

# Prudent Fixed Income Investing in an Ultra-Low Rate Environment

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**MILES** *Capital*  
*Independent Investment Solutions*

Committed to Investing for Client Success

- |                               |   |
|-------------------------------|---|
| Founded in 1982               | <ul style="list-style-type: none"><li>▪ Miles Capital is the largest independent institutional asset manager in the State of Iowa</li></ul>   |
| Independent & Employee-Owned  | <ul style="list-style-type: none"><li>▪ Singular focus on investing client assets to meet their needs</li><li>▪ Highly motivated employee owners</li></ul>  |
| Enduring Client Relationships | <ul style="list-style-type: none"><li>▪ 74% of institutional assets managed are for client relationships that have been with us for longer than 15 years</li><li>▪ 100% institutional client satisfaction</li></ul> |
| People                        | <ul style="list-style-type: none"><li>▪ 26 Employees</li><li>▪ 15 Investment Professionals</li></ul>  |
| Assets Under Management       | <ul style="list-style-type: none"><li>▪ \$3.5 Billion as of 06/30/2011</li></ul>  |

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Miles Capital is committed to engaging with our clients to help them meet their broader goals and objectives.

Investors have been attracted to bonds for numerous reasons over the years.

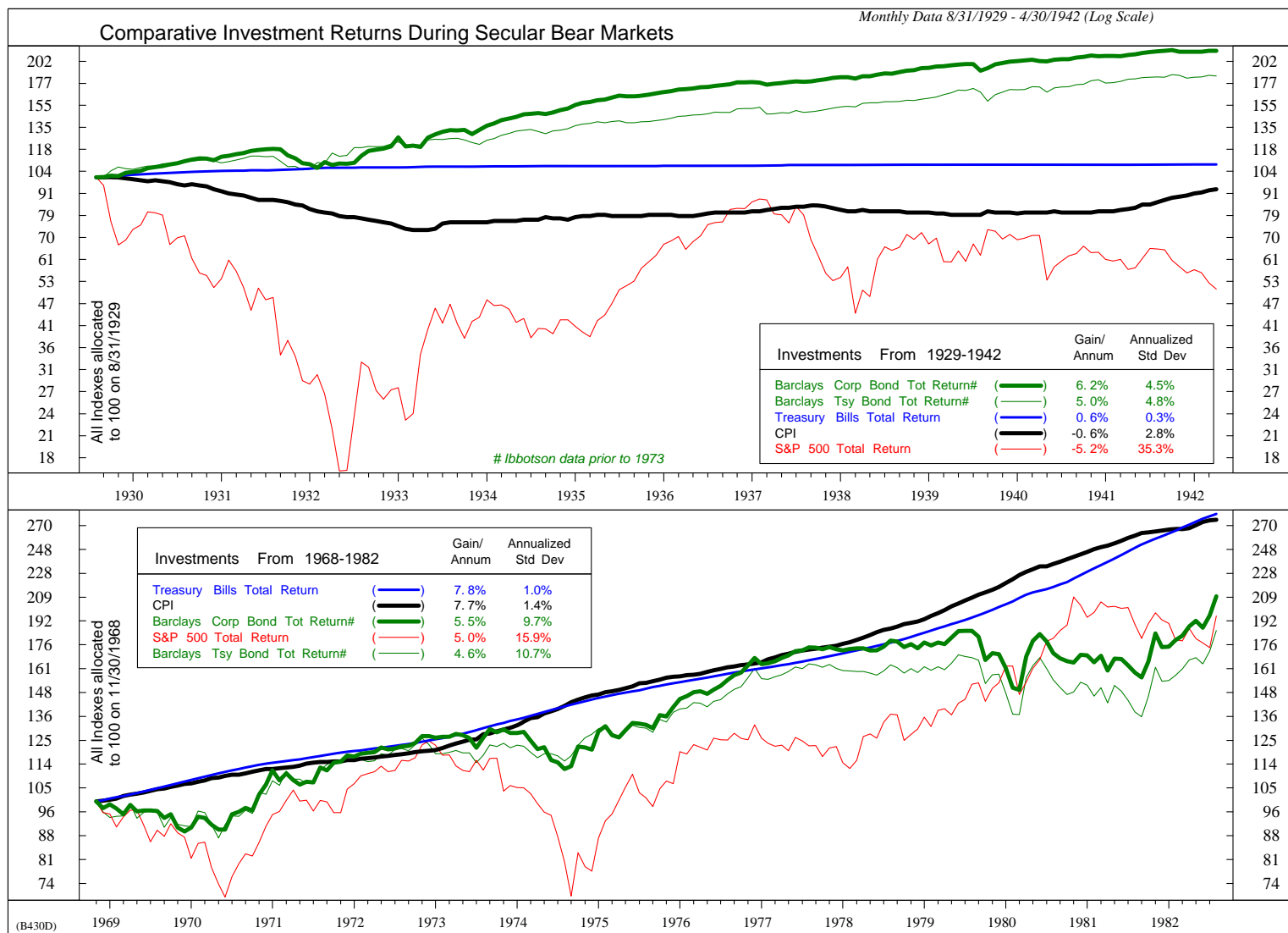
- Predictable current income based on the interest coupon on the bond
- The certainty of a specified maturity date
- The opportunity to redeem at par upon maturity
- Superior rank in the capital structure to equities
- Lower volatility compared to equities

Since the advent of Modern Portfolio Theory, investors and advisors alike have prized bonds for their diversification benefits.

- Reducing “risk” (defined as volatility of returns from one period to the next)

# Historically, Bonds Have Reduced Portfolio Volatility

## Fixed Income Performance During Bear Equity Markets



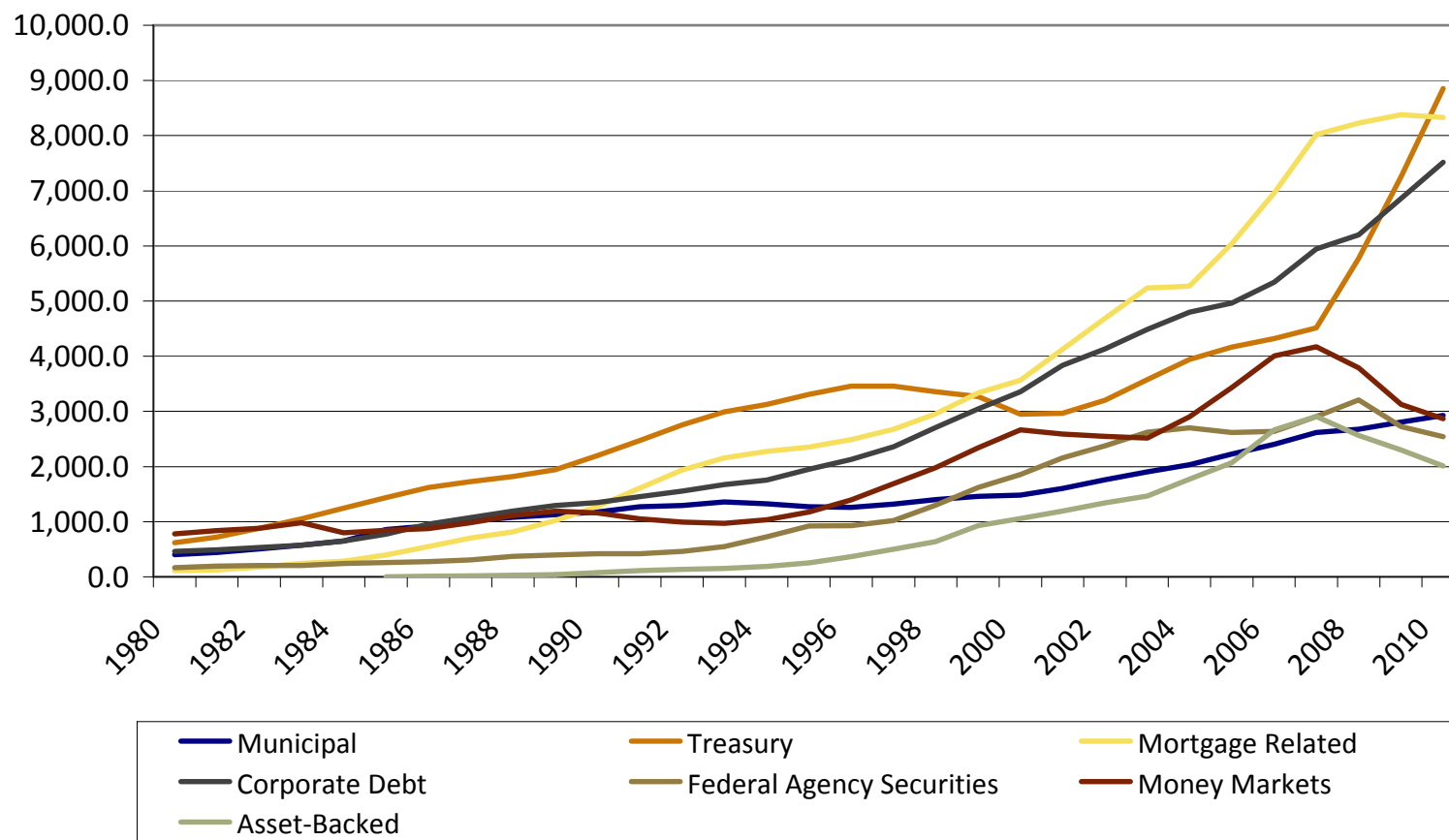
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Source: Ned Davis Research

As a result, bonds have become firmly established as one of the “big three” asset classes, so accepted that complex asset allocation decisions are often reduced to rules of thumb.

- **The Bond Market is much larger, more complex, heterogeneous, and global than it once was**

## Outstanding U.S. Bond Market Debt (\$ Billions)

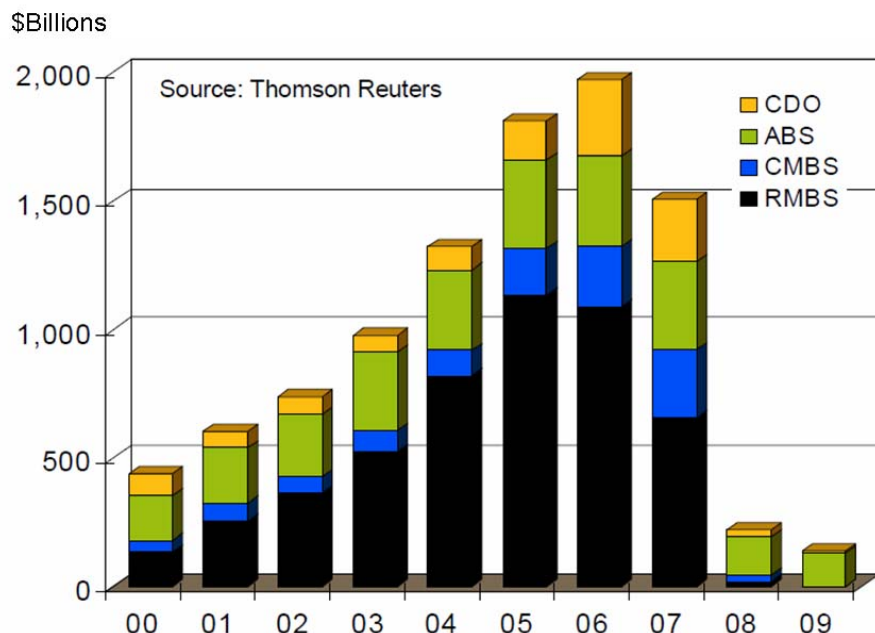


	Total
1980	2,536.4
1981	2,811.1
1982	3,192.2
1983	3,635.4
1984	3,874.5
1985	4,579.7
1986	5,215.8
1987	5,822.2
1988	6,417.1
1989	7,023.4
1990	7,656.8
1991	8,389.6
1992	9,139.6
1993	9,858.7
1994	10,436.1
1995	11,236.2
1996	12,020.6
1997	13,034.0
1998	14,339.1
1999	15,991.9
2000	16,931.1
2001	18,474.4
2002	20,053.9
2003	21,813.0
2004	23,426.1
2005	25,517.5
2006	28,337.4
2007	31,091.7
2008	32,444.5
2009	33,466.0
2010	35,042.4

Source: SIFMA

The composition, size and complexity of the bond market has changed substantially during the last 30 years.

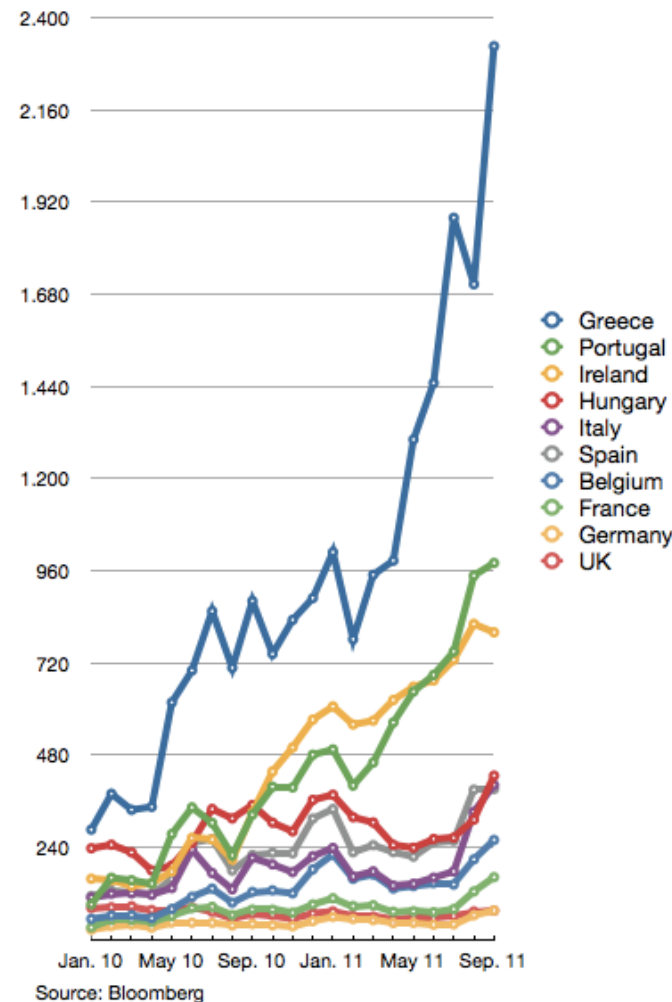
Commercial & Residential Mortgage-Backed Issuance has all but stopped.



Other Changes:

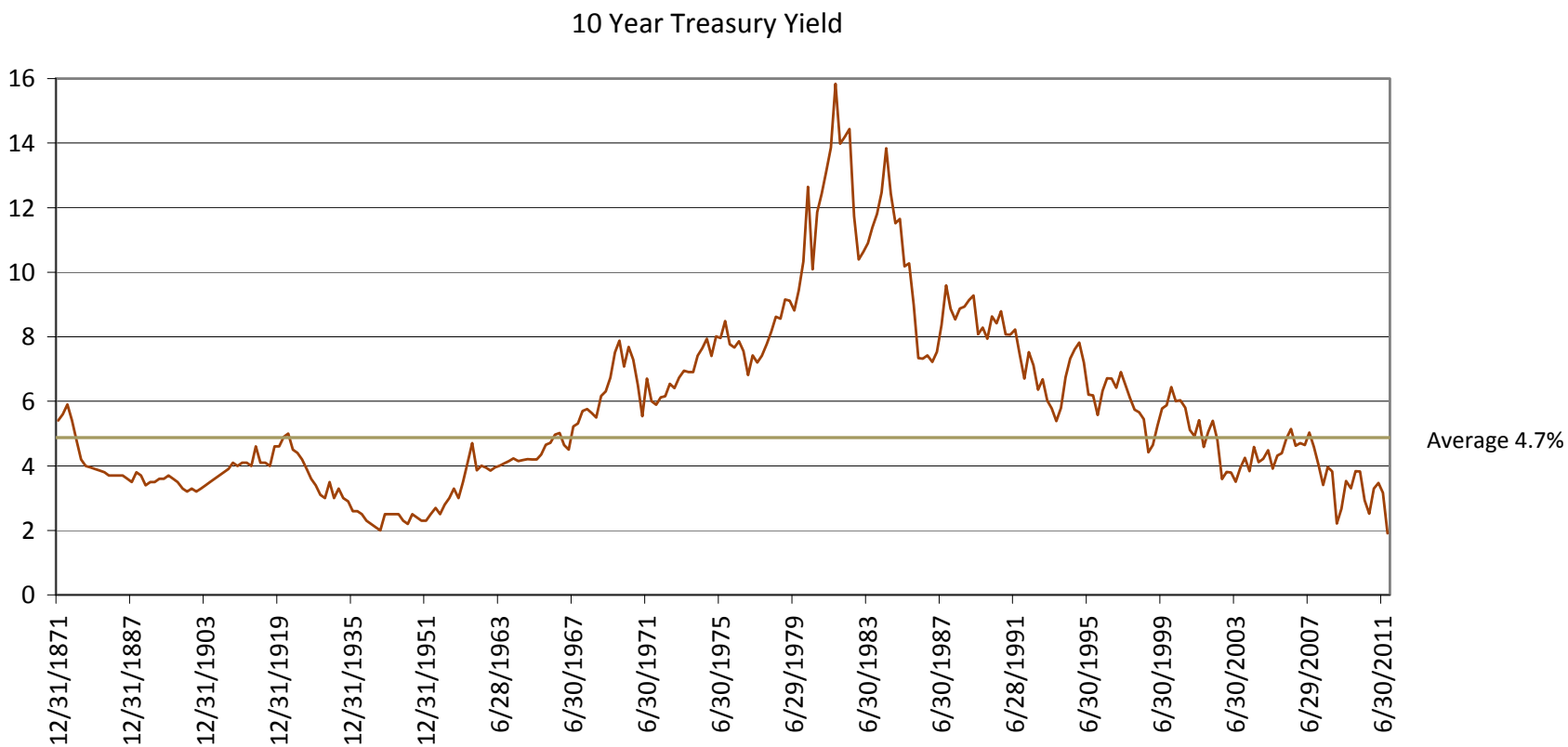
- Disappearance of municipal bond insurance
- Level of volatility increased substantially across all markets

“Secure” Sovereign Debt is No Longer



In the last 10 years, the financial markets, and fixed income markets specifically, have irrevocably changed.

- The Bond Market is much larger, more complex, heterogeneous, and global than it once was
- **Yields have declined dramatically**



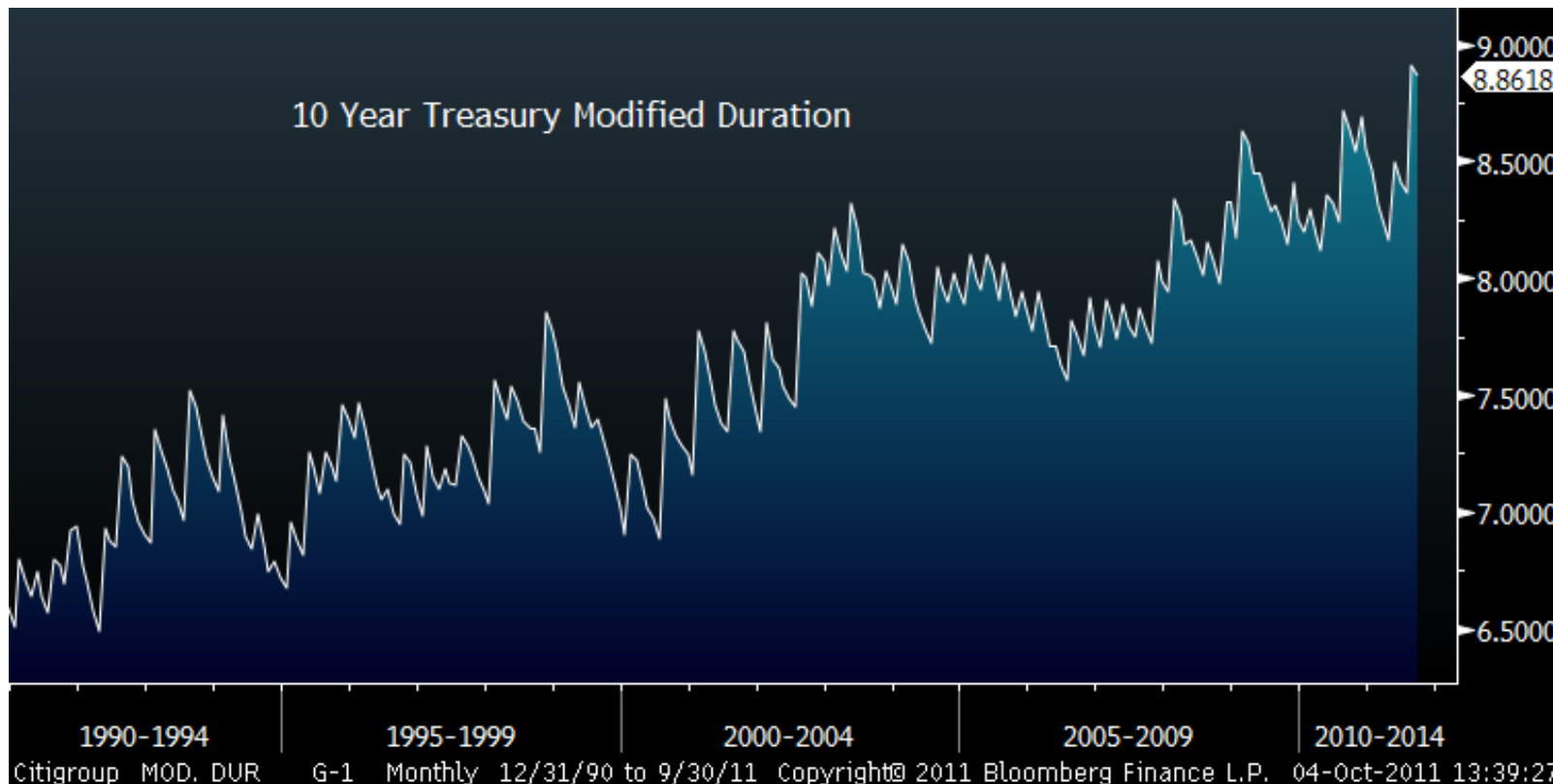
Source: Bloomberg & U.S. Federal Reserve

Yields are at lows not seen since 1950s, which makes maintaining an income-focused portfolio extremely difficult.

	October 1981	October 2011	
10 Year Treasury Yield	15.4	1.8	
Size of the U.S. Bond Market (\$billion)	2,811.1	35,227.3	13-fold increase
Mortgage-Related (as % of Total)	4.5%	23.5%	
Asset-Backed (as % of Total)	0.0%	5.3%	

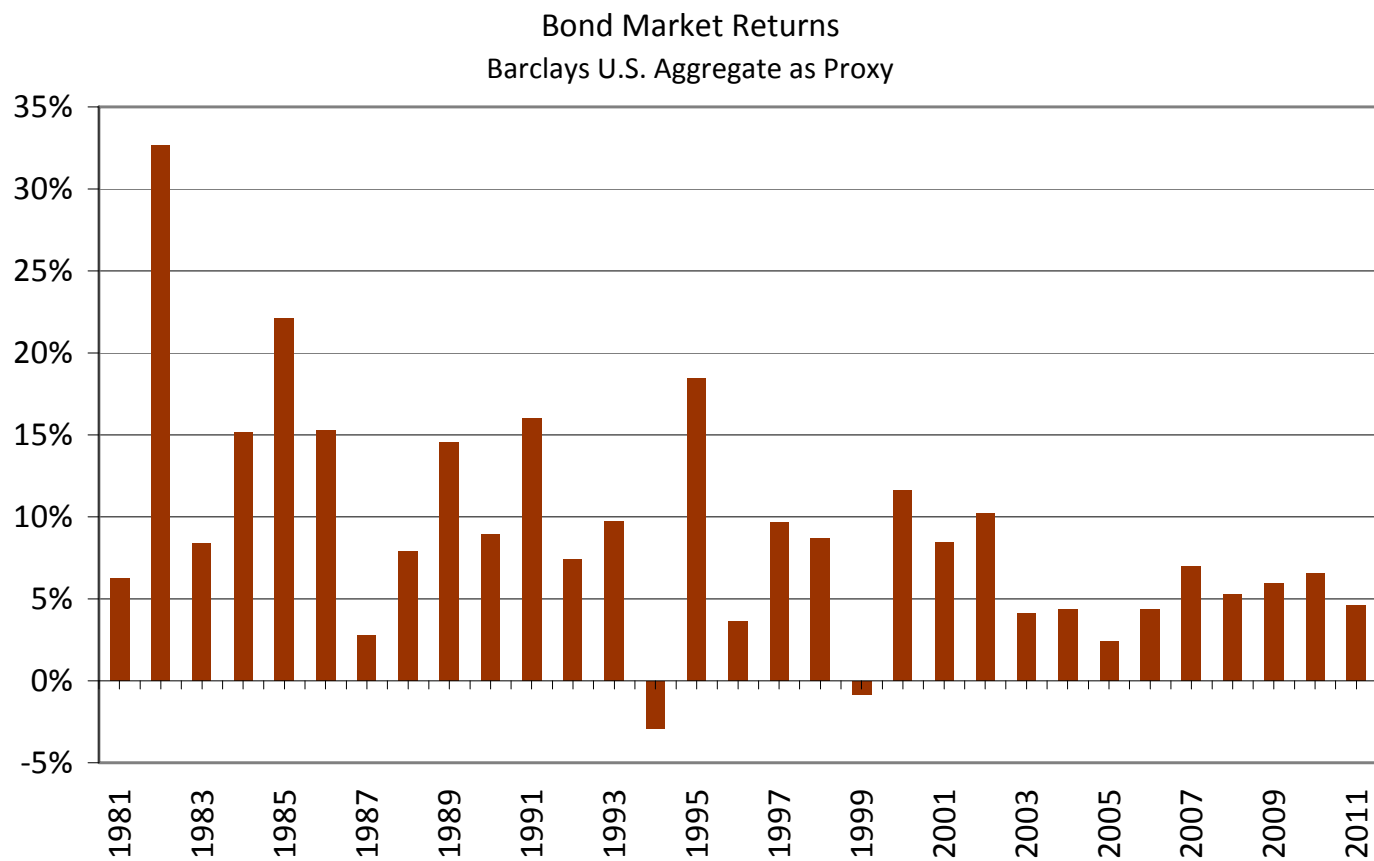
## Where Things Stand Today

- Historically low interest rates on bonds
- Investors are accepting negative real yields in a flight to safety
- Bonds offer limited capital appreciation upside
  - If the 10-Year fell to 1.25% (Japan-style stagflation), price appreciation would equal 7%
  - The average price contribution to total return over the last 30 years has been 1.3%
- But the downside risk is also substantial
  - Duration of the 10-Year Treasury is much longer than historical norms
  - Even a minor correction in yields could lead to double-digit declines in value

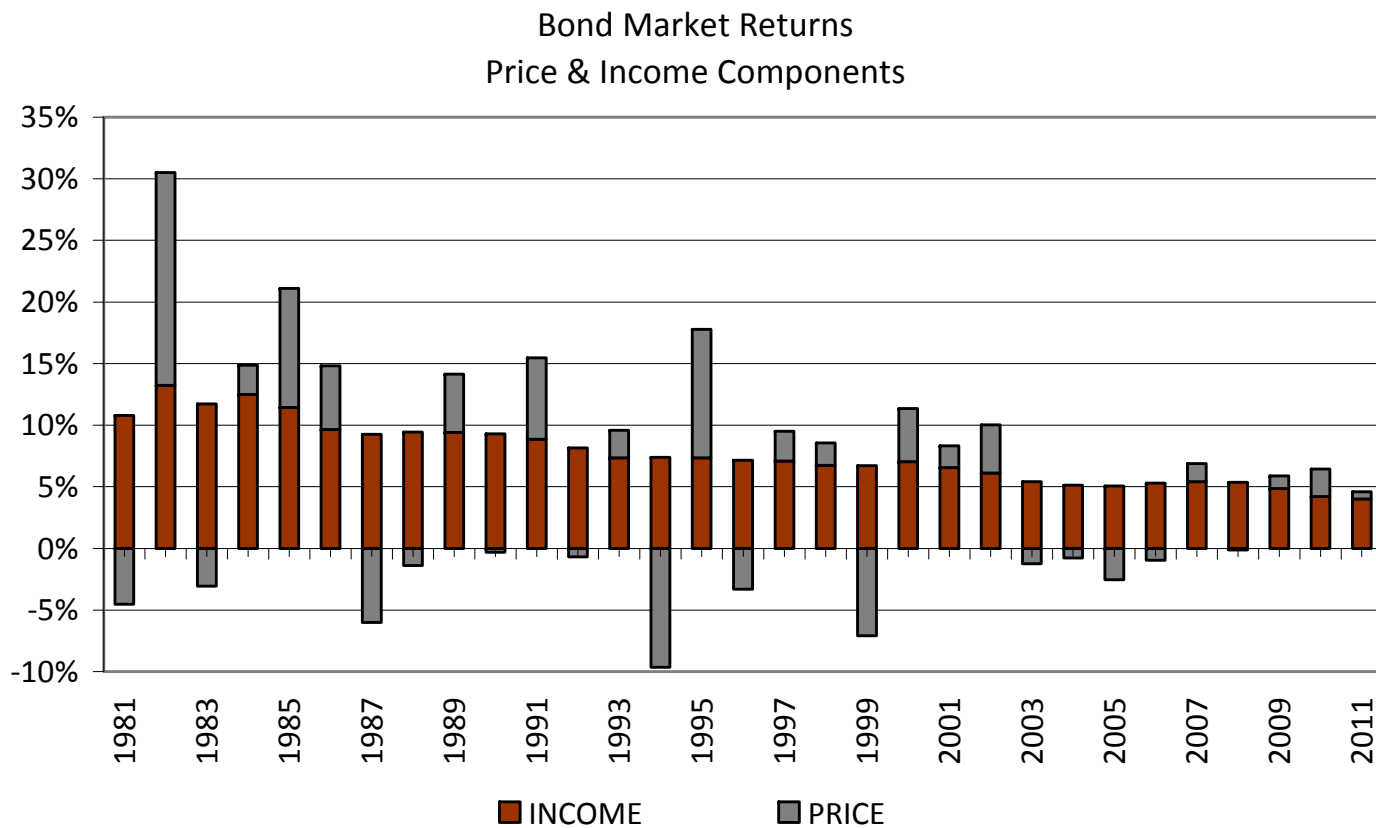


Source: Bloomberg

As duration relative to yield has risen, the impact of rising rates on market values is magnified.



Source: Barclays



Source: Barclays

- The Federal Reserve has stated they are willing to keep rates low until 2013
- The modified duration of a 10-Year Treasury is 40% longer than it was in 1992, which increases interest rate risk
- The Fed's "Twist" has pushed long-bond yields artificially lower
- While inflation is unlikely to become problematic in the short term, continued low interest rates will eventually exacerbate the inflation risk

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We have now entered an unprecedented asymmetrical risk/reward scenario for bonds.

It's time to have a talk with our clients.

- **Return expectations need to be adjusted lower**

It's time to have a talk with our clients.

- Return expectations need to be adjusted lower
- **Diversify the types of risks in client bond portfolios**

- **Reduce Duration (offset Interest Rate Risk):**  
Given the low yields on bonds, a 1% increase in interest rates will produce a 19% loss on a 30-year Treasury. Buying shorter bonds will help preserve market value.
- **Ladder Portfolio Maturities (offset Reinvestment and Opportunity Risk):**  
Laddering portfolios will provide continued reinvestment opportunities at higher rates as rates rise.
- **Consider Corporate Credit or High Yield Bonds (offset Interest Rate and Inflation Risk):**  
Higher yielding bonds have historically performed better in a rising rate environment. Spreads are wider, and the income component of performance helps offset the price component. However, high yield tends to have a higher correlation to equities than most fixed income classes, and increased credit risk.
- **Buy Treasury Inflation-Protected Securities (offset Inflation Risk):**  
The increase in income during inflationary periods helps offset price decreases, but it may be too early for TIPS to offer an advantage.
- **Add Floating Rate Securities (offset Interest Rate Risk):**  
The income will increase as rates rise, helping to offset the interest rate risk, but they pay next to nothing now as they're based on short term rates.

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None of these offers a complete hedge. Diversification across classes, sectors and durations is prudent.

	Overall Rankings During Periods of Rising Yields (Jan 94-Feb 11)
Highest Return	<b>EM Debt</b>
	<b>Commodities</b>
	<b>US Equities</b>
	<b>Distressed Debt</b>
	<b>Senior Loans</b>
	<b>Gold</b>
	<b>High Yield</b>
	<b>ABS</b>
	<b>Inflation-Linked</b>
	<b>MBS</b>
Lowest Return	<b>US Core</b>

Source: Credit Suisse Asset Management

It's time to have a talk with our clients.

- Return expectations need to be adjusted lower
- Diversify the types of risks in client bond portfolios
- **Consider whether extreme valuation disparities should lead to a change in Asset Allocation**

Asset Allocation is a long-term decision, and we generally recommend staying the course. However, there are two reasons to change a portfolio asset allocation.

## Client's Objective or Risk Changes

If a client's targeted goals are within reach, the goals have changed, or their risk tolerance is no longer the same, then asset allocation should be reevaluated.

- Especially appropriate as objectives change
- Historically been the main reason for shifts

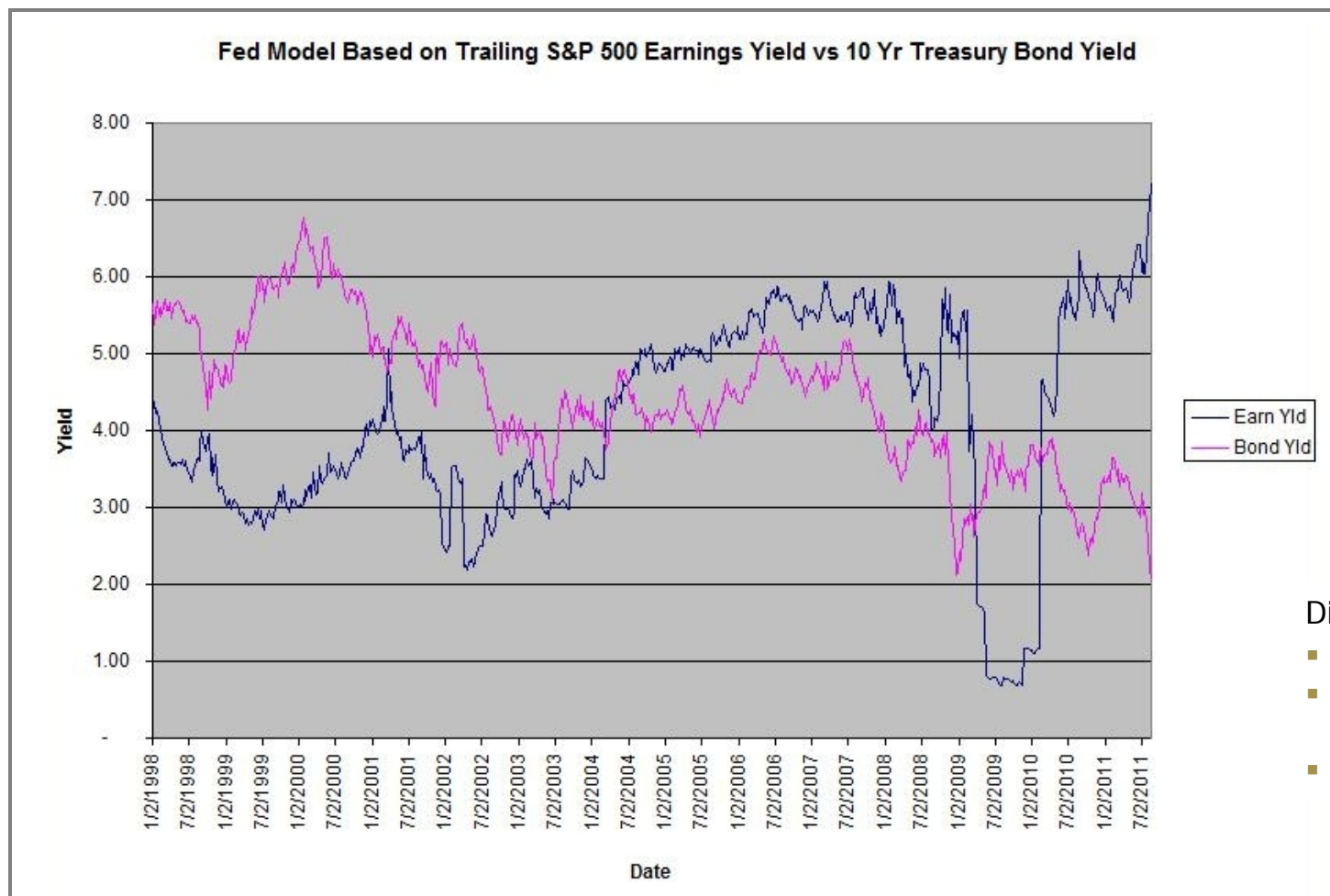
## Market Changes

If the markets change substantially and in such a way as to alter the risk/reward scenarios, then a change may be warranted.

- Now major and long-lasting changes in the market – from Agencies to CDOs to Munis to Equity
- Elevated volatility and an historically low rate environment
- Downside correlation risk

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Given the changes in the market, relative value may have shifted.



Dividend Paying Stocks Offer:

- Supportive income
- Lower relative volatility to other equities
- Superior total returns

A diversified portfolio of dividend-growing U.S. stocks now yields 3.9%.

Equities now offer a yield advantage over fixed income, although the equity classes offer different risks.

This presentation can be found at [www.miles-capital.com/insights/commentary.html](http://www.miles-capital.com/insights/commentary.html).

Questions?