Agincourt Capital Management, LLC

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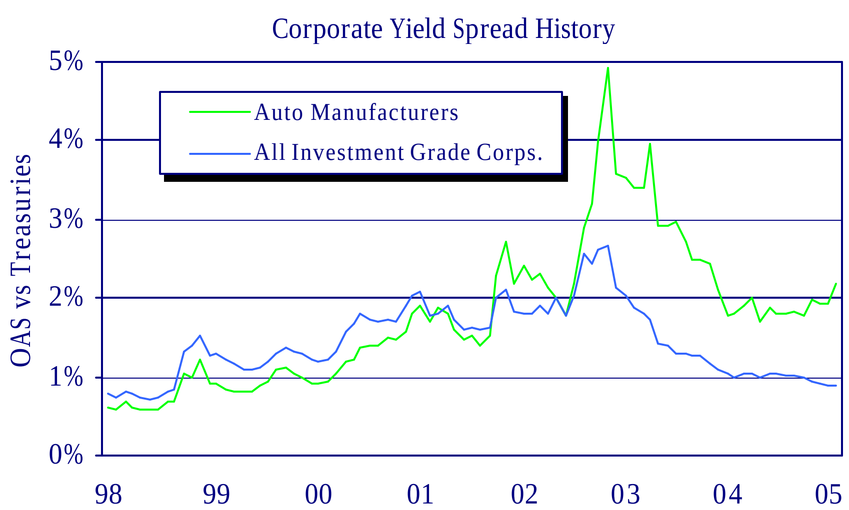
INVESTMENT UPDATE

It was only a little more than two years ago that the investment-grade corporate bond market seemed to be falling apart. High-profile bankruptcies, corporate accounting scandals, levered hedge fund shorting, skittish commercial lenders and little support from global broker/dealers added up to a market that was on the verge of failing. Prices collapsed and yields soared, as portfolio managers succumbed to the "capitulation trade" and flushed their corporates. Some of the best-known managers in the industry proclaimed that corporates were an inferior asset class, by virtue of their "asymmetric" return potential.

Of course, the corporate sector did recover, and those of us who kept our wits and stayed out of the stampede were able to produce good returns for our clients. In fact, the recovery of the corporate sector has been, in some ways, even more spectacular than its decline. As the chart on this page shows, the deterioration of the corporate sector, as measured by its yield spread over like-duration Treasuries, took nearly five years, from 1998 to late 2002, when the average corporate bond yielded in excess of 2.5% more than the yield on similar-duration Treasury bonds (these spreads are "option adjusted"). Yet it took just two years for the extra yield offered by the average corporate bond to return to more normal levels.



But while the average corporate bond has performed very well over the past couple of years, there have been a few exceptions. The most notable laggards are the bonds of Ford and General Motors. Normally, the performance of two issuers wouldn't warrant much of a discussion in the multi-trillion dollar world of the US bond market. But these aren't your typical borrowers: Ford and GM (and their affiliates) each have more than $100 billion of debt securities in the hands of investors, mostly in the form of their finance subsidiaries, Ford Motor Credit (FMCC) and General Motors Acceptance Corporation (GMAC). Ford and GM are the biggest issuers in the US corporate market, together representing 6% of the Lehman (high grade) Credit Index. In a recent survey conducted by Merrill Lynch, only 8% of high-grade investors did not own bonds of FMCC while just 14% claimed not to own GMAC bonds.

Space constraints prevent us from going into great detail as to why the automakers suffered so severely in the great sell- off in 2002 and have experienced an anemic recovery over the past few years, but it boils down to this: foreign competitors can produce cars with equal, if not better, quality at a lower cost. Since US auto makers would rather discount the price of their cars than lose market share (and risk losing the customer forever), margins have gotten increasingly thin. Profits have been further eroded by the inroads that foreign (especially Asian) manufacturers have made in taking sales away from Ford and GM's highly profitable SUV and light truck lines.

With a relatively inflexible labor force, the auto makers can't easily shrink, as many US companies have done, to find their most efficient scale of operations. What's worse, the combination of a mature, static workforce and thousands of retirees has created multi-billion dollar liabilities in the form of current and future pension and retirement benefits. Health costs for US employees and retirees are projected to cost GM more than $5 billion this year. In a recent speech, GM CEO Richard Wagoner stated that health benefits alone add $1500 to the cost of each new vehicle they produce, a cost that foreign competitors, with a much younger workforce and (at least for their overseas employees) government-sponsored health-care costs, do not have to bear.

With all these problems, an investor might choose to take a pass on the entire sector, even if it does represent a big part of the corporate bond universe. But as ever, with a higher degree of risk comes the potential for much higher returns: as the chart on the front page demonstrates, the average bond issued by the automakers (and their subs) offers more than double the yield spread of the typical corporate bond. In fact, these bonds trade at near-junk bond levels, despite their investment-grade ratings.

Keeping the ratings at the investment grade level is the key—the downside to investors is not that the bonds of GM or Ford will default any time soon. In fact, both companies have been remarkably restrained over this past business cycle in husbanding cash (GM has more than $50 billion in cash and short-term securities on its balance sheet, Ford more than $30 billion). The real risk is that the slow deterioration of their credit quality continues to the point where one or both companies get downgraded from their current "triple-B" ratings to non-investment grade status. If that were to happen, billions of dollars in GM and Ford bonds would have to be sold by investors to stay within client- or internally-imposed credit guidelines.

Last month, things turned worse. Yield spreads on both Ford and (especially) GM began to "gap out." Perhaps portfolio managers wanted a cleaner slate to begin the year or maybe they were afraid of weaker-than-expected 2004 earnings announcements, but there was a sudden unwelcome supply of automobile bonds looking for new homes, with few investors looking to add to already-full positions (keep in mind that many investors were already fully invested in the autos). The prospect of an auto manufacturer downgrade to below investment grade hung over investors' heads like the mythic Sword of Damocles.

Into the fray stepped Lehman Brothers, a major Wall Street broker/dealer, and the keeper of the Lehman Brothers Indices, the performance benchmarks used by nearly every investment-grade bond manager in the US, if not around the world. Just as inclusion in the S&P 500 can impact demand for a company's stock, so does inclusion in the Lehman Aggregate Index affect investor demand for an issuer of bonds. Lehman, presumably looking for a way to keep GM and Ford in the index, announced in January that they would change the rules for inclusion in the US High-Grade Credit Index (a component of the Aggregate Index); beginning July 1, 2005 Fitch Investors Service would also be considered in determining whether a company's ratings were investment grade. As long as two of the three ratings agencies (for more than 30 years Moody's and S&P were the only ratings considered) rate the issuer as "BBB," the bond stays in the high-grade Indices.

Since Fitch typically rates companies a little higher than either of the other two services, the quality of this benchmark has been given a quick boost. At the same time, the addition of Fitch should provide a little more stability to the indices (i.e., fewer companies dropping out). The winners are not just the auto companies, but other "cuspy" credits, as well as the handful of companies who were previously rated too low to be considered investment grade and will now be included in the indices. Overnight, the demand for these credits improved, as they became viable investments for countless new investors.

Of course, the other big winner is Fitch, a company who is well-known to European investors, but has long operated in the shadows of its two more well-established rivals here in the States. Their status has been elevated considerably, and from a business standpoint, Fitch should expect to see a big rise in revenues from companies needing to have their bonds rated by the former also-ran.

In the final analysis, what does the action by Lehman do for Ford and GM? It buys them time to continue to have access to high-grade investors, at a point where time is perhaps the most important ingredient to their long-term survival. Ford, in particular, has many new products just now coming onto the market that will hopefully slow the erosion of their market share. Similarly, GM needs time to slowly reduce its scale and either recharge or shed unprofitable product lines. For both companies, their role model may be the former weak sister of the "Big Three"—Chrysler. Chrysler has managed to find their niche in the US auto market, and now has the highest credit rating of the three (and well-bid bonds to show for it). Yes, they've had help from their merger partner (some would say "parent") Daimler, but the operations of Chrysler are far more aligned with the long-term demand of their products than the far-flung and marginally profitable global businesses of GM and Ford.

For investors like us, it also gives us a more stable environment to monitor these credits. If we do decide to sell some or all of our position in Ford or GM, we should be able to do so in a market that isn't driven entirely by fear. While we don't hold out hope that these credits will begin trading at similar yields to other BBB-rated corporates any time soon, there is every reason to believe that we will be able to collect the extra income on these bonds for the intermediate future.

After that, who knows—these companies may be able to work through some of their long-term structural problems. As always, we will be watching them very carefully.