

Fixed Income Market Trends and Perspective

Blocking and Tackling

Taxes Matter – Municipal Bonds have been a sound investment

Balanced Portfolios – Fixed income serves a role in a diversified portfolio

Global Growth Model

Growth Matters

Emerging Market Debt example

Market Environment

Since late 2002, risk has been rewarded

Valuations appear rich

The challenge of mean reversion evaluation

Structural Market Change

WIN – Whip Inflation Now – Did we win ?

How about the rest of the world ?

Globalization and convergence

Key Players and Impact

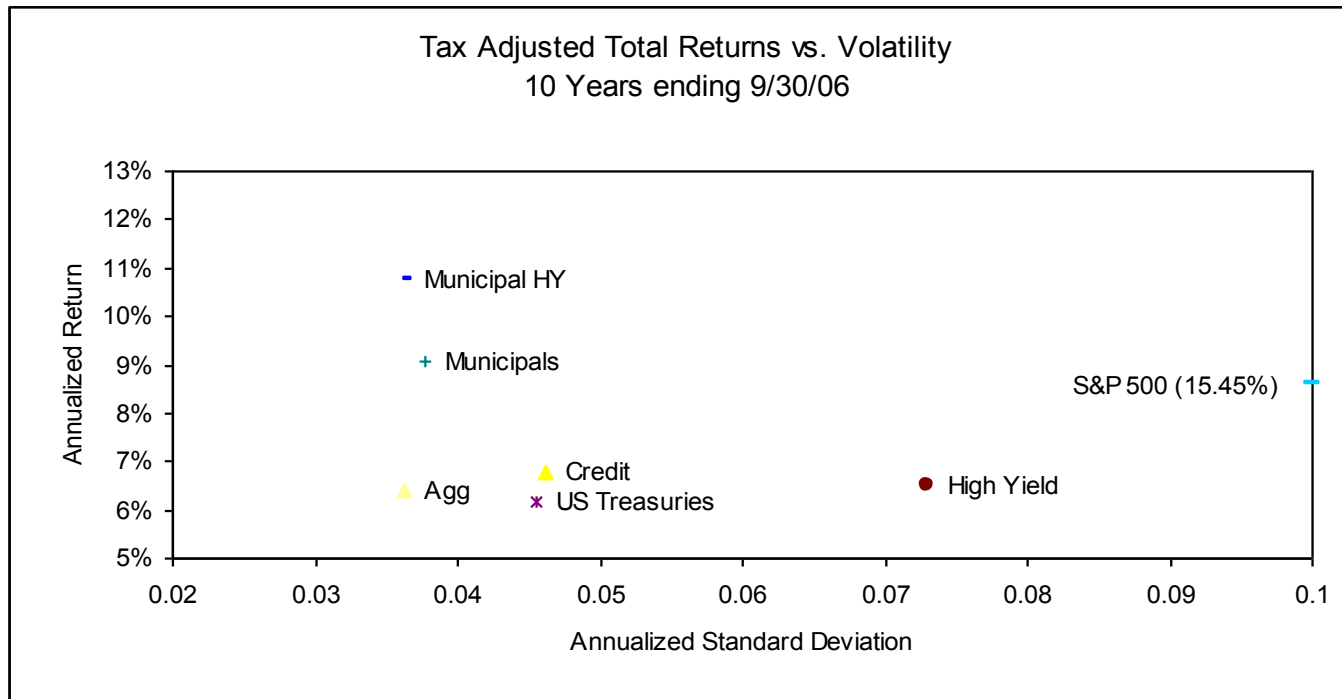
Derivative Instruments

Conclusion

Heraclitus and his takeaway

Blocking and Tackling – fundamentals review

- In an environment where many market prognosticators have forecast a low return environment, after tax investment considerations become important
- After adjusting for taxes, municipal bonds have been a sound investment outright

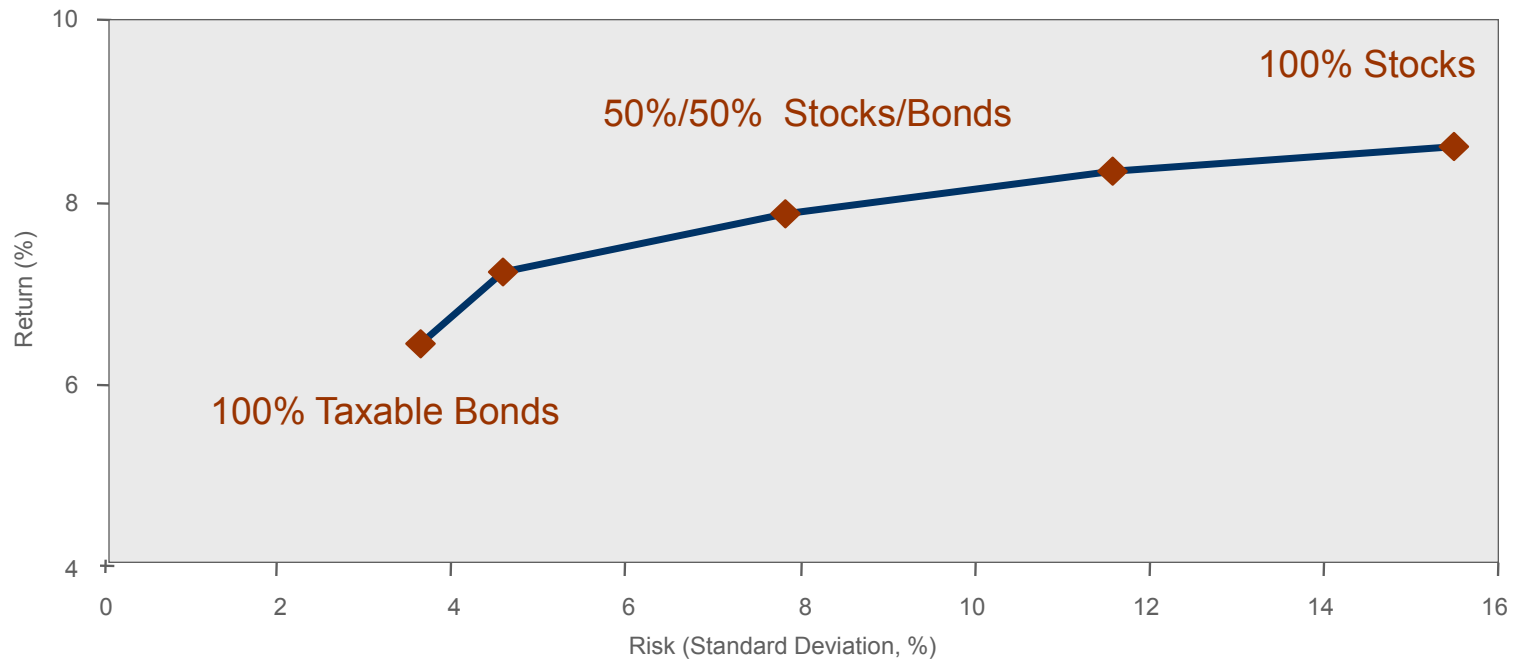


Credit is represented by the Lehman Brothers (LB) U.S. Credit Index, U.S. Treasuries are represented by the LB Treasury Index, High Yield is represented by the LB High Yield Index, Municipal High Yield is represented by the LB Tax Free High Yield Index. Municipal returns have been adjusted based on a 25% income tax bracket assumption. Past performance cannot guarantee future results.

Blocking & Tackling – fundamentals review

Fixed Income plays a key role in diversified portfolios

September 30, 1996-September 30, 2006



**50/50 Stock/Bond returned 91% of the all-stock return with 50% of risk;
75/25 Stock/Bond returned almost 97% vs. all-stock with 75% of the risk.**

Blocking & Tackling – fundamentals review

The Global Growth Model



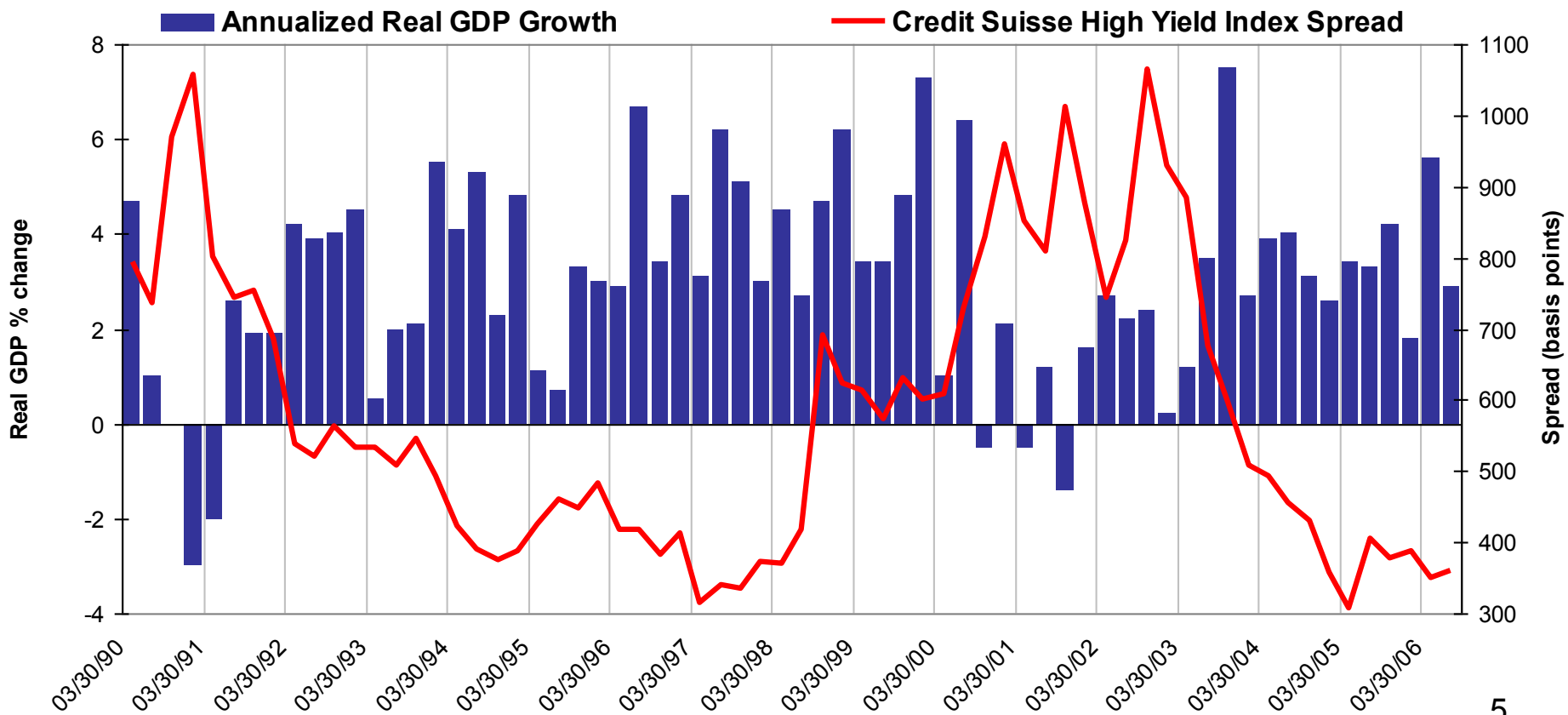
- With its voracious appetite for commodities, China (akin to late 19th century America) is a global growth engine.
- With its 7% / GDP current account deficit largely funded with foreign fund flows, the U.S. is a global growth engine.
- Europe and India also play key roles

Blocking & Tackling – fundamentals review

Growth Matters

GDP Growth vs. High Yield Spreads

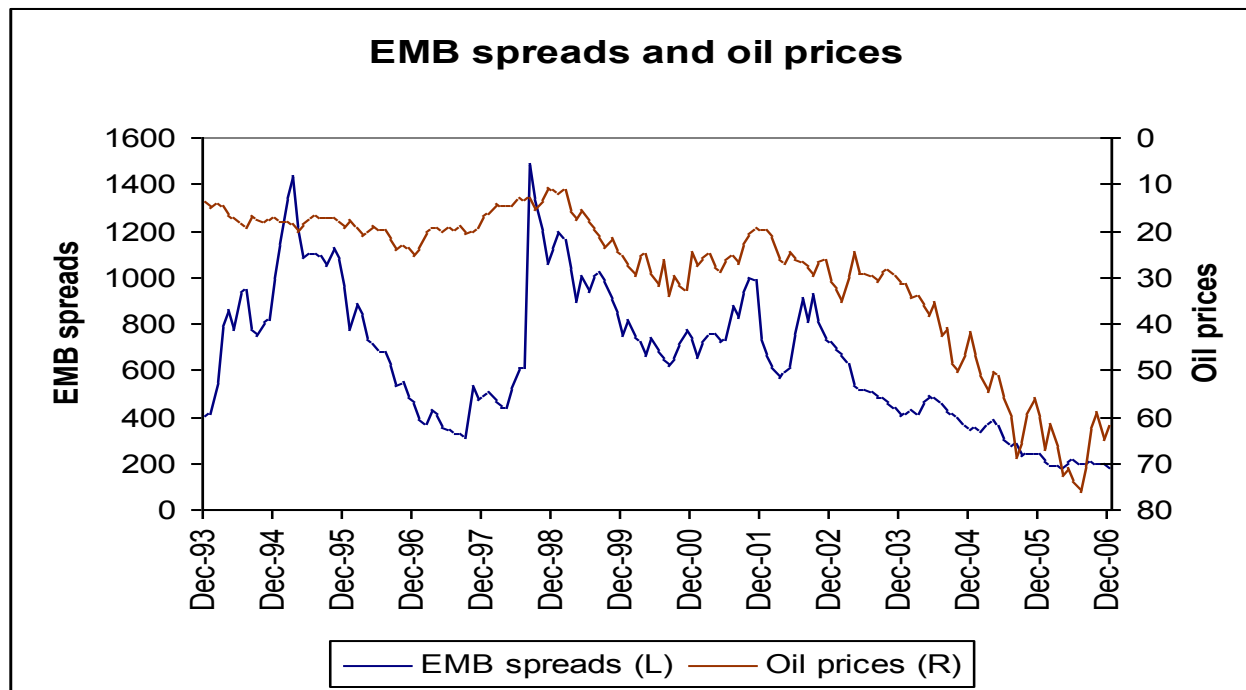
March 30, 1990 - June 30, 2006



Blocking & Tackling – fundamentals review

A strong commodity run has been a catalyst for emerging countries and contributed toward “convergence”

J.P. Morgan Emerging Market Bond Index (EMB)



Source J.P. Morgan

Market Environment

Since 2002 risk has generally been handsomely rewarded

Risk-Return Table

January 2003 - December 2006: Annualized Stats

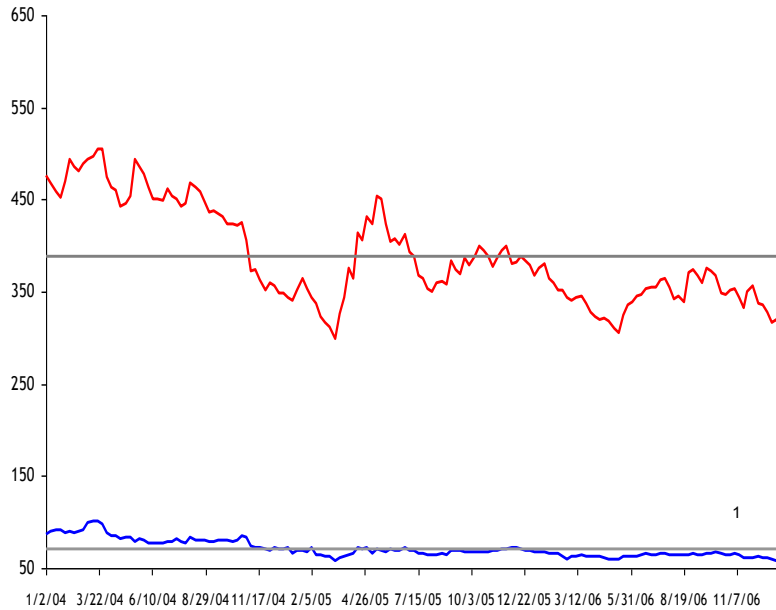
	Return	Std Dev	Sharpe Ratio
MSCI EM (EMERGING MARKETS)	36.89	16.8	2.03
JPM EMB Global Index (jpmrg)	14.33	7.01	1.67
Credit Suisse High Yield Index	13.15	4.38	2.40
Credit Suisse High Yield CCC/Split CCC	19.97	8.26	2.09
Russell 2000 Value	23.26	13.35	1.54
NASDAQ Composite	16.74	13.71	1.03
S&P 500	14.74	8.28	1.46
Lehman US Aggregate Bond Index	3.80	3.75	0.34

Source: Zephyr Style Advisor

Market Environment

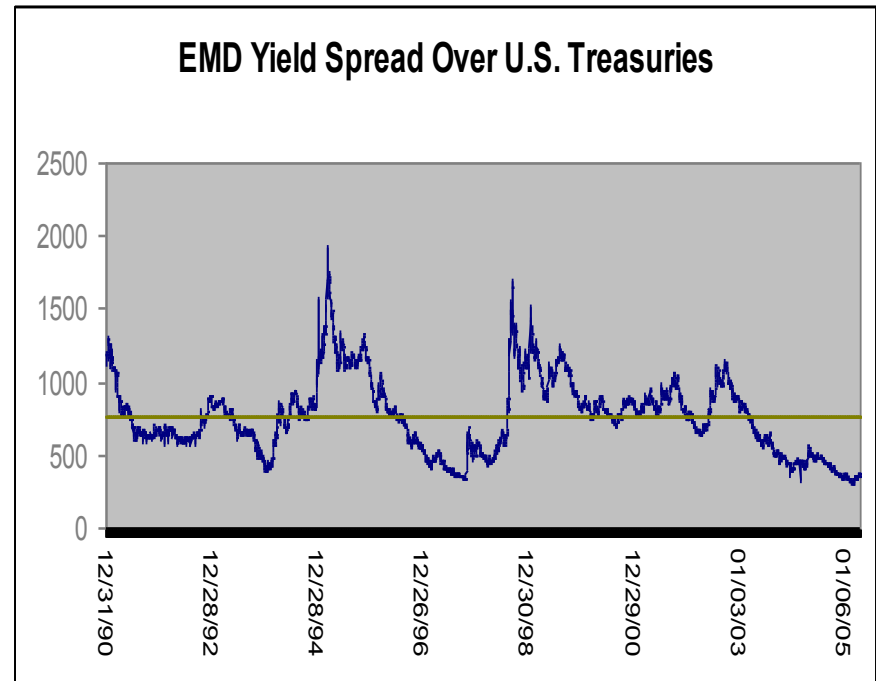
Valuations appear rich

JPM Global HY Index & LB Aggregate – Spreads
January 11, 2004 through January 11, 2007



Source: Bloomberg and Lehman Point

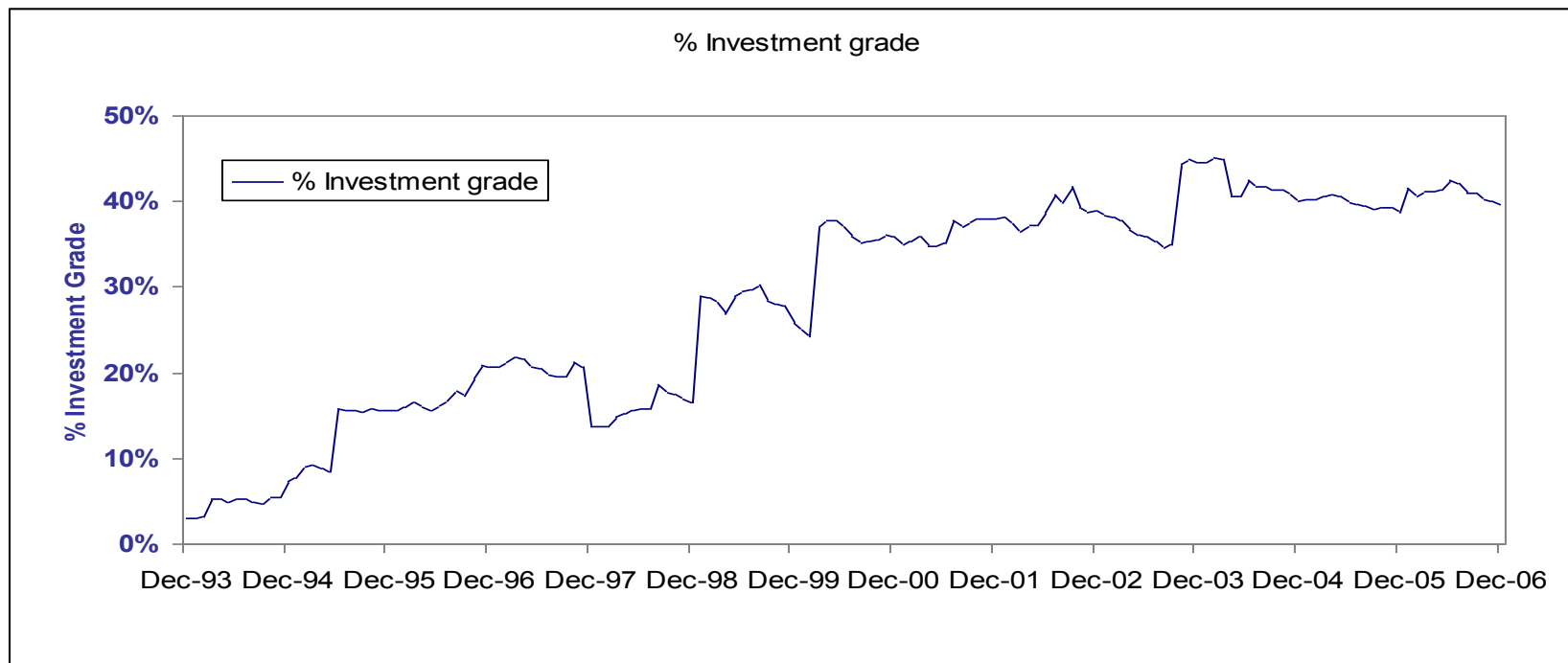
JP Morgan Emerging Market Debt Spreads over US Treasuries – December 1990 through January 2007



Source: JP Morgan

Market Environment

The challenge of mean reversion analysis



Historic spread analysis does not capture qualitative or structural change

In the case of EMD, a favorable commodity cycle in conjunction with:

Fiscal discipline

Change in ownership base – pension funds

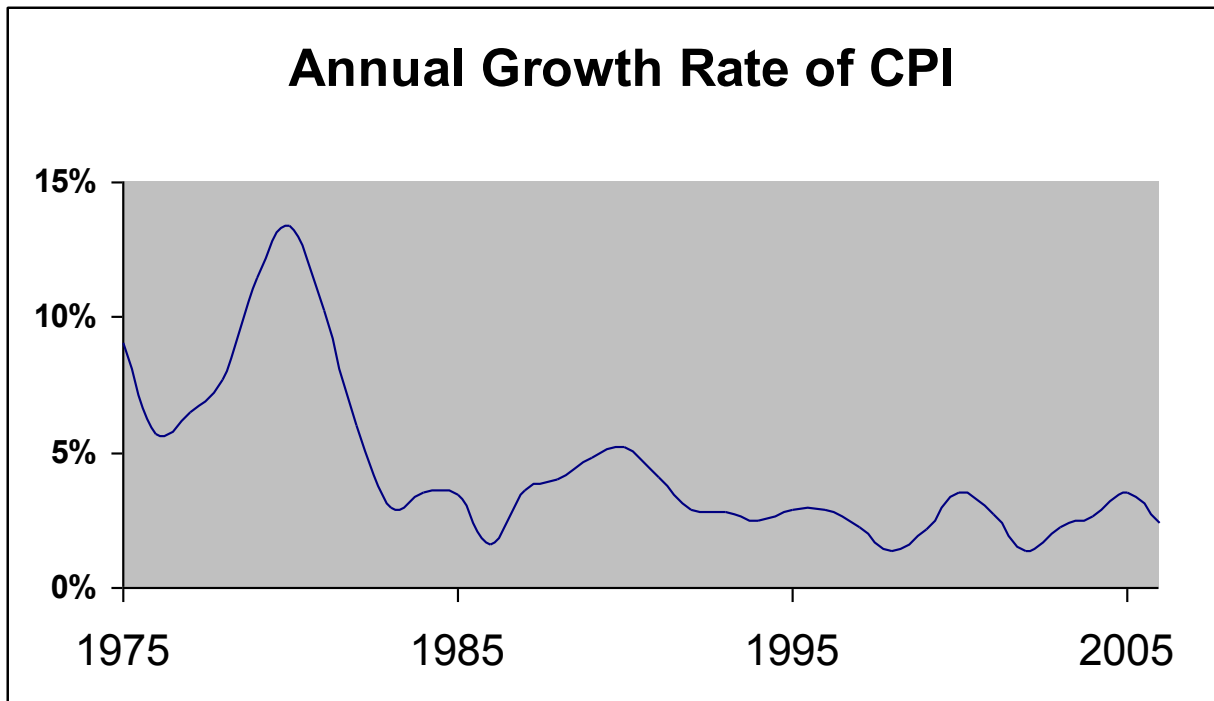
Abandonment of fixed exchange rate regimes

Convergence

Global search for yield

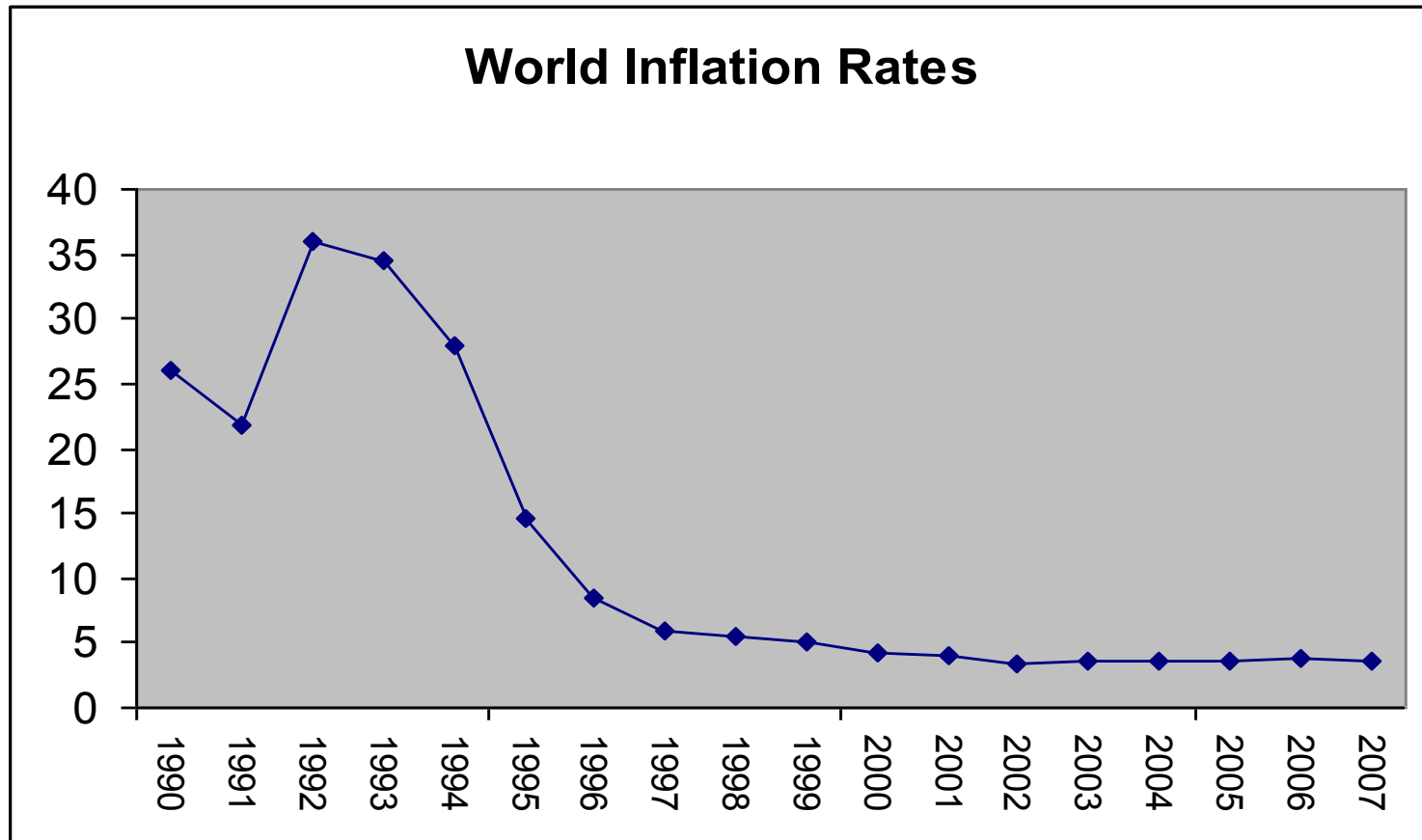
Structural Market Change – WIN

- **Whip Inflation Now** – it looks like the inflation war has been won in the US



Source: International Monetary Fund

Structural Market Change – What about the rest of the world ?



Source: International Monetary Fund

Structural Market Change – Globalization & Convergence

“ In a nutshell, I believe that the factors of globalization, deregulation, and financial innovation, arising partly in response to episodes of high inflation, have effectively eroded the central bank monopoly on the provision of monetary services and have enhanced global competition among currencies. These changes have, in turn, altered the incentives for central banks to behave badly and for finance ministries to use central banks as "piggy banks" to finance their fiscal policies. The resulting constraint on monetary policy, combined with increased public understanding of the costs of inflation, have led to institutional changes in central bank governance that bolster their credibility for maintaining price stability in the future. Improved central bank performance and credibility, thus, are the consequences of this combination of factors.”

**Source: Remarks by Federal Reserve Governor Randall S. Kroszner
At the Cato Institute Monetary Policy Conference, Washington, D.C.
November 16, 2006 “The Conquest of Worldwide Inflation**

Structural Market Change – Globalization & Convergence

A global trading club (with rules):

- **European Union** – Economic guidelines for entry
- **Global standards for trade - International Organization Standards (ISO)** - together with [IEC](#) (International Electrotechnical Commission) and [ITU](#) (International Telecommunication Union) - has built a strategic partnership with the [WTO](#) (World Trade Organization) with the common goal of promoting a free and fair global trading system

Source: <http://www.iso.org>

Structural Market Change – Key Players and Impact

- **Hedge Funds** – Lehman Brothers research estimates there are currently 9,000 hedge funds managing approximately \$1.7 trillion in assets
- **Private Equity** – Strong flows into private equity in conjunction with the willingness of private equity players' to “partner” has increased the pace and scale of LBO activity.
In the 18 months prior to August 2006, nine of the ten largest buyouts in history have been announced or completed. (source T. Rowe Price)
- **Pension Funds** – The Pension Protection Act passed in July 2006 directly impacting approximately \$1.6 trillion in DB pension assets. Although different than the US, it is generally believed that the inversion of the yield curve in the U.K. has largely been attributable to a version of pension reform
- **Tender Option Bond (TOB) Programs** – Structurally designed to provide institutional clients with yield by essentially borrowing short, investing long and adding a degree of leverage to amplify the yield. Is generally believed to be a strong contributor to flatness of today's municipal curve

Structural Market Change – Derivatives

Not a dirty word

When used in moderation, derivatives can increase the efficiency of the portfolio management process and aid in risk management

Instruments that fall under this label include:

- **Futures** – can be used to manage interest rate risk. Favorable on certain bonds that have a degree of illiquidity, but concerned with near term valuation, a short interest rate futures trade can provide a hedge
- **Options** – In international portfolios, can be long on a currency option to hedge interest rate risk at the country level
- **Credit Default Swaps** – A tool for managing risk at security specific and market levels. Other practical applications as well

Conclusion – What can we learn from Heraclitus

Heraclitus - A Greek philosopher of the late 6th century BC, who said, “You can never step into the same river; for new waters are always flowing on to you.”

In an age of abundant data, historical information provides an invaluable frame of reference for making investment decisions today. Qualifying an historical perspective with an understanding of how the world today is unique relative to the past is an even more potent formula for success. As the French found out in the late 1930's, while a formidable structure, the Maginot Line was not built for the type of warfare that unfolded during the Second World War.

Final appendix

- Past performance cannot guarantee future results.
- All charts are for illustrative purposes only and not meant to represent an investment in any particular security. It is not possible to invest directly in an index.
- Diversification cannot assure a profit or protect against loss in a declining market.
- Risks:
- **Interest Rate risk:** This is the decline in bond prices that usually accompanies a rise in interest rates. Longer-maturity bonds typically decline more than those with shorter maturities.
- **Credit risk:** This is the chance that any fund holding could have its credit rating downgraded, or that a bond issuer will default (fail to make timely payments of interest or principal), potentially reducing the fund's income level and share price.
- **High-Yield Investing**
A fund investing in high-yield corporate bonds, often called "junk bonds," could have greater price declines than funds that invest primarily in high-quality bonds.
- **Emerging market Risk:** Investments in emerging markets are subject to abrupt and severe price declines, and should be regarded as speculative. The economic and political structures of developing nations, in most cases, do not compare favorably with the U.S. or other developed countries in terms of wealth and stability, and their financial markets often lack liquidity.
- **Derivatives:** Investing in derivative instruments may involve substantial risk. The risks of investing in derivatives should be carefully weighed as it is possible to lose more than the amount invested.