Agincourt Capital Management, LLC

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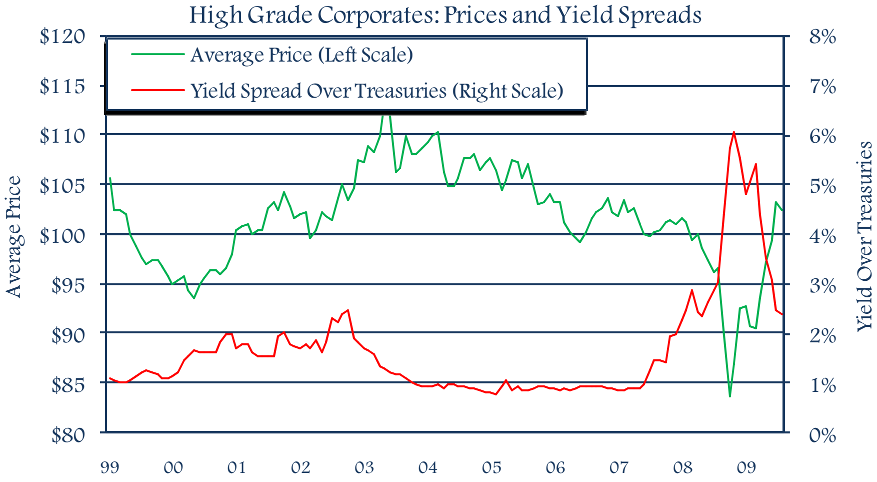
INVESTMENT UPDATE

Whoa, that was quick. Last year's credit meltdown blindsided us like a runaway Mack truck. We've barely had time to brush ourselves off, and already the credit markets have staged a remarkable comeback, pulling nervy investors with it. We're not surprised that our market has recovered, only that its recovery has been so rapid, especially in what is still a pretty ugly economy. Have we come too far too fast, or are we simply getting back to something approaching "normal?"

But before we answer those questions, let's do a quick review. Throughout 2008, and especially in the wake of the Lehman bankruptcy in September of last year, the "spread sectors"—corporates and mortgage-backed bonds—were pummeled. Treasury securities were the perceived safe haven for investors, who were scared witless and dumped stocks, corporate bonds, mortgage-backed securities, et al, as the public braced for the worst economic recession since World War II.



Those who got out early in 2008 and bought Treasuries (especially long-maturity Treasuries) profited handsomely in this historic flight to quality. But the vast majority of investors, who had been trained to stick with a disciplined approach to asset allocation, were simply unable or unwilling to make dramatic shifts in their investment mix. The results were horrific, as all non-Treasury securities underperformed by the biggest margins in at least fifty years. The worst of these are now well-documented: high-grade industrial bonds underperformed Treasuries by 17% in 2008, finance and utility bonds by more than 20%, and commercial mortgage-backed bonds by nearly 33%.

Even those of us with modest overweights in these asset classes experienced terrible relative returns in 2008. We'd seen corporates and MBS underperform before, but with high grade corporate and mortgage bonds trading down twenty, thirty, even fifty points, few people living (and fewer still actively employed in professional management) had ever seen this level of price dislocation. There was simply nothing in our experience that could have prepared us for the collapse in prices on bonds that were, in almost every case, fundamentally sound.

As we entered 2009, we were confident that we could eventually dig our way out of the performance deficit that we found ourselves in. After all, as value investors, we knew that, as long as our investments were "money good," we could make back everything we lost by simply holding on to what we owned; it could take two or three years, but if we were patient and disciplined, the performance deficit would be wiped out in time.

Today, less than eight months into the year, we're pleasantly surprised to find that the spread sectors have rebounded much faster and more dramatically than we ever would have predicted, given the extremely negative sentiment that pervaded the bond market just a few months ago. As the chart on this page shows, the average high grade corporate bond's yield has declined from 600 basis points more than Treasuries (widest since the Great Depression) to less than 250 basis points over Treasuries, similar to levels seen in the credit meltdown of 2002. Meanwhile, prices of high quality corporate bonds have risen from less than 85 cents on the dollar to back above par, and now stand just below an average price of $102.

Clearly, at this point, most high-grade corporate and mortgage bonds have returned to levels that, while not yet "normal," are at least at the low end of what could be considered extreme. Anyone who's bought spread product in the past six months is now comfortably in the black, and most quality buyers have made back much of what they gave up on a relative basis last year. In other words, the "easy money" has been made for those who were willing to take a chance that the extremes seen late last year would not hold.

Which means that things get a little more difficult going forward. The outsized capital gains that were possible a few months ago in the corporate sector have been realized (most CMBS and non-Agency MBS still trade at substantial discounts to par, however) and the yield cushion that protects non-Treasury investors from adverse movements in their bonds are less than half their former levels. But, if we ignore the data points that make up the last eleven months' history, we find that corporates are still at or above their widest levels in decades. In our internal valuation models, which examine historic yield spreads and normalize them for volatility, quality and other factors, we find that the average high-grade corporate bond remains in the 95th percentile (100th is most attractive). Similarly, CMBS are between the 95th and 100th percentile.

To some extent, these elevated yield spreads are warranted. The US remains in a deep economic recession, and while the worst may be behind us, there is still significant weakness, both here and abroad. Consumers, who make up more than 70% of the US economy, are struggling under a heavy debt load amid deflating household wealth that is measured in the trillions of dollars. We cannot expect anything more than a rather slow and anemic bounce as we pull out of recession. We have been stressing for the past couple of years the importance of bond quality, and that theme will remain extremely important in a weak recovery. In general, those companies who entered the economic downturn with low levels of leverage and lean operations should be able to at least muddle through a still-tough economic environment; those with high fixed costs or dependence on easy credit (either for their own operations or for their customers) will have a difficult time of it. We expect further downgrades and increased defaults among these vulnerable credits.

We feel much the same way with respect to the mortgage market: There will be additional downgrades, higher delinquencies and more foreclosures as home prices continue to sink and the labor markets (the classic lagging economic indicator) slip further. And while the Agency-backed US mortgage market benefits from US Government support, both from an ownership and from a yield spread standpoint (the Feds have been buying Fannies, Freddies and Ginnies to keep mortgage rates low), subprime and other poorly-collateralized mortgage securities will continue to wither and die. Between these two extremes lie the upper-end of the non-Agency MBS and ABS markets where prices remain extremely depressed and where there may be, despite the well-documented risks, some good opportunities for investors who have the skills and patience to wade through the detritus.

Typically, the early stages of an economic recovery are the best time to move down in quality and pick up the "fallen angels"—companies that, because of the cyclical nature of their business, or perhaps due to poor timing, find themselves with high levels of debt relative to their internally-generated cash flow. But buying beat-up credits at the economic low-water mark only works if you get a strong upward pulse in the recovery part of the cycle, and an economic growth rate of, say, 4% to 5%, after inflation. Given the poor condition of the consumer, and a shell-shocked and undercapitalized banking system (not to mention the barely-functioning "shadow" banking/securitization market), we don't think we're likely to see this kind of growth rate in the US economy for many quarters.

In short, credit quality remains very important, and we are reluctant to do the "down in quality trade" if that means increasing our exposure to credit-dependent firms and weak mortgage borrowers in the current environment.

Now, this is not all bad news for bond investors. We, in the high-grade market, don't need a high rate of economic growth to keep our portfolios in good shape; we can be quite satisfied with economic stability. Quality credits, both in the corporate and mortgage markets, need only to provide bondholders stable and steady cash flow, not a continued string of record earnings. And a slow, yet positive level of economic growth should be non-inflationary, which is sweet music to the ears of investors in longer-maturity bonds.

By contrast, the US equity markets are not likely to do well without a strong growth outlook. The factors cited above that make the credit markets challenging go double for equity managers. It's hard to imagine a high-growth scenario for the US economy in the next few quarters, as the consumer is in no position to pull us out with any alacrity. In general, equity holders will not be satisfied with earning stability; they need to see earnings growth in order for their investments to gain in value. Recent gains in the US stock market have been attributable to increases in earnings multiples (i.e., price-to-earnings ratios), not actual growth in corporate profits. For bond investors, this could be even more good news, as the cloudy outlook for US equities may encourage erstwhile stock buyers to park money in bonds while waiting for more positive signals from their market.

Our emphasis on quality could not insulate us from the emotional extremes of the past year; the near-failure of the global banking system shook investors' confidence to their core, and brought the entire high-grade bond market to its knees. The first step back was relatively easy, as too many assets were at giveaway prices. The next few steps will be much tougher, and will require discipline, experience, and good judgment. We welcome the challenge.