

**"SELL WHEN YOU CAN, YOU ARE NOT FOR ALL MARKETS."**

Shakespeare: As You Like It, Act III

Wise advice given by the bard from Avon over 400 years ago. For a man who never owned a bond, he had a deep understanding of our market.

These days, a day does not pass without a client asking, "is it time to sell my bonds?". Interest rates are near historic lows and cannot decline much further. Our deficit continues to rise. Unrealized profits abound in most bond portfolios; paper profits that will begin to disappear when interest rates begin to rise. The question, then, is a good one!

So, why not sell all your bonds now?

Like Shakespeare, we believe in the "sell when you can" approach; *Selectively* selling certain bond investments to take advantage of a situation in order to improve the portfolio.

We are not, however, advocates of the "sell all your bonds before interest rates rise" approach. And here's why:

- 1.) It is costly to you. Unnecessary transaction costs are the bane of good bond portfolio performance. A key to our excellent performance numbers over the years is that we keep transaction costs low.
- 2.) It assumes you know exactly when its time to sell (or buy). As an example, many people thought interest rates would rise in 2003 and kept their funds in money markets. This proved to be a costly mistake.
- 3.) Most of our clients own bonds for income and not capital gains. In these cases, trying to exactly time the interest rate cycle does not make any sense. These portfolios generate income continuously. Rising rates will not damage income flow. It is a constant ...you can count on it! In fact, the reinvestment of interest payments in a rising market helps increase the income flow.

Over one year ago we altered our portfolio management tactics in an effort to meet the challenge of a rising rate scenario. We tweaked and continue to tweak portfolios to improve performance and to protect, as best we can, against the anticipated market move. We believe interest rates probably will increase in the next year. We will remain alert and sensitive to the ongoing challenge of rising interest rates.

*Importantly*, however, we did not address the rising rate risk through the liquidation of entire portfolios nor did we reconstruct portfolios solely for the sake of establishing capital gains. We recommended that clients hold onto high yielding 8, 10, 15 year bonds. We did not sell a bond from a portfolio unless a market deficiency enabled us to exchange the sold bond with a replacement that improved the portfolio. This approach has proven to be correct as our client portfolios appreciated again in 2003.

We will not deviate from that approach now and succumb to the notion that now is the time to sell **All** bonds.

So What Should One Do?

Long Maturity Bonds .... Handle With Care

We protect against significant decline in portfolio value by recommending an avoidance of too many long-term bonds.

- 1.) While always important, a rising interest rate scenario makes portfolio duration analyses and average maturity considerations critical calculations in our portfolio research and management process.
- 2.) Adherence to the laddered portfolio principle continues to be a most important consideration, especially in a rising rate market.
- 3.) Lastly, *active* management of the portfolio helps our clients avoid harmful decisions that have the potential of being detrimental to the portfolio over the long term.

“Its About Minimizing Risks in all Types of Markets”

Our goal is to manage the entire portfolio in order to minimize risk. Sound portfolio management means the avoidance of what we term “knee-jerk reaction investing”. Many investors did just this in July and August when bond yields exploded. They sold out of high-income bonds, reinvested in short term/no return paper and found that by year-end, the summer sell-off was premature. Now, after paying capital gains taxes for the privilege of “playing the interest rate market” game, they are rewarded with having to play the game again. This time around the question and the *risk* concerns re-investment timing.

As mentioned previously, those who sold wholesale made a big mistake and their portfolios continue to underperform. Add to this the creation of another situation forcing the consideration of market timing for the re-investment of funds accumulated through the earlier sales ... *the re-investment will be a risk and there will be new costs involved! The same kind of risk (plus costs) the investor was trying to avoid when bonds were sold!* We can rephrase Shakespeare’s “sell when you can” into “buy if you must”. Perhaps this time their market timing may be on the mark! Perhaps!

Selectivity and Portfolio Improvement

As mentioned earlier, we do recommend selective trading when opportunities present themselves to increase portfolio total return. Here are two recent trades that realized nice gains for our clients:

**Client Sells**

<u>Rating</u>	<u>Amount</u>	<u>Description</u>	<u>Coup.</u>	<u>Maty.</u>	<u>Bid</u>	<u>Yield (%)</u>	<u>Principal</u>	<u>Principal &amp; Interest</u>	<u>Annual Cash Flow</u>	<u>Gain (Loss)</u>
Aaa	\$100,000	Bensenville UTGO's Call 12/30/11 @ 100 YTC 4.309%	4.8%	12/30/15	103.35	4.44%	103,350	100,856.67	4,800	4,100
	<u>\$100,000</u>	<u>Weighted Avg. Maty. (Yrs)</u>		<u>12.19</u>		<u>4.44%</u>	<u>103,350</u>	<u>100,856.67</u>	<u>4,800</u>	<u>4,100</u>

<b>Client Buys</b>
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<u>Rating</u>	<u>Amount</u>	<u>Description</u>	<u>Coup.</u>	<u>Maty.</u>	<u>Offer</u>	<u>Yield (%)</u>	<u>Principal</u>	<u>Principal &amp; Interest</u>	<u>Annual Cash Flow</u>
Fitch A-	\$100,000	Round Lake, IL Debt Certificates Call 1/01/13 @ 100	4.85%	1/1/14	100.00	4.850%	100,000	100,282.92	4,850.00
	<u>\$100,000</u>	Weighted Avg. Maty (Yrs)		<u>10.20</u>		<u>4.850%</u>	<u>100,000</u>	<u>100,282.92</u>	<u>4,850.00</u>

**Result of swap**

<u>Par Amount:</u>	Same
<u>Cash Flow Gain</u>	50.00
<u>Tax Gain/(Loss)</u>	4,100.00
<u>Cash result</u>	Principal Received back or (Contributed) 3,350.00 Net of Principal & Accrued Interest receive back or (Contributed) 4,573.75
<u>Maturity</u>	Decreased by 1.99 years

In this swap, a long-term gain of \$4,100 is realized. The total return on this investment exceeds 9%. The swap was completed to realize this gain 13 months after purchase date and to shorten maturity and lower duration (volatility) in anticipation of higher interest rates.

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NR	\$140,000	Bratenahl, OH LTGO's Yield to Call 2006 @ 3.108%	5.875%	12/1/16	109.279	4.891%	152,991	154,475.67	6,518.76	5,139
	<u>\$140,000</u>	Weighted Avg. Maty (Yrs)		<u>12.83</u>		<u>4.89%</u>	<u>152,991</u>	<u>154,475.67</u>	<u>6,518.76</u>	<u>5,139</u>

This is a straight sale that realizes a \$5,139 gain and produces a total return of approximately 7.5% in 11 months. Why did we sell? Because on 2/3/2004 an anonymous dealer bid a price of 109.279 for this bond. For some reason, an investor "paid up" for the bond. Recalling Shakespeare's maxim, we sold.

We hope this is helpful. Please call us with your comments and questions.

Sincerely,  
Bernardi Securities, Inc.  
February 2004

\*P.S. Please visit us at [www.bernardisecurities.com](http://www.bernardisecurities.com) for market updates and more details on our 2003 performance.