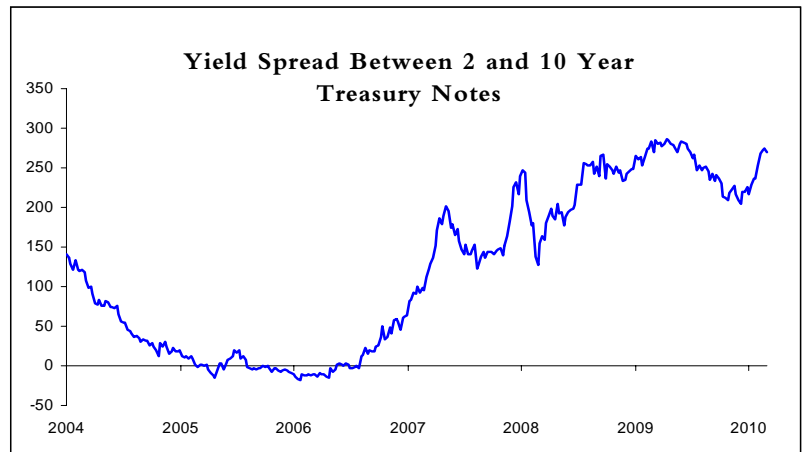




Yield Curve Opportunities

The U.S. Treasury yield curve reached historically steep levels in 2010. Different segments of that curve (which is the relationship between yield-to-maturity and the time-to-maturity) offered bond investors different total return opportunities in 2010 and, looking forward, will again in 2011.

Active fixed income investors often look for total return opportunities along different segments or maturity points of the Treasury yield curve. Take for example the relationship between the 2 year maturity and the 10 year maturity. At the end of the year, that segment of the curve could be measured at the historically steep level of 270 basis points (Chart 1). This spread between 2 year Treasuries and 10 year Treasuries began 2010 at 270 basis points and has fluctuated to as tight a level as 200 basis points this past summer. With the curve taking such a steep shape, “barbell” trades (which benefit from a yield curve flattening) should be considered. For example, a barbell trade of selling the five year Treasury and buying a ten year Treasury (and putting the balance in cash) on a duration neutral basis produced a slight yield advantage even with cash yielding only 0.01% in early November of 2010 (Chart 2). In other words, the unusual steepness of the yield curve allowed investors to position for a flattening curve with no cost! Historically, such barbell trades result in a lower overall yield – which becomes the “cost of waiting for the flattening.” Trades implemented in November had no such yield cost and in many cases (when suitable cash investments could be found with yields higher than 0.01%) resulted in large yield gains for fixed income portfolios.



Source: Bloomberg

Chart 1

| Treasury Barbell Trade | | | At 11/08/10 Yield |
|------------------------------------|-------------|---------------------------------|-------------------|
| <i>Sell:</i> | | | |
| U.S. Treasury 1.25% due 10/31/2015 | \$1,000,000 | (100%) | 1.12% |
| <i>Buy:</i> | | | |
| U.S. Treasury 3.625% due 2/15/2020 | \$ 612,600 | (61.2%) | 2.39% |
| Cash | \$ 388,000 | (38.8%) | 0.01% |
| Total Purchase & Weighted Yield | \$1,000,000 | | 1.47% |
| | | Yield Advantage of Trade | +0.35% |

Chart 2

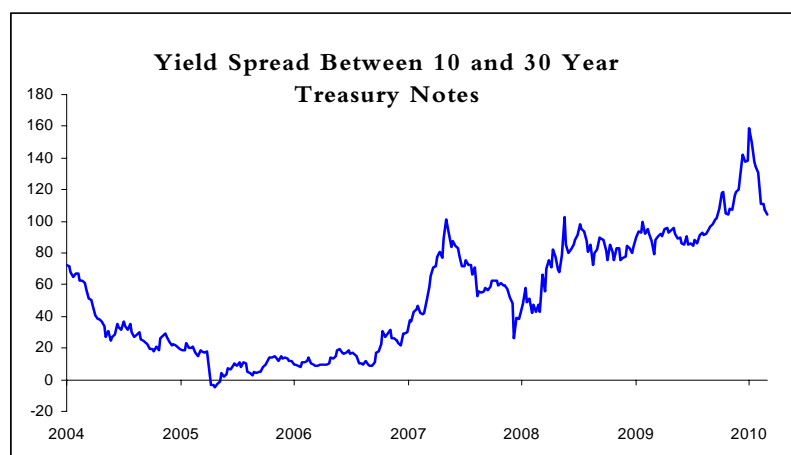
Equally intriguing in the fourth quarter of 2010 was just how steep many of the individual corporate credit curves became. For the first time in our recollection, investors were able to sell shorter maturity corporates in the 3 to 5 year maturity range and buy longer maturity corporates in the seven to nine year maturity range on a duration neutral basis pick up yield (while assuming excess cash is invested at 0.01%). For example, in November an investor had the opportunity to sell Berkshire Hathaway debt maturing in 2013 at a yield of

1.30% and invest in Berkshire Hathaway debt maturing in 2018 at 3.63%, investing the excess cash at .01% and still picking up 29 basis points of yield on the trade (Chart 3). During this time, bond managers were paid to investigate various corporate credit curves because not all credits had individual yield curves as steep as Treasuries or as steep as the Berkshire Hathaway debt curve.

| Berkshire Hathaway Barbell Trade | | | At 12/05/10 Yield |
|--|-------------|---------|----------------------|
| <i>Sell:</i> | | | |
| Berkshire Hathaway 4.625% due 10/15/2013 | \$1,000,000 | (100%) | 1.30% |
| <i>Buy:</i> | | | |
| Berkshire Hathaway 4.05% due 8/15/2018 | \$ 436,000 | (43.6%) | 3.63% |
| Cash | \$ 564,000 | (56.4%) | 0.01% |
| Total Purchase & Weighted Yield | | | 1.60% |
| Yield Advantage of Trade | | | +0.30% |

Chart 3

The “long end” of the yield curve (10 to 30 years) had even more dramatic changes in 2010. At the beginning of 2010, 30 year Treasury bonds were out yielding their shorter maturity 10 year brethren by 90 basis points (see Chart 4). By the middle of the fourth quarter of 2010, that yield advantage had ballooned to almost 160 basis points. Finally, by the end of the year that spread had contracted quickly back to around 100 basis points. Obviously, this curve volatility also provided a big barbell opportunity for investors that bought into that trade with the curve at its steepest. But even now, the “long end” of the curve at 100 basis points is very steep by historical standards.



Source: Bloomberg

Chart 4

As was the case last year, it will be difficult to forecast the shape of the yield curve in 2011. However, being vigilant on possible changes in the shape of the yield curve will again be important for bond investors. Should the yield spread between 2 year Treasuries and 10 year Treasuries return to the steepness of this past November, barbell trades could become relatively “cost free” once again. In addition, should any part of

the yield curve begin to flatten, the barbell trades of 2010 could be unwound. The most unusual thing about the curve steepness in 2010 was that instituting barbell trades was so inexpensive. With the yield curve so very steep, investors are paid while they wait for the flattening.

Fixed Income Data Bank

| Index Returns | | | |
|----------------------------------|-------------|--------------|-------------------|
| | <u>Qtr.</u> | <u>1 Yr.</u> | <u>3 Yr. Ann.</u> |
| Barclays Aggregate | -1.30% | 6.54% | 5.90% |
| Barclays Int. Aggregate | -0.75% | 6.15% | 5.82% |
| Barclays Govt/Credit | -2.17% | 6.59% | 5.60% |
| Barclays Int. Govt/Credit | -1.44% | 5.89% | 5.40% |
| Barclays 1-3 Year G/C | -0.07% | 2.80% | 3.86% |
| Barclays 1-10 Year TIPS | 0.06% | 5.22% | 4.77% |

Source: Barclays Capital

As of December 31, 2010

| Treasury Market Yields | | |
|-------------------------------|-----------------|----------------|
| | <u>12/31/10</u> | <u>9/30/10</u> |
| 3 Month | 0.12% | 0.15% |
| 2 Year | 0.59% | 0.42% |
| 5 Year | 2.01% | 1.26% |
| 10 Year | 3.29% | 2.51% |
| 30 Year | 4.33% | 3.69% |