Agincourt Capital Management, LLC

September 2009

Investment Update

They say that September is the toughest month for the markets, and it's hard to dispute that notion. Over the past century the stock market has fallen more often than it has risen during the month of September (the only month that has that distinction), and it's the only month with a significantly negative average return. Psychologists have posited that it's due to a type of mental fatigue, caused by the changing seasons, shortening daylight hours, cooler weather, and the realization that the year is almost three-quarters over; time to take profits, or at least take on a more risk-averse position.

September has even more meaning this time around, as it marks the one-year anniversary of the major events that brought the global economy to its knees. By the end of August 2008, we had seen the collapse of Bear Stearns, IndyMac and Countrywide; insurance giant AIG was being propped up with government support, and quasi-government agencies Fannie Mae and Freddie Mac had been placed under conservatorship. The markets were reeling. But what drove investors off the cliff was the September 15th shuttering of former Wall Street high-flyer Lehman Brothers, the 150 year-old firm that grew from a humble Alabama cotton merchant to become the quintessential example of unfettered greed and unregulated capitalism gone amok. In retrospect, while Lehman made massive errors and left itself highly vulnerable to market forces, it's also clear that Lehman's last role was that of sacrificial lamb, as US policymakers chose to demonstrate that the avaricious aspect of capitalism cut both ways—that investors must be exposed to both the glorious upside of investing in well-run enterprises as well as the gut-wrenching collapse of companies that, for one reason or another, can no longer compete.

The collapse of Lehman Brothers was much more than just another bankruptcy, and it's important to examine the reasons why. Since the late-1980s bank regulation had become overly accommodative, with regulators' main focus on capital adequacy. In addition, US policymakers viewed the largest banks (the distinction between commercial and investment banks was all but erased in the last two decades) under an unwritten set of policies that fell under the general description of "too big to fail." The simple fact was that the banks' growing use of derivatives and their involvement in non-traditional businesses (e.g., the creation of the collateralized debt obligation [CDO] markets) made it increasingly difficult for regulators to measure the degree of risk on the banks' balance sheets. By late 2007, with the US housing market turning south, banks began warning investors of hundreds of billions in writedowns on bad loans and investments; suddenly, it was obvious that the banks were woefully undercapitalized.

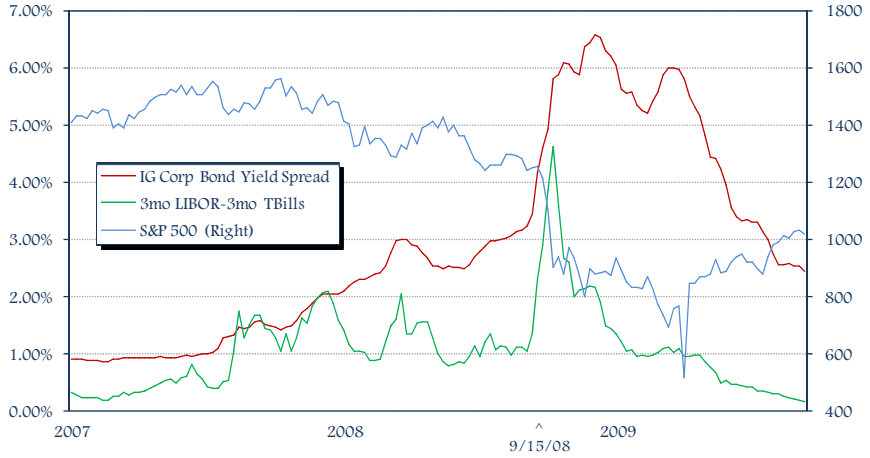
Through the first nine months of 2008, equity investors were battered pretty hard, especially in the finance sector. With the companies listed above—Bear, Countrywide, even Freddie and Fannie—stockholders had, for the most part, their entire investment wiped out, while government involvement to find a buyer or new ownership structure had protected creditors, including bondholders. The treatment of shareholders may seem unfair, but equity investors are owners of the company and are rewarded for its success and punished for its mistakes, to the point where they must be prepared to lose it all if things get bad enough. But what made Lehman different was government policymakers' (led by Treasury Secretary Henry Paulson) refusal to step in and help broker a deal to find a new buyer for Lehman. Allowing Lehman to fail meant that both the Lehman stockholders and bondholders would be wiped out. There were potential buyers for Lehman, right up to the last minute, needing only some assurance from the government in the form of loan guarantees. Bondholders (and the ratings agencies, which maintained Lehman's ratings at "single-A") were most assuredly not prepared for policymakers' conclusion that Lehman was not too big to fail.

By not committing a few billion in loan guarantees to help secure a buyer for Lehman, the government placed the high-grade bond market—and by extension, the entire global credit markets—into crisis mode. Did they know what they were doing? Yes and no. Clearly, policymakers didn't expect the markets to fall apart to the degree that they did, with investors pulling money out of assets with even a hint of risk—including the highest quality overnight commercial paper—and putting it in Treasury securities. By saying "no" after having arranged a series of shotgun marriages, the government's insistence on reinforcing the principal of "moral hazard" ended up costing them far more than the guarantees any potential suitor of Lehman might have required. The result of not saving the Lehman bondholders was a series of Government interventions, first to keep the US banking system from collapsing, including arranging the Merrill Lynch-Bank of America deal (something they refused to do for Lehman just a few days earlier), and then, over the next few weeks, by lending tens of billions of dollars to the largest US banks and putting in place programs to guarantee money market investments. But there was much more to come; in the last quarter of 2008, the Federal Reserve's balance sheet nearly tripled, to more than *two trillion dollars*, to fund economic stimulus and other new programs to keep global capital markets from grinding to a complete halt. Of course, the damage wasn't limited to just the financial sector, as consumer confidence plummeted in Lehman's wake, pulling down overall consumer spending with it.

There were both psychological and direct market effects from the Lehman collapse. Lost in the panic of collapse of investor and consumer sentiment were the tens of billions of notional dollars that Lehman had tied up in complex derivative instruments and guarantees. Liquidating Lehman meant dumping billions in non- and poor-performing assets into an already shattered market.

The chart on this page shows just how profoundly the Lehman collapse impacted the capital markets— widening risk spreads, as measured both by investment-grade corporate yield spreads over benchmark Treasuries and the spread of LIBOR over Treasury Bills to levels not seen since the Great Depression, and causing a 30% drop in the US stock market in a matter of weeks.

September was by no means the low-water mark for the markets; the investment-grade corporate bond market didn't hit rock bottom until December of last year, and the non-Government mortgage-backed market and the US stock market kept falling until late in this year's first quarter. Since then, the combination of massive central bank liquidity measures, fiscal policy stimulus and an improved global economic outlook has lifted the markets.



After twelve difficult months, the focus is only now turning to how we can avoid a repeat of the events that put us in financial jeopardy. Kansas City Federal Reserve Bank President Thomas Hoenig has come out openly against the "too big to fail" doctrine, claiming that the weaknesses of the system rather than weaknesses in the regulatory framework was what put the economy most at risk (and continues to do so). He favors orderly liquidation or transition of failed institutions to new owners (no matter their size), a closing of fiscal imbalances in trade and US Federal budgets, and careful control of inflation. He does not dismiss the option of regulatory reform, but maintains that enforcement of strict underwriting standards and beefed-up capital requirements should be sufficient from a regulatory standpoint in protecting the economy from most bank failures. We agree with Dr. Hoenig on all points. In particular, limiting bank leverage is the single best way to ensure that financial firms, so dependent on the capital markets for funding their operations, have an adequate liquidity cushion during periods of stress.

We would like to mention two other anniversaries this September.

First is the tragic anniversary of the terrorist attacks that took place on an otherwise beautiful September morning eight years ago. Nearly three thousand innocent lives were lost that day, and not just American lives; citizens of 90 different nations died in Manhattan, in the Pentagon, and in the Pennsylvania countryside. Our world and our lives will never be the same, and we will never forget those who died so senselessly.

The other anniversary is much less significant in every way, but one that we feel compelled to mention, at least in passing: Agincourt Capital Management has hit the ten-year mark. It doesn't seem like it's been an entire decade, but September 22nd will mark the day ten years ago that we walked into our new offices and began making phone calls (we barely had email back then!) to our "former" clients from Sovran Capital Management. Our earliest days were stressful, and we will be eternally grateful to those clients who made "the jump" with us and helped to ensure that the firm was on solid ground from day one.

We would also like to thank the clients who we've had the pleasure to come to know and serve in the months and years since the inception of the firm. Today, Agincourt manages $3.7 billion in fixed income assets for more than 100 clients, from Miami to Seattle. We are proud of the business we've built, but even prouder of the friends and business associates that we've gained along the way.

Finally, we need to acknowledge the excellent work and dedication of our team members. While many of our clients and the consultants that serve them have met Buoyer, Coats, Kelly and O'Hara over the years, it's the corporate team (Acey, Temple and Qureshi), the mortgage/structured product team (Armes, Marshall, Borum and Shah) and the business/technology team (Haynie, Neary, Brown, Troupe and Monger) that really deserve the credit for the day-to-day work in the trenches of the bond market that enable the firm to run smoothly and efficiently. Any success we've had over the years (including the highly volatile period just ending) is attributable to the collective work of every member of the Agincourt team.