Agincourt Capital Management, LLC

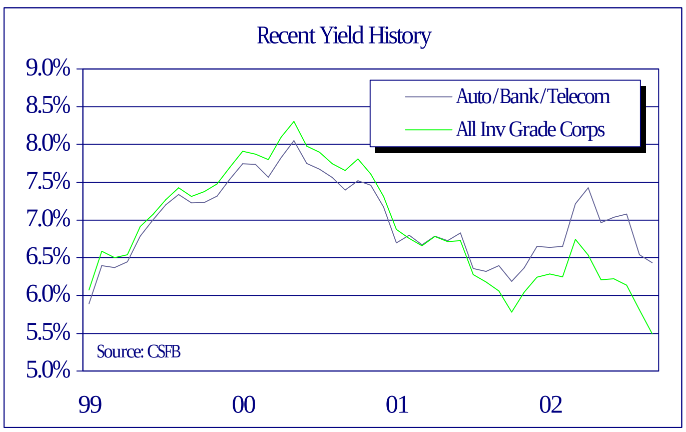
November 2002

INVESTMENT UPDATE

"I have no doubt in my mind that we could fund everything in the securitized market [next year] if we need to"—Ford Assistant Treasurer Neil Schloss, October 11, 2002

Pity the large bond issuer. Not so long ago, investors (especially of the institutional variety) paid a premium to buy large bond issues of major companies. If the issue was at least $1 billion, it was considered "liquid" enough for the Wall Street brokerage houses to trade. Smaller issues, floated by lesser companies, languished as both traders and investors focused on the "go-go" names—the largest issues with the most visibility.

Not anymore. One of the more surprising after-effects of the post-Enron corporate bond market is that more visibility just makes an issuer a bigger target for those who profit from the company's weaknesses. No, not lawyers. We're speaking of hedge funds and other capital market speculators.



As we've discussed in previous *Investment Updates*, the corporate bond market hasn't been running on all cylinders this year. After a succession of ratings agency downgrades, corporate book-cooking, and credit quality deterioration, investors' tolerance for risk has been sorely tested. The commercial paper market has shut down for all but the safest credits and the major commercial banks are refusing to lend unless they can extract major concessions from the borrower.

As bad as things are for the average borrower, they are considerably worse for the largest issuers in the bond market, as these companies have to deal with at least two additional negative factors: the derivatives markets and portfolio-based diversification rules.

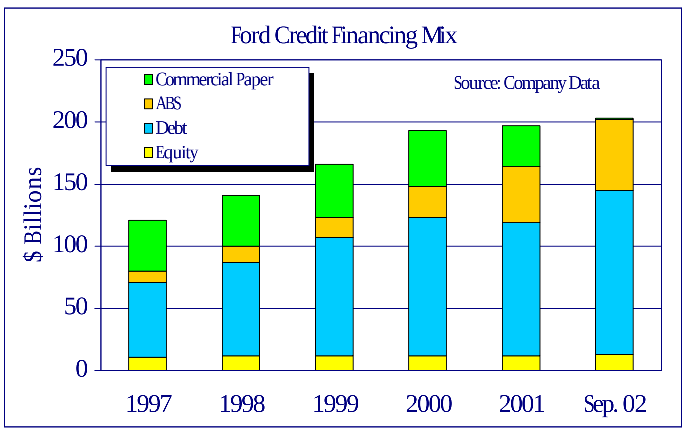
Credit derivatives allow parties to either add to or reduce their exposure to an individual company's (or group of companies') default risk. Originally used by banks to reduce their risk exposure to companies to whom they had lent, they have more recently been embraced by hedge funds to make large, leveraged bets against individual bond issuers. While these speculators can "lean on" any credit they choose, they have a strong preference to go after large issuers. The reason that large issuers get picked on has to do with the "unwinding" of the credit derivative contract—one party may have to deliver the actual collateral, namely the bonds of the individual credit. In order to maximize the profit on the trade, the collateral must be readily and cheaply available, *and in very large quantities* when the contract is "unwound". In short, hedge funds can more profitably pick on large borrowers than small ones.

The second factor that is placing additional pressure on the largest borrowers has to do with the heightened state of risk aversion in the corporate market. Portfolio managers, having been burned by individual credits over the past year, have put in place more stringent diversification rules for their portfolios. In an environment where the price of an investment grade bond can fall by 10 or 20 percent in one day, diversification is critical. As these new rules have been implemented, portfolio managers have found that the largest issuers are those that most need to be pared back in their portfolios. As a result, the market has been flooded with bonds of the largest issuers, and new buyers have yet to emerge.

In the chart above we compare the recent yield history of investment grade corporate bonds to a subset of corporates—the automotive, banking and telecommunications sectors—that represents the largest corporate issuers. These three sectors alone account for approximately one-third of the high-grade corporate universe, and include 16 of the 20 largest issuers. The chart clearly shows the premium (i.e., higher prices/lower yields) that the large issuers commanded as recently as early 2001, and how that relationship has changed over the past few months. By the end of this years' third quarter, these large issuers' bonds offered yields almost 1% higher than the average high-grade corporate bond.

The upshot of this is that life for the finance staffs of these large companies has gotten considerably tougher over the past year. The wheels of capitalism grind to a halt unless money is available at a reasonable price to those who need it—and despite the best efforts of the Federal Reserve to lower rates and stimulate capital formation, these large borrowers have been effectively shut out of the capital markets.

Fortunately, as the economy has shifted into a slower pace of growth, few companies have found themselves with big borrowing needs; in fact we believe we are in the early stages of a multi-year period where companies will be bringing down the mix of debt on their balance sheets as they "re-equitize" their capital structure.



However, for companies that depend on the capital markets to keep their operations running (such as finance companies) the current state of affairs is painful. The companies that have been hardest hit, and still appear to have the toughest road ahead, are those large companies with upcoming maturities that need to be "rolled over". No firm better demonstrates the difficulties that large issuers are having in obtaining funding than Ford Motor Company and its finance subsidiary, Ford Motor Credit.

The chart on this page shows how Ford Motor Credit's (where most of Ford's funding is done) funding mix has changed over the past few years in response to the changing capital markets environment. Borrowing grew at a very rapid pace from 1997 to 2000, mostly in the form of debt. In fact, Ford championed the multi-billion dollar bond deal during this period as a way to reduce their borrowing costs. Since year-end 2000, however, Ford has had to make some serious adjustments, virtually eliminating their commercial paper program and substituting asset-backed securities (ABS). This dramatic shift in funding reflects the difficulty that Ford has been having in the capital markets—issuing commercial paper or bonds has become prohibitively expensive (10-year Ford bonds yield more than Russian debt!). Fortunately, Ford can still issue asset-backed securities (collateralized with car loan receivables) at a reasonable cost.

Ford will face its toughest test next year, as they will have to raise an estimated $30 billion in debt. They have recently stated that they are prepared to source all of their funding in the ABS market, but it is an open question whether the ABS market (which is a fraction of the size of the corporate market) can handle the increased volume from Ford.

Ford is by no means the only company with funding problems; if Ford and others with large liquidity needs become dependent on the ABS market, we expect considerable widening of ABS yield spreads as the sector adjusts to a much heavier supply.

Clearly, the poor "technicals" in the corporate market will continue to force companies (and investors) to adjust, as many of the "tried and true" rules no longer apply. In a nervous environment, technicals can outweigh fundamental credit analysis, and that has certainly been the case this year. As we look ahead, however, we continue to believe that the fundamental case for corporate bonds is becoming increasingly positive as companies take on the difficult job of repairing their balance sheets and working off the excesses of the last decade. Before too long we believe we'll see more consistently good news on the economy and corporate earnings, further strengthening the case for improved corporate credit fundamentals. When that happens, corporate bonds, even those issued by large companies, will generate impressive returns.