FA
FINANCIAL ADVISOR

Navigating A Rising Interest Rate World

BOND MANAGERS DISCUSS THEIR STRATEGIES AND THE IMPORTANCE OF THE ASSET CLASS.

A special sponsored supplement of *Financial Advisor* Magazine

PLOTTING A COURSE

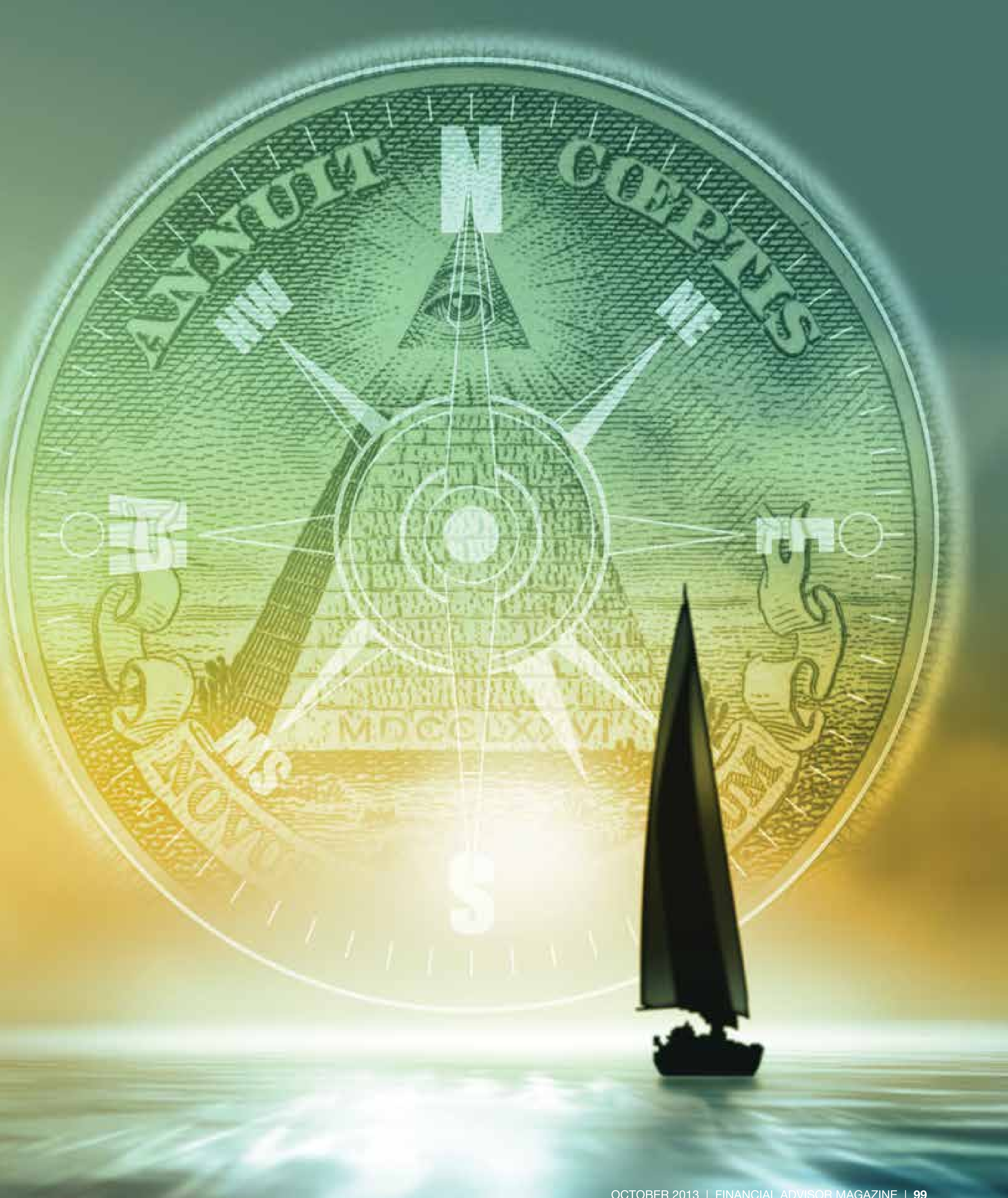
Financial advisors are adjusting bond allocations in client portfolios to decrease interest-rate sensitivity and capture higher yields.

By Jerilyn Klein Bier

Unless investors have been living on a deserted island in recent months, they have probably had some anxiety attacks over the bond market, which is facing its worst losses in decades. Bond prices fell sharply this spring after the Federal Reserve said it might taper its quantitative easing efforts sooner than expected. Speculation over how new Fed leadership next year will handle monetary policy has been rattling the bond market since summer.

But financial advisors aren't pushing the panic button despite expectations of rising interest rates. Instead, they are shortening duration of bond portfolios to decrease interest rate sensitivity. They are also tweaking these portfolios in other ways to try to capture higher yields.

"We're going from playing offense to defense," says Mark Balasa, co-CEO and chief investment officer of Balasa Dinverno Foltz LLC (BDF), an Itasca, Ill.-based wealth management firm which manages $2.5 billion for approximately 800 clients.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Balasa sees no other choice. "If we sell bonds, where do we go?" he says. "A bad day with bonds is a couple-percent loss, but nothing at all compared to the risk on stocks."

While the Barclays U.S. Aggregate Bond Index declined 2.84% this year through August 31, in 2008 stocks lost 30% to 40% depending on their asset class, he notes. Meanwhile, cash offers no return and real estate values could be impacted by rising interest rates, he says.

To prepare for higher rates, BDF has incrementally shifted its fixed-income asset allocations several times since the fall of 2012. "We're telling clients they'll probably have more changes in their bond holdings over the next two years than in the last 10," says Balasa.

In late August, BDF boosted its allocation to U.S. corporate bonds (from 15% to 25%), developed foreign market bonds (from 15% to 20%) and high-yield bonds (from 8% to 12%) while reducing its share in government-related mortgage-backed securities (from 23% to 15%), U.S. Treasuries (from 18% to 14%) and Treasury Inflation-Protected Securities (from 12% to 4%). Allocations remain unchanged in non-agency mortgages (4%) and emerging-market debt (5% to 6%).

Clients are also getting exposure to floating-rate bonds—which sport low duration—that are included in BDF's high-yield and corporate bond asset-class allocations.

BDF's current fixed-income composite mix has a duration of 3.5 years, compared with 5.3 years for the Barclays U.S. Aggregate Bond Index. "Shorter duration is another step on the road to making a portfolio more defensive," says Balasa, "but if you go too short too quickly, there's no yield."

He anticipates that through year-end, interest rates will be generally stable and the principal side will be fairly quiet as well. Over the next couple of years, depending on what the Fed does, "There will be pressure for higher rates, concerns about increased inflation, a slowly recovering economy and a need to be defensive with a bond portfolio," he says. As for who succeeds Fed Chairman Ben Bernanke, "I think there will be differences, but not huge," he says.

Meanwhile, BDF is trying to get ideas from "people who have an ear to the ground," he says, including asset managers Pacific Investment Management Co. (Pimco), State Street Corp., BlackRock and the Vanguard Group.

LONG, ERRATIC UPHILL CLIMB

FAI Wealth Management (formerly Financial Advantage Inc.), a Columbia, Md.-based firm that manages $330 million for approximately 220 families, shortened the duration of its bond portfolio at the beginning of both 2012 and 2013. "That's the best defense against rising interest rates," says J. Michael Martin, the firm's chairman and chief investment officer.

"Our expectation, and that's a lot different than knowledge, is that we have seen the low point in bond rates and it's going to be a long, erratic uphill climb," he says. Namely, he sees a continuing struggle between monetary policy and real-world supply and demand for capital.

While the Federal Reserve and some other nations' central banks will likely continue to manipulate currencies and supply and demand for bonds, global economic growth won't be anything like its pace over the past 30 to 50 years, he says. A major deterrent, he says, is an aging global population that could slow down and even shrink workforce growth.

Martin isn't worried about the Federal Reserve tightening rates. "I haven't seen anyone tightening anything yet. It's been loosey goosey for the last six years," he says. "What they're deathly afraid of is a repeat of the Great Depression," he says.

Still, he thinks that inflation risk and credit problems associated with the huge increase in government debt over the last decade will put some upward pressures on rates. Lenders have begun demanding higher yields on municipal bond issues in Michigan since Detroit's July bankruptcy filing, and other financially challenged states could potentially see similar situations. Furthermore, if the Federal Reserve stops buying bonds at its low overnight rate, the public will have to buy them and will demand higher returns, he says.

To shorten duration in the face of its concerns, FAI Wealth Management has made a number of changes to its fixed-income asset allocations. Its biggest move has been eliminating long-term corporate bonds, which had made up 10% of its bond portfolio, and switching these assets into floating-rate notes, which now comprise 24% of its total fixed-income holdings.

"IF WE SELL BONDS, WHERE DO WE GO? A BAD DAY WITH BONDS IS A COUPLE-PERCENT LOSS, BUT NOTHING AT ALL COMPARED TO THE RISK ON STOCKS."

—MARK BALASA

Earlier this year, the firm sold off its position in a bond fund it had owned for 25 years, the Loomis Sayles Bond Fund (LSBDX), which had a 5.5-year duration. It substituted it with the Eaton Vance Floating Rate Fund (EIBLX), which has a two-month duration. FAI Wealth Management also owns the John Hancock Floating Rate Income Fund (JFIIX).

The balance of FAI Wealth Management's bond holdings are in mortgage securities (20%), short-term investment-grade corporate bonds (18%), investment-grade corporate bonds (14%), global bonds (13%) and multi-sector lower quality bonds (11%), says Martin.

For mortgage securities, FAI Wealth Management uses the FPA New Income Fund (FPNIX), which has a duration of two years. Its other funds and their durations (in years) include the Vanguard Short-Term Investment-Grade Admiral Shares (VFSUX), 2.4; the Loomis Sayles Investment Grade Bond Fund (LSIIX), 5.3; the Templeton Global Bond Fund (TGBAX), 1.6; and, for multi-sector lower quality bonds, the Osterweis Strategic Income Fund (OSTIX), 2.4.

Martin doesn't plan to further shorten the duration of his bond holdings. "They're about as short as they can go and still have a bond portfolio," he says.

Bonds are critical to FAI Wealth Management since more than half its clients are retired. They comprise 58% of its asset allocation in its most conservative risk profile, designed for clients who use their portfolio for retirement income. Bonds make up 41% of its core or middle-risk profile and 23% of its accumulation profile, its most aggressive profile. The latter is geared mostly to younger clients who are still saving, as well as older clients who have a nest egg and are partially investing for the next generation. All three bond allocations, largely determined by the firm's equity exposure, have been fairly consistent the past two years, he says.

FROM BELLY TO BARBELL

Sage Advisory Services Ltd. Co., an Austin, Texas-based registered investment advisory firm with approximately $10 billion under management, has also been altering its fixed-income allocations. Until recently, it has focused on what co-founder and managing director Mark MacQueen calls the "belly" or the middle of the yield curve by buying a mix of three-, four- and five-year securities. It has begun to shift away from this strategy and is now moving its portfolios to a barbell allocation that balances longer-dated securities with very short-dated securities.

"To most, buying longer-dated securities is counterintuitive, but we create the same duration (interest-rate risk)," he says. "We believe this will be more defensive when the Fed starts tightening monetary policy."

Why? As interest rates have risen, most of the increases have been in 10-year and 30-year bonds, he says. Since the yield curve is historically very steep, Sage believes that going forward the long end will adjust up less than the intermediate sector when rates rise. Meanwhile, bonds on the front end of the barbell have very little duration risk since their maturities are so short, he says.

Sage, which runs separately managed accounts using individual securities, is also overweighting its use of corporate bonds—particularly in the financial corporate sector. Major banks are still improving the quality of their balance sheets and getting their legal issues behind them, says MacQueen.

The firm is also adding to positions in AAA-rated asset-backed securities, commercial mortgage-backed securities and agency mortgage-backed securities. It thinks the real estate side of the equation looks very stable based on delinquency and occupancy data, and it thinks the real estate market can continue to recover, he says.

Currently, Sage's fixed-income allocations are 22% in U.S. Treasuries and U.S. agency debentures, 48% in corporate bonds, 12% in AAA-rated asset-backed securities (such as credit card receivables and automobile loan receivables), 8% in agency mortgage-backed securities (like Ginnie Mae, Fannie Mae and Freddie Mac), 5% in commercial mortgage-backed securities and 5% in cash.

Sage is interested in the high-quality parts of the market, says MacQueen. "We think spreads have tightened tremendously," he says. "Though not yet back to 2007 tight, they have recovered the majority of the widening caused by the financial crisis."

Likewise, Sage believes that the other sectors of the bond market offer a better relative value compared with U.S. Treasurys and U.S. agencies. "You are being compensated appropriately for the additional risk," he says, and "as the economy improves, these sectors should all benefit from better balance sheets and more security and certainty to bond holders."

For each asset class, Sage uses products across the yield curve from short duration through long duration. "Within each product, I'm between 10% and 25% short of the benchmark from a duration perspective," he says. "If it's four years, I'm somewhere between 3.25 to 3.6 years of duration."

MacQueen doesn't expect a big increase in interest rates anytime soon. "We need to see higher GDP and lower unemployment for me to say we are going to see significantly higher rates in the future," he says. "Ten-year notes I guess could go to 3.5% or 4% easily, but seriously, there are a lot of ifs before that can happen—meaning economic growth in the U.S. and globally."

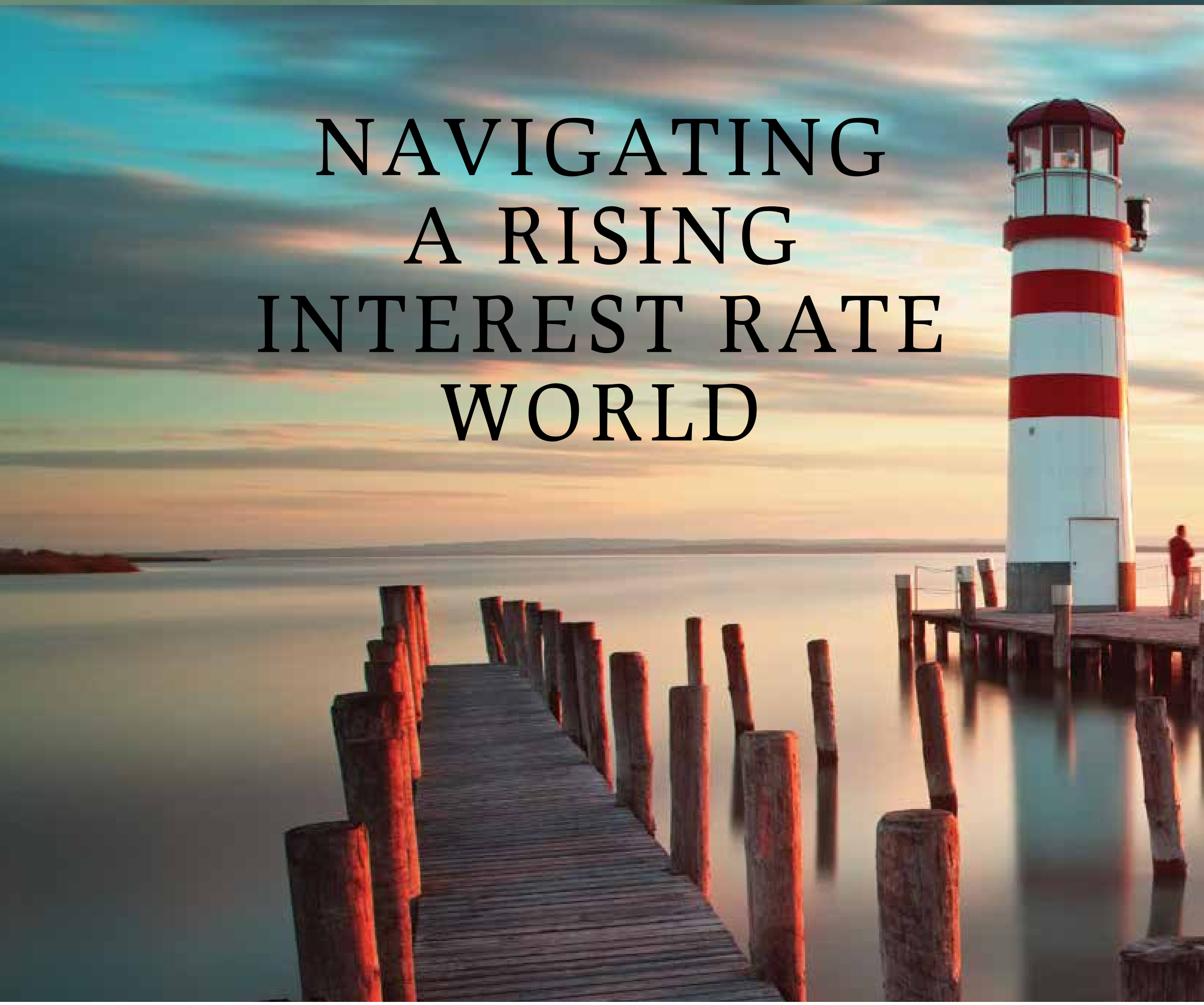
"Europe has kind of bottomed out, but they have a lot of work to do to fix themselves," he says. "They're much more intent on keeping rates low because they were late to the party of bringing them down in the first place." He also notes that emerging markets growth has slowed, particularly China.

CLIENT COMMUNICATIONS

Martin of FAI Wealth Management understands client concerns about potentially rising interest rates. Keeping them calm "is probably our biggest challenge," he says. "When you used to be able to get 5% or 6% nominal yield and now you get 3%, and then you get an increase in interest rates that knocks 2% off the value of your bond, you're an unhappy camper."

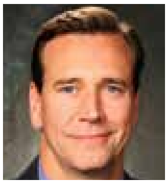
To help improve client communications about the current bond environment, BDF has developed a three-part Webinar, has sent letters to clients and makes this part of the agenda in client meetings. But ultimately the firm takes the cues from clients on how deeply to delve into these discussions. "Some want to know the details," says Balasa, and "some yawn and keep moving." FA

NAVIGATING A RISING INTEREST RATE WORLD



Expected interest rate hikes by the Federal Reserve have produced volatile fixed-income markets that are extremely challenging for many investors. But in spite of the uncertainties, financial advisors know that bonds add needed diversity to portfolios and are less risky than stock over the long term. They deliver income on a schedule to investors who need cash flow in retirement.

In the following pages, bond portfolio managers offer their outlooks in 10 commentaries that provide valuable insight on what financial advisors should consider when deciding how to allocate clients' money to this essential asset class.



Michael J. Collins
Senior Investment Officer and Senior Portfolio Manager for Multi-Sector Fixed Income Strategies
Prudential Fixed Income

Conditions May Favor Absolute Return

While perhaps counterintuitive, the economic recovery may have once again created opportunities in the bond market. After a three decade bull market in interest rates, the vast majority of appreciation from declining rates in developed countries is largely behind us. As such, some investors are looking for strategies that can provide higher yields than cash and also help hedge against rising rates.

An "absolute return" fixed-income strategy may meet both of these objectives. Absolute return solutions come in many flavors with different parameters. We believe a well-diversified strategy that actively manages duration, within a modest band relative to a near zero duration cash benchmark, represents the best approach to keeping the alpha associated with fixed-income security selection while limiting the structural interest rate beta. By comparison, portfolios with wider duration bands (e.g., up to five years) may result in a return series that is inconsistent with an investor's objective since the portfolio may drift into an intermediate or long duration "style box", possibly at an inopportune time.

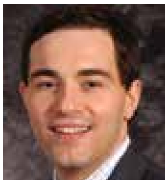
In our opinion, actively managing a diversified portfolio across sectors, security types, rates, and currencies in both developed and emerging countries provides the strongest base to consistently generate alpha, respond to changing market conditions, limit idiosyncratic risk, and manage risk.

Another potential benefit of a diversified, duration-constrained absolute return strategy is that it tends to have a low correlation to traditional fixed-income portfolios. During periods of rising government bond yields, an absolute return portfolio with a near zero duration has the potential to post positive returns.

Although the bull market in developed country government bonds is largely behind us, we believe fixed income could still provide plenty of alpha opportunities for investors.

See our corporate profile and important disclosure information on page 113.

Visit prudentialmutualfunds.com/manage-fixed-income-risks for more information.



David B. Mazza
Head of ETF Investment Strategy, Americas,
State Street Global Advisors

Adapted from After The Dust Settles: Fixed Income in a Rising Rate Environment

With abnormally low yields over the last few years, investors have been on high alert to the potential impact that an unpleasant end to a 30-plus year bull-run in bonds could have on their portfolios. With U.S. 10-Year Treasury yields rising sharply since the end of April, many investors are now feeling the pain. However, fixed income can and should remain core to investment portfolios due to its potential for income generation, diversification and capital preservation. Fortunately, there are opportunities available for savvy investors to create portfolios regardless of how far and fast rates may rise over the rest of the year.

With 10-year TIPS moving into positive territory, investors appear to be pricing in Fed tightening or at least tapering sooner than many expected. In fact, yields could move up if economic growth surprises to the upside or the market continues pricing in Fed policy changes earlier than expected. Many are looking back to previous Fed tightening signals for clues and courses of action. With 1994 and 2004 potentially providing weak guidance due to the extent of extraordinary monetary policy today, investors should look beyond the core to build portfolios that behave less like return-free risk. In doing so, investors can also move beyond certain well-trodden segments that may be crowded and no longer offer their historical value propositions. We believe unique credit exposures across multiple sectors are potentially an attractive solution today and may allow for the development of more resilient and adaptive fixed-income portfolios in a rising rate environment. Investors should consult their financial advisor to determine the desired portfolio allocation to meet their needs.

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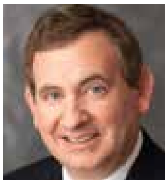

Tad Rivelle
Chief Investment Officer, Fixed Income
TCW MetWest

Bernanke's Taper Tinkering

For the past five years, the Fed has cast an exceedingly long shadow over the capital markets. Yet, after multiple rounds of stimulus, the U.S. economy has continued to disappoint on the metrics that matter most: job creation and economic growth.

Financial repressive policies were launched in 2008 in response to the systemic risks that were posed by the calamitous decline in asset prices. Judged by the level of financial stabilization that was achieved, QE1 can be judged "safe and effective" in the treatment of systemic risk. Encouraged, the Fed initiated QE2 in 2010 to ease policy at the "zero bound" and buy deflation insurance. The Fed recognized that by lifting market expectations of inflation, it could effectuate lower real rates. QE2 appeared to have some success on this front. In 2012, QE infinity was expected to solve for "full employment." The Fed was looking to take a weak recovery and make it strong by embarking on an expansion of its balance sheet.

Investors are increasingly aware that monetary policy is not a panacea and that QE3 is not meaningfully lifting the pace of hiring. Further, the Fed's extraordinary policy regime seems out of place five years after the financial crisis. Zero rates and QE have begotten distorted decision-making that has taken the form of an excess of capital flows into real-estate, leveraged finance, the emerging markets, and stocks. Asset prices have become at least moderately decoupled from fundamentals as evidenced by such dynamics as rapidly rising real-estate prices unsupported by stagnant wage and job growth. Consequently, many have a deeper appreciation that QE3 may both lack efficacy in the treatment of a weak recovery and may not be safe given the side effects that are being manifested. For these reasons, we believe that the end of QE3 is nigh, and that financially repressive policies may be generally tapered over the course of 2014.

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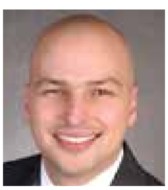

Dirk Hofschire
Senior Vice President,
Asset Allocation Research Team
Fidelity Investments

Outlook For Bonds In A Challenging Yield Environment

The current environment is tremendously challenging for fixed-income investors. The same accommodative monetary policy in place to quell deflationary trends and promote spending, investment, and job growth, has contributed to rising bond valuations and slim yield spreads. As advisors look to the bond sector for income, diversification, and capital preservation, they are concerned about the outlook for interest rates in this low-yield environment.

Key themes to consider:

• With U.S. economic growth likely to remain slow and declining demographic growth patterns globally, there is little risk of an aggressive Fed tightening over the next couple of years.

• While advisors need to help investors adjust their return expectations developed during years of strong returns for high-quality fixed-income assets, they should also make sure they continue to recognize the role this sector can play when seeking stability and diversification.

• Even in a low rate environment, history suggests high-quality bonds exhibit lower performance volatility than equities and other riskier asset classes, as well as provide important diversification benefits.

• The attributes of high-quality bonds continue to make them an important anchor within a fixed-income asset allocation.

Within an overall asset allocation, an actively managed portfolio composed of multiple fixed-income sectors can help investors meet their investment objectives—notwithstanding the interest rate environment. Active management can address the intricacies of the fixed-income market while providing bond exposures aligned with investor objectives. This approach can provide the tactical adeptness necessary as markets evolve and performance leadership changes among diverse sectors.

See our corporate profile on page 111.

Visit advisor.fidelity.com for more information.

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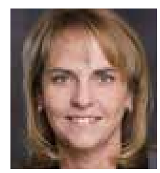

Colleen Denzler, CFA
Global Head of Fixed Income Strategy
Janus

Rising Rates: Challenge and Opportunity

Investors have flocked to bond markets in recent years, sending yields to record lows. However, an improving economy may give the Federal Reserve (Fed) the support it needs to change its accommodative monetary policy, leading to higher interest rates. We don't view this as a crisis. In our opinion, periods of rising rates are normal and can create opportunities for active bond managers.

Since 1970, there have been 21 periods in which rates rose significantly. While each period is unique, it's worth noting that over the past 40 years equities were more likely to rally, not decline, when rates rose. In the 1990s-2000s, the S&P 500 Index rose in all such periods, while in the 1970s-1980s the index rallied roughly half the time (partly because Fed policy was less effective in containing inflation during those years). Historically, strong equity markets have supported corporate credit prices even when rates were rising.

Interest rate moves also have not been linear—there were spikes and pullbacks, allowing active bond managers to buy securities at attractive valuations, reposition at different points along the yield curve and reallocate between asset classes, sectors and securities. All of this can be good for investors in terms of capital preservation and positioning for the next market cycle.

Lastly, while passive investors may experience a rocky ride, active bond managers typically have more flexibility to manage duration and to benefit from market dislocations through security selection. After absorbing the Fed's new direction, we believe market attention will shift to company fundamentals, and that companies undergoing positive structural change and balance sheet enhancement will be rewarded. In our view, managers experienced in managing duration risk and employing fundamental, bottom-up security selection will be well-positioned to maximize risk-adjusted returns and preserve client capital.

See our corporate profile and important disclosure information on page 112.

Visit janus.com for more information.

Douglas M. Hodge, CFA
Managing Director, Chief Operating Officer
PIMCO

Inflection Points: Why Demand For Bonds Will Rebound

One of the keys to successful investing is the ability to identify inflection points and predict whether underlying trends will accelerate, reverse or level off.

Federal Reserve Chairman Ben Bernanke's talk of tapering triggered an inflection point. His comments dramatically boosted interest rates, increased equity price volatility and influenced investors' risk and asset preferences.

The jump to higher interest rates has, of course, resulted in losses for most bond investors and encouraged outflows from the asset class. It also has raised concerns about further rate hikes. Yet there are reasons to believe that over the secular horizon, flows into bond funds will turn positive.

• First, bonds are less risky than stocks over the long term. Not only are stocks sensitive to rising interest rates, if less directly than bonds, their sensitivity is likely to increase over time. What's more, bonds are higher up in the capital structure, a high priority corporate obligation to pay interest and principal on a timely basis and confer a claim on assets of the company.

• Second, many of America's largest corporate pension funds and insurance companies continue to buy long-dated bonds to cover liabilities that can extend decades into the future, potentially helping to de-risk portfolios long-term. We expect individual investors will eventually follow suit.

• Finally, secular forces point to increasing demand for the steady income bonds can provide, from the rapidly increasing numbers of cash-hungry retirees in developed countries and the burgeoning numbers of wealthy individuals in emerging economies. These trends will only be enhanced by the ongoing redefinition of the social contract over who will be responsible for the financial security of individuals in their old age.

As rates reset at higher levels, yields will likely increase, enhancing the opportunity for bonds to provide even more attractive return and income. In the meantime, investors should remind themselves that the journey to financial security is a long one. It is full of bumps, turns … and the occasional inflection point.

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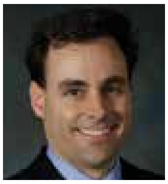
Visit pimco.com/investments for more information.



Eric Taylor
National Sales Manager for Annuities
Genworth Financial

Reduce Portfolio Volatility—Index Annuities

For decades, consumers have relied on bond mutual funds as a way to create current income and diversify their portfolio from the higher volatility associated with equities. In fact, as interest rates have generally declined since the early 1980s, many bond funds have provided solid long-term returns.

Today, the need for income and diversification hasn't changed, but the interest rate environment most certainly has. As bond funds work to manage risk from historically low yields, now may be the time for consumers to consider expanding their horizons when thinking about additional options for their fixed-income portfolio.

With yields on the rise, and three consecutive months of losses as of August, 2013, bond funds have seen significant outflows.[1]

Consumers exiting bond funds may be looking for financial products that can create:

• A source of interest income for their retirement portfolio.
• Diversification to help reduce risk, including interest rate risk.
• A better yield opportunity than other conservative financial products.

There are alternatives available to a bond fund that can help accomplish the consumer's financial goals. Although not a security, many fixed-index annuities provide financial benefits consumers are looking for:

• Guaranteed growth (if held for a specific period),
• Protection of principal from the impact of interest rate spikes and equity market declines
• The opportunity to credit interest rates similar to or higher than many fixed-income products.

To access a consumer-use tool you can customize with your contact information and give directly to clients, visit Genworth.com/index-institute/marketing-tools/fia-sales-ideas.html.

[1] http://finance.yahoo.com/qbc?s=%5ETNX+Basic+Chart&t=3m

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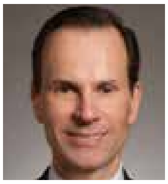

Tony Rodriguez
Co-Head Fixed Income
Nuveen Asset Management

Taxable Fixed Income Outlook: Income May Calm Rate Worries

The mid-year rise in interest rates increased investors' concerns about fixed-income positions. Focusing on a bond's most distinguishing feature—payment of income on a predetermined schedule—may offer a measure of reassurance in a rate environment that remains uncertain. Few other investments can offer this regular cash flow. Stocks pay dividends, but these can be cut or skipped. Cash investments may offer some income in a higher interest rate world, but today they pay nearly zero.

Lately the media has been focused on the end of the bull market for bond price appreciation, but historically the total return of bonds has mainly stemmed from income. Even in the period since the credit crisis—when greatly depressed bond prices staged a remarkable recovery—we calculate that more than 80% of the total return was due to income. Examining the past 30 years reveals that bonds have typically generated returns through income rather than price appreciation.

It is important to mention that rising interest rates may actually increase the income that a fixed-income portfolio may generate. As rates increase, cash flow can be used to add newer bonds to an actively managed portfolio at higher yields. Rising rates may be bad for bond prices, but they may be very good for income generation.

It was once common to complement a stock portfolio with a plain-Jane government bond fund, but today's investor may need a more diversified mix of income-generating fixed-income assets that likely mixes both high and low-quality corporate bonds with market segments considered exotic just a few years ago. This multi-sector combination is clearly not your grandmother's government bond portfolio, and this increasing complexity has created a greater need for portfolios with an active allocation style to navigate the markets.

See our corporate profile on page 112.
Visit nuveen.com for more information.

Dan Fuss
Vice Chairman
Loomis, Sayles & Company, L.P.

Managing Fixed Income In A Rising Interest Rate Environment

Our team's view on positioning funds at this time is to prepare for a secular rise in interest rates that should run at least 20 years with four or five intervening cycles. The very obvious first thing to do is to try to limit the overall sensitivity to the base rate of interest as exhibited along the U.S. Treasury yield curve. A big part of this is to bring in the maturities. However, in doing so, it is very important not to reduce the current level of income too much. The fine balance between protecting income and protecting principal must be achieved. This takes careful study and implementation of the yield curve and various yield spreads versus the base yield curve. As rates rise, coupon levels versus par value of bonds also come into play.

The next most important thing in fixed-income portfolio construction is quality and quality spreads versus the Treasury market. In general, the rising interest rate environment tends to favor stronger companies with leading market shares. As time progresses, upward and downward pressures on individual credits will surface and what used to look like reasonable value will no longer appear that way and vice versa.

Rising rates make it even more important to examine the individual differences between issues as well as the differences between issuers. The various explicit and implicit options that both investors and issuers have become more and more important as interest rates rise. Examples of this are many and include sinking funds, investors' puts and indenture provisions that normally give the issuer more latitude under certain circumstances. However, a rising interest rate environment also can improve the position of the investor in regard to the issuer's incentive to circumvent various call protection features.

Other factors that come into play as rates go higher are country of issue and currency. While, a rising interest rate environment impacts countries and their currencies, it also provides both more opportunity and more risk. This may or may not be appropriate for individual portfolios.

In short, the best way to deal with rising market risk is, to the degree possible, substitute specific risk. A rising interest rate environment can create many more opportunities to add meaningful value through good item selection—as long as you have a strong analytical team.

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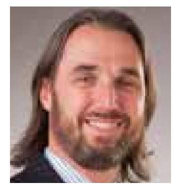

Jeffrey Sherman
Portfolio Manager
DoubleLine Capital LP

Handling With Care, Up Yield Vs. Duration

Biomimicry, to quote design guru Janine Benyus, is the art of the "apprentice of nature." The apprentice imitates the engineering found in living organisms to solve complex problems. Likewise, study of passive asset classes during periods of rising interest rates can reveal active strategies for such environments. This study also yields a bonus discovery: Fixed-income portfolios often have delivered positive returns in the face of rising rates, though not always.

Since inception, the Barclays U.S. Aggregate Bond Index has logged 439 rolling 12-month periods, 42.6% of which ended in a higher yield on the 10-year Treasury. Interestingly, the Aggregate posted rolling 12-month losses only 6.4% of the time. In another analysis at DoubleLine, we identified 17 episodes in which the 10-year yield rose more than 100 basis points, trough to peak. The Agg managed positive returns in eight episodes.

So rising rates don't doom all bond portfolios. Even passive investments of intermediate-term duration can overcome rising rates, sometimes. Active management can improve those odds. The key is to maximize income relative to duration while practicing prudent risk management.

Personally, I doubt a rising-rate spiral lurks around the near-term corner. Where's the catalyst? Disinflation? Stagnant household income? Homeownership affordability? Bank deleveraging? Curtailed federal spending? Growth looks vulnerable if the 10-year were to yield above 3%. That said, the world can always surprise, and regardless of my macro opinion, managing portfolio yield to duration is common sense.

How to implement that common sense? Diversify income streams across the global bond market. Consider adding to floating-rate debt like bank loans, CLOs and certain MBS. Own fixed-rate streams with higher yield than duration. Higher income dampens portfolio volatility and buffers interest rate volatility. At this writing, the Aggregate yields 2% with duration of 5½ years. So that index would lose more than 3% if rates rise 1% over a year. A hypothetical portfolio yielding 5% with duration of 2 would return 3%.

Finally, remember loathing of asset classes begets discounted income streams—such as in certain mortgage REITs and emerging market debt at the end of August. The prepared manager seizes these opportunities.

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