Sophisticated Process - Bonds

Research yielding a consistent investment strategy

While our philosophy may be simple, our strategy is based on very sophisticated investment analysis. We believe an investment strategy must perform well through a variety of market environments, particularly over longer periods of time. To help accomplish this goal, we have identified certain characteristics of assets that often merit further analysis and review. Of these, quality, consistency, and discipline are the key factors that frame our overall investment strategy.

Bonds

In addition to investing in high quality bonds with modest interest rate risk characteristics, we also actively manage the fundamental parameters of our clients' bond investments.

Quality

Our bond investment strategies are implemented using only high-quality bonds with modest interest rate risk characteristics. This significantly reduces both credit-related risk and price volatility.

Consistency

The fundamental parameters for our bond investments include:

- Prospective return profile
- Prospective credit risk profile
- Correlation profile, or how they and other portfolio assets may inter-relate in the future

Bond investments are only made after all three of these parameters are evaluated.

Discipline

Because these parameters are themselves dynamic and can significantly change at different points in time, disciplined, active management of these variables is necessary if bonds are to fulfill their intended roles within a portfolio.

In our "toolkit" for actively managing the dynamic risk/reward/correlation parameters are computer simulation scenarios. We start by assessing the best and worst case scenarios for interest rates, bond yields and economic conditions for the coming twelve months.

We use a computer simulation to calculate the total return potential for bonds of varying maturities and quality. This information then forms the basis for managing portfolios around bonds that offer a low probability of loss should interest rates rise while also maximize the probability that bonds will deliver the desired correlation properties relative to other portfolio investments. Maintaining this disciplined approach helps us separate fundamentals from market noise.

An essential and differentiating aspect of our bond management is the emphasis we place on selecting bonds that temper stock market volatility. Patient and disciplined adherence to this approach helps us preserve capital for clients.

The following series of tables reflect the output of a sample simulation exercise:

What if over the next year?...

If one of these happens...

A Treasury security with years to maturity of:	Current Treasury yield curve	Interest Rate Scenarios: Situation I — Yields drift near current levels	Situation II — Yields rise towards nominal GDP growth	Situation III — Inflation fears mount as economy snaps back
1	0.08%	0.08%	2.50%	2.50%
2	0.22%	0.22%	3.00%	4.00%
3	0.35%	0.35%	3.15%	4.50%
5	0.70%	0.70%	3.50%	5.00%
7	1.06%	1.06%	3.80%	5.20%
10	1.60%	1.60%	4.00%	5.30%
30	2.70%	2.70%	4.50%	6.50%

...then the 1 year return would be:

Remaining years to maturity 1 year out	Current Treasury yield curve	Total Return over the Next 12 months: Situation I — Yields drift near current levels	Situation II — Yields rise towards nominal GDP growth	Situation III — Inflation fears mount as economy snaps back
0	0.08%	0.1%	0.1%	0.1%
1	0.22%	0.4%	-2.0%	-2.0%
2	0.35%	0.6%	-4.8%	-6.6%
4	0.70%	1.6%	-8.8%	-13.6%
6	1.06%	2.1%	-12.8%	-19.6%
9	1.60%	3.1%	-17.0%	-25.2%
29	2.70%	2.7%	-32.3%	-46.6%

As bond yields change, the risk/reward potential of bonds changes:

How much do yields have to increase over a 1 year period to wipe out a year's worth of income?

Today:

years to maturity	ytm*	1 year out: Yield level required	Increase (basis points)
2	0.22%	0.50%	28
3	0.35%	0.60%	25
5	0.70%	0.90%	20
10	1.60%	1.80%	20
30	2.70%	2.84%	14

pre-panic (June 2008): A more "nomalized" interest rate environment

years to maturity	ytm*	1 year out: Yield level required	increase in basis points
2	3.03%	6.23%	320
3	3.20%	4.87%	167
5	3.44%	4.39%	95
10	4.00%	4.55%	55
30	4.50%	4.79%	29