

STW's Management of US-based Private Wealth: A Brief Overview

STW and the Private Investor

STW Fixed Income Management is an owner-operated fixed income manager in Carpinteria, California. For 30 years, through changes in markets, tax laws and trust laws, we have managed portfolios for private investors and trusts under the same Chief Investment Officer.

We pay close attention to the specific requirements of every single client and work with their advisors to maintain an understanding of their particular requirements. At the same time, STW comes from a strong parallel tradition of total return management and well-developed investment technology.

STW is not for everyone. Those seeking the comfort of a manager for whom some strong points are magnitude and brand-recognition should not choose STW. Additionally, we are specialists in investment-grade fixed income. For investors wanting one-stop shopping, we do not fill the bill.

Limited Assets and Clients

We manage about \$11 billion. That's large enough to provide the infrastructure to properly serve individual investors. We limit assets to a level where liquidity does not constrain our design and execution of portfolios we believe are right for each client.

Fifteen of our clients are families. They include individual family members and trusts with beneficiaries domiciled in about a dozen US states, Bermuda and the United Kingdom. This is a small number of clients compared to the "wealth groups" of big conglomerate managers. That's the point. We do not plan to add a large number of new private clients. We will continue to give full attention to the details of each assignment.

Teaming Up with Decision Makers

Our clients and their advisors work directly with senior portfolio managers and other key personnel. Strong support staff is important, but we don't believe the clients who rely on STW for their success want this job left to a product specialist, someone from the client service department or a second-level portfolio manager. The bond portfolios cannot be managed in a vacuum. It is important that we work together with our clients to manage their gains, losses and taxable/tax-exempt bond mix in concert with their other investments and in recognition of their changing tax situations.

Taxable Focus

We understand that management of private wealth is substantially different from that of pension, foundation and endowment portfolios. We've taken lessons from tax-exempt portfolio management, but the techniques cannot be directly transferred.

STW is not focused narrowly on the management of pension, foundation and endowment portfolios. Taxable portfolio management is an equally important focus, and private wealth management is an

important part of that. We also manage portfolios for other taxable clients, including nuclear decommissioning trusts, insurance companies and settlement trusts.

STW has invested substantial resources in investment technology. Just one accomplishment has been the development of the tools to accurately apply all aspects of taxation to our clients' portfolio results and to benchmark returns when sufficient detail is available. We know of no other manager's system that can yet tackle the full breadth of the problem.

Client-specific Modeling

The management of some clients' portfolios is rather straightforward. Others have special problems that cannot be properly addressed with simple or conventional solutions. Often, thoughtful application of mathematical models can offer insights into the best way to deal with competing goals of a portfolio.

For example, we have applied goal-oriented modeling to a couple of interesting problems. One dealt with how to best maximize the cash flow to income beneficiaries over a fixed period in a time of abnormally narrow yield spreads. Another client's problem had to do with maximizing charitable donations and after-tax income retained by the beneficiaries when the level of donations itself influenced the tax rate.

Investment Approach

STW is a value manager. We buy undervalued bonds and sell expensive ones. We do not forecast interest rates. While we manage assets in more than one currency, we stick to the home currency of each client. Our universe is all investment-grade bonds. While municipal bonds are home base for most US taxpayers, we invest in taxable bonds when they are cheap. The willingness to invest across all sectors, or "crossover management", is a hallmark of our approach.

We understand that some of the strategies that can work well for unconstrained tax-exempt investors are not useful for taxable investors. For example, because of potential capital gains taxes, we place a greater premium on not being wrong because it can be costly to reverse field when rates are falling. We also recognize that some tactics are more appropriate for periods of rising interest rates than falling rates.

We are always aware of tax implications. At times, only a limited portion of a portfolio may be tradeable given gain and loss considerations, so we focus on making every change in the portfolio count. We will use scarce losses from the portfolio, or from a client's other investments, to make important changes rather than spend them in swaps for small or speculative benefit or for fine-tuning to match benchmark characteristics.

The next decade could be an excellent one to add value through management. We believe that our value approach to total return management is well suited to the years ahead.

Portfolio Management

Every family portfolio has something special about it. This is especially true for US-based families.

Our wealthy clients' portfolios are individually handcrafted. This approach requires a particular sort of portfolio manager and strong portfolio analytical tools. There is no separation between our association with our client, the portfolio design and trading. Our emphasis is on finding just the right bonds, bond by bond, for each portfolio. This stands in contrast to today's popular practices, where portfolios are assembled by order management systems and trading is a separate function from liaison and planning, and from portfolio management.

Our private clients are already well off. In most cases, one of their goals for the mandates they give us is preservation of principal or income stream or some combination of both. Our fixed income investing takes this into account. We believe that policies aimed first at preservation of already accumulated wealth, and then extra return, are generally more desirable than higher-risk maneuvers.

Importance of Benchmarks

Benchmark choice or design is an objective way for our clients and us to communicate tolerances for interest rate, reinvestment and credit risks, as well as goals for various types of return. In general, it is better to outperform a benchmark than to underperform it, but, if too much importance is given to the benchmark, it can hinder good investment practice.

To produce inappropriate results and still beat a benchmark is no victory. To fail to meet a client's true objectives, if they are obtainable in the market, is the most basic failure. In the management of many trusts, there is a mandated balance between the interests of income beneficiaries and remaindermen. We maintain that it is far more important to properly address these real interests than to adhere to the characteristics of a popular, or even carefully selected, benchmark.

Past Performance

In our opinion, we have "good numbers". More importantly, we believe we have good sense. Total return versus a benchmark is the most commonly used rule in assessing the skill of a manager of private portfolios. We suggest making the first judgment based on the manager's understanding of the client's real requirements, sensitivity to appropriate risks and ability to effectively incorporate them into a portfolio.

Rarely are two personal accounts the same. Time horizons vary, as do tax rates, tolerances for various risks, effects of other investment activities, balance between income and principal, etc. As a result, composites of the returns of multiple portfolios are not instructive. In addition, we see tension among SEC rules, common sense and the AIMR-PPS and GIPS standards for presenting taxable composite returns.

At STW, the same people are responsible for the returns of fully discretionary assets and family portfolios. Someone can get a first impression of how our value approach works from the returns of the tax-exempt portfolios we manage. We can then discuss how decisions were shaped in personal accounts and how special considerations contributed to returns.

Billy Williams