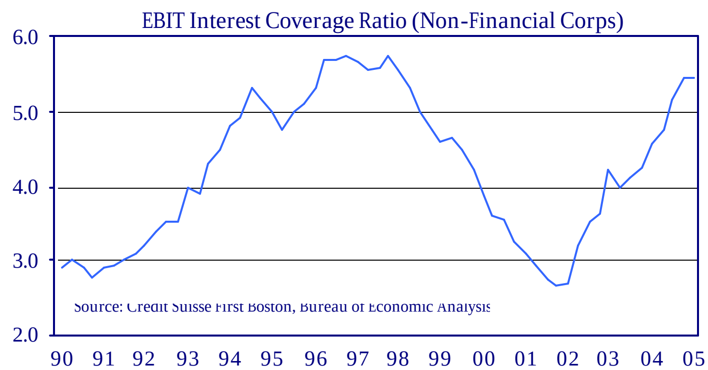
Agincourt Capital Management, LLC

August 2005

INVESTMENT UPDATE

There's a lot of chatter right now about exactly where we are in the "credit cycle." Specifically, some bond market strategists are warning that credit quality has peaked, and that we are now heading into a period of credit deterioration. They're recommending that investors begin unloading their corporate bond holdings right now. Before we address the question of whether this advice is worth following, we should first define just what the credit cycle is, and try to identify where we believe we are as of August 2005.

We're all familiar with the concept of the business cycle, but not so comfortable with what is meant by the credit cycle. While the two are similar in many ways, they have important differences. The business cycle refers to the overall health of the economy, from boom to recession, while the credit cycle is strictly concerned with the credit-worthiness of borrowers. As an economy expands, so does (generally speaking) profitability and free cash flow. Thus, a growing economy is typically associated with a rise in the confidence that borrowers will be able to pay their future interest and principal payments. Yet there are differences in timing, as the credit cycle can begin to turn down even while the business cycle is still on the upswing. The two cycles can be "out of phase."



To backtrack slightly, the current credit cycle is most notable for the magnitude of its trough phase, brought about by the meltdown of the so-called New Economy. The economic expansion of the 1990's was marked, especially late in the boom times, by a willingness of companies to use debt to fund their expansion plans. In retrospect, it all looks very foolish and short-sighted, but recall that at the time, it was widely believed that the rise in global capitalism, combined with the promise of the Internet, meant that the expansion could go on almost indefinitely. Expanding and/or making acquisitions to increase a firm's productive capacity was considered essential to meet the "permanently" higher level of aggregate demand that this New Economy promised. The debt markets were the primary source of capital to fund these expansion plans. Corporate treasurers, typically reticent to put their firms' financial health at risk by saddling their balance sheets with interest and principal obligations, were emboldened by the notion that things "really were different this time," and that an economic downturn was many years off.

When the inevitable slowdown came, these aggressive borrowers found themselves in a very tight spot. A schedule of fixed payment obligations that seemed manageable at the peak of the economic cycle looked more like Mount Everest when revenue projections failed to come through. After all, a high level of debt is merely a potential risk when cash flow and profits are high; leverage only becomes an actual risk when the money to service it is inadequate.

The bottom fell out of the credit markets in 2001 and 2002, when many borrowers (including high-profile firms like WorldCom, Qwest and Enron) defaulted, unable to make their debt payments. The damage was exacerbated by the reluctance of commercial banks to provide liquidity to many of these strung-out borrowers, some of whom could have avoided bankruptcy if the banks had filled their traditional role. In 2002, Moody's downgraded 171 high-grade companies to below investment grade, representing more than 5% of high-grade issuers. In the "junk" bond market, the numbers were downright brutal, with Moody's reporting a default rate (as measured by dollar volume) of 18% in 2001 and more than 21% in 2002.

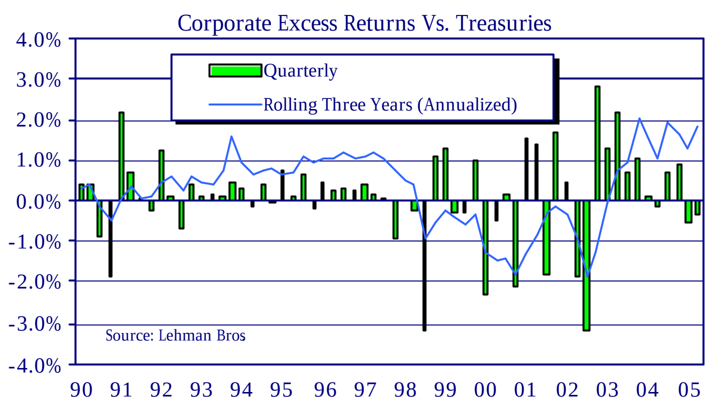
At the risk of sounding melodramatic, corporate treasurers must have felt like soldiers coming from the scene of a horrific battle, with the carcasses of failed enterprises littering the landscape. The chart on this page demonstrates just how deep the trough was, as the average non-financial companies' interest coverage ratio (the number of times that free cash flow—"EBIT"—can cover the years' interest expense) fell from more than 5.5 to nearly 2.5 from 1998 to 2002. A ratio below 3.0 is dangerously low, and implied that the overall US debt market was rated "BB," junk bond status, in 2002.

Climbing out of this trough has been the story of the last three years, as corporate treasurers have taken great strides to reduce the leverage inflicted on their balance sheets. As the chart on this page shows, credit quality has rebounded dramatically, with interest coverage now back near the peak of the mid-90's. This was accomplished by improvements both in measures of free cash flow from higher sales and CAPEX cutbacks, as well as a lower interest expenses from reduced debt levels and fairly stable all-in borrowing rates. Overall credit quality has dramatically improved, with an implied rating now somewhere between "A" and "BBB."

As shown in the chart below, the improvement in credit quality has provided strong excess returns for corporate bond investors since the bottom of the credit cycle, with the average high-grade dollar-denominated corporate bond outperforming like-duration Treasuries by 1.78% on an annualized basis for the three year period ending June 30, 2005. This ranks as one of the best three year periods in the last fifteen years, even stronger than the excess returns corporates produced coming out of the previous credit trough, when corporates outperformed by 1.52% annually from 1991 through 1993.

Which finally brings us back to the original questions—has the credit cycle peaked, and if so, should investors begin to unload their corporate bonds ahead of the next downturn?

The answer to the first question is a firm "probably." Using the EBIT coverage ratio as a guide, the credit market has attained a level of health after only three years that took five years to reach last time around. Further gains are possible, but there is a declining marginal benefit to improving credit measures from these levels, primarily due to the countervailing need to keep stockholders happy. Equity holders are aware that firms are well "out of the woods" from a credit standpoint, and are now asking that excess cash flow be returned to them, either in the form of productive new investments or, more directly, in share repurchases. Either way, we are approaching the point where bondholders should expect to see a slow tipping of the scale in favor of "shareholder enhancement" strategies.



Now, the second (and from a portfolio management standpoint, more important) question is whether this means that we should begin to reduce our corporate bond holdings to avoid the collapse (as some have predicted) of the high-grade corporate sector. This is a tougher question to answer, as there isn't much historical data to rigorously test the relationship between returns and credit quality. The measurement of duration-adjusted excess returns (the primary measure of corporate outperformance) only began fifteen years ago, providing just one full "down" credit cycle to compare. Nevertheless, in the most recent credit downturn (beginning in 1998), corporates' excess returns started trending into negative territory just as aggregate credit measures began to slide.

While we're impressed with the tight correlation between the behavior of these two factors, we're not ready to use the 1998-2002 credit downturn as a template for all future credit cycles. Keep in mind that the environment in 1998 was far different than today's—the catalyst for the poor performance in 1998 was the currency crisis in the Far East, which led to the Russian default, spiking volatility and the collapse of giant hedge fund Long Term Capital Management. None of those one-time factors are present today. Perhaps most importantly, the attitude towards the use of financial leverage has changed dramatically since then. Given the severity of the last credit debacle it's clear that corporate treasurers still keenly feel the pain of that event. Even equity investors realize that financial leverage is useful in moderation, but lethal when over-utilized. We are confident that credit quality will take a different trajectory on its downward path this time, declining at a much slower rate. Knowing that there will be no quick return to the bad old days brings corporate investors, including us, considerable relief.

In addition, the combination of superior returns and low volatility inherent in high-grade corporate bonds favor credit investing in most instances. Note that in the 1990 credit downturn, the data (though incomplete) shows that corporate underperformance was quite mild, despite very weak aggregate credit measures. A recent study by Morgan Stanley (*US Corporate Strategy—Calling the Bear's Bluff*, July 19, 2005) covering the 1989-2005 time period supports our long-held contention that corporate bonds are an asset class with superior risk/return characteristics. They found that high-grade corporates produce positive returns 73% of the time (compared to 63% for US stocks and 74% for high-yield bonds), and positive *excess returns* 64% of the time (compared to 61% for stocks and 56% for junk bonds). Obviously, stocks outperform bonds over the long haul, but with a much higher level of risk and volatility. The study found that *risk-adjusted* returns favor investment-grade bonds, with a Sharpe ratio of 1.74, compared to 0.84 for US stocks and 1.11 for junk bonds. And since we are most interested in this discussion about protecting against "downside risk," high-grade bond investors should be encouraged that they have the best Sortino ratio (a "downside Sharpe Ratio"—the average of returns divided by the standard deviation of negative returns) of the three asset classes, with a reading of 2.76, far above US stocks' 1.27 and high yield bonds' 1.28.

Morgan Stanley points out, and we concur, that with today's fairly low corporate yields and peaking credit quality, security selection will become much more important in the period ahead. With yield spreads of high-grade corporates at slightly below average levels, bond investors have less margin for error. In this environment, building a diversified portfolio of stable-to-improving credits is the best way to add total return to a portfolio without subjecting it to the considerable downside of an oversized position "blowing up."

We'll continue to maintain a modest overweight in corporates (although slightly reduced from a year ago) with a bias toward quality and diversification—and, as always, we're keeping a close eye on our credits.