Agincourt Capital Management, LLC

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INVESTMENT UPDATE

Given the recent volatility of the corporate bond market, we thought it might be informative in this monthly update to provide you with some insight on how we determine corporate sub-sector weightings in our decision-making process.

While sector weighting decisions are normally associated with equity management (consider the impact of tech stock exposure in equity portfolios over the past year), well-reasoned sector selection is vital in active fixed income management as well. While high-grade corporate bonds have a much higher degree of return correlation, there are often significant and measurable return differences among different sectors based both on specific companies' fortunes and (especially) changing fundamentals between industries.

The team at Agincourt utilizes a model to examine valuations across sectors and sub-sectors of the corporate market. Based on historic valuation measures and the corresponding credit outlook for each sub-sector, the model generates target weightings for our clients' portfolios. We will step you through this process.

The Agincourt Corporate Allocation Model

The first step is to divide the corporate market into appropriate categories. The main sectors of the corporate market are Industrials, Utilities, Financials, and Sovereigns/Supranationals. Each of these is then broken into sub-sectors and industry groups. In all, we look at 33 separate sub-sectors of the corporate bond market.

Next, we examine each sub-sector's current index weighting, both as a percentage of the index (e.g., electric utilities represent 7.3% of the corporate market) as well as its duration contribution to the total. While both measures are important, we focus on the contribution to duration figures, since this measure takes into account both the percentage and the average duration of that sector. As you know, duration can be used to measure how much a bond's price will change for a given change in yield.

With this matrix, we compare our clients' portfolio weightings to the corporate universe in 33 separate sub-sectors. This provides a detailed view of how our clients' corporate positions are over- or under-weighted compared to the corporate benchmark.

For a manager running an index fund, this is where the analysis would end; an index manager simply wants to match his portfolio's weightings with those of the index. For active managers like Agincourt, however, this is only the start. Our job is to identify undervalued securities and add them to the portfolio to the appropriate degree, while avoiding expensive bonds.

Unlike stocks, measuring the return potential of high-grade bonds is fairly straightforward. Yield to maturity is the most common starting point, and is an objective measure of value based on simple mathematics. Corporate yield spreads (the yield advantage offered by corporates over like-maturity Treasuries) are also easily calculated. Even higher-math concepts like option-adjusted spreads (OAS) and interest rate swap spreads are objective value measures compared to the much hazier equity measures of value such as earnings growth models and dividend discount models.

Because high-grade bonds are rooted so deeply in math, math-based value measures are very good at predicting future spread moves. In bond parlance, yield spreads on high-grade corporate bonds are strongly "mean-reverting": when yield spreads are particularly wide, they tighten in future periods back to their historical average; when they are narrow they widen back to more "normal" levels. In general, yield spreads tend to move with the business cycle, widening in periods of economic stress (as default risk goes up) and narrowing in good economic times.

Our model compares current and historic yield spreads for each of the 33 sub-sectors (using 15 years' history of OAS). Each sector's historical spreads are also regressed against all other corporate sectors to determine not just whether a sector is cheap versus Treasuries, but whether it's attractive compared to other corporates. A percentile ranking is calculated;

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a ranking of 100% indicates a sector whose yield spreads are at all-time highs. It is important to note that the overall corporate market and individual sectors can have very different valuations—for instance, while the overall corporate market today stands at the 98th percentile, yield spreads for pharmaceutical bonds are only at the 5th percentile when measured against the attractiveness of the overall corporate sector.

Up to this point, the analysis is all quantitative. The next step is to make qualitative judgments of each sub-sector based on its business fundamentals. As an example, today we view the retail sector as having a worse than average business outlook. (We'll leave a more complete description of our rigorous credit work to a future discussion.)

The next step is to develop target weights for each of the 33 sub-sectors of the corporate market. To do this, the qualitative outlook for each industry is factored into the rich/cheap quantitative screening to determine a quality-adjusted target weighting for each sub-sector. These target weightings simply use the universe weightings as a baseline and boost or lower the recommended allocation according to that sector's quality-adjusted value measurement. The final result is recommended duration-weighted targets for all 33 sub-sectors of the corporate market.

Outlook

As you know, the corporate market has been volatile this year, creating opportunities to add value among the various sub-sectors of the corporate market. The Agincourt corporate model shows the following five sub-sectors as having the best prospects for future bond outperformance:

1) Telecommunication companies
2) Sovereign credits
3) Finance companies
4) Insurance companies
5) Chemicals/Metals/Mining companies

The five sectors with the least favorable prospects:

1) Banking
2) Energy companies
3) Securities dealers
4) Natural gas companies
5) Automotive-related companies

Some of these recommendations have changed recently. For instance, we have been overweighted in energy companies for the past year; they have performed very well relative to most other sectors—so well, in fact, that they are now looking relatively rich. On the other hand, with massive new supply of bonds coming into the telecommunications sector, telecom bonds have cheapened considerably; we are looking to add to our position in that sector. We will be busy in the next few weeks implementing these changes.

Hopefully, this discussion has been informative and not too much like being shown around the sausage factory floor.

As always, thank you for letting us serve you. Please call if you have any questions or comments.