FIXED INCOME PORTFOLIO STRATEGY

Overview

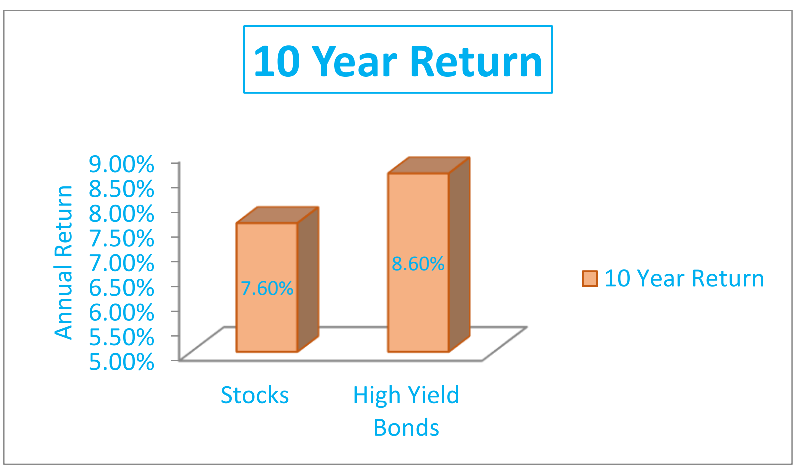
Downtown Investment Advisory (DIA) recommends that each client's portfolio include a fixed income allocation. DIA will assess the proper allocation with its clients during discovery meetings, and document its conclusions in an Investment Policy Statement. Our fixed income strategy focuses upon selecting and investing in individual corporate bonds, rather than bond funds. An individual bond enjoys a fixed interest rate and a fixed maturity date. When held to maturity, a bond investor can ignore the price movement of the bond, collect interest, and expect repayment at maturity. A bond fund, however, has no fixed interest rate and no maturity date, thereby removing the best features of a bond. A bond fund's returns are also subject to the buy and sell actions of unknown investors who often act irrationally, often forcing the bond fund manager to buy and sell in response to the moves of these investors.

DIA enhances the fixed income allocation in client portfolios by considering other types of income-producing assets depending upon each client's investment parameters. These other assets include Municipal Bonds (especially for clients in high tax brackets), Preferred Stock, REITs, BDCs, MLPs, and certain closed-end funds, each of which is discussed below.

The Corporate Bond Portfolio

DIA has extensive experience in fixed income, with 20 years of institutional investing in areas such as corporate loans, high yield bonds, mezzanine loans, and collateralized loan obligations (CLOs). DIA has analyzed and created a database of more than 200 corporate bond issues based on factors such as credit quality, yield, and duration that are suitable for various portfolio configurations. Based on current prices for these bonds, DIA can build a diversified portfolio of bonds that will target a yield-to-maturity of between 5.0% and 7.5% per year* and a duration of approximately 6 to 8 years. The bond portfolio and target yield can be tailored to match the specific needs and risk tolerances of each client, as outlined in an Investment Policy Statement.

Why corporate bonds? The historical data shows that corporate bonds, particularly high yield bonds, have performed strongly, outpacing stocks over the past 10 years with nearly ⅓ less risk, as shown in the chart below.‡



** The yield-to-maturity (YTM) target refers to the projected YTM at the time of purchase based on the interest that a bond issuer is expected to pay. However, DIA does not guarantee that the bond will actually generate the target yield. For example, if the issuer goes bankrupt, total loss of principal is possible.*
‡ 10 year returns from 9/30/03 to 9/30/13. Stocks are based on the S&P 500 Index and High Yield Bonds based on the BofA Merrill Lynch U.S. High Yield Index. Risk is measured by standard deviation, 14.6% for stocks, 10.2% for HY bonds.

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Sample Bond Portfolios

The sample portfolios below are illustrative of a few sample bonds and exemplify how DIA might construct a bond portfolio. The yields shown are based on *actual* prices for these bonds in the recent past – however, these prices may have changed since then. An actual client bond portfolio will not be limited to six bonds, rather, our goal would be to construct a diversified bond portfolio that can range from 20 to more than 100 bond holdings. As part of our day-to-day management of client portfolios, DIA will monitor new bond issuances that become available and the credit quality of existing bond holdings.

More Conservative Portfolio			
Issuer	**Coupon**	**Maturity Date**	**Yield to Maturity**
Prospect Capital	5.000%	12/15/2018	5.17%
PHH Corp	7.375%	9/1/2019	5.36%
Ryland Group	6.625%	5/1/2020	5.53%
Nustar Logistics	4.800%	9/1/2020	5.70%
Dish DBS Corp	5.875%	7/15/2022	5.77%
Equinix	5.375%	4/1/2023	5.66%
Average Yield-to-Maturity	**5.53%**		
Average Maturity (approximate)	7.2 years		
Average Duration (approximate)	5.7 years		

Medium Portfolio			
Issuer	**Coupon**	**Maturity Date**	**Yield to Maturity**
SLM Corp	6.100%	3/15/2019	6.21%
Acco Brands	6.750%	4/30/2020	6.70%
Select Medical	6.375%	6/1/2021	6.68%
Ares Capital	7.000%	2/15/2022	6.24%
CVR Refining	6.500%	11/1/2022	6.73%
RR Donnelley	6.500%	11/15/2023	6.41%
Average Yield-to-Maturity	**6.50%**		
Average Maturity (approximate)	7.9 years		
Average Duration (approximate)	6.1 years		

More Aggressive Portfolio			
Issuer	**Coupon**	**Maturity Date**	**Yield to Maturity**
Navios Maritime Holdings	8.125%	2/15/2019	7.41%
Anglogold Ashanti	8.500%	7/30/2020	7.75%
Nationstar Mortgage	6.500%	7/1/2021	7.17%
Breitburn Energy	7.875%	4/15/2022	7.16%
Winthrop Realty	7.750%	8/15/2022	7.50%
MVC Capital	7.250%	1/15/2023	7.09%
Average Yield-to-Maturity	**7.34%**		
Average Maturity (approximate)	7.6 years		
Average Duration (approximate)	5.5 years		

Other Income Securities

While corporate bonds form the core of our fixed income strategy, several other income-producing assets will be strongly considered for various portfolios to increase yield and enhance diversity. Our strategy for each asset class is as follows:

Municipal Bonds are bonds issued by government entities. The key benefit: interest earned is typically exempt from federal income tax, and may be exempt from state taxes as well. However, municipal bonds yields are typically lower than corporate bonds for the same level of risk. We will consider municipal bonds as an option for clients in high tax brackets and for those with lower risk profiles. While we will seek to purchase individual municipal bonds as well, we will also consider limited exposure to closed-end municipal bonds funds with a goal of diversifying the portfolio.

Preferred Stock is a class of equity ownership that enjoys a priority claim over general stockholders, but is more like a fixed income investment. Preferred stock is typically sold on the stock exchange in $25/share increments and carries a fixed dividend that is usually paid quarterly. The benefit of preferred stock is that it often pays a high level of income relative to the risk. However, preferred stock, unlike a bond, usually does not have a maturity date. Thus, if interest rates rise the value of the preferred stock can decline, as the fixed dividend rate becomes less attractive. With interest rates at or near historical lows, DIA approaches preferred stock with caution. We will consider preferred stock that appears undervalued, and for those clients that are income focused with longer term investment horizons.

REITs or Real Estate Investment Trusts are companies that typically own and operate income-producing real estate properties (e.g., office buildings, malls) or invest in mortgage securities. By law, REITs are required to distribute at least 90% of their taxable income to investors. This requirement means that REITs pay dividends to shareholders, usually on a quarterly basis. REIT dividend yields often can be attractive and enhance the income generation of a portfolio. However, the value of the REIT can fluctuate based on factors such as real estate values and overall stock market activity and therefore is not a fixed income security like a bond. DIA will consider REITs for those clients that are both income and equity focused.

BDCs or Business Development Companies are entities that invest in small and mid-sized businesses, typically in the form of loans. The loans that BDCs make generate interest income, which in turn is used to pay dividends to shareholders. Like a REIT, a BDC is required to distribute at least 90% of taxable income to investors. Many of the loans that BDCs offer to small businesses are at high interest rates and thus BDCs have the potential to pay attractive dividends to shareholders. Some of the largest BDCs have been highly successful and have paid consistent and growing dividends for many years. The value of a BDC can fluctuate with stock market activity, and a recession can affect the quality of the BDC loan portfolio. DIA will consider BDCs for those clients that are both income and equity focused.

MLPs or Master Limited Partnerships are a form of limited partnership that trades on a stock exchange. It enjoys the tax benefits of a limited partnership and the liquidity of a public security. MLPs are typically focused in the natural resource industries, like oil & gas or pipeline companies. Many of these MLPs earn stable income from their activities in the energy business, which is then used to pay dividends to shareholders. In many cases these dividends can be attractive and can greatly enhance an income focused portfolio. The value of an MLP can fluctuate based on industry (e.g. oil prices) and stock market activity, and will thus be considered for clients that are both income and equity focused.

Closed-End Funds are traded like a stock and are similar in many ways to an exchange traded fund (ETF), however, the closed-end fund issues a fixed number of shares. Many closed-end funds invest in fixed income assets that are difficult for many investors to access such as international bonds and privately issued municipal securities. DIA will consider such closed-end funds when the trading price is at a discount to net asset value and when they offer attractive income. Closed-end funds can be used to diversify a portfolio.

Risk Management

Investing in fixed income securities carries risks, like any other investment. DIA understands these risks and seeks to address each risk to minimize the impact:

Interest Rate Risk – Increasing market interest rates generally has the effect of lowering the value of existing fixed income investments. Many observers believe that interest rates are at or near historical lows and are likely to rise over time. Our fixed income strategy seeks to manage these risks by: building a portfolio with a target average maturity of typically less than 10 years and duration of under 7 years; laddering bond maturities so that certain bonds mature sooner and can be reinvested at the higher prevailing rates; and, reinvesting interest income earned into potentially higher-yielding assets. Finally, by focusing on a buy-and-hold-to-maturity strategy, investors can filter out the price fluctuations and wait until maturity to be repaid in full.

Credit Risk – All fixed income securities face the risk that the issuing company will go bankrupt or otherwise be unable to pay its interest and principal at maturity. Our fixed income strategy seeks to lower these risks primarily by conducting extensive credit analysis to select issuing companies that we believe are of high credit quality. Diversification is also critical – by structuring a portfolio of many fixed income investments, the impact of one bad outcome can be significantly minimized.

Market Risk – A stock market crash or other financial crisis will most likely negatively impact the value of a fixed income portfolio. Our key strategy to minimize this risk is the buy-and-hold-to-maturity strategy, which as noted above, allows the bond investor to filter out the price fluctuations and wait until maturity to be repaid in full. While the value of a stock may decline sharply in a crash with no certainty of recovery, a bond price will typically recover and approach full value by the maturity date in anticipation of the repayment of principal.

Some recent articles about bonds question where the "upside" is for corporate bonds. The nature of this question suggests that bonds are a trading "play" with capital appreciation as the main goal. DIA's strategy with fixed income is not to trade in and out of bonds for capital gains, but to earn the fixed interest offered by the bond until repaid at maturity. The fluctuations in price primarily affect the bond trader and speculator, but not the long term bond investor. Other income producing assets will also fluctuate with general market movements, but the same philosophy will be applied: hold for the long term, collect the income, and ignore the price changes.

Contact DIA for a free consultation:

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