



Montecito Private Asset Management, LLC

MPAM

FIXED INCOME SEMINAR

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(Disclaimer: This seminar is for informational purposes only and is not an offer to buy or sell securities. All investors should consider their unique investment needs and risk tolerances, and should consult with a qualified professional, before making any investment decisions.)

In tonight's seminar, I will discuss a variety of fixed income investment vehicles, along with my expectations for their future performance prospects. But first, let's take a look at the overall fixed income investing environment to gain some perspective.

The financial markets debacle of late 2008/2009 drove spreads for most fixed income investments to unprecedented levels, as compared to treasury yields, offering both attractive investment opportunities and serious risks. Even today, well over a year since Lehman Brothers failed and the financial markets seized-up, spreads for some fixed income securities remain high compared with historical norms.

Performance Summary

- The 30-year treasury lost 15% of its value during calendar 2009
- The S&P 500 gained 20% in 2009
- The commodities index gained 20% in 2009
- The U.S. dollar lost 5% in 2009
- California municipal bonds gained about 5% in 2009

Economic Overview

Although we are here to discuss the fixed income markets, I want to provide you with an overview of the economy, along with my expectations for 2010 and beyond. The key issue with the economy, and what we are all trying to determine, is: Are we, in fact, in a recovery or not? I believe we are recovering, but unfortunately, not at a pace that would be necessary to justify the current optimism or valuations for financial markets, to include the treasury market.

We have **unemployment** at 10%, a slight tick down from the high of 10.2%, but in my opinion, we have not seen the peak yet. I would expect to see unemployment peak during either the second or third quarter of 2010, at around 11%. With this stated, the current "real" unemployment rate (as opposed to the government's official statistic) is estimated to be above 17% and climbing. In California, where our current official unemployment rate is 10.6%, down from 12.2% at its peak, we are likely also above 17% for "real" unemployment. I would expect to see the California real rate of unemployment reach 20% (1 in 5) at the peak. (The difference between the official rate and the real rate of unemployment is due to individuals falling off of the unemployment benefit rolls, which is how the government (state and federal) keep track of those unemployed.)

My expectations for **GDP** growth for 2010 are for a range of 1.5% to 2% for the year. We saw GDP turn positive in Q3 of 2009, with a revised annualized growth rate of 2.2%. We still have not seen the Q4 2009 number, but it should be positive as well, and many economists are looking for growth in excess of 5% annualized for the fourth quarter.

The threat of a **double-dip recession**, meaning that we see a couple of quarters of positive GDP growth followed by another negative GDP period of two quarters or longer, is real, but

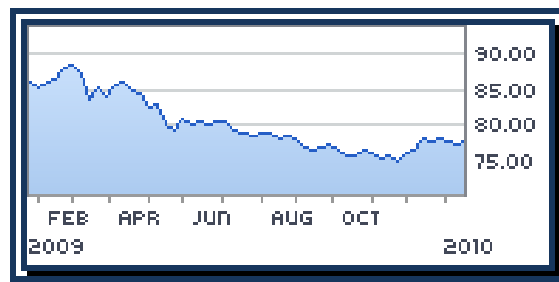
unlikely in my opinion. If we were to see a double-dip, it would be sometime this year, probably around mid-2010. Although I do not expect this to occur, it is a possibility and would be very negative for the financial markets, unemployment, and for the economy as a whole. With this said though, high-quality bonds would likely outperform other investments (more on this below).

The Dollar

The dollar has rebounded a bit recently, up about 8% from the low of around 71 on the dollar index (an index measured against other major currencies) to the current 77 or so, and the push from the dollar has pressured commodity prices somewhat in recent weeks. The dollar index peaked in February of 2009 at around 88, so it is down about 12.5% from that high to the current 77 level. A rising dollar certainly signals some potentially implications for fixed income investments.

We could interpret the recent rise in the dollar as a sign that foreign investors and consumers are seeing the U.S. economy improving, and are therefore buying our dollar-based investments and goods. We could also see it as an indication that demand for commodities, most of which trade in U.S. dollars, is rising due to increasing global demand. Finally, it could be that the dollar is rising because foreign investors see their home currency as too risky, which would indicate that the global economy is weakening (still) relative to the U.S. economy.

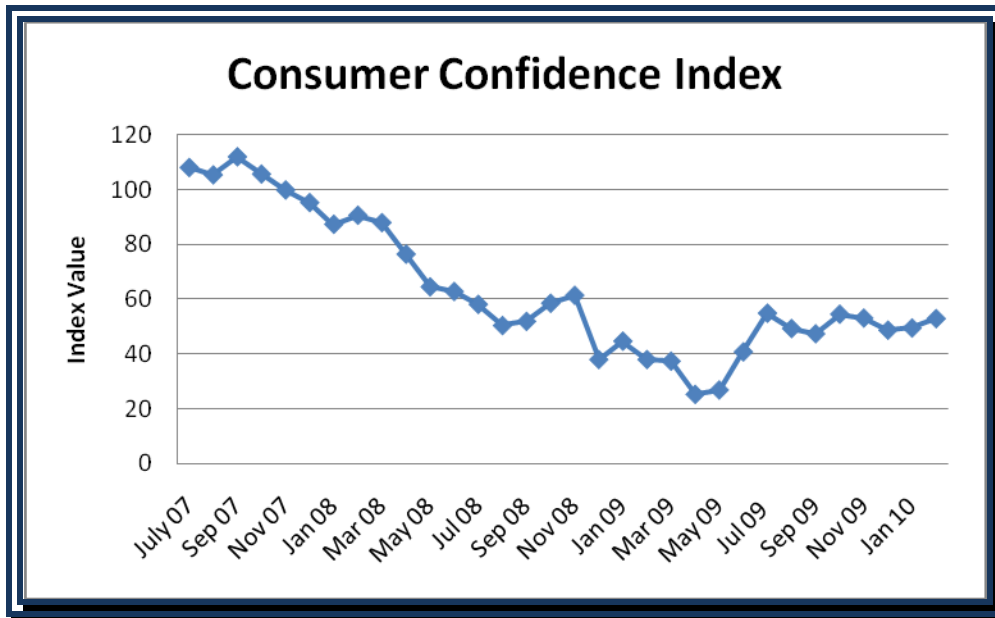
I would expect that the U.S. economy will emerge from the recessions first, and will help pull other economies out of the recession. However, the recent improvement in the dollar, like the improvement we have seen in the financial markets—stocks, commodities, and treasuries—is likely early and overly optimistic.



Dollar Index

Consumer Confidence

As you can see in the chart below, consumer confidence, which had been on a serious downtrend since about July of 2007, has recently turned-up. It's too early to tell whether this trend will continue, but for now, it is encouraging. Consumer confidence is important for the economy since it drives consumer spending (about 70 percent of total economic activity). Although consumer confidence is starting to turn positive, consumer spending is still very weak, reflecting the still very high unemployment rate, and consumers' concerns about the state of the economy. We must see consumer spending improve if we are to have a sustained recovery in the economy.



Mortgage Rates/Real Estate

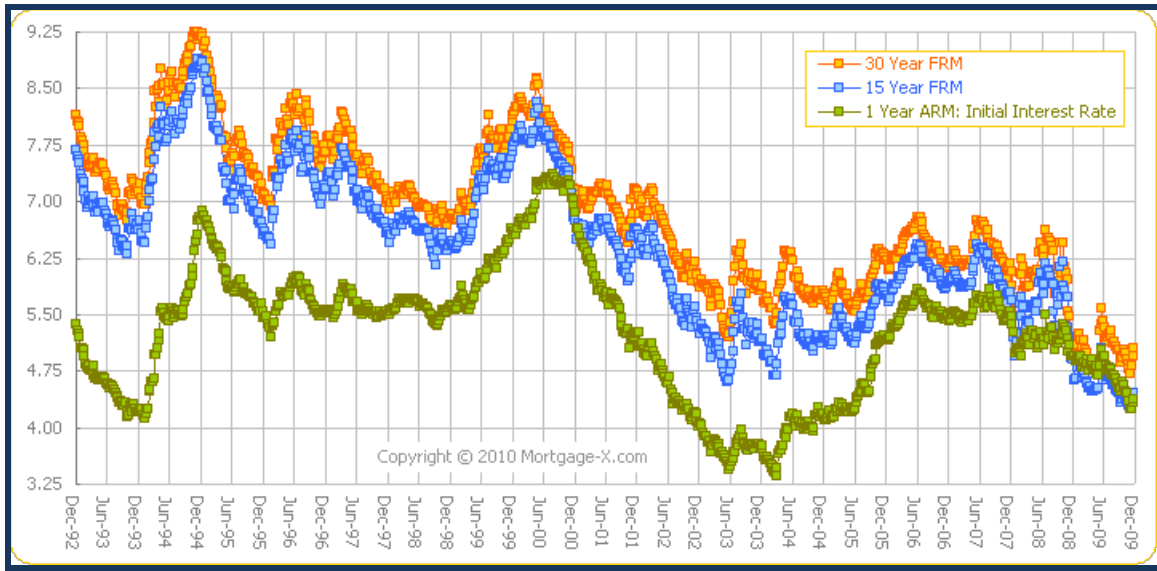
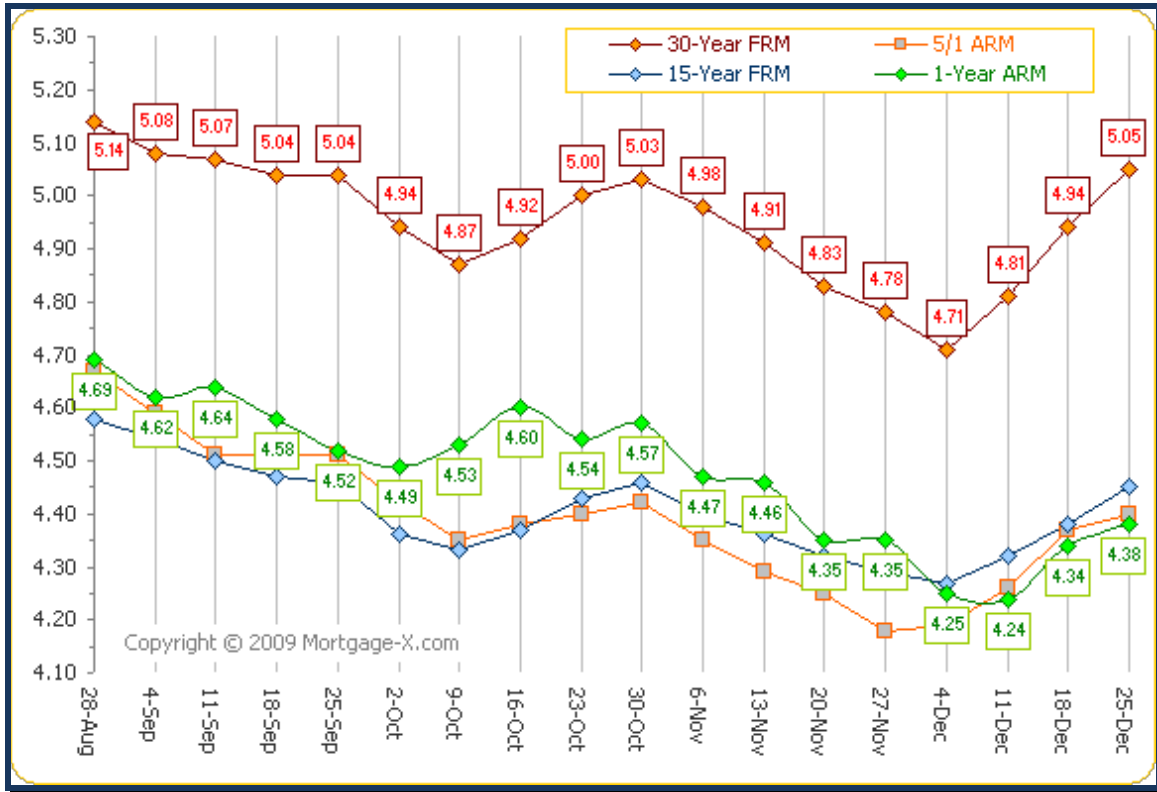
We saw mortgage rates, following the treasury curve down, dip to an all-time low around 4.71% (30-year fixed) in December of 2009 (a few weeks ago). We have seen some improvement, as the treasury curve has rebounded from its lows, to about 5% currently, but mortgage rates are still historically very, very low. This is certainly favorable for potential borrowers, although the real problem is that banks have tightened their lending standards to where it is next to impossible for anyone to get a loan, unless they have perfect credit and a huge cash position... *and then they have to catch their banker in a really good mood.*

We have seen real estate prices locally drop by over 41% from the highs in October of 2007, with the median price in Santa Barbara (the city; not the county) falling from a high of \$1.275 million to the current \$749,000 (November (most recent); source: California Association of Realtors). Despite the low mortgage rates cited above, I do not believe we have seen the low for home prices or activity, either nationally, for the state, or for our local market.

We have seen activity picking up for homes priced below about \$800,000, but I believe this is a temporary phenomenon, and that it is based on misperceptions by some buyers that they had better jump on anything below \$1 million here; otherwise they may never be able to afford a home in Santa Barbara. I believe these buyers will dry up shortly, and that prices will resume their downward spiral. I do not expect to see a bottom begin to form until late 2010/early 2011 (at the earliest), and even then, I expect it to take two to three years (at least) for the bottom to form, before we see any meaningful upside in prices.

I realize this is not what homeowners, especially those with resetting mortgages, want to hear, but this is our reality, in my opinion. Speaking of resets, we are going to experience a huge spike in mortgage rate resets between about now and the beginning of 2012, which will put even more selling pressure on local real estate prices. This is not a pretty picture, and I fear things will get worse for real estate before they get better. One need only look at the last real estate debacle (Savings & Loan crisis) in the late 1980s/early 1990s) to see the potential

for more downside—things are worse now than they were then, and we did not see the bottom start to form until about 1993, and prices did not show signs of life until late in 1996.

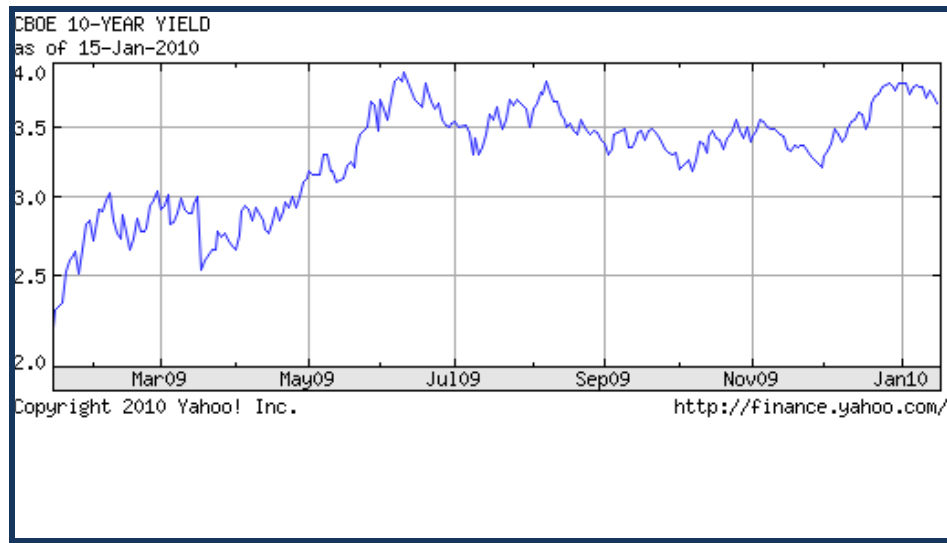


Treasuries

One issue we must address within the context of this discussion is the fact that treasury prices recently hit sixty-year-plus highs, (treasury yields hit sixty-year-plus lows). This was because of a combination of factors including: Investors in all other investment vehicles (except gold)



scrambled out of everything else and into treasuries when the financial market meltdown occurred back in September of 2008, following the Lehman collapse; foreign investors, worried about conditions even worse than those we face here in the U.S., sold foreign currency-based investments and converted to dollars so they could buy U.S. treasuries, (still considered the safest investment on the planet), despite our glaring economic and financial problems (China owns \$2 trillion worth of U.S. long-term treasuries); and the Treasury Department bought treasuries to inject more cash into the economy, driving prices up.

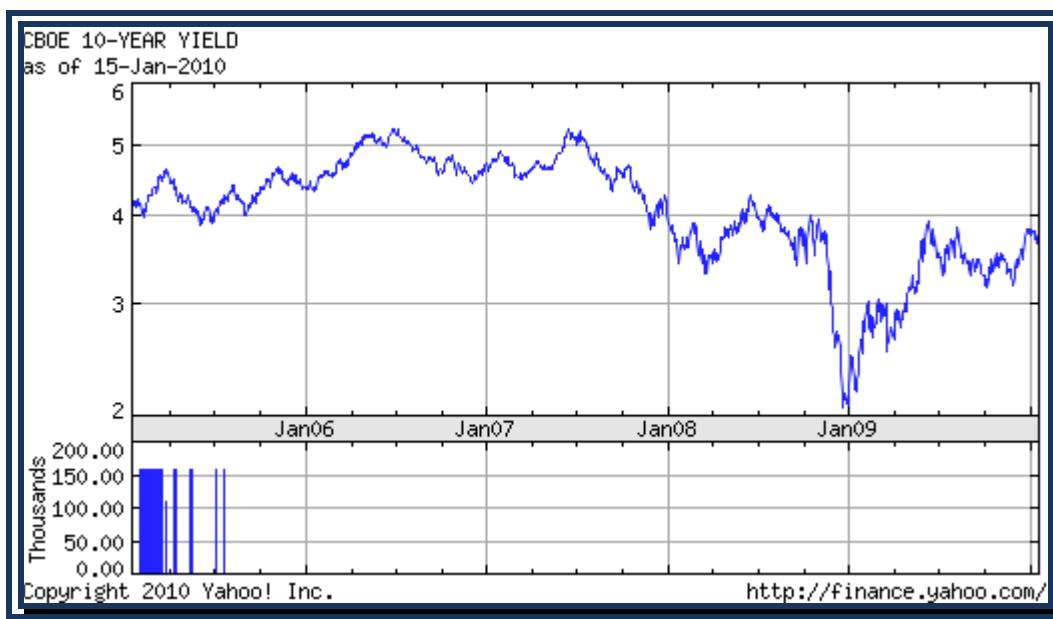


One-year chart of 10-year treasury yield

Since the lows at the end of December, treasury yields have rebounded sharply, although they are still historically very low. We have bounced from low yields around 2% on the 10-year, to about 3.71 currently. This may not seem like a lot, but on a percentage basis, it is a huge move (an 85%+ move in yield). The short end of the treasury curve is basically at zero percent, reflecting the very loose monetary policy of the Fed, and the target rate for Fed funds of a range between zero and $\frac{1}{4}$ percent. (An increase in yield is obviously a decrease in prices, since yield and price move in opposite directions.)

Where do we go from here?

I have written fairly extensively about my expectations for rates in general, as we move forward into 2010 and beyond. My general view is that rates are going to rise, and rise significantly for at least the next year, bringing the 10-year treasury up to a 5% yield or higher within one year (and I think we could see that level much sooner). Although the dollar has rebounded from its lows, it is still weak, and rates are incredibly low, leading to the potential for inflation. The Fed, which is very hawkish on inflation, will be quick to act, once they see the first real signs of inflation building. This action will be to raise rates. Higher short rates should drive the entire yield curve higher, although I expect it to flatten somewhat (more on this below).



Five-year chart of 10-year treasury yield

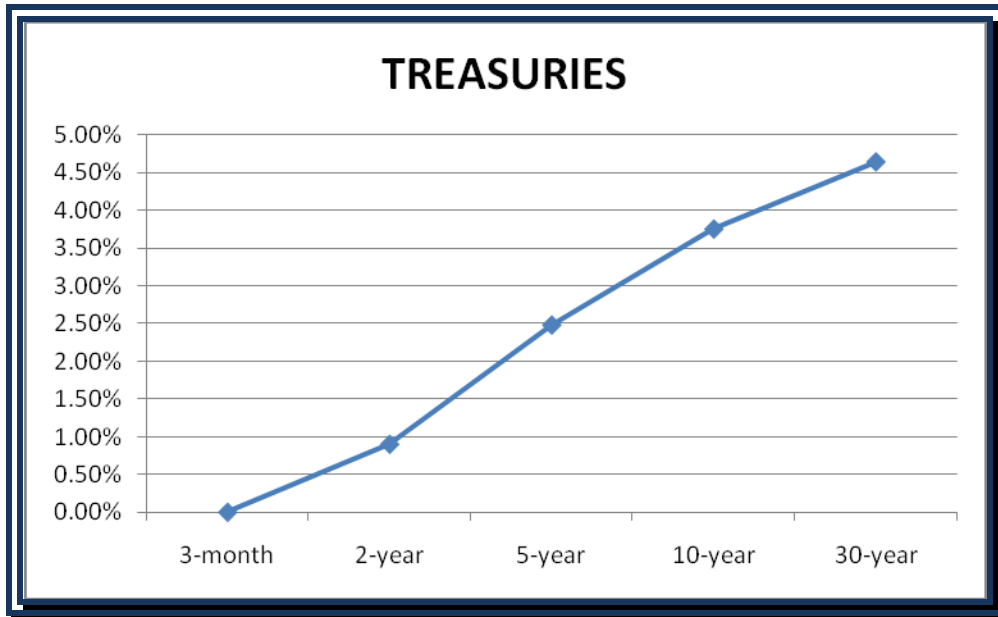
Rising rates mean falling treasury prices, and to the extent that other fixed income securities follow the treasury curve, which they typically do, we should see other fixed income securities, including other types of bonds—munis, corporates, mortgage-backed, etc.—fall in price as well. With this said, because other types of bonds are still mispriced, meaning that their yields are higher than one would expect, given the current level of the treasury curve, there could be some realignment of the curves as rates rise. (More on this below). But, in general, I do expect rates to rise and bond prices to fall over the coming year at least, and across the board (with all types of bonds).

As you can see from the chart below, the current treasury yield curve shows a very steep and positive slope. This, in my experience, has been a condition that is the most reliable predictor of economic recoveries. When the treasury curve is steep and positive, the implication is that the economy will recover within the next two to four quarters. When the curve is negatively sloped (inverted), the indication is that we are headed for recession. (We had a *very* inverted (negatively-sloped) yield curve a few quarters before the recession started, in early 2007, with the recession officially starting in December of 2007).

While the current positively sloped and steep treasury curve is a good sign of a recovering economy, it is also a sign that longer rates, and eventually the whole curve, will rise. The long end of the curve typically drags the short end around, so as long rates rise, short rates will likely also begin to rise, forecasting where short rates will go (and what the Fed will do next). (With short rates at basically zero percent, there is only one direction they can go.)

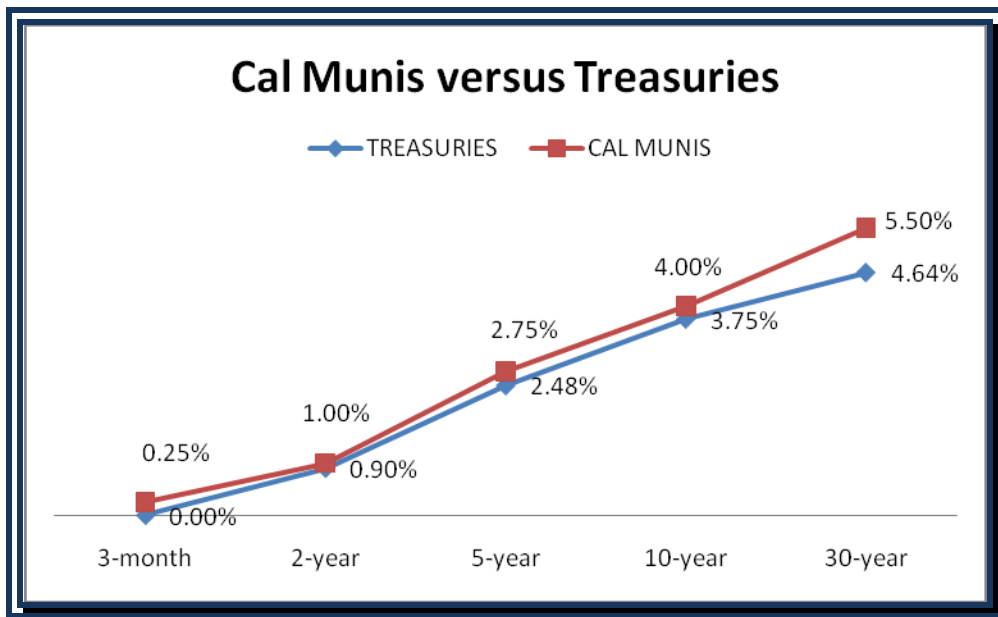
We already know that the Fed is planning to raise rates, and that the Treasury and Fed will remove liquidity from the financial system by selling back some of the treasuries they have been buying, and by allowing short-term credit facilities to mature without renewal. This will have the impact of tightening the money supply, strengthening the dollar, and raising rates. The Fed has already stated that as soon as inflation becomes a concern, they will begin raising

rates. We don't know if that will occur next month, in three months, or in six months, but we do know that the Fed will begin to raise rates within a period of months (not years).



Municipal Bonds

If we look at the current comparison between the treasury curve and the municipal bond curve (California AAA-rated bonds), we see the following relationship:



As you can see, the muni curve is *above* the treasury curve. This is not normal... historically, muni yields are *lower* than equivalent maturity treasury yields, due to the tax advantages of munis—double tax-free (state and federal). As I eluded to above, there will

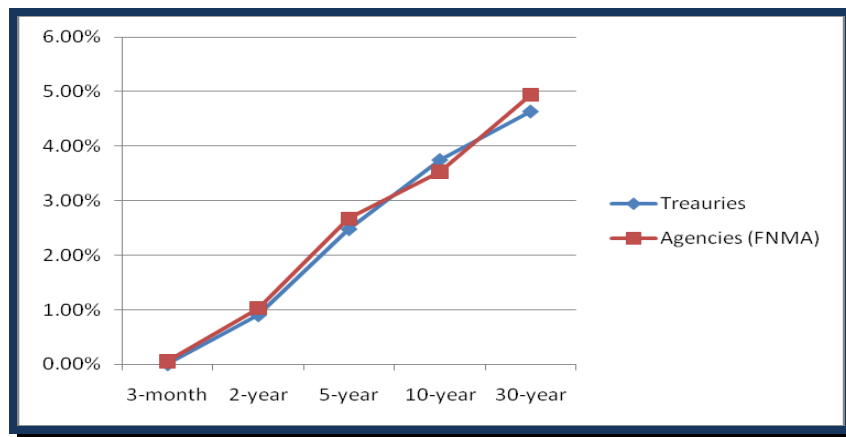
likely be some further realignment of the bond yield curves to the treasury curve, as normal historical relationships are re-established following the massive stress in the financial markets, following the Lehman Brothers failure. This means that prices of munis and some other types of bonds, may perform better relative to treasuries, as rates rise. The yield curve, for treasuries and other types of bonds, will likely flatten somewhat, meaning that short rates will likely rise on an absolute basis, more than long rates. However, since longer maturity bonds have a more pronounced price movement for a given movement in rates, prices of longer maturity bonds will likely still perform more poorly than shorter maturity bonds.

The net result of all of this is that, in my opinion, bond portfolios, regardless of the type of bonds owned, should be focused on *shorter* maturities of **five years or less**. For local taxable investors in higher tax brackets, the California muni market appears to be the best area of focus. With this stated, maintaining shorter maturities, for those investors dependent on current income from their portfolios, will be a challenge. Short maturity bonds of all types are currently providing very low yields, and thus very low current income. There may even be some money markets and other alternatives in very short-term instruments that offer higher net, after-tax yields compared to muni bonds, at least for the near-term. (Investors should explore these alternatives, and should understand their current income needs before making any changes to portfolios.)

In general, I prefer California GOs (general obligations) because they are supported by the full taxing authority of the state. Bonds supported by specific revenue sources, such as airport bonds, school system bonds, water district bonds, etc., are tied to their sole source of revenue, and are therefore, (all other things being equal) somewhat more risky. *(While this is a good general guideline, a well-diversified portfolio of revenue bonds can mitigate a lot of the potential impact of a default or multiple defaults within a muni portfolio. Those skilled in analyzing and identifying appropriate bonds, or those working with a professional, should explore all muni and other options, for their fixed income portfolios.)*

U.S. Agencies

U.S. Agencies include Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC), but also contain student loan-backed bonds, World Bank-backed bonds, etc. While there are some opportunities in the agency market, we are still dealing primarily with real estate-backed bonds, meaning that the risks inherent in the real estate market outlined above are still a real threat to the long-term performance of these bonds. I feel that a small allocation to the mortgage-backed bond market could be advantageous, although as a percentage of a total bond portfolio, this allocation should be quite small (5% or so for most investors).



CMBS

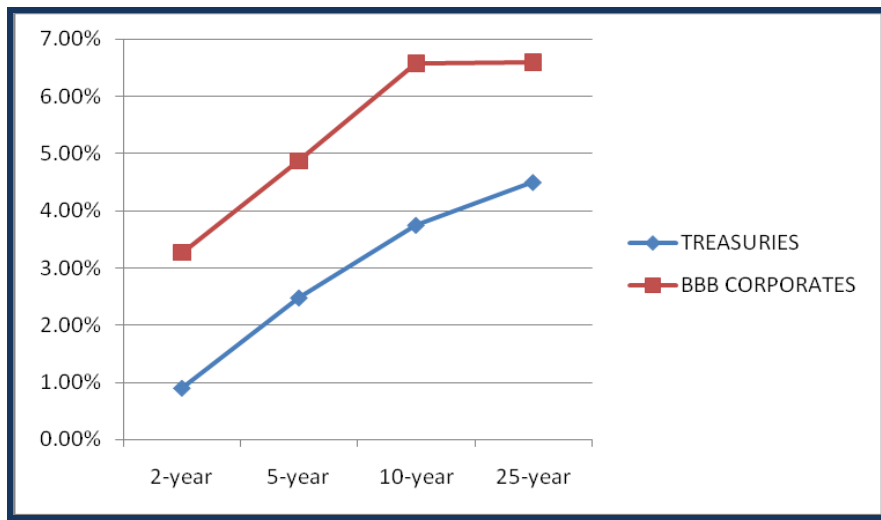
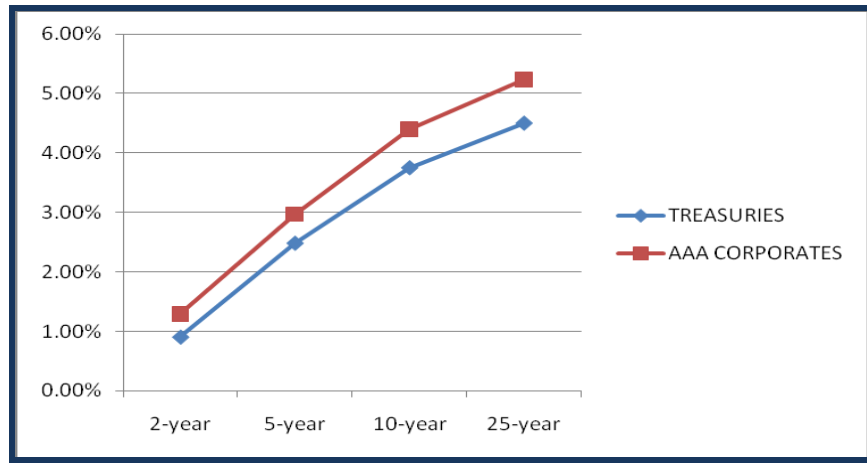
Commercial mortgage-backed securities (CMBS's) are bonds based on commercial, rather than residential mortgages. There is typically a lag between residential real estate problems and commercial real estate problems, when entering into a recession, and we have seen that developing during this recession as well. We have likely not seen the worst of the commercial real estate problems to come from the recession, so I would still consider this segment of the bond market to be risky, and therefore would not recommend a large percentage investment in this segment for bond portfolios.

Investment Grade Corporates

Investment grade corporate bonds, which historically average roughly a 100 to 150 basis point spread above the treasury curve (about 1 percent to 1½ percent), spiked in yield to a spread of about 500 basis points (5 percent) above treasuries as a result of the financial crisis. To look at it another way, investment grade corporates were offering five times the yield spread to treasuries compared to their historical average. This has two primary implications: One - investment grade bond prices were exceptionally low compared to treasury prices; and two - the perceived risk within the investment grade corporate bond market was extremely high.

AAA-rated corporate bonds are now trading at or even slightly below their historical spreads to treasuries, meaning that over the past year or so, high-quality corporate bonds have made very large price advances. From here, I would expect the top quality corporate bond market to perform in line with treasuries, in terms of price movement, with slightly higher current income from the slightly higher current yields. In other words, I would expect high-quality corporates to decline in price as rates rise over the coming several quarters.

Still in investment grade corporates, but at the opposite end, I would expect similar performance from BBB-rated corporate bonds. Spreads are at roughly 200 basis points (about 2 percentage points), which is fairly typical on a historical basis. Since spreads are roughly in-line with historical norms, I would not expect a boost in performance from realignment of the BBB-corporate curve with the treasury curve. Overall returns, due to the relatively higher yields, as compared with treasuries and AAA-rate corporates, should make these bonds perform better, again relative to treasuries and AAA-rated corporates. But, in a rising interest rate environment, they will likely still perform poorly.



Sectors of Focus

The sectors of the economy that I would focus upon within the corporate bond market are the same as those I would want to own in stock portfolios—namely **technology, financials, industrials, consumer discretionary, and some energy and materials**. This is because we want to own those sectors that should outperform the overall market, as the economy recovers. We have seen these sectors perform well over the last year or so, which supports this conclusion. However, prices are rich at the moment, and investors may want to wait for some price retracement before committing funds to new purchases of corporate bonds.

Corporate bonds gained about 18% overall (all quality rating and all maturities combined), with high-quality bonds rising about 9% and BBB-rated bonds rising about 27%, in the past year.

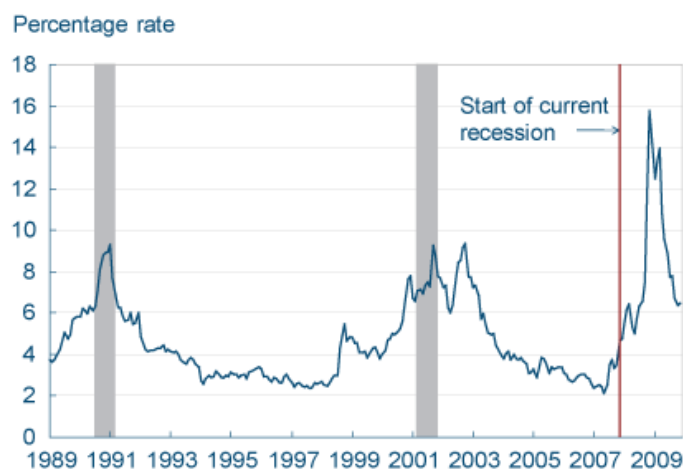
High-Yield (Junk) Bonds

The High-yield 100 index gained 27% over the past year, while the CCC-rated bond index gained a shocking 110%. European high-yield gained about 65% last year, while the global high-yield index rose 56%. (Merrill Lynch Indexes) These returns are not really surprising, since we would expect the dislocations in the financial markets to be much more pronounced for higher-risk securities, and high-yield bonds are the highest risk in the bond universe. Spreads, as with all other bond types, grew enormously when the financial markets collapsed, and have now retreated to more historically normal levels. High-yield spreads are normally about 500 basis points (5 percentage points) and spiked to 2,000 basis points and more during the crisis (the High-yield 100 Index has a current spread just below 500 basis points).

The high-yield bond market is much more of a position picker's game, and individual securities should be analyzed and chosen on their own merits, with secondary consideration given to overall market conditions, the term structure of rates, and economic expectations, among other factors. Only investors with a very high risk tolerance should consider these bonds, and those who do should limit the percentage weighting high-yield bonds will represent within portfolios.

With this said, I would say the same about the high-yield market as I did above in reference to the corporate market, which is that the money to be made from the realignment of the yield curve for high-yield in relation to treasuries has already been made, so we are facing a more normal market environment moving forward. With rising rates, I would expect the high-yield market to perform about in line with historical norms, given the current economy and expectations for rising rates. However, **one extra precaution here**—I would expect that company failures will be relatively high, given the length and depth of the current recession, and therefore the default rate for high-yield bonds will likely be somewhat higher than we would see in a typical recession.

High Yield Spread



Note: Shaded bars indicate recessions.
Source: Merrill Lynch

Preferred Stocks

Preferred stocks aren't exactly what many would call fixed income, and they aren't bonds either, but they do pay dividends and can be a good alternative to bonds if yields on bonds are unattractive, or if price declines are expected. With preferreds, one should be careful to distinguish between those that pay qualified dividends, and those that do not. Preferreds with qualified dividends allow the holder to pay the current 15% tax rate on the dividends, while non-qualified preferred dividends are taxed at the holders' current income tax rate. Be careful!

Also, we know that the Obama Administration is not going to renew the Bush tax cuts, which are set to expire at the end of 2010, so after that, the qualified dividend tax rate will not be in effect (most likely). So, prices of these preferreds could get hit leading up to the end of 2010, if not before. Since it is unclear what, if any, impact tax code changes may have on preferreds, I would recommend caution.

What does "qualified" mean?

To be classified as a qualified dividend, for certain preferred stocks, the relevant holding period is at least 91 days out of the 181-day period beginning 90 days before the ex-dividend date.

Basically, on preferred stocks, if the issuing company treats it as debt and takes a tax deduction for the dividends paid, then the dividends you receive are NOT qualified, and therefore you would pay taxes on that dividend income at your normal tax rate. Be careful! You can and should check to see if a preferred is qualified BEFORE you buy it.

REITs

Just as we saw in the CMBS section, the commercial real estate market looks somewhat negative right now. While there could be opportunities to reap big rewards by buying some of these depressed issues, I am avoiding them for now, since I believe the commercial and office real estate market is lagging the residential market, and will experience continuing problems (losses, defaults, difficulty refinancing, etc.)

Utilities

Utilities can be another good alternative to bonds for those looking for current income alternatives. Yields are down on many utilities (prices are pretty high), so one needs to be careful when evaluating these investments, and should analyze the companies just as they would a regular stock or bond investment, paying particular attention to cash flows.

Summary

Given the complexities of the financial markets following the Lehman failure, AIG virtual failure, Merrill Lynch failure, Bear Sterns Failure, and the near collapse of Citi and so many others, it almost seems that investing in stocks would be safer than bonds, which is contrary to historical norms, of course. In fact, we have seen stocks perform fantastically well,

especially from the March 2009 lows. Right now, at least with stocks, you may not get the price you want, but at least you can get out if you want to. With fixed income, the liquidity has just not been there, although it is returning, and if you needed to sell, you have probably taken a beating over the past year.

Going forward, I am still very concerned about the health of the U.S. economy and the global financial system. I am bullish on the economy longer-term however, and I do believe, unlike many, that the worst is behind us. The recent rally in stocks should tell you that we are turning the corner. While I believe investors are overly-optimistic at present, and that the pace of the recovery will be far slower than many believe (hope), I do see the clouds parting (slowly). With that said, I do not think we are out of the woods yet, and I would expect more volatility and more downside to come, including a correction in stocks of some magnitude, as well as in treasuries, corporates, and commodities. We will not go straight up, just as we didn't come straight down (although it felt that way).

For now, for taxable fixed income investors in higher tax brackets, I am recommending California municipal bonds. For most investors, the safest bet will be to focus on GOs (general obligations). There will be and now are opportunities in other Cal munis, and if you have the time, expertise, and/or professional assistance, I would look for those opportunities. Tax rates are likely to rise as well (there is no alternative, since the national debt and budget deficit are exploding), which will make demand for munis increase as well.

I am recommending keeping all bond maturities to five years and shorter, protecting portfolios somewhat from the negative impact of rising rates, and also offering opportunities to reinvest funds from maturing bonds at increasing rates.

There are certainly ongoing financial risks in the state, and the recent budget deficit should tell you all you need to know there. But, I do not believe the state will default on their bonds, although some individual cities or counties might. As stated above, I would recommend sticking with GOs, which are backed by the full taxing authority of the municipality (State of California if you buy state GO's) as opposed to revenue bonds backed by specific projects like a water district, airport, etc. There are certainly opportunities elsewhere in the state, but one needs to really do their homework and to understand the revenue base from which interest and principal payments will come, before investing. Diversification, with everything you do, is key, especially in this troubling investment environment.

I will be writing a follow-up article about local municipal bond investments, so keep reading my column in the News Press!

I hope this information has been helpful, and I hope you enjoyed the seminar this evening. Should you have any questions, please ask them after the seminar, call me at 805.898.1400, or email me (craig@mpam.bz) anytime. Also, if you would like to schedule an appointment to discuss your portfolio, the markets or economy in general, please do not hesitate to contact me.

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