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Dear Client:

Since its founding almost 25 years ago, The Colony Group has embraced the principles of asset allocation and diversification as cornerstones of its investment philosophy. These principles are important because, when appropriately utilized, they serve not only to limit downside risk and volatility but also to enhance total investment returns.

As the financial markets continue to regain their footing, it is an opportune time for clients to revisit their asset allocation plans with their financial counselors in the context of a fluid financial landscape. As part of this process, many clients have expressed new or renewed interest in learning about the use of fixed-income investments as part of their investment portfolios, a topic that we will address in this letter.

What are fixed-income investments?

The term “fixed-income investments” is broadly used to describe a wide variety of financial instruments designed to preserve capital, reduce volatility, produce income, and, in most cases, provide liquidity. Typical fixed-income investments include government and corporate bonds, bond mutual funds, money-market funds, certificates of deposit, and similar instruments.

Bonds. A bond is a debt obligation issued by a state, local, or federal government, an agency, or a non-governmental entity such as a corporation. A bondholder has the right to receive from the issuer a series of fixed interest payments during the term of the bond. If the bond is held to maturity, then the buyer also will receive the principal value of the bond at maturity.

Initially, bonds are issued by the entity wishing to borrow money. Most often, however, bonds are bought and sold on secondary markets at prices that are based on supply and demand. The prices of bonds on secondary markets fluctuate for a number of reasons, including availability and market conditions, but prices are most sensitive to changes in prevailing interest rates. Bond prices are inversely correlated to interest rates. As interest rates rise, bond prices tend to fall, and vice versa. Bonds with longer maturities are more sensitive to interest-rate changes.

For investors with access to wholesale markets, bonds typically are bought and sold in a competitive environment through dealers, and bond prices include a percentage markup to cover the dealer’s costs and profit margin. For investors acquiring bonds in the retail markets, purchases unfortunately are made from the inventory of their brokerage firm in a less competitive environment, with commissions built into the price of the bond.

Bond Mutual Funds. Bond mutual funds, much like equity mutual funds, are professionally managed and provide access to diversified bond portfolios for smaller investment accounts. Bond funds, like their equity counterparts, charge a management fee for their services.

Money Market Funds. Money market funds are liquid investment pools available through brokerage firms and banks. The underlying investments of these funds often consist of short-term commercial paper, municipal debt, and certificates of deposit. The share price of money market funds historically has been fixed at \$1, with a variable interest rate, but the share price generally is not guaranteed.

Certificates of Deposit. Most commonly available through retail banks and brokerages, CDs usually are offered for terms of 3 months to 5 years. CDs pay a fixed interest rate for the term of the investment and typically levy penalties for early withdrawals of funds.

When should an investor own fixed-income investments?

Fixed-income investments are not necessarily appropriate for all investors – particularly those with longer time horizons, greater tolerance for risk, and less need for current income. Your financial counselor may recommend fixed-income investments for your portfolio in order to accomplish one or more of the following objectives:

- Maximize return while minimizing risk
- Reduce overall portfolio volatility
- Preserve capital
- Produce income
- Provide liquidity

It is interesting to note that when equity returns are declining, fixed-income returns usually decline less so or even rise (the inverse may also be true). For this reason, fixed-income investments can offset the risks of equity investing and reduce overall portfolio risk. Moreover, while bond prices do vary based on market conditions and interest rates, the highly predictable future cash flows from fixed-income investments minimize severe price fluctuations. Relative to investments with less predictable cash flows, bonds have a tighter range of price volatility and thus can serve to mitigate extreme changes in overall portfolio value.

Perhaps above all, bonds and other fixed-income investments can be utilized to produce current income. As described earlier, a bond purchase is effectively the purchase of a stream of future cash flows. For an investor looking to create a source of predictable income from an investment portfolio, fixed-income investments may be a sensible option.

How is a fixed-income portfolio constructed?

A balanced, effective fixed-income portfolio is generally constructed under four core principles:

- Effective selection of securities to maximize return and minimize risk
- Diversification to limit exposure
- Customization to meet the investor's specific objectives
- Implementation to enhance returns and preserve capital

A complete discussion of these core principles is beyond the scope of this letter and more appropriately a subject to be discussed in detail with your financial counselor. Nevertheless, the essence of these principles is summarized in the following paragraphs.

Fixed-income security selection, particularly with regard to bonds, is a complex process. It generally involves a thorough analysis of several often-related factors:

- Duration
- Credit quality and liquidity
- Relative value and pricing
- Yield curve
- Bond characteristics and covenants
- Annual income
- Historic spreads
- Benchmarks
- Technical trends
- Economic and market factors

As these factors are considered, so too must the need for diversification within the portfolio. Diversification of fixed-income investments usually is based on a variety of factors:

- Maturity
- Industry
- Fixed-income class
- Credit exposure
- Interest-rate risk

Most importantly, a fixed-income portfolio must be structured and customized to accommodate the investor's particular goals and circumstances:

- Time horizon
- Liquidity requirements
- Risk tolerance
- Overall holdings and asset allocation
- Tax considerations
- Legal constraints
- Unique preferences and restrictions

Finally, an effective fixed-income strategy depends not only on the construction and composition of the portfolio but also on a steadfast pursuit of pricing, execution, and similar competitive advantages. Access to a broad network of brokers, as well as institutional and retail networks, is necessary to promote competition among dealers and secure the most favorable pricing and execution advantages. Constant monitoring of the portfolio is likewise essential, seizing upon select opportunities to swap securities in a continuous effort to increase yield and mitigate risk.

How do taxes affect the composition of a fixed-income portfolio?

With all of the types of fixed-income instruments available, it is important to consider the taxation of each investment. The relative value of an investment can be determined only after reviewing how the associated income will be taxed at the investor's marginal tax rate. The following is a helpful summary.

Type of Investment	Taxation of Income
Corporate Bonds	Subject to federal, state, and local taxes
Municipal Bonds	Exempt from federal taxes and state and local taxes in state of issuance
U. S. Treasury Obligations	Subject to federal taxes, but exempt from state and local taxes
Certificates of Deposit	Subject to federal, state, and local taxes
Bond and Money Market Funds	Based on the nature of the underlying investments held by the fund

What are some of the risks that must be addressed in managing a fixed-income portfolio?

All investments, including bonds, offer a return with an associated level of risk. While bonds generally are considered less risky than equities, they too carry a number of risk characteristics that must be considered and mitigated as part of the portfolio management process.

Inflation Risk. Inflation causes interest rates to rise, which, as mentioned earlier, may result in falling bond prices. Inflation also will decrease the value of the future cash flows of a bond.

Default Risk. The risk that principal and interest will not be paid when due is most applicable to corporate debt and, in rare cases, municipal debt. Debt with the full backing of the U.S. Government has little to no default risk.

Reinvestment Risk. In a declining interest rate environment, investors must reinvest income and principal at lower rates, which will lead to lower future cash flows.

Call Risk. Callable bonds allow the issuer to redeem the bond at a set price prior to maturity. An issuer is more likely to redeem a bond in a declining rate environment because new debt can be issued at lower rates. The investor must then reinvest at lower rates.

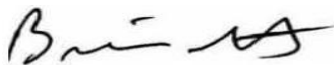
Liquidity Risk. Some issues are more thinly traded or illiquid, and finding a buyer for these investments can be more difficult.

Market Risk. There is always a risk that the bond market or a particular segment of the bond market will decline, causing all bond issues to decline regardless of their fundamental features.

Interest-Rate Risk. As previously discussed, the value of a bond will change as interest rates change. Bond prices generally will decline with higher interest rates.

As these risks suggest, investing in fixed-income instruments requires the utmost care, attention, and continuous diligence. Yet, by reducing investment risk, mitigating volatility, generating income, and lowering equity correlation, bonds and other fixed-income investments can play a vital role as part of a well-considered asset allocation plan. As always, please contact your financial counselor if you would like to discuss fixed-income investing, asset allocation, or any other financial topic.

Very truly yours,



Brian Katz
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