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Leading Through a Historic Bond Rally

Typically, the biggest risk in a bond rally is waiting too long to trim positions and getting caught in a downturn. In a recent conference call, Calvert Senior Vice President and Portfolio Manager Greg Habeeb explained how the biggest risk in recent months has been paring back too soon and possibly missing out on the opportunity to regain lost ground during the largest corporate bond rally in history.

How have Calvert's taxable bond funds generally fared this year?

Our funds have experienced a significant turnaround in the last few months. Ironically, February was one of the worst months for corporate bonds, but it was one of our best as some of our holdings rallied. That's the month things started to go our way as the subordinated financials and other battered types of securities we held started to bounce back. The good news is the February rally of our positions has continued and we've been able to take advantage of that.

In addition, the yield curve has been quite volatile this year—first it flattened, then steepened, and then flattened again. On the whole, the steepening of the curve has not been beneficial. However, we do implement trading strategies that take advantage of changes in the shape of the yield curve.

Volatility in the Treasury market has played to our strength this year as well. Generally, we sell 10-year bonds and buy two-year notes when we believe the Treasury yield curve will steepen, and then do the reverse when we believe the curve will flatten. Since February, the two-year to

ten-year Treasury spread has traded as tight as 180 basis points and as wide as 280 basis points. This unusually large range provides us with both opportunities to add to core positions and to trade opportunistically.

Does this mean the economy has started to recover?

We're a bit skeptical because there are a number of noticeably weak economic indicators right now. Unemployment tops the list, and corporate earnings have been declining as well. On the other hand, the economy has made some improvement. For example, the banking sector made some gains as the federal government made it clear it wasn't letting the whole industry go under. However, while some areas of the economy have seen small improvements, the housing market overall is still weak. The best you can say is that the decline in the housing market is slowing.

Remember that the market generally tends to look ahead and anticipate events, which can be both good and bad. In 2008, when we were seeing major financial institutions fail and unemployment rise, forward-looking investors became unduly pessimistic. The result was the worst decline in

corporate bonds this century and a massive broad-based downturn in the stock market. Currently the markets may be looking ahead, thinking that the worst is over. And, it may be and may not be.

What's your outlook for the bond market?

It's amazing that the credit markets have recovered more than 50% in less than six months and the stock market has significantly rebounded from its lows. But a strong rally, especially in such a short period of time, always harbors the possibility of a reversal. There is still upside potential. The difference in yield between corporate and U.S. Treasury bonds is still much wider than the historical mean. But we're dealing with a situation that has no historical precedent. So it's a really tough call to predict the next big move in credit spreads.

How are you positioning the Funds now?

Since March, we've been lightening up on corporate securities in order to minimize the damage if bonds do start selling off. In some cases, we've captured gains by selling securities

we felt had become fully priced, and in others, we've sold securities we still think are cheap but also have significant downside potential. Of course, if you go too light in credit, you could miss rallies. So it's a balancing act. However, at this point, I feel the rally has gone to far, too fast. I'm willing to risk missing some of the rally to be defensive if the market declines. By no means are we getting out of corporate bonds—we still have 51% stake in them in the Calvert Income Fund. We've just cut the position back so we have more flexibility if the rally is over and corporate bonds weaken.

One point I want to make is that you shouldn't read too much into the amount of cash we're holding at any one point. It doesn't mean we're bullish or bearish, and it's not a good indicator of our Funds' risk levels. Our cash position supports our trading strategies. With funds as large as ours, the cash position can change 10% during the day without changing the credit exposure.

Are there types of bonds you generally avoid?

We don't usually invest in Treasury Inflation-Protected Securities (TIPS)

or mortgages. We don't take a position on inflation in our portfolios. I don't think TIPS are sound investments. Occasionally, they have a good year—most of the time though you get substandard returns. And, while we do hold small positions in mortgages, we generally feel that holding mortgages can make it difficult to control a portfolio's duration.

What sector or types of bonds do you think have the most potential going forward?

Well, one sector would be the one with the most risk—financials. They're pretty beaten up. Over the past year, we've seen how much the government is willing to do to ensure the banking industry survives. Since the memory of last year is still fresh, financials haven't rebounded as much as other sectors. In addition, asset-backed securities, including some offered by the automobile companies, are attractive. There are still bargains out there. The ones with the most potential often have the most downside risk as well. You just have to be careful because of the vulnerability in the market in this recessionary downturn. ■

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