



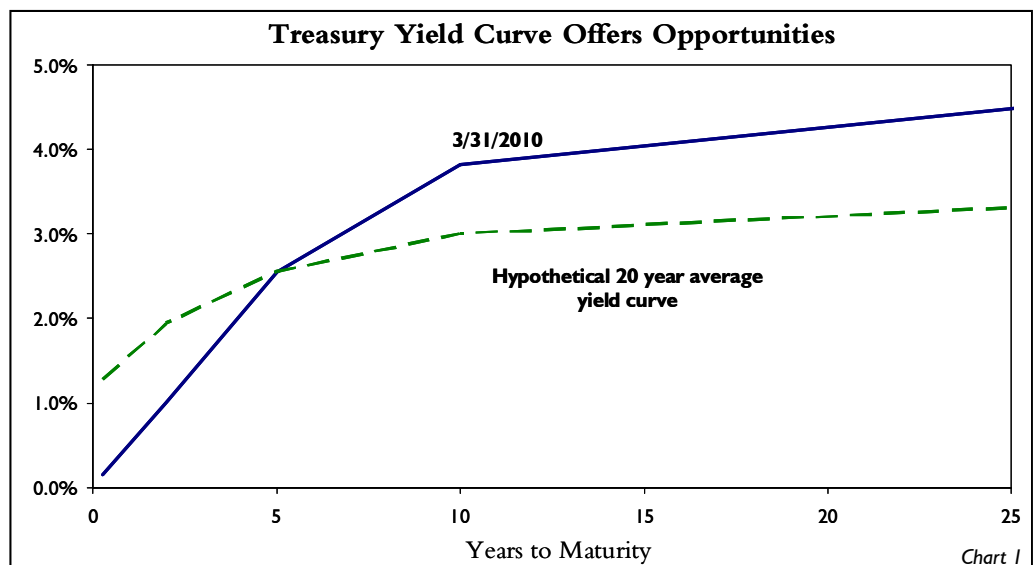
Rolling Down a Steep Yield Curve and Other Strategic Thoughts

The most dramatic event in the 2009 fixed income markets was the historic reversal of credit spreads from their all time wides in 2008 and early 2009. This spread tightening has continued during the first quarter of 2010. With corporate bond spreads returning to more normalized levels, where will fixed income investors look to provide strong returns in 2010? Different market cycles offer unique opportunities for investors. Currently, the steep yield curve is offering patient investors an opportunity.

With the Federal Reserve still targeting Federal funds near 0%, the short end of the Treasury yield curve is firmly anchored. At the end of the first quarter of 2010, the spread or yield differential between the 2 year note and the 10 year note stands at 280 basis points and the spread between the 5 year note and the 10 year note is an eye popping 128 basis points. Historical averages for these two parts of the yield curve are substantially lower. The 2 to 10 year note spread has averaged 125 basis points over the past ten years and the 5 to 10 year note spread has averaged 63 basis points over the same time frame.

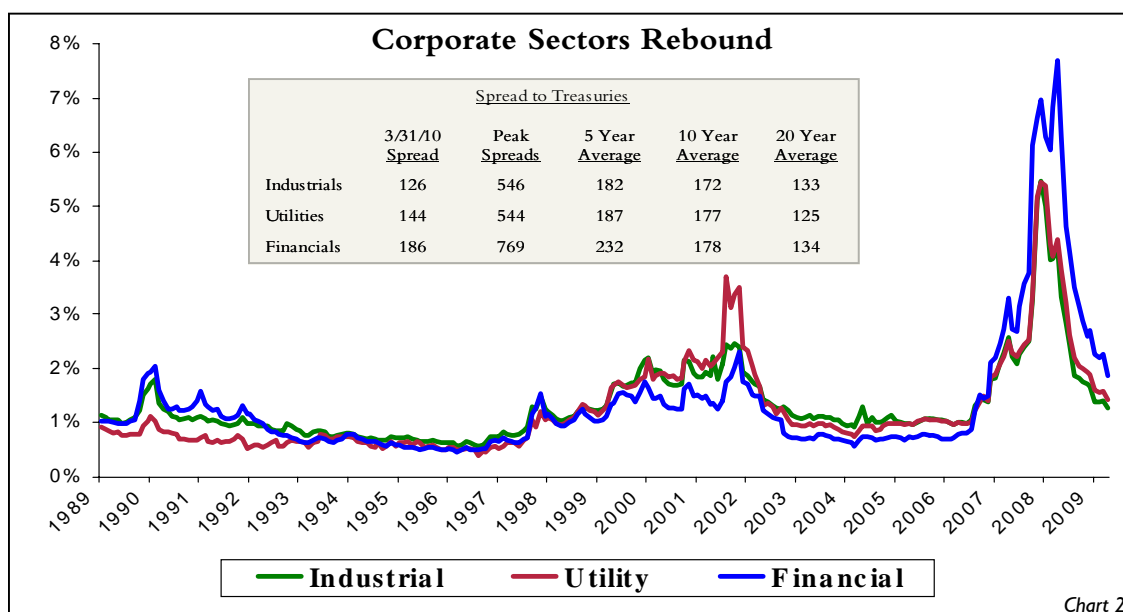
Since the Federal Reserve is currently on hold and giving no indication that they will raise rates in the near term, we believe the yield curve will stay steep for awhile. Additionally, the Federal Reserve will probably decide to exit a number of stimulative strategies before they begin to raise short term rates. The Fed is reducing liquidity in the system by starting to remove the quantitative easing that they have undertaken over the last year and a half. This process will be slow and should give fixed income investors time to take advantage of the steepness of the yield curve. A popular strategy to implement during unusual yield curve steepness is known as “rolling down the yield curve.” In this strategy, investors purchase bonds along the steepest part of the yield curve and as time passes they “roll down the yield curve.” As the bonds move down the curve, they are priced at subsequently lower yields and therefore higher prices. We currently believe that non-callable securities purchased in the 3 to 9 year maturity range offer the best “roll.” As long as the yield curve is either steep or even normally sloping (see Chart 1), this strategy will add to the total return of our accounts.

A steep yield curve historically has been an excellent economic indicator of an improving economy. In this environment, many investors implement a yield curve strategy which would structure a portfolio in a barbell fashion where the maturities of the securities are concentrated in two extremes, one in the short end and the other in the long end. This strategy tends to outperform when the yield curve flattens. In that vein, we are reinvesting cash flows in longer maturity Treasuries. These recent trades have moved our neutral stance in the long end to a modest overweight, consistent with the barbell concept.



We have continued to replace intermediate maturity Treasuries with non-callable corporate bonds. The reasons are simple. First the break-even analysis on shorter maturity corporate bonds versus U.S. Treasury securities is compelling. For example, a Caterpillar bond maturing in five years is currently being offered at a spread of 65 basis points over the 5 year Treasury. Over the next year, for this corporate bond to underperform versus the 5 year Treasury, the spread on the corporate must widen by 20 basis points or more. Given where corporate spreads are today, this analysis makes the corporate sector look the most attractive in the steepest part of the curve. This also leads us to currently underweight agency mortgage-backed securities because they do not “roll” down the curve. Agency MBS do not have a fixed maturity—rather their effective maturity ebbs and flows with changing prepayment assumptions.

Even though spreads on non-Treasury securities have compressed dramatically from their wides in 2008 and early 2009, we believe many corporate securities still represent good value (see Chart 2). While we have not been adding to longer maturity corporate bonds (due to less compelling break-even spreads), we do feel that intermediate maturity corporate bonds have good total return prospects both by spreads continuing to tighten and by having them “roll down the curve.”



Source: Barclays Capital

Fixed Income Data Bank

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Barclays Aggregate	1.78%	7.69%	6.14%
Barclays Int. Aggregate	1.81%	7.40%	6.19%
Barclays Govt/Credit	1.55%	7.51%	5.84%
Barclays Int. Govt/Credit	1.54%	6.92%	5.88%
Barclays I-3 Year G/C	0.89%	4.15%	5.01%
Barclays I-10 Year TIPS	0.85%	6.69%	6.15%

Source: Barclays Capital

As of March 31, 2010

Treasury Market Yields		
	3/31/10	12/31/09
3 Months	0.15%	0.05%
2 Year	1.02%	1.14%
5 Year	2.54%	2.68%
10 Year	3.83%	3.84%
30 Year	4.71%	4.64%