

Enhancing Index Returns

Index funds have been praised for providing low-cost exposure and have gained popularity due to the dismal performance of actively managed funds. The Payden Market Return Fund is neither of the above as it falls right in the middle. It aims for the return of the S&P 500 plus alpha, but with low volatility and tracking error. The interesting strategy of this fund is that it includes futures and bonds, although it remains an equity fund.

Q: What are the core beliefs in your way of money management?

A: This is an enhanced index strategy that provides core exposure to the S&P 500 index, but is optimized to add excess return with less volatility and greater consistency of returns.

We chose an enhanced index strategy because, historically, asset managers haven't done the best job in beating the S&P 500 in the large-cap core category of funds. And while there are different ways to create value in the enhanced index space, we chose to do it by investing in S&P futures and using the free cash to add alpha through the bond market.

But it remains an enhanced index strategy and its goal is to be consistent with the S&P 500 and to optimize the volatility of the fund versus its benchmark. The tracking error of the fund is low and we expect it to stay that way because this is what our investors are looking for – market exposure with consistent performance.

Q: What are the strategy and the process that help you to achieve these goals?

A: We believe that you need a disciplined process to achieve consistency. We start with investing in the S&P futures market, which is very large, very liquid, and has an implied financing cost which is equivalent

to short-term interest rates, or LIBOR (London Interbank Offer Rate). So, in order to beat the index, we need to beat LIBOR. We do that by using short-term bonds because our firm has a track record in beating short-term interest rates using short-term bonds. In summary, we add value by using short-term bonds to beat LIBOR.

We use various bond market tools and techniques, including duration and sector rotation. Philosophically, we believe there's a sweet spot on the yield curve, which is between 1 year to 3 and 5 years of the yield curve. As you roll down the yield curve, the risk/reward potential improves.

We also believe in diversification and we maintain a diversified portfolio of Treasuries, agency bonds, corporate securities, mortgage-backed and asset backed securities, some high-yield bonds, and emerging market bonds. That's the overall spectrum of vehicles at our disposal. Although the Treasury and the agency bonds sometimes underperform LIBOR, there are certain periods when they are useful for liquidity purposes, for example, when there is a flight to quality. So, in our portfolio, the whole broad fixed-income spectrum can play an important role.

Q: Why do you prefer bonds with shorter term maturities?

A: Historically, the typical yield curve has

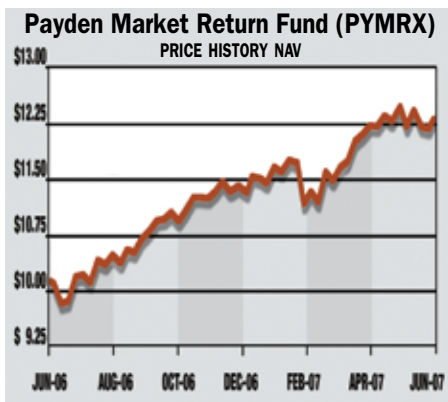


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had an upward slope. There are many theories on the reasons, but the reality is that the longer the period for which you lock up your money, the more you should be compensated, and that's reflected in the upward sloping yield curve. Everything else being equal, you should be paid a higher yield in a 5-year bond than in a 2-year bond.

But the difference between the 5-year and the 2-year yield isn't always as great as the difference between the 6-month and the 2-year yield. So we believe that there is a sweet spot in the front end of the curve. And since there is no free lunch, the longer the duration of the portfolio, the more you are subject to the volatility of interest rates. The impact on the value of your bond due to interest rate changes will be greater for the bonds with longer duration. Because we seek consistency, we need to manage the duration of the bonds relatively close to the duration of our liability, which is the LIBOR.

That's the rationale for keeping the duration short. Nevertheless, due to interest from our clients we have different dura-

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tions in our separate accounts. If there is enough demand, we could open a fund with longer-maturity bonds, but that will be a different product. Overlaid with the S&P 500 futures, it should provide even higher alpha, which will also come with higher volatility and tracking error.

Q: Could you explain the rationale behind using the S&P futures?

A: This is an equity fund despite the fact that it uses short-term bonds. The index funds would buy the basket of stocks of the underlying index, either all of them or an optimized selection. In those cases the return to the investors will be the return of the S&P 500 minus the expenses. In active strategies, the managers make active bets against the index by underweighting or overweighting certain sectors or stocks with the idea to generate alpha or excess return above the return of the S&P 500.

In our case, the goal is to get the return of the S&P 500 plus alpha without the added volatility and with a low tracking error. Just like active strategies, we aim for a return above the return of the S&P 500, but with more consistency. That is why we are willing to tolerate alpha that is lower than that of an active manager. But since many active managers have a hard time beating the S&P 500 anyway, our strategy has been quite attractive. Essentially, this is an S&P 500 enhanced index strategy that provides added value through various techniques in the bond market.

So the S&P 500 futures pay the S&P 500 return minus LIBOR. That provides exposure that is consistent and well-correlated with the S&P index. We still have access to the cash because we didn't need to spend all of it to get the S&P 500 exposure, and we can invest that cash in the bond market. Then, all we have to do is beat LIBOR, which is our cost. If we beat LIBOR, we beat the S&P 500.

In our case, the futures can be viewed as a cost center. That cost has fluctuated and needs to be managed but only from a cost standpoint and there's no active equity betting. Nevertheless, we have to roll the futures on a quarterly basis and we have to make sure that their exposure is accu-

rate. We always aim to have a 100% exposure, not 95% or 105%, as we just reflect the market with the futures. And that takes a fair amount of infrastructure.

Q: What's your approach for selecting the bonds you invest in?

A: We use a top-down approach, where we start with the broad factors such as interest rates, inflation, and macroeconomic trends including GDP growth, etc. We also look at technical flows. Then, of course, from a sector standpoint, we estimate the credit climate. For example, we may consider the chances of a recession, the rate of growth of the economy, if the spreads are too tight, if they will tighten further, etc. All of those factors are part of our outlook.

Once we have laid out the broad outlook, we can decide on the duration of the portfolio, the sectors in which we should invest, and the parts of the yield curve that we should overweight or underweight. Basically, those are the three main decisions that we have to make.

If we believe that interest rates will rise, we want to be exposed to short-term bonds as much as possible, and this is the big challenge in this strategy. Ideally, we would have a very short duration because the LIBOR itself has no duration. Of course, if we think that interest rates will fall, we'd want to be as long as possible. But because of our discipline, we wouldn't take excessive risk on duration; we would stay within reasonable limits. Even if we absolutely love the market, we recognize the fact that we don't have a crystal ball, and it wouldn't be prudent to place the duration way beyond the duration of LIBOR. We keep in mind that one of our major objectives is to maintain consistency over time.

On the sector side, we rely on our specialists in all the different sectors. We have mortgage specialists, corporate bond, emerging market, and high-yield bond specialists. Depending on our outlook on the economy and the yield, we will put together the portfolio. If we think that the economy is relatively stable or doing very well, and if we like high-yield bonds, we will have below investment grade bonds in the portfolio as well.

The number of bonds depends on the environment, but we usually hold many bonds because we insist on diversification. Right now we have over 100 bonds in the portfolio but, usually, we hold about 60 or 70 bonds.

Q: When interest rates are rising and bond values are falling, how difficult or easy is for you to generate alpha?

A: That's probably the most important issue for our strategy. It is nice to out-yield LIBOR in all environments, but when rates are rising, you have no other way of winning, unless you go short.

Duration is really the measure of the percent change in the price of your bonds for a unit change in the interest rate. For example, if interest rates rise 1%, a 5-year duration bond will be hit with 5%, and you would lose 5% of the value of that bond. For a bond with 1-year duration, the negative impact on the price will be 1%. You're also getting paid the coupon, and if your loss refers to just one bond in a diversified portfolio, you might be alright. But if your entire portfolio has a duration of five years, it may take a while for you to recover.

That's why in a rising interest rate environment the duration should be as short as possible even negative, and then the yield should be as high as possible. Right now LIBOR is around 5.4% and you need to be making more than that on your bonds. Bonds that don't have a lot of interest rate exposure but pay 5.70% or 6%, work well in that environment. But such bonds carry some other risks. Without interest rate risk, you would either have to deal with structure risk or, most likely, with credit risk.

Q: What are the challenges in generating excess return in the opposite scenario, when rates are declining?

A: When rates are falling, you need to make sure that you have a long duration. The ideal case would be to anticipate the falling rates and to move to a longer duration early enough. But if you didn't capture that moment and your duration is still short, you missed the boat. Ba-

sically, if rates fall by 1%, you add 100 basis points of performance on a 1-year duration bond. But you have to be aware why interest rates are falling. For example, in the case of an increased risk of a recession, there is a flight to quality, and rates fall because everybody rushes to short-term treasuries. In that scenario, you would do well staying purely in 2-year or 5-year Treasuries with no credit risk.

Q: What types of risks do you perceive and how do you manage them?


A: The major risks are the interest rate risk and the spread risk. But there is structure risk as well. For instance, mortgage-backed securities may be rated AAA and have no credit risk, but they still carry structure risk. This aspect has to be managed as well.

Q: Historically, how much alpha have you been able to add using the enhanced index strategy?

A: Again, it depends on the environment. In some environments we've added over 100 basis points, but in the last few years it has been extremely difficult because of the inverted yield curve. On average, since inception in 1994, our strategy has added around 60 basis points of alpha, although in certain periods we have added 120 basis points.

Q: Is there a certain environment that is particularly difficult and may lead to negative alpha?

A: These are the periods with inverted yield curve, widening credit spreads, and rising interest rates. Each of them can cause problems and all three of them at once are especially challenging.

Overall, our strategy is suitable for investors who don't necessarily seek the highest possible alpha but seek a core equity exposure to the broad market that is efficient and stable. Our strategy will not underperform significantly but it's not going to outperform significantly either. And the main driver of the return remains the stocks in the S&P index despite the fact that bonds provide the alpha portion. There is still strong correlation with the index and this remains an equity strategy. 

Payden Market Return Fund

Symbol	PYMRX
Website	www.payden.com
Address	Payden & Rygel 333 South Grand Avenue 32nd Floor Los Angeles, CA 90071
Tel. No.	800-572-9336
Inception	12/01/1995

PORTFOLIO

Total Net Assets*	\$65.2
Avg Mkt Cap (\$ Weighted)	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	191%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$5,000
Min Subsequent Investment	\$1,000
Min Initial IRA Investment	\$2,000

RISK (AGAINST S&P 500 DAILY REINV INDEX- 3 YEARS)

Alpha	-0.07
Beta	1.02
R-Squared	0.99
Ann. Std Deviation	7.46
Sharpe Ratio	0.94

RETURNS VS. LIPPER LG-CAP CORE INDEX

	PYMRX	Index
1 Year (Cum.)	19.89%	19.12%
3 Year (Ann.)	10.95%	10.87%
5 Year (Ann.)	10.70%	9.34%

RETURNS VS. S&P 500 DAILY REINV INDEX

	PYMRX	Index
1 Year (Cum.)	19.89%	20.59%
3 Year (Ann.)	10.95%	11.68%
5 Year (Ann.)	10.70%	10.71%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	0.45%

PORTFOLIO MANAGER

Asha Joshi	1995
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*millions **1 month after purchase

Data through: 06/30/07

Source: Company Documents; Lipper

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