Interview: Brian McMahon of Thornburg Investments

By Robert Huebscher
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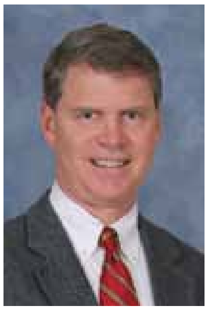

Brian McMahon is the chief executive officer and chief investment officer for Thornburg Investment Management, where he is responsible for the company's overall investment activity. Brian is also a co-portfolio manager for the $3.8 billion Thornburg Investment Income Builder Fund (TIBAX). The fund's goal is income production, and it is in Morningstar's World Allocation category. It has outperformed its benchmark, the Morningstar Moderate Target Risk, over the last year (43.40% versus 14.30%), three years (3.15% versus 1.68%) and five years (8.31% versus 3.40%). It's yield is 6.83%. The A shares have an expense ratio of 1.25%. Data are as of November 19.

We spoke with McMahon on November 11.

I'd like to understand your economic forecast – whether it is v- or u-shaped – and how that guides your asset allocation decisions.

> I'm not sure if the recovery will be v- or u-shaped, but I believe we will get a quicker recovery outside the US than inside the US. In fact, I think it is already underway. The reason is that the US economy has more profound structural adjustments to make.

What are those adjustments?

> We became far too dependent on housing and on an expansion of retail industries – basically an expansion of debt-financed consumption. The US became addicted to that over the last 20 years – particularly in the last 10 years.
>
> That did not happen in the rest of the world. Some retailers here need to retrench or go out of existence. We are over-retailed and over-housed, with far too much construction, relative to the rest of the world.
>
> It will look more v-shaped outside the US and more u-shaped inside the US.

When you refer to outside the US, are you referring to developed or emerging economies?

> Both, but definitely in emerging markets. From the end of Q4 of 2008 to the end of Q3 of 2009, some emerging markets like Russia and maybe Turkey were

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down almost 10% in their GDP – more than the US. But it was because production stopped, and now it is ramping up. Over the next four quarters they will probably be up 10%.

Even Russia, which is heavily dependent on commodities and energy?

Yes, I think so, because there is not a lot of debt either at the consumer or the business level. They retrenched and now they are starting up again. I think Russia will produce more barrels of oil in 2009 than they did in 2008, by a few hundred thousand barrels a day on average. Even though the price is down, activity is up. I just returned from my fourth trip there, and I am always surprised by the steady progress they are making.

How does this enter into your thinking about your asset allocation? Are you emphasizing investments in emerging markets?

The fund has a very specific mission, which is the production of income. As a result of what we have seen in the last two or three years, particularly in the US, there are two things that are in scarce supply – jobs and income. They are related in some ways. The aggregate dollars of dividends paid by the S&P 500 will be down 26% from 2008 to 2009, which is the kind of cut that we have not seen in the last couple of generations. The last time we saw this was in the 1930s, but not in the lifetimes of any of today's investment professionals.

This is a new paradigm, and when you combine that with the low yields on savings-oriented investments, such as money markets and Treasury bonds, there is a big shortage of income. That is particularly troublesome for those individuals over age 55, who are the prime clients for your audience.

Income shortage is a big issue, and we have tried to get in front of it [last year] by recognizing that big dividend cuts were coming and, frankly, even though it was painful for our NAV in the fourth quarter of 2008 and the first quarter of 2009, we bought bonds right into the teeth of the storm. I had a theory that it was a huge "going out of business sale" when Lehman's $700 billion balance sheet was liquidated. Lots of other hedge funds and leveraged bond holders were liquidated.

That was not something to be feared; it was something to take advantage of.

What kind of bonds were you buying at that time?

All kinds – utilities, first mortgages, and others. We ran our bond allocation from 15% up to almost 50%. That was not easy to do, because we did it at a time when we weren't getting any net new money. As of September 30, our bond

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allocation was just above 40%, but that was mostly a reflection of equity prices increasing more than bonds during the third quarter. We tried to anticipate the scarcity of investment income, and we believe the majority of investors are not "hip" to this issue.

There is a big income shortage. Investors are still pouring money into bank deposits, which pay virtually no interest. Those deposits stood at $6.25 trillion as of the end of the second quarter. This shortage of income will continue into 2010. If you don't believe me, listen to what Bernanke and every other Fed official are saying. They are going to keep short-term rates low, and they are going dare, double-dare, and triple-dare those who are holed up in those assets to move into risky assets.

AT&T now has a dividend yield of approximately 6%. Are some of these high-quality dividend-paying equities attractive for the fund now?

We don't own AT&T, but we do have very large holdings in that sector. Telecommunications services is by far our biggest single sector, at over 14%. We own China Mobile, Telefonica, Telstra and France Telecom. I don't like AT&T because these other names are more attractive.

These stocks, as a group, haven't done much this year. In a way they have suffered the same fate as AT&T, which is that they are not what the market wants. Tragedies and comedies have been rewarded; the market does not seem to want [the more typical] serious drama.

What justifies your high allocation to this sector?

It has the best cash- and dividend-generating stocks. Our fund depends on businesses that are able to generate cash and are willing to share that cash with their shareholders. We don't want crummy businesses that devour cash. These stocks that are capable of producing dividend income will come back into fashion. They are just not in fashion right now, and that is true in the US and everywhere in the world.

What is the dividend yield on the equity portion of your portfolio?

About 6%. We own Coke and McDonalds, which yield a little more than half of that, and we own quite a few names that yield more than that. There aren't many that yield less than 3%.

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Are these yields attractive relative to Treasury and investment-grade corporate yields?

I hope so. Equities have not been as attractive, relatively speaking, this year.

But that's because of price movements and not because of dividend yields.

Correct. People have not been focused on income production. The telecom sector was down only 20% last year. The sectors that have performed the best this year are those that were down a lot more last year.

What is your exposure to the financial sector, and what names do you still own there?

We own a lot, including some common and preferred stock. Some of those preferred positions we took during the financial crisis. We own an 8.5% convertible preferred from Fifth Third Bancorp and a Huntington Bancshares preferred, but we don't have common positions in US banks. That is a big change, because three or four years ago the banking sector paid the biggest dividends. It's hard for us because there is not much to pick from.

Outside of that sector, we like business development companies like Apollo Investments, some of the mortgage REITs, and companies like Annaly and Chimera, which have yields up in the double digits. The weather is very good for them. You don't want to fall asleep on those stocks, but right now, with the yield curve where it is, things look pretty good.

How do you view the prospects for inflation versus deflation? Do you believe budget deficits will inevitably force interest rates higher over, say, a 10-year time horizon?

Interest rates are so low now that it is probable they will go up. However, it's also probable that they won't go up as far and as fast as some people think. It's not going to be easy for us to have inflation at a time when employment is as slack as it is in the US. Not only is it slack right now, but over the last 10 years US employment went from 131 million to 138 million jobs and all of those jobs – more than 100% of the 7 million new jobs – were added by small- and medium-sized businesses. Big businesses were net job cutters – really net job exporters – through the last decade.

Surveys of small businesses say they are not about to go out and hire a bunch of people. Even though there is a crying need to somehow socialize medical costs, the plan that's being hatched right now is not one that will motivate small businesses to hire people. Maybe a surprise for 2010 is that we are not going to

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get as much of a snapback in employment as people have hoped for. Any snapback has to be led by small-business hiring.

Employment is a very important ingredient in creating the atmosphere for inflation. If the dollar completely falls out of bed, everything we import will go up in price, and we could get some commodity inflation. But I don't expect the kind of cost-push inflation that happened in the 1970s. It could develop, but it won't hurt us badly in 2010.

So we are looking at a low-inflation environment for the next year.

Yes. Helicopter Ben [Bernanke] is trying to fight deflation in a variety of ways. In the US and some other countries low inflation will prevail. China will post near double-digit GDP growth this year without any inflation.

Does this give you cause to pare back any of your fixed income exposure?

No. We bought these positions at attractive prices. With a shortage of income, our shareholders want us to hold on to those positions. With new money that comes in, we won't buy the same securities as we did six or 12 months ago at much lower yields. I hope some of the former decent dividend payers that have taken a siesta will revert to form and begin paying dividends again.

What are some examples of those?

We may see that in some of the banks or maybe in the tech sector, if business gets a little bit better. Then there are the McDonalds and Coca Colas that chug along. Their price goes up, so the dividend does not look that high, although McDonalds' price was essentially flat in 2009.

McDonalds has grown their business but not their stock price. They don't face any appreciable commodity-price inflation. They absolutely benefit from the current labor market. They can hire better people cheaper than they could 10 years ago.

To understand your exact view on inflation, are you a buyer of TIPS now, with the 10-year breakeven rate at a little over 2%?

We don't own TIPS, so that's the proof that is in the pudding. Several years ago, our funds had 10% to 20% in TIPS. I'd rather do a laddered portfolio than a TIPS portfolio, because it allows us to manage the duration and play the yield curve.

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What are the biggest risks the fund faces?

The biggest risk we face is that we dip back into significant negative GDP growth and it tips the unemployment rate to 12% or higher. If that happens – which is neither likely nor impossible – then we will love our bonds and it will be tough sledding for certain stocks.

If you're 38 years old and saving for retirement in 25 years, it will be a great investment opportunity. If you are 62 and saving for retirement in the next few years, or if you are already retired, it is really bad news. Different people will have different reactions, as they should.

We have to try to moderate things, and make sure that we provide income. It is a really challenging environment for those who want to earn income from their investments.

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Thornburg Investment Income Builder Fund, A Shares (TIBAX Incep: 12/24/02)
Total Returns as of 6/30/10 (annualized for periods over one year)

	YTD	1-Yr	3-Yr	5-Yr	Since Inception
Without sales charge	-3.20%	16.82%	-2.84%	5.98%	10.58%
With sales charge	-7.55%	11.57%	-4.32%	5.01%	9.90%
Blended Index	-6.07%	10.34%	-6.60%	1.72%	5.81%
S&P 500 Index	-6.65%	14.43%	-9.81%	-0.79%	3.99%
Morningstar Moderate Target Risk Index	-2.73%	12.15%	-1.93%	3.61%	6.93% *

30-day SEC Yield, as of 6/30/10: 5.14%

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thornburg.com. A shares have a maximum sales charge of 4.50% and a 30-day redemption fee of 1%. The total annual fund operating expense of the Fund's class A shares is 1.30%.

Correction: The Fund's benchmarks are the S&P 500 Index and a Blended Index of 75% MSCI World Index and 25% Barclays Capital Aggregate Bond Index. The Morningstar Moderate Target Risk Index is not the Fund's benchmark.

Thornburg Investment Income Builder Fund Top 10 Holdings, as of 6/30/10 1) Telestra Corp. Ltd. 2.8%; 2) Swiss Re Capital I, LP 2.5%; 3) Enel S.p.A. 2.3%; 4) Total SA 2.2%; 5) France Telecom SA 2.1%; 6) Eni S.p.A. 2.1%; 7) Phillip Morris 2.0%; 8) Vodafone Group plc 2.0%; 9) McDonald's Corp 1.9%; 10) Huntington Bancshares Pfd. 1.9%

Investments in the Fund carry risks, including possible loss of principal. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in small capitalization companies may increase the risk of greater price fluctuations. Funds investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Investments in the Fund are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity. There is no guarantee that the Fund will meet its investment objectives.

The views expressed by Brian McMahon reflect his professional opinions and are subject to change. Securities, countries, sectors, and industries mentioned are presented to illustrate the types of investments in the Fund. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy or sell securities.

The Blended Index is composed of 25% Barclays Capital Aggregate Bond Index and 75% MSCI World Index. The Barclays Capital Aggregate Bond Index is composed of approximately 8,000 publicly traded bonds including U.S. government, mortgage-backed, corporate and Yankee bonds. The index is weighted by the market value of the bonds included in the index. The index is weighted by the market value of the bonds included in the index. The MSCI World Index is an unmanaged market-weighted index that consists of securities traded in 24 of the world's most developed countries. Securities are listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated with net dividends reinvested, in U.S. dollars.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The Morningstar Moderate Target Risk Index represents a portfolio of global equities, bonds, and traditional inflation hedges, such as commodities and TIPS. This portfolio is held in a static allocation of 60% equities and 40% fixed income, which is appropriate for U.S. investors who seek average exposure to equity market risk and returns.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

V-Shaped Recovery – A type of economic recession and recovery that resembles a "V" shape when charting certain economic measures. The "V" shape indicates the economy took a sharp downturn and recovered quickly from its lows.

U-Shaped Recovery – A type of economic recession and recovery that resembles a "U" shape when charting certain economic measures. In this scenario, the economy takes longer to begin growing again compared to a V-shaped recovery.

TIPS, or Treasury Inflation Protected Securities, are either a U.S. Treasury note or bond that offers protection from the effects of inflation. Using the Consumer Price Index as a guide, the value of the principal is adjusted to reflect the effects of inflation. A fixed interest rate is paid semi-annually on the adjusted amount. At maturity, if inflation has increased the value of the principal, the investor receives the higher value. If deflation has decreased the value, the investor receives the original face amount of the security.

*Since 1/3/2003

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