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1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Total Return Review

Viewing the Markets from a Total Return Perspective

By Howard L. Simons (847) 304-1511

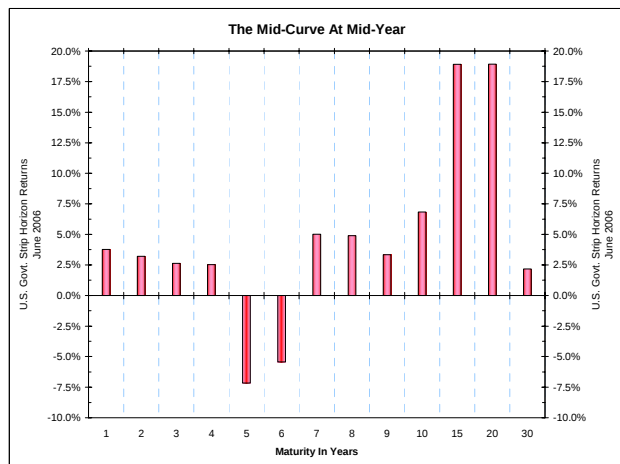
and Neil Bouhan (847) 304-1511

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Market Transition Lifts Barbells

That the continuous rise in short-term interest rates should make cash more attractive should surprise exactly no one. That the opposite end of the spectrum should occur, long-dated strips doing well in a time of general risk aversion and portfolio retrenchment, was discussed in our May [Total Return Review](#). **Long-duration bonds should do well when the end of federal funds rate hikes comes into view and the yield curve is inverted.**

Even so, the large gains seen in the cash+25-year strip barbell versus the five-year strip bullet (following page, bottom table) is striking. June's returns on strips due May 15th 2011 and 2012 were negative; we should note the returns on weighted-average five-year strips remained slightly positive on the month. **This is about as close to a perfect trade as any bullet/barbell combination is likely to get.**



The role of Japanese monetary policy in determining the returns of other asset classes was large and is likely to continue.

Equities

June was two half-months. Until the Bank of Japan restored some withdrawn liquidity into the system after June 13th, May's selloff remained in full force. Global markets recovered their losses to end the month near-unchanged, with the emerging markets

and resource-linked markets such as Canada lagging. In U.S. dollar terms, these indices lost 0.21% and 1.56%, respectively.

Fixed Income: The Importance of Reinvestment

For all of the concern regarding the Federal Reserve, U.S. fixed-income markets led world returns both in local currency and U.S. dollar terms in June. Canadian and Japanese bonds performed poorly.

The past six months illustrated the importance of coupon reinvestment to total return. Thirty-year Treasury returns were **down** 8.97% over this period, the worst six-month performance since the -12.02% return for the period ending in July 1999. Only 1980 and 1994 were worse for 30-year Treasuries than 1999.

Furthermore, the only other the six-month periods in the available data sample extending back to 1927 with worse returns were the ones ending in: July 1996, -9.43%, June 1994, -11.83%, September 1987, -13.95%, May 1984, -9.61%, February 1980, -17.82%; and January 1969, -10.32%.

Experienced bond traders might be surprised to learn the recent six-month period was this negative. Why was this so?

The much lower coupon yields on the 30-year bond translate, all else held equal, into longer duration and therefore greater rate sensitivity by virtue of positive convexity. The modified duration of the 30-year bond at present is 14.27, meaning a 1% move in 30-year yields will produce a 14.27% move in its price. In contrast, vintage 1981 bonds yielding 14% had a modified duration of 6.5. To produce a 10% loss in 1981 required a 2.5% yield increase over three months. A similar loss today requires only a 1% increase in yield.

Commodities

As in the case of equities, commodities had two half-months. The major indices recovered from first-half losses to close near-unchanged on the month.

U. S. Fixed-Income Total Returns

	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Treasury Cash:	0.40%	0.78%	1.82%	3.89%	2.31%	2.31%	4.07%
3 Month	0.42%	0.79%	1.81%	3.88%	2.31%	2.28%	3.97%
6 Month	0.40%	0.78%	1.83%	3.93%	2.40%	2.52%	4.16%
Treasury Coupons:	0.29%	-0.69%	-2.82%	-3.42%	0.79%	4.74%	5.65%
2 Year	0.10%	0.39%	0.65%	1.50%	1.23%	3.30%	4.76%
5 Year	0.08%	-0.15%	-1.25%	-2.07%	0.27%	4.22%	5.43%
10 Year	0.23%	-1.12%	-3.83%	-5.16%	0.08%	4.70%	5.74%
30 Year	0.79%	-3.21%	-8.97%	-10.83%	1.05%	6.21%	6.73%
Treasury Strips:	1.11%	-2.36%	-6.69%	-8.49%	2.53%	7.83%	9.07%
5 Year	0.08%	0.05%	-1.06%	-2.35%	0.46%	5.09%	6.37%
10 Year	0.28%	-1.34%	-4.36%	-6.44%	1.10%	6.88%	8.01%
15 Year	1.22%	-2.02%	-7.32%	-10.52%	1.76%	8.21%	9.15%
20 Year	1.54%	-3.10%	-9.83%	-13.60%	2.97%	8.82%	10.01%
25 Year	2.14%	-4.14%	-12.84%	-18.26%	2.27%	8.70%	10.32%
Broad Indices							
Salomon "BIG"	0.22%	-0.10%	-0.77%	-0.80%	1.90%	4.88%	6.17%
Lehman Aggregate	0.21%	-0.08%	-0.72%	-0.79%	2.06%	4.98%	6.22%
Lehman Government/Credit	0.22%	-0.14%	-1.15%	-1.52%	1.60%	5.13%	6.25%
Government Indices							
Lehman Government	0.28%	0.03%	-0.88%	-1.15%	1.32%	4.74%	6.04%
Lehman Treasury	0.32%	-0.06%	-1.29%	-1.67%	1.17%	4.68%	5.99%
Lehman Agency	0.19%	0.20%	0.01%	0.02%	1.60%	4.82%	6.14%
Agency Benchmarks							
2 Year	0.20%	0.69%	1.22%	1.94%	1.92%	3.87%	N/A
5 Year	0.04%	-0.06%	-0.43%	-1.36%	0.82%	5.10%	N/A
10 Year	-0.08%	-1.31%	-2.18%	-3.80%	1.19%	6.37%	N/A
30 Year	0.47%	-1.91%	-5.49%	-7.55%	2.87%	8.32%	N/A
Other Indices							
Merrill Corporate	0.08%	-0.40%	-1.47%	-2.00%	2.14%	5.82%	6.62%
Lehman Mortgage	0.19%	0.01%	-0.07%	0.41%	2.89%	4.64%	6.13%
Lehman Inflation Notes ("TIPS")	0.28%	0.49%	-1.77%	-1.64%	3.75%	6.99%	N/A
Merrill High Yield	-0.38%	0.20%	3.07%	4.71%	8.47%	8.35%	6.81%
Merrill Muncpal	-0.38%	0.06%	0.36%	1.13%	4.01%	5.76%	6.33%

Treasury Cash: Equal-weighted total-return avg. of the Treasury yield curve from 3 to 12 month maturities.

Treasury Coupons: Equal-weighted total-return avg. of the Treasury yield curve from 2 to 30 year maturities.

Treasury Strips: Equal-weighted total-return average of Treasury Strips from 1 year to 30 years.

Sources: Bloomberg, Ryan Labs, Lehman Brothers, Merrill Lynch, Salomon Smith Barney and Arbor Research & Trading

Total Return Comparisons: The "Bullet" versus "Barbells"

Portfolio Type*	As of 6/30/06					
	MTD	Diff.	QTD	Diff.	YTD	Diff.
Bullet (4.74 Duration)	0.08%		0.05%		-1.06%	
5 yr and 10 yr	0.09%	0.01%	-0.21%	-0.26%	-1.42%	-0.36%
5 yr and 30 yr	0.10%	0.02%	-0.21%	-0.26%	-1.40%	-0.35%
2 yr and 10 yr	0.16%	0.08%	-0.32%	-0.37%	-1.44%	-0.38%
2 yr and 30 yr	0.24%	0.16%	-0.34%	-0.39%	-1.30%	-0.25%
Cash and 10 yr	0.31%	0.23%	-0.33%	-0.38%	-1.49%	-0.43%
Cash and 30 yr	0.52%	0.44%	-0.37%	-0.42%	-1.32%	-0.27%
Cash and 25 yr Strips	0.73%	0.65%	-0.12%	-0.17%	-0.88%	0.18%

*This analysis compares the total return of the 5-Year Strip or the "bullet" to cash neutral, duration neutral barbells.

Its purpose is to quantify the effect of the yield curve on total return.

Sources: Bloomberg and Ryan Labs

World Fixed-Income Total Returns (in U.S. Dollars)

	in U.S. Dollars						
	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
J. P. Morgan Government Bond Indices							
Country							
Canada	-1.52%	3.60%	3.04%	9.69%	11.93%	13.55%	9.42%
France	-0.74%	4.74%	5.49%	2.91%	6.99%	14.49%	5.97%
Germany	-0.71%	4.87%	5.73%	3.05%	7.07%	14.39%	5.63%
Italy	-0.64%	4.37%	4.62%	2.37%	7.16%	14.84%	7.43%
Japan	-2.22%	2.72%	1.42%	-5.85%	1.26%	2.28%	2.20%
United Kingdom	-1.76%	5.23%	5.73%	4.30%	7.89%	11.66%	9.29%
United States	0.40%	-0.11%	-1.41%	-1.82%	1.22%	4.85%	6.10%
Region							
Europe	-0.83%	4.85%	5.53%	3.11%	7.19%	14.29%	6.74%
Global	-0.97%	3.01%	2.59%	-0.58%	4.13%	8.40%	5.56%
Global Non-United States	-1.38%	4.00%	3.88%	-0.19%	5.04%	9.60%	5.03%
J. P. Morgan Emerging Markets Bond Indices							
EMBI Plus	0.08%	-2.39%	-0.72%	5.24%	10.20%	11.42%	11.92%
Region							
Latin	0.93%	-2.01%	0.63%	7.50%	11.95%	9.48%	10.60%
Non-Latin	-1.13%	-2.94%	-2.69%	1.98%	7.72%	15.86%	14.65%

World Fixed-Income Total Returns (in Local Currency)

	in Local Currency						
	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
J. P. Morgan Government Bond Indices							
Country							
Canada	-0.52%	-1.24%	-1.91%	-0.40%	4.70%	6.70%	7.20%
France	-0.29%	-0.87%	-2.68%	-2.56%	3.22%	5.43%	5.93%
Germany	-0.26%	-0.75%	-2.46%	-2.43%	3.30%	5.33%	5.69%
Italy	-0.19%	-1.22%	-3.49%	-3.08%	3.38%	5.75%	7.30%
Japan	-0.29%	-0.47%	-1.77%	-2.87%	-0.38%	0.51%	2.62%
United Kingdom	-0.60%	-1.31%	-1.86%	1.08%	3.87%	5.71%	7.41%
United States	0.40%	-0.11%	-1.41%	-1.82%	1.22%	4.85%	6.10%
Region							
Europe	-0.30%	-0.93%	-2.61%	-2.13%	3.41%	5.60%	6.45%
Global	-0.14%	-0.62%	-2.06%	-2.21%	1.84%	4.03%	5.47%
Global Non-United States	-0.30%	-0.77%	-2.26%	-2.33%	2.02%	3.71%	5.23%

Sources: Bloomberg and J. P. Morgan & Co. Incorporated (<http://www.jpmorgan.com/>)

U. S. Equity Total Returns

	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Broad Market							
Dow Jones Industrials ²	-0.05%	0.94%	5.22%	11.08%	9.87%	3.46%	9.16%
NASDAQ Composite ¹	-0.26%	-7.01%	-1.08%	6.47%	10.92%	0.81%	6.00%
NASDAQ 100 ²	-0.27%	-7.44%	-4.03%	5.93%	9.82%	-2.71%	8.99%
NYSE Composite ²	-1.00%	-0.96%	5.72%	14.75%	16.02%	6.41%	9.94%
Russell 2000 ⁴	0.67%	-4.98%	8.26%	14.66%	18.77%	8.53%	9.08%
S&P 500 (Capitalization Weighted) ³	0.13%	-1.44%	2.71%	8.63%	11.22%	2.49%	8.32%
S&P 500 (Equal Weighted) ¹	-0.21%	-2.05%	4.06%	11.94%	17.13%	8.56%	11.95%
S&P 400 MidCap ³	0.02%	-3.15%	4.24%	12.98%	18.14%	9.30%	13.82%
S&P 600 SmallCap ³	1.90%	-2.76%	9.72%	16.09%	21.22%	11.49%	12.01%
Wilshire 5000 ¹	0.18%	-1.96%	3.37%	9.92%	12.98%	4.02%	8.45%
Interest Rate Sensitive							
PSE Electric Utility Index ²	2.27%	6.18%	4.17%	6.71%	18.66%	8.09%	9.89%
KBW Bank Stock Index ²	-1.04%	1.87%	5.12%	12.09%	11.36%	6.56%	12.60%
S&P 500 Financial Index ²	-0.62%	-0.13%	3.11%	12.40%	12.37%	4.93%	12.64%
Other Indices							
Morgan Stanley Consumer Index ²	1.12%	1.12%	4.46%	9.70%	8.36%	4.64%	8.87%
Morgan Stanley Cyclical Index ²	-0.66%	2.41%	6.76%	19.04%	20.98%	10.95%	10.89%
S&P 500/Barra Growth ³	-0.07%	-3.46%	-0.93%	4.85%	7.30%	0.60%	7.04%
S&P 500/Barra Value ³	0.33%	0.61%	6.53%	12.63%	15.25%	4.24%	9.18%
Gold/Silver Stock Index ²	0.83%	1.66%	12.71%	56.14%	24.35%	24.05%	3.11%

Sources: ¹ Wilshire Associates Incorporated (<http://www.wilshire.com>) and Ryan Labs Inc.

² Bloomberg L.P. and Ryan Labs Inc.

³ BARRA, Inc. (<http://www.barra.com>) and Standard & Poors (<http://www.spglobal.com>)

⁴ Frank Russell Company (<http://www.russell.com>)

Commodity Total Returns

	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Commodity Total Return Indices							
Reuters/CRB ¹	0.84%	5.21%	6.82%	18.30%	16.12%	11.53%	4.27%
Goldman Sachs Commodity ²	1.16%	6.74%	5.25%	13.42%	20.16%	14.57%	8.09%
Rogers International Commodities ³	-0.31%	5.44%	10.05%	20.01%	23.63%	19.73%	12.07%
S&P Commodity ⁴	-0.40%	1.20%	-5.14%	6.22%	14.26%	11.21%	5.43%

Sources: ¹ Reuters/CRB (<http://www.crbindex.com/crbindex/>)

² Goldman Sachs (<http://www.gs.com/gsci/>)

³ Beeland Management Co., L.L.C.

⁴ Standard & Poor's (http://www.spglobal.com/indexmaincommodity_data.html)

World Equity Total Returns (in U.S. Dollars)

	in U.S. Dollars						
	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Morgan Stanley Capital International Indices							
Country							
Canada	-1.56%	0.53%	9.07%	32.10%	29.08%	17.29%	14.40%
France	1.15%	3.12%	16.77%	27.85%	24.76%	10.60%	11.27%
Germany	-0.95%	0.19%	14.07%	30.75%	25.92%	8.47%	8.65%
Italy	0.58%	5.23%	14.41%	22.14%	23.37%	14.10%	12.20%
Japan	-1.11%	-4.56%	1.95%	35.96%	25.19%	6.97%	0.06%
United Kingdom	1.00%	4.93%	13.64%	20.91%	21.29%	10.06%	9.61%
United States	0.11%	-1.57%	2.52%	8.83%	11.38%	2.37%	8.25%
Region							
World Index	0.01%	-0.33%	6.37%	17.50%	17.41%	6.25%	7.38%
EAFE	0.04%	0.94%	10.50%	27.07%	24.43%	10.53%	6.75%
Emerging Markets (Free)	-0.21%	-4.27%	7.33%	35.91%	34.77%	21.57%	6.66%

World Equity Total Returns (in Local Currency)

	in Local Currency						
	As of 6/30/06			Annualized Ending 6/30/06			
	MTD	QTD	YTD	1 Year	3 Years	5 Years	10 Years
Morgan Stanley Capital International Indices							
Country							
Canada	-0.56%	-4.16%	3.84%	19.94%	20.74%	10.22%	12.07%
France	1.61%	-2.41%	7.72%	21.05%	20.37%	1.85%	11.23%
Germany	-0.50%	-5.18%	5.23%	23.79%	21.49%	-0.12%	8.70%
Italy	1.04%	-0.41%	5.54%	15.64%	19.03%	5.07%	12.06%
Japan	0.84%	-7.53%	-1.26%	40.27%	23.15%	5.12%	0.48%
United Kingdom	2.19%	-1.59%	5.48%	17.18%	16.77%	4.19%	7.72%
United States	0.11%	-1.57%	2.52%	8.83%	11.38%	2.37%	8.25%
Region							
World Index	0.54%	-2.86%	3.16%	15.77%	15.64%	3.47%	7.36%
EAFE	1.12%	-4.02%	3.92%	24.16%	20.61%	4.24%	6.46%
Emerging Markets (Free)	0.09%	-2.88%	6.51%	34.12%	30.51%	19.20%	10.57%

Sources: Bloomberg and Morgan Stanley Capital International (<http://www.msdata.com/>)

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511

Fax (847) 304-1749

e-mail: research@biancoresearch.com

<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599

James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 625-1860

Fritz Handler fritz.handler@arborresearch.com

Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560

Fax (847) 304-1595

e-mail inforequest@arborresearch.com

<http://www.arborresearch.com>

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602

Daniel Lustig dan.lustig@arborresearch.com

Phone (866) 877-0266

New York Sales Office

The Chrysler Building

405 Lexington Ave

New York, NY 10174

Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326

Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

Director of International Sales (847) 304-1560

James L. Perry james.perry@arborresearch.com

Brent E. Glendinning brent.glendinning@arborresearch.com

London Sales Office

4 Broadgate

2nd Floor

Room 57

London England EC2M 2QY

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com

Phone 44-207-965-4784

Fax 44-207-965-4787