

Global Bond Portfolio Strategy

In our last report we made a number of major changes in our recommended asset mix. We reduced our overweight dollar currency exposure by a modest amount and raised our exposure to both the euro and Scandinavian currencies. Our exposure to the euro remains underweight, but less so than before. We also cut our exposure to sterling from overweight to neutral weight, given our concern that narrowing U.K./U.S. interest-rate differentials would push sterling lower versus the U.S. dollar.

As we look ahead, we see no reason to initiate any new recommendations. The yen appears quite firm at the present time but long-run fundamentals argue for a major weakening over time. As for duration exposure, we retain a modest underweight portion on a global scale, believing that higher oil prices coupled with a gradual pickup in global demand will tend to push bond yields higher over the balance of the year.

Recommended Global Asset Mix (Percent Breakdown)													
Currency Bloc	Currency Decision		Market Decision			Bond Selection Decision					Portfolio Risk		
	Net Currency Position	Currency Hedge	Gross Currency Position	Cash	Bonds	1-3 Years	3-5 Years	5-7 Years	7-10 Years	Long	Portfolio Duration	Currency Risk	Interest Rate Risk
U.S. Dollar	48 <i>32</i>	+6	42 <i>32</i>	0	42 <i>32</i>	0 <i>11</i>	24 <i>6</i>	18 <i>2</i>	0 <i>3</i>	0 <i>10</i>	4.2 <i>5.5</i>	1.50	1.17
Canadian Dollar	6 <i>3</i>	0	6 <i>3</i>	0	6 <i>3</i>	0 <i>1</i>	6 <i>1</i>	0 <i>0</i>	0 <i>0</i>	0 <i>1</i>	2.6 <i>6.1</i>	2.00	0.85
Australian/N.Z. Dollars	2 <i>1</i>	-2	4 <i>1</i>	0	4 <i>1</i>	0 <i>0</i>	4 <i>0</i>	0 <i>1</i>	0 <i>0</i>	0 <i>0</i>	2.3 <i>4.4</i>	2.00	2.09
Japanese Yen	9 <i>18</i>	0	9 <i>18</i>	0	9 <i>18</i>	0 <i>3</i>	3 <i>3</i>	3 <i>4</i>	3 <i>6</i>	0 <i>2</i>	6.2 <i>6.2</i>	0.50	0.50
U.K.	6 <i>6</i>	0	6 <i>6</i>	0	6 <i>6</i>	0 <i>1</i>	0 <i>1</i>	3 <i>1</i>	3 <i>1</i>	0 <i>2</i>	5.9 <i>6.8</i>	1.00	0.87
Euro	25 <i>36</i>	-4	29 <i>36</i>	0	29 <i>36</i>	0 <i>9</i>	9 <i>8</i>	15 <i>5</i>	5 <i>8</i>	0 <i>6</i>	4.8 <i>5.2</i>	0.69	0.74
Scandinavia	4 <i>3</i>	0	4 <i>3</i>	0	4 <i>3</i>	2 <i>1</i>	2 <i>1</i>	0 <i>1</i>	0 <i>0</i>	0 <i>0</i>	2.2 <i>4.1</i>	1.33	0.71
Swiss Franc	0 <i>1</i>	0	0 <i>1</i>	0	0 <i>1</i>	0 <i>0</i>	0 <i>0</i>	0 <i>0</i>	0 <i>1</i>	0 <i>0</i>	0.0 <i>5.7</i>	0.0	0.0
Total	100 <i>100</i>	0	100 <i>100</i>	0	100 <i>100</i>	2 <i>26</i>	48 <i>20</i>	39 <i>14</i>	11 <i>19</i>	0 <i>21</i>	4.9 <i>5.4</i>		0.91

How to Read These Tables: The recommended exposure to currencies and bond markets is intended for fund managers whose time horizon for investments decisions is three to six months. Asset mix recommendations are highlighted in **bold**. Global capitalization weights are shown in *italics* as reflected in the **Merrill Lynch Global Government Bond Index** (rounded to the nearest whole number). The extent to which the asset mix recommendations deviate from market capitalization weights represents our recommended overweighting and underweighting of the respective markets. The **gross currency position** indicates our recommended percentage allocation to each of the major fixed income markets prior to currency hedging. The **net currency position** indicates our recommended exposure to each of the major currencies after adjusting the gross currency position for **forward currency purchases(+)** or **sales(-)**. Details on how the recommended portion of funds committed to bonds should be allocated is provided under the section entitled **Bond Selection Decision**. **Currency Risk** is defined as the ratio of our recommended net currency position to the market capitalization weight. **Interest-Rate Risk** is defined as the ratio of our recommended portfolio duration to the market's average duration multiplied by the ratio of our recommended gross currency position to the market capitalization weight. A reading above 1.00 for these risk measures would indicate greater recommended portfolio exposure to currency and/or interest-rate risk than a market weighted basket of global and/or European bonds would be exposed to and vice versa. To ensure adequate diversification, we adopt an investment policy which requires that the minimum recommended currency and interest-rate risk measures in each market be set at 0.50.

European Bond Portfolio Strategy

European Bond Markets: Recommended Asset Mix (Percent Breakdown)												
Currency Bloc	ML Index	Currency Decision		Market Decision			Bond Selection Decision			Portfolio Risk		
		Net Currency Position	Currency Hedge	Gross Currency Position	Cash	Bonds	Maturity Structure			Currency Risk	Interest Rate Risk	
							1-5 Years	5-10 Years	10+			
Euro-Region Currencies:												
EMU Broad Mkt	EMU0	75 82		75 82	0	75 82	45 42	24 31	6 9	4.3 4.7	0.91	0.83
Direct Gov't	EG00	37 52		37 52	0	37 52	20 25	13 19	4 7	4.7 5.1		0.67
Quasi Gov't	EQ00	11 8		11 8	0	11 8	7 5	3 3	1 1	4.0 4.2		1.26
Pfandbriefe	EP00	19 16		19 16	0	19 16	14 10	5 6	0 0	3.4 3.7		1.09
Corporate ex-Pfandbriefe	ER00	8 7		8 7	0	8 7	4 3	3 3	1 1	4.6 4.7		1.08
Sterling Broad Market												
Sterling Broad	UK00	17 13		17 13	0	17 13	6 4	7 4	4 5	5.8 7.0	1.28	1.12
Gilts	G0L0	10 9		10 9	0	10 9	3 2	4 3	3 3	6.3 6.7		1.05
Non-Gilts	UN00	7 4		7 4	0	7 4	3 1	3 1	1 2	4.8 6.2		1.23
Other Pan-European Markets												
Denmark	G0M0	3 2	0	3 2	0	3 2	1 1	2 1	0 0	4.6 4.8	1.56	1.50
Sweden	G0W0	2 2	0	2 2	0	2 2	1 1	1 1	0 0	4.0 4.4	1.01	0.91
Switzerland	G0S0	0 1	0	0 1	0	0 1	0 0	0 0	0 0	0.0 5.2	0.00	0.00
Diversification Markets (Not included in the Pan-European Broad Market Index)												
Norway	G0J0	0 0	0	0 0	0	0 0				0.0 4.5	0.00	0.00
EU High Yield	HE00	0 0	0	0 0	0	0 0				9.0 5.0	1.00	1.82
£ High Yield	HL00	0 0	0	0 0	0	0 0				11.4 5.8	1.96	3.84
ABS	na	1 1	0	1 1	0	1 1				na na	na	na
Converging Four		1.5 1	0	1.5 1	0	1.5 1				0.0 3.8	2.44	0.00
Total		100 100	0	100 100	0	100 100	53 48	34 37	10 14	4.4 4.9		0.90

Note: Bond Selection categories do not sum to 100% because allocations for Switzerland and Diversification Markets are not broken down by maturity.