

Two Streams of Returns

When developing its strategy, Osterweis Strategic Income Fund, started with the premise of managing money with no restraints. It identified two consecutive cycles, and to capitalize on both of them, the fund emphasized the ability to switch between investment grade and high yield bonds – two asset classes that are usually considered mutually exclusive. The manager Carl Kaufman also believes in equity-like analysis and in going beyond the charts and the quotes.

Q: What is the investment philosophy of your firm?

A: In our investment philosophy, flexibility is a key word. The firm was founded twenty years ago by John Osterweis with the belief that managing money requires maximum flexibility and should not be ruled by style boxes. On the equity side, we believe that growth and value represent a continuum, not separate asset classes. On the fixed income side, flexibility means not only investing in both investment grade and high-yield, but also the ability to be really aggressive on the duration profile when necessary.

Q: How did you come up with this philosophy and why you consider it a better way to manage money?

A: Initially set as an equity shop that manages money for wealthy families, endowments, and non-profit organizations, the firm has always sought out-of-favor companies with a problem that can be fixed, such as a failed acquisition or a failed new product launch. Once the problem is fixed, you get back the cash flow plus the growth premium. The firm had been investing in fixed income in addition to the equity, because if you like the stock, you should like the high yield bonds as well. If there's an improving story, the company should be getting upgrades.

But that wasn't really a strategy so four years ago we decided to come up with a strategy that's based on the idea of managing money with no restraints. We came up with several observations of the fixed income market that guided our philosophy. The first one was that most people don't look for alpha in fixed income because they don't want to take too much risk. They are either investment grade or high yield investors. There's a clear line drawn in the middle, which most investors don't cross, so they stay in their box.

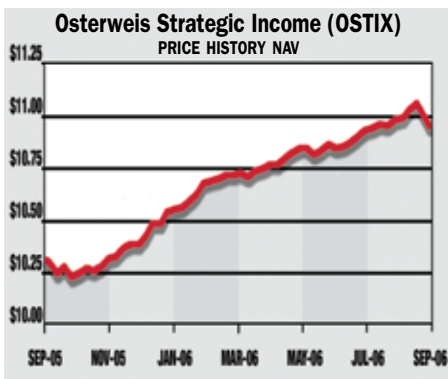
The second observation was that there are two bond market cycles, not just one. The first one is the interest rate cycle, which most investors are familiar with because of its impact on investment grade bonds. Since risk of defaults is low in the investment grade world, interest rates represent the largest variable according to which prices are adjusted. When interest rates are going down and bond prices are going up, that's great.

But what happens when interest rates go up because the economy is strengthening? Bond prices move down and the investment grade manager is limited to managing duration as his only defense. This is the second cycle, the credit cycle, when



CARL KAUFMAN was a senior member of the convertible bond team at Robertson Stephens, prior to joining Osterweis Capital Management in 2002. Prior to that, Kaufman spent nineteen years with Merrill Lynch, in their Institutional Sales office, specializing in convertible and equity sales and trading. Kaufman graduated from Harvard University and attended New York University Graduate School of Business Administration and is a principal of Osterweis Capital Management.

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high yield managers enjoy equity-like returns. The interest rate cycle delivers its best returns when rates are falling and the economy is weakening. By definition, these two cycles can never happen at the same time; they're always consecutive.

So we designed a strategy that enables us to switch between the two when appropriate. In that way we can participate in both cycles and eliminate the negative returns associated with each of those asset classes in the down part of their cycles.

The third thing we noticed was that the transition periods between the cycles can last as long as a couple of years. To manage those transition periods, we decided that instead of looking for the most attractive area in the bond market, we should be looking at the riskiest part to be avoided at any time to eliminate the areas of greatest risk. A perfect example is the period when interest rates were going down to 1%. At that point the risk of interest rates changing direction was very real. We found that the area of greatest risk was the long-term investment grade class because you wouldn't want to have a 30-year Treasury when interest rates start going back up.

As you progress both in the investment grade and in the credit cycles, you find that duration becomes an increasing risk. Obviously, at 6% you want the longest dated portfolio that's practical and as you get lower,

you want to reduce duration. That strategy achieves two things. First, it limits the volatility of the portfolio, which is usually greater at the turning points. Second, it allows an easy transition into the next cycle, which requires a different set of investments. You don't take a hit selling a short-dated bond portfolio, so this is a very elegant solution for managing the transition points.

Q: How that philosophy translates into an investment strategy and process?

A: The first step of the process is deciding where we want to be. Depending on where we think interest rates and the economy are going, we're either in high yield and convertibles, or in investment grade. Typically, we're not going to be in investment grade and high yield at the same time.

The next step is looking at that market in terms of risk management. As we get further into the credit cycle, for example, we'd avoid the more leveraged companies, the riskier credits. We emphasize credit work during the credit cycle, which involves visiting companies and talking to a lot of managements because we believe that adds value. We don't just sit here looking at quotes and talking to brokers.

Then we build the portfolio one bond at a time. We have a rather concentrated portfolio of 35 to 50 names. The idea is to make sure that every name can stand on its own and that we're totally comfortable with its credit metrics and its management. We put the companies through our own hurdles, so we wouldn't simply buy benchmark issues or depend on the rating agencies, who can be slow to react to fundamental changes. We try to buy what we think are the best risk/reward candidates regardless of the universe we're looking at.

Q: What's your strategy for the transition stage that you mentioned?

A: We mostly use duration as a defense. We've found one sector that seems to be very stubborn in terms of negative returns and that's one-to-three year non-investment grade bonds. This sector hasn't had a down year in the last eight or nine years.

I have an explanation although I can't give you any academic research to back it up. The majority of non-investment grade issues typically belong to companies with few pieces of debt and maybe a bank line. My feeling is that nothing gets you as focused as a potential bankruptcy. If you're the manager of a company with one piece of debt outstanding coming due within two or three years, you're incredibly focused on making sure you get that refinanced because the alternative is pretty severe. It may mean bankruptcy so it's an incredibly focusing experience.

Also, when you get into short-term high yield, the volatility of the price is lower than in longer-dated bonds. If there's a credit widening because of a weak economic period, the move is not that big on the shorter end as it is on the longer end.

Q: What's your approach to research? Can give us some examples of ideas that became part of your portfolio?

A: At the firm we have seven senior equity analysts who are all partners and we all look at credits in the same way. Because we play in the convertible market, we all look at the companies in the same way and we're all very collegial and so we have this additional valuable resource and they have us as a resource. It's really the whole team that scouts out new names. As a result of our fixed income work, we've added some names to the equity portfolio and vice versa.

About a year ago we were looking at the nutritional market, which had been very weak, and particularly at General Nutrition. Their problem was

partially related to the industry and partially to the company itself. The industry issue was related to the Atkins craze, a very profitable product that had become a large part of their revenues, about 30%. Unfortunately, when the Atkins craze died out, they were stuck with the inventory.

The company-specific issues had to do with supplier relations and on-time payments. They also had problems with their franchisees in getting them in line with the company's operations. General Nutrition not only manufactures nutritional supplements but also has about 5,000 retail stores of which less than half are franchises. The company-owned units were always doing better than the franchisee operations but the franchisees always thought they knew better.

When talking with management, we discovered that they had hired two new executives especially to take care of the supplier and the franchisee issues and were implementing new incentives and measures. We also discovered that the company had pretty much liquidated the Atkins inventory. Going forward, we expected them to get back to normalized sales. So we estimated that the bonds were trading very cheaply and we took our position. The results in the next two quarters were very positive and continue to this day. Now it's a question of when we decide to exit at this point.

Q: In terms of portfolio construction, what benchmarks do you follow?


A: I don't manage to a benchmark and I pay more attention to what the economy is doing or what interest rates are doing because that affects my portfolio much more than a benchmark. We keep the portfolio relatively concentrated at 35 to 50 names because over 50 bonds are difficult to know well individually. We've been emphasizing short-dated paper over the last year and, currently, effective

duration is between 1.5 and 2 years. Right now about 50% of the portfolio is in short-dated bonds, 20% is in high-yield special situations, and the balance is split in the convertible area between busted convertibles, equity sensitive convertibles, and preferred convertibles.

Q: What kind of risks do you perceive and how do you measure and control them, especially in the current phase of the cycle?

A: The major risk in any credit cycle is the default risk. We control that by focusing on cash flow and by doing extensive due diligence. For example, at the end of 2002, the rates were coming down and there was huge default risk in the telecom area. But due to our focus on cash flow, we did not have any telecom exposure because there was no free cash flow in that industry. We didn't want to be in long-dated investment grade because we felt that the interest rate cycle was near an end.

Also, most of the companies that we're buying have improving fundamentals. We tend to buy things when they're down a bit and with improving fundamentals they hold up better in a down market. Even when they trade down, they usually don't get hit quite as hard as the weaker credits.

And we're not just looking at yields and leverage but also at operations and future potential. Many bond investors aren't looking at the company's prospects as much as they're looking at where they are at that point in time. We do things a little bit differently and I think that helps us. We analyze bonds much like equity analysts analyze companies with the added layer of fixed income and credit metrics. As a firm, we analyze the companies and then decide what the best part of the capital structure is to invest in. 

Osterweis Strategic Income

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Tel. No.	866-236-0050
Inception	8/30/2002

PORTFOLIO

Total Net Assets*	\$64.7
Avg Mkt Cap (\$ Weighted)*	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	86.92%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$5,000
Min Subsequent Investment	\$500
Min Initial IRA Investment	\$1,500

RISK (AGAINST LEHMAN US AGG TR INDEX)

Alpha	0.49
Beta	0.16
R-Squared	0.04
Ann Std Deviation	2.44
Sharpe Ratio	1.54

RETURNS VS. LEHMAN US AGG TR INDEX

	OSTIX	Index
1 Year (Cum.)	10.03%	5.19%
3 Year (Ann.)	6.75%	3.93%
Inception (Ann.)	9.02%	4.51%

RETURNS VS. LIPPER MULTI-SECT INC INDEX

	OSTIX	Index
1 Year (Cum.)	10.03%	7.70%
3 Year (Ann.)	6.75%	6.89%
Inception (Ann.)	9.02%	8.10%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	2.00%
Total Expense Ratio**	1.50%

PORTFOLIO MANAGER

Carl Kaufman	2002
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*millions **as of 03/31/06

Data through: 9/30/06

Source: Company Documents; Lipper

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