

# Strategic Income Fund Flexibility

■ by Jason Brady, CFA  
Portfolio Manager

Though we are now past Halloween, I can tell you that the investment environment is still pretty scary. The Federal Reserve is doing its best not to frighten the market, but Ben Bernanke's "unusually uncertain" outlook means that the quantitative easing has a sequel. This further action of purchasing U.S. Treasury securities is likely to drive interest rates to further lows, at least in the short term, and further to add liquidity to a market which already seems awash in it.

This backdrop makes the normally difficult search for yield even tougher. Many investors are in need of significant income and typically turn to "high yield" funds to find notable dividends. As we have written many times, the simple yield statistic is potentially quite misleading. At Thornburg Investment Management, we believe we have a better income-generation mousetrap in the form of our Strategic Income and Strategic Municipal Income Funds. Both funds have a goal of high but sustainable dividends, without resorting solely to the below investment grade portion of their respective universes.

The idea behind these funds is that "high yield" in the context of a fund type is not an investment goal but an

asset type. Most taxable high-yield funds are solely focused on below investment grade corporate bonds. In tax-exempt land, those same funds are very heavily invested in below investment grade munis.

This focus ultimately makes these funds less flexible and correspondingly less capable of succeeding in multiple different investment climates. Below investment grade corporate bonds represent less than 2% of the total taxable investment universe. For municipal bonds, the below investment grade portion of the market is less than 3.9% and furthermore has a large number of correlated issuers (tobacco bonds are a big part of the junk muni market and all reference cigarette sales). There is no reason to ignore huge chunks of the market merely because they do not have a very low credit quality, in fact, quite the opposite. By constantly sifting through the available choices across many sub-asset classes, we are able to generate an interesting income stream from a variety of different sources. We believe this is likely to lead to a more stable fund with a robust yield.

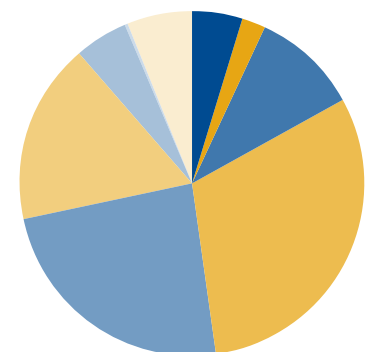
This is the reason that our Strategic Income Fund has a much larger purview than a typical "high yield" fund. Though we are currently focused on corporate bonds,

that focus is a result of our belief that corporate balance sheets are the most attractive bond investment. Given the choice between government bonds, asset-backed bonds (mortgages, commercial mortgage, auto loans, etc.) and corporate bonds, we're skewing towards corporates. However, we are also finding very interesting opportunities in the other asset classes. As an example, we own the bonds of New South Wales, an Australian state. Because we hold about half the fund in investment grade bonds, we do have some exposure to interest rates. If U.S. Treasuries sell off, a portion of our fund will be affected. An environment of higher U.S. Treasury rates (and lower high-quality bond prices) is likely one that involves higher inflation expectations and solid global growth. As a "commodity currency," the Australian dollar (AUD) is likely to perform well in this sort of environment relative to the U.S. dollar (USD). As a result, our positions (including the New South Wales security) that are denominated in AUD will likely rise in price due to that AUD outperformance, thus mitigating the declines in value from our higher quality USD positions. Of course, it could work in the opposite direction, but we are receiving notable income from the

position as a cushion against adverse moves.

Ratings are not a great measure of an individual bond's risk, but in aggregate they are probably a reasonable metric around credit. The Thornburg Strategic Income Fund's largest rating category is BBB at 31%. The second largest ratings category for the fund, at BB (but called "junk" despite being only one category

**Thornburg Strategic Income Fund**  
Credit Quality Ratings as of 12/31/10



AAA	5.4%
AA	2.2%
A	9.6%
BBB	31.4%
BB	24.1%
B	16.8%
CCC	4.7%
CC	0.0%
C	0.1%
Not Rated	5.6%

We have used ratings from Moody's Investors Service. Where Moody's ratings are not available, we have used Standard & Poor's ratings.

*Continued*

lower than the “investment grade” BBB) represents 24% of the fund. This BBB/BB focus is due to the large quantity of interesting bonds with a good risk/reward balance at these levels. Many funds and buyers ignore these categories due to their labels, but with historically low Treasury yields and some notable credit risk still in the market environment, we’d prefer to be away from the two ends of the ratings spectrum.

The Thornburg Strategic Income Fund even has a small allocation to equity securities. While the Thornburg Investment Income Builder Fund has a mandate for growing income, the Strategic Income Fund is searching for high but sustainable income. As such, the occasional “bond-like equity,” which exhibits little growth but terrific income generation, is attractive. While adding equities to

what is primarily a bond fund can add volatility (which we work hard to mitigate), we can find no good reason why we should ignore an asset class that can be another diverse source of cash for the fund.

The Strategic Municipal Income Fund, though of course restricted to bonds that are exempt from federal income taxes, also takes a broader look at the market than a high-yield muni fund might. One example of that investment philosophy is the fund’s holding of Texas Public Financing Agency Revenue Bonds for the IDEA Academy Charter School. Rated BBB by Standard & Poor’s, these bonds are secured by a gross revenue pledge and a mortgage on all the school’s facilities. IDEA has had significant success in the border towns of Texas and a number of their schools have been ranked very highly both nationally and in the state; all 16 schools exceed academic performance standards for students in the state. Pledged revenues cover debt service more than two times, and the schools have been very successful with fund raising efforts, most recently receiving a \$15 million grant from the U.S. Department of Education. The fund bought these tax-exempt bonds at an \$83 dollar price to yield 6.5% and has been adding to the position, even at higher levels.

While many tax-exempt investors would be thrilled with this position, the BBB muni market is not the natural habitat for either high-yield or high-grade funds. As such, the fund has found significant opportunities in that ratings category as evidenced by the holdings.

So, back to the current market environment. There is, indeed, significant uncertainty. The developed world economic outlook is not terrific, with growth below potential despite the fact that we are supposedly in the midst of a recovery. With central banks depressing yields and cash paying zero, it’s easy to overpay for bonds. At the same time, in a slow growth world, income will remain a very large part of investors’ total return.

Thornburg Investment Management has always tried to “go where the value is.” It is a mantra of ours across our funds, regardless of the asset classes in which we invest. The two Strategic Funds are merely examples of that same thought process applied to the large universes of taxable and tax-exempt income. ■

*Before investing, carefully consider the Fund’s investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit [thornburg.com](http://thornburg.com). Read it carefully before investing.*

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

Investments in the Funds carry risks, including possible loss of principal. Bond funds 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. This effect is more pronounced for longer term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Funds invested in mortgage backed securities may bear additional risk. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in equity securities are subject to additional risks, such as greater market fluctuations. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in the Funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

There is no guarantee the funds will meet their objectives.

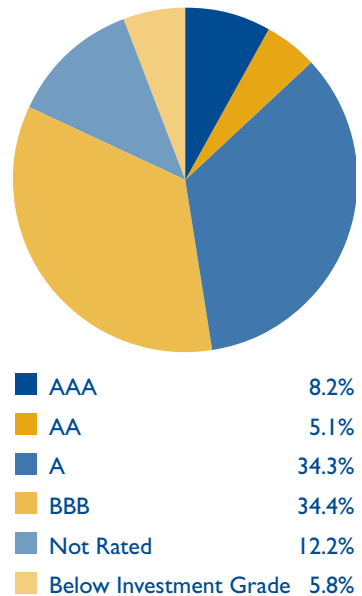
Income from the Strategic Municipal Income Fund may be subject to the Alternative Minimum Tax.

**Asset-backed Security** – A security whose value and income payments are derived from and collateralized (or “backed”) by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

**Bond Credit Ratings** – A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings of AAA (the highest), AA, A, and BBB are investment-grade quality. Ratings of BB, B, CCC, CC, C and D (the lowest) are considered below investment grade, speculative grade, or junk bonds. Unless otherwise noted, the ratings listed are from Bloomberg Market Data and are a combination of ratings from Standard and Poor’s, Moody’s Investors Service, and Fitch Ratings.

**U.S. Treasury Securities** – Securities such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the “full faith and credit” of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

**Thornburg Strategic Municipal Income Fund**  
Credit Quality Ratings as of 12/31/10



We have used ratings from Standard & Poor’s (S&P). Where S&P ratings are not available, we have used Moody’s Investors Service. Where neither rating is available, we have used ratings from Fitch Ratings.