Essential Investment Partners

Where Do We Go From Here?

Searching for Attractive Returns in Fixed Income

Following an historic “flight to safety” rally in U.S Treasury securities in 2008, investors benefited greatly from a “flight to risk” rally in corporate and municipal bonds in 2009 and early 2010. A logical question is “where do we go from here?” as investors worry about the risk of rising interest rates and the negative impact this would have on their bond holdings. With money market funds and Treasury bills providing yields near zero, investors would prefer fixed income investments with good yields but without the attendant risks.

The Essential Absolute Return Portfolio is designed to seek attractive returns (through income or short term capital gains) while protecting capital, through a variety of investment strategies involving open and closed end mutual funds. A particular focus is on closed end fund “special situations” in which upcoming corporate events are catalysts for value that are not fully recognized by the market. More information on this strategy is available at www.essentialinvestment.com .

Let’s discuss our current views on the broader fixed income market sectors.

U.S. Treasuries

The huge Federal budget deficit and the corresponding need for greatly increased issuance of U.S. Treasury bills, notes and bonds has many investors, including us, concerned about how much interest rates will have to rise to attract buyers. However, we don’t think there is any historical evidence that Federal deficits in and of themselves spawn actual inflation. And, Treasury security buyers haven’t slowed down their acquisitions. Indeed, it has been surprising how readily the new supply has been absorbed so far.

The major bond indices will increasingly be weighted towards Treasury securities as their proportion of the bond market continues to rise – this will provide a natural set of buyers for Treasury securities among those investors who index their fixed income investments.

We believe short term interest rates are likely to remain lower for longer than most expect as the Federal Reserve will be slow to raise rates. The Fed’s initial tightening efforts are most likely to be reflected in unwinding the quantitative easing (QE) they have achieved through their asset acquisition programs.

The difference between short term rates and long term rates is already historically high so the withdrawal of the Fed's QE programs over the coming months will be an important test for the direction of long term rates. We expect some tick up in mortgage rates as the Fed stops its program to purchase more than $1 trillion of mortgage-backed securities. A further test will come when the Fed starts selling the mortgage and Treasury securities it owns to reduce the size of its balance sheet toward pre-crisis levels.

If, as we expect, the economy grows slowly in the coming year, long term Treasury rates may not rise significantly over the remainder of this year. But if inflation expectations were to take root or foreign buyers take a step back, sentiment could change quickly.

All of these cross-currents leave the Treasury market in a delicate state with substantial risks that rates could move significantly in either direction – this is not a risk/reward dynamic we like.

We believe Treasury Inflation Protected Securities (TIPS) have generally been overpriced reflecting higher inflation expectations that we believe are likely. In addition, like other Treasury bonds, TIPS are sensitive to changes in the level of interest rates so they may lose value if rates rise, offsetting the benefits of inflation protection.

Municipals

This market is really a tale of two cities (pun intended) as fundamentals are bad but technical factors are positive. On the fundamental side, the weak economy has slashed income and sales tax receipts, creating big deficits for state and local governments. While the economy seems to have turned the corner toward recovery, the recovery in tax revenues will likely be slow for the next few years. The erosion of property values has impaired property tax receipts and this process probably hasn't worked its way through the system completely yet because of the lag effect of property valuations on tax assessments. However, in many cases debt service has legal or constitutional priority over other creditors and the history of municipal finance suggests actual bankruptcies are unlikely to prove as damaging as headlines might suggest.

A long term fundamental problem for the municipal market is the contingent liabilities represented by both pension and health care obligations that are not funded. Lacking political resolve or extraordinary investment performance, this problem will be with us for another 10-20 years.

The technical condition (*i.e.*, supply/demand balance) of the municipal bond market has been extremely strong. The advent of the Build America Bond program has dramatically reduced the availability of tax-exempt municipals. The program's recent proposed extension will have a similar impact for the next three years. At the same time, the expectation that marginal tax rates will rise makes municipals' tax-exempt income feature even more attractive.

In the short term, we expect that technical factors will keep the municipal bond market in good shape, making selective investments attractive.

Investment Grade Corporate Bonds:

Restored credit market stability, historically strong corporate cash positions and a gradually improving economy are all factors providing support to investors in investment grade corporate bonds.

In addition, very high investor demand for bonds has provided technical support. This is probably best reflected in dollar inflows into bond mutual funds – since the beginning of 2009, bond funds have received approximately $400 billion of new money, most of which has come into taxable bond funds. Not surprisingly, credit spreads have shrunk dramatically making it hard to find good bargains, making careful selection a priority.

High Yield/Bank Loan Corporates:

The restoration of credit market stability and the improving economy have been even more important to the high yield/bank loan bond market. In these markets, credit spreads had reached all time highs of 20+ percentage points in late 2008 before falling more than 10 percentage points in 2009. Currently, credit spreads are just below average recession levels, leaving bonds moderately attractively priced.

A gradually improving economy provides better earnings and cash flows, which should lead to improving credit quality and even upgrades. In fact, rating agency upgrades recently began to outpace downgrades.

High yield bank loan pricing has become more attractive with the elimination of the alternative lending sources that disappeared with the financial crisis. In addition, lending standards are higher than in the recent past, making current "vintage" loans more likely to be of high quality. Bank loans also re-price against LIBOR (London Inter-bank Offered Rate) or the Prime Rate making them attractive when short term rates rise. We are cautiously optimistic on high yield and high yield bank loan returns in 2010.

Responding to the strong demand by investors, high yield issuance has been very active over the last several months. However, any hint of an economic relapse could dry this liquidity up quickly. And, the potential for "crowding out" as Treasury issuance rises is most acute in the high yield market.

Non – Dollar Bonds:

We expect the dollar to be weaker over the next few years as the U.S. economy grows slower than many Asian, emerging market and commodity-based economies. Our trade deficits will stay high and the government will continue to issue large amounts of debt to fund the fiscal deficit. All of these factors will put continued pressure on the U.S. dollar.

A weaker dollar is one way to reduce our trade deficit and even though there is not an official "weak dollar" policy, there seems to be a de facto policy in place. Owning non-dollar bonds provides protection against this risk and we believe investors should make them a part of a well-diversified portfolio.

Fixed Income Closed End Funds:

Closed end bond funds, which were extremely cheap a year ago, are no longer cheap. The discounts to net asset value have converged towards zero, with some funds trading at premiums. At current prices, closed end fund investors face both heightened net asset value risk and discount widening risk. If interest rates rise gradually, we are less concerned about net asset value risk. However, we prefer to seek special situations that provide attractive absolute return potential and that are not especially sensitive to interest rates.

There are also selected convergence trade opportunities (in which we expect discounts to decline), especially in California related funds. The California risks are well known and generously priced in the market. See our Closed End Fund Investing Process paper at www.essentialinvestment.com for additional information.

Alternatives/Distressed Debt:

We are very favorably disposed to alternative fixed income asset forms such as merger arbitrage. (Merger arbitrage generally involves buying the securities of a company being acquired and shorting the securities of the acquiring company, capturing the uncertainty and time value spread between the two.) This is an area that is seeing increasing activity and value. In addition, it is very responsive to any increase in short term rates and thereby provides investors with protection in a rising rate environment.

Distressed debt funds are becoming of interest to us. A key to their success will be a stable to improving economy which increasingly looks likely. However, we will be cautious in evaluating these opportunities as we believe there may be a great deal of capital on the sidelines waiting for distressed opportunities to appear. This leaves open the possibility that the return potential may not justify the risks.

Conclusion:

In summary, we recommend avoiding U.S. Treasury bonds and notes, TIPS and other long term bonds. We think investors should favor high quality municipal bonds and select investment grade and high yield corporate bonds. In addition, exposure to non-dollar bonds and alternative strategies such as merger arbitrage and distressed debt will be important. Finally, we continue to find value in closed end fund special situations that are carefully selected for their attractive return potential and limited downside risk.

Important Information

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