



Performance as of 6/30/10 is as follows:

<i>Intermediate Fixed Income Portfolio</i>	Rainier Intermediate Fixed Income	Barclays Capital U.S. Intermediate Government/Credit Bond Index	Lipper Intermediate Investment Grade Index
Quarter	2.17	2.97	3.06
1 Year	8.25	8.28	14.30
3 Years	6.88	6.98	6.53
5 Years	5.05	5.26	4.91
10 Years	5.60	6.06	6.02
Inception 5/10/94	5.70	6.25	6.23

Gross Expense Ratio is 0.67% as of 6/30/10.

*Performance data quoted represents past performance, which does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than quoted. Performance data current to the most recent month-end may be obtained by calling 800.280.6111 or by visiting [www.rainierfunds.com](http://www.rainierfunds.com).*

The Barclays Capital U.S. Intermediate Government/Credit Bond Index is an unmanaged index composed of all bonds covered by the Barclays Capital U.S. Intermediate Government/Credit Bond Index with maturities between one and 9.99 years.

Lipper Intermediate Investment Grade Index consists of funds that invest in investment-grade debt issues (rated in the top four grades) with dollar-weighted average maturities of five to ten years. The Lipper Intermediate Investment Grade Index tracks the total return performance of the 30 largest funds in the category.

References to other mutual fund should not be considered an offer of these securities. The opinions expressed are those of the author and are subject to change, are not guaranteed and should not be considered recommendations to buy or sell any security.

**Mutual fund investing involves risk. Principal loss is possible. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments.**

Free cash flow measures the financial performance of a company by subtracting capital expenditures from operating cash flow.

*The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-280-6111 or by visiting [www.rainierfunds.com](http://www.rainierfunds.com). Please read it carefully before investing.*

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# Corporate Bonds Still Have Upside Potential

Rainier Investment Management's Matt Kennedy discusses the interest-rate environment, attractiveness of the corporates sector, and fixed-income ETFs versus fixed-income mutual funds.

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**Fund Manager Q&A** | 06-11-10 | By Morningstar.com

Matt Kennedy is the director of fixed income at Rainier Investment Management. As the portfolio manager of Rainier Intermediate Fixed Income Portfolio (RIMFX) ★★★★★, he recently answered our questions on the potential effect the macroeconomic/interest-rate environment will have on the fund's steady pace of returns. He also discussed expectations of interest-rate behavior in the coming years, the fund's weighting in corporate bonds, and the importance of active management.

**1. You've quietly built a strong record in a very crowded category. For investors who may not know you, why should they invest with you versus some of the better-known managers in this category such as PIMCO, Fidelity, TCW, Vanguard, and so on.**

Generally speaking, we believe investors are looking for stability and capital preservation when considering alternatives for the fixed-income allocation of their portfolio. The foundation of our philosophy and strategy is to emphasize quality and risk control in order to preserve our clients' capital in weak markets while still delivering competitive long-term portfolio returns.

The fund is a long-only portfolio and doesn't utilize derivatives, leverage, or foreign currencies. Environments such as the one we saw in 2008 are when our approach to fixed-income investing sets itself apart, as Rainier Intermediate Fixed Income generated positive returns while many of our peers experienced negative returns.

Rainier is a boutique fixed-income manager. The focused breadth of our fixed-income offerings relative to our larger peers' provides several advantages which have the potential to positively affect performance. Our size allows us to consider more potential investment opportunities than a larger manager can. Investment ideas for a larger manager need to be of significant size to make an impact on performance. At Rainier, we are able to consider a wider array of potential investment ideas and trading opportunities that offer value for the benefit of our clients. Additionally, our structure is designed to expedite the execution process to take advantage of attractive investment opportunities when

they present themselves. Fixed-income research, trading, and portfolio management all take place in the same room, which facilitates immediate discussion of ideas and efficient execution.

**2. The fund has returned more than 5.5% annually during the past decade. Looking into the future, how likely do you think it is that the macroeconomic/interest-rate environment will allow the fund to keep up that pace?**

Our long-term average annual return of 5.5% was generated through a variety of macroeconomic and interest-rate environments. Irrespective of what happens in the short term with regard to the macroeconomic environment or interest rates, we expect to be able to deliver returns in line with our long-term track record over time. As our clients have come to expect, within our philosophy and strategy, we emphasize risk management and capital protection in down markets relative to our benchmark rather than purely focusing on absolute returns.

Although interest rates have moved somewhat higher during the last three months and are significantly higher than levels reached at the apex of the financial crisis at the end of 2008, we are still in a low interest-rate environment by historical standards. Since the beginning of 2010 the rise in rates can partly be attributed to the improving outlook for the economy and the expectation that the Fed will eventually raise interest rates in response.

In conjunction with the improving economic environment, credit spreads have tightened significantly. Credit spreads, especially in corporate bonds, are still attractive on a historic basis as well as relative to other assets classes. As the economic recovery continues to gain momentum, we expect credit spreads to tighten further resulting in outperformance relative to asset classes such as Treasuries and agencies.

If interest rates were to move sharply higher, the short-term impact on return would not be consistent with our 5.5% long-term average annual return. However, over the longer term, the rise in rates would

reflect the positive momentum in the economy, leading to tighter credit spreads and improving valuations on corporate bonds which would mitigate the negative impact of a rise in interest rates on returns. Additionally, the rise in rates would lead to higher overall yields on fixed-income investments and be beneficial for future nominal returns.

**3. Do you expect interest rates to rise gradually or quickly in the upcoming years? How are you positioning the portfolio to hold up in such an environment?**

Our current expectation is for interest rates to rise gradually. We understand current fears in the market regarding the potential for inflation. Consumer spending, which represents almost 70% of gross domestic product, is exceeding expectations. Regional and national manufacturing and nonmanufacturing indexes are in expansionary territory and continue to show improvement in the critical order-activity and employment categories.

With the economy gaining momentum, it's only a matter of time before demand for loans picks up and banks begin to lend the unprecedented \$1.1 trillion of reserves, potentially stoking inflation from the demand side. However, in our opinion, the current pickup in the economy has been driven more by temporary government stimulus measures than by an underlying fundamental economic strength. We believe the economy is in the process of making this transition, but once the fiscal stimulus ends, economic growth will settle back to a level that reflects the headwinds from high unemployment, still-high household debt levels, and low capacity utilization.

Additionally, the core consumer price index figure is barely more than 1% and continues to trend lower, providing the Fed some latitude in delaying interest-rate hikes in response to the recent improvement in the economy. The Fed would probably rather risk a slight uptick in inflation to ensure a stable economic recovery than tighten monetary policy too early and risk a double-dip recession.

Our current position in the fund is an overweighting in corporate bonds reflecting their attractive valuations and our positive view on the transition to a sustained economic recovery and the outlook for corporate bonds in that environment. Credit spreads for corporate bonds are still attractive on a historical basis, especially when considering the actions issuers have taken during the last 18 months to reduce costs, improve free cash flow, and strengthen balance sheets. As the economy improves and interest rates rise in response, our expectation is for corporate bond valuations to also improve, offsetting the rise in rates and leading to outperformance.

**4. The fund currently has approximately half of its assets in corporates. Can you explain why that sector remains attractive after the strong recent rally?**

There are two overriding factors that are driving our positive outlook for performance in the corporate bonds sector. The first, as mentioned earlier, is that the economy appears to be transitioning from a fiscal stimulus-supported recovery to a self-sustaining economic recovery.

We aren't expecting a robust V-shaped recovery, but it appears that the aggressive actions taken by the corporate sector in response to the slowdown in demand are paying off. As demand slowed abruptly in mid-2008, the corporate sector immediately took steps to cut costs, improve free cash flow, and strengthen balance sheets. As a result, corporations were able to mitigate the damage to profitability and margins during the recession. Now that the economy is beginning to improve, corporations are reaping the benefits of the enhanced operating leverage as a result of the lower cost base and have been reporting better-than-expected margins and profits during the last couple of quarters.

The second factor is valuation. Corporate bonds still offer upside relative to lower-yielding asset classes such as Treasuries and agencies. Corporate bond valuations have rallied significantly since spreads peaked in late 2008. Compared with valuations in early 2007 prior to the bursting of the housing bubble and onset of the financial crisis, corporate bond spreads remain historically attractive and are comparable to levels from early 2003 when the economy was exiting the 2000-02 recession. As the recovery continues to materialize, corporate bond issuers should benefit from higher revenues and stronger cash flows. At the same time, investors' appetite for risk should increase as they seek higher-return investment opportunities.

This shift into higher-potential-return assets, such as corporate bonds, should result in improving valuations for corporate bonds relative to Treasuries. Additionally, as the economic recovery takes hold, the Fed will eventually begin to transition away from its current accommodative monetary policy and raise interest rates which should further result in corporate bonds outperforming more interest-rate-sensitive assets such as Treasuries and agencies.

**5. What do you think of fixed-income exchange-traded funds, and what would you tell an investor deciding between an investment in a fixed-income ETF versus a fixed-income mutual fund?**

Due to the inefficiencies of the fixed-income market, active management by an experienced portfolio manager adds value in

being able to position a portfolio based on economic and market conditions. Looking back during the last 10 years, the fixed-income market has seen unprecedented periods of volatility with more frequent and pronounced boom and bust cycles. Having a proven and experienced manager that can position a portfolio for protection on the downside as well as take advantage of opportunities on the upside is a significant advantage compared with a rules-based portfolio that does not have the flexibility to adjust to market conditions.

Our goal is to outperform the market over the long term through active management, emphasizing quality and risk control. Although ETFs can give an investor exposure to fixed income, they are not designed to outperform. ETF construction is based on a set of rules which are designed to mimic a target benchmark or index and require the ETF to make purchases or sales that are not always efficient or in the best interest of an investor from a total-return perspective.

An ETF may have a larger-than-desirable exposure to an asset class such as Treasuries or agencies because increased issuance have made those assets a larger part of the market. An ETF may be forced to sell positions that are downgraded or removed from the index and buy credits that are added, whether or not they provide value. ETFs may also be prevented from selling positions to lock in gains in securities that have reached full value, or selling securities to limit losses.

Active managers have a number of tools at their disposal to create portfolios that can outperform ETFs in various market conditions. Asset allocation is one example. Treasuries and government agency securities make up a significant portion of the fixed-income market but currently provide relatively low yields and limited prospects for potential outperformance in the current environment. An overweight in even the highest-rated corporate securities can add yield and total-return potential to a portfolio, with minimal change in the overall quality of the portfolio.

Managers can also adjust these asset allocations over time to adapt to changing market conditions. For example, as the likelihood of an economic slowdown increases, an active total-return-oriented portfolio manager can reduce exposure to corporate bonds while increasing Treasuries. This would position the portfolio to benefit as the probability of interest-rate cuts by the Fed increases. Again, ETFs are locked into replicating the asset allocation of a benchmark and are not positioned for outperformance.

Credit selection is another area where managers can add value. In most cases, ETFs hold positions to maturity or are forced to make changes based on the actions of ratings agencies. ETFs will buy and sell positions after upgrades or downgrades have already been priced in. Managers that analyze credit and relative value are able to add undervalued and improving credits and avoid overvalued or deteriorating credits. Managers are also able to add value through trading by selling positions to lock in gains or avoid losses.

Although ETFs may serve a specific role for some investors, the structure and rules that define their construction prevent outperformance by definition. Experienced managers that employ an active total-return management style have advantages that should allow them to consistently outperform over the long term.

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