

INVESTMENT UPDATE

Rudyard Kipling wrote, "If you can keep your head when all about you/Are losing theirs and blaming it on you"; Dickens wrote, "It was the best of times, it was the worst of times", and Woody Allen said, "I don't want to achieve immortality through my work. I want to achieve it through not dying". All three were on to something...well, at least Kipling and Dickens were. We can recall no previous time when the bond market offered more disasters disguised as opportunities—and vice versa. For a substantial portion of the bond market, the traditional tools of value-based portfolio management have been useless over the past couple of months, as heads are being lost, right and left.

As we've mentioned before, certain sectors of the corporate market are experiencing a "mania-in-reverse", a sort of mirror image of the irrational exuberance that drove the NASDAQ Index to the limits of stupidity a few short years ago. As with the dot-com bubble, investors have abandoned fundamental security analysis; but this time, instead of ignoring risk, investors are consumed with the fear of risk. Over the past few months, portfolio managers have been burned by corrupt corporate borrowers who doctored their books and misled investors, had the rug pulled out from under them by ratings agencies that are no longer providing objective ratings, given poor advice by conflict-ridden brokerage firms, and were pressed by their own investment committees not to get stuck holding the "next Enron".

For all its sophisticated analytic tools, supercomputer-generated derivatives, Nobel-winning PhD's, and expensively staffed ratings agencies (not to mention *Institutional Investor* All-American Wall Street analysts) the modern bond market is still at the mercy of human behavior and institutional weaknesses. The human behavior topic has been tackled before with more expertise than we could possibly muster; we'll risk oversimplifying the behavior of investors by referencing the often-used mantra: "markets are driven by fear and greed". The emotional aspects of our markets are undeniable and inevitable.

As strong as the emotional pressures on the bond market are, the institutional weaknesses in the system

are currently having an impact on bonds at least as negative as those caused by investors' erratic behavior. Typically in the past we've seen institutional support helping to offset the volatility of investors' emotions; in the present market structural forces (some temporary, some more permanent) are conspiring to add to the volatility.

Specifically, we would point to a lack of support among the large brokerage firms, fundamental changes at the ratings agencies, and a general unwillingness by bankers to extend credit as the main sources of institutional instability.

Once upon a time (about three or four years ago), the major Wall Street firms would step into a disorderly market and provide stability, often to protect an existing position of their own, and always with the purpose of making a profit by buying up undervalued securities. Experienced, savvy bond traders earned most of their annual bonuses on "running their own book". While it didn't always work (some companies' bonds fell for fundamental reasons no buying program could offset), and often took the form of "picking off" competitors and inexperienced money managers, the practice provided some stability to bond prices that had fallen below "fair value". However, this practice began to decline with the growing influence of leveraged funds and megalopolistic money management firms, and all but disappeared after the brokerage industry lost millions trying to trade through the hedge fund crisis of 1998. Since then, Wall Street's emphasis has been on "riskless" trading, underwriting new issue corporate bonds, selling derivative-based products (an additional source of volatility, in their own right) and protecting their investment banking business.

The ratings agencies aren't helping to calm the corporate bond market, either. After taking heat for failing to foresee the Enron disaster, Moody's and Standard and Poor's have been forced to demonstrate that they're doing *something* to improve the predictive nature of their credit ratings. Moody's recently acquired KMV, a firm known for its work estimating the risk of default for a company's bonds based on the behavior of that company's stock. Moody's is now using that data—the price action of the stock—to help determine



the credit quality, default risk and ratings of a company's bonds. As a result, Moody's has begun to downgrade bonds not based on the firm's ability to service its debt, but based on the fact that investors (for whatever reason) are selling the stock. This is an unfortunate, but fundamental change in the way that Moody's is measuring credit quality, and will only add to the volatility already present in today's emotionally charged market. S&P is also making similar "market-based" adjustments to their credit models.

The third main source of institutional instability is the toughening, and in some cases withdrawal, of bank lending in the capital markets. Traditionally, banks have provided a source of funding for companies in addition to what they might raise by issuing debt or equity. Bank lines of credit are typically arranged through a syndicate of banks and provide considerable flexibility to the borrower, as they can be "drawn down" as needed for seasonal swings in cash flow or to back up other, more formal debt instruments during business lulls. But bankers, already known for risk aversion, have become even more wary recently towards large corporate borrowers. Through their increasingly heavy use of derivatives, "shorting" credit risk when borrowers' securities prices fall, bankers have added to the volatility in bond prices. Banks have also been actively renegotiating terms and even pulling credit lines from long-time corporate borrowers just as these firms are suffering a cash crunch. These actions only serve to undermine investors' already shaky confidence.

The wildest swings in the high-grade bond market occur when the emotional factors and the institutional constraints combine to create an explosion of activity. This is what we've been witnessing over the past few months, especially in the telecom sector. As we've mentioned before, the destructive path left by Enron was so widespread that today there is no support from investors, analysts, traders or reporters for companies who have "issues".

WorldCom has been the biggest casualty in this environment, a firm whose bonds' prices have fallen by roughly 50% this year. Their sins? Poor operating performance in a beleaguered industry; disappointing earnings, management shake-up, and an SEC investigation into their accounting. The most troubling of these would be the SEC investigation, but for the fact that there are scores of companies now being investigated by the SEC (again,

thanks to Enron). WorldCom's fundamentals deteriorated much more quickly than anyone expected a few months ago (how a defensive, recession-proof industry morphed into a leveraged play on the economy is, by itself, a case study) and now finds that \$30 billion of debt is a heavy burden when revenues aren't growing. Since April, Moody's (with input from their KMV model) downgraded WCOM from "A3" to "Ba2", as their stock declined to \$2 per share.

Yet even WorldCom, for all its faults, should be able to muddle through this downturn. Cash flow is sufficient, given a lower level of capital expenditure than in the recent past (and with some support from its banks) to service debt at least over the next three or four years. As with most companies, if their business falls off a cliff all bets are off, but given a likely gradual recovery in their sector over the next few years they are a viable company, albeit one with a high degree of leverage.

We could bore you with our detailed financial projections for WorldCom and other problem credits, demonstrating their financial adequacy and underscoring the stark disparity to the prices of their bonds in the marketplace—but fundamentals are not driving this market and may not matter again for a while. Our market, its participants and institutions are in a dark period, challenging the most seasoned portfolio managers. The people and institutions that comprise the modern bond market created this environment and only these same market participants will be able to pull the market out of its funk. There is no quick fix as trust has been shaken, traditional tools have been abandoned and institutional norms changed. Only time, borrowers' demonstrated ability to deliver on their obligations, and institutions' adjustment to an unfamiliar landscape will heal our markets' nervous dementia.

In the meantime, we are fine-tuning our models and procedures to not only protect our clients' portfolios in this environment, but to profit as well. It has never been harder to keep your head than it is right now in the current state of the bond market. Our collective head is still firmly attached. But, unlike Woody Allen, we're happy to acknowledge our own mortality.

