Agincourt Capital Management, LLC

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INVESTMENT UPDATE

Less than three years ago the financial markets were in a state of near-ecstasy intoxicated by the elixir of the Internet. Investors fell over each other to buy a piece of an untested company, while dreaming of outlandish profits flowing from that endless font of wealth, the World Wide Web. Investors didn't trouble themselves with the messy details of just how these tiny companies would deliver on their promises, only that easy money was ripe for the pickings. In the fantastic economy of the future, brick and mortar companies would soon be replaced with "virtual" stores, perhaps best exemplified by eToys, a company that in 1998 had a market capitalization in excess of Toys R Us, but with revenues less than a single average Toys R Us store.

It was a mania, a rarely seen confluence of events that causes a group to act in a way that they would never behave if not part of the crowd. As Gustave LeBon's wrote in his seminal 1895 treatise *The Crowd: A Study of the Popular Mind*

> The decisions affecting matters of general interest come to by an assembly of men of distinction…are not sensibly superior to the decisions that would be adopted by a gathering of imbeciles…In crowds it is stupidity and not mother-wit that is accumulated…[As part of a crowd] a man descends several rungs in the ladder of civilization. Isolated, he may be a cultivated individual; in a crowd, he is a barbarian—that is, a creature acting by instinct.

Perhaps a little harsh, but in retrospect Dr. Le Bon's description seems fairly accurate; how else to explain why people would plunk down good money to buy eToys (at its peak) at a price equal to 120 times sales (that's sales, not earnings—there were never any earnings!). There can be no doubt that many investors, including many sophisticated professionals, abandoned the tools that enforce rational behavior when they bought these dot-com companies.

In a financial mania, you're safe as long as someone is willing to pay an even-more inflated price for something that you paid way too much for. Manias always end badly for those who enter the fray in the final round of price appreciation. Of course the end of the dot-com bubble was all too predictable; only the timing was in question. As interested bystanders we were stunned that the bubble grew as large as it did before bursting. But burst it did, with the NASDAQ falling 60% in 12 months from its peak in March 2000.

But manias also serve the purpose of reminding us that, in the end, rationality wins and reason prevails over emotion.

That's especially comforting to those of us involved in today's dysfunctional corporate bond market, which has been suffering from a kind of mania-in-reverse. As was the case with the NASDAQ, emotion not brainpower is in control. But instead of unbridled greed, today we have a contagion of fear. Investors are shunning corporates out of overblown concerns of widespread credit deterioration and default.

As we discussed last month, much of the nervousness present in today's corporate bond market can be traced back to Enron. To some extent, that's understandable—after all, if a bond investor cannot rely on the veracity of published, audited financial statements, it calls into question the essential relationship of trust between the borrower and lender. Lenders (bondholders) simply won't lend to those they cannot trust. But the emotions depressing corporate bond valuations cannot be attributed to just one spectacular meltdown—they've been building for three or four years.

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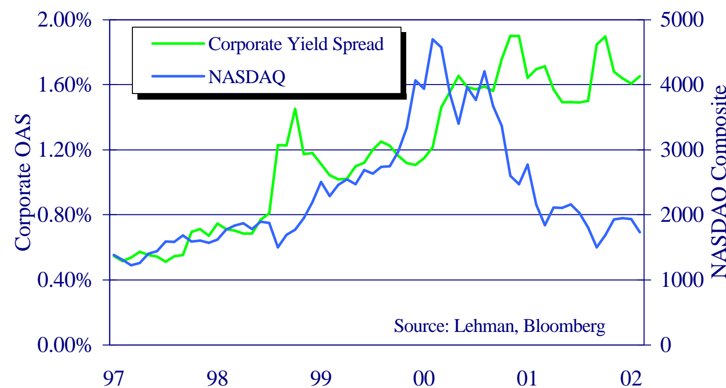
As the chart below demonstrates, the inflation of the NASDAQ and the inflation of corporate bond yield spreads (and relative depression of corporate bond prices) took similar paths in the late 1990's. This wasn't just a coincidence, as the wild expansion of the '90's was fueled by the leveraging of corporate balance sheets—good for stockholders, bad for bondholders. But the NASDAQ eventually came crashing back to earth, while the yield risk premium for corporates remained in the stratosphere long after the debt-financed growth frenzy cooled.

There have been a number of explanations over this period to justify the often-overly generous yields on corporates. In 1998, it was the Russian bond default/Asian currency/hedge fund meltdown that scared investors away from credits. In 2000, the inversion of the Treasury yield curve (itself driven by a mini-mania over the "scarcity" of long Treasuries) caused interest rate swap spreads to widen. Wider swap spreads made hedging corporates more expensive, which drove corporate yield spreads wider. Last year, investors were concerned that the economic slowdown would have a negative impact on credit fundamentals.



But these explanations fail to explain the current state of affairs: Despite a general reduction in corporate leverage, despite a resurgent economy and despite a very steep yield curve, corporate bonds' yield spreads over Treasuries remain at levels that show that investors are still not acting with their brains. A quick calculation reveals that corporates with three-year maturities that offer yield spreads over Treasuries of 150 basis points would have to widen by an *additional 75 basis points* to underperform Treasuries over the next 12 months. "Break-even" analysis makes it clear that, although emotions could continue to rule some investors' decisions, those willing to apply a disciplined approach to this market stand to outperform.

Thorough credit analysis of individual companies will also continue to be a critical component of successful management of corporate bonds in the current nervous environment. With the general lack of trust between borrowers and lenders there are many solid companies whose bonds are getting unjustifiably punished, and a number of credits whose problems are genuine and whose bonds should be avoided. Our job is to dig deep for the critical information necessary to recognize the difference between the two; this is a difficult job in today's market, but our credit team is up to the task.

As we've mentioned in recent pieces, the disarray in the corporate sector provides plenty of opportunities to add value—it is Agincourt's kind of market. While emotions will always be part of the investment equation, we're expecting a gradual cooling of emotions as fundamental analysis moves back into place as the driving force in the high-grade bond market. This will come when investors re-learn to trust their own analytical skills and quit running scared from every hint of bad news. As was the case when the dot-com stocks fell to earth, a company's bonds and stock eventually trade in accordance with the underlying strength of that company, not on rumor, speculation or the hysterical behavior of a crowd.

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