



Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

AUGUST 2010



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Managing Bonds in a Low Interest Rate World

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What should a bond manager do when confronted with record low interest rates, no prospect of monetary policy tightening, and uncertainty about whether the economy is in a soft patch or nearing deflation? This issue is not a theoretical exercise. It describes the environment upon which investors must base their decisions today.

When treasury yields were at record low levels in 2003, most bond managers rushed into higher risk corporate bonds and mortgage-backed securities to “grab yield.” This strategy worked for several years as the economy recovered and spreads between higher risk and treasuries narrowed. However, it backfired in 2007-2008, when the economy weakened and corporate and mortgage-backed securities sold off and spreads widened.

Beginning in late 2008, our investment strategy centered on overweighting investment- grade corporate bonds because corporate bonds were very attractive in absolute and relative terms, and we believed the economy would benefit from massive policy stimulus. More recently, however, the average yield of the Barclays Corporate Index has fallen to less than 4.0% (see Figure 1), while the economy has softened. Thus, while the strategy has generated attractive returns to date, the risk-reward balance is much less favorable.

Figure 1: Yield of Barclays Corporate Index



Source: Barclays, Bloomberg

With the economy now at a critical juncture, we are mindful of how its performance impacts credit risk and interest rate risk on bond valuations. For example, corporate bonds typically underperform treasuries in a recession due to increased credit risks; conversely, they typically outperform treasuries in a recovery. That said, corporate bonds are subject to interest rate risk, and they are less liquid than treasuries. With yields approaching all-time lows, we find long-dated corporate bonds to be unattractive now.

Weighing these considerations, the approach we currently favor is a “credit barbell” that combines very high quality securities (long-term treasuries and AAA CMBS) with higher- risk instruments (BB and B high yield paper). In doing so, our objective is to construct portfolios that provide competitive yields, while also offering downside protection against credit risk and interest rate risk.

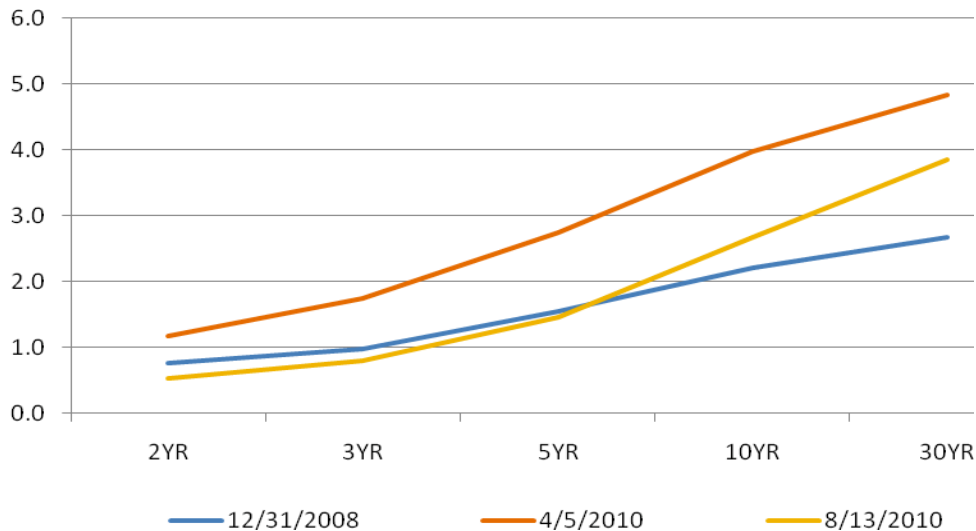
The Current Landscape

Amid the gyrations in the economy and financial markets this year, one clear trend stands out: Interest rates and inflation have fallen to record lows in the United States, Europe and Japan. While many investors view this situation as temporary, the recent slowing of the U.S. and global economy suggest that it could persist for a while.

Indeed, at this month's FOMC meeting, the Federal Reserve acknowledged that recovery was more modest than anticipated and announced it would reinvest the proceeds from maturing mortgage-backed securities into longer-term treasuries. In doing so, the Fed signaled that it is not comfortable removing excess liquidity from the banking system in the current environment.

These developments have caused treasury yields to decline further, such that the front end of the curve currently is below levels reached in December 2008, when the financial system appeared on the brink of collapse (see Figure 2.) The bond market is pricing in that the Fed will not raise interest rates until late 2011, at the earliest. Moreover, investors are now less concerned about the Fed's "exit strategy" and are focusing on possible actions the Fed could take to reinvigorate the economy.

Figure 2: Treasury Yields Are Nearing Record Lows



Source: Bloomberg

This has given rise to a debate about whether the Fed should pursue a second round of quantitative easing in which it would expand its balance sheet through purchases of treasuries. Our assessment is that the round of quantitative easing during the financial crisis was effective in lowering mortgage rates and in reopening the inter-bank market. However, we are skeptical that a new round of quantitative easing will be able to jump start the economy, as banks already have ample excess reserves.

At the same time, we do not think the United States is headed for Japanese style deflation because of rapid adjustments by businesses, households and policymakers to the financial crisis: U.S. corporate profits have rebounded to pre-crisis levels, the household saving rate has increased to 6% recently, and the U.S. policy response has been much greater than Japan's in the 1990s. Consequently, we believe the current low rate environment will eventually give way to rising interest rates as the economy regains momentum. The challenge for bond managers, therefore, is to develop a strategy for the current environment, while recognizing that it could change quickly.

Formulating a New Strategy

In response to this environment we are making significant changes to our portfolios. Even with long-term treasury yields near all-time lows, we prefer owning them instead of high quality long-term corporate bonds. We also view commercial mortgage-backed securities and high yield bonds as attractive alternatives to high-quality, intermediate corporate bonds and agency MBS. This needs some perspective given events of the last several years.

In a white paper entitled “The Unbundling of Fixed Income” (April 2009), we wrote about changes in the fixed income market and how investors should look at their portfolios. We noted that with treasury yields at record lows following a 30 year rally, the risk in so-called “risk free” assets was increasing given the likelihood of rising interest rates in the future.

By late 2008, we had put in place a structural underweight of government bonds and an overweight of credit-sensitive assets (investment grade and high yield corporate bonds). Our rationale was that credit risk premiums had increased to more than double their previous highest levels and absolute yields were very attractive. This strategy turned out to be the correct one, as corporate bonds (investment grade and high yield) briskly outpaced treasuries (see Figure 3). However, with yields now approaching record lows, the opportunity for these types of returns in corporate bonds has passed, and investment managers must consider new strategies to generate attractive returns going forward.

Figure 3: Total Returns for U.S. Bond Market Segments

Total Return 12/31/2008 – 07/31/2010	% Return
Barclays U.S. Treasury Index	2.76%
Barclays Credit Index	24.92%
Barclays High Yield Index	70.96%

Source: Bloomberg

Favoring Long-Term Treasuries over Corporate Bonds

One may first ask why we are buying long Treasury bonds with some of the lowest bonds yields on record. The answer lies in the various forms of risk involved in investing in long maturity corporate bonds.

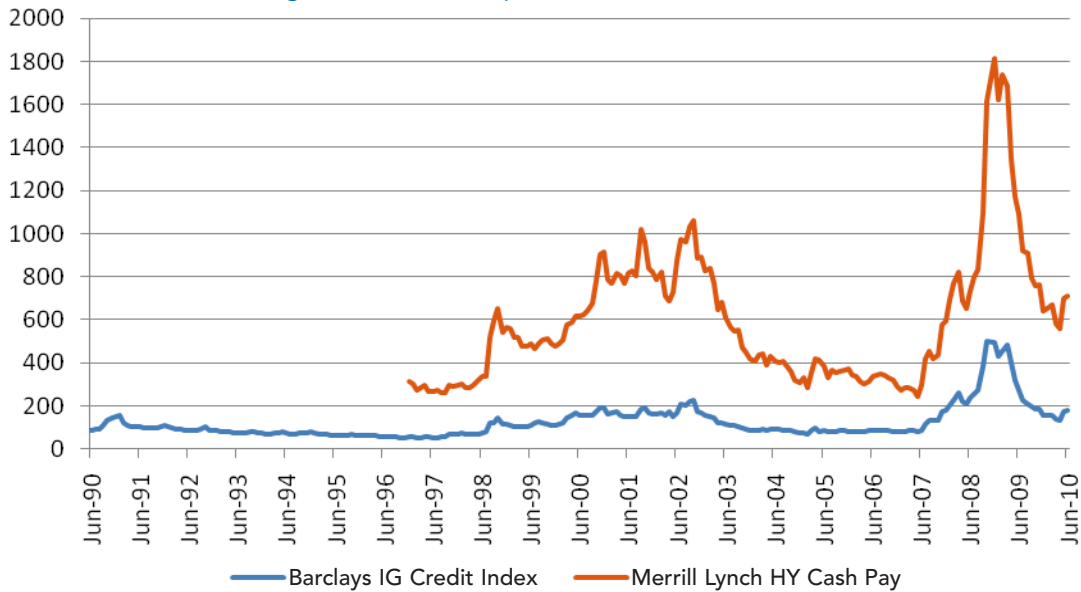
The risk premium (in excess of treasuries) for owning a corporate bond compensates investors for both credit risk and liquidity risk. From a credit risk perspective, the economic outlook and health of corporate profits are the main considerations. At the moment, there are offsetting considerations: The economy is currently subject to a number of uncertainties and headwinds, but corporate profits have experienced a healthy rebound, due to aggressive cost cutting measures. However, we believe the economy and markets are in uncharted waters, such that “tail risks” – or outlier outcomes – are large enough to require a larger risk premium for high quality corporate bonds.

Liquidity risk, by definition, is the risk of not being able to sell bonds at attractive prices, or in some instances not being able to sell at all. If bond markets were to experience difficulties, liquidity will be essential and we feel the risk premiums, especially in the higher quality corporate bonds, do not offer adequate compensation. We are also concerned about being able to exit positions in a rising interest rate environment, and it is more difficult to do so in long maturity corporate bonds than in treasuries.

Adding High Yield Bonds and CMBS

At first blush, it may seem counterintuitive to add to high yield bonds when the economy is facing the current uncertainties. However, we believe the high yield sector is attractive relative to other sectors, even considering these risks. First of all, default rates have steadily drifted lower as the economy improved and income and balance sheets have strengthened. Moreover, the risk premium for high yield bonds has remained relatively large in contrast to many other sectors. (See Figure 4)

Figure 4: Credit Spreads versus Treasuries



Source: Bloomberg

High yield has also proved to be an efficient asset class over the past few years, behaving largely as expected during and after the financial crisis. This stands in stark contrast to other asset classes that were perceived to be “less risky” assets including money markets, mortgage backed securities and investment grade corporate bonds.

One lesson of the last few years is that there are many forms of risk. High yield holds the rare distinction of having the perceived risks to be aligned with the actual risks. The Fort Washington high yield strategy is especially effective in this type of investing environment. Our strategy focuses on the higher quality spectrum of the market (BB and B- rated securities), emphasizing companies with free cash flow, stable asset values, and quality business models and management. The return expectations for our strategy are to provide downside protection in difficult markets and to experience most of the upside in very strong markets, with the blend of these periods resulting in outperformance over a full market cycle.

Finally, we believe that commercial mortgage-backed securities (CMBS) offer attractive value versus other high-quality intermediate term sectors, such as corporate bonds and agency mortgage-backed securities. This sector is considered troubled by many, but the key to successfully investing in this sector lies in the types of securities purchased. As is our philosophy with High Yield, the riskier portions of the market do not offer attractive value and we believe the higher quality portions offer an attractive risk/return tradeoff.

Conclusion

We began by asking what strategy a bond manager should pursue in the current low interest rate environment. One approach that many managers are pursuing is to stretch for yield. While this strategy has worked thus far, it effectively adds to credit risk when the outlook for the economy has become more uncertain, and spreads for investment grade corporate bonds versus treasuries have narrowed significantly.

By comparison, the approach we favor is a “credit barbell” that combines high quality instruments (long dated treasuries and AAA CMBS) with BB and B- rated corporate bonds. Our goal is to construct a portfolio that offers a competitive yield and which balances credit risk, interest rate risk and liquidity considerations. Based on stress tests we have conducted for both rising and falling interest rate scenarios, we believe our new strategy meets these objectives.



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