spike in spreads from 2000 to 2002 has subsided. The current Baa spread falls below its long-term average. The current AAA spread rests at its historical average. Current credit spreads do not provide investors with incentives to reduce portfolio quality levels.

current shape of the yield curve does not provide a compelling reason to extend duration. The modest credit spreads do not provide sufficient reward to degrade portfolio quality. Regardless of how the capital markets and economic environment unfold, high quality fixed income will likely continue to play a vital role in a balanced portfolio to protect against episodes of equity market losses. Yanni Partners will advise each client of the appropriate fixed income portfolio strategy based on each client's unique circumstances.

Conclusion

The persistence of low interest rates presages low prospective nominal fixed income returns. The challenge for investors is further compounded when considering that real returns might differ from nominal returns in the event of material inflation or deflation. The risks of investing in fixed income today can be mitigated with careful attention to portfolio construction. The

Calendar of Events

March 24
2005

Yanni
Partners
Client
Symposium

Pittsburgh Airport
Wyndham Hotel

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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