Agincourt Capital Management, LLC

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INVESTMENT UPDATE

As we've mentioned before, the job of an active portfolio manager is not to avoid risk, but to skillfully manage it. To beat the market, a manager has to take more risk than the market in some periods and less in others. Recently, many risk-averse portfolio managers that outperformed in the highly volatile markets of early '02 were shocked—*shocked*—when beaten-down corporate bonds that had been left for dead suddenly found new life late in 2002. A number of high-grade corporate bonds' prices rose by ten percent or more in November alone. Risk is a two-way street—not taking risk can sometimes be the biggest risk of all. And yet, when credit market participants are in a blind panic (as they were for most of last year), risk comes to be viewed as something that should simply be avoided.

As many managers found out last year, one cannot be on "one side of a trade" indefinitely. At the same time, taking an active role can mean running the risk of being "whip-sawed", on the wrong side of the trade in both up and down moves. A number of equity investors suffered this fate a few years back when, after tiring of watching their low-tech stocks lag, they bought the dot-com stocks just before they went into free-fall.

We believe strongly that active management, despite its perils, has clear advantages over passive strategies. The main advantage of being an active manager is that we don't have to passively accept the risk the market is giving us; we can adjust the amounts and types of risk we are willing to shoulder. Market conditions change and so must our strategies. As an example, over the past five years as interest rates declined and credit quality softened, high-quality/long duration strategies have outperformed. Now, with Treasury yields at 40-year lows and with the outlook for credit quality improving, the best strategies of the recent past will most likely not be the winners of tomorrow.

In evaluating the risks and opportunities of the current market, active bond managers must make specific allocation decisions on the "high-beta" issuers in the corporate market. First, a word of explanation: the term "high-beta" is borrowed from the equity market to describe a company whose stock price moves to a greater degree (in both up and down markets) relative to the market as a whole. High-beta stocks are more volatile, offering both more downside and greater potential returns than the average company's stock. Corporate bond participants have begun to apply this term to bonds that are even more beaten down (and therefore, have more room for improvement) than the average company's bonds in the current depressed corporate sector.

The reason the high-beta bonds have been trashed is that these credits possess more of what has hurt investors in their recent experience with corporates. In general, these are large companies with highly leveraged balance sheets. Many of them were serial acquirers in the late 1990's whose expansion was funded with debt, and now find themselves struggling in a slower-growth economy. Most are rated "BBB" and some may end up getting downgraded to junk status. Many are guilty of having used aggressive accounting in the past and a few have been (or are currently being) investigated by the SEC.

It is tempting to simply dismiss these companies and put one's time and effort into examining less problematic credits but for one big factor: these companies comprise a significant portion of the high-grade universe. Included in this group are names like Ford, Sears, AT&T and AOL. Like it or not, active managers have performance benchmarks and these large issuers represent a measurable percentage of the benchmark index. We can recall no period in the past when a handful of corporate bonds represented so much potential return.

This is perhaps active bond managers' greatest challenge in early 2003: how to deal with the "have-nots" of this unusually bifurcated corporate bond market. The implications are not trivial. On the next page is a table with some statistics (as of January 31, 2003) for the 25 cheapest credits among the largest issuers in the Lehman Credit Index compared to the Index itself. We'll call them the "Ugly 25".

We see that while the 25 cheapest bonds represent only 3% of the companies in the credit universe,

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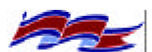

they comprise 18% of the market value of all investment grade corporates. Again, the Ugly 25 include some of the largest companies in the US bond market, companies who are struggling *precisely because they have so much debt outstanding*. The degree of investor antipathy is reflected in the spread over Treasuries of the Ugly 25, where their market-weighted average yields are nearly 3% higher than Treasuries, almost twice the yield advantage of the average high-grade corporate bond.

	Mkt. Value ($Bln.)	# Issuers	Spread vs. Treasuries	"Spread Duration"
The "Ugly 25"	$ 372	25	299 Basis Pts.	316
Lehman Credit Index	2,048	739	157	886
Ratio	**18%**	**3%**	**1.9x**	**35%**

The last column in the table shows the "spread duration" of this group compared to the Credit Index. Since duration measures bonds' sensitivity to yield changes, this calculation indicates that more than one-third of the high-grade corporate market's potential return comes from only 25 issuers. In short, for high-grade bond managers, performance in 2003 will be highly dependent on how well they select the winners (and avoid the losers) from these 25 bonds.

Without going too deeply into the arcane world of bond analytics, we will briefly outline how we handle the analysis of these bonds (of course, this is in addition to all the "normal" work we do on the other 97% of the corporate sector!). First comes the careful measurement of each bond's weighting in the benchmark Index, both as a total and as a part of its industry (more on this later). Next comes an examination of each bonds' "richness/cheapness" relative to both the overall market and its industry. Next we analyze the potential returns each of these bonds are likely to produce in various yield spread widening and tightening scenarios that we create. With this information, we can measure the impact that these 25 bonds will have individually on the market.

The final step is the customary "roll up your sleeves" work of credit analysis. We pick each of these companies apart and perform a full examination of all aspects of their businesses and make projections of their likely prospects. As we mentioned earlier, industry analysis is also important, as we may choose not to invest in a particular credit in the Ugly 25, but if we like the industry, buy a smaller company in the same industry that has better credit fundamentals but with equal or superior return prospects.

So in the end, much of the success or failure of active high-grade bond managers over the next few months will depend on old-fashioned security selection. Some of these 25 bonds will be winners; some will continue to struggle. Newly troubled credits will enter the group as improving credits graduate from "high-beta" status. Our job is to examine these companies very carefully and make explicit decisions on which ones (and in what quantities) are appropriate for our clients' portfolios. Ignoring them or pretending that they don't exist is not an option.

This Investment Update, as well as past editions, is available on our website: www.agincourtcapital.com