

Bonds for the Long Term

February 12, 2003

With rates near 40-year lows, many fixed income investors are questioning whether this is a good time to invest in bonds. By their nature, the prices of bonds react inversely to the changes in interest rates; therefore, if interest rates rise, the price of the bond will fall. Specific security characteristics such as duration, call provisions, credit quality and convexity may make one bond's price fluctuations more volatile than another's. In general, the above rule holds true for most fixed income securities.

To better understand the relationship between changes in interest rates and bond price volatility, we examined historical quarterly returns for various Lehman Brothers Index benchmarks. **Based on our analysis, we believe rising interest rates may not have as negative an impact as one might expect on the annualized total returns for a three-year time horizon. Moreover, rising interest rates do not necessarily lead to negative total returns over shorter time periods.**

We reviewed the quarterly return data from a number of the Lehman benchmarks. For the purposes of this commentary, we focused on two primary indices—the Lehman 10-Year Municipal Index and the Lehman Aggregate Bond Index. As a proxy for interest rate changes in the bond market, we used changes in the 10-year Treasury Yield. As we expected, the negative return quarters were accompanied by an upward shift in the 10-year Treasury Yield. Conversely, declines in the 10-year Treasury Yield were associated with positive returns. The following four charts show the correlation between increases in the 10-year Treasury Yield and the quarterly index returns. There were far fewer negative return quarters than periods where the 10-year Treasury Yield rose from quarter to quarter.

- ▶ Over the past 22 years, the 10-Year Lehman Municipal benchmark has experienced 20 negative return quarters, while the 10-year Treasury Yield rose in 43 quarters over the same time period. (See chart 1.)
- ▶ For the Lehman Aggregate Index, the Treasury Yield has risen in 55 quarters over the past 26 years, while the returns have only experienced 22 negative quarters over the same time frame. (See chart 2.)

A review of the quarterly rolling 3-year time-weighted annualized returns for the indices highlights the benefits of a long-term fixed income investment strategy:

- ▶ During the past 22 years, the 10-Year Municipal Index has experienced positive returns for all quarterly rolling 3-year time periods. (See chart 3.)
- ▶ The Aggregate Index has experienced only two 3-year periods where the annualized returns were negative. (Returns during these two periods were modestly negative but are worthy of mention since they represent periods when rates increased dramatically. In both 3-year periods, rates rose over 500 bps in an attempt to stifle inflation.) (See chart 4.)

In Summary

While there may be some quarterly or even annual periods of negative performance, a relatively short 3-year time horizon has historically, with two extreme exceptions, resulted in positive returns. In large part, this can be attributed to the fact that income and reinvestment represent a significant component of total return, which tends to mitigate the impact of adverse price movements. This theory is consistent with McDonnell's philosophy that a commitment to fixed income securities should be a long-term strategy compatible with the investor's time horizon and volatility tolerances.



Guiding Portfolio Strategies

McDONNELL INVESTMENT
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CHART 1:
10-Year Municipal Return* vs. 10-Year Treasury Yield
12/31/80 through 12/31/02

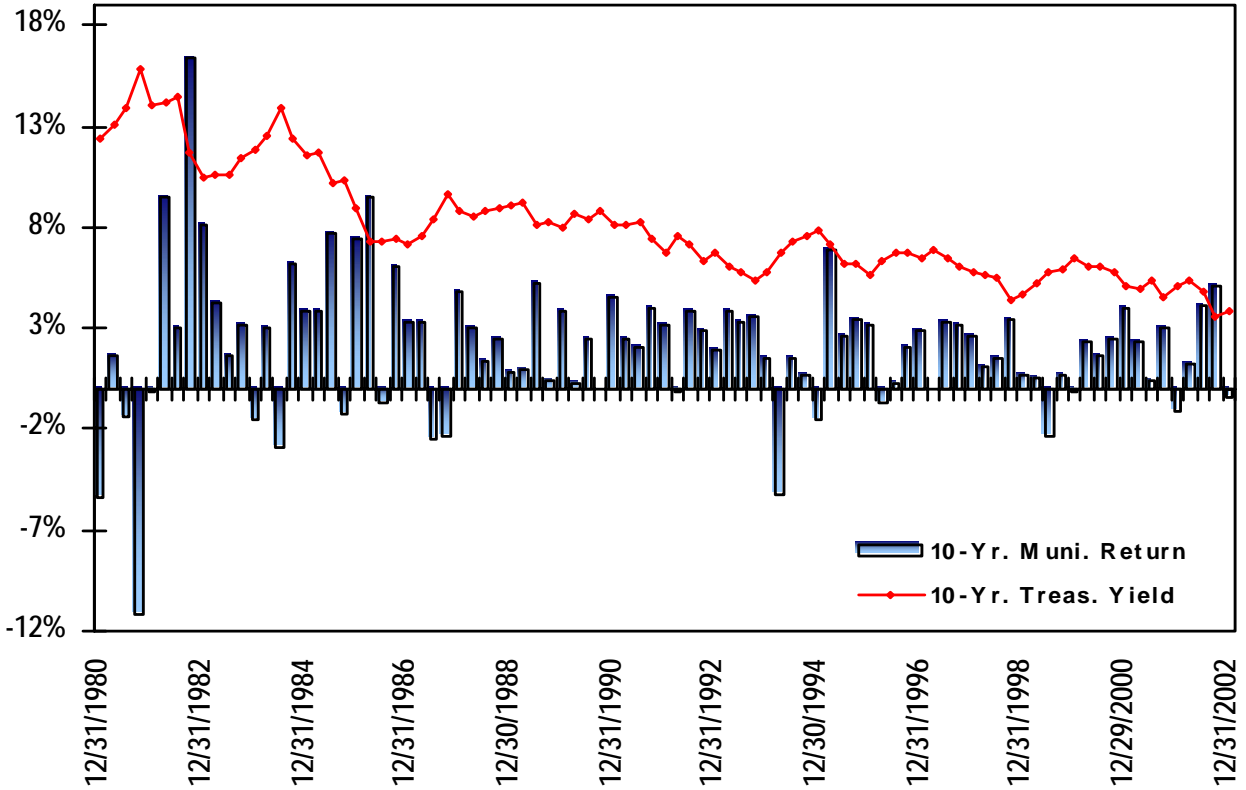
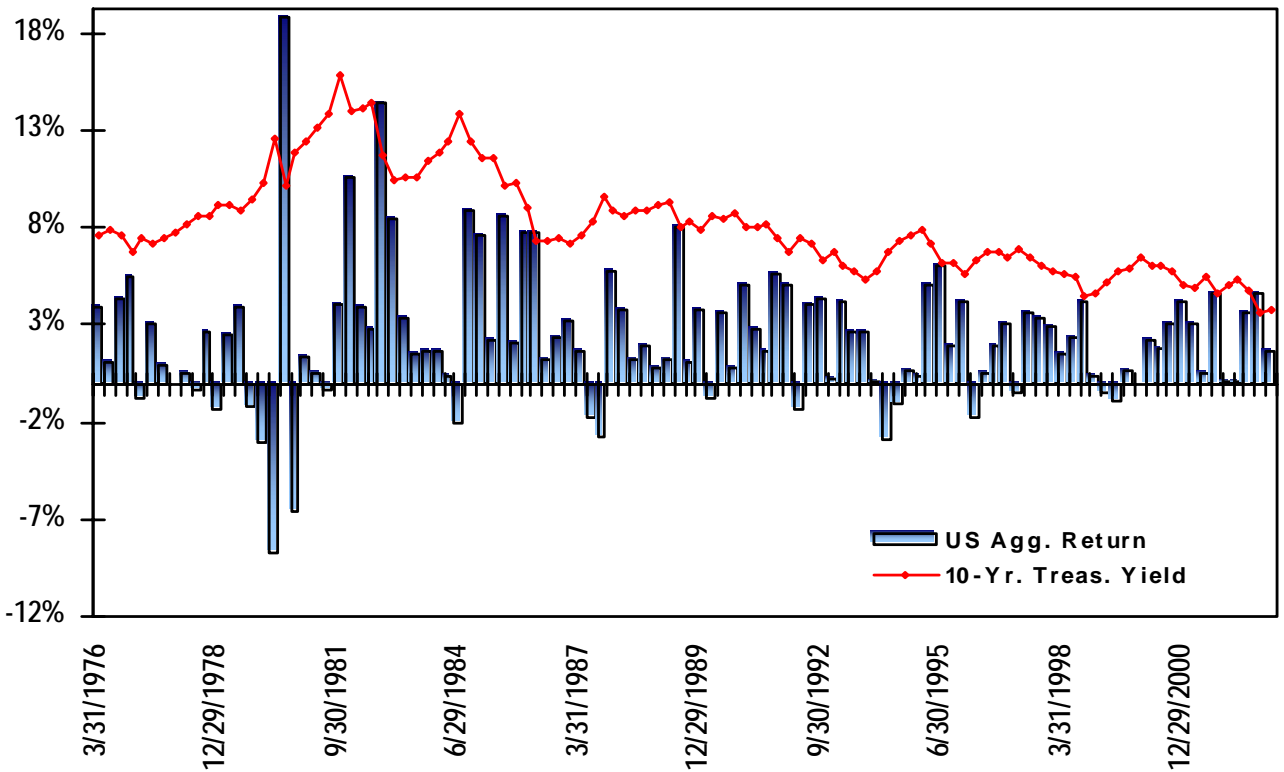


CHART 2:
U.S. Aggregate Returns* vs. 10-Year Treasury Yield
3/31/76 through 12/31/02



*The return data for the Lehman Indexes was analyzed based on the time period of index inception through 12/31/02. The indices are unmanaged and do not reflect any fees or expenses. McDonnell believes the data to be reliable but does not make any representations as to its accuracy or completeness. It is not possible to invest directly in the Index.

CHART 3:
3-Year Time Weighted Annualized Returns through 12/31/02
Lehman 10-Year Municipal Index

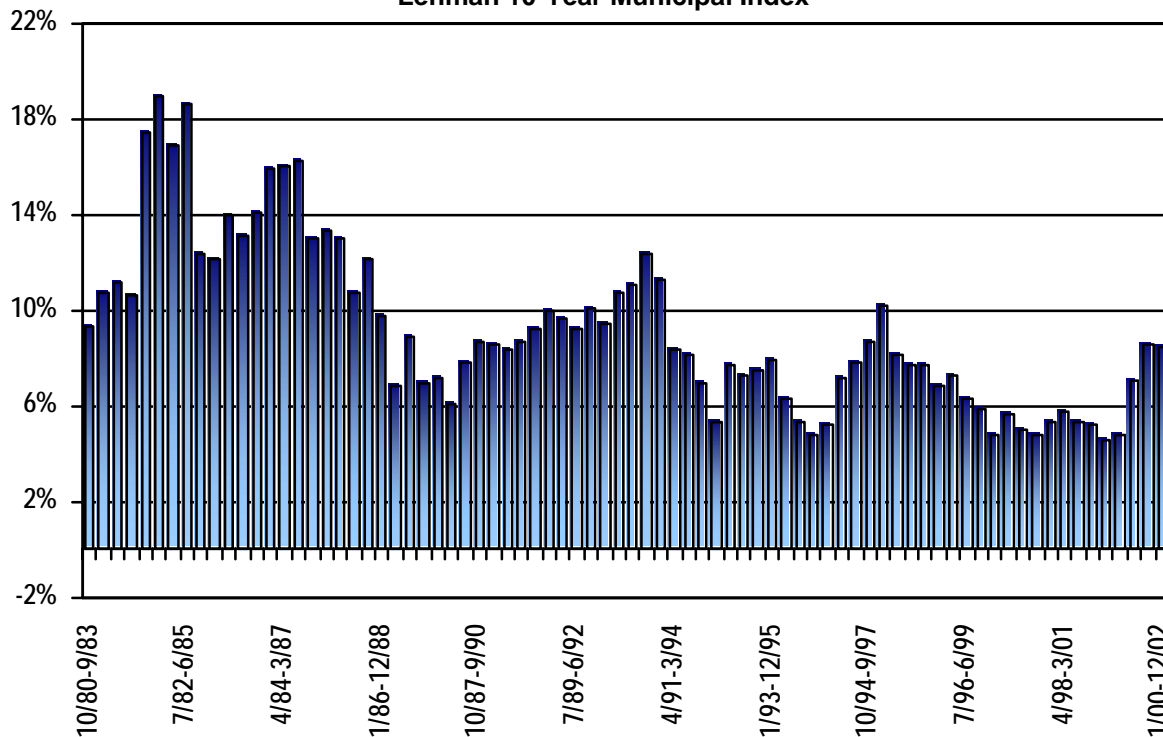
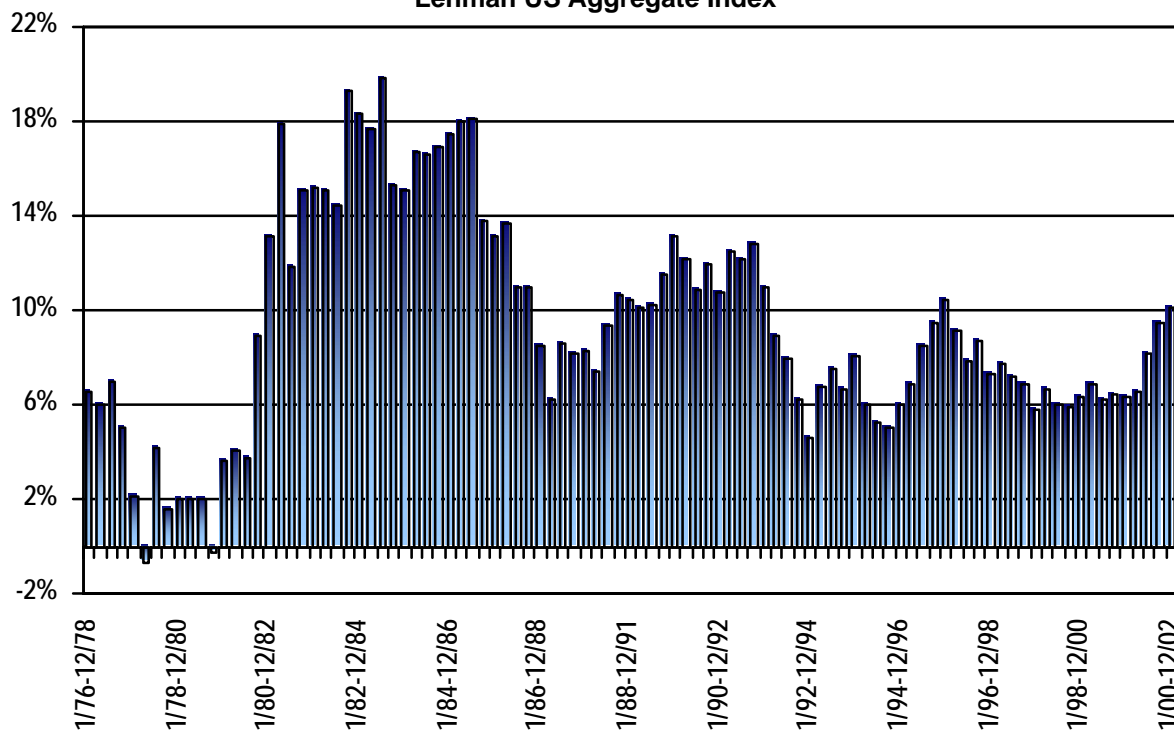


CHART 4:
3-Year Time Weighted Annualized Returns through 12/31/02
Lehman US Aggregate Index



*The return data for the Lehman Indexes was analyzed based on the time period of index inception through 12/31/02.

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