Tim Anderson, CFA, Chief Fixed Income Officer January 13, 2010

Fixed Income Navigator – Fourth Quarter Review

The "riskier" sectors of the fixed income market ended 2009 with another quarter of impressive returns, although the quarterly return momentum has consistently slowed since the second quarter. High yield had a record year, with a 57.5% total return (price change + coupon income), exceeding the previous record of 39.2% in 1991. Corporate bonds turned in an equity-like performance, up 19.8%, although returns were held back by a sharp increase in longer-term Treasury yields. The 10-year Treasury yield backed up 1.63%, to 3.84%, leading to a loss of almost 10%, a sharp reversal from its 20% gain during 2008. This was the worst return for 10-year Treasuries in at least the last 20 years, even worse than 1994's 8.3% loss, when the Fed raised the Fed Funds Rate from 3% to 5.5% and the 10-year yield jumped from 5.8% to 7.8%.

Fourth-Quarter Portfolio Adjustments

1. **Shortened portfolio durations.** We made some minor changes to our fixed income positioning during the fourth quarter. We've had a 0% weighting to U.S. Treasuries (since March), agencies (since April), and mortgage-backed securities ("MBS," [since May, except the conservative portfolios, in which we are strongly underweight]). We still believe that investment grade corporate bonds offer the best value within the Traditional Fixed Income sector, but we have been lowering our exposure to the asset class by continuing to shorten our maturities/durations. Most of our corporate bond holdings now have maturities inside five years (with the exception of some remaining exchange-traded fund [ETF] exposure). While we believe corporate bonds still offer good relative value (versus Treasuries), spreads have now tightened to levels consistent with past economic recoveries and are unlikely to provide much of a cushion against an eventual increase in interest rates without having a negative impact on their prices.[1] Our portfolio durations are now around 3 to 3.5 years, about 1.5 to 2 years shorter than our benchmarks.
2. **Reduced emerging market debt and increased high yield.** We remain neutrally weighted to alternative fixed income, but we moved to a slight underweight to emerging market debt and a slight overweight to high yield bonds. The high yield default rate has likely peaked at around 13% and market consensus is that it will fall sharply during 2010 to around 4.5–5.5%, near its long-term average. We believe that this is a reasonable assumption, as we expect corporate earnings to recover sharply and the capital markets remain receptive to even the "junkiest" issuers, allowing them to refinance maturing debt at attractive yields. In contrast to improving corporate credit metrics, sovereign/municipal balance sheets continue to deteriorate and are likely to do so as long as unemployment remains high. In general, we have a preference for corporate credit over sovereign credit and revenue bonds over state/local government bonds.

2009 Fixed Income Returns – Value of Active Fixed Income Management

Returns. The chart below shows quarterly and full year returns for various sectors of the fixed income market, some of which exceeded the S&P 500's 2009 gain of around 26.5%. The contraction in risk and liquidity premiums, as well as large purchases by the Federal Reserve (Quantitative Easing) has now taken spreads (yield premium above Treasuries) on agencies back to normal levels and spreads on agency-backed MBS to record lows. We remain negative on these two sectors and maintain 0% weightings in most of our portfolios. Spreads on corporate and high yield bonds are now at levels consistent with past economic recoveries. Further gains in these sectors will likely be much more muted going forward, and their ability to withstand rising Treasury yields is much reduced. Returns going forward will likely be driven much more by coupon payments than capital appreciation; we think high yield still has a reasonable shot of earning its coupon in 2010, while corporate bonds may have a more difficult time doing so.

Value of Active Fixed Income Management. The total return for the broad fixed income market — comprised of a blend of Treasuries (31%), Agencies (14%), MBS (34%), and investment grade corporate bonds (21%) — was 5.2% in 2009. The broad market returned 6.2% during 2008, although the performance of Treasuries (+14%) and Corporates (-7%) were basically flipped. By actively overweighting/underweighting various sectors of the traditional fixed income market, and tactically adding exposure to alternative fixed income sectors (high yield and emerging markets) instead of passively investing in the broader market, investors have the opportunity to add substantial value to their fixed income allocations over time.

[1] In a rising interest rate environment, the value of fixed-income securities generally declines.

	1Q09	2Q09	3Q09	4Q09	2009	1Q09	2Q09	3Q09	4Q09	2009	12/31/2009	
	Total Return (%)					Yield Change (bps)						Yield
10-year Treasury	-2.72	-6.19	2.58	-3.55	-9.71	45	87	-23	53	163		3.84%
Broad Market (Govt, Corp, Mtg)	0.10	1.50	3.56	0.03	5.24							
	Total Return (%)					Change Risk Premium (bps)					Risk Premium	Yield
Agencies	-0.34	-0.22	1.68	-0.20	0.90	-6	-48	-1	-4	-53	28	2.22%
MBS	2.23	0.61	2.31	0.51	5.76	-78	-48	-9	-16	-151	14	3.65%
Corporates	-1.43	10.82	8.32	1.22	19.76	-18	-255	-96	-45	-414	190	4.89%
High Yield[1]	5.02	23.19	14.82	6.04	57.51	-109	-648	-262	-154	-1,173	639	9.08%
BB	8.28	15.26	11.24	4.59	45.21	-194	-330	-227	-82	-833	473	7.57%
B	4.00	21.90	11.11	4.81	47.64	-122	-567	-218	-155	-1,062	597	8.59%
CCC	-0.05	41.27	26.26	10.38	96.79	92	-1,441	-393	-259	-2,001	1,000	12.53%
Emerging Markets[2]	3.29	10.07	10.22	1.55	27.24	-62	-187	-100	-35	-384	274	6.27%
Preferreds	-23.19	33.73	12.30	4.10	20.07	107	-428	-167	-60	-548	225	6.48%
Munis	4.43	2.73	8.07	-1.27	14.45	-78	-88	-58	-23	-248	0	3.72%

Source: Merrill Lynch; Past performance is no guarantee of future results.

1. High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.

2. Investments in international and emerging markets securities include exposure to risks, including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

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