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WHERE NOW: FIXED INCOME

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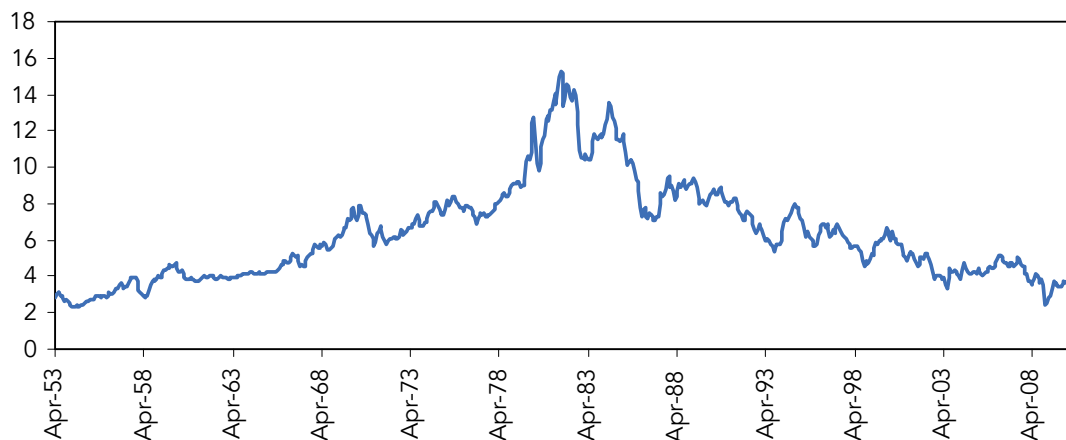
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► PUTTING FIXED INCOME RETURNS INTO PERSPECTIVE

Treasury bond yields have declined dramatically throughout the last 30 years (Chart 1). These significant declines, combined with current monetary and fiscal policy, have resulted in a legitimate debate regarding the future path of interest rates. While many bond strategists have concluded that the fixed income market's best days are over, others believe deflationary pressures resulting from the debt crisis will prevail for years to come. Of course, no one knows what will happen during the next several years, and such uncertainty raises an important question: What constructive role, if any, can fixed income play in your portfolio allocation going forward?

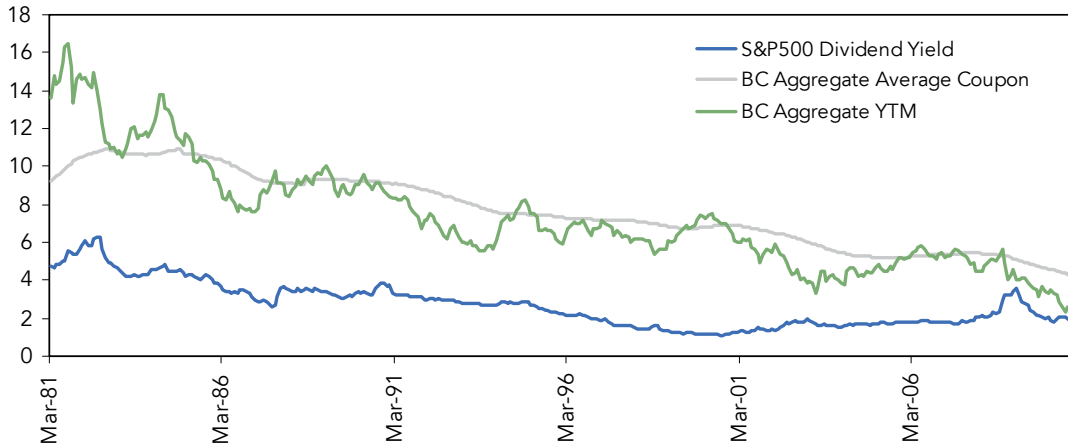
In determining portfolio allocations, an analysis of several scenarios, including a wide range of possible outcomes that quantify the effect on bond portfolios, may be beneficial. It's important to remember that while interest rate risk receives most of the attention, reinvestment risk poses the greatest overall threat to many investors. Being underinvested, or building a bond portfolio with a maturity structure that is too short, may result in a less-than-adequate income stream in future years. Investors should continue to hold fixed income securities for the same reasons they have in the past, unless their objectives have changed.

► CHART 1 – U.S. TREASURY 10-YEAR YIELD HISTORY

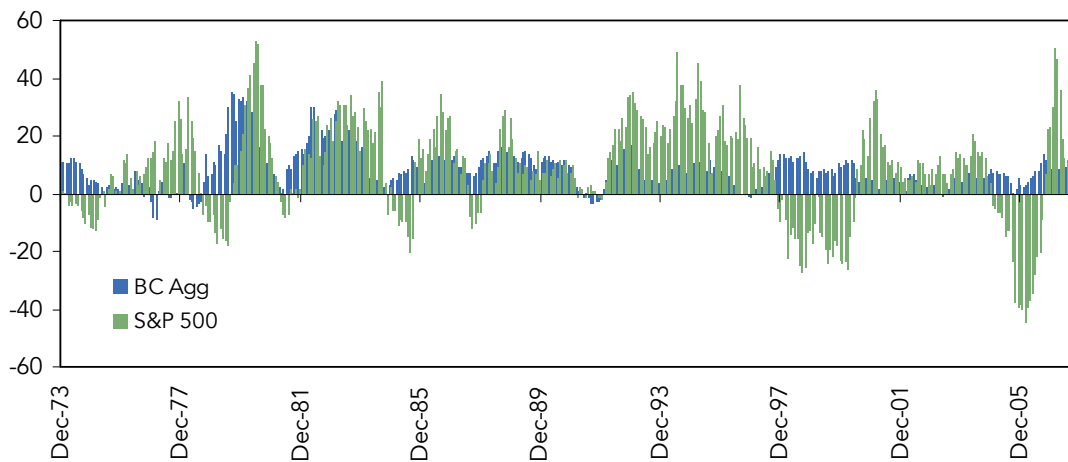


Before we begin the scenario analysis, it's worth reviewing why fixed income assets routinely have been a component of most investment portfolios. Since 1980, rate levels and volatility have led to an increased use of fixed income instruments as speculative tools. But, the more common and appropriate role of bonds is to provide income, preserve capital, and provide liquidity. Regardless of future interest rate movements, fixed income will remain the asset class best suited to pursue these objectives. With respect to income, comparing the yield-to-maturity of the Barclays Capital U.S. Aggregate Bond index to the dividend yield of the S&P 500 demonstrates a bond portfolio will provide a higher and more reliable coupon stream to meet ongoing cash-flow needs (Chart 2). Regarding market value stability, the total return history of these two widely followed indices indicates U.S. large cap equities' annualized standard deviation of return is approximately three times as large as that of the aggregate bond index. In addition to being more stable, higher-quality bonds have performed well when riskier asset classes have declined in value (Chart 3).

▶ CHART 2 – YIELD HISTORY



▶ CHART 3 – BC AGGREGATE / S&P 500 12-MONTH TOTAL RETURN



In addition to their traditional objectives of income, safety, and liquidity, fixed income allocations have increased in recent years due to their effectiveness in liability immunization. In particular, plan sponsors are seeking to better match assets and liabilities to manage the impact of benefits obligations on the income statement. Although bonds may not be the best source of return for plan sponsors, they are the best instrument for matching the changes in market value of their liabilities.

Since the inception of the Barclays Capital U.S. Aggregate Bond index in 1976, calendar-year total returns have been positive in all but two years. Surprisingly, the negative returns did not occur during the dramatic rate increases of the late 1970s and early 1980s, but in 1994 and 1999, at -2.92% and -0.82%, respectively. It's worth noting that the Barclays Capital U.S. Intermediate Government/Credit index, a benchmark with a lower duration than the aggregate index, has had only one negative year since its inception in 1973. In 1994, the index returned -1.93%. The Barclays Capital 1-3 Year U.S. Government/Credit index has never had a negative annual total return in the 35 years since its inception.

The worst 12-month period for the aggregate index occurred in 1980, when the Federal Reserve's control of the money supply pushed the overnight federal funds target rate to more than 20%. The 12-month total return of the aggregate index as of March 1980 was -9.21%. Interestingly, after a positive return of 11.33% in the following month, the 12-month total return as of April 1980 was +1.24%.

It's worth emphasizing that if interest rates rise, coupon returns subsequently increase. And the higher yields climb, the more dramatic this effect becomes going forward, particularly if a bond is held to maturity. Regardless of a bond's yield-to-maturity at the time of purchase, if rates increase throughout the life of the bond, the realized compound yield of the security increases proportional to the rate increase. The reinvestment of coupons—and principal in the case of securitized bonds such as mortgage-backed securities—at higher prevailing rates increases the security's return throughout the holding period. This may seem counterintuitive, but once you purchase a bond and if you can hold it to maturity, the best thing that can happen to maximize the bond's holding-period return is for interest rates to rise quickly and sharply.

Using a scenario analysis framework, we can quantify the effect of a dynamic interest rate environment. The table below summarizes various outcomes. Although an instant sharp rise in interest rates is not a practical assumption, it represents the worst-case scenario. But, even with an immediate and dramatic rate increase of +300 basis points, the total return of a bond portfolio benchmarked against the Barclays Capital U.S. Aggregate Bond index would decline a manageable -10.39% over a one-year horizon. Extending the investment horizon to three years results in a holding period return of -1.62%, or an annualized return of -54 basis points. A 200-basis-point increase during a 36-month horizon, which would represent a doubling of the current five-year Treasury rate, has a holding period return of +3.04%. Additionally, it's important to remember that in maintaining exposure to fixed income, you continue to realize the three most important characteristics of bonds: income, safety and liquidity. It's also important to note that the results of an adverse rate scenario would be even more benign for portfolios managed to benchmarks with lower durations and more rapid re-pricing characteristics than the Barclays Capital U.S. Aggregate Bond index.

► **BENCHMARK TOTAL RETURNS: SCENARIO ANALYSIS**

Investment Horizon / Rate Change	-100	-50	-25	100	200	300
12 months	9.004	6.632	5.414	-0.816	-5.713	-10.39
24 months	13.269	10.909	9.697	3.497	-1.383	-6.051
36 months	17.63	15.28	14.07	7.903	3.044	-1.602

Reducing fixed income exposure in favor of alternative asset classes provides no guarantees. While consensus suggests there's a negative correlation between equity prices and bond prices, history demonstrates an unstable relationship. Throughout the last 45 years, using the rolling 120-day moving average, the full period correlation between stocks and bonds is -0.12, with a maximum value of 0.744 and a minimum value of -0.743. Interest rates can fall as a result of declining inflation or decelerating growth. On the other hand, rates may rise as a result of healthy demand or accelerating inflation. Each of these scenarios may result in different outcomes for stocks and

commodities. In the 1970s, when rates were rising, stock prices increased minimally. In the 1980s and 1990s, rates declined, and stocks experienced some of the most significant increases in history. In the first decade of the 21st century, bond yields fell, and so did stock prices.

Hedge funds using market neutral strategies experienced significant return volatility in the summer of 2007 due to market dislocations and a lack of liquidity. Likewise, bond managers who incorporated unconventional sources of risk experienced significant declines in total returns during 2007 and 2008.

► **IN CONCLUSION**

In conclusion, because we never will know with certainty the future path of interest rates or the return of alternative asset classes, we believe investors can and should rely on fixed income to satisfy the same objectives they traditionally have pursued.

► **S&P 500 VS. BOND YIELDS – BY DECADE**

	Jan-70	Jan-80	Jan-90	Jan-00	Jan-10
Tsy Yld 10 yr	7.862	10.662	7.984	6.515	3.817
S&P 500	93	106.52	352.2	1441.47	1132.99
Rate Changes		280	-268	-147	-270
Price Changes		14	246	1089	-308

► **LARGE RATE CHANGES**

	May65- Dec69	Dec69- Mar71	Mar71- Sep75	Jan00- May03
Δ Tsy Yld 10 yr	365	-235	295	-329
%Δ S&P 500	4.10%	9.00%	-16.40%	-30.90%

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Our founding team started managing institutional assets in 1989, using the same sound, proven fundamental principles we continue to use today. For more than 20 years, 100% of our resources have been focused on managing institutional investment portfolios. We continually enhance our research, fine-tune our quantitative models and advance our technology, data sources and trading platforms.

We are confident our philosophy will continue to be successful in the future, given our time-tested and proven process of stock selection and risk control.

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