Agincourt Capital Management, LLC

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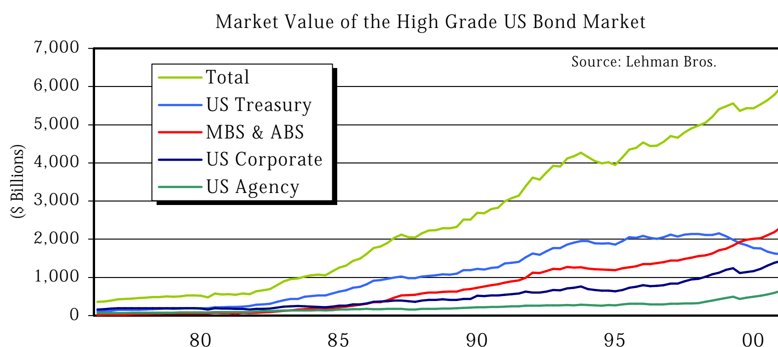
INVESTMENT UPDATE

Two bright young representatives of a firm offering a new internet-based service for bond portfolio managers recently visited our office. We were a little surprised to learn that one of these twenty-somethings is the son of an old friend, a portfolio manager that two members of the Agincourt team have known for many years.

We were initially shocked that a contemporary of ours could have a son old enough to be in the business, until we realized that we were (or would soon be) that old ourselves! Some of us have been working in the capital markets for 20 years and have seen the bond market evolve dramatically over that time. Thinking about these young people sitting across the conference table got us thinking about how different the bond market is today compared to when we first started in the business.



The modern US bond market was formed in the early 1980's. Prior to that time, the bond market was a fairly serene place, dominated by intermediate-maturity Treasury bonds and a few industrial and utility bonds. Interest rates had been essentially stable since the earliest years of the century. The deregulation of the banking industry and the inflation of the 70's changed everything. By the early 1980's interest rates had risen dramatically and bond prices had plummeted, earning fixed income securities a reputation as "certificates of confiscation". Treasury issuance exploded as the Federal Government borrowed money to cover the budget shortfall. Corporate issuance grew as well, as both investors and issuers increased their tolerance for financial leverage. The mortgage-backed securities market also gained critical mass during this time period. The chart above shows the dramatic growth of the US bond market over the past 25 years.

In 1975, the high-grade US bond market had an aggregate value of approximately $175 billion. By 1980, it was over $500 billion. Perhaps most impressive was the twelve-year period from '82 to '93 when the bond market grew by more than sixfold, an average growth rate of 17% per year, to more than $4 trillion.

Not only the size, but also the complexity of the bond market evolved in the eighties. Those of us who were around during the "greed decade" witnessed the proliferation of new products that seemed to spring up weekly from the minds of Wall Street Ph.D.'s. CMO's (and all their progeny), asset-backed securities, derivatives and portfolio insurance were just some of the new ideas available for the first time in the eighties.

This was also a time when the large brokerage firms held a distinct advantage over their customers. Wall Street controlled the inventory of bonds and could exert significant leverage over their customers. This was the era when Salomon Brothers (well documented in Michael Lewis' entertaining book Liar's Poker) and a few other firms dominated the bond market. Customers, with limited resources (both from a monetary as well as a research standpoint) were often at the mercy of the Wall Street firms. Perhaps the most controversial character of the 1980's bond market was Michael Milken, who transformed sleepy Drexel Burnham Lambert into a bond trading juggernaut. Known for their strong-arm sales tactics, Milken and Drexel nevertheless created the modern junk bond market. Their ultimate fall from grace left a void in the high-yield market that took their competitors years to fill.

Throughout the 1990's the balance of power changed. Money managers began committing considerable resources to improve their ability to analyze the

highly complex securities Wall Street was pushing. Hedge funds and private money managers were able to attract many of the "best and brightest" away from the big broker's proprietary trading desks. Powerful analytical packages (Merrill Lynch's Bloomberg, Salomon's Yield Book) became widely available, providing portfolio managers many of the same tools as those used by the Street. The leveling of the playing field meant that the brokers could no longer extract excessive profits from their customers. Consolidation in the money management business led to a handful of giant fund managers who couldn't help but move the market whenever they make a tactical change; they grew to the point where the Wall Street firms could no longer easily handle (much less manhandle) the typical transaction of one of these fund-managing behemoths.

The liquidity of the bond market took a decided turn for the worse in 1998. The combination of the currency crisis/Russian bond default and the violent implosion of a number of high-profile hedge funds cost the brokerage industry millions in lost profits. As a result, liquidity dried up as Wall Street firms refused to position bonds they weren't sure could be immediately re-sold. Many broker dealers are just now beginning to emerge from the bunkers they built in the aftermath of the 1998 liquidity crisis.

Which brings us back to our twenty-something guests. Their firm, like so many new endeavors today, uses the Internet to disseminate valuable market data. Increased information, especially for corporate bonds, improves liquidity. Improved liquidity encourages both investors and the Street to buy corporates. Other firms, notably TradeWeb, have developed on-line trading systems, allowing money managers to buy or sell Government securities (and one day, corporate and mortgage securities) on-line, in real time, at the best price among all the major broker/dealers. We applaud all efforts to increase the transparency of prices and improve the execution of trades in the bond market.

While we don't expect to see as many changes in the bond market over the next 20 years as we've seen in the past 20, there's no question that the market will continue to evolve. This much is certain: the composition of the US bond market is undergoing a dramatic transformation. As shown on the chart on the front page, the value of Treasuries outstanding is declining, a trend we believe will continue for at least the next four or five years. Meanwhile, each new day brings more new corporate bonds, mortgage-backed securities (MBS) and US Agency issues. According to Lehman Brothers, the high-grade corporate sector is now larger than the US Treasury market (MBS exceeded Treasuries in mid-1999). As the relative size of the Treasury sector shrinks and the "spread" markets grow, portfolio managers will have to adapt.

Many firms will have to completely re-vamp their investment strategies in adjusting to the structural changes that lie ahead in the bond market. Some firms have very little experience with non-Treasury securities, others have size constraints (i.e., they are too big) that limit their ability to utilize corporate bonds effectively in their clients' portfolios. In preparation for the possibility that Treasuries may shrink to the point of losing their benchmark status, analytic systems are being recalibrated to deal with alternative, non-Treasury benchmarks (such as interest rate swaps).

Agincourt is exceptionally well prepared for these structural changes in the bond market. Our yield-driven philosophy has led us to hone our skills over many years in both the corporate and MBS sectors. More recently, we have continued to devote significant resources to upgrading our capabilities in analyzing the credit markets. With the recent improvements in sentiment, credit fundamentals and liquidity, corporates are finally beginning to perform up to the high expectations we've had for the sector for quite some time.

Who knows—maybe the twenty-somethings will be able to capitalize on the potential of the Internet to benefit Agincourt and its clients. A Napster or eBay for the bond market? We'll keep you posted.