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WHITE PAPER

FIXED INCOME – WHAT NEXT?

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Fixed Income – Interest Rate Increase, Inflation

With the economy seemingly making a recovery from depressed levels and the first signs of inflation emanating, as evidenced in the March CPI numbers, the question remains: What is next for fixed income investors?

Until recently, industry experts were expecting interest rates to remain unchanged in 2004. However, many analysts are on the brink of changing their opinions. For example, Mr. Ed McKelvey, a senior economist from Goldman Sachs, hinted at the possibility of an interest rate increase in August 2004 (see New York Times – Unexpected Surge in Consumer Prices Fans Inflation Fears). However, the federal funds futures seem to be pricing in an increase in interest rates in July 2004.

With interest rates at a 45-year low, it is not a matter of whether the Federal Reserve will raise interest rates – it is a matter of when. This is an important issue in the fixed income markets, as higher interest rates would imply lower bond prices resulting in capital loss. This loss would be offset somewhat by higher yields. Depending on the time horizon of the investor and the speed and the magnitude of the increase in interest rates, total returns could be negative, neutral, or even positive to fixed income investors. In addition, consideration must be given to the impact of inflation on the fixed income investments.

If an investor has a time horizon of three years or longer, the total return from bonds will generally be positive even if the interest rates were to spike by as much as 200 basis points (100 basis points = 1%). A scenario analysis by PIMCO reveals that long-term investors can still expect positive returns if they are long-term holders because the capital loss from an interest rate hike is offset by higher coupon payments. In the long run, 90% of bond returns come from the income stream and only 10% of the returns are related to capital.

The scenario analysis performed by PIMCO is illustrated below in Exhibit 1. The simulation was performed on the Citibank BIG Index, a market-capitalization weighted index,that includes fixed-rate Treasury, Government-sponsored, mortgage, asset-backed, and investment-grade issues with a maturity of one year and longer.

Exhibit 1

Change in Interest Rates	**1-Year**	**3-Year**	**5-Year**	**7-Year**	**10-Year**
+ 200 bps	-3.3%	3.2%	4.5%	5.0%	5.4%
+100 bps	0.8	3.9	4.5	4.7	4.9
0 bps	4.6	4.5	4.4	4.4	4.4
-100 bps	7.6	4.7	4.2	3.9	3.7

Source: PIMCO

Western Asset Management Company, ("WAMCO"), also performed a simulation under a "Worst Case Scenario" to highlight what could happen to one of their flagship products – Core Plus. Please keep in mind this is a worst-case scenario and in reality, the interest environment could be entirely different and possibly much milder. The analysis below assumes a 300 bps spike in short-term interest rates and 100 bps increase in long term rates. In addition, the analysis assumes that the 10-year TIPS yield would increase by 35 bps and the 30-year TIPS yield would increase by 25 bps.

In such a scenario and assuming the portfolio composition as illustrated in Exhibits 2 and 3, the estimated annualized and cumulative returns are as shown.

Exhibit 2

Annualized Returns

	Weight	1 - Year	2 – Year	3 - Year
Non- TIPS	93.9%	-4.31%	0.36%	2.42%
TIPS 10-year	1.45	2.77	3.45	3.56
TIPS 30-year	4.65	1.89	3.03	3.40
Core Plus	100%	-3.92%	0.53%	2.48%

Source: WAMCO

Exhibit 3

Cumulative Returns

	Weight	1 - Year	2 – Year	3 - Year
Non- TIPS	93.9%	-4.31%	0.72%	7.43%
TIPS 10 year	1.45	2.77	7.02	11.08
TIPS 30-year	4.65	1.89	6.15	10.54
Core Plus	100%	-3.92%	1.06%	7.63%

Source: WAMCO

As can be seen from Exhibit 2 and 3, for time horizons longer than one year, even under the worst-case scenario, investors come out ahead generating positive total returns. From Exhibit 2, we see that an investor can expect an annualized 2.5% return in the worst-case scenario.

We believe that the worst-case scenario is very unlikely, as the Fed has learned from previous experience, that drastic moves in interest rates result in a chaotic financial environment. The Fed typically uses only gradual or incremental increases (or decreases to stimulate a poor economy) in interest rates and as such we believe that investors should not move into cash or asset classes violating our time-tested asset allocation guidelines.

One method that our investment managers are utilizing to combat inflation in reflating economies, is by having an exposure to TIPS. In the interest of limiting short-term losses to fixed income portfolios, investment managers have also shortened the duration of their fixed income securities in reflating economies (such as US or Japan) and have increased the duration of their securities in Euro and/or UK which will obviate the potential damage of rising interest rates. In addition, investment managers have bet against the currencies of structurally weak countries, such as the US, that are plagued with a huge trade and federal deficits.

Besides the above strategies, investment managers have moved some of the assets out of the US fixed income market and into international debt. However, if income consideration is of prime importance, municipals are an attractive asset class with the tax-exempt status being an advantage for the asset class. When the structural deficiencies, such as current account and budget deficits, are eventually addressed via higher tax rates, investment managers believe that municipals are a very attractive proposition for clients looking for income.

The fixed income investment managers and mutual funds on our focus list are making these changes to our clients' portfolios. The managers with a total return focus have the latitude to make investments in these categories as and when necessary in order to maximize returns for investors. For example, the PIMCO Total Return Bond fund has 5% exposure to the emerging market debt as well as about 8% exposure to TIPS to combat inflation. WAMCO has also moved to higher allocation to TIPS (9%-12%) and has shortened its duration relative to the benchmark (3.4 - 3.6 v/s 4.3 for LBAG). We are continuously evaluating each of the fixed income managers and funds on our focus list and monitoring how each investment manager positions their fixed income portfolio.

Fixed Income – Conclusion

- The Beacon Pointe Research Team believes that as interest rates and inflation increase, although of concern, the increase will not be as problematic over the long-term. Although an increase in interest rates will hurt the performance of fixed income bonds in the short-term, higher interest rates are actually positive for investors as they can re-invest the coupons at a higher rate. Numerous studies from investment managers on our focus list support this conclusion.

- Present client fixed income investment managers have the ability to not only move up and down the yield curve, but also to target specific maturities and sectors they believe will provide the best defensive hedge against an interest rate increase. Investment managers also have the ability to tactically move into instruments that protect against unexpected inflation. The manager research team will continue to closely monitor the investment decisions of each fixed income manager on our focus list.

- Clients should stay with their long-term asset allocation guidelines. We believe our asset allocation guidelines are more than adequate to protect our clients' capital as long as they have a long-term horizon.