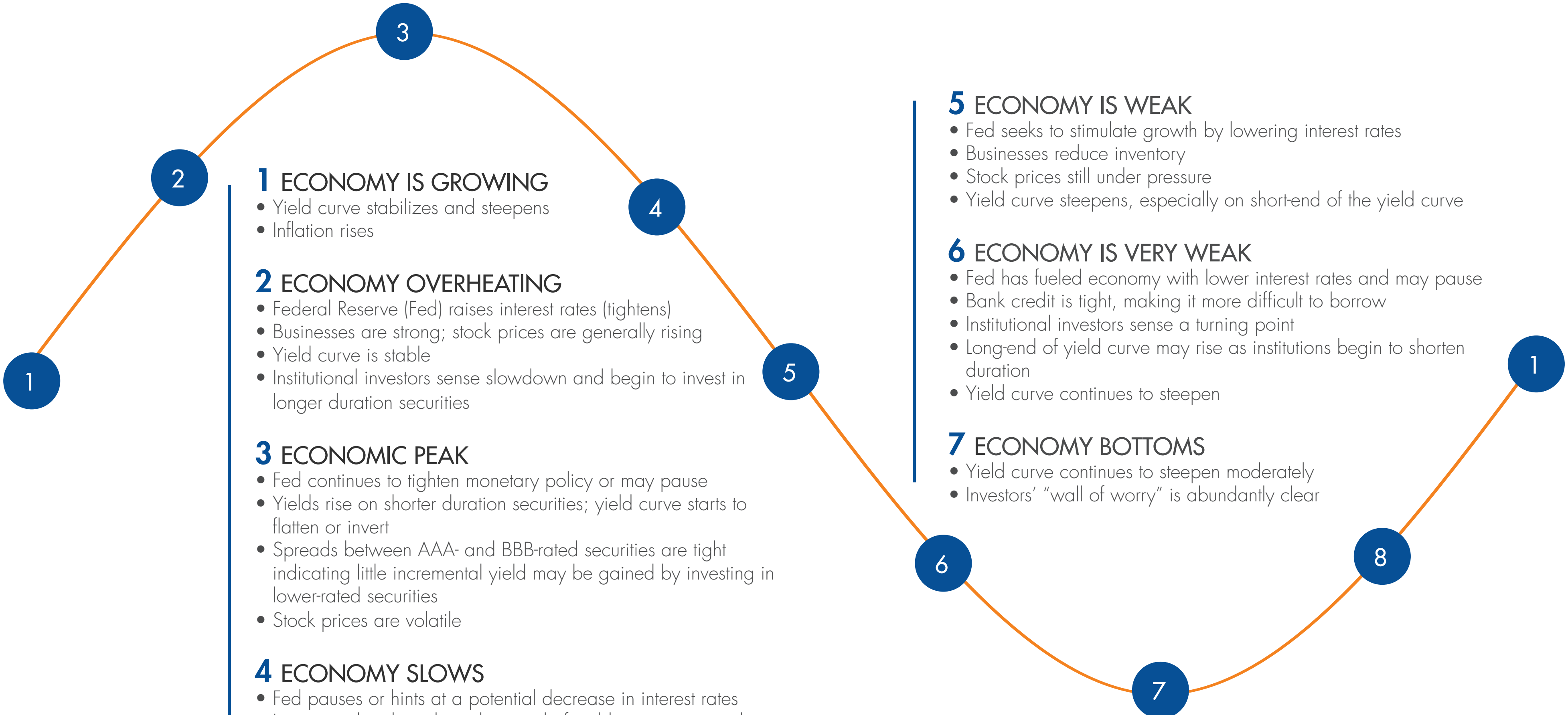
Ideas & Insights

Navigating Market Cycles

Economic and Business Cycle



1 ECONOMY IS GROWING

- Yield curve stabilizes and steepens
- Inflation rises

2 ECONOMY OVERHEATING

- Federal Reserve (Fed) raises interest rates (tightens)
- Businesses are strong; stock prices are generally rising
- Yield curve is stable
- Institutional investors sense slowdown and begin to invest in longer duration securities

3 ECONOMIC PEAK

- Fed continues to tighten monetary policy or may pause
- Yields rise on shorter duration securities; yield curve starts to flatten or invert
- Spreads between AAA- and BBB-rated securities are tight indicating little incremental yield may be gained by investing in lower-rated securities
- Stock prices are volatile

4 ECONOMY SLOWS

- Fed pauses or hints at a potential decrease in interest rates
- Institutions buy heavily on long-end of yield curve, causing long yield to drop
- Yield curve is likely flat or inverted, as investors await Fed action
- Businesses and stock prices come under pressure
- Investors become conservative; rein in spending and investing
- Spreads between AAA- and BBB-rated securities widen

5 ECONOMY IS WEAK

- Fed seeks to stimulate growth by lowering interest rates
- Businesses reduce inventory
- Stock prices still under pressure
- Yield curve steepens, especially on short-end of the yield curve

6 ECONOMY IS VERY WEAK

- Fed has fueled economy with lower interest rates and may pause
- Bank credit is tight, making it more difficult to borrow
- Institutional investors sense a turning point
- Long-end of yield curve may rise as institutions begin to shorten duration
- Yield curve continues to steepen

7 ECONOMY BOTTOMS

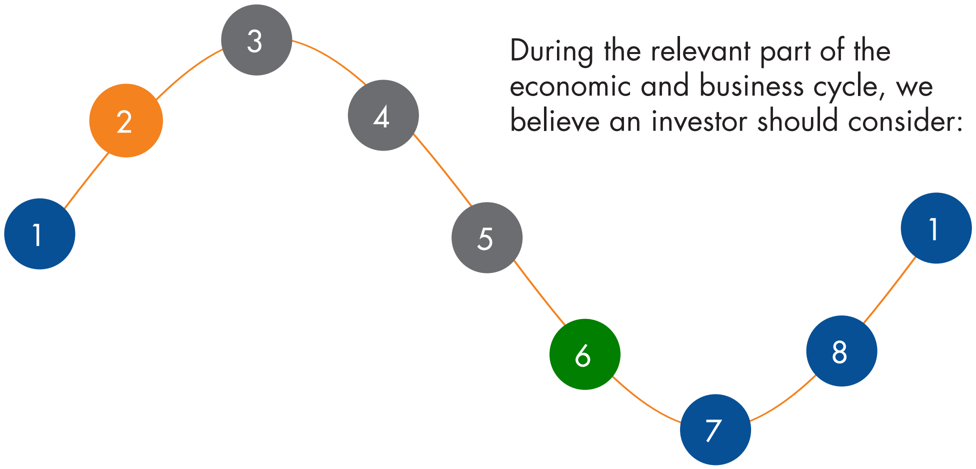
- Yield curve continues to steepen moderately
- Investors' "wall of worry" is abundantly clear

8 ECONOMIC GROWTH BEGINS

- Yield curve approaches steepest point as corporate profits improve
- Fed maintains its easing stance due to lack of long-term inflationary pressures
- Investors cautious about economic recovery as evidenced by "wall of worry"
- Recent economic history still fresh; businesses cautious about spending and hiring

Managing Market Risk and Credit Risk

A·A·M ADVISORS ASSET MANAGEMENT



During the relevant part of the economic and business cycle, we believe an investor should consider:

2 PORTFOLIO ADJUSTMENT: Decrease Credit Risk

- Harvest gains from lower credit quality securities which likely improved with a strong economy
- Increase portfolio credit quality and/or enhance portfolio asset allocation by considering:
  - –Government-related debt
  - –US Treasuries
  - –Corporate bonds
  - –Municipal and taxable municipal bonds
- Be cautious with BBB-rated credits in seeking to avoid undue credit risk

PORTFOLIO ADJUSTMENT: Increase Market Risk

- Seek to lock-in higher yields; keep in mind short-term rates tend to decline after economic peaks
- Increase duration/volatility beyond benchmark
- Consider using market or discount coupons

3, 4, 5 CONTINUE THEME

- Decrease credit risk
- Increase market risk

6 PORTFOLIO ADJUSTMENT: Increase Credit Risk

- Take "reasonable" credit risk based on investor's situation and objectives, as these securities could postentially post gains in an improving economy
- Harvest any gains from AAA-rated credits
- Increase exposure to corporate bonds
- Look for value in:
  - –Fallen angels
  - –Sympathy bonds
  - –High yield securities may start to look appealing, as spreads likely near their widest point

PORTFOLIO ADJUSTMENT: Decrease Market Risk

- Reach benchmark levels
- Harvest gains from shorter-maturity, high-quality issues; emphasize credit risk
- Consider premium and/or cushion bonds
- Be cautious of both interest rate and duration risk

7, 8, 1 CONTINUE THEME

- "Reasonable" credit risk based on investor situation and objectives
- Decrease market risk

All investments involve risk; principal loss is possible. Past performance does not guarantee future performance. Fixed income securities are subject to certain risks including, but not limited to: interest rate risk (changes in interest rates may cause a decline in the market value of an investment); credit risk (changes in the financial condition of the issuer, borrower, counterparty, or underlying collateral), prepayment risk (debt issuers may repay or refinance their loans or obligations earlier than anticipated); below investment grade risk (commonly known as "high yield" or "junk" securities, they may be considered speculative and may be subject to greater market and credit risks. Accordingly, the risk of defaults may be higher than investment grade securities. In addition, these securities may be more sensitive to interest rate changes and may be more likely to make early returns of principal. AAA, AA, A, and BBB are investment grade ratings; BB, B, CCC/CC/C and D are below-investment grade ratings; duration risk (measures the sensitivity of a bond's price to a one percent change in interest rates. The higher a bond's duration, the greater its sensitivity to interest rates changes.) Market risk, or systematic risk, is the risk that results from the characteristic behavior of an entire market or asset class.

A **yield curve** shows the relationship between the yields on short-term and long-term bonds of the same investment quality. A **premium bond** has a price higher than its face value. A premium bond generally occurs when a particular bond's coupon rate exceeds the interest rates prevailing at the time. **Fallen angels** are bonds whose rating declined from investment grade to high yield. A **cushion bond** is a type of callable bond that sells at a premium because it carries a coupon rate that is above market interest rates. A **sympathy bond** trades lower as part of a broad sector move, despite having different fundamentals and metrics. Bond credit **spreads** refer to the difference in yield between a US Treasury bond and another debt security of the same maturity but different credit quality. Credit spreads are often used as a barometer of economic health; widening is viewed as "bad" and narrowing is viewed as "good".

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