FOCUS ON INCOME

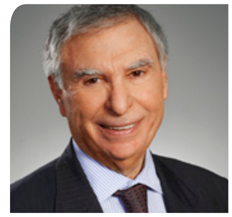
BOND INVESTORS MAY WANT TO TAKE STEPS NOW TO ADJUST THEIR PORTFOLIOS

July 2014

The most recent major geopolitical events—the tragic Malaysian Airline explosion, and the Israeli/Palestinian conflict—have introduced volatility into the equity markets and have had the effect of keeping interest rates low. There has been a flight to safety along with a general view from international investors that the US is ahead of the rest of the world economically. Money has moved here seeking a safe haven and, to some extent, based on a belief that the dollar could strengthen relative to other currencies. At the same time, we have seen the US continue to have significant employment increases and some small signs of inflation creeping into the system. Pundits are beginning to move their targets on when the Federal Reserve will begin raising the Fed Funds rate. It has been our view that interest rates will likely rise over the next twelve months with markets anticipating a move by the Fed. While the precise timing remains a question, we believe individual investors may want to follow the lead of some institutional investors and act now to reduce the risk of principal loss in their fixed income holdings when rates begin to move. The recent pause in rates caused by the significantly weaker GDP numbers in the first quarter, magnified by the recent geopolitical events, has provided more of a window in which to adjust portfolios.

INTEREST RATES COULD RISE AS QUANTITATIVE EASING IS PHASED OUT AND THE ECONOMIC NUMBERS IMPROVE, LED BY THE EMPLOYMENT OUTLOOK

Fixed income is at a turning point, whether it's measured by interest rates, the yield curve or the availability of credit. If we look at history, today's interest rates are at unusually low levels following a 30-year downward trend in yields across the curve tracking the Fed Funds rate, as shown in *Figure 1.* While there have been periods of volatility, with periodic rises in interest rates, this trend has provided a fairly consistent tailwind for good conventional bond returns. (Please read my blog post, "Hypothesizing about the debut of the modern era," if you would like to know the significance of starting Figure 1 with the year 1955 and why I use a five-year rolling average.)



Jack Rivkin
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Jack Rivkin has had a long and varied career in the investment industry encompassing private and public equity, investment policy and management. He is known as a keen observer of investment and business strategy, with over 46 years of investment research and asset class expertise. He is a respected thought leader and has held senior roles in the investment industry including Chief Investment Officer and Head of Private Asset Management at Neuberger Berman and Director of Global Research and head of the Worldwide Equities Division of Lehman Brothers Inc. Following his time at Lehman Brothers, he was a Vice Chairman and Director of Global Research at Smith Barney (ultimately a subsidiary of Citigroup), and an Executive Vice President with Citigroup Investments making direct investments and leading an investment team. Jack is the co-author of *Risk & Reward—Venture Capital and the Making of America's Great Industries*, Random House, 1987. He is a regular guest on various media including CNBC and Bloomberg. He is the principal subject in a series of Harvard Business School cases describing his experience as Director of Research and Head of Equities at Lehman Brothers. He has served as a director of a number of private and public companies and the New York Society of Security Analysts.

Jack earned his Professional Engineering degree from the Colorado School of Mines and his MBA from the Harvard Graduate School of Business Administration.

FIGURE 1.

EFFECTIVE FEDERAL FUNDS RATE

30 Years of Falling Rates | January 1955–July 2014

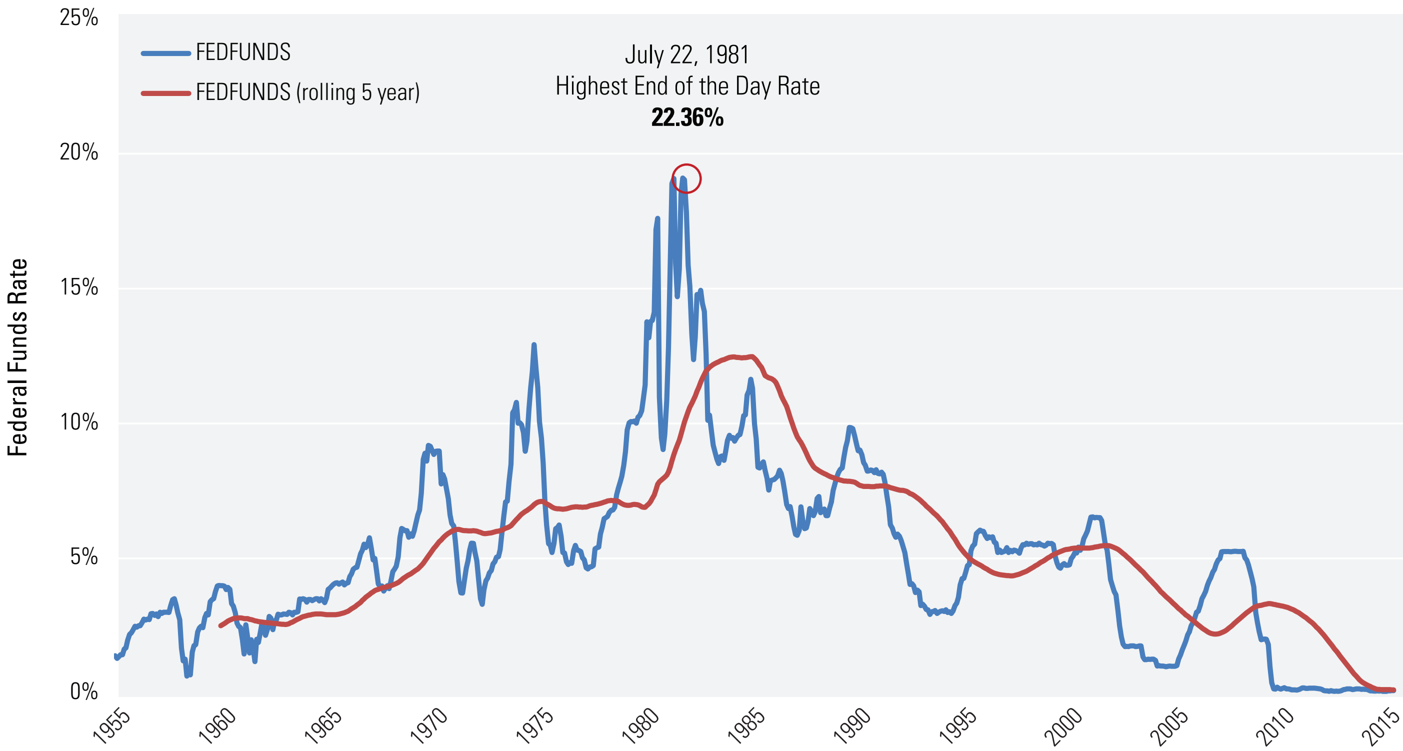

Figure 1 compares the annual federal funds rate—the rate at which the most creditworthy institutions lend to each other overnight— with a federal funds rate five-year rolling average since 1955. Source: Federal Reserve Economic Data; Altegris.

FEDFUNDS: Effective Federal Funds Rate. An estimate of 0.10% was used for July 2014.

As of early 2014, the Fed funds rate—the rate at which the most creditworthy institutions lend to each other overnight—is 0.08%, or 22.28 percentage points below its single-day high on July 22, 1981. (For those of you too young to remember, that record was reached two years after Paul Volcker became Fed Chairman.) All along the yield curve, whether we're talking 30-year bonds or two-year notes, rates are only about 100 basis points above historic lows, as shown in *Figure 2.*

There has been some widening and an actual flattening of the yield curve in response to early signals that we may return to a more "normal" rate structure, as *Figures 3 and 4* indicate. In my view, this flattening of the yield curve results from investors selling shorter duration bonds and thus driving short term rates up and prices down at same time the Fed and other investors seeking safety or yield continue to buy at the longer duration of the curve, pushing rates lower and prices higher.

We believe that rates will most likely rise in the near future and if the yield curve responds normally, this will affect a substantial part of the fixed income holdings of the average investor. *Figure 5* gives our range of the possible timing of rate hikes and their levels. Our analysis reflects continued tapering of Quantitative Easing which, at the current pace, will end in October 2014. It also factors in Federal Reserve Chair Yellen's suggestion in mid-March that interest rate hikes could occur about six months after quantitative easing ends. Moreover, as mentioned, there are signs that the economy is improving, which is reflected in the most recent jobs report.

FIGURE 2.

DAILY FEDFUNDS RATE VS. DAILY US TREASURIES

Yield Curve Comparison | January 2009–June 2014*

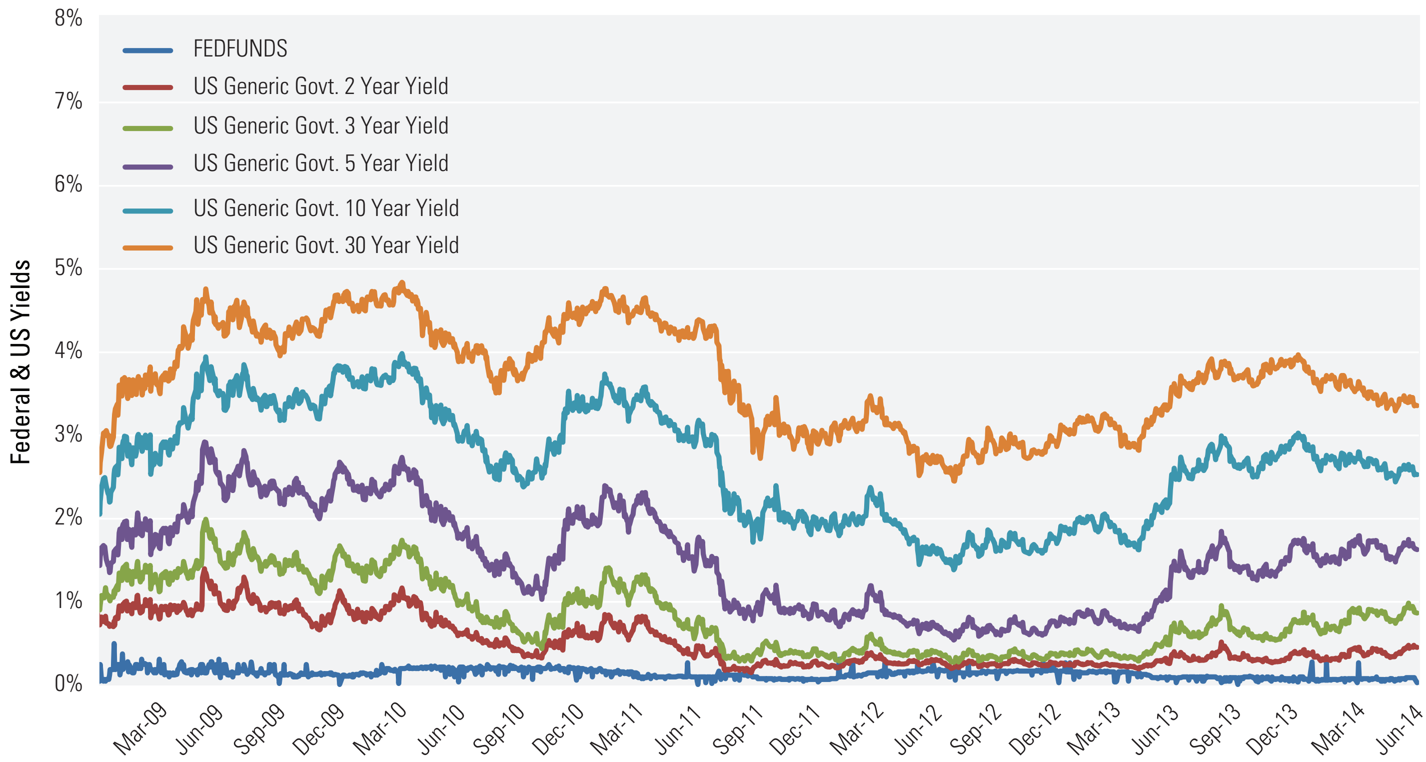

Figure 2 compares the yields of US Federal Funds Rate (FEDFUNDS) with multi-year US Generic Government (USGG) bonds from January 2009 through June 30, 2014. Source: Federal Reserve Economic Data; Bloomberg; Altegris.

Past performance is no guarantee of future results. The data are represented by market benchmarks and do not represent the returns of any actual investments.

**Data through June 30, 2014.*
Indices: FEDFUNDS: US Federal Funds Rate. US Generic Govt. 2YR Yield: USGG2R Index; US Generic Govt. 3YR Yield: USGG3R Index; US Generic Govt. 5YR Yield: USGG5R Index; US Generic Govt. 10YR Yield: USGG10R Index; US Generic Govt. 30YR Yield: USGG30YR Index.

FIGURE 3.

YIELD CURVE ANALYSIS

Flattening of the Yield Curve | November 1, 2013 - April 1, 2014

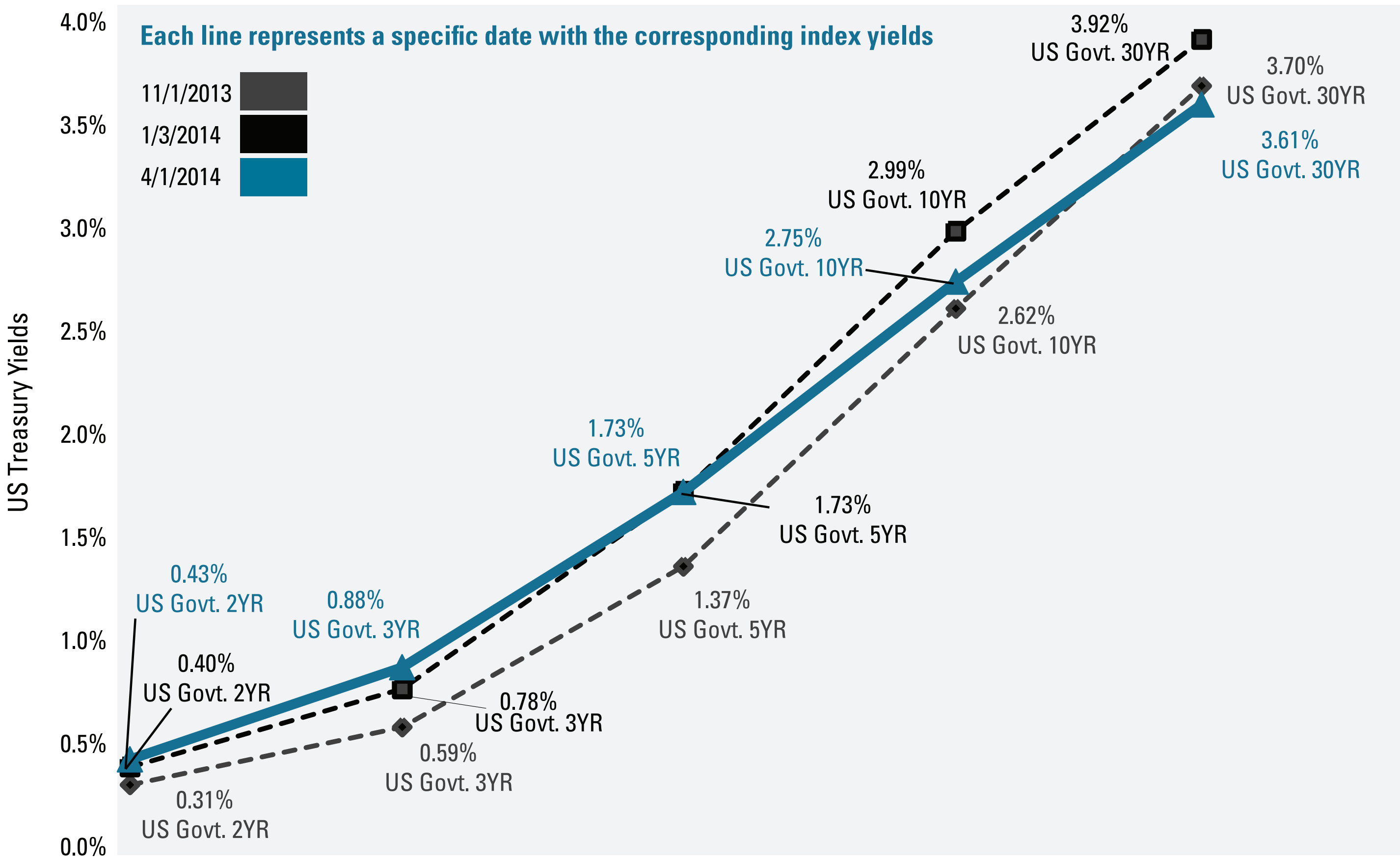

Figure 3 shows how the yield curve has flattened, as illustrated by the blue line representing yields as of late March 2014. Source: Bloomberg; Altegris.

Past performance is no guarantee of future results. The yields are represented by market benchmarks and do not represent the performance of any actual investments. Indices: US Generic Govt. 2YR Yield: USGG2R Index; US Generic Govt. 3YR Yield: USGG3R Index; US Generic Govt. 5YR Yield: USGG5R Index; US Generic Govt. 10YR Yield: USGG10R Index; US Generic Govt. 30YR Yield: USGG30YR Index. Data Source: Bloomberg. Source: Altegris

OUR OUTLOOK

Thus, barring an economic collapse in China or other major geopolitical event, we think rates are likely to rise in a reasonably steady path to something more “normal.” We don’t know precisely when this will happen and how high rates will go. (Most forecasters seldom make a prediction that includes both a number and a date. Anyone who gives both is usually making up at least one of the two.) If the yield curve responds normally, this will affect a substantial part of the fixed income holdings of the average investor.

STRATEGIES INVESTORS CAN USE TO POTENTIALLY PRESERVE THE VALUE OF THEIR FIXED-INCOME HOLDINGS

There are a number of actions investors can take to provide a measure of downside protection and still generate yield. The most obvious is to move the fixed income portion of a portfolio into cash and wait for rates to adjust. The problem with that option is the difficulty in timing the market and getting zero return while one waits. Another option would be to reallocate to investment managers with income-oriented portfolios that don’t correlate to conventional fixed income indices but provide a yield and maybe some principal return. A number of strategists have suggested this, but flows indicate no real sense of urgency on the part of the average investor, although institutional investors are making these shifts. We believe there is some urgency to begin this process in earnest. We can’t wait to buy fire insurance or rebuild the house after the fire.

There are a variety of strategies that provide some protection against rising rates and still can produce reasonable returns. These include investing in income-producing assets such as Master Limited Partnerships (MLPs) or Real Estate Investment Trusts (REITs) that are offering decent yields now and also mitigate the risks of inflation, as cash flows could increase with an improving economy, resulting in higher distributions. But using MLPs and REITS as hedges against rising rates requires skill and understanding of each vehicle. Not every one of these vehicles will behave the same in a rising rate or an inflationary environment.

For those who can forego immediate liquidity, there are non-conventional lending portfolios which contain a substantial amount of higher yielding, floating rate securities that will typically move with rising rates. (I discussed this in my CIO Perspective on investing in illiquid credit, which describes the appeal of investing in higher-yielding, private portfolios, recognizing that liquidity is an issue.)

It's also possible to invest in more liquid fixed income long/short mutual funds with hedged positions that seek to provide downside protection if rates rise. There are now several managers who have been running hedged fixed income portfolios for some time—going both long and short securities in a way to produce yield with risk characteristics in terms of duration that provide a dampening of what could happen to a portfolio when rates move. Some are taking advantage of what may be an extended credit cycle. Caused in part by the Fed's actions, many companies have been able to refinance

FIGURE 4.

RATES FOR TWO-YEAR VS. OTHER US TREASURY MATURITIES

Yield Curve Comparison | January 2009–June 2014

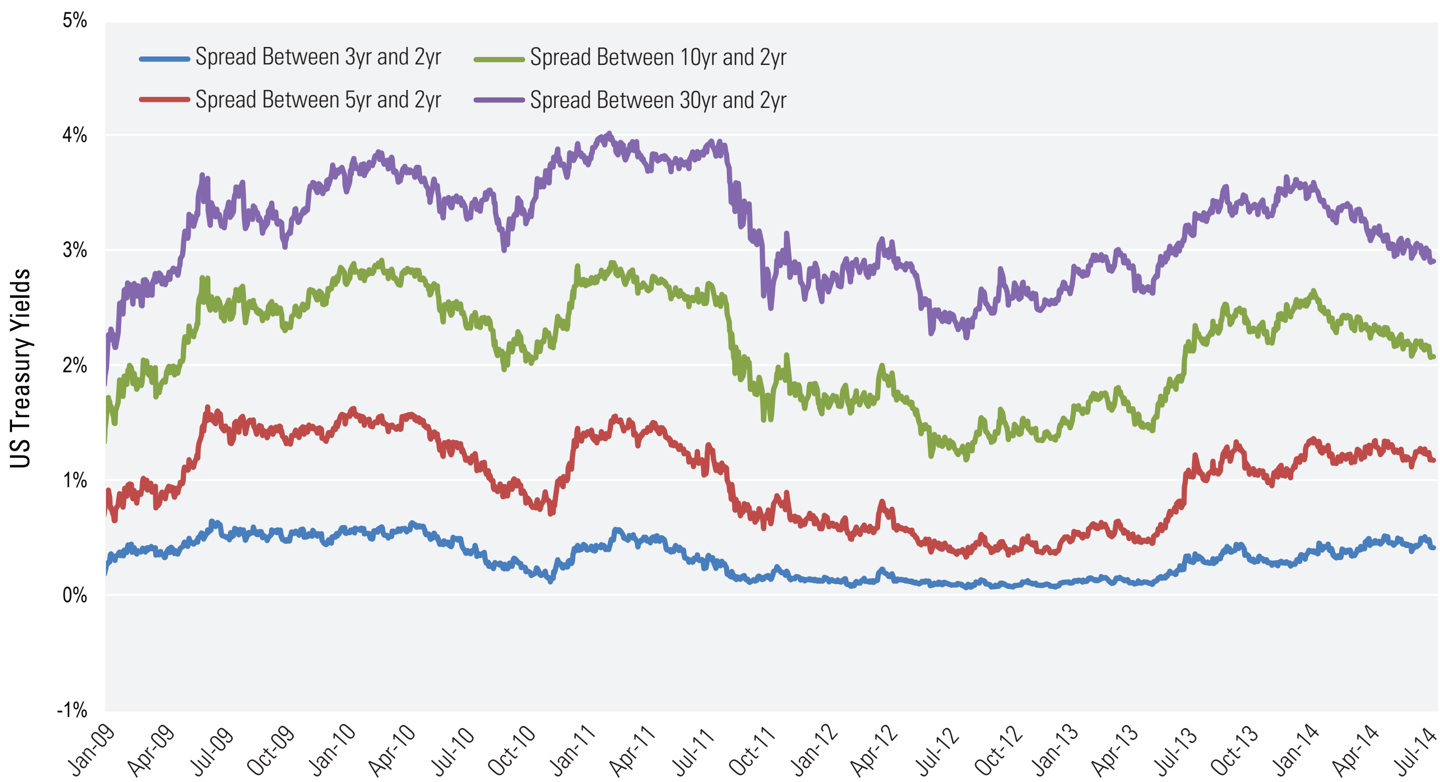

Figure 4 shows how the gap between two-year and 30-year U.S. Treasuries is narrowing while shorter term rates are not, another way of demonstrating the flattening of the yield curve. Source: Bloomberg; Altegris.

Past performance is no guarantee of future results. The yields are represented by market benchmarks and do not represent the performance of any actual investments.

Spreads indicate value between the US Generic Govt. yield indices.
Indices: US Generic Govt. 2YR Yield: USGG2R Index; US Generic Govt. 3YR Yield: USGG3R Index; US Generic Govt. 5YR Yield: USGG5R Index; US Generic Govt. 10YR Yield: USGG10R Index; US Generic Govt. 30YR Yield: USGG30YR Index.

FIGURE 5.

EFFECTIVE FEDERAL FUNDS RATE

Hypothetical Growth Projection | January 1955–December 2020*

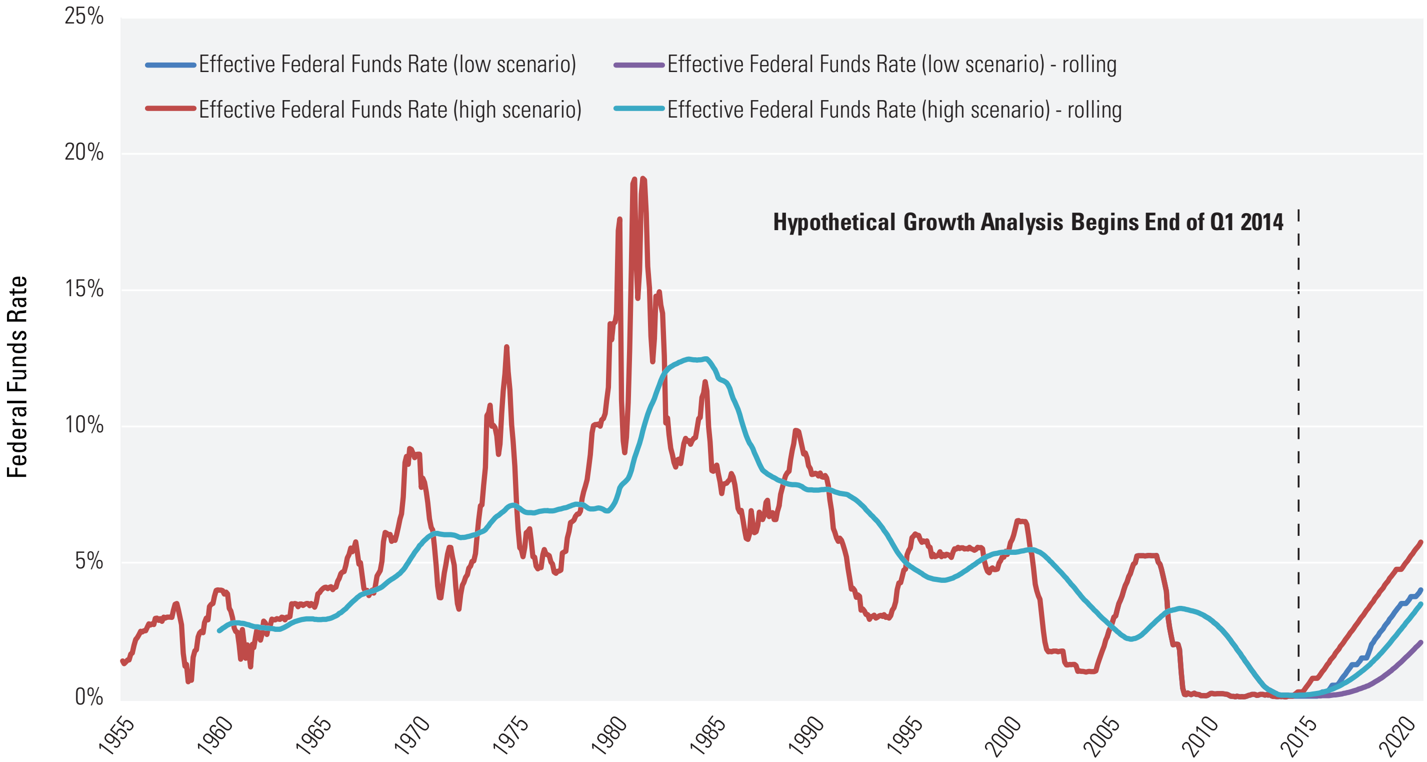

Figure 5 reflects Altegris's view that the federal funds rate and the related 5-year rolling average rate could begin rising in 2015.
Source: Federal Reserve Economic Data; Bloomberg; Altegris.

Past performance is no guarantee of future results.

**Data projected through Q4 2020.*
FEDFUNDS: Effective Federal Funds Rate. An estimate of 0.10% was used for July 2014.

debt at reasonable rates, while pushing maturities out for several more years. (As evidence of this phenomenon, as of the 4th quarter of 2013, only 9.5% of all high-yield bonds outstanding were scheduled to mature in the next three years—an unusually low level.) Conversely, companies which were not able to refinance or have experienced other difficulties could represent good short candidates.

There are other strategies using convertible bonds and mortgage-backed securities that offer similar opportunities to take advantage of a rising rate environment and economic recovery. Each of these portfolios, whether involving one manager or several, has its own risk and return characteristics and differs from conventional bond portfolios. But like conventional bond portfolios, they do provide daily pricing and liquidity.

FINAL THOUGHTS

Using the available data on the characteristics of the portfolios, a good financial advisor can build a portfolio of fixed income funds with the goal of protecting principal in a rising rate environment. Given the uncertainty of when and how fast the Fed will raise rates, it is not easy to know when to pull the trigger of such a reallocation. In the face of such uncertainty, with the markets providing a window, perhaps the best time to act is now.

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All investments carry a certain degree of risk including the possible loss of principal. Complex or alternative strategies may not be suitable for everyone and the value of any portfolio will fluctuate based on the value of the underlying securities. Investing in debt or fixed income securities involves market risk, credit risk, interest rate risk, derivatives risk, liquidity risk, and income risk. As interest rates rise, bond prices typically fall. Below investment grade, distressed, or high yield debt securities are considered speculative and are subject to heightened liquidity, default, and credit risks.

ABOUT ALTEGRIS

The Altegris group of affiliated companies is wholly-owned and controlled by (i) private equity funds managed by Aquiline Capital Partners LLC and its affiliates ("Aquiline"), and by Genstar Capital Management, LLC and its affiliates ("Genstar"), and (ii) certain senior management of Altegris and other affiliates. Established in 2005, Aquiline focuses its investments exclusively in the financial services industry. Established in 1988, Genstar focuses its investment efforts across a variety of industries and sectors, including financial services. The Altegris companies include Altegris Investments, Altegris Advisors, Altegris Funds, and Altegris Clearing Solutions. As of June 30, 2014, Altegris had $2.35 billion in client assets, and provided clearing services to $499 million in institutional client assets.

GLOSSARY

Short. Selling an asset/security that may have been borrowed from a third party with the intention of buying back at a later date. Short positions profit from a decline in price. If a short position increases in price, the potential loss of an uncovered short is unlimited.

Long. Buying an asset/security that gives partial ownership to the buyer of the position. Long positions profit from an increase in price.

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