



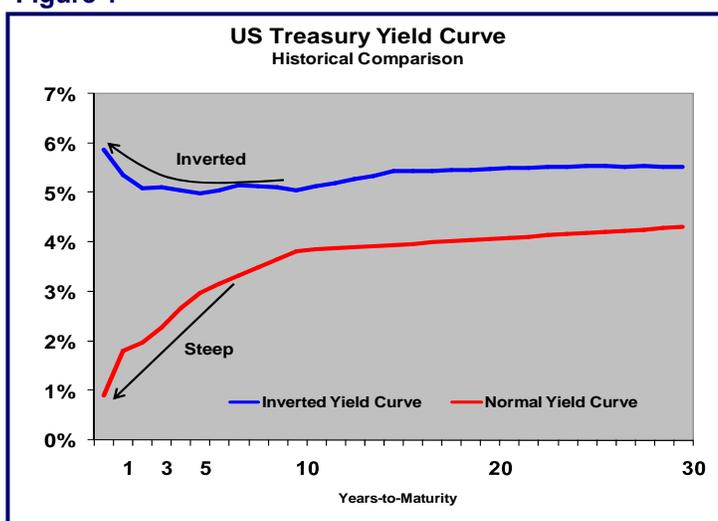
Enhanced Cash Strategy

For clients with a short to intermediate investment horizon and for whom the overriding consideration in the construction of a portfolio is the safety of the investment principal, we recommend an **enhanced cash strategy**. There are effectively two strategies for investing excess cash reserves, a money market strategy and an enhanced cash strategy. Both emphasize safety and preservation of capital. Where they differ is with respect to liquidity requirements, with liquidity being defined as the *ability to convert a security to cash at, or near its' current market value*. While money market vehicles offer "near-perfect" liquidity, an enhanced cash strategy seeks a tradeoff between higher yields and modestly lower liquidity to increase total return. Importantly, an enhanced cash strategy is not intended to replace the money market component, rather it is intended to be a complimentary part of a comprehensive cash management strategy, utilized within that portion of your cash allocation that could be considered more permanent in nature.

TERM PREMIUM

Generally speaking, there are three primary strategies we utilize within an enhanced cash mandate to generate excess returns over cash. The first strategy involves capturing the **term premium** available by extending the duration or maturity of the portfolio beyond cash. The normal shape of the yield curve is upward sloping, with bond yields rising as maturities are extended. This is illustrated in [Figure 1](#) where we can see that a normally shaped Treasury yield curve is both upward sloping and relatively steep, particularly at the front end of the curve. (red line) Under these circumstances, extending the maturity of the portfolio, even modestly at the short end, offers the sharpest increase in return per unit of risk. This is clearly reflected in [Figure 2](#), which graphs the annualized one month returns for on-the-run Treasury bonds versus their annualized standard deviation, or volatility of return (a proxy for risk), for the period 12/31/77 through 12/31/09. As highlighted by the **red circle**, we can see that the

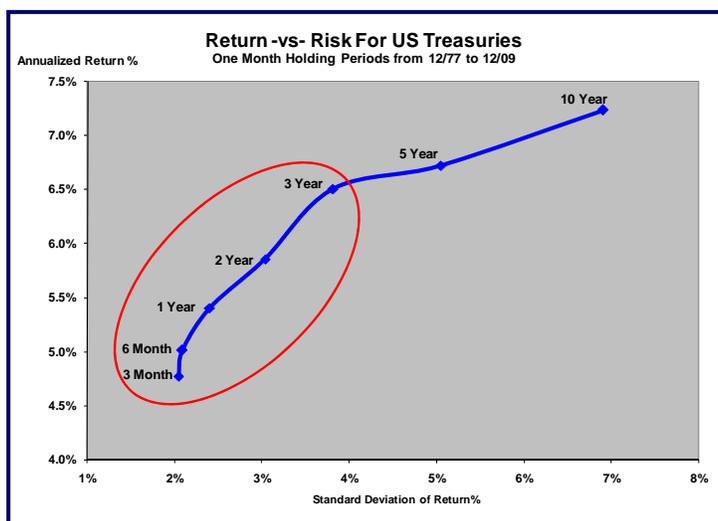
Figure 1



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increase in return per unit of risk rises sharply when the portfolio holding period is extended from 3-months out to 3-years before flattening markedly. This underscores the potential benefit derived by extending the maturity of a portion of a cash portfolio. This strategy can be pursued utilizing any sector of the investment grade bond universe provided the yield curve for that sector is not **inverted**, a condition whereby short-term yields are higher than long-term yields. (See **blue line** in **Figure 1**) However, as yield curve inversions are rare events, this is a strategy which is typically available to active bond managers.

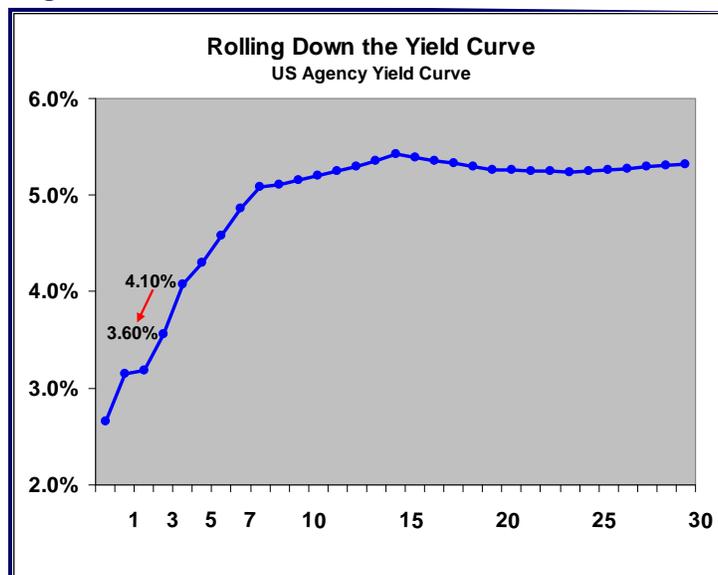
Figure 2



CURVE ROLL

Another strategy we can employ to increase total return is closely related to a concept unique to fixed income securities — **time**. As Einstein once observed, *"the only reason for time is so that everything doesn't happen at once"*, and what doesn't happen at once to a bond is its' maturity. The combination of a bonds' fixed coupon and fixed maturity date, along with the natural upward sloping shape of the yield curve, provides the **opportunity** for increasing total return from the **passage of time** due to **yield curve roll**. Yield curve roll simply refers to the potential upward re-pricing of a fixed coupon bond as it rolls down a steep yield curve with the passage of **time**. This is illustrated in **Figure 3** where we reproduce a historical US Agency yield curve that is quite steep, particularly at the front end of the curve. If, in our example, we purchased a 4-year Agency bond to yield 4.10% and simply held it to maturity, our total annualized return on this bond over the entire 4-year horizon would be very close to the purchased yield of 4.10%, assuming all cash flows were re-invested at or near the purchased yield. However, assuming the shape of the yield curve remained positively sloped and interest rates remained relatively unchanged over the next year, then in one year's **time**, the 4-year Agency bond purchased to yield 4.10%, would become a 3-year Agency bond priced to yield 3.60%. The curve roll in our example, would be equal to the one-year yield drop of **50 basis points** (4.10% to 3.60%) and would equate to approximately 1.8% in additional return in the form of **price appreciation**, for a total realized return of nearly 6%. This increase in price due to

Figure 3



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aging or "rolling down the yield curve" represents an **opportunity** which may be pursued by active managers to increase total returns. Of course as neither the yield curve nor yield levels are static, judgment must be exercised to determine if the bond should be sold and the proceeds reinvested or if it should simply be allowed to continue to roll down the yield curve. With our extensive experience in fixed income markets, this is an area where we have been able to augment total returns without incurring additional market risk.

SPREAD SECTORS

A final strategy we can employ to increase total return is the use of **spread sectors**, to the extent the client mandate allows, to capture both increased yield as well as the potential for capital gains from positive movements in yield spreads relative to Treasury yields. **Figure 4** illustrates this **opportunity** by graphing the historical trend in yields for the 2-year Treasury bond (**white line**, upper chart) and a generic 2-year Agency bond (**orange line**, upper chart), as well as the **spread** between them (**green area**, lower chart). Looking at the upper chart, we can see that while nominal yields on both Treasury and Agency bonds have been falling to historically low levels, the lower chart indicates that agency yield spreads have varied widely, from a low of -7 basis points (1996) to a high of over 200 basis points (2008). The most recent widening of Agency yield spreads to their record high of 212 basis points occurred subsequent to the collapse of Lehman Brothers in the fall of 2008 and was a reflection of the flight to quality response into Treasury bonds. However with the effective nationalization of both Fannie Mae and Freddie Mac, agency bonds do not expose a portfolio to any additional credit or default risk. The yield premium or spread on Agency bonds relative to Treasury bonds, reflects the modestly lower liquidity associated with trading Agency bonds compared to Treasury bonds. The lower liquidity associated with Agency debt stems primarily from the increased number of issuers and securities outstanding as compared to a profile of a single issuer (US Treasury) with only around 300 separate Treasury bonds outstanding. In addition to the incremental yield pick-up available by utilizing Agency bonds, there can be additional return **opportunities** from **capital gains** to the extent that yield spreads on Agencies tighten after their purchase. Given the average yield pick-up with Agencies over Treasury securities and the potential capital gains available from a tightening of Agency yield spreads coupled with the absence of incremental credit risk, utilizing Agency bonds in a portfolio as Treasury substitutes offers an excellent **opportunity** to increase total returns over a Treasury-only portfolio.

THE DIFFERENCE IS OPPORTUNITY

At Redstone, we believe actively managed bond portfolios should provide returns over and above those of passively managed portfolios when the results are measured across complete market cycles. However, predicting returns is a process that is fraught with peril. The reason is due to the fact that the difference between a simple **purchased yield** on a marketable security, which can be known with certainty at any given time, and the **potential total return** from that security, is

Figure 4



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opportunity. And for the most part, **opportunity** is driven by changes in the market, such as changes in yield levels, the shape of the yield curve, risk spreads and volatility. This, in a nutshell, is the fundamental difference between **passive** and **active management** of investment portfolios, the belief that markets offer **opportunities** for active managers to increase return over simple purchased yield. Active bond managers attempt to take advantage of market **opportunities** by pursuing multiple strategies, based on their proprietary macroeconomic views, particularly as they relate to expected trends in interest rates, yield curve reshaping and yield spreads. These views are generally expressed through the active management of a portfolio's duration, yield curve exposure, and sector weighting. In contrast, a passive strategy of simply laddering bond portfolios suffers from the inability to take advantage of **opportunities** from market movements, temporary supply and demand imbalances, and market inefficiencies. Also, because bonds are traded over the counter via a network of independent dealers, bond prices are determined on a negotiated basis rather than through an auction process of competitive bidding in a centralized exchange, like it is for stocks. As a result, there is no single visible price for each outstanding issue on a daily basis. This creates **inefficiencies**, and these **inefficiencies** allow managers who understand the nuances of both the markets and fixed income securities, an additional **opportunity** to add value to fixed income portfolios by exploiting these inefficiencies through the identification and the trading of mispriced securities. In our opinion, this **opportunity** is available only to those with extensive experience in fixed income markets and who have developed long-term relationships with the dealers who actually offer those securities.

Redstone Advisors, Inc.

(316)687-2143

jyeskie@redstoneadv.com