Agenda

A Short History of the Post-Financial Crisis Bond Environment
Impact of Expansionary Monetary Policy on Investors
Where We Stand Today
The Role of Fixed Income in Defined Contribution Investment Menus
Evaluating Fixed Income Options
The Impact of Rising Interest Rates on Bond Funds
The Federal Reserve Has Targeted Low Rates

Effective Fed Funds Rate

Source: Board of Governors of the Federal Reserve System
Quantitative Easing to Stimulate Growth

Total Assets of the Federal Reserve

Source: Federal Reserve Bank
Historically Low Yield Environment

10-Year Treasury Constant Maturity Rate

Source: Board of Governors of the Federal Reserve System
Most Bond Investors Haven’t Felt the Pain

(Oct. 2008 - Sep. 2014)

Morningstar Category Averages
Declining Rates Pushed Up Bond Prices

10-Year Treasury Constant Maturity Rate

Source: Board of Governors of the Federal Reserve System
Narrowing Spreads Helped Bond Returns

Moody’s Seasoned Baa Corporate Bond Yield Relative to Yield on 10-Year Treasury Constant Maturity
(Percent, Daily, Not Seasonally Adjusted)

Source: Federal Reserve Bank of St. Louis
Where We are Today

The Federal Reserve is expected to announce today the end of its bond buying program known as quantitative easing.

We believe the Federal Reserve will likely continue to keep the Fed Funds Target Rate near zero at least until some time in 2015.

Barclays US Aggregate Bond Index Yield at 2.36% as of 9/30/2014
### Traditional Defined Contribution Investment Menu

#### Tier 1: Age- or Risk-Based Lifecycle Funds (QDIA)

#### Tier 2: Core Array

<table>
<thead>
<tr>
<th>Stable Principal</th>
<th>Fixed Income</th>
<th>U.S. Equity</th>
<th>International Equity</th>
<th>Specialty</th>
</tr>
</thead>
<tbody>
<tr>
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<td>Specialty</td>
</tr>
<tr>
<td>Money Market / Stable Value</td>
<td>Intermediate Bond</td>
<td>Large Value</td>
<td>Large Blend</td>
<td>Large Growth</td>
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<td>Mid Value</td>
<td>Mid Blend</td>
<td>Mid Growth</td>
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<td>Small Value</td>
<td>Small Blend</td>
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#### Tier 3: Self-Directed Brokerage Account or Mutual Fund Window

- Focus is on equity diversification by dividing funds among the Morningstar Style Boxes
- Fixed income is usually represented with a single fund benchmarked against the Barclays US Aggregate Bond Index and one stable principal option
Bond Portfolio Objectives

- Capital Preservation
- Income
- Equity Diversification
- Total Return
Trends in Fixed Income Investing

• Low yields are leading to the development of new products and the expanded use of existing products that were previously a very small niche of the market
  • Floating rate debt or bank loan products
  • Non-U.S. debt
  • Emerging market debt
  • TIPS
  • High yield bonds
  • Unconstrained bond funds
• These products are primarily targeted at investors whose objectives are income and total return
Fixed Income as an Equity Diversifier

2008 Calendar Year Performance

- Barclays Capital US Aggregate Bond Index
- S&P 500 Index
- Russell 1000 Value Index
- Russell 1000 Growth Index
- Russell Mid Cap Value Index
- Russell Mid Cap Index
- Russell Mid Cap Growth Index
- Russell 2000 Value Index
- Russell 2000 Growth Index
- Russell 2000 Index
Actual Results Differed from Expectations

2008 Calendar Year Performance

The gray bars represent the intermediate bond peer group 5-25% percentile, 25-50% percentile, 50-75% percentile and 75-95% percentile performance.
Evaluating Fixed Income Options

Core Bond Funds

Core bond funds provide investors with exposure to investment-grade bonds as represented by the Barclays Capital U.S. Aggregate Bond Index. The funds invest primarily in U.S. Treasuries, governmental agency bonds, mortgage-backed securities, and investment-grade corporate bonds. They hold a wide range of maturities with an average in the intermediate range. The funds have limited ability to invest outside their benchmark in sectors of the fixed income market not represented in the index.

Core Plus Bond Funds

Core plus bond funds provide are similar to core bond funds in that they primarily provide investors with exposure to investment-grade bonds as represented by the Barclays Capital U.S. Aggregate Bond Index. These funds have greater flexibility to invest in higher yielding sectors of the fixed income market in order to generate higher total returns. Examples of sectors that are frequently found in core plus bond funds are high yield, non-U.S. and emerging market bonds. The higher return expectation also comes with greater risk expectations.

Notes

• Morningstar lumps both core and core plus bonds within their Intermediate Bond peer group making peer group comparisons difficult
• Core and core plus are industry terms that have developed over time without specific, regulated definitions. As a result, two core plus managers may have different levels of flexibility in investing in the “plus” sectors.
New Strategies

Multisector Bond Funds
Multisector-bond portfolios seek income by diversifying their assets among several fixed-income sectors, usually U.S. government obligations, U.S. corporate bonds, foreign bonds, and high-yield U.S. debt securities. These portfolios typically hold 35% to 65% of bonds in securities that are not rated or are rated by a major agency such as Standard & Poor’s or Moody’s at the level of BB (considered speculative for taxable bonds) and below.

Unconstrained Bond Funds
As the name implies, unconstrained bond funds provide the investment manager broad latitude to invest across sectors of the fixed income market without limit. The funds typically invest heavily in the “plus” sectors of the fixed income market but also have greater latitude to manager duration exposure, even to the extent of creating a negative duration portfolio.

1Morningstar Category definition
Active vs. Passive

Annualized Performance (Last 5 Years Ending 9/30/2014)

Excess Returns are calculated versus the Barclays Capital U.S. Aggregate Bond Index; Alpha is calculated using multifactor returns-based style analysis against a set of passive indices including the BofA ML 3-Month T-Bill Index, BofA ML US Corporate Index, BofA ML US Treasury Index, BofA ML US Agency Index, BofA ML All US Convertibles Index ex Mandatory, BofA ML US Mortgage Backed Securities Index, BofA ML US Fixed Rate Asset Backed Securities Index, BofA ML US Fixed Rate CMBS Index, BofA ML US High Yield Index, BofA ML US Municipal Securities Index, and BofA ML Fixed Rate Preferred Securities Index.
The Impact of Rising Interest Rates on Bond Funds

Source: Schwab Center for Financial Research. This assumes an average interest rate of 3.0%, an even 1% increase in rates each year for the first five years, an average duration of 4.5 years and reinvestment of interest income. It shows cumulative return, not annualized return or dividend yield.

Note: This is meant as an illustration, and won’t represent actual performance for any specific mutual fund. Actual performance will depend on fund management, as well as market conditions.
Disclosures

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