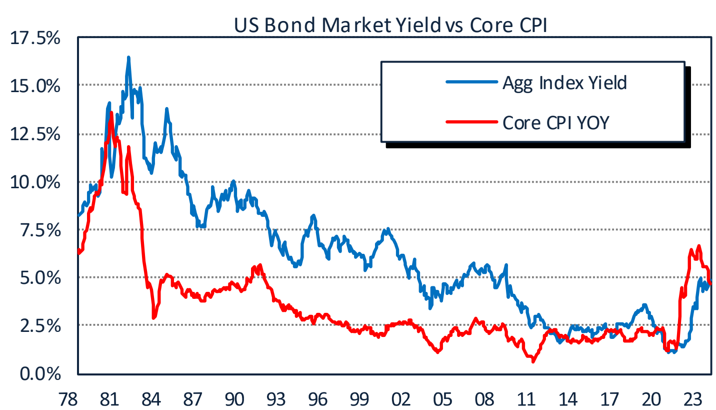
Agincourt Capital Management, LLC

INVESTMENT UPDATE

We are going to do something a little unusual for us, and make a bold statement: It's a good time to buy bonds.

We are ever-reluctant to "call the market," whether it's for buying or selling purposes, mainly because it's impossible to know until after the fact whether your timing was good or not. Trying to time the market by finding the optimal entry or exit point is all but impossible—accurate macro analyses that "predict" market moves are regularly laid to waste for any number of reasons, including technical factors (i.e., supply/demand imbalances), emotional factors, or unexpected exogenous events that change the course and direction of the market. Calling the top or the bottom of the market is, in short, a fool's errand.

On the other hand, studying data to draw conclusions about the underlying values that exist in the market, and making informed decisions about how those values may change in the future is not just helpful, but essential to our way of investing. This is investing based on fundamental research, not on hunches or hopes (which you can get any time of day on cable TV). In the stock market, it all comes down to picking companies that will grow earnings and appreciate in value over time by more than the overall market (or one's benchmark index). In the bond market, the key to outperformance is similar, but different in important respects.



The main difference in bond investing, compared to equities, is that there are typically more "knowns" in the bond market. For instance, as long as the issuer of the bond remains financially viable, the bond will have a known terminal value (i.e., 100 cents on the dollar) on the bond's maturity date. We also know that the income component of the bond—the bond's coupon payments—will be secure and (except for floating rate notes) fixed for the life of the bond. If the issuer of the bond fails to either make an interest payment on time or pay the par value of the bond at maturity, the issuer is in default and will be forced into bankruptcy.

While these factors limit the upside return potential of bonds compared to stocks, it makes the securities themselves far more…secure. More importantly, it makes security selection in the bond market more straightforward than in the stock market. Most bond investors (particularly in the high grade bond market) don't use terms like "turnaround story" and "uncovered gems" when picking bonds; instead we're focused on finding bonds whose issuers have stable to improving credit profiles, which for the most part are large, well-known companies with established lines of business. We want to own companies who will not just avoid missing mandatory payments, we don't even want to deal with companies with questionable credit ratings, as we could be forced to sell those bonds if their ratings fall below our clients' minimum quality guidelines. Earnings growth is good, but we want stability.

Admittedly, that's oversimplifying things to an extent. Besides finding stable issuers there's quite a bit of complexity in the building of bond portfolios; the point remains that bond investing, compared to other asset classes, relies on the fact that bond returns are, over the long term, predictable. That predictability means that when valuations become stretched they tend to revert to the mean. The gravitational pull of an all-but certain payout schedule anchors bond valuations and allows clear-headed analysis to win out over longer periods of time.

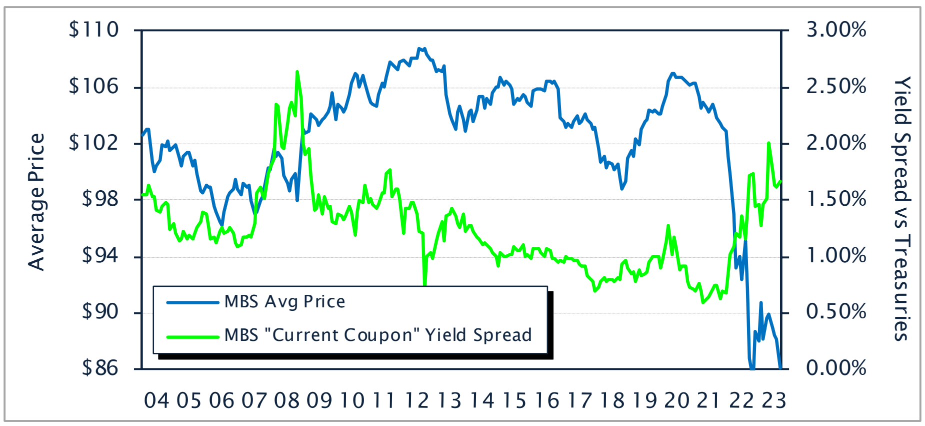
The fundamental reason why the bond market is attractive right now has everything to do with the yields currently offered by high-grade bonds, which are above the highs of the last decade and a half. Yield—the return on investment you are likely to earn over the life of a bond--is the single most important determinant of bond returns. The yield on the bond, especially longer-maturity bonds, will not correspond to your rate of return over every time period; these are bonds, not CDs, and are subject to price changes on a minute to minute basis. But when yields are high, you can be assured that your expected returns over time will be higher than when you're in a low yield environment. That's just how bond math works.

The chart on this page shows that the long bull market for bonds, which began in the early 1980s, has ended. The return of inflation over the past three years made it official. The move

200 South 10th Street ♦ Suite 800 ♦ Richmond, VA 23219 ♦ T: 804.648.1111 ♦ WWW.AGINCOURTCAPITAL.COM

to higher rates has been extremely painful, with the broad US Aggregate Index returning -13.1% in 2022. Those returns were by far the worst in the history of the Bloomberg (formerly Lehman Brothers) Indexes, despite the fact that yields rose by a similar extent (if not more) in the 79-81 period. The reason why returns were so much worse this time: the lack of yield. If you're not earning much in the way of coupon income, there's no "cushion" to help offset the declining prices of bonds in your portfolio when rates move higher. In 1981, the yield of the Aggregate Index averaged 14.7%; by 2020 it had fallen to 1.3%.

Over the past three years, the bond market has sold off, with prices dropping and yields rising, to such an extent that we can now build portfolios of high quality bonds with yields that can hold their own against riskier assets. The S&P 500 has done well this year, but stock prices are expected to fall if we slide into the recession that most economists are calling for next year. The S&P's dividend yield is only 1.5%, which is no longer competitive with what you can earn from those same companies' bonds. A typical high-grade corporate bond is currently yielding 5.5% to 6.0%, which provides an ample income cushion to withstand another rate hike or two from the Federal Reserve, should that come to pass.



Speaking of the Fed, its fight against inflation has been the defining feature and driving force behind bond prices post-COVID. More recently, inflation has been moving in the right direction, as the Fed has pushed up its overnight lending rate by more than 500 basis points since early 2022, helping to snuff economic growth. While we're not yet ready to declare that the Fed's Open Market Committee is done raising rates, it's no stretch to say that they're getting close. We are finally seeing the impact of the Fed's rate hikes (and associated higher yields further out the yield curve) on the US labor market, as monthly growth in new jobs is beginning to fade. A weakening jobs outlook provides cover for the Fed to pause additional rate hikes, allowing them to observe the cumulative impact of higher rates on the broader economy.

But here's the thing: We don't need rates to fall from here. Yes, falling rates translates to higher bond prices, which would boost returns as bond values rise, but most bond managers (and our clients) would be quite happy for rates to stay at their current levels. For the first time in years, bonds are poised to make a real contribution to our clients' portfolio returns. Even short rates are attractive; the Fed funds rate's upper range is currently at 5.5%, measurably above the rate of core inflation for the first time since 2007. The "real" (inflation-adjusted) Fed funds rate is now 1.2%, compared to -6.2% when the Fed began this hiking cycle in February of 2022.

The Fed maintains that it still wants to get inflation down to its 2% target, but that doesn't imply that it will continue to raise rates until that occurs. In fact, it's most likely that, because of the lags that occur as policies flow through the economy, the Fed will hold steady while inflation readings are still well above target. We'd go a step further and posit that the Fed would be satisfied if we could get in the 3% neighborhood for core inflation in this cycle. You may recall that the Fed adjusted its policies in the Fall of 2020 (the timing couldn't have been worse) to allow inflation to run above 2% in the expansion phase of the economic cycle so that it could avoid hitting the "zero lower bound" (i.e., a Fed funds rate of 0%) during recessionary periods. There's nothing magical about 2% inflation, and there are reasonable arguments that 2% is too low, as it ties policymakers' hands while penalizing investors and savers.

We will wrap this up by highlighting a bond sector that we believe is particularly attractive right now based on its relative value prospects: US agency-issued mortgage-backed securities (MBS). This sector, even more than corporate credits or Treasury securities, possesses unusually good return prospects. Agency MBS have the full backing of the US government, so there's no real default risk, which means they don't have the credit risk that could limit the demand for corporate bonds if the economy slips into recession. MBS yield spreads are more than 150 basis points above similar-duration Treasuries, a level comparable to single-A and triple-B rated corporate bonds. MBS prices have been under pressure since the Fed ended its large-scale asset purchases of MBS last year, and have fallen in price along with other classes of high grade bonds. As the chart on this page shows, this combination of wide yield spreads and average prices below 90 cents on the dollar hasn't occurred in decades, offering investors government-quality bonds with high yields and excellent price appreciation potential if rates fall in the coming months. And, again, if rates don't fall (or continue to rise), we earn plenty of income in the meantime.

Of course, there are no guarantees in life (or in the capital markets), so invest according to your risk tolerance. And when you do, give the bond market your consideration.