Fixed Income Market Commentary

January 2012

Bonds Were Boffo in 2011

Bond investors had another bang-up year in 2011, as steady income and rising prices rewarded those who stayed the course.

Another, less-obvious benefit was the peace of mind bonds provided in the face of all of the negative stories and events that haunted other asset classes at various points during the year. 2011 was an apt reminder of precisely why we own bonds in the first place. It is not always about the highest yields; rather it is about the balance, diversification and lower volatility that bonds bring to a portfolio.

For the third year in a row, every major sector of the bond market that I track closed in positive territory. Not a bad feat, considering the year began with a consensus view that interest rates were too low and had nowhere to go but up-which typically would translate into losses for bond portfolios without protection from just such an eventuality. And the wave of defaults forecast for the normally placid municipal bond market never appeared over the horizon.

I will admit to having thought we would face slowly rising interest rates over the course of the year, but the true bond market skeptics missed the mark by a country mile. Why? Investor demand for high quality, low volatility investments simply did not wane. In fact, as the news from various parts of the globe turned more uncertain, the flight to quality that I have referred to so many times before pushed prices up, and yields down, dramatically. The benchmark 10-year Treasury saw its yield fall to a record low 1.72% in September. At year-end, prices and yields have barely budged, with the 10-year ending at 1.87%.

Surprisingly, with inflation a non-issue for much of the year, **inflation-linked bonds**, or TIPS (Treasury Inflation Protected Securities) were the best performing sector of the bond market, generating a total return of 13.5%. Investors bought them, at least in part, on a bet that inflation would rise with economic expansion. Indeed, headline inflation peaked in September at 3.9%, a big jump over the 1.6% rate last January. However, more recent figures show inflation has already begun to ebb, again. In addition, TIPS benefitted from their triple-A ratings in a year when high-quality was in high demand. As I have said several times in the past, if you require the highest quality bonds available, then why not get the ones that have a built-in inflation hedge to boot?

I believe demand for TIPS will continue into 2012 largely from institutional investors and funds alike. This should keep prices elevated and yields low. While the inflation-protection component is valuable, I also believe TIPS are now richly-valued and that there are other pockets of the bond market more deserving of investors' attentions.

The **Treasury market** was roiled in August when Standard & Poor's downgraded the credit rating on U.S. Treasury debt from AAA to AA+ amidst the congressional debate over the debt ceiling. In an ironic twist, the Treasury market rallied in response, with Treasurys up almost 3% during the month.

Overall, nominal (non-inflation-linked) Treasurys returned 9.8%. The flight to quality in response to everything from the euro debacle to the budget debate kept demand strong. Treasury investors also had the Federal Reserve to thank for at least some of this outstanding performance. Whether it was through the quantitative easing programs or "Operation Twist," one arm of the government was actively buying another arm's debt and, in so doing, helped drive its own borrowing costs lower. Nice deal.

Investors remain risk-shy, and I expect Treasury prices to remain high well into this year. The current uncertainty in the euro zone may dissipate, but it won't happen quickly, easily or without pain and losses for some foreign issuers and buyers. Longer-maturity Treasurys should remain in demand for those looking to ride out what could be a bumpy year.

The outlook for shorter-maturity bonds depends (naturally) on numerous factors. The Fed has indicated it will not raise short-term interest rates in 2012. Economist John Maynard Keynes was reported to have said that when the facts changed, he was apt to change his opinion as well. The same could be said for the Fed. The depth of the European recession (depression?) will have a great influence on where Treasury prices and yields head next. Of course, our own domestic economic strength will play a significant role as well.

Barclays Fixed Income Index Returns Through 12/31/11

	Duration	Dec.	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.32	0.00%	0.15%	0.22%	0.37%	2.44%
US Treasury Index	5.92	0.97	9.81	5.87	-3.57	13.74
US TIPS Index	4.23	0.04	13.56	6.31	11.41	-2.35
US Aggregate Bond Index	4.95	1.10	7.84	6.54	5.93	5.24
US Govt / Credit Index	6.01	1.29	8.74	6.59	4.52	5.70
US Credit Index {A2}	6.74	1.94	8.35	8.47	16.04	-3.08
US High Yield Index {B1}	4.19	2.66	4.98	15.12	58.21	-26.16
Caa component	3.71	3.31	1.18	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.39	1.44	6.97	12.84	34.23	-14.75
Municipal Index	8.08	1.90	10.70	2.38	12.91	-2.47
Municipal Index - 5 Year	3.93	1.32	6.93	3.40	7.40	5.78

Source: Barclays Capital

In the **corporate bond (credit) market**, returns were also strong, similar to last year, as global demand and the search for yield continued unabated. I recall thinking when a few corporate issuers were able to sell bonds with fixed coupon rates of less than 1% in 2010 that it was, if not a once-in-a-lifetime event, darned close. It turns out that was just the beginning, as companies from Texas Instruments and IBM, to PepsiCo and Procter & Gamble (higher quality, blue-chip names) were able to sell billions of dollars of bonds at sub-1% rates. No wonder so many corporate balance sheets are strong.

Speculative grade or **high yield bonds** managed to overcome investors' "risk-off" mentality as the search for yield continued, though the asset class's return of just under 5.0% sharply lagged last year's performance. This should not come as a total surprise. In the three years since the 2008 credit crisis, when high-yield bonds took a drubbing, the "junk" market has returned a whopping 91%. The fact that this asset class took a breather is understandable. But several factors, including an improving economy, continued low default rates and lower borrowing costs, should make high-yield bonds and their issuers increasingly attractive in 2012. Having said that, I continue to believe that the higher-quality segment of the high-yield market is the most appealing. At Adviser Investments, we believe we will have another year of "slow-growth, not no-growth," and, in that environment, higher-quality high-yield should benefit. While continued risk-off behavior stemming from euro-land worries could impinge on returns, in a yield-starved environment, high yield will receive plenty of attention as the asset class can offer equity-like returns with lower volatility.

Despite the aforementioned, dire warnings from false prophets at the start of the year, one of my favorite areas, the **municipal bond market**, overcame an early selling frenzy and the primary muni index returned 10.7%. I was quite clear, as punditry swirled, that I did not believe that a tidal wave of defaults was imminent. In fact, the default wave never materialized. While a few issuers did indeed default, as a few always do, the size and scope was miniscule.

As 2011 ended, many munis offered a better value than many Treasury, agency or corporate bonds. I routinely find munis with higher yields than those on taxable securities, which is an unusual relationship, because securities providing taxable income should yield more, not less. The bond market has, in some places, been turned upside down.

Facing the start of a new year, many investors remain worried about rising interest rates and the potential damage this could have on their bond portfolios. My advice is to be vigilant, but not to panic. As always, bond investing involves a lot more than yield alone. Now, more than ever, I believe it is important to have a disciplined approach to building a bond portfolio that attempts to mitigate the ill effects of a rising-rate environment. Whichever way interest rates move, bonds continue to be a great portfolio diversifier and shock absorber when paired with more risky assets.

While I don't expect the bond markets' returns to be so positive each and every year, I think demand will remain higher in 2012 and returns will follow. With this as the backdrop, I expect more good news for bond investors this year, albeit in a more modest fashion than investors experienced in 2011.

Happy (unhappy?) anniversary to the ZIRP

You may not know it by its acronym, but you certainly have felt it in your savings and money market accounts. ZIRP, the Federal Reserves' zero interest rate policy, has had a profound impact on investors and savers. After cutting the Fed Funds Rate to 0% during the 2008 financial crisis, the Fed has been loath to raise it in fear of snuffing out our economic recovery.

Millions have felt the cost in their checking and savings accounts as money market yields have gotten stuck near 0% (Fidelity Cash Reserves has had an average yield of just 0.03% for the past 24 months). Savers are being penalized for being fiscally responsible! Certificates of deposit aren't offering much better.

While there are higher-yielding options available, none of them include the dollar-in, dollar-out next-day liquidity that many desire, and require.

I would caution that, before making a move to boost your yield on your "rainy day" accounts, that you make sure any changes remain consistent with your individual tolerance for risk. We all keep money in cash and money markets for myriad reasons, many of which may well trump the rate of return received. At Adviser Investments, we are always available to review your risk profile with you and work towards developing an investment strategy that best meets your needs.

Wishing you all the very best and a prosperous and happy new year.

Christopher Keith
Senior Vice President
Fixed Income Manager