



July 1, 2010

## **Where are the TLT's? "Treasury Bonds"**

Dear Advisor,

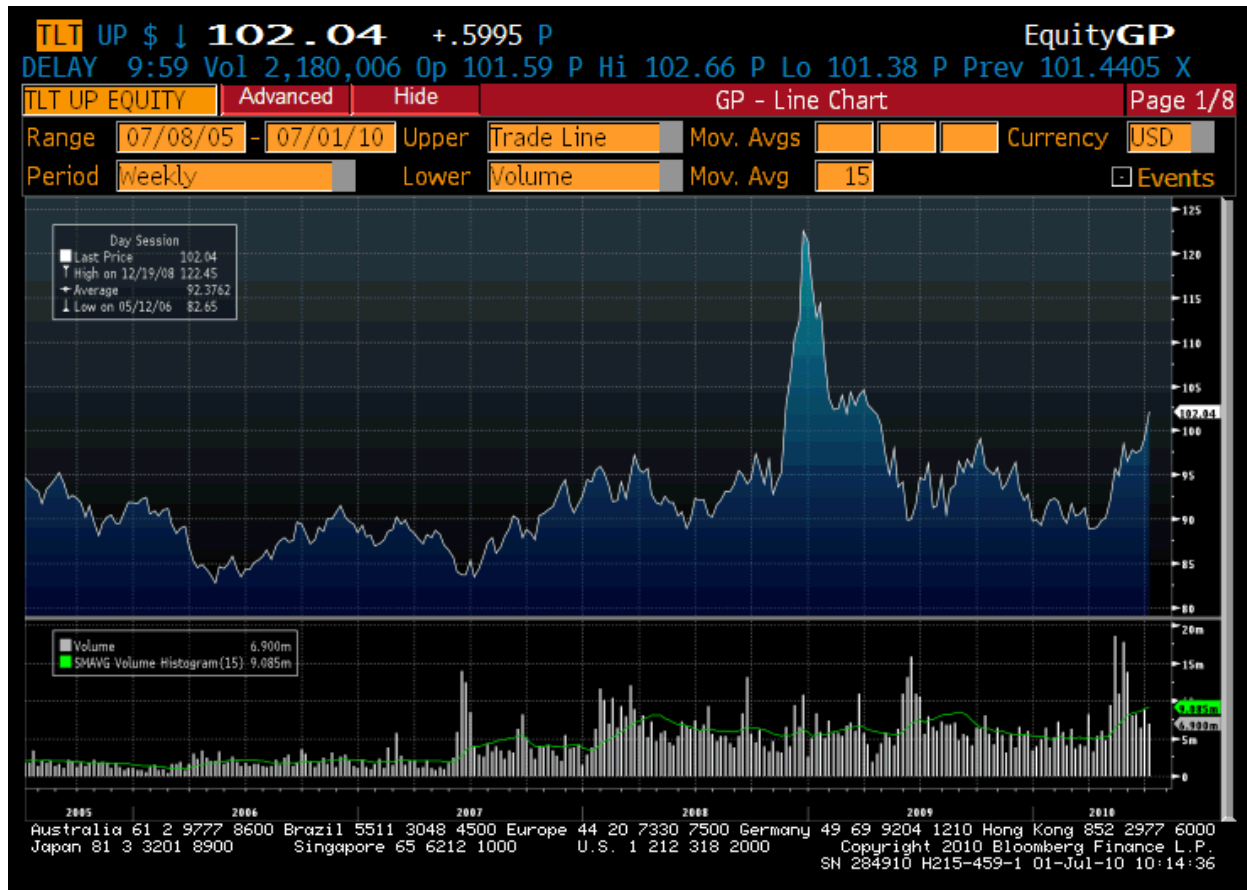
As we round the quarter from the 2<sup>nd</sup> quarter into the 3<sup>rd</sup>, I'm happy to report that the performance of our STAR III strategies is looking good – Alpha in particular. However, many of you will notice that we are not purchasing the Treasury ETF (TLT) at current prices. I'd just like to remind you that this is not an oversight, but is part of our strategy's design. I'd like to take a moment to recap how we incorporate and manage the TLT in both our Alpha and VEGA accounts.

The TLT holds a laddered portfolio of Treasury Bonds from 20 – 30 years in maturity. Just like the bonds themselves, the TLT will rise in price as yields fall. However, TLT has no intrinsic growth potential. It's value is the sum of its coupon payments (yield) and the option premium we collect from selling covered calls. At prices above 100, the yield falls below 4%. This changes the risk/return parameters enough to where the return from the coupons does not offset the risk to principal should yields rise back above 4%. Therefore, we do not purchase the TLT above 100, and instead keep the percentage that would be allocated to the ETF in cash as a strategic reserve for when the price falls back to within its normal range. I describe cash in this context as a "zero-duration bond." No duration = no interest rate risk.

How long might the TLT stay above 100? This is hard to predict with 100% accuracy, but the short answer is "not long." The structure of the ETF, whereby bonds that go from 20 years to maturity to 19 years are replaced with the new 30 year bond, means that the price of the TLT will adjust to the new level of interest rates over time. At the moment, the low yield on the Treasuries is a flight to quality in response to a declining stock market and worries over a double dip recession. As markets adjust to the current economic climate prices will stabilize, and the TLT will trade back down to more normal levels. At that point, we will begin repurchasing the ETF and selling calls.

In back testing there was one period, the financial crisis of late 2008-2009 where the TLT spiked above 120. As you can see on the chart below, prices traded back down to below par, even though the S&P didn't reach its lows until March 9.

## Partnervest Advisory Services LLC



Please let me know if you have any questions or would like to discuss a specific client account in greater detail.

Sincerely,

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