



INVESTMENT UPDATE

There's no more difficult question that a bond manager has to answer than "Where are interest rates going?" We understand that it goes with the territory, but it's still frustrating, simply because there is no way to answer the question without sounding a little silly. The truth is that nobody really knows where interest rates will be in the future with any degree of certainty, which means that timing the purchases and sales of bonds based on forecasts of interest rates is a fool's errand. There are, quite simply, too many variables, too many "outside" events that can affect interest rates, bringing even the most sophisticated econometric modelers to their knees, begging for forgiveness and enlightenment.

As a result, we'd like to talk about the future path of interest rates! No, not because we have a forecast, but because it's vital that we, on an ongoing basis, perform scenario analysis on our portfolios to see how they do in various interest rate environments. Like car manufacturers who test-crash their cars, we

think we know what the results will be, but we need to see how our portfolios perform when under real stress. Unlike an auto manufacturer, we can do this in our offices, with powerful computers and sophisticated software, with no broken glass or loud noises...at least until one of the computers freezes up.

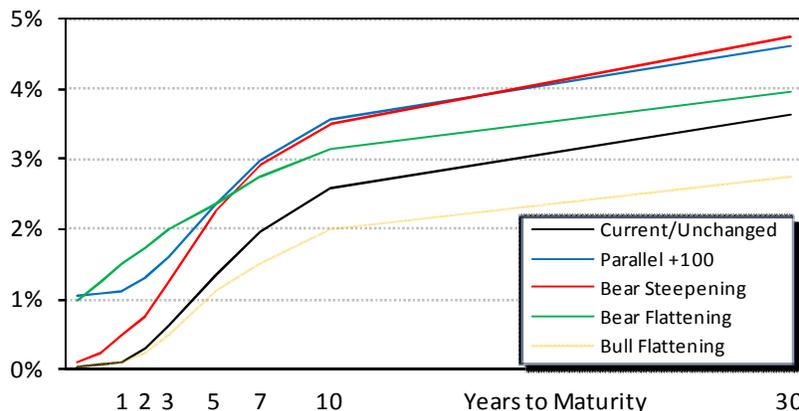
Our typical scenarios involve taking today's benchmark US Treasury yield curve (connecting-the-dots on the interest rates of Treasury bills, notes and bonds along the maturity spectrum) and subjecting these yields to various movements, both parallel (rates all moving by a fixed amount in the same direction) and twisting or non-parallel shifts in the yield structure over time. We can also adjust how non-Treasury bonds move relative to the Treasury yield curve—i.e., having all, or specific subsectors, of corporate bonds, or mortgage-backed securities, move in relation to benchmark Treasuries. In doing so, we cause all the bonds in the portfolio to re-price over time, impacting each bond's total return, and affecting other factors such as reinvestment rates and "roll," the way bonds' prices change as they age and "roll" down to a lower spot on the yield curve. This is complicated stuff, involving thousands of calculations and some pretty heavy math, especially when it comes to modeling how bonds with embedded options (such as the call/prepayment options in mortgage securities) behave in various interest rate scenarios. At Agincourt, we use a system called "Yield Book," which is li-

censed by Citigroup; it is widely recognized as the best analytical system commercially available.

Given today's yield curve, we're somewhat limited in the types of "down rate" scenarios we can look at; obviously, with short-term Treasury yields at or near zero, we won't be subjecting portfolios to, say, a "minus 50 basis point, parallel" scenario. Likewise, with rates at historic lows, it doesn't require a heroic interest rate forecast to assume that there are more conditions, and therefore scenarios, under which interest rates will rise. It therefore makes sense, in today's market, to run more "up rate" scenarios.

The chart here shows the scenarios we've chosen for this exercise: an "unchanged" scenario, a parallel shift of +100 basis points (1.00%), a "bear steepening" scenario where short rates remain essentially unchanged while long rates move up by 100 basis points or so, a "bear flattening" where short rates move

up by 100–150 basis points and long rates only move up by 30 basis points, and a "bull flattening" where short rates remain near zero, but long rates fall by 90 basis points. The "current/unchanged" yield curve is based on levels from August 12 of this year; since rates have moved up a bit since then, getting to the higher/steeper scenarios



would be a little less painful than what is implied in the projections that follow, since some of that pain has already been marked to today's market.

The point of this exercise is to see how these changing interest rate scenarios impact different kinds of portfolio strategies. We know that, in general, longer duration portfolios will underperform shorter duration portfolios under rising rate scenarios, but we need more precision than that. Again, high-powered analytical tools are needed to test how various portfolio strategies perform over time under varying conditions. In order to make the process repeatable (we'd like to be able to re-test at least monthly, as market conditions change) we use well-known bond indexes to represent different strategies. In this exercise, the following indexes have been selected: The Aggregate Index (which includes all US Treasury and Agency issues, high-grade corporate bonds, and Agency mortgage-backed, asset-backed, and commercial mortgage-backed securities [MBS/ABS/CMBS]); the Government/Credit Index (same as the Aggregate, but no MBS/ABS/CMBS); the Intermediate

Government/Credit Index (same as the Government/Credit, but with no maturities longer than 10 years); and the 1-3 Year Government/Credit Index (same as the Intermediate Government/Credit, but with no maturities longer than three years). In addition, we show two indexes that contain only high-grade corporate bonds--the Credit Index has maturities of 1- to 30-years, while the Intermediate Credit Index has only corporates with maturities of 10 years and less.

The results are shown in the top table. As there's a lot of data to sift through, we color-coded the best and worst-performing indexes/

strategies for each of the scenarios. We've also added some additional information--the duration and yield to maturity of

each of these strategies, and some averages for how each strategy performs. For the averages, we present both a simple (equal weighted) average of returns, and an average return weighted by our own judgment of the likelihood of the various scenarios. Here are the weights we used: Unchanged=25%; +100=20%; Bear Steepening=35%; Bear Flattening=5%; Bull Flattening=15%. You will notice that we have chosen more "up rate" scenarios (3 of 5), compared to only one "down rate" scenario, and one unchanged rate scenario; further, in our weighted average of returns, we assign an 85% chance that rates will, in general, remain the same or go up in the next year.

Despite apparently having stacked the deck in favor of short

-duration portfolios, the shortest duration portfolio--the 1-3 year Government/Credit--is, on average, the worst performer. Further, the longest duration portfolio--the Credit Index--averages either the best or the second best, depending on which averaging method we use. Here at Agincourt, our mantra over the years has been "Yield Wins Over Time," and this table shows why. In a low-yielding environment, having more yield in your portfolio helps cushion the impact of rising rates and falling bond prices. Obviously, there's a tradeoff, and under the most severe interest rate/price moves, the impact of longer duration will wipe out most or all of your yield advantage. All things considered, we'd give the overall prize to the Intermediate Credit strategy, the portfolio that comes out on top in our preferred average weighting, and comes in first or second in every scenario except the lone "bullish" scenario.

In order to further stress-test these results, and to eliminate

any bias for strategies and portfolios with heavy allocations to corporates and MBS, we subject these same portfolios to the additional condition that yield spreads widen over the period by 50 basis points (0.50%), which would put corporates into the 90th percentile and MBS into the 97th percentile of their 20-year trading range, a fairly dire (and highly unlikely, in our opinion) projection. We present these results in the second table. As one might expect, the returns for the all-corporate Credit portfolio take it squarely on the chin, while the best-performing portfolio, on average, becomes the Intermediate

Government/Credit strategy, an index with only 35% in corporates and 0% in MBS.

But a "funny thing happened on the way to the

scenario analysis." You'll notice in the last table that, even after widening yield spreads, the Intermediate Credit strategy came in second place, on average, to the Intermediate Government/Credit, and performed no worse than fourth in any of the scenarios. When combined with its first or second place performance on the "spreads neutral" averages, and solid, consistent performance in almost every scenario, we have to call this portfolio strategy the clear winner for those concerned about rising rates over the next year.

Fortunately--and not coincidentally, since we regularly put our

scenario analysis to good use in our clients' portfolios--our portfolios are over-weighted in intermediate-maturity corporates, even

in our "core" portfolios that are managed against the Aggregate or Government/Credit indexes. As the scenario analysis shows, corporate bonds in the five- to nine-year maturity range represent the sweet spot in today's high-grade bond market; they have decent yield (compared to other alternatives) while carrying only a modest degree of interest rate risk. Further, since they lie on a section of the yield curve that's very steep, they generate additional return as they "roll" down the yield curve with the passage of time, which means they get repriced at lower yields (and higher prices, all else equal) as they age.

These results are not cast in stone, and are, as always, subject to regular, thorough review. But hopefully we've provided you some valuable insight into the challenges and opportunities the next twelve months may hold for bond investors.

	Avg Dur	YTM	12 Month Projected Returns (%)					Average Return	
			Unchanged	Parallel +100	Bear Steep	Bear Flat	Bull Flat	Simple Avg	Wtd Avg
Aggregate	5.31	2.37	2.92	-1.47	0.72	-0.20	5.08	1.41	1.44
Gov Credit	5.57	2.05	2.79	-1.56	-0.43	0.10	5.99	1.38	1.14
Int Gov Credit	3.80	1.51	2.38	-0.44	0.63	-0.20	3.57	1.19	1.25
1-3yr Gov Credit	1.84	0.54	0.73	-0.11	0.46	-0.38	0.79	0.30	0.42
Credit	6.59	3.25	3.99	-1.42	-0.14	1.01	8.21	2.33	1.95
Int Credit	4.40	2.46	3.37	0.03	1.21	0.51	4.95	2.01	2.04

	Eff.Dur	YTW	12 Mo Returns With Spreads +50BP to US Treasuries					Average Return	
			Unchanged	Parallel +100	Bear Steep	Bear Flat	Bull Flat	Simple Avg	Wtd Avg
Aggregate	5.31	2.37	1.53	-2.83	-0.70	-1.54	3.74	0.04	0.06
Gov Credit	5.57	2.05	1.73	-2.53	-1.41	-0.95	4.81	0.33	0.11
Int Gov Credit	3.80	1.51	1.76	-1.03	0.03	-0.81	2.94	0.58	0.65
1-3yr Gov Credit	1.84	0.54	0.60	-0.24	0.33	-0.51	0.66	0.17	0.29
Credit	6.59	3.25	1.34	-3.82	-2.56	-1.57	5.30	-0.26	-0.61
Int Credit	4.40	2.46	1.71	-1.56	-0.40	-1.11	3.25	0.38	0.41