

FIXED INCOME ALTERNATIVES

**Finding Value And Safety In An Uncertain
Fixed Income Environment**

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THE MDE GROUP, INC.

Your family's most trusted advisor

FINDING VALUE AND SAFETY IN AN UNCERTAIN FIXED INCOME ENVIRONMENT

Introduction

Clients traditionally view the fixed income portion of their portfolio as the “rock solid” part of their nest egg. Historically, clients have looked to bonds to preserve capital in the face of a flight to quality that often times would cause declines in the stock market. Furthermore, many retired clients rely on their fixed income investments to either supplement or provide for the bulk of their retirement income. Given these behavioral tendencies, investors often can least tolerate a loss, or sub par return, in the fixed income area. However, the fixed income environment of the past several years has made it very challenging to add value and preserve purchasing power using conventional techniques.

The conventional wisdom in the investment community, with which we agreed, was that it was just a matter of time before the yields in the fixed income market reverted to the mean, providing investors with a more acceptable risk/reward equation. So as to mitigate loss in the face of a rising interest rate environment, MDE’s investment policy has been to be patient with the market by keeping the durations of bond portfolios relatively short and/or by exchanging some duration risk for some credit risk. Once the seemingly inevitable increase in interest rates occurred, we had planned to increase the duration of bond portfolios to receive a more appropriate yield for the increased duration risk inherent in holding longer dated paper.

However, the bond market has baffled conventional wisdom over the past year as the intermediate and longer term parts of the yield curve have yet to respond proportionately to the Fed’s policy of continually raising short term rates at a “measured pace.” Therefore, short-term portfolios continue to lose money in inflation adjusted terms while longer-term portfolios continue to provide inadequate yields to compensate for the real possibility of substantial principal loss in the face of an increase in intermediate and long-term rates.

Over the years, The MDE Group’s Investment Committee has demonstrated an ability to adapt to challenging and changing market environments by creatively looking “outside the box” in order to add value. Given our open architecture, we have done so by abandoning the “style box,” and finding non-traditional investment managers who “blur the lines” between asset classes and investment styles or by giving managers “more tools in their tool box” to meet varying market challenges. In the past, our efforts in this regard have been primarily concentrated in the equity, “hybrid” and “alternative” investment asset classes. However, of late our efforts have been focused on applying our best thinking to the current perplexing, uncertain and challenging fixed income environment.

Since we are not prescient, we can neither offer any predictions as to the future nor any magic bullet for the unknown future environment. However, we do suggest a specific mix of “old” and “new” ideas that can potentially reduce risk and enhance return in this difficult fixed income environment. In characterizing these ideas, we are drawn to an analogy between diamonds and fixed income investments. In the context of investments in tangible assets, diamonds traditionally are viewed as a storehouse of value. The “Four C’s,” (i.e., color, clarity, cut, and carat) generally characterize diamonds. Since fixed income investments are generally viewed as the storehouse of value in the context of an intangible investment portfolio, our recommended combination of these ideas also can be characterized as the “Four C’s,” (i.e., current, credit, currency, and consistency). Each of these fixed income ideas, as well as a combined recommended strategy, is summarized below.

Current

In the context of this theme, we use the term “current” to describe traditional long only, credit rated, domestic, fixed income investments that have been part of the MDE Wealth Management platform for years. Under this umbrella, we would include active municipal bond managers such as Credit Suisse and more passive firms such as Lehman Brothers.

We would also include the Gannett Welsh & Kotler (GWK) hybrid taxable strategy that consists of a “barbelled” mix of high yield and investment grade bonds, of varied maturities, that in combination produce an investment grade rating with a good risk adjusted yield.

These investments, and these managers, remain a staple in our clients’ fixed income portfolios. We are not advocating they be abandoned. However, at this particular time under current market conditions, we believe there is increased risk in a fixed income portfolio consisting solely of those more traditional long only, credit rated, domestic, fixed income investments. In general, these types of fixed income investments respond to two primary sources of risk. The first is interest rate risk, or the risk of a fall in the price of the bond due to rising interest rates. The second is credit risk, or a risk in the fall of the price of the bond due to a credit downgrade or default.

Over the past 25 years, long-term interest rates on 30-year bonds have fallen from 14.82% to 4.79% on February 28, 2005. With rising inflation, falling unemployment, a weak dollar, a continued large federal budget deficit, and an expanding economy, it is difficult to envision an environment that would result in continued falling interest rates. To the contrary, conventional thought has anticipated rising longer-term rates for more than the past two years. To reduce interest rate risk, we have reduced the duration of traditional fixed income portfolios with Credit Suisse and Lehman Brothers.

One may choose to limit interest rate or duration risk, but stretch for higher yields by taking on increased credit risk. This is one of the techniques employed by GWK. While this technique has continued utility, the current credit spread, (i.e., the differential in yield between Treasury Notes and BB rated corporate bonds), is now close to its long-term historical average.

In sum, the “easy” money in the bond market has already been made by following strategies that lengthened duration and/or increased credit risk. That said, we do not advocate a complete abandonment of the traditional fixed income portfolio. Our challenge is to combine different techniques with the traditional techniques to add value and reduce risk in today’s difficult environment.

Credit

As discussed above, one of the major drivers for bond returns is credit, (i.e., a bond issuer’s perceived ability to meet its coupon and principal repayment obligations under the terms of the bond instrument). While credit spreads have generally reverted to their historical norms, there are still opportunities to exploit credit inefficiencies in the municipal bonds. One way a manager can add value in the municipal bond arena is to find and exploit bond mispricings using intensive credit analysis. At times, good quality bonds may offer an above average yield due to the absence of a credit rating from a rating agency such as S&P or Moody’s. Obtaining credit ratings can be a costly process. Some issuers consciously choose not to obtain credit ratings if the bond offering is small or simply to save the cost of obtaining such rating. The lack of a credit rating does not, per se, make an offering a “junk” credit. Therefore, in the case of “unrated” or “non-rated” bonds, credit analysis is key.

Intensive credit analysis is the primary value added mechanism employed by the Nuveen High Yield Municipal Bond Fund. Nuveen & Company is one of the largest fixed income investment firms in the world and has the resources to conduct thorough and proper credit analysis. Nuveen has an edge in capitalizing on the inefficiency of the municipal bond market, which is less cyclical and has a lower historical correlation to the broader fixed income markets. Municipal bonds also have lower default rates, higher recovery rates and more attractive taxable equivalents relative to corporate bonds thereby making municipal bonds a more attractive medium with which to exploit credit inefficiencies. The historical performance of the Nuveen High Yield Municipal Bond Fund is consistent with a strong record of security selection and credit analysis. Security specific risk is mitigated by the fact they hold some 500+ different securities. Nuveen further mitigates its credit risk with a strict security selection discipline. The management team generally only purchases bonds that have a lien on physical assets to support the obligation, or bonds backed by facilities deemed essential to their communities. For example, the management team has a positive bias toward bonds

issued by hospitals that are the sole providers of services to the surrounding community. Where hospitals are the sole providers of essential services to small to mid sized communities, political pressures make defaults very unlikely. The Nuveen fund also holds some traditional high yield municipal bonds, but due to excellent security selection, their volatility has been more in synch with investment grade bond funds. In general, one disadvantage to municipal bond investing is that certain types of municipal bonds are subject to Alternative Minimum Tax (“AMT”). We estimate that about 20% of the income in the Nuveen strategy is subject to the AMT.

As of February 28, 2005, the Nuveen High Yield Municipal Bond Fund had a yield to worst (i.e., the worst of maturity or call) of 5.88% (net of fees and expenses) and a stated duration of 6.98 years. However, since lower rated debt generally tends to be less sensitive to interest rate movements, the estimated effective duration should be between 4 – 4½ years. By way of comparison, a 5-year AAA rated municipal bond would have a comparable duration and had a pre-tax yield of only 2.93% on February 28, 2005. A 10-year AAA municipal bond had a duration of approximately 7.5% and was yielding 3.63% before taxes as of that date.

The large number of holdings in this strategy necessitate that it be managed in a mutual fund format to optimize its efficiency. As a larger Registered Investment Advisor, MDE is able to access the no load institutional share class of this fund on behalf of its clients and provide a relatively cost effective option to this type of labor-and-expertise intensive investment strategy. Since this investment vehicle is an SEC registered mutual fund, it has the added attributes of SEC oversight, liquidity and transparency. Investors can further mitigate their risk by dollar cost averaging into this investment over a period of time.

In our view, the skill demonstrated by the management team at Nuveen, combined with the substantial differential in yield versus AAA municipal bonds, makes an investment in this fund an excellent addition to a fixed income portfolio.

Currency

Government issued money market instruments (i.e., those instruments that mature in less than one year) are considered to be virtually risk-free. Sovereign governments, unlike corporations or individuals, have the privilege of literally printing money to pay their obligations. Given its perceived virtual risk free status, the 3-Month U.S. Treasury Bill was yielding 2.82% as of March 24, 2005. This yield is low by historical U.S. standards, but even lower by current global standards. However, venturing abroad to specific countries in search of higher yields exposes the investor to considerably greater risk. Clearly, investing in a money market instrument offered by Mexico, for example, is riskier than its corresponding U.S. Government instrument. However, a diversified and largely uncorrelated portfolio of many of these money market instruments historically has generated attractive and uncorrelated returns with moderate risk. This is precisely the strategy employed by the Lazard Emerging Income Fund.

As of February 28, 2005, the Lazard Emerging Income Fund offered a yield to maturity of 6.8% and average portfolio duration of only two months. By way of comparison, a 3-Month U.S. Treasury Bill was yielding 2.78% at the time. However, in investing, as in life, there is never any “free lunch” and this fund is no exception. Currency risk is a key determinant in the net return of this strategy to U.S. investors in the short term. The fund should perform well with the backdrop of a weak dollar, but may have much of its yield advantage evaporate in the event of a surging dollar. However, the low cross correlation of the emerging countries’ currencies with each other mitigates some of the currency risk in the portfolio. Furthermore, over the long term, the currency impact tends to even out.

The Fund is structured as a limited partnership, thereby reflecting many of the attributes typical of most hedge funds. Lack of daily liquidity may be detrimental to investors who rely on their fixed income portfolios to provide for the bulk of their income. Although all of the current investors in Lazard Emerging Income, including some of the largest institutional investors in the U.S., are subject to a penalty on withdrawals within the first twelve months of investment, we have negotiated flexible redemption privileges based on MDE client specific needs and circumstances. We can also arrange for quarterly total return distributions for income-oriented MDE clients. Additional negative attributes include the K-1 form and its corresponding international tax issues. However, U.S. investors will get a credit for any foreign

income taxes withheld. For MDE clients, we have negotiated the minimum investment size to \$250,000 for qualified investors. This represents a substantial reduction from the Fund's stated minimum of \$1,000,000. The fee structure on this investment is a base fee of 1% and an incentive fee of 10%—about half of the typical hedge fund.

In summary, the Lazard Emerging Income Fund offers a high yield to maturity, low duration risk, a hedge against the falling dollar, and is largely uncorrelated with traditional domestic fixed income portfolios. Notwithstanding its hedge fund format, we believe this vehicle provides a strong risk/reward profile and will serve as an excellent diversifier and yield enhancer to a fixed income portfolio.

Consistency

A consistent positive annual return historically has been one of the primary drivers behind holding fixed income investments. However, as discussed above, the ability to generate consistent positive returns through traditional approaches to fixed income investing is now questionable. Most traditional bond investments earn their returns from clipping coupons and capital gains/losses due to interest rate shifts. While the Nuveen and the Lazard investments described above employ different value added mechanisms that make them appropriate additions to a traditional fixed income portfolio, income from coupons are a major driver of their returns. However, some bond managers take a decidedly more activist approach to achieve consistent positive returns.

The stated goal of the Metropolitan West Strategic Income Fund (Metro West) is to produce a consistent absolute return without suffering any material annual losses. It attempts to achieve this goal through active and opportunistic management across the entire spectrum of fixed income investments. In short, it is a fixed income “hedge fund type investment” cloaked in the mutual fund format. As such, the Metro West fund holds long and short corporate bonds, collateralized bond obligations, bank loans, convertibles and other derivative instruments. In sum, it searches the entire fixed income universe for short-term trading opportunities. A typical trade may involve purchasing a BBB rated Financial Bond and selling short a BBB rated Homebuilding Bond. The spread between the two investments is the primary determinant of the return on the trade, not the movement of market interest rates.

Due to the opportunistic trading style employed by the Metro West Fund, its yield to maturity is not a meaningful measure of its expected return. Rather, the target return estimated by its portfolio manager may be the more meaningful measure. While it is impossible to predict the return of this or any other fund, the portfolio manager of the Metro West fund projects a 6% target return for the upcoming year, net of fees and expenses. Of course, there are no guarantees, but we view a 6% total return without material interest rate or credit risk as very attractive in the current fixed income environment. Since the Metro West product is a mutual fund, as with the Nuveen fund, it has the positive attributes of SEC oversight, liquidity and transparency. A dollar cost averaging strategy can also be employed to mitigate risk.

Under the theme of “consistency,” we must also include those “current” alternative investments used by MDE that also can be employed as fixed income substitutes to the extent a client does not require current cash flow from the fixed income part of the portfolio. The stated objectives of these alternative investments are to offer long-term fixed income-like risk and a return profile closer to equities. These funds achieve these objectives by primarily generating their returns from sources other than those subject to substantial interest rate and credit risk. Included in this mix are traditional hedge funds of funds such as The Bank of New York Multi Manager Fund, Titan Masters Fund, Paradigm, and Lazard Multi Strategy Fund. In this mix, we would also include The Alternative Fund—the goal of which is to provide the same or better risk adjusted return attributes than traditional funds of funds with the added benefits of transparency, liquidity and a substantially reduced fee structure as compared with traditional alternatives.

Recommended Fixed Income Asset Allocation

The MDE Group's Investment Committee recently agreed to the following fixed income allocation in its Model Portfolio. The Model Portfolio is a starting point that is tailored to each client's unique needs and circumstances. Nevertheless, it serves as a useful point for discussion.

Fixed Income Strategy	Recommended Allocation
Credit Suisse / Lehman Brothers Municipal Bonds	20%
GWK Total Return Portfolio	20%
Nuveen High Yield Bond Fund	20%
Lazard Emerging Income Fund	20%
Metropolitan West Strategic Income Fund	20%

As noted above, alternative investments can also be included in this mix since they are likely to produce a positive return under all market conditions and should exceed the returns generated by a fixed income portfolio over time.

While we cannot forecast interest rates with any degree of certainty, we may be able to infer that rates will rise, based on long-term averages. In this context, we must consider the expected performance of our Model Fixed Income Portfolio under alternative interest rate scenarios. Duration, which is a measure of the interest rate risk, quantifies the percentage gain or loss in a portfolio that accompanies a 1% change in interest rates.

Sensitivity Analysis

Yellow = "Current Investments"

Green = "New Investments"

Fixed Income Strategy	Change In Interest Rates	Duration*	Yield To Maturity**	Strategy Net Return
Credit Suisse / Lehman Municipal Bond Account	+1%	3.25	2.80%	-0.45%
GWK Total Return	+1%	4.25	4.75%	0.50%
Metropolitan West Strategic Income Fund	+1%	1.60	6.00%	4.40%
Nuveen High Yield Bond Fund	+1%	4.50	5.88%	1.38%
Lazard Emerging Income Fund	+1%	0.20	6.80%	6.60%
Average Of All				2.49%
Average of "Current Investments"				0.02%
Average of "New Investments"				4.13%

Credit Suisse / Lehman Municipal Bond Account	+0%	3.25	2.80%	2.80%
GWK Total Return	+0%	4.25	4.75%	4.75%
Metropolitan West Strategic Income Fund	+0%	1.60	6.00%	6.00%
Nuveen High Yield Bond Fund	+0%	4.50	5.88%	5.88%
Lazard Emerging Income Fund	+0%	0.20	6.80%	6.80%
Average Of All				5.25%
Average of "Current Investments"				3.78%
Average of "New Investments"				6.23%

Credit Suisse / Lehman Municipal Bond Account	-1%	3.25	2.80%	6.05%
GWK Total Return	-1%	4.25	4.75%	9.00%
Metropolitan West Strategic Income Fund	-1%	1.60	6.00%	7.60%
Nuveen High Yield Bond Fund	-1%	4.50	5.88%	10.38%
Lazard Emerging Income Fund	-1%	0.20	6.80%	7.00%
Average Of All				8.01%
Average of "Current Investments"				7.53%
Average of "New Investments"				8.33%

* Estimated effective duration in GWK and Nuveen portfolios is based on the fact that bonds of lower credit quality are less sensitive to changes in interest. Actual duration of GWK portfolio is 5 and of Nuveen portfolio is 6.88. If bonds responded to interest rate movements based upon the actual duration, changes in value would be greater than indicated.

** Municipal bond yields in Credit Suisse/Lehman and Nuveen portfolios are exempt from Federal Income Tax. We utilize the target return for MetroWest instead of the YTM since it is likely to be the more accurate measure.

The key “takeaways” from the previous Sensitivity Analysis include the following:

- MDE’s Model Fixed Income Portfolio outperforms the “current” fixed income strategies under a rising interest rate scenario.
- MDE’s Model Fixed Income Portfolio has less volatility, over the entire range of interest rate outcomes, relative to the “current” fixed income strategies.

Conclusion

In addition to the strategies discussed above, we have also examined Treasury Inflation Protected Securities (TIPS), step-up bonds, inverse floaters, and other instruments that tend to outperform in a rising interest rate environment. However, in our view, our “new” recommended fixed income investments provide a better risk-return tradeoff at this time. At some point in the future, we may revisit taking a tactical position in the securities mentioned above, or include them in some client portfolios on a case-by-case basis.

Our goal in proposing a restructure of our clients’ fixed income portfolios, using the ideas discussed above, is to create a more balanced fixed income portfolio that can withstand a number of interest rate environments. We do so, not by completely eliminating risk, but by taking other forms of calculated risks (i.e., credit, currency, relative value, and manager execution) and by increasing our diversification across strategies. The low correlation of returns between these strategies results in a reduction in the interest rate risk through diversification in the types of “market bets” being made in the fixed income portfolio. This strategy should produce a less volatile, and hopefully superior fixed income type return in the current difficult fixed income environment.

In the weeks ahead, you will be hearing more from your MDE Wealth Management Counselor about implementing the most suitable fixed income strategies for your portfolio. Our goal is to ensure that the fixed income segment of your portfolio remains “rock solid,” regardless of the changes in interest rates.