White Paper:

NPH Fixed Income Research Update

Authored By:

Bob Downing, CFA

NPH Senior Investment & Due Diligence Analyst

National Planning Holdings, Inc.

Due Diligence Department

National Planning Holdings, Inc. (NPH℠) is the holding company for four independent broker dealers: Investment Centers of America, Inc.; INVEST Financial Corporation, Inc.; National Planning Corporation℠ and SII Investments, Inc. NPH is one of the largest independent broker dealer networks in the United States.

Investing in Fixed Income in the Current Environment

Interest rates are currently at extraordinarily low levels due to the recent global recession, purchases of Treasuries by the Federal Reserve, and strong investor demand for the generally perceived "safe haven" of fixed income investments. Current investor preferences have driven bond prices up to extreme levels and kept interest rates at historically low levels. In the current fixed income investment environment, transitioning a portfolio to fixed income or investing in traditional "core" bond funds is more risky than ever, and could potentially expose a portfolio to exactly what investors are trying to avoid - loss of principal.

This NPH research update is written to provide readers with 1) high level discussion points regarding the current fixed income investing environment, and 2) information on alternative or non-traditional fixed income investment ideas.

Are we in a bond bubble? Bonds have outperformed U.S. stocks, as measured by the Barclays Aggregate Index compared to the S&P 500 Index[1] through 9/30/10, over the last 10-, five-, three-, and one-year periods. Since rates peaked in the early 1980's the bond market has earned the distinction of being in the longest bull market of any asset class in U.S. history[2]. Currently, there is strong demand for fixed income investments, but a speculative bubble seems unlikely since investors are seeking safety rather than high returns. There are significant risks to bond fund investors should interest rates unexpectedly begin to rise. The result of the high demand for bonds is that investors are being paid less than ever to take on more risk in the current environment.

It is possible to lose money investing in bond funds, especially in a low interest rate environment. A typical "core" bond portfolio will tend to have significant risk if interest rates increase. 80% of the total return in a typical "core" fixed income portfolio, as defined by the Barclays Aggregate Index, is derived from U.S. Government Securities which could have a negative return if interest rates rise. As interest rates rise the value of bonds go down, resulting in a loss of principal. Conversely, if interest rates go down the value of bonds go up.

As mentioned, the fixed income market is not without risk. We believe investors should maintain their appropriate fixed income allocation going forward, being mindful not to over weight bonds. Additionally, rather than attempting to time the bond market in this low interest rate environment, we suggest investors diversify their fixed income allocation and consider alternative fixed income investments in addition to core bond funds. The alternative bond products mentioned below have a cushion or spread in excess of U.S. Government Securities, with prices supported by economic fundamentals.

---

[1] The Indices mentioned are unmanaged and unavailable for direct investment. Past Performance is no guarantee of future results.

[2] Robert Huebscher, "Misconceptions in the Great Bond Bubble Debate," Advisor Perspectives, October 12, 2010

Managing Interest Rate Risk:

Recently economists have suggested the potential for a slowing economy in the near term with the potential for deflationary pressure. While other experts have argued in favor of potential inflationary pressure due to the current loose monetary policy of the Federal Reserve. The inflation versus deflation debate is currently causing uncertainty with investors. The basic concern is that unexpected inflation will hurt bond portfolios (expected inflation is priced in), and unexpected deflation will benefit bonds as their income stream will become more valuable. The majority of fixed income total return is the income stream.

Deflation is a concern, but appears to be an unlikely scenario. It is worth considering how deflation would affect portfolios and what it would mean for bond fund investors. For investors, if deflation were to emerge, long-term Treasury bonds might turn out to be the best performing asset with cash also providing a decent return, at least in real terms (after inflation). Investing for the unlikely event of deflation is risky since rates are already at historic lows. As mentioned, we suggest maintaining a diversified portfolio including core funds – one that can provide some protection in the form of cash and Treasuries to guard against the possibility of deflation. Treasury exposure can be attained with most “core” or intermediate bond funds that track the Barclay’s Aggregate Index.

Inflation is probably a more likely scenario than deflation, but still showing little in the way of signs in the current economic environment. Bond prices further out on the yield curve (longer maturities) are just now starting to price in some inflationary pressure down the road. Given that inflation will deteriorate the value of a bond, we would expect bond values to be lower if inflation were a concern. Currently there are few signs of inflation in our economy.

Harvard Business School professor, Luis Viceira, recently identified through his research that economists have been relatively good at predicting inflation over the last several decades. Economists did miss the oil induced inflation in the 70’s, but overall economists have provided solid support that interest rates reflect inflation expectations. Economic forecast surveys show low inflation expectations, averaging about 2.3% over the next 10 years with even lower expectation in the short term. Another measure of inflation expectation is the break-even Treasury Inflation-Protected Security (TIPS) rate; this is calculated by subtracting the 10-year TIPS rate from the corresponding nominal 10-year Treasury rate.[3] The current break-even TIPS rate is approximately 2.0% as of December 2010, right at the lower end of the Fed’s target inflation range.

What is the most effective way to manage interest rate risk in the current environment? Lower the duration of the portfolio with shorter maturity bonds. At some point interest rates should increase, causing bond prices to go down. The lower the duration, the less interest rate risk the portfolio is exposed too, and the less sensitive the value of the bond fund or bond portfolio is to changes in interest rates. Consider bond funds with varying duration measured in years.

---

[3] Robert Huebscher, “Misconceptions in the Great Bond Bubble Debate,” Advisor Perspectives, October 12, 2010

An alternative, and source of additional diversification, to interest rate risk within a fixed income portfolio is credit risk (credit worthiness of the entity issuing the bond), as related to specific companies or countries. Taking on more credit risk can diversify a traditional portfolio and buffer or cushion unexpected increases in interest rates. Adding fixed income securities with credit risk should increase overall returns over the longer term because of the higher yield and diversification benefits. A broadly diversified fixed income portfolio should provide more attractive returns compared with an all Treasury portfolio. Attractive sectors to consider with generally less interest rate risk than a core or pure U.S. Treasury portfolio include international, emerging markets, floating rate (bank loans), and corporate credit (both investment grade and high yield). These alternative bond sectors are not without risks, nor are they backed by the full faith and credit of the U.S. Government as to the timely payment of principal and interest, and will be discussed below.

International Fixed Income, Developed and Emerging Markets:

The global fixed income market offers a large opportunity set for potentially achieving returns in excess of the Barclays Aggregate. Many funds pursue "safe spreads" above U.S. Treasuries by investing in developed market and emerging market debt with higher yields than dollar denominated issues.

Currently investors demand a significant yield premium for emerging market sovereign debt as compensation for political risk, currency risk, liquidity risk, inflation risk, and credit risk. The trend has been improving in most emerging markets as a secular development. This may be a good place to potentially earn a high yield while the principal increases. An increase in the value of an emerging market portfolio is much more likely than an increase in a traditional "core" bond product, primarily due to the continued growth of emerging economies and favorable fundamentals. Although international fixed income investing does have its own unique set of risk factors.

Local currency debt offers relatively high yields. For example, as of June 30, 2010 five-year sovereign bond yields where 12.32% in Brazil, 9.46% in Turkey, and over 6.0% in Mexico. All three countries offer much lower debt-to-GDP ratios compared to developed governments.[4]

Corporate Credit, High-Yield Bonds & Investment Grade Corporate Bonds:

U.S. investment grade and high yield spreads have just recently recovered to the long term averages. A slow economy combined with continued corporate earnings improvement and strong fundamentals could create an environment for continued corporate bond strength.

Corporate credit fundamentals are much improved now with corporate balance sheets in general showing substantial cash and more conservative deleveraging. The 2010 rally in

[4] Oppenheimer Funds, "Finding Value in International Fixed Income", Oppenheimer Funds Capital Market Perspectives, September 23, 2010

investment grade bonds was driven primarily by declining interest rates. The favorable picture in the corporate sector has yet to be realized and there is room for price appreciation. Credit spreads in both investment grade and high yield are very attractive relative to risk, based on improving fundamentals.

Floating Rate Debt:

This fixed income option may provide some degree of safety in an uncertain interest rate environment. The coupons are reset periodically and track any increases (or decreases) in the general interest rate environment. The addition of a floating rate portfolio will actually reduce the overall interest rate sensitivity of a client's overall fixed income holdings.

Dividend Paying Stocks:

The current market environment has resulted in a historically high dividend yield on stocks, foreign and domestic. As of October 2010, The Dow 30 yield was 2.60%, while 10-year Treasury yields were below 2.5%. In addition, the 10 largest dividend-payers in the U.S. had a yield of roughly 4%. Investing in dividend paying stocks gives the potential for additional upside if the economy starts to grow and interest rates increase. During the 4^{th} quarter of 2010 these relationships moved to a more normal relationship primarily due to the 10-year Treasury yield rising to 3.30%. There still may be an opportunity in dividend paying stocks.

TIPS:

Since 1997 when first issued, Treasury Inflation-Protected Securities (TIPS) have become the default option to guard against possible inflation. TIPS are designed to provide exposure to real interest rates and pay a coupon tied to the actual rate of inflation as measured by the Consumer Price Index (CPI). The face value of TIPS is adjusted to reflect real measured inflation. There is a problem with TIPS, however, when inflationary expectations are higher than real inflation rates as measured by CPI. In this scenario, fixed income prices, including TIPS, would drop.

Conclusion:

Opportunistic fixed income allocations or managed portfolios offer a potential solution to the current challenges faced in the current fixed income environment. While it is important to remember that no amount of diversification can assure a profit or protect against a loss in a declining market, a portfolio independent of traditional (core) benchmarks offers several potential benefits. The most compelling benefit is access to a broader opportunity set – and outsourcing the timing and sizing decisions to an active manager. Active fixed income managers have resources and access to a global market and can be opportunistic in investing in the best relative value fixed income assets and can switch to a more defensive portfolio as appropriate. This will not only diversify the fixed income portion of a portfolio, but may also offer potentially higher returns over the intermediate investment horizon.

A fixed income portfolio, made up of bonds, continues to be an anchor and provide diversification in nearly all properly allocated portfolios. Continued reliance on “core” bond portfolios to provide the significant portion of this slice of the pie may increase risk and not provide much diversification over the intermediate investment horizon. Most core portfolios have significant weighting in U.S. government bonds, which could have a negative return in a rising interest rate environment, while alternative type investments offer the potential for positive returns with the added benefit of diversification. Although the current environment presents risks to consider and to be aware of, fixed income will continue to provide income and cash flow to help dampen potential volatility. Continuing to invest solely in traditional core fixed income creates additional risks and a larger potential to lose money in the fixed income market than most investors imagine.

Understanding the potential risks and diversifying your fixed investments will aid in avoiding losses before they occur. Fixed income investments are not risk-free investments and depending on the market environment and characteristics of the investment product need to be properly understood and diversified. Less reliance on “core” fixed income and more exposure to “alternative” fixed income could benefit portfolios.