Agincourt Capital Management, LLC

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INVESTMENT UPDATE

Year-end is a good time to look back over one's shoulder, take stock of what has passed and calculate how well you've managed. Those of us in the investment management business spend endless hours examining history, in the hope that we might both learn from it, and, as the saying goes, avoid repeating the mistakes we might have made in the past. The collapse of the US housing market, and its colossal impact on the global economy, the banking system, consumer behavior and public policy (to name just a few of the knock-on effects) has provided a truckload of "teachable moments," to use a modern euphemism.

But what you may be wondering, and what we want to know, is how did Agincourt do in examining the developments in the housing market before and during the crisis, and whether we took the necessary preventative steps to protect our clients' portfolios from permanent harm. It might also be helpful to know if the investment team at Agincourt took advantage of any opportunities created by the extreme movements in the bond market.

Fortunately, it's easy to examine what we were doing and thinking, as we document our thoughts every month—four times per year with our quarterly letter to clients and, more publicly, eight times per year with these *Investment Updates*. We took the opportunity to read back through the past five years or so of *Investment Updates* (you can too—they're all up on our website!) to do some self-examination. In order to save you the time and effort, we've distilled our findings and will share them with you.

We first began ruminating on the unusual appreciation of the US housing market in late 2005, writing in December of that year that "the housing market, after the price inflation of the past few years and with interest rates at higher levels, is due for price correction." We wrote that that was one of the main risks we were looking at in the coming year (2006) was "a small, but not insignificant possibility" of "a severe deflation of housing values." In February of 2006 we wrote about how Agency-backed MBS could actually benefit from a slowdown in the appreciation of home prices, as it would cause prepayments to slow. While it seems trivial today, when it came to analyzing mortgage securities, our biggest concern in early 2006 was prepayment risk.

In March of '06, we took on the subject of consumer finances, particularly as they related to the inflation of the US housing market. We pointed out that "a severe correction in home prices [and] the resulting marked slowdown in consumer spending would likely lead to weakness in the labor markets" under what we called a "meltdown scenario." We also pointed out that this "asset-collapse scenario" was "our economy's Achilles' heel right now." Like most observers, though, we believed that home prices would not crater: "We expect that there will be a fairly muted correction in home prices, one that will not kill off consumer confidence or force an early collapse of consumption," noting however that "we have to be prepared for [more dire] alternative scenarios."

Note that in the context of the times, our outlook was pretty negative: Home prices were still rising, and the subprime origination machine (and its CDO derivatives) was running in top gear. Lenders were continuing to offer generous terms to borrowers with poor credit history and home builders were still building new homes at a peak level of two million units per year (a number that would eventually sink by 75%). Throughout the remainder of 2006, we revisited the topic of falling US home prices a few more times, but tended to focus on the positive aspects of it: dampening inflation, increased savings, and a normalization of an inverted yield curve (the Fed—far too late—was trying to suppress excessive borrowing by raising short-term rates).

We wrote about the subprime mortgage market in detail for the first time in May of 2007, two months before the first clear signs of strain began to show in this market. Again, we did a good job in identifying the dangers of directly investing in these bonds, writing that "buyers of mortgage credit based on subprime loans made [in 2005 and 2006], especially for adjustable rate mortgages, will continue to see increasing defaults and poor recovery rates on their investments for the next few quarters," but the worry was how these borrowers would handle the higher resets on the ARMs with short rates spiking, and prices down 5%. We underestimated both how much prices would fall ("home prices seem to be bottoming out") and the ultimate impact:

> Three-quarters of the US mortgage market is made up of "prime" mortgage loans, while only one in ten are both subprime and adjustable. Furthermore, even if defaults of these adjustable subprime loans double from their previous highs, we are looking at an increase in the overall foreclosure rate of less than 2% from current levels…

Again, with the full benefit of hindsight, our projection for home prices and the knock-on effects of the collapse of the subprime market were far too optimistic. In this, we were not alone—essentially no one was projecting, at this early date, much more than a five to ten percent decline in US home prices. Worse, not even the Wall Street firms that packaged and sold (and in many cases, also purchased) subprime-backed bonds knew the total size of all the derivatives whose prices were tied to these crummy mortgages.

Over the next couple of months, visible cracks began to appear in the subprime market as banks tried to sell off their holdings and were forced to mark down what couldn't be sold. There was a sense of panic creeping into the market, but we continued to draw a clear line between subprime (where we were projecting default rates "at 50% before it's

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all over") and high-quality bonds; we were optimistic that the Fed would keep any contagion effects from spreading into high-grade bonds. We also wrote, "we believe the ratings agencies will end up with egg on their faces for assuming that a financially-engineered package of subprime mortgages somehow can be transformed into a high quality investment," which certainly turned out to be true.

By September of 2007 (the collapse of Lehman was still a year away!) we began to write about the psychological impact of growing losses and the realization that financial leverage had magnified the size of the subprime market, but we placed qualified confidence that the Fed, "as the world's most powerful and influential central bank, is taking the first steps in assuaging investors' collective psyche," while also noting that, "there is no quick fix." By November, we had ratcheted down our outlook for the US economy, connecting the mortgage market to consumer spending: "job growth will slow and savings rates will rise as consumers realize that they can no longer depend on their homes to provide an income buffer."

As we entered 2008, the yield advantage offered by investment-grade corporates over Treasuries had topped 2%, more than double the level of just six months earlier, and fast approaching the wides of the credit meltdown of 2001-2002, even though fundamental credit quality was far superior to the era of Enron, WorldCom and the dot-com busts. We recognized the differences in February when we wrote: "we're not experiencing a traditional credit downturn where companies find themselves, near the end of the business cycle, with too much debt on their balance sheets...Today's problems really get down to a fundamental lack of trust in...the way risk has been 'structured.'" But we underestimated just how much worse things would get when we wrote that, "2008, before it's all over, may end up being pretty good for astute bond investors." Ouch.

The bond market settled down a bit in the early summer of 2008, and we wrote in June about the Fed's expanding role, both in arranging the purchase of Bear Stearns by JP Morgan and the new programs they had put in place to provide the liquidity necessary to keep the capital markets orderly. But by August, "bad craziness" was gripping the bond market, with "essentially every non-Treasury security …now trading at or near record levels of incremental yield." We once again warned of the dangers of low quality MBS but correctly predicted (just days before FHLMC and FNMA were taken over by the Federal Government) that investors who owned Agency-backed MBS "will end up 'money good,' getting their principal and interest back in whole and on time."

But once again, we underestimated the ultimate size of the US housing collapse. We noted that the $500 billion threshold of writedowns from MBS had been reached, and that it "could total another $200 billion before it's all over." We also predicted that "peak-to-trough US home prices likely [are] headed for a 20% 'correction.'" We now know (using the Case-Schiller/S&P figures) that US home prices bottomed out in April of 2009 at a level 33% below the peak reached in July of 2006. As for our prediction of $700 billion in MBS writeoffs, that came up a bit short as well; the IMF now estimates that total losses for US and Euro banks will be in the neighborhood of $2.8 trillion!

In the last four months of 2008, we saw the capital markets come to a grinding halt, as the lack of trust we had been writing about for months reached into every corner of the bond market, especially after the collapse of Lehman in September. By November, we realized that we were heading for a deep recession, correctly noting that "the US labor market is now deteriorating at a rapid pace, with unemployment at its highest level since 1994 and on a path to test the highs of the early 80s." But we also pointed out that "corporate bonds are cheap" and "high grade [corporate] bonds provide unheard-of opportunities for capital appreciation," while "Treasuries are at their lowest yields in five decades and offer little return potential."

This was a turning point for our markets, as November/December 2008 marked the point where all the bad news (and then some) was finally fully priced into the trading levels of high-grade bonds. While it would be another few months for the US stock market to bottom, and many more months for the US housing market and the economy as a whole to begin showing signs of improvement, year-end 2008 was the point where bond investors began to see that prices had dropped too much, and began to buy. Of course, we had been a little early in purchasing corporates and MBS, but as value investors, that is what our discipline teaches us—namely, purchase high quality companies whose bonds have been "beaten up" and sell off bonds whose upside is limited. In the final months of 2008 (and into the first half of 2009), we moved from slightly overweighted in high grade credit to our biggest overallocation relative to the broad bond market in more than a decade.

Corporate bond prices began to improve in the first few months of 2009, but commercial MBS (CMBS) and non-Agency MBS showed little positive movement. In March of '09 we wrote that "the average CMBS is currently priced in the Barclays Index at 67 cents on the dollar, which is equivalent to a yield to maturity of more than 13%," and that non-Agency MBS were even more undervalued than CMBS. This was a defensive move on our part; while we didn't necessarily want to buy more of these bonds, we foresaw ratings downgrades that might cause us to have to sell the bonds unless we could get our clients to see just how cheap they were. Fortunately, most of our clients agreed and we have since been able to realize significant returns on these holdings, despite widespread downgrades (some to below investment grade status).

In general, when we look back on the period leading up to and including the historic dislocations in our markets, we give ourselves pretty good marks for identifying the issues impacting the bond market. Likewise, we're satisfied with the actions we took in our clients' portfolios during this period—we followed our discipline in allocating our clients' funds in a way that, while initially appearing risky, ultimately paid off with significant outperformance over the full period. However, we didn't do such a great job in estimating the size and depth of the poor underwriting in the US mortgage business, or the degree to which US housing prices could (and ultimately did) fall. It wasn't until mid-2009, when some of the dust had finally settled, that we fully understood the enormity of the size and reach of the "bad paper" and its effect on the US and global economies. The process of unwinding and deleveraging continues today—and will for many more months, if not years.