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The **Goldman Sachs Strategic Income Fund** employs a flexible investment approach that seeks to capitalize on the most attractive total return opportunities across global fixed income markets utilizing GSAM's best ideas and which can adapt to changing market conditions.

## Strategic Income Fund:

A Q&A with Co-Portfolio Managers Jonathan Beinner and Mike Swell

*Dramatic changes in the global economy and markets since the financial crisis have reshaped the investment landscape. Risks and opportunities are surfacing in unexpected places, and to address them effectively, we believe investment strategies must adapt.*

*GSAM's Chief Investment Officer and co-Head of the Global Fixed Income team, Jonathan Beinner, and co-Head of Global Lead Portfolio Management, Michael Swell, discuss how the new Strategic Income Fund will seek to respond to the challenges ahead.*

### Why did GSAM launch the Strategic Income Fund?

**Beinner:** We created this Fund because we believe major changes are under way in the global bond markets, brought on by the global financial crisis and its aftermath. In our view, investment strategies will need to adapt, to preserve the traditional benefits of a fixed income allocation, and to address new risks.

Investors have historically turned to fixed income to help them manage risk and seek solid return potential. But we believe traditional fixed income funds may be less able to meet these needs in the future, for two main reasons.

First, the indices most commonly used to benchmark the performance of fixed income mutual funds are dominated today by unprecedented levels of government sector<sup>1</sup> debt<sup>2</sup> – an asset class that we believe faces considerable challenges. Following the recession and two years of near-zero interest rates, yields of government-sector debt are at historic lows. Moreover, we believe a number of factors are contributing to higher risk in government sector debt, including slow economic growth, a surge in government debt following the financial crisis and uncertainty about the outlook for inflation. In our view, all of these factors suggest growing interest rate risk - or the risk of a decline in bond if interest rates rise. As a result, we think investors dependent on traditional bond portfolios for returns may face potentially more risk, for less reward.

Second, we believe compelling opportunities have arisen across fixed income sectors that are not typically included in traditional portfolios. For example, we think high yield credit and emerging market debt offer much more attractive compensation for risk. Both sectors entail more credit risk and liquidity risk compared to government sector debt, and emerging market debt includes currency risk. However, in our view, the market is providing more attractive yield for investors willing to take these risks compared to interest rate risk. In addition, we think credit and liquidity risks are declining while interest rate risk in government sector debt is rising.<sup>3</sup> As a result, we believe scope and flexibility are increasingly important to successful investing.

<sup>1</sup> The Barclays Capital US Aggregate Index and the Barclays Capital Global Aggregate Index are the most commonly used fixed income benchmarks whose sector weightings include all of the below-mentioned sectors.

<sup>2</sup> We view government sector debt as domestic and sovereign debt, quasi government such as agency government-guaranteed and agency non-government guaranteed bonds, municipal bonds and agency residential mortgage-backed securities.

<sup>3</sup> High-yield credit and most emerging market debt are deemed non-investment grade fixed-income securities, which are considered speculative. Non-investment grade fixed-income securities and unrated securities of comparable credit quality are subject to the increased risk of an issuer's inability to meet principal and interest payment obligations. Please see page 8 for additional risk disclosures.

These factors are integral to the Strategic Income Fund. The Fund can access a broad range of fixed income sectors across the globe, deploying our best ideas in pursuit of attractive total returns. The Fund's flexibility in investing in the global bond markets also means we can turn defensive when we believe risk is outpacing potential returns. For example, if we anticipate an economic downturn, we could shift the Fund's investments into Treasuries, or cash.

#### What are the main changes you see in today's investment environment, and what were their catalysts?

**Beinner:** The combination of extraordinary policy measures in the US and abroad and an uncertain growth outlook in the wake of the global financial crisis has boosted risk and lowered returns in markets traditionally considered safe havens. At the same time, advances in developing economies, and broad deleveraging in the private sector (i.e., decreasing the amount of debt they have by paying it off), are supporting credit quality in markets traditionally regarded as higher risk.

As the recession hit two years ago, central banks and governments were forced to expand their balance sheets to stimulate their economies. The Federal Reserve, European Central Bank (ECB) and Bank of England cut interest rates close to zero, and went to even greater lengths to avert deflation by buying securities. Many governments deployed large spending packages that obliged them to borrow more. The combination of these monetary and fiscal policies pushed yields of the most widely used benchmarks, including the Barclays Capital US Aggregate Bond Index (Barclays Aggregate), lower and national debt levels higher.

Debt-to-GDP ratios have climbed to 100% or more in large, developed economies.

In some of the largest developed economies, including the US and parts of the Eurozone, the ratios of debt to Gross Domestic Product (GDP) are set to exceed 100% in the coming years, if they haven't already, according to the International Monetary Fund (IMF).<sup>4</sup> In Japan, that ratio is already around 226%. Investors are balking, as we see from the ongoing turmoil in peripheral Eurozone markets, which has forced the ECB to buy government debt to prevent a liquidity crisis. This market backlash is forcing governments to tighten their belts, and fiscal cuts pose a further setback to growth, which is still struggling at below-trend rates.

Rising risk in major government bond markets leads us to another development we think is highly relevant for fixed income investors: the gradual breakdown of traditional risk relationships. For example, compare this scenario of increasing debt and sluggish growth in developed economies with the story in emerging markets. According to the IMF, debt-to-GDP ratios across emerging markets are around 30% to 40%, thanks in part to robust growth – that is expected to nearly triple that of the developed world this year.<sup>5</sup>

Moreover, general improvements in fundamentals across emerging markets have been recognized in widespread credit ratings upgrades<sup>6</sup> which contrast with a recent deterioration in credit quality in the developed world. This deterioration is clearest at the Eurozone's peripheries: Ireland and Portugal are the most recent to suffer negative ratings actions, in a trend that has cost Spain its triple-A rating and Greece its investment grade status.<sup>7</sup>

<sup>4</sup> Source: World Economic Outlook (WEO) as of October 2010.

<sup>5</sup> WEO as of October 2010.

<sup>6</sup> The average credit quality of the JPM Emerging Markets Bond Index (EMBI) Global Diversified Index improved from Ba3 in December 1993 to Ba1 in December 2009, with Brazil, Peru, Russia and Mexico gaining investment grade status during the same period.

<sup>7</sup> Investment Grade bonds are rated BBB or higher.

Upgrades are also starting to outpace downgrades in high-yield corporate credit, where fundamentals have improved dramatically since the financial crisis. Record corporate cash levels, cleaner balance sheets and stronger earnings have seen a sharp drop in high-yield defaults from more than 10% in 2009 to less than 1% in 2010, according to JP Morgan data as of the end of November.

### What potential problems does this new environment present for the traditional model of fixed income investment?

**Swell:** We believe that the traditional investment approach may pose setbacks on several fronts for portfolios seeking returns and lower risk in this new investment environment.

First, as discussed, we see limited income opportunities for portfolios focused on government sector debt. In our view, such portfolios are missing out on a diversity of potentially higher yielding assets.

For example, yields on the Barclays Aggregate, whose weighting in government secured debt accounts for 77% of the index<sup>8</sup>, have increased recently but remain close to their lowest levels in 30 years. However, higher yielding sectors, such as US investment-grade corporate credit, comprise barely a fifth of the Barclays Aggregate, while investment-grade emerging markets external debt comprises about 1%. Meanwhile, asset classes that offer yields more than double what is available in these sectors are excluded from the Barclays Aggregate altogether, such as high-yield corporate bonds and non-agency mortgage securities, which offer exposure to the US housing market.

Second, the low yield on portfolios with heavy concentrations of government-sector debt leaves them less cushion to absorb duration risk: the risk of rising interest rates eating into returns. While we don't see the Federal Reserve or other G3 central banks tightening monetary policy in the next six to 12 months, rates are likely to increase over the next couple of years.

And third, the technical outlook, in our view, is unfavorable for government-sector debt. In terms of supply, large fiscal deficits in developed countries will likely keep government borrowing requirements high for the coming years, despite belt-tightening efforts. Continued heavy issuance could drive bond prices lower, as large institutional buyers demand higher returns. Moreover, continued issuance of government debt will help preserve the large weighting of government-sector debt in various leading fixed income indices, including the Barclays Aggregate.

We believe the Fund, with a flexible investment approach, can seek to navigate those risks and perform well in dynamic market conditions.

We think it is important to scrutinize the make-up of fixed income benchmarks, especially those that may not represent as broad a range of sectors as believed.

**Yields presented are for illustrative purposes only and do not reflect the performance of the Goldman Sachs Strategic Income Fund. Past performance is not indicative of future results, which may vary.**

<sup>8</sup> The Barclays Capital US Aggregate Bond Index is used by 167 out of the 300 Intermediate Term Bond Funds and 27 of 93 Multi-Sector Bond Funds that indicated they use a benchmark, according to Simfund as of December 31, 2010. Index weighting is as of December 31, 2010. Source: Barclays Capital.

### How does the Strategic Income Fund compare to traditional fixed income funds?

**Swell:** We're trying to create a methodology for investing that is much more flexible, that can change the risk of a portfolio more dynamically than a traditional fixed income fund can. We see this methodology as a balance of intelligent offense, where we can add risk, and proactive defense, where we can take risk down as the need arises.

The Fund utilizes a flexible investment approach. Portfolio risk can be adjusted to prevailing market conditions more dynamically.

So how do we decide when to add risk to a portfolio, to execute the intelligent offense? The Fund gives investors a way to outsource investment decisions to a deep team of active managers with diverse skills in fixed income with the scope to invest across different types of strategies. We think that this approach can generate higher levels of risk-adjusted return potential.

The Fund also offers a measured focus on yield, which means we are not seeking yield at any cost. We weigh a range of factors to determine how risk should be shifted in the portfolio as we see certain bond prices diverge from their fair value, or as our view on risk assets becomes either more negative or more positive.

On the defensive side, three key factors will be critical to our decision making. The first is the macroeconomic outlook, both domestic and global, including growth, leading indicators, inflation and employment. A second, complementary factor is the technical environment, including market volatility and asset flows, which help drive short-term performance.

And the third factor is valuation: whether the assets are priced attractively from both a macro and technical perspective. For example, over time, as the economy peaks, we may start to reduce risk if we believe that peak is not yet reflected in asset prices. Conversely, in a trough period where assets in a certain sector have yet to re-price for an improving economic scenario, we may add risk.

This last point is crucial. Making an investment is not merely a function of a positive or negative outlook. You also need to assess how that outcome would affect the risk and return of the pricing of a particular asset. Successful investing requires blending economic and technical expectations with market valuations. Of course, there is no guarantee that the Fund's investment methodology will be successful.

### Which areas are your favored sources of yield?

**Swell:** Currently, emerging markets are, we believe, among the most appealing sectors, as their generally lower debt ratios and stronger growth are major attractions, as discussed. You would think in that environment, and with more investors allocating to emerging markets, there wouldn't be many opportunities left for yield. But significant risk premiums are still available on emerging markets debt, particularly in local markets such as Brazil, Indonesia and Mexico.<sup>9</sup>

US non-agency mortgages is another asset class undergoing a positive transition, in our view, offering the most attractive yields in the fixed-income market today. Though delinquencies remain high in the residential mortgages sector, the levels are stabilizing as

We see a lot of income-generating opportunities in the fixed income markets, including emerging market debt – issued in local currency – and US non-agency mortgage securities.

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<sup>9</sup> The generic yield to maturity (YTM) for the 10-year bond denominated in the local currency for each country is 12.02%, 7.17% and 6.96%, respectively. Source: Bloomberg, as of December 31, 2010.

we progress through the foreclosure cycle. Our base case forecast is for another 5% to 8% decline in house prices, but the market still seems to be positioned for a more severe outcome. We think that's an attractive risk-adjusted return profile, which is generally unavailable to traditional fixed income portfolios.

By contrast, we see far less compelling opportunities in commercial mortgage-backed securities (CMBS). Commercial mortgages offer significantly lower yields compared to the residential mortgages sector; moreover, delinquencies continue across various vintages<sup>10</sup> of commercial mortgage-backed securities.<sup>11</sup> Yet these securities, which in our view are potentially riskier additions to portfolios, are included in the Barclays Aggregate and other indices.

In sum, we see a lot of income-generating opportunities in the fixed income markets. But we believe they are clearly underrepresented by traditional fixed income investment strategies where you are investing primarily in low-yielding Treasury securities and agency mortgage securities. We also think that a lot of the changes in the market that Jonathan discussed earlier are here to stay. With these changes in mind, we believe the way to invest in fixed income today is through a flexible strategy that allows tactical adjustments between higher risk and low risk, and this is the way we've designed the Strategic Income Fund.

**Thank you, Jonathan and Michael**

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<sup>10</sup> A vintage defines the unique characteristics of underlying loans and how these underlying assets are being pooled in a Mortgage-Backed Security or MBS.

<sup>11</sup> Source: GSAM and Trepp, LLC; as of December 31, 2010.

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**Michael Swell** is the co-head of Global Lead Portfolio Management within the Global Fixed Income and Liquidity Management team at Goldman Sachs Asset Management (GSAM). In this role, he is co-leading the global team of portfolio managers who are responsible for overseeing multi-sector portfolios. Previously, Michael was a senior portfolio manager and co-head of the US Fixed Income group. Michael joined GSAM in 2007 as a managing director and head of Structured Products.

**For more information, please speak with your investment professional.**

**A summary prospectus, if available, or a Prospectus for the Fund containing more information may be obtained from your authorized dealer or from Goldman, Sachs & Co. by calling 1-800-526-7384. Please read the summary prospectus, if available, and the Prospectus, which contains a fund's objectives, risks, charges and expenses, and other information about the Fund, carefully before investing.**

**Risk Considerations:**

The **Goldman Sachs Strategic Income Fund** invests in a broadly diversified portfolio of US and foreign investment grade and non-investment grade fixed income investments including, but not limited to: US Government securities (such as US Treasury securities or Treasury inflation protected securities), non-US sovereign debt, agency securities, corporate debt securities, agency and non-agency mortgage-backed securities, asset-backed securities, custodial receipts, municipal securities, loan assignments and participations, and convertible securities. The Fund's investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity and interest rate risk. The guarantee on certain US government securities applies only to the underlying securities of the Fund if held to maturity and not to the value of the Fund's shares. The Fund's investments in mortgage-backed securities are subject to, among other risks, prepayment risks. These risks may result in greater share price volatility. The Fund may invest in high yield, fixed income securities that, at the time of purchase, are non-investment grade, also known as "junk bonds." High yield securities involve greater price volatility, are less liquid and present greater risk than higher rated fixed securities.

The Fund may also invest in foreign issuers which are denominated in currencies other than the US dollar and in securities of issuers located in emerging countries denominated in any currency. The Fund's foreign and emerging market investments may be more volatile and less liquid than its investments in US securities and will be subject to the risks of currency fluctuations and sudden economic or political developments. At times the Fund may be unable to sell certain of its portfolio securities without a substantial drop in price, if at all.

The Fund may also make substantial investments in other derivatives instruments, including interest rate futures contracts, options (including options on futures contracts, swaps, bonds, stocks and indices), swaps (including credit default, index, basis, total return, volatility and currency swaps), other forward contracts and other derivatives instruments. The Fund may engage in foreign currency transactions for hedging purposes (including cross hedging) or for speculative purposes. Derivative instruments may involve a high degree of financial risk. These risks include the risk that a small movement in the price of the underlying security or benchmark may result in a disproportionately large movement, unfavorable or favorable, in the price of the derivative instrument; risks of default by a counterparty; and the risks that transactions may not be liquid. Moreover, there is no guarantee that any attempt by the Fund to hedge against currency fluctuations will be successful.

The Fund is subject to the risk associated with implementing short positions. Taking short positions involves leverage of the Fund's assets and presents various other risks. Losses on short positions are potentially unlimited, as a loss occurs when the value of an asset with respect to which the Fund has a short position increases. The implementation of short positions, as well as the use of derivatives generally, involves sophisticated investment techniques that have the potential to add additional risk to the Fund.

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The J.P. Morgan EMBI Global Diversified Index is an unmanaged index of debt instruments of 31 emerging countries. The Index figures do not reflect any deduction for fees, expenses or taxes. It is not possible to invest directly in an unmanaged index.

High yield, lower rated securities involve greater price volatility and present greater risks than higher rated fixed income securities. Fixed income securities of emerging countries are less liquid and are subject to greater price volatility and will be subject to the risks of currency fluctuations and sudden economic or political developments. The securities markets of emerging countries have less government regulation and are subject to less extensive accounting and financial reporting requirements than the markets of more developed countries.

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