

Asset Returns

Oct 30, 2009	YTD	2008	2007	10 Year	20 Year
Domestic stocks					
Large	16.8	-36.7	5.2	-1.3	8.4
Large Value	10.9	-36.5	-0.7	1.4	9.1
Large Growth	24.9	-38.2	11.5	-4.2	7.5
Small	15.5	-34.2	-1.8	3.0	7.8
Small Value	9.2	-28.7	-10.2	6.1	10.0
Small Growth	20.6	-38.4	6.9	-0.7	5.2
Micro Cap	15.8	-36.7	-5.2	6.4	9.8
International stocks					
Large	21.3	-41.0	10.0	1.5	3.7
Large Value	24.3	-41.7	4.2	3.5	5.5
Large Growth	18.3	-40.2	15.0	-0.6	1.8
Small	38.7	-43.9	5.7	7.0	-
Small Value	37.2	-41.7	3.0	9.5	-
Emerg. Mkts.	51.7	-48.9	33.2	9.5	-
EM Value	72.2	-53.9	45.6	13.4	-
EM Small	78.9	-54.5	38.0	11.5	-
Sectors					
U.S. REITs	12.4	-38.8	-17.8	7.7	7.5
Energy	17.4	-39.0	36.8	11.5	12.0
Bonds					
Short Term	2.0	4.0	4.7	4.0	5.3
Five Year	4.5	4.0	5.2	4.7	6.8
Long Bond	-8.8	22.5	9.2	7.8	9.6
Total Market	6.0	5.1	7.0	5.4	7.2
Other					
Inflation	-	3.8	4.1	2.9	3.0
Comm. RE	-	-6.5	15.9	10.5	7.9
Residential RE	-	-9.8	0.9	4.9	4.0
Hedge Funds	-	-18.3	14.1	6.0	-
Commodities	-	-36.0	16.7	1.7	1.8

SOURCES:

Large Cap data is based on S&P 500 returns.
 Large Value and Growth returns are based on Russell 1000 Value and Growth data.
 Small Cap, Small Value & Small Growth are based on Russell 2000, R2000 Value and R2000 Growth data.
 Micro Cap returns are based on the CRSP 9-10 index of the smallest publicly traded stocks.
 Int'l Large, Large Value and Large Growth are based on MSCI's EAFE Indexes.
 International Small & Small Value returns are based on small company data in developed markets from DFA.
 Emerging Markets data is from MSCI's Emerging Market.
 Emerging Market Value and Small Cap data is based on Indexes maintained by DFA.
 REITs are based on the Wilshire REIT index.
 Energy data is from S&P's energy index.
 Short term bonds are represented by Lehman's index.
 Five year bonds are five year treasury returns and long term bonds are 20 year treasuries.
 Total Bond market is the Barclays Aggregate Index.
 Other data comes from the Federal Reserve, National Association of Realtors, HFRI & the CRB.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS. INVESTMENT OBJECTIVES, RISKS, CHARGES, EXPENSES AND OTHER IMPORTANT INFORMATION ABOUT A FUND ARE CONTAINED IN THE PROSPECTUS; READ AND CONSIDER IT CAREFULLY BEFORE INVESTING. PROSPECTUSES ARE AVAILABLE ON COMPANY WEBSITES OR FROM TSI.

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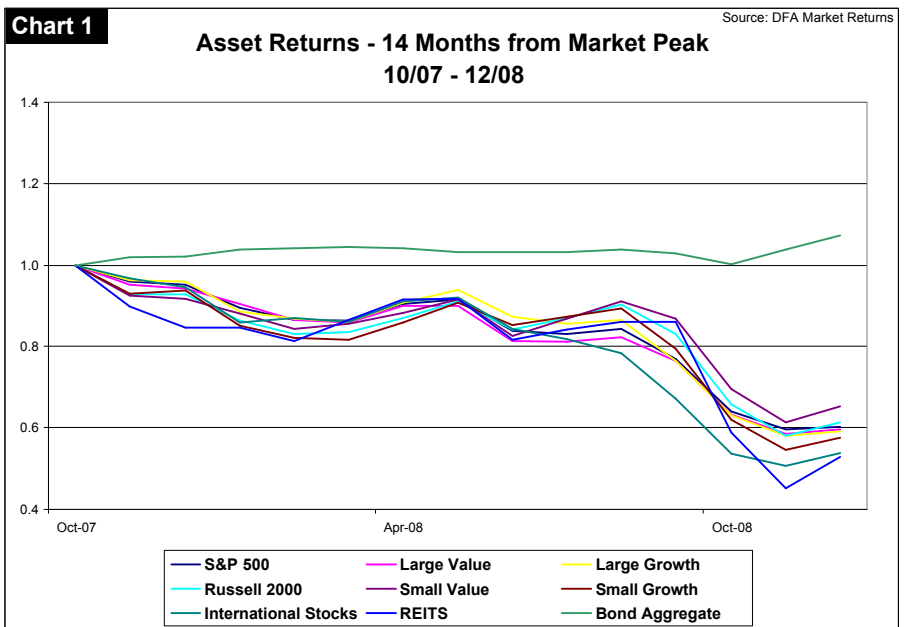
Bonds and Diversification

Last quarter I discussed correlation and diversification across the various equity asset classes. I observed that most equity asset classes moved down together last year and early this year during the financial crisis. Diversification strategies that worked well in the 2000/2001 environment performed poorly in 2008/2009 because correlations across asset classes increased above their historic ranges. Chart 1 shows the resulting performance for various assets from the market peak in 2007 through December 2008.

The one asset class that distinguished itself in this environment was fixed income, as represented by the Bond Aggregate index in this chart. Although it had limited appreciation, the bond index was actually up during a time most equity indexes shed 30-50% of their value. Portfolios with bonds showed lower volatility and losses during the market decline.

However, bonds are not a monolithic investment class with little differentiation across the market. Much like stocks, there are many different types of bonds with dramatically different return and volatility characteristics. For example, Long Bonds (20 year treasuries) were up 22.5% last year but declined 8.8% year-to-date. At the same time, Five Year Government bonds appreciated 4.0% last year and are up 4.5% this year. Although, both are U.S. government bonds, they performed very differently.

In this newsletter I'll discuss the characteristics of different bond classes and the factors that drive their performance and volatility. Additionally, I'll review their impact on a diversified portfolio's returns and volatility.



Barclay's Aggregate Bond Index

The most commonly cited bond index was formerly called the Lehman Aggregate Index. When Lehman failed last year, Barclays took over Lehman's index business. This index is representative of the domestic bond market and includes issues based on their share of the total outstanding debt. U.S. government related debt makes up almost 75% of the index. 36% of the holdings are treasury bonds and bonds from government agencies like Fannie Mae and Freddie Mac. Another 38% are mortgage backed bonds guaranteed by government agencies. The remaining 25% of the index includes bonds issued by industrial and financial companies and a small sampling of asset backed bonds.

Although mortgage backed securities played a big part in the financial meltdown, the problem securities were not issued by the government agencies. Instead, they were issued by investment banks and independent mortgage originators. Those bonds had only limited representation in this index. As Chart 1 demonstrates, the high concentration of government-related debt and low exposure to sub-prime mortgages allowed this bond index to appreciate over the period from late 2007 through 2008.

The biggest drivers of performance for this index are current interest rates and inflation expectations. The overall portfolio has average maturities of 5-8 years. If investors expect rates to rise in coming years, the prices for bonds will decline. Conversely, the index will go up in value if interest rates are falling. Because of the high concentration in government bonds, there is little default risk in this index.

Although the Barclay's Index is the most widely cited proxy for the bond market, it is an incredibly diverse universe and I'll look at some segments of the market through the remainder of this newsletter.

Long Term Government Bonds - This market includes U.S. government bonds that mature in more than 20 years. Since the government prints the money used to repay the bonds, the bonds have little default risk. However, their distant maturities make them very sensitive to changing interest rates. In 2008 the segment appreciated by over 20% as investors flocked to the safety of government sponsored debt. This year, the segment is down almost 9% as rates have climbed and investors turned their attention to the potential for inflation. Table 1 shows the long term returns of various bond classes. As you can see, the volatility for the long term segment is almost twice that for the Total Bond Market.

Table 1

	30 Year	
	Returns	Volatility
1 Month T-Bill (TBILL)	4.7%	0.8%
1 Year Fixed Income FF (1G)	5.9%	1.9%
5 Year Gov't Fixed Income FF (5G)	6.7%	5.1%
Total Bond Market LEH (TB)	7.1%	5.8%
Long Term Fixed Income VG (LB)	8.0%	10.3%

Due to their volatility, long term bonds are not suitable for reducing portfolio volatility. Additionally, the long term returns reflect the historic decline in rates since the late 70's inflationary environment. Consequently, the returns are likely to be lower in coming years as the current yield on 30 year treasuries is closer to 4% than the 8% return over the last 3 decades.

Investment Grade Corporate Bonds – These bonds are issued by high quality companies and have a wide range of maturities. For a bond to be considered "Investment Grade" it should be rated Baa/BBB by the ratings agencies. Prior to the recent financial turmoil, these bonds were perceived to be relatively low risk. However, during the recent meltdown many investment grade companies saw their bonds trade at significant discounts to face value and investors fled to the safety of government debt.

High Yield Bonds – Although a relatively small part of the overall bond market, high yield (junk) bonds get a lot of attention from investors and commentators. The issues are more speculative than "Investment Grade" bonds and consequently pay higher yields. During periods of market turmoil, high yield bonds often move with stocks. Consequently, many investors treat the segment like a proxy for the equity markets. While they offer higher returns than higher grade bonds, their correlation to equities should always be considered.

Municipal Bonds – State and local taxing authorities issue bonds to fund capital expenditures and ongoing operations. The bonds are often exempt from federal and tax income taxes. They usually pay lower interest rates than other bonds with similar default risk, reflecting the tax advantage status.

Foreign Bonds – Foreign governments and corporations issue bonds in their local currencies and in U.S. dollars. The foreign currency component adds a potential diversification benefit to a fixed income portfolio (also a potential risk). High quality government bonds from foreign issuers (i.e. Germany, Japan, Australia, etc.) can diversify existing portfolios. Additionally, bonds from emerging markets can often pay attractive yields and provide a currency hedge against a declining dollar.

Conclusion

I've only touched on some of the largest parts of the bond market, but my purpose is to highlight different parts of the bond market and outline a few of the considerations for each of those segments. Ultimately, all asset classes should be considered in the context of their impact to risk and return in your overall investment portfolio. Bonds can be important tools in the portfolio construction process.

Gabe Thornhill

Disclosure: Bonds are subject to default risk, risks associated with interest rate movements and other risks unique to bonds. The diversification benefits of bonds do not protect against loss in a declining market.