

INCOME BUILDER

MAJOR POINTS:

- **Market Outlook:** Market in correction mode. Economic recovery still intact. Long-term prospects for the financial markets unclear. (p1)
- **Fixed Income Performance Through Mid-Year.** Credit sensitive sectors shine. U.S. Treasuries underperform as expected. Short-maturity TIPS outperformed the market significantly as fears of deflation subsided. At current levels, TIPS appear to be fairly priced. Modest upside potential still exists in corporate bonds. (p2)
- **GE/GE Capital split?** Regulatory changes will likely prompt GE management to reconsider its commitment to its financing subsidiary. According to CEO Immelt, a wide gulf now exists between GE Capital's implied value and its actual worth. GE could capture this difference for its shareholders by spinning off the business. (p7)
- **Barclays Capital 1-3 Year Credit Bond Fund (CSJ):** This ETF appears to be a good choice for fixed income investors. Focuses on good credit quality (average credit rating of single-A). Short average maturity limits interest rate risk. (p8)
- **ACTION THIS ISSUE:** Adding CSJ to the fixed income portfolio. (p8)

MARKET ACTION

BY STEPHEN P. PERCOCO

Since the early-March lows the stock market has mounted a strong advance that has essentially recouped this year's previous losses. The S&P 500 is up 36% since early March, but only 2% year-to-date.

The stock market's recovery has been paced by the growing recognition that the Federal Reserve's massive intervention has helped the credit markets return normalcy. Increased availability of credit has, in turn, helped corporations take their feet off the brakes and begin the process of rebuilding inventories. In time, probably before the end of the year, the economy will turn up, but the job market may not begin to recover until sometime in 2010.

For the moment, many traders believe that the stock market has come a little too far too fast. So they expect at least a modest correction over the next few weeks. Such a correction could also help to confirm the early-March low, setting the stage for a sustained rally through the end of the year and perhaps into 2010.

Others want to see more evidence that the economy is really on the mend before stepping in to bid stocks higher. The recent



Source: Stockcharts.com

data on the economy has been mixed. Some indicators, like durable goods, have bounced back nicely. The housing market has also stabilized, albeit at very low levels, over the past few months. However, industrial production is still on a downside and capacity utilization is at a record low for the post World War II era. Better economic news across the board combined with forecasts of improving revenues and earnings by major corporations seem to be the key to convincing investors that an economic recovery is for real.

Although a correction certainly appears to be in the offing, it is a good bet that the stock market will be higher by year-end. That assertion assumes that

there are no major exogenous events, such as a blow-up in the Middle East, that would change the outlook dramatically.

After that, however, it is unclear just how long any recovery in the stock market and the economy will be sustained. Many people are worried about the negative ramifications of all of the Federal government's efforts to keep the economy from sinking. Inflation is probably the main concern, but a potentially sharp drop in the dollar could also quickly derail any recovery.

Despite the uncertainty, I believe that it is still prudent to take money out from under the mattress and put it to work in stocks or in selective segments of the fixed income markets.

Mid-Year Fixed Income Review

The various fixed income sectors have recovered almost completely from October's financial market meltdown. Credit sensitive sectors, which suffered the most last fall, have seen the greatest gains; while the U.S. Treasury bond market, the primary beneficiary of flight to safety buying, has seen yields rebound nearly to pre-crisis levels. Although most of the easy money has been made, there is still a modest degree of upside in the most credit sensitive areas, assuming that an economic recovery begins to take hold within the next several quarters. There is still, though, considerable uncertainty as to how these sectors will perform over the long-term.

Many aspects of the financial crisis were unprecedented. Yet, the progression of the recovery in fixed income markets was predictable. The crisis started in the short-term credit markets and spread quickly to all types of investment securities. Amidst the turmoil, Fed Chairman Ben Bernanke said early on that both the financial markets and the economy would recover once normalcy returned to the credit markets.

The onset of the crisis was evident in the surge in the interbank lending rate, known as 3-month LIBOR (see Chart). Last September, LIBOR spiked from around 2.75% to nearly 5% in just a few weeks, putting it more than 450 basis points over the yield on 3-month T-bills. This was the highest spread on record. But through the Fed's efforts to boost bank liquidity and support the commercial paper market and money market funds, LIBOR fell back to 2% just as fast. With the Fed's massive intervention, the credit markets quickly began to heal.

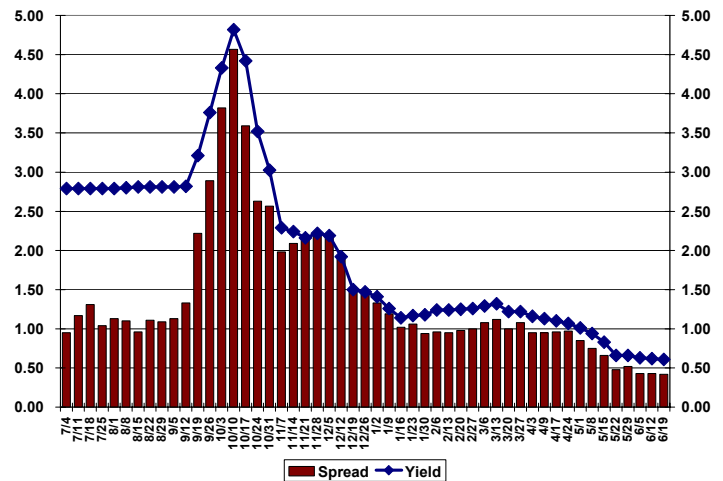
As the panic began to fade, those sectors, like investment grade corporate bonds, that were less sensitive to the economic downturn and which had suffered the least in the sell-off, recovered the fastest. Meanwhile, sectors with high credit risk, like CCC-rated junk bonds, did not recoup most of their losses until just recently, until confidence about the prospects for an economic recovery began to rise.

Although the broader market, as measured by the Barclay's Capital Aggregate Index, posted a 5.2% gain for all of 2008, performance was mixed across all fixed income sectors. Future prospects for these sectors are also quite varied.

Municipal Bonds. The Merrill Lynch Muni-master Index, a broad measure of the municipal bond market, delivered a total return of 1.2% in 2008. That wasn't as good as the Barclay's Aggregate Index, but it was certainly better than the stock market and also many other fixed income sectors.

Within the muni market, however, performance was quite mixed. Intermediate term munis, those with maturities averaging 7-12 years, gained 3.5% in 2008, but longer

3-Month LIBOR yield and spread vs. 3-Month T-Bill yield



Source: U.S. Treasury, Barron's

maturity muni bonds, with maturities in excess of 22 years, lost 15.5%. This had nothing to do with interest rates. Long-term U.S. Treasury bonds rallied sharply as the year came to a close, earnings double-digit returns. Thus, taxable-equivalent credit spreads for munis widened significantly. There are several possible explanations for the disparity.

First, the turmoil in the financial markets and the fear of a potentially deep and long-lasting recession raised concerns about the possibility of increasing defaults. Investors were probably still comfortable that major problems would not become widespread in the near-term, but they were probably unwilling to make that bet for the long-term.

Second, several major investment banks withdrew from the muni market. The loss of capital and liquidity was probably most significantly felt in the long end of the muni yield curve.

Third, several important credit insurers were downgraded, making their guarantees less valuable. Bonds that were rated AAA and that had traded as such, lost value to reflect their higher risk.

Since the beginning of the year, the muni market has recovered much of its lost value. The Muni-master Index is up 3.3% to date, driven by the gains in the longer maturity issues, which are up 13.2%.

Despite the recovery, however, the risks have not gone away. True, municipal bond defaults have never been high. The peak during the Great Depression was less than 2%. But times have changed. Certain classes of munis, like revenue bonds, did not exist until the 1960s. It is also almost certainly true that municipalities on average are more highly leveraged today and the muni bond market is much bigger today, with substantially greater diver-

sity in the types of bonds issued. Consequently, there is a much higher probability, in my view, that defaults will exceed the previous records.

For that reason, many financial advisors are recommending that investors focus on General Obligation bonds or those issued to finance critical infrastructure, like water, sewer and power projects. By some estimates, this accounts for about 70% of the market. Such a focus may be a good start, but it is probably not enough to avoid significant potential losses.

For those investors seeking to maximize total return, therefore, more homework is required. The Municipal Securities Research Bureau (MSRB) has launched a website called EMMA (emma.msrb.com) from which investors can get financial reports and offering memorandums of many municipal bond issuers. Both government and industry participants are pushing municipal bond issuers to disclose more information on a timely basis, but it will take time to achieve broad participation. Those who invest in municipal bond mutual funds will also want to spend more time reading prospectuses and annual reports to ensure that their fund's performance and execution of its strategy is on track.

In these tough times, investors may also consider putting their money in this sector to support their own state and local governments. In this case, investment returns should not be disregarded, but they should instead be considered a secondary objective.

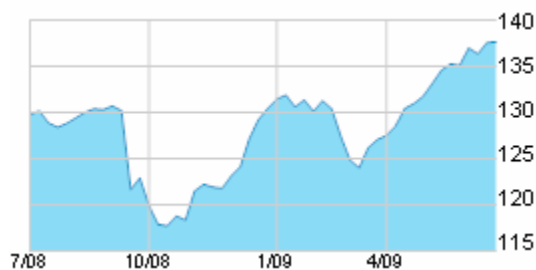
Investment Grade Corporate Bonds. As with nearly all fixed income sectors, investment grade corporate bonds sold off sharply in the weeks immediately following the collapse of Lehman Brothers. However, these securities reached their lows in early November and recovered steadily until the end of the year. By year-end, they had regained all of what had been lost.

A somewhat similar result has occurred this year. High grade corporates sold off modestly during the February-March slide in the equity markets, but not nearly as badly as in October. Since the equity market's early-March lows, they have rallied nicely, so that year-to-date gains as of June 26, were 6.3%, according to the Bloomberg/FINRA Investment Grade Bond Index. Investment grade bonds now carry yields of less than 6%, lower than they were before the October financial crisis.

Within the investment grade sector, those bonds carrying the greatest credit risk - i.e. those carrying the lowest investment grade rating of BBB - suffered the most in the sell-off and have recovered the most in the rebound. By and large, the highest rated corporate bonds were unscathed during the turmoil, except perhaps those issued by certain large financial institutions.

I have been a strong advocate of investment grade bonds for some time now. In Bulletin 1315 (February 2008), I argued that a portfolio of short- to medium-term, higher quality corporate bonds would fare relatively well in a weak

FINRA /Bloomberg Investment Grade Bond Index
One-Year Total Return Performance as of 6/30/09



stock market. Their strong relative performance over the past year confirms my belief, at least so far. Consequently, I still maintain that this should be a primary focus of this Investment Bulletin.

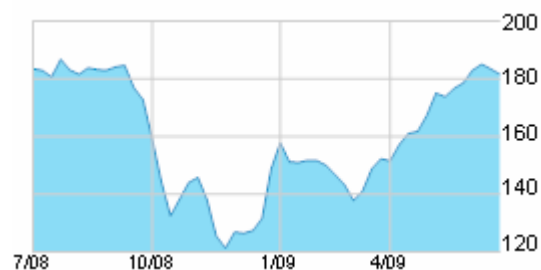
It remains to be seen, however, how such a portfolio will perform in an inflationary environment. I have proposed managing interest rate risk by keeping the average maturity of a fixed income portfolio low, in the range of 3-5 years, and laddering the bonds so that general increases in interest rates can be incorporated into the portfolio over time. This addresses the problem of interest rate risk, but it does not solve it. Accordingly, we will have to include other securities like TIPS and floating-rate instruments and even stocks to obtain a more complete solution.

High Yield Corporate Bonds. The non-investment grade corporate bond market suffered some of the biggest losses in the October meltdown, but it has also generated the highest returns off since early March. At the mid-November lows, the FINRA/Bloomberg High Yield Index was off more than 40% and the average yield of bonds included in the index approached 25%.

The high yield market regained some ground before the end of 2008, driven in part by the government's decision to bail out GMAC; but it declined again in early 2009 along with the stock market. After bottoming out in early March, at a level higher than the 2008 mid-November lows, the high yield sector has rallied sharply. Year-to-date, it is up 25% and it has essentially recovered all of its 2008 losses. Average yields are now around 11%, the same as before the crash.

(Continued on page 4)

FINRA /Bloomberg High Yield Corporate Bond Index
One-Year Total Return Performance as of 6/30/09



(Continued from page 3)

Like the stock market, many market watchers believe that the high yield market has also rallied too quickly. They point out the defaults are likely to reach post-War highs this year of around 14%. It would not be surprising, therefore, to see the high yield market pull back modestly, along with the stock market, in the coming weeks. Assuming that the economy stays on the road to recovery, however, there still should be modest upside potential after that. Longer-term, the fate of the high yield market is similar to that of the stock market.

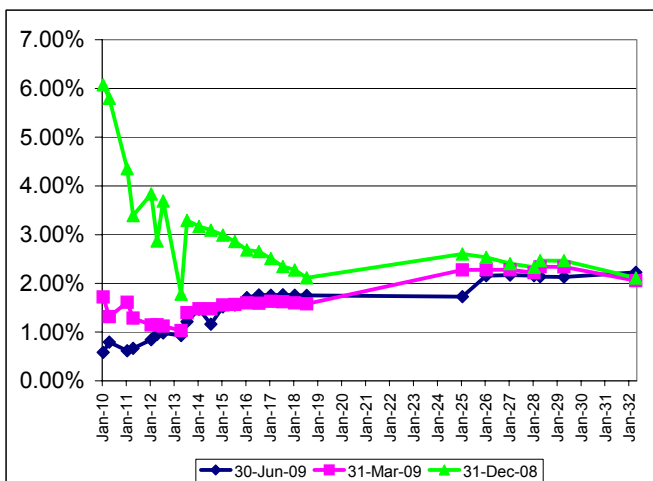
TIPS. The TIPS market went on an unusually thrilling roller coaster ride during the market meltdown. Prices of TIPS fell sharply in October, mostly on fears of deflation, but also because some institutional investors were forced to sell their TIPS holdings. At the lows, short-term TIPS carried yields substantially higher than straight Treasurys, a sign that investors expected deflation to reign for the foreseeable future. (Deflation reduces principal on TIPS, but not below par value.)

As the financial markets stabilized and investors began to anticipate a quicker end to the economic downturn, short-term TIPS rallied sharply. As shown in the chart below, their yields fell from around 3% on average at the beginning of the year to below 2% by the end of the first quarter. This translated into double digit annualized investment returns for investors. In the second quarter, yields on short-term TIPS have declined further, but only slightly.

TIPS have been much less volatile on the long end of the yield curve. Annualized year-to-date returns are positive, but much more modest. During the May-June period, when prices on straight Treasury bonds fell sharply, longer-term TIPS also fell by about 4 points on average. However, they rallied back along with the rest of the Treasury market as the second quarter came to a close,

At current levels, TIPS yields are about equivalent to their

The TIPS Yield Curve: December 31, 2008 to June 30, 2009



Average Yield, Total Returns and Spreads on TIPS vs. Treasurys

Yields as of June 30, 2009, Total Returns for First Half of 2009

Maturities	Average Treasury Yield	Average TIPS yield	Spread (bps)	YTD Total Return on Treasurys	YTD Total Return on TIPS
2010-2014	1.56%	0.98%	58	-1.78%	12.19%
2015-2018	3.23%	1.73%	150	-10.42%	10.04%
2025-2032	4.26%	2.15%	211	-20.58%	7.31%
Totals	2.82%	1.53%	129	-9.65%	10.18%

Source: Barron's; Income Builder calculations

recent historical averages. Accordingly, they do not, in my view, offer significant upside from here. Indeed, in a rising interest rate environment, TIPS have declined in price, but less than straight Treasurys. Longer-maturity TIPS are more vulnerable to interest rate risk.

Those seeking to add some measure of inflation protection to their portfolios might still consider investing in TIPS; but I would recommend focusing on shorter-maturity TIPS, say in the 3-5 year range.

U.S. Treasury Bonds. Treasurys were the star performers during last fall's market debacle. Investors seeking safety bid up the price on the 10-year Treasury note so much so that its yield fell to 2.25%. As most financial sectors have rebounded over the past couple of months, Treasury bond yields have risen back to pre-crisis levels. This has resulted in double-digit losses. Holders of 15-30 year Treasury bonds have suffered annualized losses in excess of 20% since the beginning of the year.

Like municipal bonds, it is difficult to make a strong case for investing in long-term Treasury bonds from a total return perspective. Not only will yields continue to rise as the economy mends, but there is a risk that inflation could be much higher in the years ahead, which would drive interest rates much higher in the years ahead.

On the other hand, investors might consider investing in Treasurys as a way to support the Federal government in these difficult times, thereby making total return a secondary objective.

Mortgage-backed Securities. Although rising defaults on mortgage loans were a primary cause of the financial crisis, the returns on mortgage-backed securities - i.e. those backed by the Federal government - have been spectacular, relatively speaking. MBS mutual funds earned average returns in the high single-digits and even the low double-digits in 2008. So far in 2009, the returns have been more modest, but still quite respectable at around 3%.

Like Treasurys, the primary catalyst for the superior performance was the implicit support of the Federal government. Ginnie Maes are expressly guaranteed by the U.S.; Fannie Mae and Freddie Mac paper is effectively guaranteed, following the placement of both institutions into government receivership in September 2008.

While that support will continue for the foreseeable future, it is no means guaranteed. Within the next year or two, the government will have to formulate a long-term plan for both Fannie Mae and Freddie Mac. Depending upon the state of the economy and financial markets at that time, the U.S. could decide to restructure these giant institutions and either eliminate or limit its guarantee. Any decision to have investors bear more of the credit risk on mortgage-backed securities would likely have a negative impact on the market values of those securities.

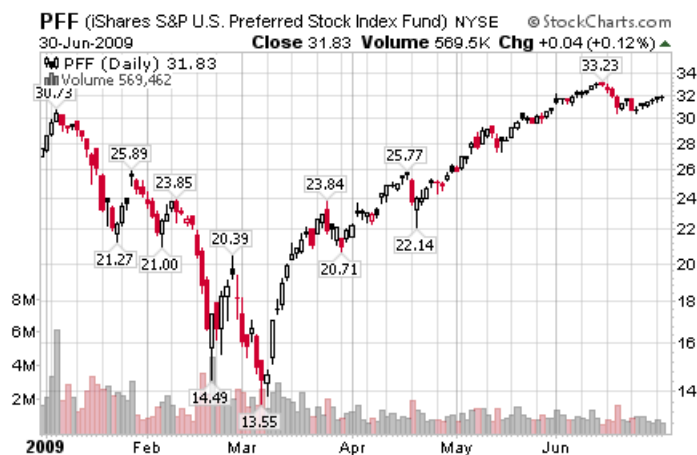
For that reason, I would recommend that those looking for the relatively attractive yields on mortgage-backed securities focus more on GNMA mutual funds.

Preferred Stocks. Preferred stocks have been among the star performers over the past three months, as indicated by the chart for the iShares S&P U.S. Preferred Stock Index Fund (PFF) (shown below). Although PFF has nearly tripled in price off of the early March lows, it still carries a high dividend yield of just under 9%. Other preferred stock ETFs have rebounded just as sharply and their dividend yields remain high at more than 10%,

Although the biggest moves in this asset class have already been made, there is still probably a modest amount of upside left, assuming that the economy and financial markets continue to recover. Dividend yields on preferreds could fall to 7%-9% from current levels around 9%-11%.

Even so, I am not an advocate of investing in preferred stocks for the long haul. Since most preferreds are perpetual, they are fully exposed to the risk of rising interest rate. On top of this, their low ranking in the capital structure provides little cover, in the event that the issuing company runs into financial difficulties.

Consequently, I am more inclined to consider preferred stocks on a case-by-case basis, focusing on those that face a mandatory redemption (to limit interest rate risk) or certain trust preferreds that are backed by subordinated debt instruments of an issuing company that I believe has the potential to show marked improvement in its financial performance. Similarly, I would choose to invest in those



preferred stocks that have an equity conversion feature. In these cases, I would consider them primarily as equity substitutes rather than fixed income investments.

Closed-end Funds. There are many closed-end funds devoted to the fixed income sector. Major categories covered by these funds include municipals, investment grade corporates, high yield corporates, foreign bonds and loan participation funds.

In general, I like the reporting practices of closed-end funds. Performance is reported on a quarterly basis through a full set of financial statements. Many closed-end funds provide lists of securities sold and purchased during the quarter. Many also provide details of other types of investments or contractual arrangements entered into, such as written covered calls and collateralized puts. As a result of this more detailed disclosure, it is easier for individual investors to track the performance of their fund investments.

The main problem with closed-end funds, however, is that many are leveraged. Leverage works well for common stock investors in a strong economy and falling interest rate environment; but it can result in significant losses when both of these factors are trending in the opposite direction.

Last fall, as the pace of the economy's slide accelerated, many closed-end funds were hit especially hard. By law, closed-end funds must have \$2 in assets for every \$1 in preferred stock that they carry. When asset values plunged, therefore, they were forced to sell some of their holdings at rock bottom prices in order to reduce their leverage. This magnified their reported losses.

Many closed-end funds have issued variable-rate instruments, like auction-rate preferred securities and variable-rate demand obligations. These securities carry money-market rates, which are generally reset every 7 to 28 days. Since short-term interest rates are now quite low, this form of leverage helps enhance the returns to common shareholders in a closed-end fund. But it could prove troublesome, if short-term rates begin to rise.

There are some unlevered, fixed-income focused closed-end funds out there, which would be the first screen that I would apply as a potential long-term investor.

Open-end Mutual Funds. One of the oddities of this tumultuous period is that many general fixed income mutual funds underperformed their benchmark, the Barclays Capital Aggregate Index. Before analyzing the reasons why, it is important to understand how many fixed income mutual funds are structured.

Within the taxable fixed income sector, many mutual funds are structured according to the average maturity (or duration) of the bonds in their portfolios. Intermediate bond funds, for example, focus on average maturities in the 5-10 year range, while long-term bond funds carry average maturities in excess of 10 years.

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While all intermediate bond funds may have roughly similar average maturities, the composition of sectors and credit quality in their portfolios may therefore differ considerably. These differences can obviously be a key determinant of credit quality.

The Barclay's Aggregate Index, a broad-based measure of the fixed income market, recorded a gain of 5.2% in 2008, but many intermediate and long-term bond funds posted losses. The primary reason for the Aggregate Index's superior performance was its relatively heavy weighting in U.S. Treasury bonds, which outperformed all other fixed income sectors in 2008, as discussed above.

Fixed income mutual funds that focused on other sectors, like corporate bonds, for example, suffered modest declines in the market sell-off. Those broad market bond funds that had the heaviest weightings in junk bonds suffered the most.

Of course, the reverse is true so far this year. Junk and emerging market bonds have posted the greatest gains in the fixed income market this year. Consequently, those funds with heavy weightings in these sectors have outperformed their peers.

The structuring of fixed income mutual funds by average maturity is designed to give investors the opportunity to control interest rate risk. However, bond values are also affected greatly by credit risk, as we have seen this year. A clear delineation in mutual funds exists between investment grade and non-investment grade-rated funds. However, there are comparatively few offerings to delineate within the investment grade sector. Similarly, many broad-based bond funds can include a fairly high proportion of non-investment grade bonds.

Those advisors, like me, who believe that fixed income is a good sector in which to invest, acknowledge that the asset class does carry some significant risks, including both interest rate and credit risks, going forward. For that reason, we want to be able to fine tune the construction of portfolios to better manage these risks. However, this is difficult to do with current mutual fund choices. (This point was the subject of a recent WSJ article, "Taking a Narrow-Minded View on Bonds," April 27, 2009.)

It remains to be seen whether the mutual fund industry responds with more fixed income investment choices. Such an expansion is probably more likely over time with ETFs, which have a more firmly established tradition of slicing and dicing the asset classes that they serve.

The composition of broad market-based fixed income mutual funds may become more of an issue over time, primarily because the U.S. government is already well on its way to becoming a much larger presence in the fixed income markets. With a greater need to raise funds through bond issuance to finance the budget deficit, the U.S. government will likely carry a much greater weighting

Performance of Various Bond Indexes

Total Return for 2008 and First Half of 2009

	Total Return	
	2008	H109
Treasury Ryan ALM	20.0%	-6.0%
Ryan 10-yr. Treasury	22.5%	-7.3%
DJ Corporate	2.4%	9.2%
Barclays Aggregate	5.2%	1.9%
High Yield 100 (Mer. Lynch)	-20.2%	17.0%
Fixed Rate MBS (Barclays)	11.2%	2.9%
Muni Master (Mer.Lynch)	1.2%	3.8%
EMBI Global (JP Morgan)	-3.1%	14.5%

Source: Wall St. Journal and Income Builder calculations

in the portfolios of broad market based fixed income mutual funds. Indeed, this flood of issuance may eventually make it more difficult for all issuers in all other fixed income sectors to raise funds, which could raise interest rates across the board.

ETFs. The number of ETFs devoted to the fixed income market has been growing. iShares, for example, now offers 27 funds. One of its funds mimics the Barclays Aggregate Index. Ten are U.S. Treasury securities funds, ranging from short- to long-term maturities. Three are a combination of government and investment grade corporate bonds. One is a mortgage-backed securities fund. Three focus on international bonds, including emerging markets. Four are state-specific municipal bond funds.

The five credit-oriented iShares funds concentrate primarily on the corporate bond market. Two cover the investment grade and non-investment grade (junk bond) segments of the corporate bond market. Two cover short and intermediate maturity bonds and one is a general credit fund that can hold the full spectrum of credit quality and maturities.

Although I believe that short-term oriented fixed income ETFs may be appropriate alternatives to actively managed funds, I would not recommend those ETFs that focus on intermediate- and long-term bonds as long-term investments. In my view, longer-term bonds ought to be reviewed periodically to determine whether their credit quality is holding up. If not, they ought to be considered as candidates for sale. With ETFs, the assumption is that all investments will be held until maturity. It may be more appropriate, therefore, to consider longer-maturity fixed income ETFs as trading vehicles.

Summary. Fixed income sectors with credit exposure have recovered in recent months as optimism about an approaching economic recovery has become more widespread. There is still short-term upside potential in many of these sectors, but it is much more limited. From a longer-term perspective, certain niches, such as medium-term investment grade corporate bonds offer decent income potential and much greater downside protection than a broadly diversified stock portfolio.

General Electric: Is A Spin-Off of GE Capital in the Offing?

The past 9 months have been very rough on GE shareholders. GE's stock is down 55% since the end of September 2008. The stock fell to a low of \$5.87 in March, but it has since rebounded recently to around \$12.

Certainly, most of GE's businesses are exposed to the vagaries of the economic cycle; but the primary cause of the sharp decline in GE's stock was concern about the health of its financing arm, GE Capital Services.

Up until 2008, GECS has been a major driver of profit growth and a significant source of operating cash flow for the consolidated company. Both wings of the financing business, commercial and consumer, had experienced rapid growth in loans outstanding and profit margins, in part due to efforts to expand the business overseas.

Many analysts had been concerned about GE's rising credit exposure, especially to U.S. consumers and certain segments of the commercial real estate market. However, GE Capital's growth continued right up until the October sell-off.

GE Capital made its money not only from the expansion of its lending activities, but also from the low rates that it paid on its own borrowings as a result of its AAA-rating. It earned a wide net interest margin - the spread between the rate received on its loan assets and the rate paid on its borrowings - in part because of its heavy reliance on short-term financing, much of which was in the form of commercial paper.

When the commercial paper market shut down in the wake of the failure of Lehman Brothers, GE Capital was in a pickle until the Federal Reserve came to the rescue. Although it is not a commercial bank and so does not fall under the regulatory eye of the Federal Reserve, it was nevertheless permitted to participate in the Fed's Commercial Paper Funding Facility.

Soon after, GE Capital was also allowed to participate in the FDIC's Temporary Liquidity Guaranty Program. Under the TLGP, investors in GE Capital's debt offerings received the FDIC's guaranty of repayment. It was recently reported that GE Capital has been the largest issuer under the TLGP, issuing some \$340 billion of debt.

Government support not only helped GE Capital avoid liquidity problems, it also helped boost its profitability by lowering borrowing costs. As a result, GE has been able to reaffirm its guidance of a profitable year for GE Capital.

Even so, concerns about the long-term status of GE Capital have continued to weigh on GE's stock. CEO Jeff Immelt acknowledged this recently in an interview with Charlie Rose. He noted that at the market peak, GE Capital carried an implicit valuation of \$200 billion; today, that value is closer to \$10 billion. (If this is correct, it implies that GE Capital is valued at less than 20% of its book value.) Maybe \$200 billion was too high, but \$10 billion is also too low, according to Mr. Immelt.



Achieving a permanent solution for GE Capital therefore appears to be the key to a recovery in GE's share price.

At the same time, however, the financial landscape is changing, which will undoubtedly cause GE to rethink its commitment to the financing business. The Obama administration has proposed requiring all industrial loan companies to come under the Fed's jurisdiction. It has also been a strong advocate of beefing up capital as a way to putting banks on sounder footings. With an equity base equal to 10% of assets, GE Capital appears to be well capitalized; but regulators might require it to hold additional capital, if its assets are deemed to be risky. In addition, accounting rule makers have proposed requiring financial institutions to put more securitized assets on their balance sheets. (Under current rules, these assets are treated as sales when securitized, which keeps them off the balance sheet.) Finally, new proposed tax rules which would reduce the ability of corporations to shelter income abroad may affect GE Capital's future profitability. The business may see an increase in its tax bill anyway, if it is unable to continue to grow its asset base.

More regulation, higher capital requirements and reduced profitability could reduce future expected investment returns for GE Capital, which in turn could cause GE to consider spinning off the business to its shareholders (perhaps in conjunction with a sale of equity designed to boost its capital base).

Still, Mr. Immelt has recently reiterated his firm's commitment to the financing business, in part because of its strategic importance to the industrial businesses. GE could retain its competitive advantage either by keeping the lending verticals (e.g. project financing) or it could retain an equity stake in the spun-off GE Capital to ensure its access to financing for its industrial customers.

In any case, through its participation in government support programs, GE Capital is effectively a regulated financial institution today. In order to justify keeping it in the fold, it will have to break free of government support and restore its profitability on its own, which may be a daunting task. A full or partial spin-off may be a more effective solution and a bigger benefit to GE shareholders.

Barclays 1-3 Year Credit Bond Fund (CSJ)

CSJ is an ETF that is designed to track the performance of the U.S. investment grade credit sector. Its primary benchmark is the Barclays Capital (formerly Lehman) 1-3 Year U.S. Credit Index.

Besides corporate debt, the Fund invests in the dollar-denominated debt issues of sovereign, supranational, local authority and non-U.S. agency organizations. For example, one of its largest holdings are KfW Bankengruppe, a large financial institution originally created under the Marshall Plan to facilitate the post-war rebuilding of Germany. KfW is 80%-owned by the Federal Republic of Germany and 20%-owned by the federal states.

Its second largest holding is the European Investment Bank, which was created in the late-1950s to facilitate the integration of the European Union.

Besides these investments, the Fund holds bonds of major corporations such as AT&T, Citigroup, Verizon, Pfizer, General Electric, Campbell Soup, Home Depot, Morgan Stanley, ConAgra, Berkshire Hathaway and many others.

Other foreign issuers include Nordic Investment Bank, Asian Development Bank and the Republic of Chile.

The average credit rating of its portfolio is single-A. Nearly 40% of its holdings are rated either AAA or AA.

By restricting its investments to bonds that mature within one to three years, its interest rate risk is limited.

The Fund has performed quite well over the past 18 months or so compared to many other asset classes; but it

was not untouched by October's financial market tsunami. For all of 2008, the Fund's total return, including expenses equal to 0.20% of assets, was -0.07%. Its worst quarterly return was -3.00% in the 2008 third quarter. So far this year, through June 30, the fund is up 6.27%. In fact, its 2009 second quarter return of 5.09% was its best ever.

Because its risk profile is attractive to many investors in these tumultuous times, the Fund has been growing rapidly. At the end of March, the Fund held 156 investments with total net assets of \$1.44 billion. By the end of June, its portfolio had grown to 349 investments with total net assets of \$2.40 billion. So growing demand from investors combined with modest appreciation in investment grade securities (due to greater optimism about a quicker economic recovery) helped boost CSJ's assets and share price.

(It should be noted that its benchmark, the Barclays Capital 1-3 Year U.S. Credit Index includes about 600 issues. Thus, CSJ tries to replicate the performance of that Index, even though it invests in many fewer issues.)

After such a strong run, the timing of our consideration of this investment is not optimal. Still, the Fund offers a dividend yield of about 4%, which is attractive given its risk profile and yields on other short-maturity investments.

Over time, this Fund (and other open- and closed-end funds like it) should be able to deliver a decent and much less volatile return. Of course, nothing is without risk these days, so I intend to monitor the composition of CSJ's portfolio as well as its performance going forward.

ACTION THIS ISSUE:

I am adding 100 shares of the Barclays 1-3 Year Credit Bond Fund (CSJ) to the fixed income portion of the model portfolio. I consider this to be an initial position and a potential surrogate for cash. As noted above, CSJ has performed quite well so far this year. If interest rates rise further, it will likely underperform, but in any case, its overall performance should be much less volatile than other asset classes, namely common stocks. I will monitor future developments with an eye toward adding to this position over time. I also will continue my quest to identify other cash alternatives that I believe can provide a decent, inflation-adjusted return with relatively low risk.

Number	Security	Recent Price	Yield	Safety	Rel. Perf. Rank
100	Barclays 1-3 Year Credit Bond Fund (CSJ)	103.00	4.00%	A-	3

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