

INVESTMENT UPDATE

Enron: the company that everyone loves to hate. The stories of management's callous disregard for their employees, investors and creditors have made Enron an easy target for those critical of corporate America. Even though we never bought their bonds, we join with the entire investment community in our deep disdain for Enron's management. CEO Kenneth Lay was famous for shouting down analysts in conference calls who questioned the company's accounting practices; now we learn that his hubris blinded him to the few reasoned voices in his own management team. While the media has certainly helped to sensationalize the story of Enron's downfall, we have no sympathy for a management team that profited from private partnerships while leaving shareholders, lenders and employees to twist in the wind.

From the standpoint of bond investors, Enron's collapse spewed a poisoned cloud of mistrust and cynicism into our market. Last November, just as the economy was showing signs of renewed life, investors were blindsided by Enron's fall—it took less than 30 days for Enron to go from investment grade to Chapter 11. The collapse of Enron was so sudden, so expensive and so widespread that investors are still in a state of nervous shock; no one wants to be guilty of buying the "next Enron".

It's not difficult to measure the psychological impact of the Enron collapse in the bond market—all one has to do is look at the way the average corporate bond's yield spread (the extra income over comparable-maturity Treasuries) has widened in recent weeks. Hardest hit have been those companies that are either: 1) in a business even remotely similar to Enron's, 2) reporting disappointing earnings, or 3) delaying earnings announcements, even if the delay is due to the company taking special care to ensure that their accounting practices are conservative.

As a result, the corporate bond market has reverted to the "flaky" behavior that has occasionally characterized its conduct over the past few years. Gen-

eral yield spreads are wider, while a handful of otherwise solid credits are trading at fire-sale prices. Tyco is one of the most prominent examples, a company built on a voracious acquisition strategy that (despite ample evidence to the contrary) short-sellers contend has hidden countless bookkeeping sins. Despite \$4 billion in projected free cash flow this year and a bondholder-friendly reorganization plan that seeks to reduce the company's consolidated debt by \$11 billion, Tyco bonds' prices dropped to distressed levels in recent weeks. Investor fear that Tyco could be the "next Enron" virtually eliminated any retail interest that is needed in this type of market to offset the speculative shorting of the bonds.

While Tyco may be the hardest hit it is by no means an isolated case. Bonds of The Williams Companies, WorldCom, Qwest—all solid corporate credits with ample free cash flow—have been decimated in recent weeks for little more than weakness or delays in earnings. Corporate bond investors have been taught to look beyond short-term earnings gyrations and focus instead on what really matters to bondholders—cash flow and leverage measures. But in this post-Enron world there is a belief that something sinister lurks behind nearly every corporate borrower.

The Ratings Agencies

Traditionally, in times of market volatility Moody's and Standard & Poor's (the major ratings agencies) are a source of calm and carefully reasoned opinion for bond investors. But something critical has happened to the voice of reason: they got burned by Enron too, and are now looking to save face.

Last year was a particularly tough year for the ratings agencies—in addition to Enron, there were a number of high-profile credit meltdowns, as well as the well-documented bankruptcy of California utilities and the September 11th-related weakness in the travel and leisure industry. But most of the fundamental credit problems in 2001 came from com-



panies who had taken on a high level of debt in the boom years of the late 90's but couldn't service the debt when the economy slowed. Despite their best efforts, the ratings agencies couldn't keep pace with the rapid deterioration of many credits, especially after September 11. Enron's collapse was a flashpoint; investors needed a scapegoat and the ratings agencies came under fire for not protecting investors from the financial shell game at the energy-trading giant.

Last month, both major agencies announced that they would be revising their methodology for rating corporate bonds. While these proposed changes and their details are subject to revision, the main message is that Moody's and S&P will be acting more quickly to upgrade or downgrade a corporate credit based on perceived changes in a company's credit rating. This "hair trigger" approach is a marked change from the agencies' long-standing policies of looking over a full business cycle in assessing a companies' credit worthiness.

While we understand the need for the ratings agencies to appear to be "doing something" to modernize an oft-criticized process, we are concerned that these proposed changes may do more harm than good. Included in the list of changes for both major services are the use of measures of "market sentiment, as evidenced by the price volatility of a company's securities" (S&P) and "more extensive use of market information" (Moody's). In other words, the ratings agencies will be looking at how a company's securities are trading in the open market to help judge the credit worthiness of their bonds.

This is exactly what the corporate bond market does not need right now: in volatile markets driven by hedge fund rumor-mongering, commercial bank credit-hedging and Wall Street duck-and-covering, investors need a dispassionate and objective assessment of a company's credit fundamentals. Markets are often driven by fear and greed and can move to extremes—if the agencies begin using the price behavior of a company's stocks and bonds, they will be adding an element of emotion to a process that should be purely factual.

What's worse is that when a ratings agency ex-

presses a negative opinion based on "market based" information, it may very well turn out to be self-fulfilling. In today's nervous investment world we've witnessed announcements that have caused a company's stock price to fall (e.g., missed earnings) which, in turn, pushed their bond prices lower, *even though the event shouldn't have impacted the bonds*. Into this environment the ratings agency should step and inject a dose of sanity, rendering an opinion as to whether there has been an event that impacted the bond's creditworthiness. Unfortunately, under the proposed new methodology the agencies are more likely only to add to the panic by downgrading the bonds due to lower stock and bond prices. "Acting first and asking questions later" will only add to market volatility.

Unfortunately, this highly stressful environment looks like the reality bond investors will be facing as the markets emerge from the Enron rubble. High-grade bonds will continue to offer unusual value and unusual volatility. We will need to continue to be extremely careful in selecting corporate credits as even solid companies may underperform when emotions run wild. On the other hand, there should be ample opportunities to pick up bonds of well-managed companies with ample positive cash flow and conservative leverage measures at attractive prices.

As always, Agincourt will continue to update our valuation measures to adjust to fundamental changes in the bond market. With the ratings agencies' new methodology dictating a shorter-term view of credits, we are expecting an accelerated pace of ratings swings. It is reasonable to assume that until investors become acclimated to this climate, risk premiums will probably be higher for corporates as investors demand yield in compensation for volatility. Longer term, transparency should improve and so should the quality of earnings, as companies, their auditors and even the ratings agencies recognize the costs associated with insufficient disclosure can be lethal.



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