

INVESTMENT UPDATE

As another year comes to a close, we'd thought it might be fun (well, fun for a bond investor, anyway) to take a look back at a couple of our "predictions" from the past year or so.

Last November, as the economy appeared to finally be pulling out of recession, we wrote about how the yield curve was likely to change shape. By way of review, the yield curve is a snapshot in time of the line that connects the yields on

fixed income securities (typically Treasuries) with maturities ranging from overnight to thirty years (see top chart). When the economy begins to strengthen, the yield curve tends to flatten as short-term rates rise due to tighter monetary policy by the Federal Reserve, while long rates remain relatively stable as productive resources in the economy are still plentiful (keeping a lid on inflation) and demand for longer-maturity credit is still relatively weak.

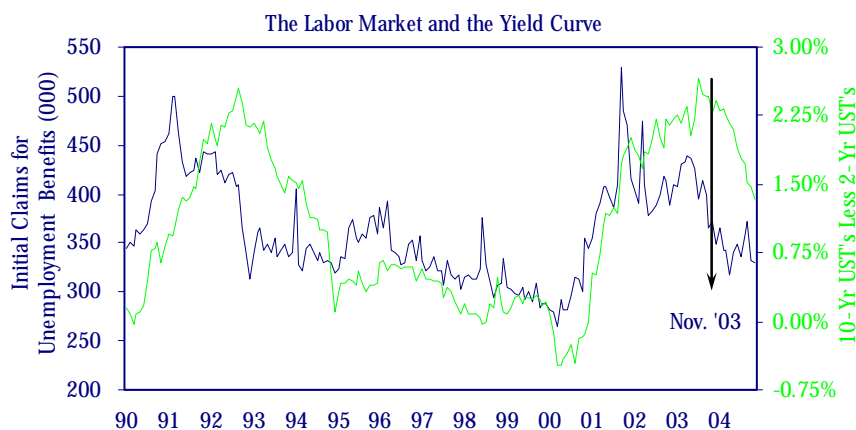
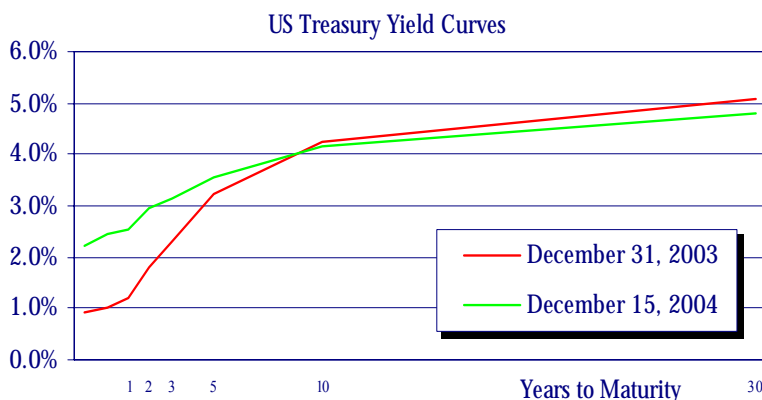
Our expectations last November were that the yield curve was likely to flatten, with short rates rising more than long rates, and we identified "a concurrent, if not leading indicator of yield curve movements": initial claims for unemployment benefits. We showed that unemployment benefit claims had already turned down, and that lower claims had tended to predict a decline in the spread between the yields of ten- and two-year maturity Treasury bonds. We reproduce this chart, and its subsequent movement since last No-

vember at the bottom of this page.

As the chart shows, the yield differential between short and longer maturity bonds began to narrow shortly after we published the November 2003 *Investment Update*, and in fact, has since flattened more quickly and a little more dramatically than we expected.

As we pointed out at the time, in a flattening yield curve scenario, the conventional wisdom prescribes a re-allocation of bond portfolios into a more "barbelled" structure, by selling intermediate-maturity holdings and using the proceeds to buy a combination of short and long maturities. As we also mentioned last year, "Yield curve management also involves an element of market timing: since putting on a "yield curve flattener" means giving up yield...even if the curve does move in the desired direction after some period of time, it may not move enough to make the trade profitable..."

This year, with the yield curve flattening measurably and in fairly quick order, it would seem that "barbell" strategies would have been big winners. Yet the answer depends on how the barbell was structured and how much of the portfolio was re-allocated. As the top chart shows, while the biggest increases in rates across the yield curve over the past year have been in very short maturities (long maturity bond yields have actually fallen YTD in 2004), the biggest price declines this year have come in the two- to three-year area of the curve. As a re-



sult, the best performing yield curve strategies were those that utilized fairly radical barbell positions, combining very short and very long maturities. Re-allocating approximately 10% of a portfolio in a duration-neutral yield curve trade by selling three-year maturities and buying a combination of three-month bills and long bonds would have produced approximately 15 basis points (0.15%) in additional return YTD. On the other hand, “intermediate barbells” produced little, if any, extra return: a duration-neutral barbell strategy that re-allocated funds from five-year maturities into a combination of two- and ten-year bonds would have produced *negative* value added in 2004.

What we’ve left out of the analysis, of course, is the timing aspect of these trades, as there have been periods this year when one area of the yield curve was moving while other maturities were fairly stable. Active management strategies only work if they’re put on at the right time, and taken off at the right time. Miss the entry or exit point, and you can miss out on making any measurable extra return.

The second topic we wanted to update is the recent performance of TIPS. When we last visited the market for Treasury Inflation Protected Securities in February of this year, we noted that TIPS appeared unattractive for total rate of return bond investors:

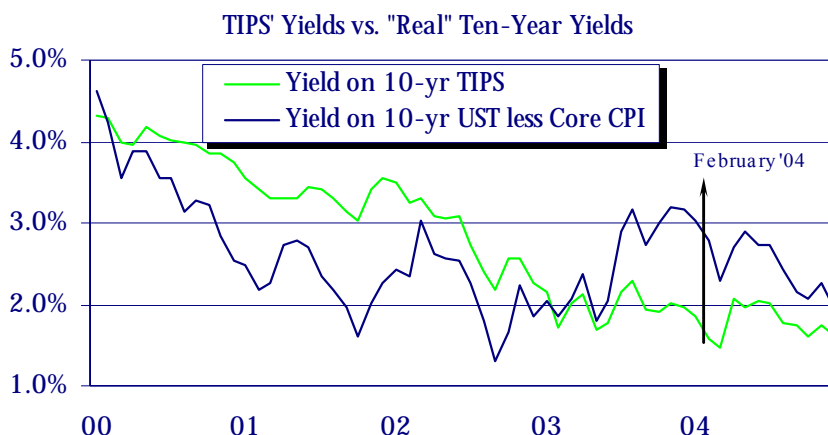
Currently, TIPS prices are extremely overvalued; but that is certain to change. If our outlook is correct, TIPS may underperform significantly in a rising rate environment if investors demand higher real yields.

We were concerned in February that TIPS’ prices had risen to the point that their yields (which, by definition, are inflation-protected) paled in comparison to the inflation-adjusted yields of nominal Treasury securities. As the chart on this page shows, by the end of ‘03 and into the beginning of this year, ten-year TIPS’ yields had fallen well below the 2% level, while inflation-adjusted “real” yields on nominal ten-year Treasuries were still more than 100 basis points higher.

From a total return investors’ standpoint, TIPS lose much of their attractiveness when they offer yields lower than those on inflation-adjusted nominal Treasuries. In order for TIPS to outperform nominal Treasuries when their yields are this low, inflation must rise—either enough to wipe out the inflation-adjusted yield advantage of the nominal bond or by a sufficient degree to warrant buying an expensive “insurance policy” against inflation with the purchase of TIPS.

Inflation did increase fairly dramatically, with core CPI rising from 1.2% in February to 2.1% in October. We predicted that the gap between TIPS and inflation-adjusted yields would narrow, and it did—just not in the

way we anticipated. Instead of TIPS getting cheaper, *real yields become richer*. This occurred because even though inflation rose, nominal ten-year Treasury yields didn’t, a surprising and unwelcome development for many investors (see our *Investment Update*



from last month). The result is that now both TIPS and nominal Treasuries seem to offer little value for total rate of return bond investors, and both appear to be in line for an “adjustment.”

As always, we offer our projections with the caveat that, while we put our best efforts forward, forecasting is a risky business! While we’ve had a good track record of getting many of the broad macroeconomic factors right, the wild card is always human behavior, and it’s human behavior, with all its vagaries and emotions, that drives markets and determines the prices of bonds. Especially in the short-term, the path that humans take can diverge radically from the direction pointed out by investment fundamentals.

Accordingly, our clients’ portfolios aren’t designed to “make it or break it” based on our economic outlook. While we may shade our portfolios one way or another based on the metrics of certain macro factors, this analysis is, more than anything else, simply a foundation that we use in our value-based investment strategies.

As we look ahead to 2005, we wish you a prosperous New Year—one where all *your* projections come true!

