



In most years, it is difficult to make distinctions among bond managers. Too often, investors try to find the manager who offers the highest current yield. This often leads managers to take additional risks, extend maturities, or use leverage in hopes of generating a little extra yield to help them stand out from the pack.

Worse yet, many managers try to deter clients from investing in “boring” high-quality bonds because they have a better (usually more expensive) alternative. Generically referred to as fixed income substitutes, they include preferred stocks, asset-backed securities, high dividend paying stocks, and leveraged bond funds. The common denominator is that they offer more income, but are supposedly “safe”.

And there are other managers who encourage investors to abandon bonds altogether because they believe they can divide the assets into many different “buckets” (perhaps they call them “style boxes”). They claim that their models can provide adequate diversification without bonds – that these buckets do not move in the same direction at the same time. Put another way, these managers believe they can diversify away the risk without having to invest in those boring old bonds at all.

Warren Buffett has said that “it’s not until the tide rolls out that you can tell who is swimming naked.” It is safe to say that there were many bond managers who were skinny dipping in 2008. In contrast, we stuck with high quality bonds, did not extend maturities, and avoided asset-backed securities and leverage. As a result the bonds managed at Kovitz Investment Group in Calendar Year 2008 earned over 4% after fees when, according to Lipper and Morningstar, the average bond manager lost money.

The lessons learned in 2008 and the virtues of staying focused on true asset class diversification will remain relevant for years to come. Investors who take this to heart will avoid getting distracted by Wall Street’s next fixed income substitute.

If you have more than \$500,000 to invest, and would like to talk about how we can customize a bond portfolio to your credit quality, duration, state and tax parameters, please call us at 312-334-7300 or visit our website at www.kovitzinvestment.com.

The indicated investment returns represent all client accounts that held fixed income securities during the relevant periods (as measured monthly, based on accounts that held fixed income securities at the end of each month). This represents 34% of accounts and 35% of assets for 2008; 37% of accounts and 36% of assets for 2007; 38% of accounts and 37% of assets for 2006; 40% of accounts and 37% of assets for 2005; and 41% of accounts and 43% of assets for 2004. Fixed income investments in such accounts include federally taxable and tax-free securities. “Tax-free” securities include municipal bonds, and “Taxable” investments include U.S. Federal government and agency, taxable municipal, and corporate bonds. Investment returns for federally taxable bonds are included on a pre-tax basis. KIG’s standard fixed income fee schedule is as follows: ½ of 1% of fixed income assets up to \$5 million, and 3/8 of 1% of fixed income assets over \$5 million, and is a negotiable rate. KIG compares its fixed income performance to the Lipper Intermediate Term Municipal Index, and the Barclays Capital Intermediate U.S. Credit Index, which KIG believes are appropriate benchmarks, considering the characteristics of the indices (such as average maturity, duration, and credit quality). The performance of these benchmarks in 2008 was -2.3% and -2.8% respectively. The performance of these indices does not include deductions for transaction costs, management fees or other fees, and assumes reinvestment of income into the indices. Past performance is not an indication of, and does not guarantee future results. Securities investments are subject to risk and may lose value.