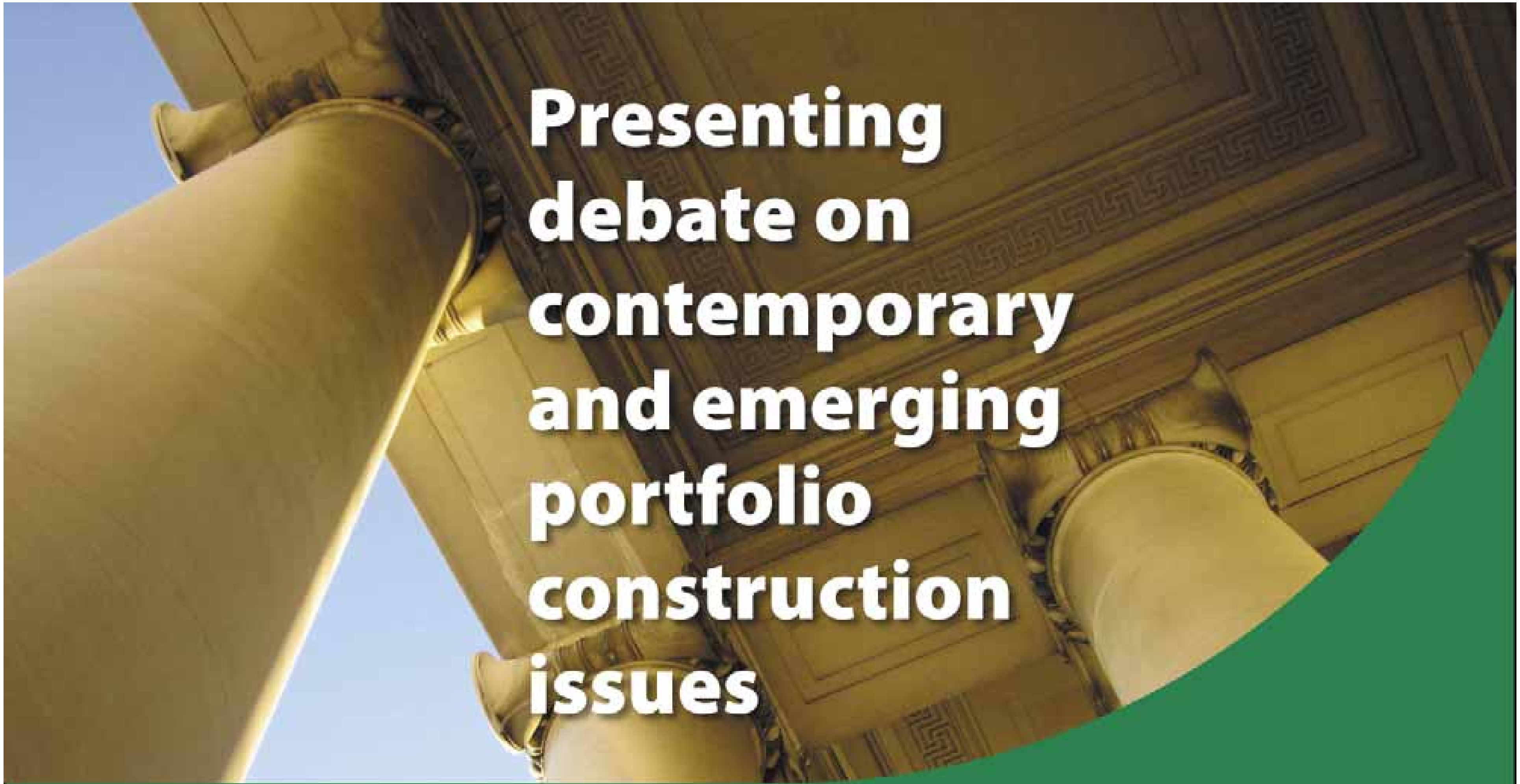


portfolio construction

CONFERENCE

15 & 16 August 2007 | AJC Convention Centre, Randwick, Sydney

When top down models went out of date - Fixed Income as an Alpha Source

Peter Walsh
Director, Retail Business

PortfolioConstruction Conference
August 2007

Outline

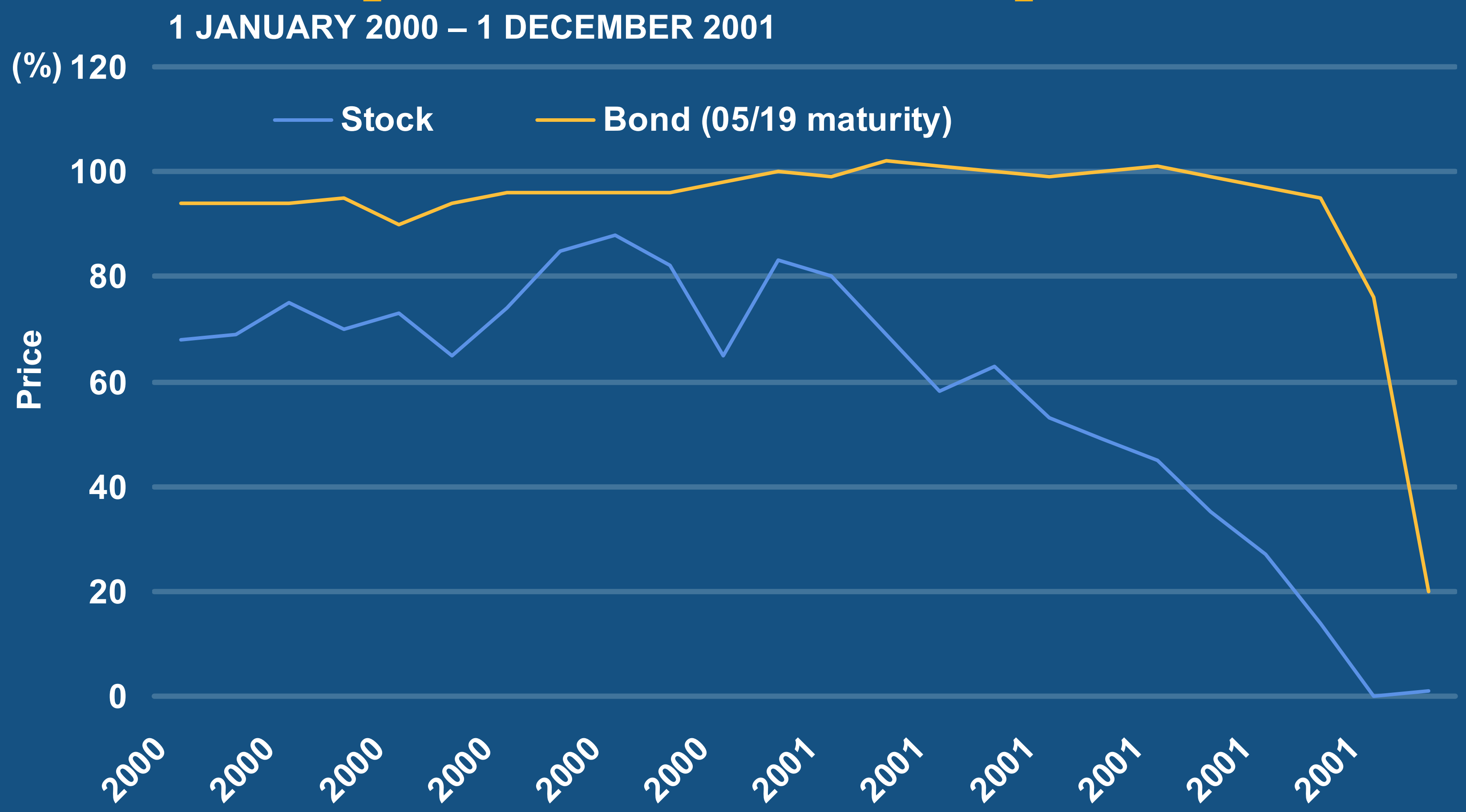
- Traditional view of Global Fixed Income
- Evolution of Fixed Income Markets
- Evolution of Investment Process
- Recipe for Fixed Income Alpha

Traditional view of Fixed Income

- Safe, necessary, boring
- Efficient – less alpha than equities
- Volatility is too low to generate alpha

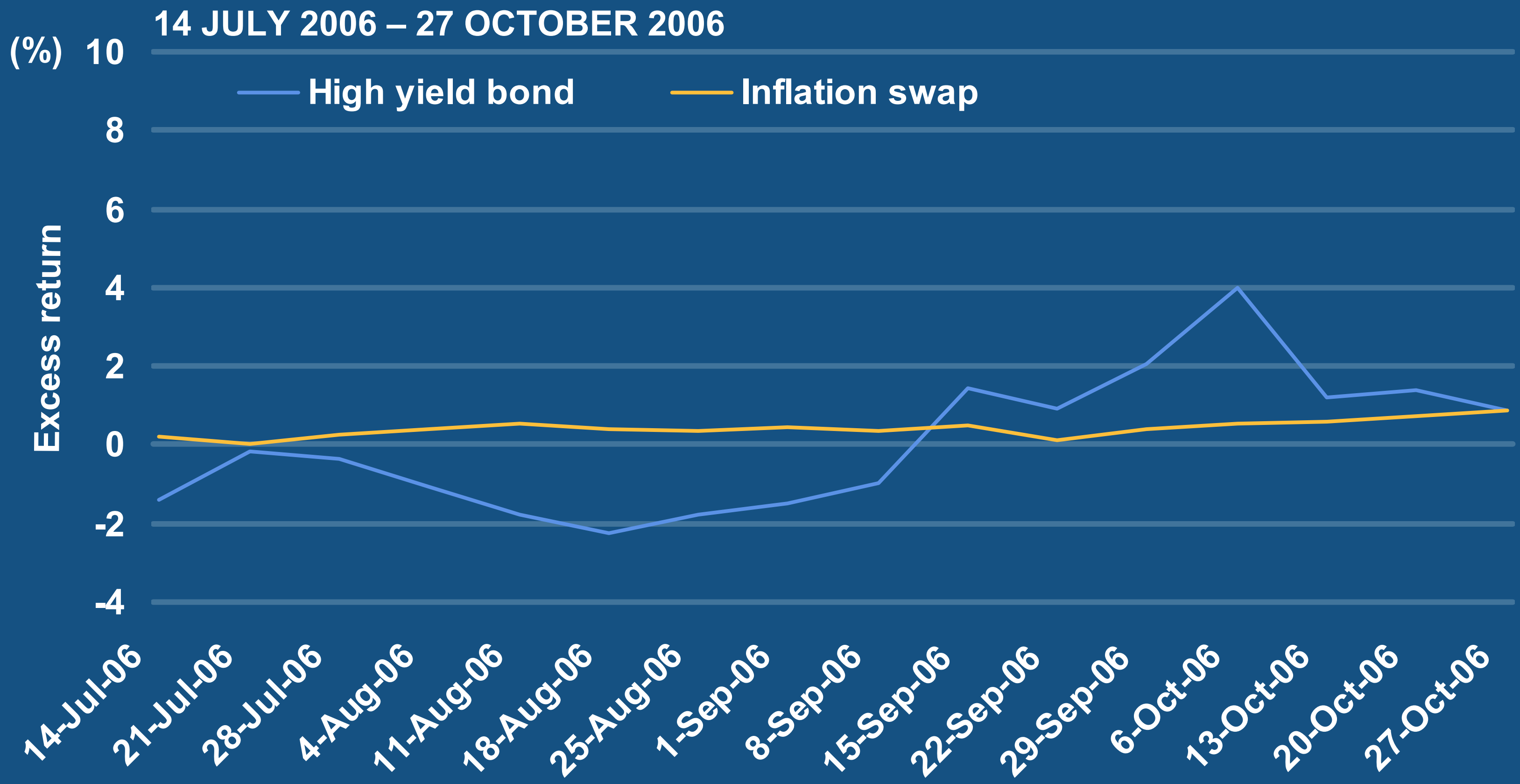
Traditional view of Fixed Income

Enron stock price vs. Enron bond price



Source: Bloomberg.

Traditional View of Fixed Income
Inflation Swap vs High Yield Bond
- rolling 12 month excess returns

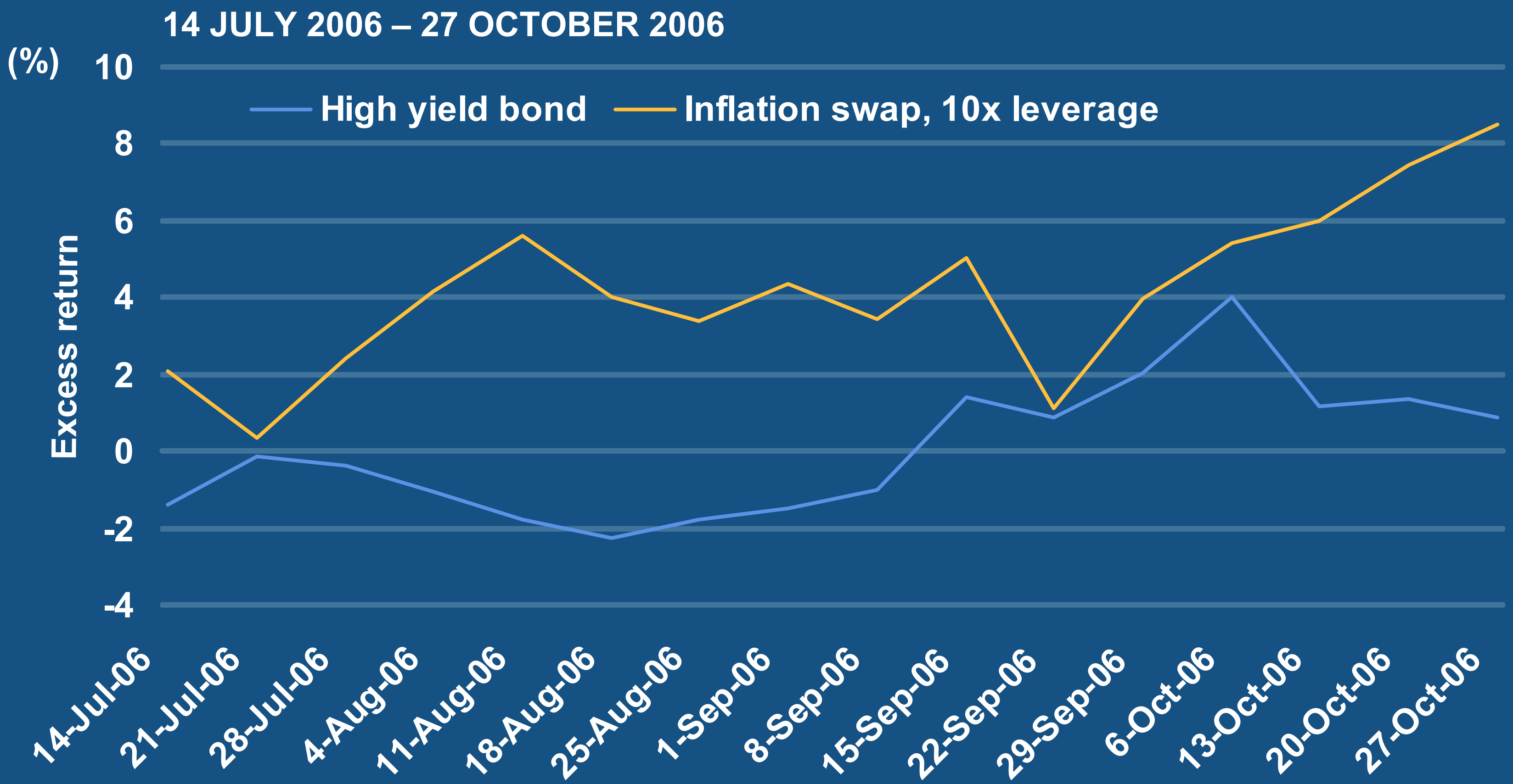


Source: Bloomberg, Merrill Lynch.

Traditional View of Fixed Income

Inflation Swap 10x vs High Yield Bond

- rolling 12 month excess returns

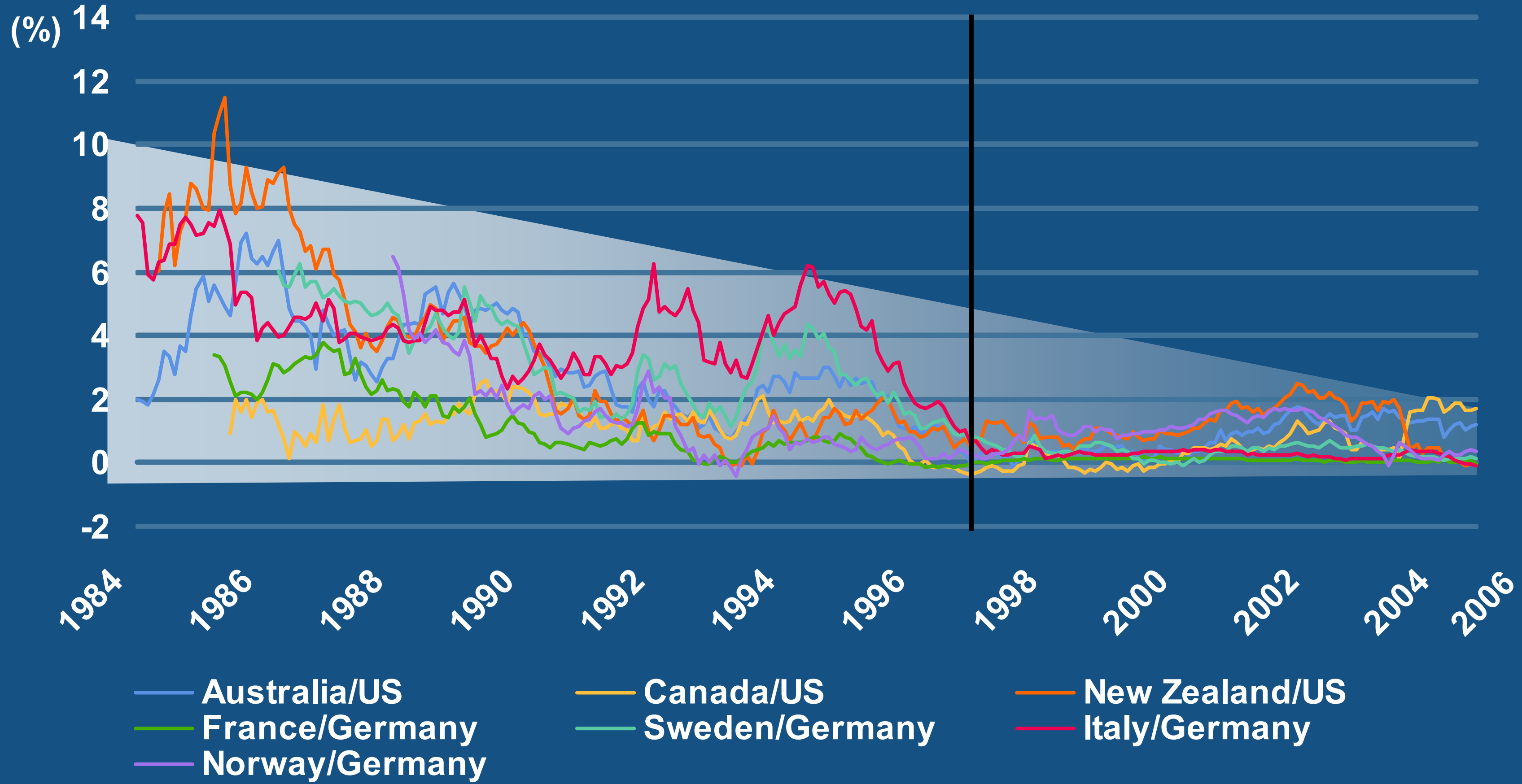


Source: Bloomberg, Merrill Lynch.

Evolution of Fixed Income Markets

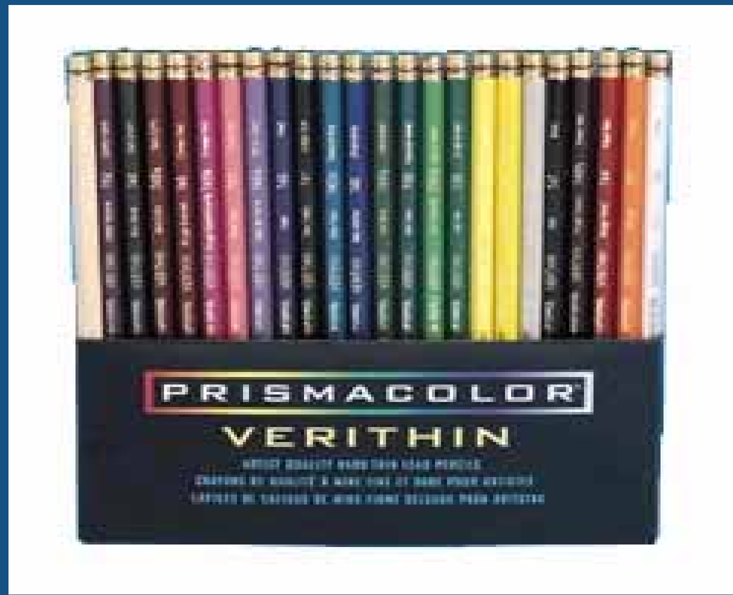
Diminished opportunity in country

TEN-YEAR YIELD SPREADS BY COUNTRY



Source: Datastream.

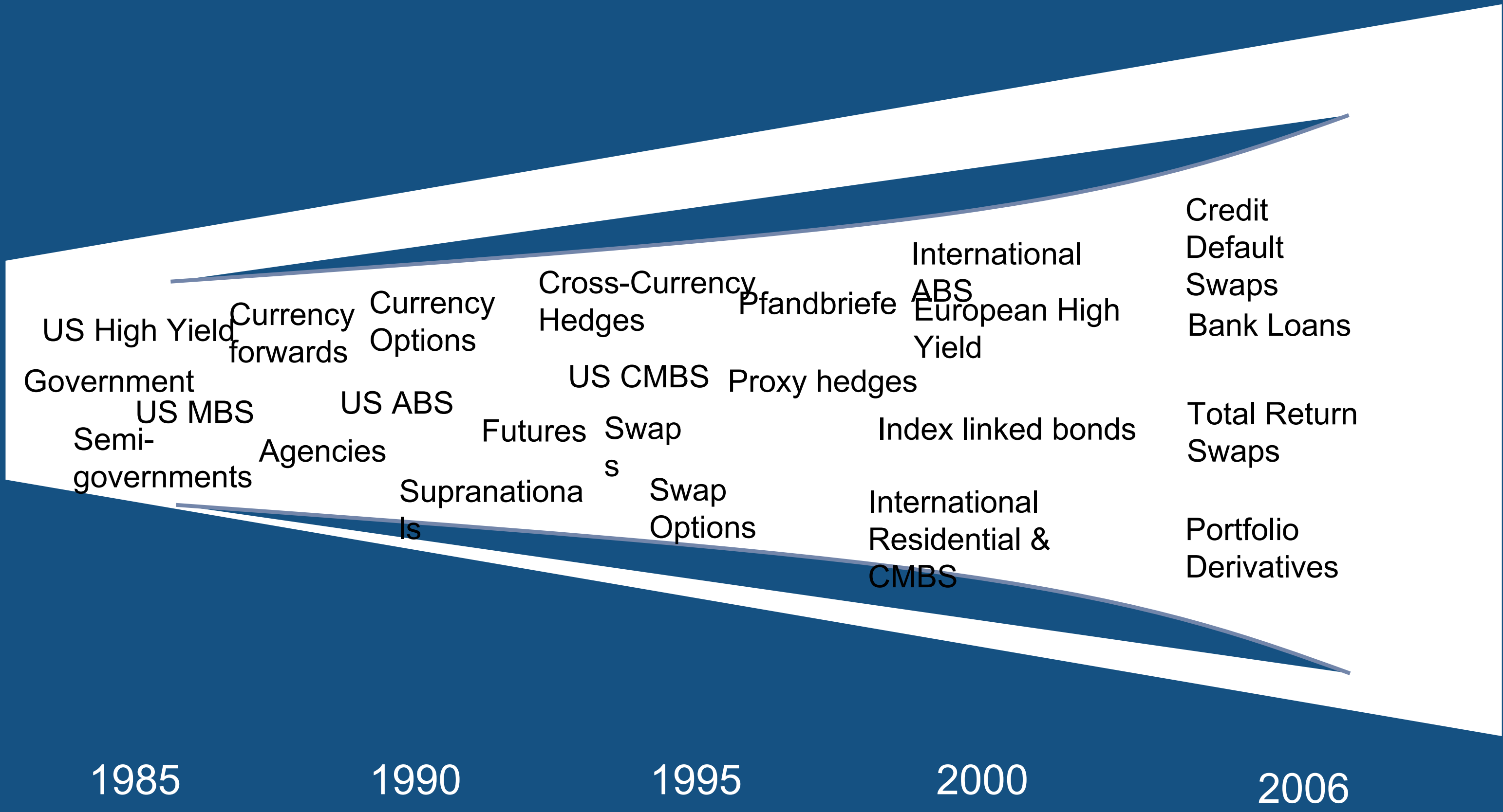
Evolution of Fixed Income Markets



Traditional

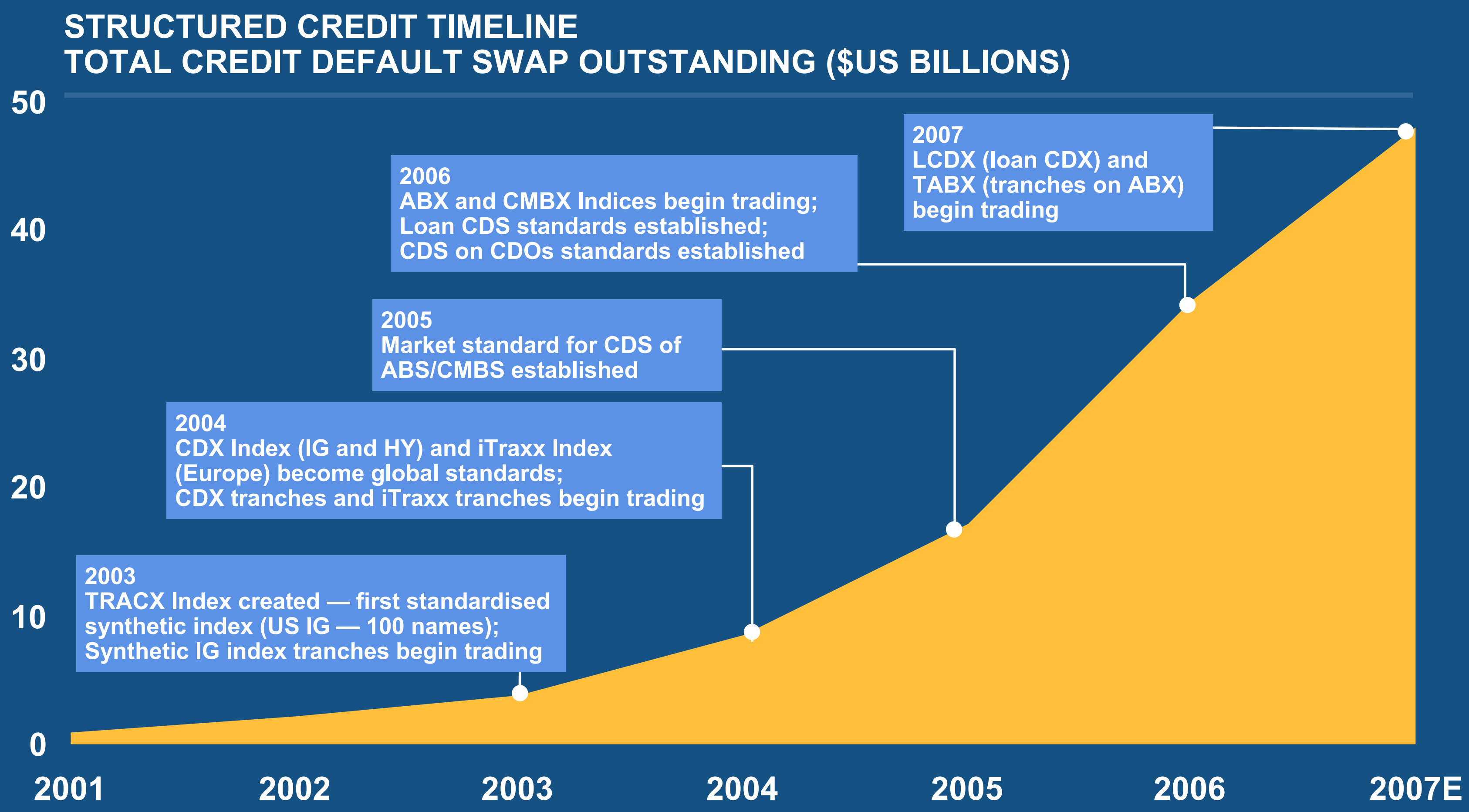
New

Evolution of Fixed Income Markets
Increased Sector/Security Opportunity



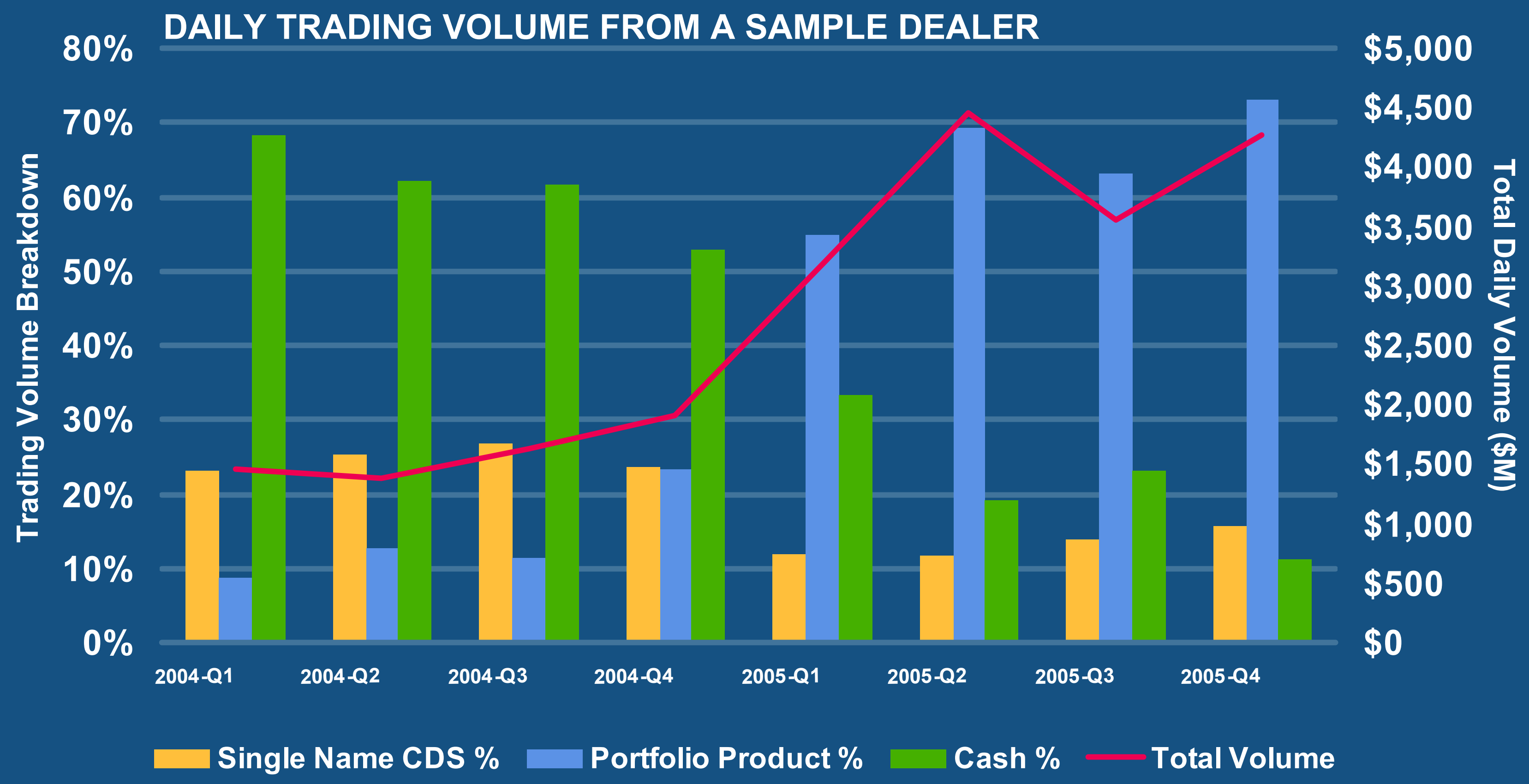
Source: Putnam Investments.
Sector opportunities are shown for illustrative purposes only.

Evolution of Fixed Income Markets
Rapid growth and innovation



Sources: ISDA and Putnam Investments as of 15/6/2007.

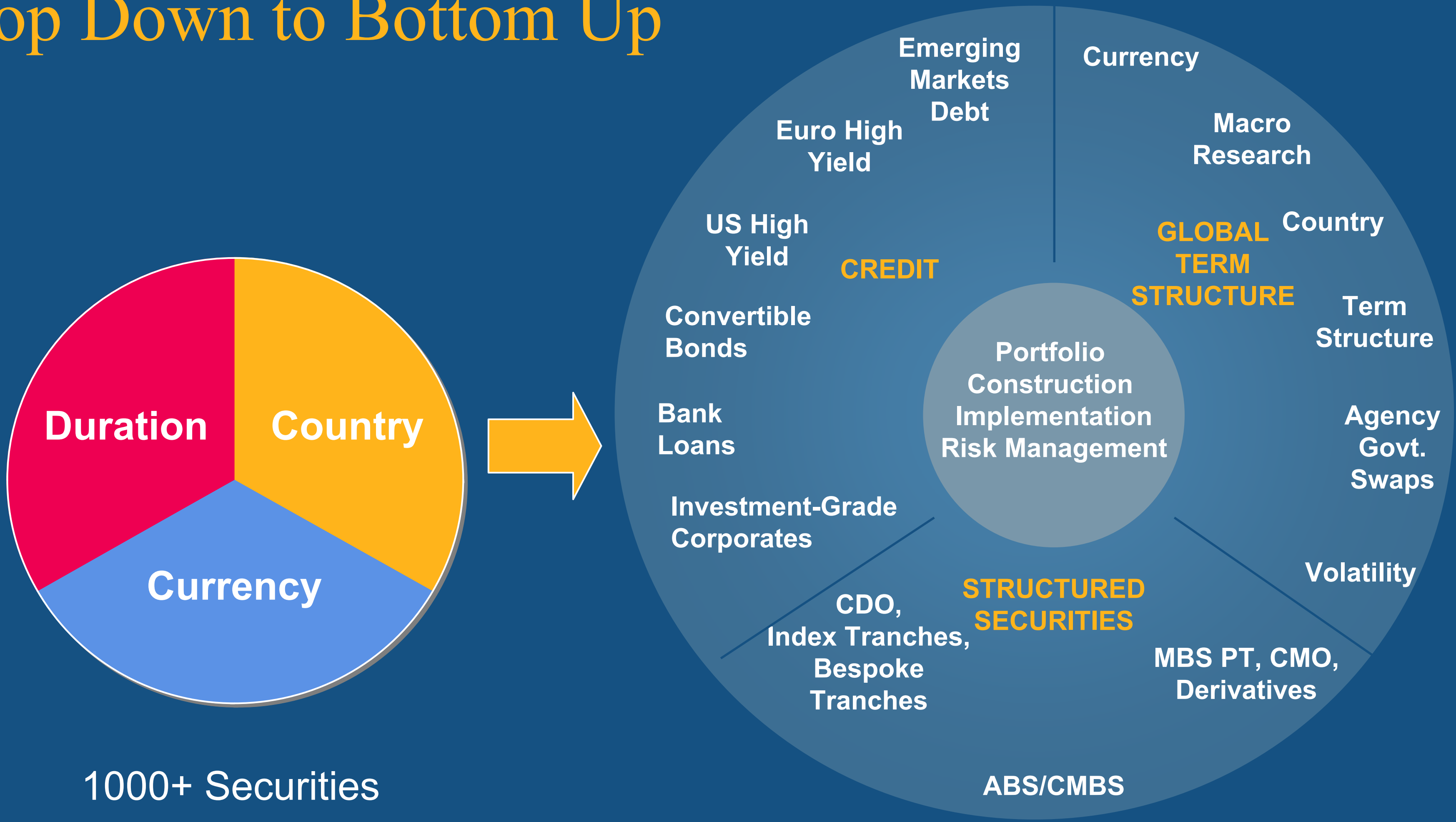
Evolution of Fixed Income Markets
Significant and increasing liquidity



Source: Lehman Brothers U.S. Flow Credit Trading Desk (Average Daily Volumes).

Evolution of Investment Process

Top Down to Bottom Up



1000+ Securities

14000+ Securities

Evolution of Investment Process

Inefficiencies to exploit

- Currency – not all investors are return oriented and hence deviations from fair value
- Term structure – real v nominal rates, mispricing of volatility
- Credit – different models, different views on size, volatility and correlation of default rates
- Liquidity – sensitivity to ratings or short time horizons creates forced sellers

Old Recipe for Fixed Income Alpha

- Historically small returns

- If large:
  - Usually taking significant market risk (Beta)
    - Long duration
    - Overweight credit
  - Volatile
  - Unrepeatable

New Recipe for Fixed Income Alpha

- Security selection
- Diversification
- Risk Management
- Derivative expertise
- Flexible guidelines

New Recipe for Fixed Income Alpha

- Asset Backed Securities
- Credit Derivatives

New Recipe for Fixed Income Alpha

➢ Derivatives

- Enable isolation of opportunities
- Can reduce risk
- Can add security selection opportunities
- Are the future

➢ Shorting

- Allows a larger opportunity set
- Asymmetry in your favour
- Little fundamental difference from being underweight

New Recipe for Fixed Income Alpha

- Leverage
  - Allows less volatile, but great risk-adjusted returns to be competitive with higher return more volatile sectors
  - Increasing size should equally increase return and risk

Summary

- Security selection is the best source of alpha in fixed income
- Diversification is necessary to avoid typical downside risk of bonds
- Be cautious of excess returns that were driven by large market moves – “big bets”
- Derivatives and shorting can add to alpha while decreasing volatility
- Investment managers need risk systems capable of monitoring the diverse exposures, volatilities and correlations

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Appendix: What happened to credit this year?

V

- Not all AAA's are the same
- Leverage can amplify returns and can have more downside than upside
- The use of quantitative models is an art and a science