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Perspectives

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Brian Katz, Chief Investment Officer

Seth Hieken, Managing Director

An unseasonably chilly wind blew through the financial markets in June, emanating from deep in the mortgage market in the now-notorious subprime segment. After skating past February's scare with scarcely a shudder, fixed-income investors this time huddled together and turned a collective shoulder to the harsh terms proposed by recent bond issuers. Compounding the abrupt angst was a stealthy but insistent rise in real (net of inflation) government bond yields, reflective of stronger non-U.S. economic activity that is beginning to absorb excess global savings. The yield on the bellwether 10-year Treasury note backed up over 5% by period end, up from 4.65% at the close of the first quarter. Equities, too, caught cold, as pundits rushed to forecast the end of the easy financing that has facilitated the boom in mergers and acquisitions (M&A) activity.

Still, earlier gains in stocks far exceeded the modest June retreat, allowing equities to record substantial returns during the quarter. The S&P 500 advanced 6.3%, the MSCI EAFE index of developed market international stocks gained 6.4%, and the small-cap Russell 2000 index returned 4.4%.

We believe it is premature to predict the onset of winter regarding the M&A cycle. While private equity firms may find financing incrementally more expensive going forward, market-wide returns on capital remain well above the cost of capital, implying that M&A (and leveraged recapitalizations) still make eminent financial sense; and those firms are sitting on billions of dollars in uninvested cash that must be put to work or returned to investors. Meanwhile, corporate balance sheets remain quite healthy, leaving plenty of capacity for strategic deals.

In the end, however, the constructive conditions for shareholder value enhancement rest not only on the cost of credit but also, more importantly, on its availability. Credit can remain nominally inexpensive, but if lenders curb their enthusiasm, the cycle will end. Given that lenders' balance sheets are robust – thanks at least in part to risk-spreading mechanisms that were not present during the last credit cycle – and that default rates remain low outside the beleaguered subprime area, we think a creeping ice age is more probable than a flash freeze.

ASK MR. FIXED INCOME

With attention lately centered on fixed-income markets, we thought it would be helpful to ask the leader of our bond group, Michael Stevens, about investing in fixed income and how our approach at The Colony Group is differentiated. Since joining The Colony Group in 2005, Mike has utilized his quarter century of experience to enhance our fixed-income strategy and process.

Q: How have conditions in the corporate bond market affected The Colony Group's bond strategy?

A: Our current corporate bond strategy is to invest in sectors that are less prone to event risk (*e.g.*, leveraged buyouts and recapitalizations). We therefore have focused on large-cap industrial credits such as General Electric and United Technologies, money center banks, utilities and railroads. In our opinion, these areas are less likely to be targets for leveraged speculation.

Q: Mike, what distinguishes The Colony Group from other active bond managers?

A: The Colony Group provides a fixed-income separate account solution to our clients that is re-

sponsive to individual client needs and that capitalizes on our ability to provide a high level of advice. We strive to provide a total solution to our clients in the areas of financial counseling, equity investing, and fixed income investing. We approach the fixed-income challenge as risk managers with the goals of seeking out competitive prices both on purchasing and selling bonds, focusing on best relative value, actively managing portfolios to improve return, meeting specific client needs and objectives, and pricing risk using the best tools available.

Q: Why shouldn't investors simply buy a bond mutual fund or a bond index fund?

A: There are a number of factors that our clients should consider as they evaluate fixed-income options:

- Bond funds usually are not tailored to the individual circumstances of a client and generally do not provide the tax efficiency and transparency that can be achieved by separate accounts.
- The Colony Group can structure separate accounts to meet each client's needs as specified in the client's Investment Policy Statement, including with respect to risk preferences and the client's tax situation.
- We consider bond mutual funds to be a low advice vehicle, while The Colony Group can provide a high level of advice and service.
- The average intermediate bond fund annual fee is 1.02% (source: Vanguard).

High fees and low advice are not compelling value arguments for our clients.

Q: Why shouldn't investors buy individual bonds themselves and construct their own bond "ladder"?

A: Individual investors usually purchase bonds from the retail distribution channel of the brokerage firm where they have an account and can only buy bonds that are owned and offered by that one broker. As a result, the individual investor may be burdened by high costs and limited choices. The NASD recently conducted a study of average dealer mark-up and found that the average mark-up was 1.5% on fixed-income investments.

Broker/dealers typically act as the principal in fixed-income transactions, while broker/dealers typically act as agents for equity trades. The important difference is that as principal, the broker/dealer is not required to disclose the mark-up, while as agent, the broker/dealer discloses the compensation that is received. The Colony Group, on the other hand, trades as an institutional investor. The result is that we are able to purchase bonds from an inventory of multiple dealers, and the average mark-up is .125% to .20%.

Bond ladders are the currency of low advice channels because laddering is a mechanical approach to investing that does not take into account best relative value. In my opinion, it is difficult to justify the fees charged with a ladder approach. Laddered bond portfolios may give the client a false sense of comfort since the common wisdom is that (1) in a rising interest rate environment,

the client will benefit from the short maturity bonds that mature and will have cash available to invest at higher rates and (2) in a falling interest rate environment, the client also will benefit from the long maturity bonds that will continue to provide high income. The reality is that, based on today's yield curve, a portfolio constructed with laddering will have a 4.27-year duration and thus will have significant interest rate exposure. By comparison, the duration of the Lehman muni blend index is currently 4.07 years. Generally, a bond portfolio with a shorter duration will be less volatile and therefore subject to less downside risk.

Q: Some full service brokers offer to manage client bond portfolios for "free" – how can The Colony Group compete while charging a management fee?

A: Full service brokers usually have their expertise in the equity market and view bonds as a required service for which they provide limited expertise or value. Most bond portfolios that are constructed by full service brokers are based on a buy and hold proposition with minimal active management or advice. As noted above, the retail distribution is a high cost channel, and the client typically is limited to one dealer's inventory. Additionally, dealers normally do not provide clients with total returns against a specified index or a risk management expertise. Finally, as previously mentioned, a survey by the NASD indicated that the average mark-up on bond transactions is 1.5% of the par amount, so a broker may not actually be managing a bond portfolio for "free".

- Seth Hieken