

Role of Fixed Income in Wealth Management Portfolios

Investment Theory

There are many approaches that investors adopt with respect to managing fixed income assets. Some investors are solely focused on maximizing coupon income. These myopic bond buyers pay little or no attention to such variables as credit risk, duration risk, reinvestment risk, or call risk. As long as the issuers make the required bi-annual coupon interest payments and remit the stated principal value at maturity, this class of fixed income investor ignores such concepts such as temporal total return or risk-adjusted returns. These less sophisticated buyers are often pejoratively referred to as “retail” accounts.

Alternatively, there exists a second class of fixed income investors who recognize that bond investing is much more complicated than it may appear to be on the surface. These people readily admit that they lack sufficient expertise in this area and seek the help of professional management services. These individuals typically opt to delegate the bond selection process to a mutual fund portfolio manager. While this approach improves the risk/return characteristics of their fixed income assets, it unfortunately ignores the interrelationship of the bond portfolio with other assets owned by the investor.

A third class of investor also acknowledges that they have neither the time nor the knowledge to manage their assets in the most effective manner. Their decision to retain a professional money manager, such as LaSalle Bank, to craft asset allocation strategies utilizing sophisticated modeling techniques will provide long-term benefits. This is because the asset allocation models look beyond simplistic current yield statistics when purchasing bonds and instead explore how the prospective purchases will interact with the other holdings in the account under various economic scenarios.

To put things in perspective, it may help to recall the investment landscape prior to 1952. At that time investors focused their energy on identifying the risk and reward characteristics of individual securities, be they stocks, bonds, real estate, precious metals, or whatever. As a consequence, investors tended to assemble portfolios of securities which individually had attractive risk-reward characteristics. Aggressive investors had a heavy dose of equities, as it was widely recognized that stocks have greater long term expected returns compared to high quality fixed income securities. Fixed income assets were sought by more conservative savers because their prices were much more stable.

In 1952 Harry Markowitz challenged investors to look beyond simple measures of expected values and standard deviation at the individual security level. In a paper entitled “Portfolio Selection” (first published in the *Journal of Finance*), he advocated incorporating correlation measures into the decision-making process. In laying the foundation for the Modern Portfolio Theory (MPT), Markowitz stressed the importance of the role played by diversification. Out of the entire universe of possible portfolios, he postulated that certain ones will optimally balance risk and reward. Markowitz termed these portfolios the “efficient frontier”. See Figure 1 for a graphical representation of the efficient frontier.

The underlying rationale for the MPT is that the performance of different asset classes varies over the course of the business cycle. For example, large capitalization equities tend to produce healthy returns when the economy is growing briskly and corporate profits are strong. Conversely, high quality bonds (U.S. Treasuries, U.S. Government Agencies, and Investment Grade Corporate bonds) tend to outperform in a weak

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economy that is characterized by low credit demand and subdued inflation pressures. **The relatively low correlation coefficient between equities and high quality bonds argues for a blending of the two asset classes to smooth out returns. The diversification benefits of high quality fixed income securities is the foremost reason why the Corporate Bond Working List for LaSalle Bank is restricted to top tier corporate issuers.**

The correlation between equities and below-investment grade bonds is much higher than that of equities and high quality debt. The same factors that negatively impact the stock market (poor corporate earnings, weak economic outlook, etc.) tend to also hurt the performance of the high-yield debt market. This severely limits their diversification potential.

Investment Practice

The debt of the Big Two auto manufacturers is no longer considered “investment grade” by the fixed income community. Although none of the major rating agencies (S&P, Moody’s and Fitch) have officially demoted their debt to high yield status (BB+ and below), the yields on their bonds already trade as if they were in fact part of the “junk bond” universe. The higher yields offered on the debt of General Motors and Ford reflects the market’s lack of confidence in their ability to withstand an economic shock. **In our view, if the economy was to unexpectedly slip into a recession and the stock market posted losses, investment portfolios would not be helped by having auto bonds amongst their fixed income holdings.** This would be especially true if the catalyst for the recession was a sustained run-up in fuel prices.

Readers of Phil Mierzwa’s Weekly Yield Commentary have a sense of how volatile the prices of auto paper have been on the secondary market over the past two years. It is not uncommon for their spread to Treasuries to move 40 basis points or more in a single day’s trading session. (See Figures 2 & 3). Consequently, our Wealth Management clients who own these bonds are seeing significant valuation swings on their monthly account statements. This can be disconcerting for our clients who are expecting their fixed income holdings to be the stable part of their portfolio. As a result of these factors, **effective immediately, we are issuing a Sell Rating for all GM and Ford debt maturing in 2010 or later.**

If the root of the domestic automobile manufacturing industry malaise was cyclical in nature, an argument

might be made to “ride out the current storm” and wait for conditions to stabilize. However, in our opinion, the problems affecting the industry are more structural in nature. By some estimates, the annual worldwide automobile production capacity is as much as 24 million units greater than what demand would warrant. This glut of cars and trucks inevitably leads to price wars and hefty rebates, with the resulting pressure on profits. However, under the current set of conditions it is impractical for the Big Two to cut production levels. Our domestic manufacturers are saddled with enormous fixed costs, restrictive labor agreements, and debilitating legacy costs for retirees. Of course, many of their international competitors are struggling as well. While it would arguably make things easier for Ford and General Motors if a few of their foreign competitors exited the business, many will not for jingoistic reasons. For example, both Fiat and Mitsubishi have received government subsidies to stay solvent. Mitsubishi, which lost \$2.1 billion last year on a 37% drop in sales, is about to receive another \$3 billion bailout in an attempt to protect the jobs of its 43,000 employees.

General Motors in particular has a host of problems that hurt its long-run profitability outlook and contributed to the 25% drop in the company’s stock price last year. While the company finished 2004 with a 14.5% global market share, in order to attract buyers it had to offer an average discount of 20.7% off the sticker price of its vehicles. In contrast, the average discount on Honda and Toyota vehicles was only 7.7% during the same period. For you trivia buffs out there, you might be interested to know that General Motors is currently the world’s largest purchaser of health care insurance. Last year it spent \$5.2 billion providing health care benefits to 1.2 million workers, retirees and dependents. Medical costs increases, particularly in prescription drug coverage, more than wiped out the much-ballyhooed tax benefits contained in the Medicare Reform Act which aimed to subsidize corporate drug expenditures. The demographics of GM employees and its retirees continue to hurt cost costing efforts as well, with the company having 2 retirees for every active employee.

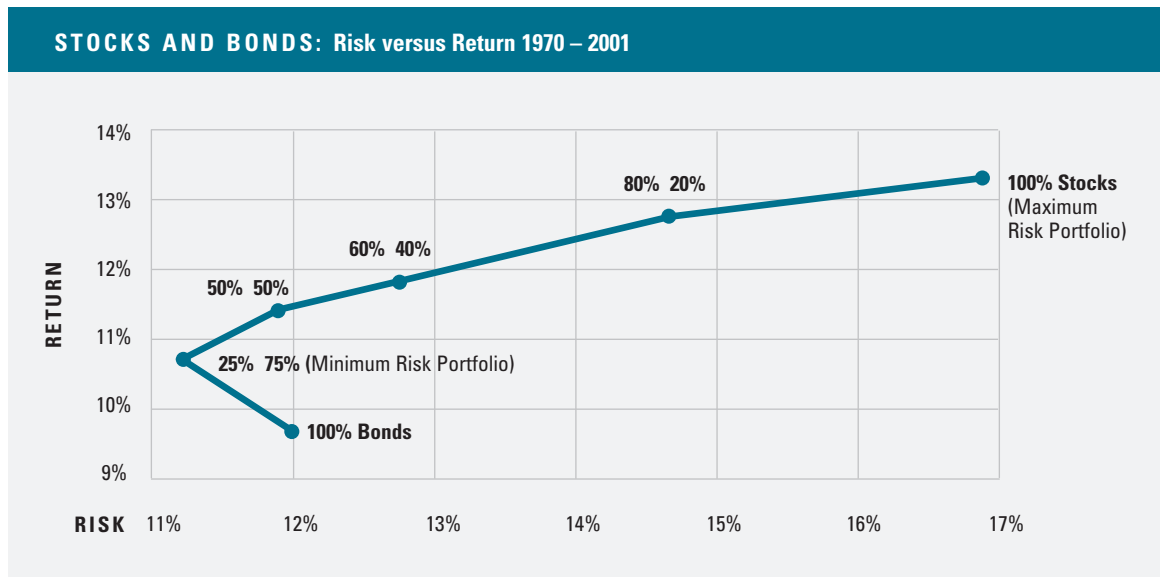
To avoid any confusion, let it be clear that **the Fixed Income Team is not insinuating that we think either of the Big Two is in any danger of defaulting on their debt in the immediate future.** Both companies were profitable in 2004. GM posted earnings (excluding special items) of \$3.6 billion, or \$6.51 per share. It made a profit

sharing contribution of \$195 for each of its UAW hourly employees (down from a peak of \$1,775 in 1999). While some analysts express concerns that General Motors Acceptance Corporation, the company's financing subsidiary, now accounts for 80% of its profits, we view it as a positive that their mortgage and insurance businesses continue to excel. Ford Motor posted similar results, racking up profits of \$3.5 billion (\$1.73 per share), with \$2.9 billion accounted for by Ford Credit.

Despite a successful 2004, the long term outlook for the domestic auto makers is bleak. Until the industry can find a solution for reining in labor cost and benefits, and the overpopulated industry finds a way to consolidate and reduce capacity, earnings will remain under pressure.

Any correction in their sales could have dire consequences, as Ford and GM are both very highly leveraged. Currently they are the second-and third-largest issuers of debt in the \$2 trillion Lehman Brothers U.S. Credit Index, trailing only General Electric (roughly \$55 billion of Ford bonds and \$51 billion of GM debt are represented in the index). Total debt outstanding for each issuer is well over \$250 billion, which of course far exceeds the value of their common stock. Continued price volatility of Ford and General Motor's debt, coupled with the possibility that these issuers may officially lose their investment grade status, makes these bonds unsuitable for the typical trust account.

Figure 1



Risk is measured by standard deviation. Return is measured by arithmetic mean. Risk and return are based on annual data over the period 1970-2001. Portfolios presented are based on Modern Portfolio Theory.

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Figure 2

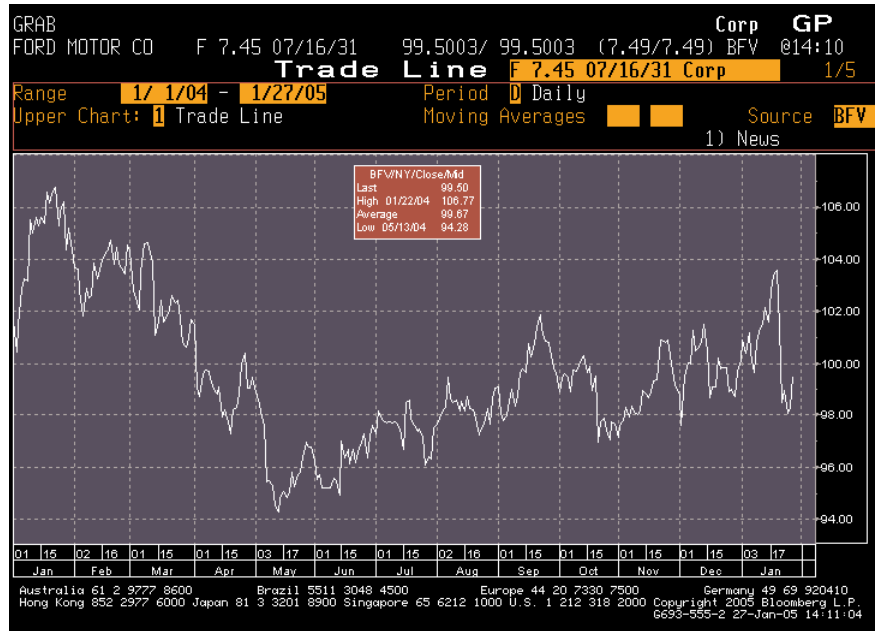
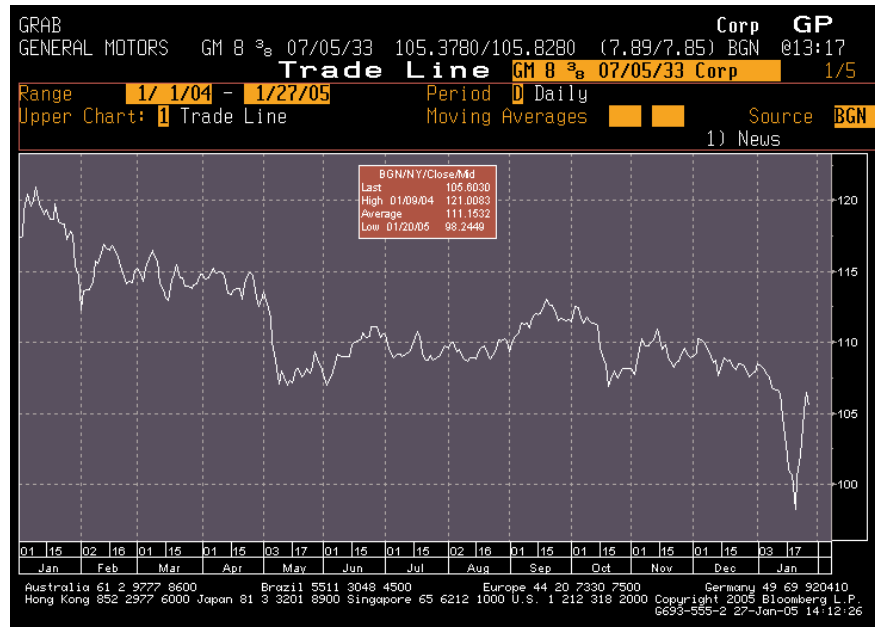


Figure 3



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