

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## A Deep Value Approach to Fixed Income



**LINDA NIEMELA WILLIAMS** is the director of fixed income investments at Lowry Hill. Her responsibilities include overseeing the firm's fixed income strategy, trading, monitoring developments in the bond market, and making recommendations to other Lowry Hill investment professionals. Linda has specialized in fixed income securities since 1984 and has traded municipal, corporate, mortgage-backed, government, and agency bonds for three broker-dealers during her career. Previously, she was senior vice president and manager of the municipal and unit investment trust trading desks at John G. Kinnard & Co., a regional broker-dealer. Her experience has included underwriting municipal bond issues throughout the Midwest, managing the company's bond inventory, marketing bonds to the

brokerage sales force, and providing training and continuing education in fixed income securities. Linda has a master's degree in business communication from the University of St. Thomas Graduate School of Business in St. Paul, Minnesota, and a bachelor's degree in speech-communication from the University of Minnesota. She has served as the secretary and board member of the Minnesota Institute of Public Finance, a lobbying and educational organization serving the Minnesota municipal bond community. She is also a member of the Twin City Bond Club. Linda was recently named an "Alumnus of Notable Achievement" by the University of Minnesota's College of Liberal Arts.

**TWST:** Would you begin with a brief overview of Lowry Hill and your responsibilities with fixed income?

**Ms. Williams:** Lowry Hill is a private asset management firm, established in 1986. We work primarily with families and foundations and require a minimum of \$10 million in investable assets. Our assets under management are approximately five billion dollars, and of that, roughly one billion dollars are in fixed income. I am the director of fixed income investments and have been with Lowry Hill for 10 years. I have been in the fixed-income business for a total of 26 years and have traded municipals, Treasuries, agencies, corporates and mortgage-backed products. However, my specialty is municipal bonds. At Lowry Hill, we have an individualized focus for our fixed income accounts, buying bonds that fit the clients' individual needs or the needs of their foundations.

**TWST:** Do you customize the fixed income assets in every client portfolio?

**Ms. Williams:** Yes. We look at each client's needs for income, state of residence, whether or not tax-free income is needed, etc. We buy individual securities in each client's account based on those needs.

**TWST:** Do you have a top-down macro approach before you start to select securities?

**Ms. Williams:** We view the fixed income portion of the account as the stability piece, so we focus on high-quality, low-risk investments. We purchase high-grade municipal bonds, Treasuries, agencies and corporates. In general, we try to stay relatively short, mainly because of the low interest rates in the current environment. From there, it's individual security selection based on what is most attractive in each sector of the market.

**TWST: What are the investment criteria that you'd specifically look for in the various fixed-income assets?**

**Ms. Williams:** The first criterion is that of credit quality. We typically buy securities rated "A" or better. We also conduct our own analysis of the credit, independent of the bond rating. We look at maturity, call features, premium or discount, and of course, yields to call and maturity. Although we often buy bonds that carry bond insurance, we still require the underlying credit to meet our minimum standards on its own. That is something we paid attention to even before the municipal bond insurers got into trouble.

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When analyzing credits, we look at the issuer's financial statements to determine a municipality's amount of outstanding debt, whether or not pensions and other benefits are funded, the kind of general fund balances that exist, and so on. We typically buy general obligation bonds for which the municipality pledges their full faith and credit, or essential purpose revenue bonds such as water and sewer bonds.

**TWST: What about the yield spreads?**

**Ms. Williams:** What makes sense for a client's account is dependent on which products provide the best value at that point in time. Treasuries have been very expensive for quite

been when spreads were wider.

We buy only high-grade names, thereby limiting the selection pool. This is particularly true in the corporate market, where strong demand is exacerbating the selection process by inflating prices. We have found that agencies and taxable municipals have been a better value than corporates. Earlier this year, municipals got quite expensive (when compared to Treasuries), and were trading at a low percentage of Treasuries. If the client wasn't in the highest tax bracket, there were times when it just didn't pay for him or her to buy a municipal versus agencies or another product.

Conversely, back in the fall of 2008, when everyone was afraid of everything, municipals got tremendously cheap when compared to every other product. For individual accounts we bought quite a large number of municipals at very favorable prices because other people were nervous or had to sell what was liquid. That happened to be municipals at that time.

**TWST: What about the agencies? You mentioned you had exposure to agencies.**

**Ms. Williams:** We do buy a fair amount of agencies. We have typically bought more of the state-tax exempt names like Federal Home Loan Bank and Federal Farm

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some time. Consequently, we've focused primarily on agency bonds for accounts that need taxable income. At times, corporates have been more attractive than agencies. Recently, that hasn't been the case. After the financial crisis eased and credit spreads narrowed, corporates weren't as compelling as they had

Credit. We own some **Fannie Mae** (FNM) and **Freddie Mac** (FRE) debentures, but we never bought any mortgage-backed product. A large number of our purchases have been callable agencies, which typically have yields closer to corporate bonds. We often ladder the call dates in addition to laddering

the maturities in client accounts to avoid having all the bonds called at one time.

**TWST: Why are you wary of the corporates? Is it because they've become so fully valued?**

**Ms. Williams:** I just think they are expensive for the risk profile. There is also a lack of names that are "A" or better.

a difference there can be in bid prices. We can put a bond out for the bid among our network; among 10 different firms that bid on that particular bond, we may have a range in price of three points or more. I think a lot of people hope that the bond market is more efficient than the reality that it is just an over-the-counter market in which you have to work hard to find the best price. We're trying

*"We do monitor our holdings for erosion of credit quality and will sell positions if we're concerned about what's happening with the underlying credit. We pay attention to municipal news and changes in rating, acting on any credit concerns that arise."*

Many of the available names that are rated "A" or better are financial companies. During the financial crisis when everyone was unsure about who was in need of TARP and what kind of shape the banks and the financial companies were in, spreads were attractive. Yet it was also a time where there were just too many uncertainties. We didn't want so much exposure to one sector. Now that spreads have narrowed, we feel we can do better buying agencies or buying taxable municipals.

**TWST: What about the valuation metrics of the different bonds and the yields? Specifically, could you discuss the individual bond selection within sectors determined by yield to call date, yield to maturity, and so on?**

**Ms. Williams:** Some people would say it's a detriment that any bond is worth whatever someone on the other side is willing to pay for it, but it's a benefit for those that are able to analyze credits and find bonds that might be mispriced. At times, whoever is offering a specific bond may not really know the characteristics. Subsequently, we can pick up a bargain because we know more about that bond than the person who is offering it. With respect to our purchases, we work with a network of about 48 different broker-dealer firms. For a given bond, it is shocking to see what

to provide value to our clients by working a fairly large network to find the best available price.

**TWST: It is interesting that you hear all the time about inefficiencies in the equities markets, but rarely about the inefficiencies in the bond market.**

**Ms. Williams:** Yes, many sectors of the bond market are much less efficient than the stock market. The Treasury market certainly isn't worse. That's a market where the price is not going to differ much from firm to firm, perhaps only one-thirty-second in price. However, when things were at their worst in the municipal market, and even the corporate market, over the last couple of years, dealers just didn't want to add inventory. As a result, the price differential from firm to firm was huge, and it was very difficult to get a good bid. Then, as investors saw how bad the quotes were, they got even more nervous that there may have been a fundamental problem and not just a liquidity or pricing problem. A lot of firms

and individuals sold bonds at fire-sale prices when there really weren't the fundamental problems that people thought existed.

**TWST: Do any clients want you to invest in high-yield bonds?**

#### Highlights

*Linda Niemela Williams focuses on high-quality, low-risk fixed income investments. She purchases high-grade municipal bonds, Treasuries, agencies and corporates. She says that agencies and taxable municipals have been a better value than corporates. She has focused on agency bonds for accounts that need taxable income. She is a long-term investor who tries to make good purchase decisions based on value, not a short-term search for a quick profit. At times she has swapped out low-coupon bonds and reinvested at higher market rates. All decisions are based on whether a client can use the tax loss, available bonds for reinvestment, etc. The biggest differentiating factor is the credit work she does, analyzing the financial statements of the individual credits and making decisions based on that information, rather than relying only on ratings. She buys only the high-quality bonds and doesn't take a lot of risk, which she considers better for the client than chasing the hot topic of the day.*

**Ms. Williams:** We get that request from time to time, but that is just not a market that we have felt is worth pursuing. As we have seen on numerous occasions, market participants have not done a great job properly evaluating risk. We typically don't see enough value offered for the risk one is implicitly assuming for buying most high-yield credits. Furthermore, stretching for yield

*"The main issue now is the concern with credit quality. We are already buying high-quality names, and we continue to monitor them on a regular basis. The biggest risk is what's out there that we don't know about. Financial statements are backward-looking, and we do monitor current municipal news. Still, there may be events that we are unable to anticipate."*

with riskier securities goes against our philosophy that the bond money should provide the "ballast" for our portfolios. Because we are already accepting some volatility on the equity side, we choose not to double up on it by taking it on the bond side, too.

**TWST: What about international bond investing? Have you looked at that area?**

**Ms. Williams:** Yes, we've looked at it many, many times. We always end up coming to the same conclusion. Inefficiencies on pricing that I mentioned earlier are even more pronounced for international bonds. You have to buy very large-sized

*"The biggest differentiating factor would be the credit work that we do, where we are analyzing the financial statements of these individual credits and making a determination based on that information rather than relying only on the ratings. I believe another difference is that we are not trying to be everything for everyone. Our strategy is to buy high-quality bonds, and we don't take a lot of risk on the fixed income portion of our portfolio."*

blocks to get any kind of fair pricing, and the liquidity is very poor. While much has been written and spoken about on this topic—including much table pounding on the financial news channels—the liquidity hasn't been there when it's been really imperative. Again, this would compound the potential risk and variability in a portion of our portfolios where we are seeking stability. We have an international equity model, so our clients are exposed to other currencies and other international businesses through that model. Even though investors may have an interest in international bonds, that's just not a market in which we've chosen to participate.

**TWST: Another aspect of bond investing has been the surge in ETFs. What are your views on them?**

**Ms. Williams:** There seems to be one for every type of product you'd ever want. At Lowry Hill, we are dealing with clients who have large portfolios and a fairly large amount to invest. We can provide enough diversification by buying individual

bonds instead of ETFs. We then also have the control of buying specific maturity dates and the decision-making ability regarding whether or not to sell prior to maturity.

If you're buying ETFs or the bond funds, the manager of those funds is the one making those decisions. If you buy a bond at today's interest rate and choose to hold it to maturity, regardless of what interest rates do, you would still get your par value back. If you're investing in a fund, and the fund manager chooses to realize losses when rates rise, you would have some erosion of principal.

**TWST: What is your firm's sell discipline?**

**Ms. Williams:** Our sell discipline is dependent on the individual accounts. In general, we are long-term investors, trying to make good purchase decisions based on value, not short-term investors looking for a quick profit. At times, we have swapped out low-coupon bonds and reinvested at higher market rates. Those decisions are based on whether the client can use the tax loss, available bonds for reinvestment, etc.

We do monitor our holdings for erosion of credit quality and will sell positions if we're concerned about what's happening with the underlying credit. We pay attention to mu-

nicipal news and changes in rating, acting on any credit concerns that arise.

Another example of our sell discipline regards TIPS, (Treasury Inflation Protected Securities). We try to buy those opportunistically in client accounts. We are buying them for the inflation component, but there are times where TIPS have gotten quite cheap. We've then increased our allocation. When the price ran up substantially, we sold a fair amount of those securities. We're not constantly looking to reposition the portfolio, but we do act opportunistically when the situation arises.

**TWST: What happens if the holdings of any particular issue grow too large? Do you have a limit on the size of holdings?**

**Ms. Williams:** We don't really have that problem. For the most part, we are buying small percentages of any given name in a client account. We generally try to stay below 5% per name, so even with price appreciation, we wouldn't typically get to a large enough percentage of the account that we would need to trim a name.

**TWST: You discussed various details regarding your firm's sell discipline, but what are the risk management techniques you can tell us about in the management of fixed income?**

**Ms. Williams:** I think the main issue now is the concern with credit quality. We are already buying high-quality names, and we continue to monitor them on a regular basis. To me, the biggest risk is what's out there that we don't know about. Financial statements are backward-looking, and we do monitor current municipal news. Still, there may be events that we are unable to anticipate. Examples would include **Enron**, which was a highly rated name until just weeks before its bankruptcy. In the cases of fraud, it is almost impossible to foresee a problem.

The concern I have is that there may be one-off situations in which one has no way of knowing the "story" until it hits the news. As far as other overall risks, we do keep our position size relatively small per name. We don't double-up on names by buying several different maturities of the same name. For municipal bond clients in high state-tax states, we try to diversify as much as we can within the state and buy bonds from different areas. We also stagger or ladder the maturities to minimize interest rate risk.

**TWST: What about the macro risks to bond investing, like the interest rate environment and inflation? Do you see any headwinds in the fixed income arena for the rest of the year?**

**Ms. Williams:** The expectation certainly is for higher rates. Of course, that is a concern. Since we try to buy opportunistically,

we bought some longer bonds at very cheap levels in late 2008. More recently, we've been staying quite a bit shorter—typically just buying in the shorter end—because we are concerned about rates rising as we head into next year. I don't know that we will see substantially higher rates by year-end, but I certainly would expect us to see some higher rates. We've been slow to invest money in recent months because the rates have been so low, and it seems there are few good values available. We've seen slightly better yields during the last month, but those opportunities have been short-lived. We don't rush in and buy everything all at once. We also had positioned for inflation to some degree through TIPS and through some of our equity strategies. We also bought a fair amount of step-up agencies, which can be an alternative inflation hedge for some accounts. Step-ups start at a low coupon for a stated period of time and then step to a higher coupon if the bond is not called on the call date.

**TWST: That's interesting. Is that new?**

**Ms. Williams:** They've been around for many years, but issuance tends to vary significantly, depending on interest rates. They were fairly popular a number of years ago when interest rates were lower. There are different structures, some with one-time calls and others with more frequent calls. Some have only one step date while others may start at a lower coupon but step up every six months or so. If you are buying **Fannie** or **Freddie**, they are issued in smaller denominations. Federal Home Loan Bank issues are a minimum of \$100,000. We feel they are an interesting way to provide some inflation component if you are concerned about rising interest rates.

**TWST: What do you think distinguishes your fixed income approach at Lowry Hill from that at other peer companies? What do you feel you bring to the table for your clients that other firms might not?**

**Ms. Williams:** I would say the biggest differentiating factor would be the credit work that we do, where we are analyzing the financial statements of these individual credits and making a determination based on that information rather than relying only on the ratings. I believe another difference is that we are not trying to be everything for everyone. Our strategy is to buy high-quality bonds, and we don't take a lot of risk on the fixed income portion of our portfolio. That's really what we stick to rather than choosing the hot topic of the day and then chasing after it.

**TWST: Is there anything that we didn't touch on that you wish to add?**

**Ms. Williams:** I feel this is a difficult time for many investors because of the concerns highlighted in the news, whether it is pension problems, state budget deficits, lower revenues from lower taxes, etc. Those concerns are greatest for those

that have invested in municipal bonds. Plus, I don't think municipal bonds are very well understood by the general public. It's very difficult to be an individual investor in the municipal bond market and be able to get good information. The MSRB and other industry groups have been trying for many years to get more information to the investing public, but it's tough. It's important for investors to find a broker or money manager that they trust—one who can provide them with good information and good advice.

**TWST: Thank you. (PS)**

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- \* Credit Risk - financial risk that the issuer will not be able to repay the principal upon maturity as promised.
- \* Call Risk - longer-term bonds are usually callable. The bonds may be called before the maturity date if interest rates decrease.
- \* Market Risk - if the bond must be sold before the maturity date, the bond may be worth more or less than the face value depending on interest rate movements.
- \* Inflation Risk - recognizes the value of assets or of income will be eroded as inflation shrinks the value of a country's currency.
- \* Liquidity Risk - some securities are very hard to sell if there is a thin trading market or if the bond is relatively unknown.