

Fixed-Income

Q4
2011

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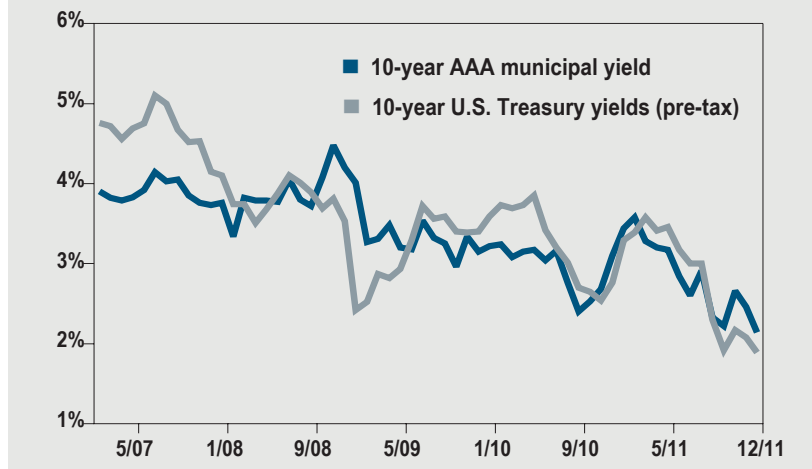
Extreme volatility and frustration with the market's continued disregard for company fundamentals prompted many investors to seek safety in low-yielding bonds during the quarter, as they did all year. Treasury prices rose 9.8% in 2011, despite a summer ratings downgrade by Standard & Poor's. The municipal and investment-grade markets also saw continued strength, rising 7.6% and 7.8%, respectively.

Once again, uncertainty surrounding the fate of the Eurozone and concerns over the inability of U.S. politicians to overcome their differences and meaningfully address the deficit prompted investors to move into fixed-income securities. While bonds took a bit of a breather in the fourth quarter, they remained in positive territory. High-quality bonds delivered strong growth throughout the year, proving to be important components of a balanced portfolio by helping to preserve capital, generate income and offset equity volatility.

The Federal Reserve has repeatedly stated that short-term policy rates will remain near zero at least until mid-2013. Because resolving the European sovereign debt crisis will be a slow process and questions about U.S. fiscal policy remain, we don't foresee a

Municipal bond yields are more attractive than usual relative to U.S. Treasuries

Figure 1



Sources: Board of Governors of the Federal Reserve System (U.S. Treasury yield) and Municipal Market Advisors (municipal yield). AAA municipal yield represents the closing average of the 10-year AAA general obligation municipal yield.

marked increase in interest rates any time soon. In such an environment, our emphasis will continue to be on credit quality and on identifying relative value across the maturity spectrum.

Fed Chairman Ben Bernanke is unlikely to introduce another round of quantitative easing unless the Eurozone's troubles deepen and China experiences a hard landing from the government's attempts to rein in inflation. However, Bernanke has made it clear that he will not hesitate to launch more accommodative monetary policy if necessary to help prevent another recession in the U.S.

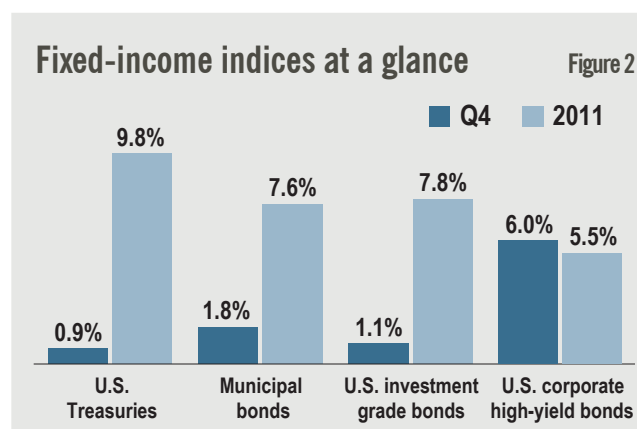
Jefferson County, Alabama, made headlines when an inability to refinance a massive sewer renovation drove the municipality to seek bankruptcy protection in the fourth quarter. A pricey incinerator project nearly caused a second default in Harrisburg, Pennsylvania, but for a ruling that placed the city under the state's guidance. Neither case disrupted demand for municipal bonds, however, because the problems related to these specific projects were unique. Regardless, your managers continue to watch this sector for signs of weakness related to tightening government budgets, strained tax revenues and rising demand for services among their constituents.

In municipal portfolios, we are focusing on bonds that are supported by dedicated and reliable revenue streams not dependent solely on the health of the municipality. Revenue bonds can be carefully evaluated for strength of management and growth potential in a manner similar to the research-based

assessments we conduct for equities. In turn, our fundamental research helps portfolio managers avoid bonds that carry an excessive risk of default.

Among taxable bonds, mortgage-backed securities remain a central focus, and managers continue to concentrate on areas that carry less risk of refinancing. On the corporate side, investment-grade corporate bonds lost some of their appeal in the last half of the year amid intense volatility across equity markets.

Although bond yields are expected to remain low, we continue to see the value that high-quality bonds offer portfolios, providing balance and much-needed protection from fluctuations in equity markets. Because volatility is likely to linger as long as macroeconomic uncertainty abounds, bonds will continue to be an important portfolio component in 2012. ■



Sources: Barclays Capital U.S. Treasury Index (U.S. Treasuries); Barclays Capital 1–10 Year Municipal Bond Index (municipal bonds); Barclays Capital U.S. Aggregate Index (U.S. investment grade bonds); CS High Yield Index (U.S. corporate high-yield bonds). Index results are presented in US\$ unless otherwise noted. All indices are unmanaged and reflect the reinvestment of dividends, interest and other earnings.

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