

The Banyan Guide to Bond Surrogates

Investing for Higher Income Plus Growth Potential All-in-One

Earning a reliable stream of income is one of the primary reasons investors hold fixed-income securities. But today's record-low interest rates present a big challenge if you're counting on earning attractive yields from fixed-income holdings.

Yields on most fixed income investments — across the board — are near record lows. For example, yields on short-term savings instruments, such as bank certificates of deposit (CDs), money market funds and even US Treasury securities are near record lows. Likewise, corporate bonds have also witnessed a steep decline in yield over the last few years ... making it more difficult than ever to earn an adequate level of income to meet financial needs.

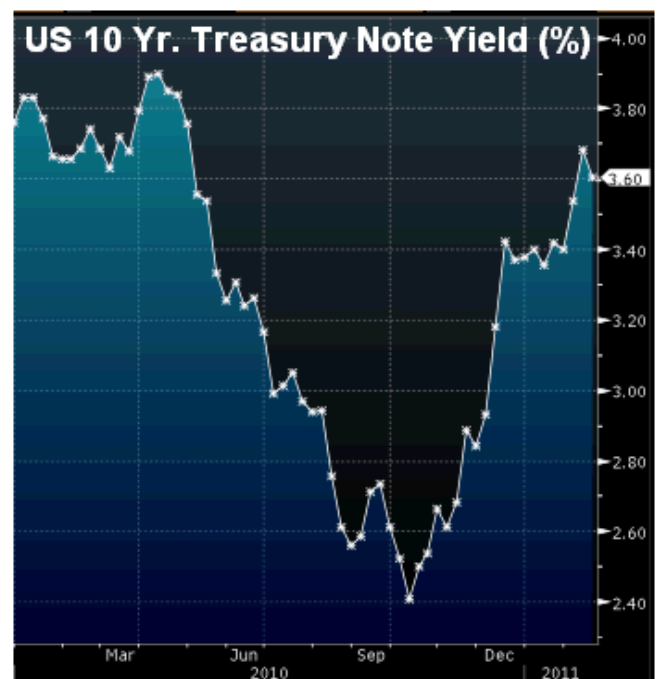
Here's the dilemma: The majority of fixed-income investors count on bond holdings to generate a regular income stream; fewer invest in bonds for capital appreciation potential alone. The most common way to achieve higher current income from traditional bonds is to invest in longer-term bonds or be willing to make a trade off in terms of lower credit quality bonds. But, reaching for the extra yield a 20- or 30-year bond provides may be the wrong choice right now.

The reason: With government debt levels soaring, the specter of inflation could rear its ugly head at any time. If you can be certain of anything in today's turbulent financial markets, it's that interest rates are eventually going to move higher from near-record low levels.

It is only a question of timing, in our opinion.

Should inflation surge higher, then interest rates will

Interest Rates on the Rise Since Fed Announced QE2

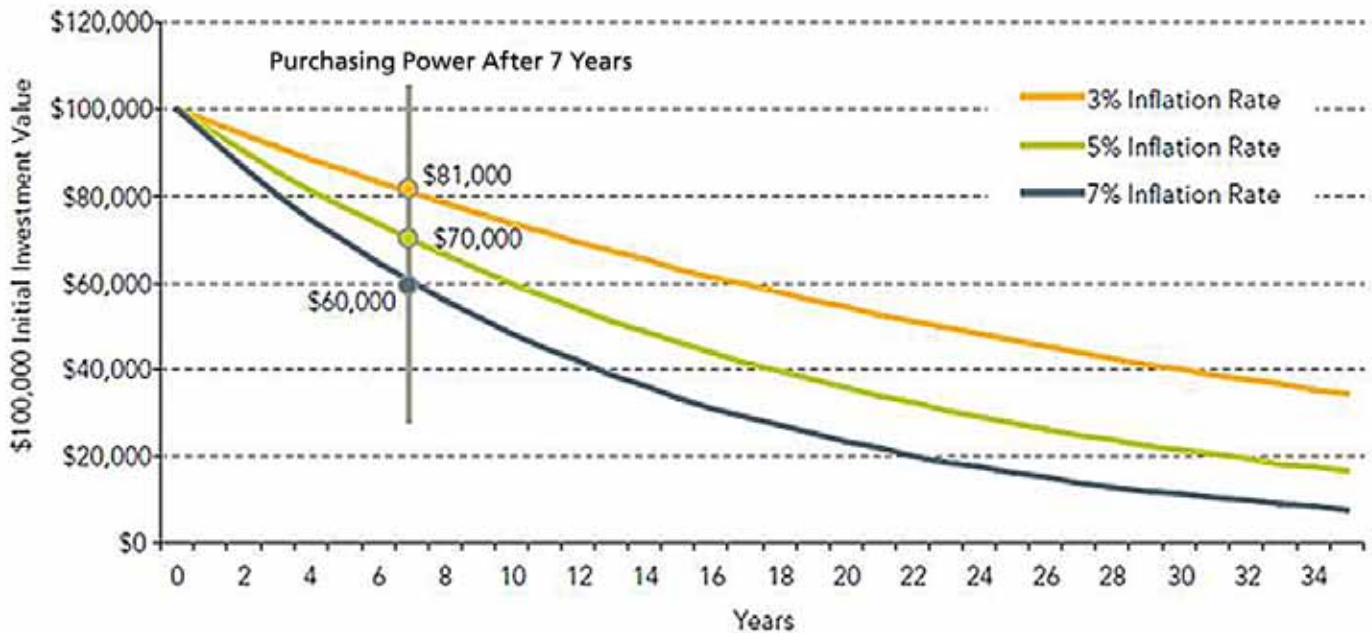


Source: Bloomberg Market Data, 2/25/11

climb, causing your bonds — government and corporate alike to suffer a potential loss of capital as prices on those previously issued bonds with lower rates become less valuable. And when yields go higher, bond prices go lower. As a result, if you're holding a portfolio full of long-dated bond maturities during a rising rate climate, you face a potential loss of capital.



Inflation's Effect on Purchasing Power



Source: FMR Co, MARE: 5/1/09

Many investors today may simply not be prepared for this potential hazard. In fact, money has been pouring into fixed income mutual funds over the past several years, potentially putting investors at even greater risk from an interest rate reversal.

If you are an income-oriented investor with a moderate risk tolerance, then this may be the right time to get another look at your fixed-income investments and consider rebalancing your portfolio. Let's take a look at the 10-year US Treasury note — the recognized benchmark for interest rates.

Today, 10-year US Treasury bonds yield less than 3.5 percent — which isn't much earning power over the next decade. The tradeoff for such a low yield is the perception of lower risk.¹

Treasury bonds are considered relatively risk-free because it's assumed the US Treasury would never default. In other words, lending money to the US government is considered a low "credit risk" — most likely you'll get your stated coupon payments and your principal back at maturity — but they are still susceptible to other types of risks. What we're emphasizing here is interest rate risk — the risk of interest rates rising causing the value of bonds to

decline. This can have an equally devastating impact on an investor's portfolio if it's not managed carefully because it erodes the value of your principal over time.

While your credit risk with Treasury bonds may be negligible, you can't discount the impact of interest rate risk ... the risk that future inflation and higher interest rates could reduce your purchasing power as rates climb.

Consider this, the historic inflation rate since 1926 has been about 3 percent, so a 10-year Treasury yielding 3.5 percent today offers you a real (inflation-adjusted) yield of just one-half of one percent.²

That's not much protection against even a small inflation uptick.

Needless to say, even longer-term corporate bonds of higher quality are not offering much yield pickup either.

What steps can you take now to potentially boost your income and hedge against the risk of higher interest rates and inflation?

One step is to begin paring back your conventional long-term

bond holdings — including long-term corporate bonds, long-term US government bonds, and zero-coupon bonds. For certain investors, there are alternatives.

One alternate you may want to consider is adding specialty investments. Investments we refer to as **bond surrogates**. These investments can offer both higher yields now, along with a growing income stream over time ... plus capital appreciation potential.

With traditional bond holdings, you're locked into a fixed-coupon interest rate for 10, 20 or even 30 years and, if you sell before maturity, you could suffer a loss of capital if interest rates are higher. And right now, these fixed yields are near record low levels.

But with the bond alternative securities we detail in this special report, you may be able to realize some significant investment benefits. In fact, many of these bond surrogates offer the potential for ...

#1 Higher current income ...

#2 Longer-term capital appreciation...

#3 AND rising yields over time!

Let's take a closer look at these bond surrogates to see how they could be an alternative to bonds in your investment portfolio ...

Emerging Market Bonds

If you prefer the greater certainty offered by fixed-coupon securities, there are other types of bonds, bond funds and ETFs that can offer higher current yields than you'll find in longer-term domestic bonds today. Plus, they can offer some other added benefits as well.

Many countries and corporations around the world pay higher interest rates than those available in the US today. Plus, the credit quality for some of these bonds is just as good — and in some cases, perhaps better — than domestic bonds.

Many over-indebted mature nations have been subject to credit rating downgrades recently (Japan, Portugal, Ireland, etc.). Meanwhile, credit quality has been stable or rising for many developing nations.

International bonds or fixed-income funds focused on these more fiscally responsible regions of the world can provide higher

yields than available in the US. What's more, these securities are often denominated in local currencies that can rise in value when the US dollar falls, providing you with the extra benefit of a currency hedge. You must, however, be very selective as there are certain unique risks for international investing such as political risk, currency risk, differences in accounting procedures and the amount of public information available about non-US companies.

Many large, multinational corporations outside the US issue corporate bonds as well — companies like Nestle, BP, Toyota, and Daimler Chrysler come to mind. But international bond funds or ETFs may be a better way to approach international fixed-income markets. That's because you're able to spread out your credit risk using a broad mix of bond holdings.

An international bond fund or ETF may include many different bonds from a diverse mix of countries and companies from around the world, giving you instant diversification in a single security.

One example is the WisdomTree Emerging Markets Local Debt Fund ETF (NYSEArca: ELD), which provides broad diversification in local bonds from a range of emerging market countries, including Brazil, Chile, Poland and South Korea, among others. This ETF offers a yield to maturity of 5.5 percent with a relatively short effective duration of just over five years.³

Consider Corporate Credit

In our view, growing strength in the US economy coupled with strong corporate balance sheets makes higher yielding US corporate bonds look attractive — especially those of medium term maturities.

One reason: As profits recovered in 2010, cash levels among US corporations grew to the highest percentage of total assets since 1959!⁴

Another: Corporate bonds have two built-in advantages over Treasuries that can help cushion them against rising interest rates so if you invest in bonds for reasons other than security, consider this...

First, they are somewhat protected by the higher yields they typically enjoy over Treasury bonds of comparable maturity.

Second, when rates rise due to growing strength in the econ-



High Yield Corporate Bonds Outperform Treasury Bonds



Source: Bloomberg Market Data, 3/11/11

offer you a better margin of safety and lower volatility than others ... and many offer a rich dividend yield too ... oftentimes higher than today's bond yields.

Equities that have dynamically expanded their dividends on a consistent basis over a long period of time are a special breed of securities that can offer significant advantages for patient, long-term investors.

Standard & Poor's keeps a list of stocks in the S&P 500 Index that have managed to boost their annual dividend payments each and every year for the past quarter-century. Known as Dividend Aristocrats, very few stocks make the cut. In fact, only 42 stocks made the grade in 2011.⁷

One of these is 3M Company (NYSE: MMM), a blue-chip household name that also happens to be on the Banyan buy list.

omy, corporate yield spreads tend to tighten, which can provide additional capital appreciation potential even when Treasury bond prices slip.

Late in 2010, for example, after the Federal Reserve announced a second round of quantitative easing, long-term Treasury bond prices took a hit as yields moved higher. But tighter corporate yield spreads helped offset the interest rate backup for investors in higher yielding corporate bonds.⁵

Over the last six months, for instance, high-yield corporate bonds have rallied about 3 percent higher, even as US Treasury bond prices tumbled.⁶

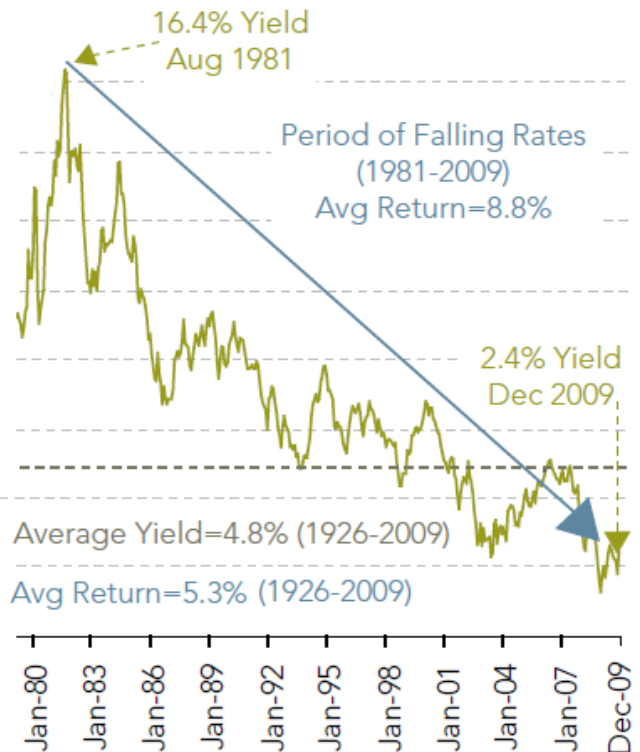
That said, you've got to be very selective when it comes to choosing individual corporate bonds, not to mention foreign bonds, for your investment portfolio.

Dynamic Dividend Plays

Many of the bond surrogates we have selected are actually equity-based. And for fixed income investors, buying individual stocks to produce cash flow requires due diligence and careful selection. Remember, not all equities are created equal. Certain stocks may

Nowhere to Go But Up?

Intermediate-Term Treasury Bond Yield



Source: FMRCo (MARE) as of 12/31/09

3M pays an indicated annual dividend of 2.4 percent today, and has been boosting its annual payouts for the past 25 years ...

In fact, 3M has been paying dividends each and every year since 1916!⁸

Think about that for a moment: 3M has consistently paid dividends through two World Wars, the Great Depression, the inflationary 1970s and the recent financial crisis. Through thick and thin, it has never skipped a dividend payment! That's an extraordinary track record. And it's a big advantage that too many income-seeking investors miss.

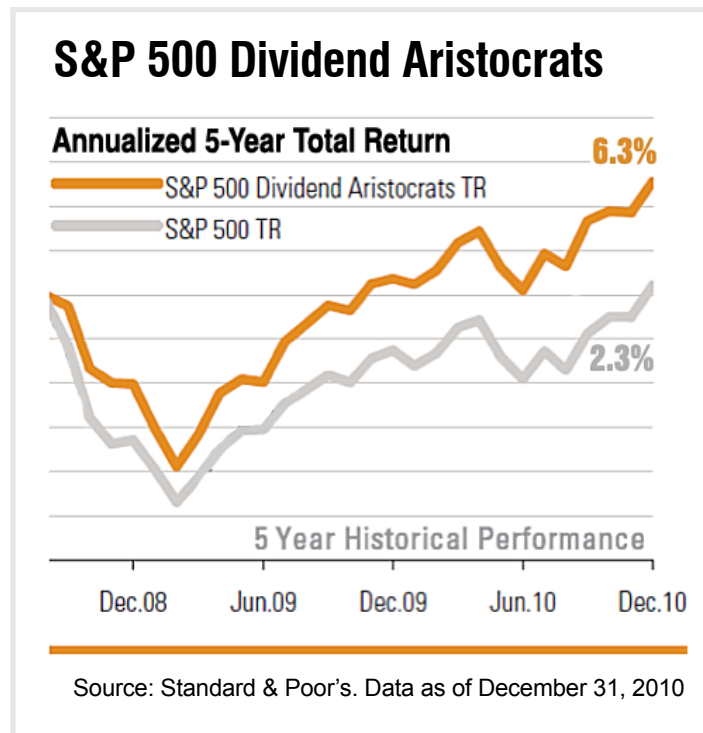
A yield of 2.4 percent today may not sound like much income, although it's more yield than you'll get from a 5-year US Treasury ... and nearly as much as a 10-year T-bond ... but the annual payout from bonds are fixed ... while 3M's yield has consistently grown larger.

For example, if you invested in 3M 10 years ago, your current "effective" yield has grown much higher ... to more than 4 percent today! That's because 3M's dividend has continued to grow. In fact, 3M's annual dividend has grown more than 83 percent since 2001 alone!⁹

So if you had purchased 3M shares in 2001 at an average price of \$52 a share, you would have already collected \$16.78 per share in annual dividend payments along the way. That's one-third of your original investment paid back through dividends alone! Plus your effective dividend yield today (on your original cost basis) has nearly DOUBLED since 2001 to 4.2 percent today!¹⁰

Indeed, 3M has been a dynamic dividend play. And there are many others on our current buy list at Banyan Partners including, Johnson & Johnson (NYSE: JNJ), Kimberly-Clark (NYSE: KMB), and Abbott Labs (NYSE: ABT), among others.

Stocks in this elite group have consistently outperformed the



overall stock market in recent years too ... and by a wide margin. For instance, the S&P Dividend Aristocrats Index has posted total returns of nearly 6.3 percent annually over the last five years. That's almost three times the return of the S&P 500 Index, which is only 2.2 percent per year over the same period!¹¹

Of course, dividend paying common stocks are not an identical substitute for Treasury bonds by any means. It's not an apples-to-apples comparison. Companies can reduce or even eliminate dividends. And stock prices, even blue-chips like 3M, are more volatile than government bonds.

That's why you've really got to do your homework evaluating any investment before investing, because with any stock, there is a risk of loss. We're simply pointing out that Treasury bonds pose a different type of risk, which you also need to be fully aware of.

The bottom line is that with a little patience, and if you're willing to do your homework, you can own high quality blue-chip equities with the potential for attractive and growing dividend yields over time. This equity component of your portfolio can not only help meet your income needs, but also may provide an important hedge against inflation and price appreciation potential that bonds may not be able to match in today's low interest rate environment.

Asset-Backed Equities

A more elite class of equities in terms of their generally higher income potential, are shares of Master Limited Partnerships (MLPs). These securities often pay dividend yields in the range of 7 to 8 percent. Many investors aren't that familiar with MLPs, even though they have generated some of the best gains of any asset class over the last decade.¹²



For example, the Alerian MLP Index, a composite of the 50 most prominent energy Master Limited Partnerships, produced a total return (including dividends) of 17.4 percent annually over the past 10 years, compared to a gain of just 2.5 percent for the S&P 500 Index.¹³ (It is not possible to invest directly in an index).

And over the last five years, the performance of MLPs really shined — beating the S&P 500 Index by a margin of nearly 7-to-1 in total return over the period!¹⁴

The higher dividend yields that MLPs offer ... not to mention the fact that income payouts may be tax-deferred ... helps to insulate these securities from wide price swings, but keep in mind, their market value will fluctuate just like any other stock.

MLPs are essentially asset-backed equities. Many operate in the energy sector and are backed by the cash flows from specific hard assets ... like oil and gas pipelines or storage terminals. The advantage here is that MLPs generate regular and recurring fee-based income, which doesn't fluctuate as much as energy commodity prices.

An example of an MLP on our Banyan buy list is Enterprise Products Partners (NYSE: EPD) the largest publicly traded MLP, which operates more than 50,000 miles of onshore and offshore oil and gas pipelines. Enterprise pays an indicated dividend yield of nearly 6 percent.¹⁵

We believe that dividend growth rates for MLPs in general could run in the mid-to-high single digit range in the coming years, resulting in annual total returns above 10 percent.

As an added bonus, MLPs also offer another potential advantage: favorable tax treatment.¹⁶

Since they typically pay out almost all their annual cash flow in the form of dividends, 70 percent or more of the payouts from many large MLPs are tax-deferred to the investor. But a word of caution

applies: Buying MLPs within an IRA can cause a taxable event if you aren't careful due to Unrelated Business Taxable Income received from the investment, so be sure to consult with your tax professional.¹⁷

These securities are not without unique risks of their own. MLPs, like dividend paying stocks, are subject to market price fluctuations and dividend payouts can change or be cut. Careful selection is necessary to help you steer away from industry specific volatility and commodity-price risk. But the relatively high dividend yields offered, plus the potential for increasing yields over time, can also help insulate these bond surrogate securities from the threat of higher inflation that can devastate long-term bonds.

Bond surrogates of all kinds, including equities, with a strong track record for dividend growth potential and MLPs, can help you earn more income than bonds may provide and should help reduce the risk of higher interest rates and inflation. But please keep in mind that when investing in these or any individual security, you've got to be willing to roll up your sleeves and do the work necessary to uncover the right securities. Also, it's important to

MLPs Outperform Stock Market and Bonds

Current Yield Comparison

Alerian MLP Index Yield	4.67%
Bond ETF Yield	3.24%

10 Year Annualized Total Return

Alerian MLP Index	17.43%
S&P 500 Index	2.52%
Barclays US Agg. Bond Index	5.61%

Source: JPMorgan Chase & Co. as of 3/8/11

properly diversify your portfolio among multiple securities.

At Banyan Partners, we perform extensive research and balance sheet analysis on hundreds of companies, including a large number of bond surrogate securities. We closely monitor each security on a daily basis and provide each client with a customized portfolio that is best suited to their specific investment goals and desire for income.

Whatever investment approach you follow, be sure to do your homework carefully and make sure each investment is appropriate for you based on your risk tolerance, time horizon and investment experience. There is no substitute for careful analysis.

There's no better time than the present to consider taking that next step and learning more about how to help protect your wealth from the threat of higher interest rates and inflation. And we invite you to

contact us to discuss the investments that are most appropriate for your individual needs. If you have a portfolio of \$250,000 or more*, contact a Banyan Financial Advisor today for your complimentary and no-obligation comprehensive review of your current investment portfolio.

You'll receive a personalized, one-on-one consultation including a complete review of your current fixed income investments ... and it won't cost you a penny. There's no cost or obligation for this valuable consultation; our goal is to help you manage your money more effectively.

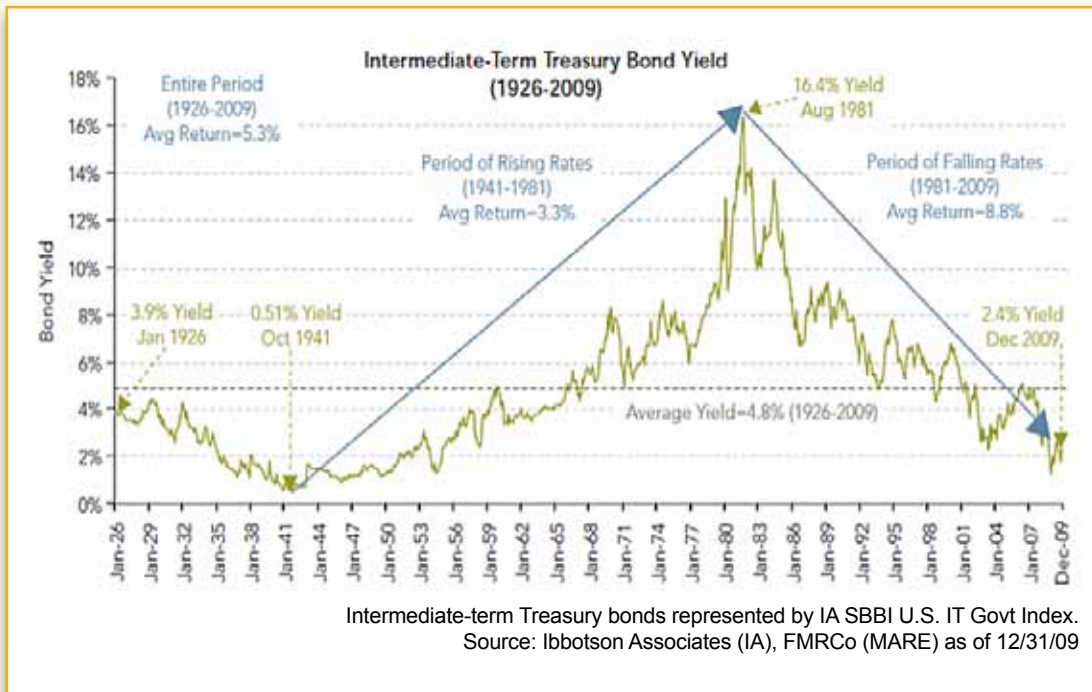
After receiving your complimentary portfolio review, you may

or may not choose to act on our recommendations, but either way you'll have the benefit of our insights and expert opinions about your investments.

At Banyan Partners, we're convinced we can provide you with fresh insights about your investments and we're happy to provide you with more details about the full spectrum of professional and customized money management services and strategies we offer.

We invite you to contact us right away for your complimentary portfolio review. Just call a Banyan Financial Advisor today at 800-814-3045.

Why Long-Term Bonds Face Stiff Headwinds



Since 1926, the return on intermediate-maturity Treasury bonds has averaged 5.3 percent annually. Historically, most of this return ... over 90 percent ... has come from coupon payments — or the annual yield received.¹⁸

Today's coupon yield for newly issued 10-year Treasury notes is only about 4 percent; however, quite a bit less than the average annual return of 5.3 percent.

That means today's bond market investors must count on a lot of price appreciation

potential to produce just average returns going forward.

How likely is that?

We don't think it's likely ... for a very important reason. The grand bond bull

market that started in 1981 is no longer running full steam ahead. This bull market for bonds began from a favorable starting point when Treasury bond yields peaked at 16.4 percent in August 1981— ah, the good old days.¹⁹

From such lofty yield levels, there was almost no place for yields to go but DOWN and for bond prices to go but UP. Sure enough, bonds returned an average of nearly 9 percent annually over the nearly 30 years that followed the 1981 interest rate peak.²⁰

A significant tailwind pushing bond returns higher during that period was steadily falling inflation and interest rates.

But today, this tailwind has turned into a hostile headwind for the bond market. With inflation likely to return due to massive government deficits ... and with Treasury yields already at such low levels today ... the upside for long term bonds appears much more limited from this point.

During the last secular bear market (or down trend) for bond prices — from

1941 to 1981 as interest rates and inflation were on the rise — investors in Treasury bonds (intermediate maturity) earned a yearly return of just 3.3 percent during this period as bond prices steadily declined about 1 percent per year. This price erosion also ate into income gains of 4.4 percent annually!²¹

The long bond bear market more than half a century ago is perhaps a better model for what could happen in the years ahead.

¹ Wall Street Journal: Pimco's Gross Dumps Treasuries and the Market Yawns, 3/10/11

² FMRCo. (MARE) as of 4/15/09 (See: 4 Ways to Seek Higher Income [DIB] pg. 10)

³ WisdomTree, data as of 12/31/10

⁴ Fidelity Investments: What Bond Owners Need to Know, 2/23/11

⁵ Fidelity Investments: Fixed Income: Opportunity and Risk, 1/26/11

⁶ Bloomberg market data: 3/11/11

⁷ Standard & Poor's, data as of 12/31/10

⁸ Standard & Poor's, data as of 3/5/11

⁹ Ibid.

¹⁰ Ibid.

¹¹ Standard & Poor's: S&P 500 Dividend Aristocrats, 3/5/11

¹² Barron's: Even Better Than Bonds, 12/7/09

¹³ JPMorgan: Alerian MLP Index ETNs, 3/8/11

¹⁴ Ibid.

¹⁵ Enterprise Products Partners L.P., 3/7/11

¹⁶ Barron's: Even Better Than Bonds, 12/7/09

¹⁷ Ibid.

¹⁸ FMRCo (MARE): Bonds: Lower Yields, Lower Expectations, 3/2/10

¹⁹ Ibid.

²⁰ Ibid.

²¹ Ibid.

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