Fixed Income Market Commentary

October 2011

The Die is Cast.

Usually I'm a positive person and I like to think it shows in my disposition and outlook.

However, when I consider the situation in Greece, and the issues surrounding the Eurozone's sovereign-debt crisis, my optimism is sorely tested.

I believe Greece will default on its debt. But that, by itself, is not the biggest part of the problem. The bigger issue is the domino effect this could have on other European banks, and beyond. For Greece, the die is cast-the future is determined.

Does that mean there are Trojan horses already inside your portfolio gates? Not necessarily.

Investors in our managed-bond portfolio strategy can continue to take comfort in the fact that our holdings are made up entirely of dollar-denominated, domestic, higher-quality issuers. We have no direct, or even indirect, exposure to Greece and peripheral European debt.

From day one, our managed-bond program has focused on what I know best: The domestic fixed-income market. When foreign exposure is appropriate, Chief Investment Strategist Rusty Vanneman, the research team and I carefully review and select top fund managers in the areas we wish to cover. We continue to work as a team to build the appropriate bond and bond-fund portfolios for each individual client.

As I noted, our agency, corporate bond and municipal bond exposures have no direct link to Europe. That does not mean that the bond market is immune to the goings-on in Europe-the flight-to-quality trade that brought Treasury bond yields down to historically low levels is a prime example of that. But as far as credit risk is concerned, there is no link. So, while I expect the news from Greece to be negative and the eventual default to occur, our clients should not expect to be directly impacted in their bond accounts. There are other things for us to focus on-there always are-but what happens in the land sandwiched between the Ionian and Aegean seas is not one of them.

Market Review

The **Treasury** market continues to be the big winner this year as institutional investors remain in a flight-to-quality stance. Whether it's the debt-ceiling debate, S&P's credit downgrade of U.S. Treasurys or the Fed's Operation Twist, it's easy to see why investors have been spooked. Yet, calling Standard & Poor's credit downgrade into question, Treasurys remain the go-to vehicle for large, institutional money because there is no other market large enough and liquid enough to accommodate the volume. And, to my way of thinking, Treasurys remain among the safest securities in the world. The risk they carry is market-driven, not default-driven-period. As a result, the Treasury market's performance is topping just about everything else. During the third quarter, the Barclays Treasury index, which comprises nominal Treasury securities of all maturities (average maturity is just over 7.5years) returned 6.47%; for the year it's up 8.84%.

Inflation-linked Treasurys slipped a bit in August, but the year-to-date numbers still top all other fixed-income sectors in our data box below, including nominal (non-inflation-linked Treasury bonds), up 10.59%.

Barclays Fixed Income Index Returns Through 9/30/11

	Duration	Sep	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.33	0.00%	0.13%	0.22%	0.37%	2.44%
US Treasury Index	5.94	1.75	8.84	5.87	-3.57	13.74
US TIPS Index	5.45	-0.24	10.59	6.31	11.41	-2.35
US Aggregate Bond Index	4.96	0.73	6.65	6.54	5.93	5.24
US Govt / Credit Index	5.98	1.03	7.47	6.59	4.52	5.70
US Credit Index {A2}	6.67	0.25	6.54	8.47	16.04	-3.08
US High Yield Index {B1}	4.53	-3.27	-1.39	15.12	58.21	-26.16
Caa component	4.05	-5.67	-6.45	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.32	-4.49	1.94	12.84	34.23	-14.75
Municipal Index	8.14	1.03	8.40	2.38	12.91	-2.47
Municipal Index - 5 Year	3.93	-0.19	5.40	3.40	7.40	5.78

Source: Barclays Capital

On the opposite end of the spectrum is the speculative-grade, **high-yield** market, which lost 3.27% during September. Junk bonds have now suffered two consecutive negative months, something that has not happened since October to November 2008. The "junkier" rated component of this market really took it on the chin, down 5.67% last month. While investors have recently shown their preference for quality over yield, I believe the selloff in high-yield is beginning to make the sector look very attractive.

Finally, the **municipal-bond** market posted another solid month, returning just over 1% in September. Despite a couple of defaults over the past few weeks, the cumulative number of defaults in 2011 is nowhere near the level that had been projected by at least one high-profile banking-sector analyst at the beginning of the year. In spite of this individual's dire warnings, municipal bonds remain a lower-risk, lower-volatility asset worthy of investor consideration.

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