INVESTMENT MANAGER RESEARCH

THE CASE FOR INTERMEDIATE BONDS
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CONFIDENTIAL – PROPRIETARY

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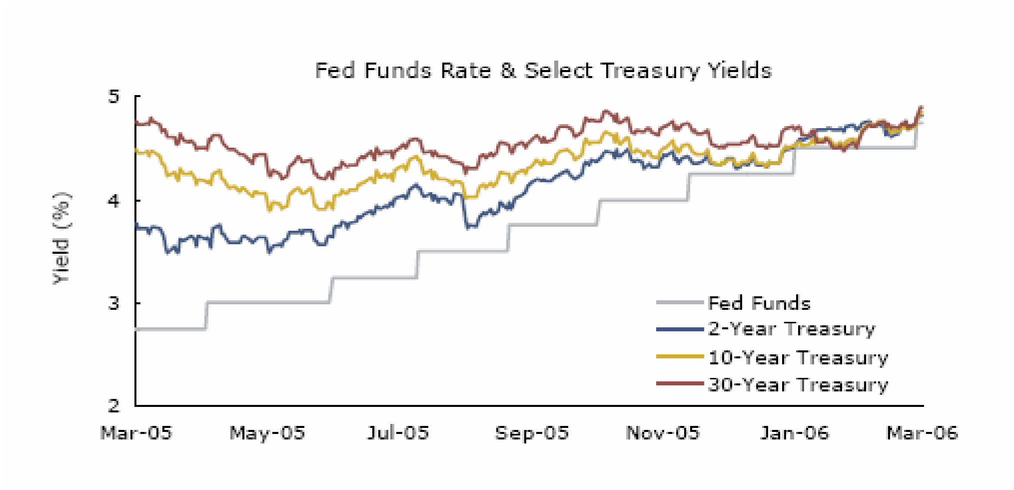
The Case for Intermediate Bonds

Typically, when interest rates climb, one would want to extend the average maturity of the bond portfolio to take advantage of higher yields. However, in recent times the short-term interest rates have resulted in a higher yield on money market funds to the extent of 4.2%, which is not much less than the 10 year Treasury yield of about 5%.

In such a scenario, one would be inclined to be in shorter duration funds to take on less interest rate risk. However, if the Fed were to reverse track, (the likelihood of that happening is higher now than it has been in recent times), then it would be prudent to be in slightly longer duration portfolio of bonds. See Figure 1 below for the recent interest rate hikes from the Fed.

Figure 1



Source: PIMCO

We understand the predicament of our clients who feel they would be better off in money market funds returning roughly 4%. We believe, however, that for periods over one year, our fixed income allocation is structured to take the timing issue out of question, as it is difficult to predict interest rate movements.

The longer-term performance numbers for the various PIMCO funds (cited here as an example only) with varying duration targets are listed on Table 1 on the following page.

Table 1

	3 Months	One year	Three Years	Five Years
PIMCO Short-Term	0.91	3.22	2.27	2.90
Citi 3-Month T-Bill	*1.03*	*3.47*	*2.01*	*2.14*
PIMCO Low Duration	0.26	2.45	2.32	4.34
Merrill Lynch 1-3 Yr	*0.38*	*2.32*	*1.42*	*3.18*
PIMCO Total Return	-0.53	2.66	3.63	5.91
LBAG	*-0.65*	*2.26*	*2.92*	*5.11*

The above table shows that for periods over a year, it makes prudent sense to have a longer duration than to lower duration money market funds. This is especially true in that one would lock the loss in moving from money market funds, when interest rates decline, to longer duration non money market funds. For instance, in 2001 the yield on money market funds declined from 5.9% to 1.6%. In contrast, the yield on the 10-year Treasury bonds stayed around 5%.

As can also be seen from the Table 1 above, the longer duration Total Return Fund helps provide decent capital appreciation over time. However in the short term the longer duration Total Return Fund can result in negative returns. The scenario analysis performed by PIMCO shows that shorter duration products tend to have lesser negative return periods than the longer duration funds in a shorter time horizon. The scenario analysis is illustrated in Table 2 below. However, this is achieved at the expense of lower returns as shown in Table 1 above.

Table 2

PIMCO

Based on Monthly Returns (Net of Fees) for periods 10/31/87-3/31/06.

Depicts # of Periods with Negative Returns:

	1 Mos	3 Mos	6 Mos	9 Mos	12 Mos	2 Year	3 Year	5 Year	10 Year
PIMCO Short -Term Fund	6	2	0	0	0	0	0	0	0
PIMCO Low Duration Fund	37	17	4	0	0	0	0	0	0
PIMCO Total Return Fund	62	42	22	17	9	0	0	0	0
Total Periods	222	220	217	214	211	199	187	163	103

Depicts % of Periods with Negative Returns:

	1 Mos	3 Mos	6 Mos	9 Mos	12 Mos	2 Year	3 Year	5 Year	10 Year
PIMCO Short-Term Fund	2.70%	0.91%	0%	0%	0%	0%	0%	0%	0%
PIMCO Low Duration Fund	16.67%	7.73%	1.84%	0%	0%	0%	0%	0%	0%
PIMCO Total Return Fund	27.93%	19.09%	10.14%	7.94%	4.27%	0%	0%	0%	0%
Total Periods	222	220	217	214	211	199	187	163	103

If investors were to take a time horizon longer than one year, we can see that even the longer duration PIMCO Total Return Fund has no negative return periods. We believe the prudent course for our investors is to ignore short-term volatility and take a longer time horizon (over a year). This would result in avoiding a situation where money market yields drop, as seen in 2001 when the yields dropped from 5.9% to just 1.6%.

Please contact your Beacon Pointe Consultant should you have any questions.