AUREUS ASSET MANAGEMENT

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Aureus Asset Management, LLC
Investment Perspectives
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Fixed Income: Opportunities and Challenges

Summary

For much of the past several decades, fixed income investments had lower volatility and lesser returns than equities, and importantly acted in the market differently than equities. In 2008, everything changed. With the significant exception of Government bonds, many fixed income instruments became highly correlated with the stock market and produced negative total returns, thereby not protecting broadly diversified portfolios as much as past experience would have indicated.

In 2009, market participants have seen a more normal bond market. Riskier parts of the fixed income market have been the more rewarding, as well as the more volatile. This is due in part to unprecedented Government efforts to rescue the economy and financial markets, and in part to greater public confidence in present Government policies.

Aureus Asset Management believes that careful attention must continue to be paid to both risks and potential rewards in fixed income, as these will have an impact on the economies and the stock markets around the world.

I.

Starting in the 1990s, US consumers began to add substantially to overall levels of debt. By 2007, personal balance sheets became more leveraged with debt than at any other time in our history. Much of this was in response to very easy credit terms, low short-term interest rates, and new financial instruments which made borrowing almost effortless. Financial institutions not only encouraged the accumulation of debt on the part of consumers but took on far too much debt themselves.

In late 2007 and throughout 2008, we saw cracks in these policies and beliefs. Home prices began to fall, the economy slowed, and some major financial institutions either went bankrupt or were forced to take Government money in order to survive. The credit markets were thrown into turmoil, as major banks and brokers refused to continue to make markets in many forms of debt. It became almost impossible to find a buyer for corporate, municipal, and financial institutions' bonds towards the end of last year.

The bond market ended 2008 with its worst performance on record, again with the single exception of Government bonds. Spreads between rates on Government issues and those of almost any other borrower hit astonishing levels which had never been seen before. Fear ruled, and confidence was at abysmal levels.

II.

In 2009, normality has begun to return to the fixed income market. Spreads have contracted, by Government yields rising while corporate and municipal yields declined. Yet we are not back to what would have been considered normal levels of spread relationships as recently as just a few years ago. The hangover from the deleveraging process in this country is not over, but the process of deleveraging now seems more understood and accepted.

Because of the intervention by the Federal Reserve and the US Treasury, fears of collapse have almost disappeared even though the recession continues. There are still signs of caution: few banks are lending aggressively, consumers are paying down their credit card and home equity lines, and companies are hoarding cash. However, the desire to avoid risk at any cost, and place most of one's assets in very short-term cash, has changed. Because of current Federal Reserve policy, the yield on cash stands at just above zero percent, which has encouraged investors to turn towards longer-term assets such as corporate bonds and stocks.

Despite the rally in many fixed income assets, yields still seem competitive, possibly excepting Treasuries which are relatively low. There appear to be interesting opportunities for specialists in bank loans, corporate debt, municipals and debt of foreign countries. As an example, the Government has introduced one new form of long-term debt, the Build America Bond (BAB). BAB issues are taxable municipal bonds, normally from a state, city or town. They can be general obligations of the municipality or funded through particular revenues such as a sales tax. The US Government subsidizes 35% of the income payment directly to the municipality, thereby encouraging the municipality to invest in infrastructure as part of the Federal stimulus program. Because of the subsidy, the after-tax yield on these BAB bonds compares favorably with that of typical tax-exempt municipals. Thus, a new market has developed for these long-term bonds; buyers, such as pension funds and endowments, which before had little interest in municipals now find these BAB bonds attractive. This is just one example of the many forms of longer term fixed income which seem reasonably valued today.

Conclusion

Fixed income did not protect diversified portfolios all that well last year. However, we believe that there are opportunities available today in both tax-exempt and taxable bonds which provide useful diversification and attractive potential returns. Aureus will maintain a sharp eye on these opportunities and will continue to make them available to our clients, through direct investment or through approved external managers.

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GLOBAL RETURNS SUMMARY

(%)	Year-to-Date 2009	Second Quarter 2009	First Quarter 2009	Calendar Year 2008	Calendar Year 2007
US EQUITY GENERAL					
S&P 500	3.16	15.93	-11.01	-37.00	5.49
NASDAQ	16.36	20.05	-3.07	-40.54	9.81
Dow Jones Industrial Average	-3.75	11.01	-13.30	-33.84	6.43
NYSE	2.57	18.60	-13.52	-40.89	6.58
Russell 1000	4.32	16.50	-10.45	-37.60	5.77
Russell 2000	2.64	20.69	-14.95	-33.79	-1.57
Russell 3000	4.20	16.82	-10.80	-37.31	5.14
INTERNATIONAL EQUITY					
MSCI EAFE	8.42	25.85	-13.85	-43.06	11.63
MSCI Emerging Markets	36.22	34.84	1.02	-53.18	39.78
MSCI Asia ex Japan	35.87	34.98	0.66	-52.23	40.52
MSCI Japan	2.67	23.05	-16.57	-29.11	-4.14
MSCI United Kingdom	13.07	26.59	-10.68	-48.32	8.39
FIXED INCOME					
Lehman U.S. Aggregate	1.90	1.78	0.12	5.24	6.97
Lehman U.S. Treasury: 1-3 Year	0.00	-0.14	0.14	6.67	7.31
Lehman U.S. Treasury: 20+ Year	-19.25	-9.40	-10.88	33.72	10.15
Merrill Lynch Municipal Index	7.27	2.72	4.43	-3.95	3.29
Merrill Lynch US High Yield Index	29.37	23.19	5.02	-26.39	2.19
ALTERNATIVE ASSETS					
HFRX Global Hedge Fund Index	5.57	4.85	0.69	-23.20	4.23

Notes:

MSCI indices are gross, all other indices are total return.

Source: FactSet, MCSI Barra, Hedge Fund Research, Inc.