Agincourt Capital Management, LLC

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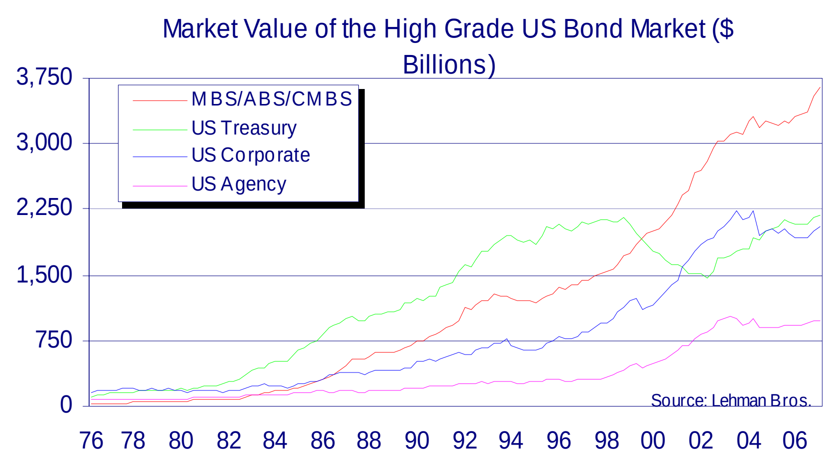
INVESTMENT UPDATE

"Nothing endures but change"—Heraclitus (535-475BC)

Although we doubt that Heraclitus was thinking of the bond market 25 centuries ago, the US high grade fixed income market, like everything else, is mutable. As staid and boring as it sometimes appears, our market has changed dramatically over the past decade or so, and there's no reason to believe that will not continue to be the case in the future. This month we'll take a look at recent changes in the bond market and make some predictions about what might lie ahead.

The chart on this page shows both the growth of, and the change in the composition of, the high-grade US bond market over the past 30 years. This period covers what most bond investors would call "the modern era," marked by the introduction of the Lehman Aggregate Index in 1975. Traditionally, this Index has included all investment-grade US-dollar denominated bonds with maturities of one year and longer, in the following categories: Treasury notes and bonds, Agency debentures, Agency-issued mortgage pass-through securities, and corporate bonds. Over the years, the Index has been expanded to include a wider variety of bonds, reflecting some of the new instruments that have been introduced by Wall Street and adopted by bond managers. Some of these products include 15-year mortgage-backed securities (MBS), which were added to the Index in the mid-1980's, asset-backed securities (ABS) in the early 1990's and commercial mortgage-backed securities (CMBS) in 1999.

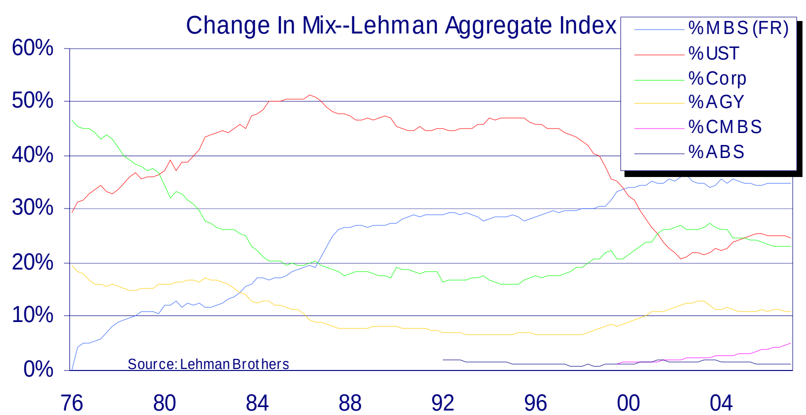


There have been other modifications to the Aggregate Index, mostly focused on re-classifying groups of bonds already in the Index. The most notable of these was the elimination of the "Yankee" bond category approximately five years ago. Yankee bonds included all US dollar-denominated bonds issued in the US (or global) markets by non-US entities; this included issuers such as the Canadian provinces, foreign corporations and supranational entities (the World Bank is the best known of these). In a move to make the Aggregate Index more global and less US-centric, Lehman re-classified Yankees and placed these bonds into broadened existing categories: non-US corporate issuers' bonds were simply placed into whatever industry they belonged (e.g., British Telecom was placed into the now-globalized "telecommunications" industry sector) while "Agencies," which formerly only included US Agencies such as the Federal Home Loan Bank, were expanded and renamed "Government Related," a catch-all for all dollar-denominated US and non-US government bonds, including sovereigns and supranationals.

We should also mention that, as broad as the Lehman Aggregate Index is, it doesn't include everything; in fact there are entire classes of bonds that fall outside of its purview. One of the biggest of these are non-investment grade bonds, which by definition, are included in a separate Index (the Lehman High-Yield Index). The Lehman "Agg" also excludes certain illiquid bonds, such as small issues and unregistered corporate bonds. Likewise, the Aggregate doesn't include non-dollar bonds or municipal bonds; like junk bonds, they both have their own index. What's surprising to some is the fact that the Aggregate does not include many of the "derivative" instruments that have become commonplace in institutional portfolios, even among many traditional bond managers. The main reason is that including derivatives of bonds often amounts to double-counting securities that are already in the Index—for instance, Agency-backed collateralized mortgage obligations (CMOs) are backed by Agency pass-throughs already included in the Agency MBS subset of the Aggregate Index. In addition, many of these derivatives are thinly-traded and nearly impossible to track and price (Lehman attempts to price every bond in their Indexes every day).

Despite these omissions, the Agg is the most popular benchmark for the vast majority of "core" fixed income portfolios here in the US for the simple reason that, with more than 7,000 issues, it fairly represents the broad, "investable" (to use Lehman's term), high grade US bond market.

As the chart on the front page shows, the high grade US bond market has grown rapidly over the past three decades, from $330 billion at year-end 1976 to $8.9 trillion today—a twenty-six-fold increase, which converts to a compound growth rate of more than 11% per year. The fastest pace of growth over this period occurred in decade of the 1980's, when the market grew by an annual rate of 18%, led by explosive growth in the MBS sector (which expanded by 28% annually in the 80's). In the 1990's the growth rate slowed markedly; even more significant was the dramatic change in the mix of bonds in the 90's. As the chart below shows, US Treasuries' share of the market, which grew to more than 50% due to the massive Treasury issuance supporting the large budget deficits of the 1980's, began to lose share as corporate and MBS issuance outpaced Treasuries in the 90's. The total market value of the Treasury market peaked at $2.2 trillion in the third quarter of 1998, and fell for the next four years, until the escalating cost of the wars in Afghanistan and Iraq and the 2000-01 recession led to a resumption of deficit spending. The market value of Treasuries has just recently exceeded its previous peak, although its share of the US bond market is still just half of its 1986 level.



Another trend that changed in recent years was the break in the steady upward growth of the high-grade US corporate bond market. You may recall that the 1990's (especially the second half of the decade) were marked by the debt-financed expansion of many companies, eager to keep shareholders happy while raising their firms' productive capacity to meet the insatiable appetite of the New Economy. When it all went pear-shaped with the most recent recession, companies found themselves saddled with debt that threatened (and in some cases, terminated) their existence. Like Treasuries a few years earlier, corporate issuance slowed, and from 2003 to just about a year ago, corporate bonds' market value shrank as corporate CFO's chose to pay down more than they issued. Today, as measured by Lehman Brothers, the market value of the high-grade corporate market is 9% lower than it was in mid-2003, while corporates' share of the Aggregate Index fell from 27% to 23%.

In a similar fashion, the market value of the US Agency market has remained essentially flat for nearly five years. This time span corresponds with the increased scrutiny by Federal overseers and the resulting change of strategy for the major GSEs (Government Sponsored Enterprises)—Fannie Mae and Freddie Mac. After more than doubling, to over $1 trillion in market value from 1999-2002, the GSEs' balance sheets have remained essentially flat for the past four years. Meanwhile, Agency debentures' share of the Agg has slipped from 13% to 11%.

As the charts demonstrate, the sole sector of the high-grade US bond market that has continued to grow, both in dollars and as a percentage of the overall market is the combined mortgage-backed/asset-backed securities market. This obviously reflects the expansion of home ownership in the US, as well as the increased repackaging of commercial mortgage loans into securities. In fact, given the growth in market value of the US housing market over the past decade, it's surprising that the MBS sector isn't larger—but we must keep in mind that the mortgage Agencies have strict underwriting standards (size constraints, credit scores) that determine which home mortgages can be securitized into pass-through certificates. The newly popular low- and no-documentation, jumbo, subprime mortgage loans do not pass muster with the Agencies, and therefore will not show up in the Lehman Aggregate Index.

Looking forward, on April 1st, Lehman will expand the list of securities in the Aggregate Index to include, for the first time, certain qualifying securities backed by adjustable rate mortgages (ARMs). Lehman estimates this will add more than 1200 securities to the Aggregate Index, worth $321 billion. More importantly, it will boost the combined MBS/ABS/CMBS category by more than 2%, to 43.4% of the Aggregate Index. Since adjustable-rate mortgages have short effective maturities, adding these securities will shorten the duration of the Index by nearly 1/10 of a year.

Beyond that, it seems likely that we'll see a resumption of new issuance in the US corporate market, as the business cycle plows ahead and companies fund expansion and acquisitions via the increased use of debt. The Treasury market is likely to stay on its current modest growth trend, but will begin to accelerate over the next decade unless a new wave of fiscal discipline sweeps over Washington. On the other hand, we don't expect Agency issuance to grow substantially, as they are now operating under much greater financial scrutiny from their Federal overseers.

Finally, we predict that the variety of securities in the Aggregate Index will continue to expand, reflecting the introduction of new products as they are adopted by fixed income managers—even those, like Agincourt, who specialize in "core" strategies.