

# Seix Investment Advisors Perspective

## ABOUT THE BOUTIQUE: Seix Investment Advisors LLC



Seix Investment Advisors LLC (Seix) is a fundamental, credit-driven fixed-income boutique specializing in both investment grade and high yield bond management. Seix has applied its bottom-up, research-oriented approach to fixed income management for over 18 years. The firm's success can be attributed to a deep and talented group of veteran investment professionals, a clearly defined investment approach and a performance-oriented culture that is focused on delivering superior, risk-adjusted investment performance for our clients.



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Jim is Chief Executive Officer and Chief Investment Officer of Seix. Prior to joining the firm in 2008, Jim was Head of Investment Grade Corporate & High Yield Bond Management for American Century Investments. Jim's High Grade team sub-advises several of the RidgeWorth Funds, including the RidgeWorth Investment Grade Bond Fund which won a Lipper Performance Award in 2009. He has appeared on CNBC and Bloomberg television, and has been quoted in a range of national publications. Jim has more than 25 years of investment management experience.

### Perry Troisi

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Perry is a seasoned Senior Portfolio Manager focused on the Government Related and Securitized asset classes and a member of the Seix Investment Policy Committee. Before joining Seix in 1999, he was a Portfolio Manager at GRE Insurance Group, where he was responsible for all North American fixed income assets within the Group. Perry has over 20 years of experience in the investment management industry.

## Review of Third Quarter 2011

### WE'VE CALLED IT LIKE WE'VE SEEN IT

The fact that our so out of consensus view since last summer has suddenly become the consensus is both rewarding and discomfoting at the same time. The hope that permeated the landscape by the end of the second quarter dissipated quickly in the third quarter. The GDP revisions released at the end of July seemed to really recalibrate economic expectations. We learned through these revisions that the recession was actually deeper, the recovery weaker, and the current trajectory of growth suddenly far less promising. This fundamental reality combined with the debt ceiling debate (fairly gruesome political theater), the ensuing downgrade of the United States' long term sovereign debt rating by S&P, and the worsening of the European sovereign debt/banking crisis culminated in a major "risk off" environment and a re-pricing of all risk premiums, which seemed somewhat reminiscent of 2008 all over again. While total returns in the investment grade space managed to stay positive across most of the primary sectors, commercial mortgage-backed securities (CMBS) being the lone exception, excess returns were universally negative and painfully so in some sectors. As for the High Yield market, total returns were very negative and their corresponding excess returns were even more painful. Exhibit 1 provides all the detail, using Barclays' Indices data.

**Exhibit 1 - Negative Excess Returns as Risk Re-prices**

	Q3 Total Return	Q3 Excess Return	YTD Total Return	YTD Excess Return
Aggregate	3.82	-2.02	6.65	-1.44
Treasury	6.48	n/a	8.84	n/a
Agency	2.42	-0.49	4.36	-0.15
RMBS	2.36	-2.21	5.30	-1.31
ABS	2.42	0.00	4.90	0.80
CMBS	-0.86	-3.52	2.82	-2.08
Corporate	2.85	-5.11	6.10	-4.49
High Yield	-6.06	-10.35	-1.39	-7.94
HY - Ba/B	-4.49	-8.98	0.07	-6.74
HY - Ba	-3.71	-8.77	1.17	-6.33
HY - B	-5.22	-9.18	-0.95	-7.12
HY - Caa	-11.73	-15.01	-6.67	-11.91
HY - Ca-D	-25.02	-29.07	-20.74	-27.28
HY - Loans	-4.40	n/a	-1.96	n/a
S&P 500	-13.87	n/a	-8.68	n/a

Sources: Barclays Capital, S&P

Past performance is not indicative of future results.

This environment also dramatically altered expectations for interest rates in general, as the first half of the year saw most market pundits and participants predicting and positioning for higher rates. For most of the last decade, market pundits have been habitually obsessed with and convinced that higher rates were inevitable in the early part of each new calendar year. The emphasis on the direction of rates typically dies out by the second quarter in most years, but this year the focus has been particularly persistent. The third quarter put an end to it finally in 2011. For most of the quarter the flight to quality (even a downgraded quality) was unrelenting, driving yields across most of the yield curve to new post-war capital market lows. The ten-year treasury reached a new low of 1.72% on September 22nd, before ending the quarter at 1.92%, capping a three-month rally that drove its yield lower by 125 basis points! This performance was that much more impressive when you consider that flight to quality rallies typically benefit shorter parts of the yield curve before the long end. Given the already low level

of short rates amidst nearly three full years of a zero interest rate policy (ZIRP) from the Federal Reserve, the short end of the yield curve has very little room to go lower. This allowed for a considerable outperformance by the long end that flattened the yield curve, an outcome we've been anticipating and positioned for all year. Exhibit 2 illustrates the change in rates during the third quarter.

**Exhibit 2 – Lower Rates and a Flatter Yield Curve**  
**HISTORICAL YIELD CURVE**

	6/30/11	9/30/11	Change
3 Month	0.010	0.020	0.0102
6 Month	0.097	0.051	-0.0458
1 Year	0.183	0.102	-0.0815
2 Year	0.458	0.243	-0.2146
3 Year	0.796	0.402	-0.3936
5 Year	1.761	0.952	-0.8090
7 Year	2.496	1.432	-1.0646
10 Year	3.160	1.915	-1.2445
30 Year	4.371	2.913	-1.4576

Sources: Bloomberg

### Volatility is the Only Certainty

In our Q1 perspective, we illustrated our confusion with the markets' perception of what the end of quantitative easing 2 (QE2) meant for the capital markets. The consensus was in broad agreement that the end of QE2 meant higher rates/steeper yield curve as they solely focused on just one side (the removal of the largest buyer of US Treasuries) of the mechanics of QE while seemingly ignoring, what in our view was the more important aspect of QE, that being the cash that is injected into the markets as the Fed buys US Treasuries (which is intended to go into riskier assets in a zero interest rate environment). Our view focused on the latter aspect and what QE2 meant to the price of risk during its lifetime. After the QE2 inspired rally in the stock market as well as the tighter spreads in investment grade and high yield bond markets, a retracement of these risk premiums (wider) was our out-of-consensus base case following the end of QE2. The re-pricing that ultimately ensued was far more volatile than even we anticipated over such a short period. The third quarter was dominated by that brutally binary market activity that produces days of full scale "risk off" that get interrupted with periodic reprieves of "risk on". "Risk on/risk off" remains the current state of the market and the volatility is further exacerbated by the very same policymakers who pretend to understand the problems and are in full crisis mode crafting a "solution."

The role of policymakers has taken center stage as we enter the fourth quarter because of the markets' renewed focus on the European Sovereign Debt/Banking crisis. The crisis is daunting and the magnitude of the potential losses massive, but what seems even more overwhelming at times is the number of voices speaking on behalf of the Eurozone. We must remember that while the Euro is one currency, it is composed of 17 sovereign

nations with different issues to contend with now. Every passing day the markets are subject to a litany of pronouncements from the European Central Bank (ECB), the European Union bureaucracy, or any of the 17 individual sovereign nations within the currency union. While offering very little in the way of consistency in message, given the vastly different constituencies within the Eurozone, the result is tremendous volatility across all asset classes.

Our expectations are low for a timely or orderly resolution to what ails the Eurozone as European politicians and policymakers follow the Geithner/Bernanke/Paulson strategy of "kicking the can" that started during the Bush administration and has continued unabated with the Obama administration – so much for change. The root issue remains excessive debt, which is exactly what our own economy is dealing with today. Globally, some very bad decisions were made repeatedly and ignored for many years, compounded by massive misallocations of capital by both creditors and debtors. This has resulted in a global solvency crisis that policymakers and politicians across the world think can be solved through massive liquidity injections, financial engineering and more debt and leverage. The simple fact needs to be accepted that you cannot solve a debt problem with more debt. If the goal is to craft a viable solution to the European crisis then debt restructurings must be put on the table, losses finally recognized, banks that are insolvent should right size their balance sheets via debt for equity swaps where necessary and assets are then free to trade from weak hands to strong hands. A mechanism also needs to be established for countries to exit the Euro. Unfortunately, many governments and central banks have proactively sought to prevent this very painful but natural healing process from playing out as they pursue the impossible pain free-solution under the guise of this being a liquidity rather than solvency issue. A very legitimate overriding fear about the fragility of the global banking system combined with the political clout of bondholders whose credit analysis went no further than assuming that the institution in question was "too big to fail" (an idiosyncratic concept) has promoted this unhealthy environment where intervention is sold as a necessary evil in order to save the banks while shifting the excessive debt over to taxpayers through the governments' balance sheet. Perhaps this market volatility is foreshadowing that all of these "too big to fail" institutions collectively are "too big to save"?

Our own elected and unelected (Federal Reserve) leaders have been all too proficient in adding to the U.S. taxpayer's plight as this post credit bubble collapse has evolved. Faced with the potential contagion from the Euro area crisis, U.S. leaders' strategy is to promote that same fiscal profligacy universally. The end game in Europe appears to be down to either the ECB having to engage in massive money printing, a fiscal union where sovereignty is lost, or Germany (and other strong nations) having to step up and pay for the losses and capital shortfalls of the entire Eurozone (sovereign and banking systems). At present those sub-optimal solutions are not being embraced for obvious reasons.

## Quantitative Creativity

The Federal Open Market Committee (FOMC) was also prominent in offering a multitude of pronouncements in the third quarter using their newfound “communication tools” from the Bernanke monetary policy toolbox. The August 9th statement from the Federal Reserve offered its first time certain commitment to low rates, specifically stating that economic conditions “are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.” Apparently the previously used “for an extended period” was deemed unsatisfactory by some on the committee. While this time certain commitment was conditional on the economic outlook, the change was deemed by most as a “dovish” surprise. This was followed up in the September statement with Operation Twist, which has the Federal Reserve selling \$400 billion of three year and shorter Treasuries with the proceeds used to purchase six year and longer Treasuries. The objective of this strategy, according to its own statement, is to “put downward pressure on longer term interest rates and help make broader financial conditions more accommodative”. Additionally, the FOMC also returned to directly investing in the mortgage market, committing to reinvest all principal payments from its holdings of agency debt and agency mortgage-backed securities back into agency mortgage-backed securities. Both initiatives will be in force through June 2012.

While such creativity from Chairman Bernanke and the FOMC is deemed as both necessary and effective easing by a majority of the committee, the vote was far from unanimous. Both meetings saw three dissenting votes against the new monetary easing initiatives. It's been nearly 20 years since an FOMC meeting saw three dissenting votes! The dissenters were Richard Fisher (Dallas Fed), Narayana Kocherlakota (Minneapolis Fed), and Charles Plosser (Philadelphia Fed). In “Fed speak” these dissenters would be described as “hawks,” or FOMC members whose bias is to guard first and foremost against inflation and in defense of the Fed's hard earned reputation as an inflation fighter. A “hawk” sees the Fed's dual mandate as having a distinct priority that favors price stability over maximum employment. Opposing this bias are the “doves,” FOMC members whose leanings are less inflation centric, prone to providing monetary accommodation more freely and decidedly more receptive to the dual mandate and its unemployment component. Given that all the other votes were in favor, it is fair to describe the balance of the FOMC as more “dovish.”

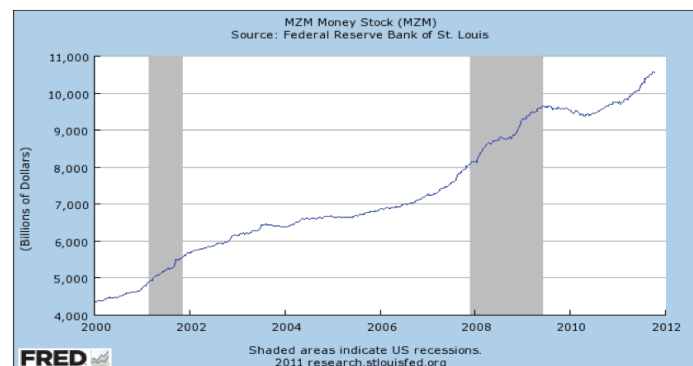
The FOMC voting ranks are the Fed's Board of Governors (seven members), the president of the New York Fed, and four of the remaining eleven regional Reserve Bank presidents who serve one year terms on a rotating basis. Given the dissenting votes came from that rotating pool, their voting terms end in December. Rotating in for voting terms in 2012 are the following regional bank presidents: Sandra Pianalto (Cleveland), Jeffrey Lacker (Richmond), Dennis Lockhart (Atlanta) and John Williams (San Francisco). Unfortunately, the more “hawkish” bias of the dissenters is being replaced with voters who possess a more “dovish” bias. Clearly this is a market implied bias put on a regional bank president based on factors like a prior FOMC voting

record or for new members, perhaps the bias they have exhibited in published literature. Despite its subjectivity, the consensus would definitely describe three of the four incoming FOMC voters as possessing a “dovish” bias and only one that possesses a “hawkish” bias (Lacker). Hence, the 2012 rotation sees three “hawks” and one “dove” get replaced by three “doves” and one “hawk.” That makes for a pickup of two for the “dove” camp. This addition to an already like-minded majority will make it easier next year for Chairman Bernanke to get more creative or perhaps more unconventional with monetary policy, should the weak recovery continue and a path to maximum employment remain elusive.

In our view this is a very unwelcome change and likely to foster more monetary policy experimentation. This will only serve to promote even greater distortions in valuations, capital allocation, and capital market flows, all under the comical premise that the FOMC has a “statutory mandate” to keep trying! Zero interest rate policy (ZIRP), quantitative easing (QE1, QE1.5 and QE2), and now the latest Operation Twist should have proven to the FOMC that our economy is far more dynamic and complex than their models, theories and spreadsheets imply. The experiment should have ended with QE1 unless the objective always had more to do with subsidizing “too big to fail” banks (which are bigger now than they were before the financial crisis), elevating risk assets (collateral values) and stock prices in particular, rather than putting conditions in place to assist the economy, savers, people who live paycheck to paycheck and those living on a fixed income. The problems and imbalances the macro economy exhibits are more structural in nature and not prone to a monetary policy solution, either conventional or unconventional. At a minimum the Federal Reserve should remember a very important part of the Hippocratic Oath and “never do harm.”

We should remember that ZIRP and QE are extraordinary, emergency measures, but are such extraordinary measures still warranted after the patient is out of intensive care? We would venture to say that higher short term interest rates and the removal of other emergency measures would be more stimulative to the household sector and economy in general than ZIRP, QE, or Operation Twist. According to the St. Louis Fed, there is over \$10 trillion in MZM, a monetary aggregate that stands for “money of zero maturity” and captures most savings deposits, large time deposits, and money market fund balances. Exhibit 3 below shows the explosion of this MZM series over the last decade:

**Exhibit 3**



Yes, over \$10 trillion sitting in bank and money market like accounts and they have been earning essentially nothing for almost three years. Unfortunately, it appears that it will be at least two more years before the household sector and savers can expect to earn even a little interest on their money.

Instead, more of what we hear from different corners of the monetary policy sphere is the potential need to alter the standard operating procedure of the FOMC. Instead of declaring a desired range for inflation (there is no stated range for unemployment) and relying on the perceived control of short-term policy rates to achieve the outcome, some believe that more radical targeting needs to be incorporated by the FOMC. These proposals include formal inflation and/or unemployment targeting and even nominal GDP targeting (sometimes referred to as formal price level targeting). The differences are not easy to delineate and require more time and ink than a quarterly perspective offers, but consider the ramifications implied by just one of these policy prescriptions. A graph of the weakness of the current economic backdrop would show nominal GDP well below an FOMC target path for trend growth, leaving policymakers in a position to allow for higher inflation to “catch up” to the trend growth line. Sounds harmless, right? History would counsel otherwise. If we have learned anything from economic history, it almost always reminds us that inflation, however small, can be very dangerous, self-fulfilling and self-perpetuating.

Paul Volcker, the former chairman of the Federal Reserve from 1979 to 1987, is perhaps the best known inflation fighter in the modern era of central banking. Year over year CPI at the end of 1979 was 13.3%; at the end of 1987 it was 4.4%, with a low of 1.1% at the end of 1986. He recently penned an Op Ed in the *New York Times* titled “A Little Inflation Can Be a Dangerous Thing” (September 18, 2011). Mr. Volcker carefully says he does not see us on the edge of serious inflation today, but cautions that:

*“the danger is that if, in desperation, we turn to deliberately seeking inflation to solve real problems – our economic imbalances, sluggish productivity, and excessive leverage – we would soon find that a little inflation doesn’t work. Then the instinct will be to do a little more – a seemingly temporary and ‘reasonable’ 4 percent becomes 5, and then 6 and so on”*

Like so many other things, we fear that even the lessons of the 1970s stagflation period are lost on our current policymakers. Seemingly buried under every depression study known to mankind, Chairman Bernanke and many other FOMC members seem intent on ignoring this more recent history in favor of what they perceive to be a more analogous historical period. Given the dynamic evolution of our economy over the past century it is exceptionally hard to ascribe more importance to one period over another. But when some proposals try to obscure what is nothing more than deliberate promotion of inflation as a policy objective, we take offense to the effort and agree with Mr. Volcker when he states that “*taking on the risks of deliberately promoting inflation would be simply irresponsible.*”

### A Tribute to Another Lone Voice in the Wilderness

We would be remiss if we failed to recognize the contributions and acknowledge the retirement of one of the longest serving policymakers within the Federal Reserve System, Thomas Hoenig. Mr. Hoenig recently reached the Fed’s mandatory retirement age after serving as President of the Federal Reserve Bank of Kansas City, the headquarters for the 10th Federal Reserve District (there are 12 districts in total) since 1991. Mr. Hoenig, a well known “hawk” with a voting history to back it up, was a revered central banker who understood the limitations and dangers of monetary policy in both the conventional and unconventional form. We will remember him most for his tireless effort as seemingly the lone voice in policymaking circles warning about the misguided and costly policies of “too big to fail” financial institutions, QE and the dangers of asset bubbles. With all due respect to the current slate of Federal Reserve officials and the difficult task at hand, we believe the economy and the country would be better positioned to find a path to sustainable growth sooner if the Federal Reserve were led by central bankers like Paul Volcker and Tom Hoenig.

### Portfolio Positioning

We were well positioned for the volatility and risk re-pricing of the third quarter. Portfolios were overweight spread product, but sector positioning was fairly defensive. Driven by such individual security selection, particularly in the residential mortgage-backed securities (RMBS) and Corporate sectors, portfolio returns exceeded benchmark returns by a very respectable margin.

Since we remain in a zero interest rate policy world, an environment that is likely to be in force over the next few quarters, we continue to seek safe income at a reasonable price. Portfolios remain overweight investment grade corporate bonds, still at a lower weighting relative to recent years, but we have begun adding select high quality exposure through the new issue market as concessions have widened amidst the volatility. Corporate spreads are likely to remain under pressure for the balance of 2011, but better valuations offer more compensation for this risk.

Throughout the quarter we maintained our RMBS exposure as this sector still represents our largest overweight. Our portfolio construction, which emphasized the usage of structure (collateralized mortgage obligations or CMOs), carried the day in Q3. It offered cash flow and duration stability at a time when more index like RMBS portfolios were contracting amidst the rally in treasuries. Despite these very low rates, prepayments remain muted and the sector offers attractive yield over paltry treasury rates. While still modestly “up in coupon” we lightened our premium coupon exposure in mid-summer to guard against the volatility that comes with potential government initiatives to assist homeowners in obtaining refinancing alternatives. Portfolios continue to be overweight CMBS as well, but similar to Corporate Bonds, it is on the lighter side relative to recent history. The exposure remains largely in seasoned, well structured exposure near the top of the capital structure.

Having entered the quarter with only 5% allocated to High Yield bank loans, the re-pricing of risk provided an opportunity to shift this exposure away from this more conservative allocation of High Yield loans and into High Yield bonds. The bank loan sector did absorb the “risk-off” environment better than bonds and with the Fed’s new commitment to keep rates near zero until the summer of 2013, the demand for floating rate product lost one of its competitive advantages. These developments prompted us to swap out of our 5% loan exposure into bonds. When market fears reached a pinnacle in mid-August, the default rates implied by spreads in the High Yield market went beyond our own forecasts when looking out over a one year time horizon. This allowed us the opportunity to add another 5% in High Yield bonds, bringing our core plus portfolios to 10% by the end of August. We view this as a neutral position for our core plus mandates.

We continue to remain void the “government-related” sectors of the market, consisting mainly of agency debt (government-sponsored entities, Fannie Mae and Freddie Mac) as well as sovereign and

supranational paper. The sector overall has an asymmetric risk profile from our perspective while offering very little yield.

The rate rally in Q3 was led by the long end of the yield curve. Using 2s/10s as a proxy, the curve flattened a little over 100 basis points (from +270 to +167). Our portfolios were positioned accordingly where mandates permitted. Inside +200 basis points will make further gains from curve flattening slower to materialize. While still historically steep, the environment is full of cross currents that include a Fed trying to flatten the curve and a Treasury still trying to extend the average maturity of our nation’s outstanding debt. The Fed program is temporary while the Treasury will be extending for several more years. While still positioned for a flatter curve, our exit from this strategy is probably closer today than at any time in the last two years.

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RCBP-SA-0911

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