



Reinhart Partners, Inc.
Registered Investment Advisor

Active Bond Management In a Rising Rate Environment

February 2011

Reinhart Fixed Income Philosophy

High quality investment grade fixed income portfolios

Duration similar to that of the benchmark

Well structured portfolios with predictable cash flows

Emphasis on liquidity

Consistent performance

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Total Rate of Return

The Prospect of Rising Interest Rates

How quickly sentiment can change. In early 2010, the conventional wisdom was that the economic recovery had taken hold and interest rates were poised to rise. Then, the European debt crisis hit and talk of a double dip recession and deflation drove rates back toward historically low levels. Bonds rallied. More recently, what seems to be a sustained economic recovery and fear of an overly accommodative Federal Reserve have caused interest rates to rise resulting in a tough fourth quarter for fixed income investments.

The past year has shown the difficulty in predicting short term moves in rates. Though the timing may be uncertain, it is likely that rates will have to rise from these still low levels. However, it is simplistic to just state that rates are going higher. A more nuanced approach is to ask which rates are going higher and by how much.

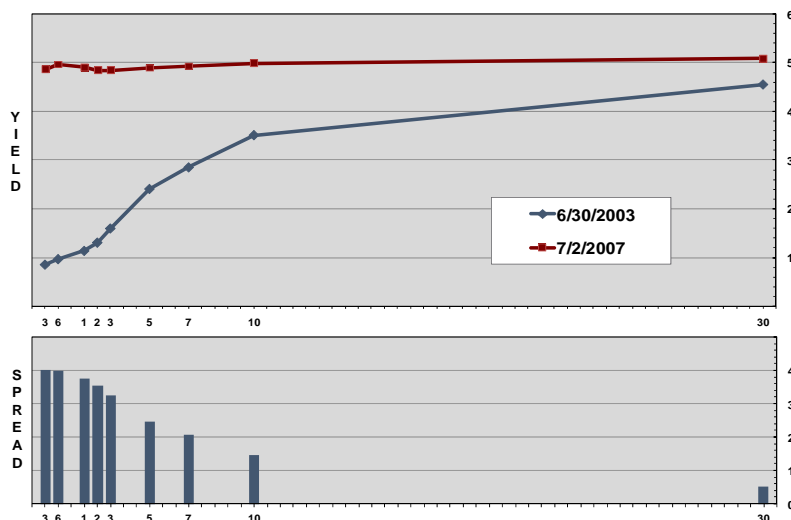
Like most market participants, we expect short-term rates to rise fairly dramatically once the Fed begins reversing its extremely accommodative monetary policy. Our outlook for longer rates is less threatening. Though we do expect long rates to rise, that move will be muted compared to the short end of the

yield curve. The rise in rates that followed the last recession took nearly four years to play out and, as the chart below shows, the move in short rates was far more dramatic than in longer maturities.

Our intermediate-term estimate is that 4.5% is fair value on the 10 Year Treasury, up from its current yield of 3.50%. This target assumes 2.0% to 2.5% GDP growth and 2.0% to 2.5% core inflation. For rates to move much higher than 4.5%, our estimate of GDP growth or inflation expectations must be too low. Unfortunately, we struggle to come up with a scenario in which the economy surprises us materially on the high side, especially with high unemployment and Government stimulus waning.

We could be too conservative in our estimate of inflation expectations. There is well founded fear that extremely loose monetary and fiscal policies have set this country up for a period of runaway inflation. We doubt the ability of the Fed and Congress to do all that it will take to keep domestic inflation under control. Still, in the intermediate term, it is unlikely that a fragile economy saddled with low capacity utilization and stubbornly high unemployment will generate a sustained pickup in the core inflation measures.

Historical Yield Curve
June 2003 vs. July 2007



Source: Bloomberg

Managing Risk Yields Rewards

Reinhart Partners adds value through the opportunistic management of exposure to credit risk, interest rate risk, structure risk & liquidity risk.

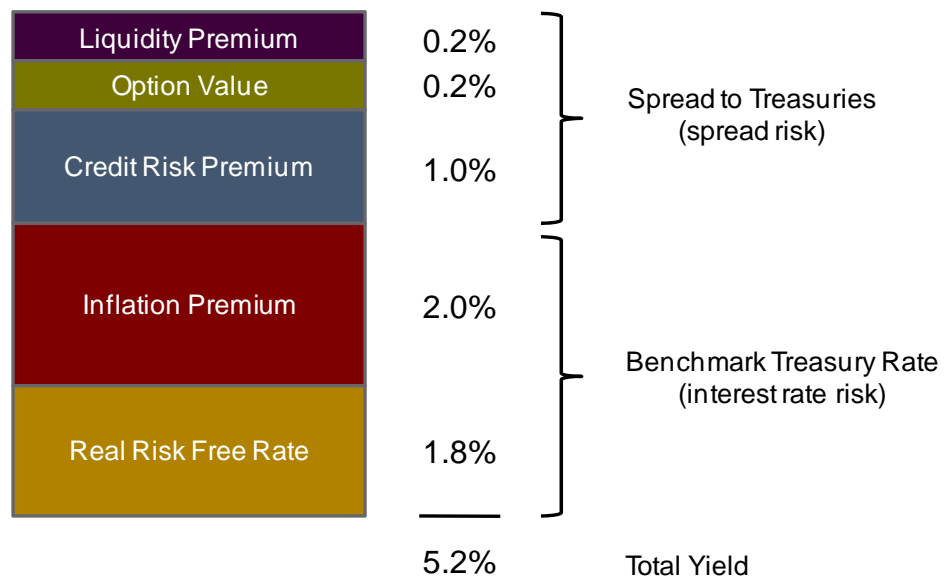
Though we believe many investors are too fearful of the prospect of rising rates, we do not think investors will be rewarded for taking on excessive interest rate risk. However, taking on interest rate risk is not the only source of return in a fixed income security or portfolio. Investors are also paid a premium for taking on credit, structure and liquidity risk.

The yield to maturity of a bond is simply the accumulation of the various risk premiums embedded in the security. To understand the risk/reward characteristics of a bond, it is necessary to dissect their various sources. Reinhart Partners breaks risk premiums into two broad categories: 1) interest rate risk, which consists of exposure to changes in the real risk-free rate and inflation expectations, and 2) spread risk, which consists of exposure to credit, structure/option risk (embedded calls, sinks, puts and prepayments) and liquidity risk.

In most market environments, performance that is driven by interest rate risk and spread risk are inversely related. For example, we would expect that if the economy continues to recover, interest rates will rise leading to negative performance for bonds. However, at the same time, we would expect spread risk to contribute positively to returns as credit, structure and liquidity premiums shrink. This would help offset the negative impact of higher rates.

If an investor believes that a recovering economy will lead to higher interest rates, they might hedge their fixed income investments by taking on some spread risk. Remember, in a rising rate environment, yield is your friend.

Risk Premiums

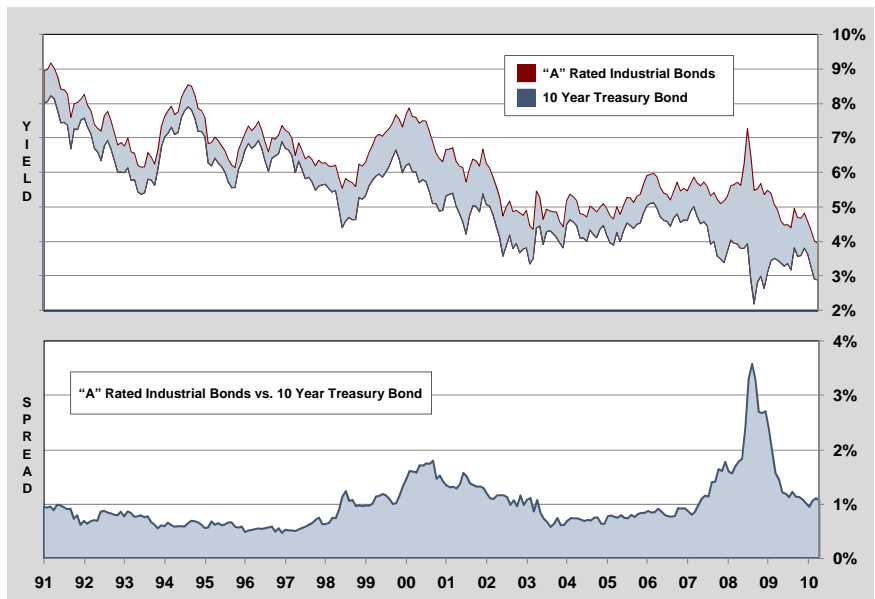


Fair Value In Uncertain Times

Now that we have dissected interest rate risk, what about credit risk? We keep hearing that credit spreads (the extra yield an investor receives over a similar maturity Treasury bond as compensation for taking on credit risk) are too tight and that there is no longer value in high quality corporate bonds.

The chart to the right shows historic yield spreads between the 10 Year Treasury and an index of 10 Year "A" rated industrial bonds. Although spreads have come in dramatically from their all time high of early 2009, they are just back to their longer-term mean. In our opinion, this indicates that although the easy money in the spread sectors has been made, investment grade corporate bonds are not expensive. We believe that they are fairly valued and if the economy continues to recover, credit spreads will eventually move tight of the mean.

10 Year Treasury vs. Index of "A" Rated Industrial Bonds
1991 - Present



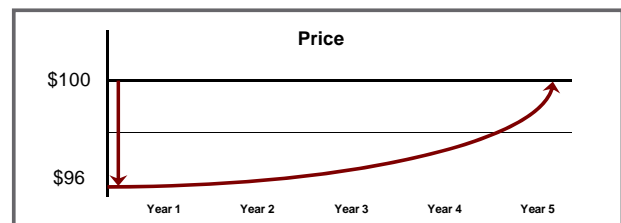
Source: Bloomberg

Have You Really Lost Money?

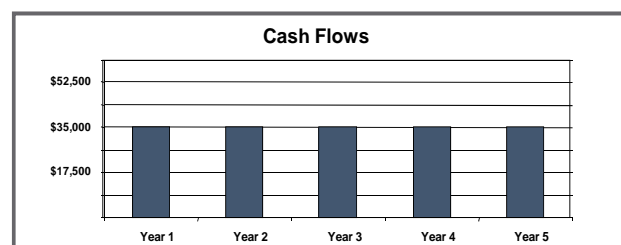
Even with spread risk premiums falling, is it possible that investors will see negative total returns in a rising rate environment? This will happen if interest rates are rising faster than spreads are contracting. But has the investor really lost money?

The accompanying charts show what would happen (approximately) if the yield on a \$1mm, 5 year, 3.5% coupon bond were to instantaneously rise from 3.5% to 4.5%, a 1% rise in rates. The investor would see the price of their bond fall by about 4% (from \$100 to \$96). With a coupon yield of 3.5%, the total return in year one would be a negative 0.5% (3.5% coupon income less the 4.0% capital loss). Though there is a paper loss, what is the impact on the client's cash flows?

Although a non-cash, mark-to-market loss occurred, cash payments equal to 3.5% of the par value of the bond will be deposited in the client's account that first year. The same will happen in years 2-5. At the end of 5 years, the client gets the par value of the bond back. Therefore, as the bond approaches maturity, its market price must return to \$100.



An investor can look at this bond as one that lost them 0.5% as soon as they bought it. Alternatively, he or she can take relief that, despite a short-term negative total return, the real return on this bond, if held to maturity, is 3.5% per year for the next 5 years. A patient investor can ignore short-term price volatility. After all, bonds mature at par.



Four Things to Remember

Below are four key points to remember about Reinhart's fixed income strategy:

- **High Quality** - Our strategy is conservative - bonds are there for you when equities are not.
- **Opportunistic** - We move ONLY when it adds value to the portfolio.
- **Transparent** - Our portfolios are easily understood and the holdings are well known.
- **Research Intensive** - We take the time and commit the resources to understand potential causes of financial distress for each investment we make.

Founded in 1991, Reinhart Partners is a Mequon, Wisconsin based investment advisor with over \$3 billion under management. We have a talented team of professionals dedicated to one goal - to exceed our clients' investment objectives through the active management of equity and fixed income portfolios.

Our founding principles:

- Build a firm around strong products and superior client service.
- Know our clients - we will understand each client's objectives and our clients will have access to the decision makers on their portfolios.
- Hire talented people, with larger firm experience, who want to apply their skills at a more personal level.
- Make key employees partners in the success of our firm.
- Develop a culture that makes Reinhart Partners a rewarding place to work and a firm with whom clients want to do business.



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