

The Hunt for Value

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Most economists do a lousy job of forecasting interest rates. In June 2004, the 55 top economists surveyed by the *Wall Street Journal* expected the yield on 10-Year Treasuries to rise to 5.14% by the end of the year. Instead it fell to 4.22%.

At Thornburg, we choose not to try to make these forecasts. While that isn't to say that we don't have an opinion (we do!), we instead rely on our time-tested strategy of laddering high-quality short- and intermediate-term bonds. This lays a solid foundation for the management of our bond portfolios, historically capturing most of the upside with less volatility over time.

We focus our time on those areas where we do see opportunities to add value. With over 1.5 million municipal bond issues in circulation, opportunities to deliver superior returns do exist through security selection, tactical (not strategic) yield curve positioning and knowledgeable execution.

Security Selection

With such a broad array of issues to choose from, there are several ways in which careful selection can add value.

Credit Analysis – Many bond issuers apply to ratings agencies for a credit rating – some of the better known agencies include Moody's, S&P, and Fitch. This rating is often a major determinant in the price investors are willing to pay for the

bond. With the large number of issues outstanding however, the rating assigned may be reflective of older, outdated information. When our analysis differs from the assigned rating, we may look to purchase the bond at a price below its intrinsic value.

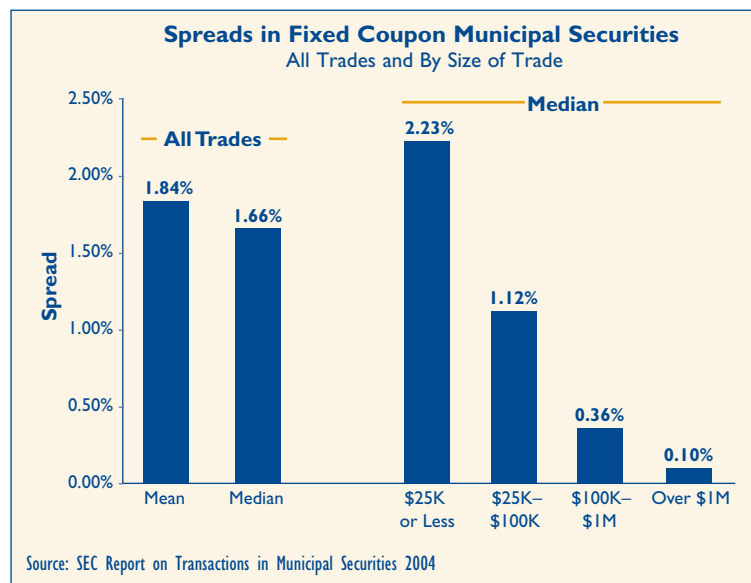
Geographic Concentration and Sector Rotations

– At times, regions or individual states may experience difficult economic or budgetary periods – witness Texas in the mid-1980s, Massachusetts in the early 1990s, and California in the mid-1990s. The same holds true for sectors of the bond market. While this presents issues to avoid, it also provides opportunities to the astute buyer to purchase certain issues at attractive valuations. We look to take advantage of these situations, when prudent.

Structure – Structural elements of bond issues include a bond's coupon, dollar price, call protection, maturity, and sinking fund payments. Much like geographies and sectors, these features come in and out of favor, presenting cases where we can buy bonds at attractive valuations.

Yield curve positioning

As mentioned above, we do not believe that most bond professionals or economists have the ability to successfully predict the overall direction of interest rates on a consistent basis. This is a major rea-



son for our laddering strategy. However, the yield curve is constantly shifting and changing shape based on the supply and demand of bonds at certain maturities. While we target an equal weighting of the ladder over time, we will often focus purchases on certain parts of the curve based on relative attractiveness. This may result in moderate overweighting of some maturities for certain portfolios.

Execution

Dealer Network – There were 12,731 new bond issues* in 2006 ranging in size from less than \$1 million to \$3.1 billion (with an average of \$31 million). Some of the most attractive issues were under \$30 million and were underwritten by bond firms that most had never heard of. Once in the secondary market, many of these issues rarely make it into dealer inventories avail-

able to retail investors. In an effort to gain access to as many issues as possible, Thornburg maintains relationships with over 200 dealers, with some of these relationships going back over 20 years.

Besides providing access to attractive opportunities, this dealer network also gives institutional investors, such as Thornburg, the ability to shop for the best price. According to a study by the SEC in 2004, investors buying bonds in increments of \$25,000 or less paid over 20 times the markup of investors buying bonds in increments of \$1,000,000 or more. Having an extensive dealer network gives us the leverage to negotiate the best possible price.

Timely Buying – Bond market psychology tends to be cyclical in nature. We have seen periods of weeks or months when every piece of new economic data is interpreted as a

reason to buy bonds. During periods like these, short-term traders and momentum players tend to dominate the market. Thornburg stays involved in the market during these times, but because we typically don't chase or push the market, we tend to have less success buying bonds in these cycles. However, when sentiment shifts and the momentum players get out of the way, there tends to be less competition for bonds and our bids get hit more often. In this way, we typically have more success buying bonds on our terms when we buy into market weakness.

These are just some of the ways bond portfolio managers add value. At Thornburg, our strategy of laddering short and intermediate bonds lays the foundation for portfolio man-

agement. Once that foundation is laid, Thornburg bond portfolio managers strive to add additional value through yield curve positioning, rigorous credit analysis, opportunistic buying, and careful shopping. The result is a well-structured portfolio designed to provide an opportunity to achieve above market performance.

Carefully consider the Fund's Investment objective, risks, sales charges, and expenses; these are found in the prospectus, which is available from your financial advisor or www.thornburg.com. Read it carefully before you invest or send money.

As with direct bond ownership, Funds that invest in bonds are subject to certain risks including interest rate risk, credit risk, and inflation risk. The principal value of bond funds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in the fund are not deposits or obligations of, or guaranteed or endorsed by, any bank, the Federal Deposit Insurance Corporation, the Federal Reserve Board or any government agency.

The laddering strategy does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Spread is the difference between the bid and the ask price of a security or asset.

*Source: Bond Buyer by Thomas Financial

Thornburg Issue Selection Process

