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Think Your Traditional Fixed Income Portfolio is Safe? Think Again.

Point of View With Rick Rieder and Bob Miller

In the aftermath of the twin credit and sovereign debt crises, opportunities and risks in fixed income investing have changed dramatically and the old ways of accessing income, return and capital preservation no longer work. In this context, BlackRock's fixed income experts discuss why traditional strategies should be replaced with a flexible fixed income approach.

- Interest rates are near historic lows but will be volatile over the next few years, meaning traditional fixed income strategies are unlikely to deliver attractive returns with acceptable risk.
- Investors should consider non-traditional strategies and fixed income sectors to cushion against likely increased market volatility and potential rise in interest rates and inflation.
- A flexible fixed income approach offers investors an opportunity to enhance yield, income and total return while seeking to mitigate the risks associated with a volatile interest rate and credit environment.
- Flexible fixed income strategies that seek to capitalize on market opportunities, while also managing duration and credit risk, should be a core holding in a diversified fixed income portfolio.

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What is your outlook for interest rates?

The unprecedented monetary policy intervention from the Federal Reserve and other global central banks is directed at creating growth via inflation. This policy of buying bonds through quantitative easing and reinvesting proceeds into the longer-dated Treasury and mortgage bonds means that interest rates have been pushed lower artificially. In explicit terms, the goal of the strategy is to forestall the current forces of deflation emanating from balance sheet deleveraging and credit contraction prompted by banking sector restructuring and the European sovereign crisis. While never explicitly stated by policy makers as such, the strategy is implicitly intended to cause future inflation. While we don't foresee interest rates skyrocketing dramatically, we believe the Fed programs have reduced the interest rates of longer dated bonds a great deal —by as much as 100 to 150 basis points (1 to 1.5%).

As investors begin to expect stimulus programs to wind down, interest rates should rise. But the pace of increase will be determined by the pace of withdrawal of intervention. In the near term (meaning for the next 6 to 12 months) we see little rationale for this to occur. Hence while we expect some increase in rates under the scenario that the US economy continues its gradual pace of growth, the full extent of the impact on interest rates will not be fully realized in the short run. That implies roughly only a 50 basis point increase in rates were (i) the latest iteration of the European sovereign crisis to not spill out of control and (ii) the US continues along its gradual growth path.

Longer term, expectations about economic growth, the progress of the European debt crisis, or an exogenous event, will continue to make interest rates volatile. But any easing of these aforementioned deflationary threats could eventually reveal greater inflationary threats and hence lead to more of a secular rise in interest rates. For now, that remains a longer term concern while the near term deflationary threats amidst a global policy environment of un-precedented unconventional intervention keeps rates low for now.

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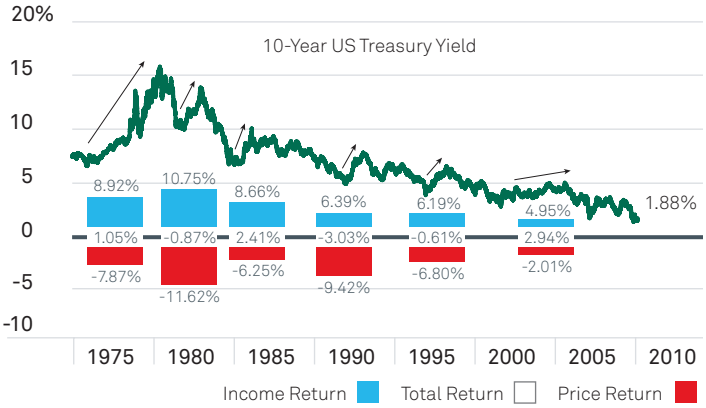
Does fixed income still offer good investment opportunities in this low rate environment?

Yes. However, we feel strongly investors need to change the way they think about fixed income investing since it is indisputably different from the past 30 years. Over that time, investors in core intermediate duration (a measurement of interest rate risk; in this case higher sensitivity to moves in interest rates) bonds enjoyed strong total returns, as represented by the Barclays US Aggregate Index (Agg) average of 8.5%. However, investors typically experience bond price declines when rates spike sharply, though higher interest rates may offset these price declines (see Figure 1). Given today's historically low interest rate environment, it would be virtually impossible to see record low income provide a buffer against rising interest rates.

Figure 1: A Traditional Core Bond Strategy May Not Make Sense Anymore

Barclays US Aggregate Bond Index performance during 10-year Treasury yield spikes



Source: BlackRock, Barclays, Bloomberg and Lipper. Rate spike time periods are 12/31/76-9/30/81, 4/30/83-5/31/84, 8/31/86-10/31/87, 9/30/93-11/30/94, 9/30/98-1/31/00, 5/31/03-6/30/07, respectively. Returns for the Barclays US Aggregate Bond Index are annualized. Past performance does not guarantee future results.

What are the limitations of a broad bond market benchmark index?

Consider today's leading fixed income benchmark, the Barclays US Aggregate Index (Agg). By construction, the index replicates the debt sold in the market. Hence today it is heavily weighted toward interest-rate-sensitive securities, primarily US Treasury issues. In fact, including US Treasury debt, agency debt and agency mortgage-backed securities (MBS), the Agg is roughly 75% government or government-related securities that are heavily sensitive to the movement of interest rates. Effectively, investors in Agg-benchmarked or similar portfolios are overweight interest rate risk at a time when it's providing the least value in 30 years. So investors need to consider a flexible fixed income approach to manage interest rate risk and open up opportunities in a wider range of fixed income sectors.

What do you mean by "flexible" fixed income?

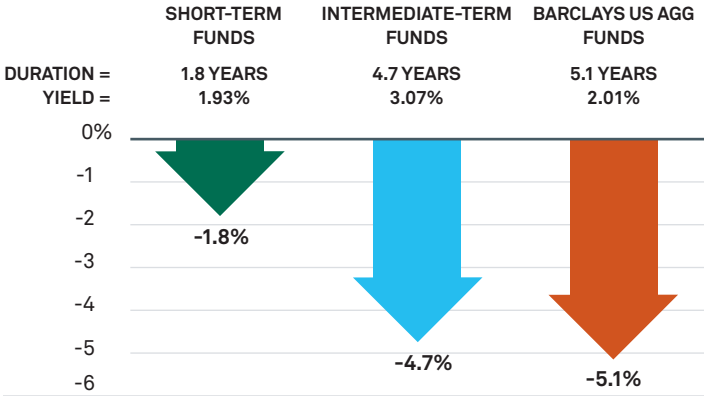
Having flexibility allows a manager to find the correct balance of exposures in the portfolio for example between interest rate risk (duration) and credit risk that make up the total fixed income risk of the portfolio. Benchmarking forces a bond manager to replicate that index (with some limited room to "tilt" the portfolio) limiting the portfolio's potential for returns. As fixed income markets evolve from global deleveraging and government intervention, being flexible to protect against rising interest rates and invest where the opportunities lie will be crucial to a successful fixed income portfolio.

Why is it so important to manage interest rate risk? Isn't the Fed holding rates down for years to come?

Various factors have kept interest rates low during this period of continued intervention and protracted European sovereign uncertainty. However, because the starting point for yields is so low, there is very little room for rates to rise before returns in fixed income turn negative. For example, over the period of March 6 to March 19, 2012 given a backdrop of improving US economic growth and subsiding European fears, yields on the 10-year US Treasury spiked from 1.94% to 2.37%. A 40 basis point increase like that can wipe out the total returns of an intermediate bond fund for a year. About two-thirds of all bond mutual funds have a duration greater than their coupon. This

Figure 2: Rise in Interest Rates Hits Intermediate and Long Duration Bonds Most

Bond price effect of a 1% increase in interest rates

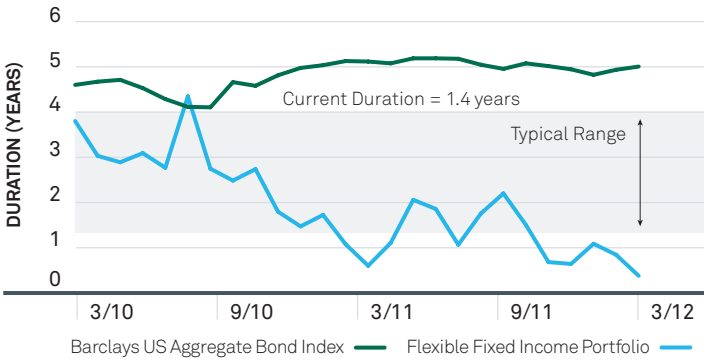


Source: BlackRock. Data as of 3/31/12 as represented by the Lipper Short Investment Grade Debt and Lipper Intermediate Investment Grade Debt category averages. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

1 Note this figure comes from regressing Aggregate index returns against returns of the Treasury index. Over the 30 year time period, 86% of the variability in Aggregate index returns can be explained by the returns of the Treasury index. Technically, this is the "R-squared" of the regression of Aggregate index returns vs. the Treasury index returns.

Figure 3: Duration Flexibility is Key to Long-Term Returns

Fund duration vs. Barclays US Aggregate Bond Index



Source: BlackRock, Barclays.

means their interest sensitivity exceeds their income. For example, where duration is just equal to coupon, a 100 basis point rise in interest rates would erode all returns for these funds. In many cases duration far exceeds coupon and hence even a lower amount of increase in interest rates erodes all returns.

All this is to point out that in the event interest rates rise, the price of a bond will fall. The greater the duration, the more the bond price will fall in the case of an increase (see Figure 2). The Figure illustrates how higher-duration bonds (closely related to longer maturity bonds) are affected more negatively than lower-duration bonds. So investors need to choose a manager who will manage yield curve exposure, and the duration of the portfolio (see Figure 3).

What does this mean for traditional core bond portfolios?

It means investors in traditional core bond portfolios are not being compensated for the significant amount of duration risk they're assuming. This is particularly true because we believe with interest rates at historic lows, well below their fair value, future interest rates are much more likely to rise than decline. Ultimately, investing in fixed income in this world of low interest rates requires a broader array of asset classes and balancing out of fixed income exposures than a traditional core bond portfolio offers.

If traditional bond portfolios will not succeed, what will?

This new world of fixed income means investors should actively manage the balance between duration and credit risk. For example, the Fed's very accommodative monetary policy measures have made Treasury yields unattractive while creating an opportunity in credit sectors of the market. Liquidity provided by the Fed has allowed companies to refinance debt, push maturities further out and build cash balance levels. This will serve to keep default rates low for the next several years, creating an attractive opportunity in credit on a risk-adjusted basis. In addition, credit sectors provide a buffer against rates moving higher as the spread over Treasuries will likely compress as economic growth improves.

With such wide flexibility, how do you think about structuring fixed income portfolios?

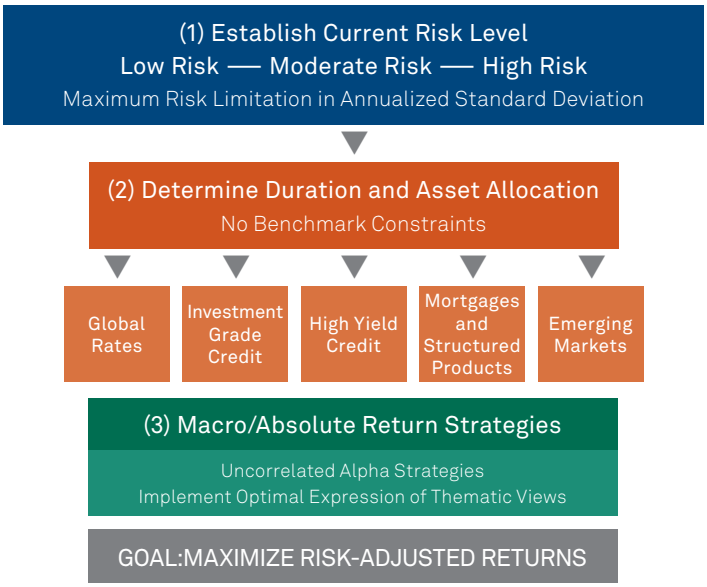
That is one of the key challenges of managing a flexible fixed income portfolio. We look across the spectrum of fixed income sectors to determine: where are the investments with real upside, and where is the fresh investment idea? There are a couple of things we do to help us identify these.

Initially, the portfolio management team establishes a budget for the amount of risk (measured by standard deviation) that they will take across the portfolio, based on the current environment. The managers then allocate risk between duration and credit, as well as across each fixed income sector of the market, such as corporate investment grade, high yield, asset-backed securities, etc. The team also employs various absolute positive return strategies to seek to generate excess return opportunities uncorrelated to the market. Thereafter, macro strategies are employed to capture structural changes in the market and to hedge extreme risk scenarios (see Figure 4).

Each investment decision must satisfy a rigorous risk analysis, which includes questions such as: Is the balance between duration and credit risk optimal for this market? Is this an attractive risk/reward opportunity? How does this investment impact the overall risk budget?

Figure 4: Actively Balancing Opportunity and Risk

An overall risk budget that guides investment decisions



Does a flexible strategy take on more risk than a traditional strategy?

First let's be clear about what risk means. It means the risk of loss of value, a decline in the NAV of the fund. And risk comes in many forms, so even a US Treasury security that might be considered "risk free" can certainly decline in price. An Agg-benchmarked portfolio today is taking on an enormous amount of interest rate risk that cannot be easily mitigated in a traditional benchmark orientated fund.

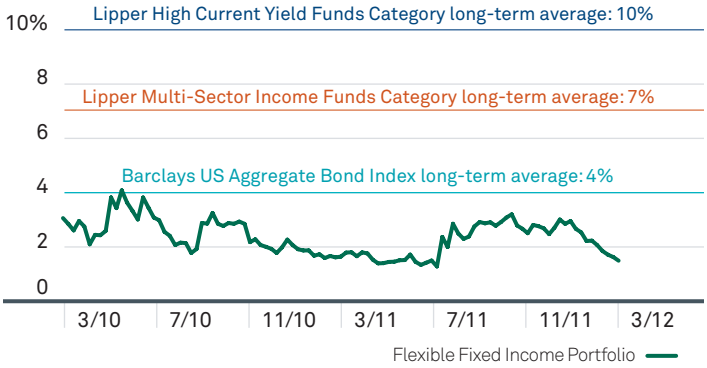
On the other hand, the flexible fixed income manager can mitigate some risk that may come with being tied to a benchmark by using additional tools to go outside the limitations of a benchmark. And in a fixed income environment where rates may rise, the flexible manager can defend against a rise more effectively than a traditional benchmarked portfolio, potentially having a lower-risk/higher-return profile than the traditional core bond portfolio. Our goal is to limit the portfolio's aggregate risk to stay within the boundaries of what investors find acceptable for a core bond portfolio (see Figure 5).

How should an investor incorporate a flexible strategy into their portfolio?

Given the environment of today and tomorrow means low to rising interest rates, we recommend investors allocate a meaningful portion of their traditional core fixed income portfolio to a professionally managed, flexible strategy through a mutual fund. This would allow the investor to take advantage of diverse sector exposures and flexible risk-managed duration exposure to seek to achieve both returns and protection on the downside.

Figure 5: The Importance of a Risk Controlled Framework

Volatility as measured by the standard deviation of returns



Sources: Barclays, Lipper.

Outside of that core position, advisors can help clients add tactical positions in specific sectors such as mortgages, floating rate or high yield, global bonds or inflation protected securities in order to increase their portfolio's diversification and income potential. Specific allocations for each particular asset will vary based on an investor's goals, risk tolerance and time horizon, and these considerations should be discussed with an experienced financial professional. In our view, however, incorporating a professionally managed, flexible strategy into an overall fixed income portfolio can help enhance the overall success of an investor's entire portfolio.

Investment involves risks. *Bond values fluctuate in price so the value of your investment can go down depending on market conditions. The two main risks related to fixed income investing are interest-rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Investments in non-investment-grade debt securities (high yield or "junk" bonds) may be subject to greater market fluctuations and risk of default or loss of income and principal than securities in higher rating categories. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments in emerging/developing markets or smaller capital markets. Asset allocation strategies do not assure profit and do not protect against loss.*

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