

Inflation/Duration Risk

Inflation is becoming an increasing concern to investors. How can one help protect one's portfolio against this threat? What should one do with a fixed income portfolio? An obvious strategy is to shorten duration as much as possible and favor floating rate instruments. This approach, however, may result in a significant give-up of yield.

We reviewed the performance of corporate bonds against ten year Treasuries over the last ten years. As expected, the higher the credit rating the closer the correlation to Treasuries. Over the last ten years high yield bonds have tended to have virtually no correlation, or even a negative correlation to ten year Treasuries. This can be seen in the table below which traces the correlation of different credit categories to Treasuries over the last 10 years, 7 years, 5 years and 3 years.

Treasuries vs		AA	A	BBB	BB	BB/B	B	CCC
Years	10	0.90	0.85	0.72	0.06	-0.09	-0.18	-0.28
	7	0.92	0.88	0.75	0.04	-0.09	-0.19	-0.28
	5	0.92	0.89	0.85	0.33	0.15	-0.01	-0.25
	3	0.81	0.74	0.68	0.00	-0.21	-0.34	-0.48

Below please find a comparison of monthly returns of ten year Treasuries vs. B/BB credits during the past 12 months. We have highlighted the B/BB category because it provides a compelling lack of correlation without significantly sacrificing credit quality.

Date	10 Year Treasury	BB/B	Date	10 Year Treasury	BB/B
6/30/2007	-0.72%	-1.68%	12/31/2007	-0.18%	0.48%
7/31/2007	2.46%	-2.64%	1/31/2008	3.55%	-0.79%
8/31/2007	2.12%	1.44%	2/29/2008	0.98%	-0.95%
9/30/2007	0.09%	2.24%	3/31/2008	1.13%	-0.41%
10/31/2007	1.24%	0.73%	4/30/2008	-2.39%	3.62%
11/30/2007	4.17%	-1.57%	5/31/2008	-2.01%	0.21%

We should keep in mind that inflation tends to favor borrowers since they pay back their indebtedness in currency that has diminished in value.

Today's high yield market allows our investors to benefit from an attractive portfolio of B/BB credits with a duration of less than four years and a yield of approximately 8%. This translates into a real or inflation adjusted yield of about 5% which is somewhat below our seventeen year historic gross return of 6.3% above inflation.

