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Managing Investments Through the Volatile Financial Crisis

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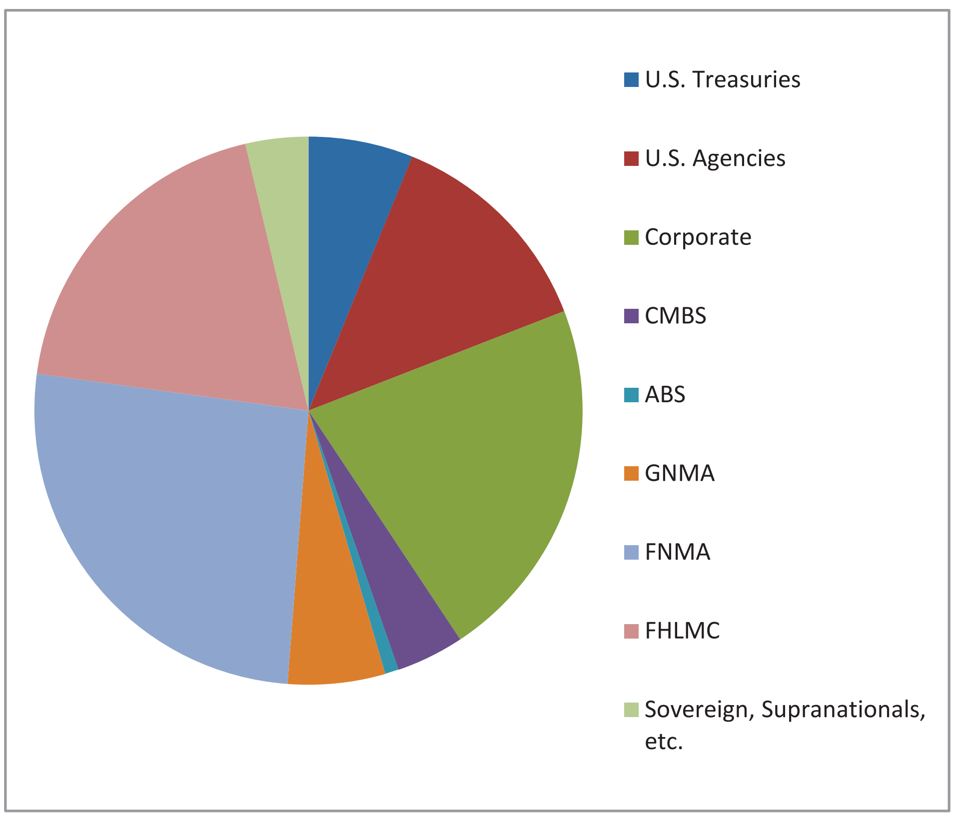
During these volatile times in the financial markets, investors are wondering where, other than Treasuries, fixed income portfolio allocations should be made. This question is especially important after the downfall of storied investment institutions like Merrill Lynch, Lehman Brothers and Washington Mutual. One answer involves shifting investment goals from incremental outperformance to preservation of principal. Diversification provides meaningful risk reduction and would support this new goal. Basic diversification involves investing across the various fixed income sectors, as well as within each sector. For example, investment selections could be made among several issuers in the corporate sector, different types of municipalities in different states, and various types of collateral within the structured product sector. These sectors are discussed further below.

The Corporate Sector: An investor's corporate bond focus should be on an issuer's market leadership and financial stability as well as the issue's structure. An issuer's access to capital to retire maturing debt and fund new business is necessary for short-term viability. Long term viability may be inferred through a strong balance sheet, limited leverage, and stable earnings generation capacity. Corporates require continuous monitoring because, as has been seen so often this fall, a company's financial situation can change quickly, with disastrous consequences.

The Municipal Sector: A municipal allocation can be diversified in several different ways: 1) geographically, thus mitigating exposure to regional economic slowdowns or catastrophes such as hurricanes, earthquakes, etc; 2) by source of payment -- e.g. tax-backed general obligation debt



This pie chart shows how the Lehman Aggregate Index is diversified. Municipal bonds could be considered for further diversification.

versus project specific revenue debt, which is backed by tolls or user fees -- thereby limiting the effects of reductions in tax revenues or property values; and 3) by sector, avoiding exposure to high default risk sectors such as industrial development, land secured debt, elderly care and tobacco settlement bonds. Underlying credits should be reviewed if there is an insurance wrap on the bond.

The Mortgage Sector: The agency-backed mortgage security market, which includes three Government Sponsored Entities (GSE), Fannie Mae, Freddie Mac and Ginnie Mae, continues to perform well in an environment where investors are focused on safety and principal preservation. These issues are almost as secure as Treasuries, because the United States government continues to imply their guarantee in an effort to stabilize the country's housing market. The government's backing of GSEs give them the added benefit of liquidity in these times of volatility, allowing them to be sold efficiently in the secondary market.

Diversification in the current economic climate requires not just sector allocation, but also conservative investment choices with attention to issuer balance sheets, leverage and earnings generation. Watch this space in future issues for more detailed core fixed income diversification articles.

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