Agincourt Capital Management, LLC

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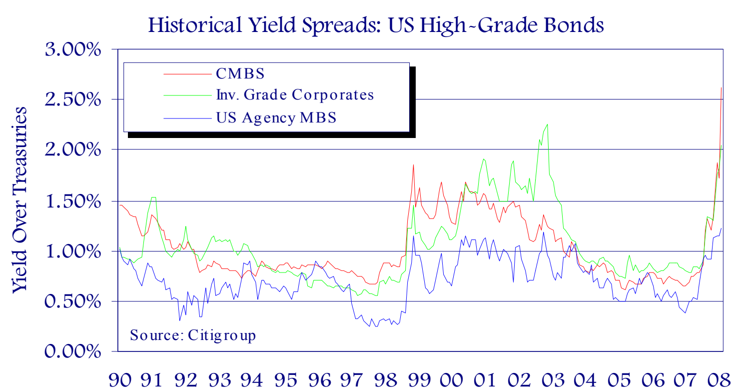
Investment Update

The current credit crisis is both highly unusual and surprisingly tenacious, as it rolls from sector to sector. First it was the collapse of the subprime loan market which brought down the specialized investment vehicles (SIVs) that supported these loans and the CDO's that invested in them. Then the banks and brokers that retained many of the riskier elements of these loans and controlled the SIV's were forced to write down the value of the collateral. The banks and brokers decided they'd had enough and curtailed lending and trading; the investors decided they'd had enough and curtailed buying.

Like a slow-motion train wreck, the hits have just kept on coming—now monoline insurers, who both "wrapped" low-grade securities and bought them as investments to boost their portfolio yields, are coming under pressure as regulators and investors question the adequacy of their capital given the uncertain quality of their assets. Meanwhile, prices on leveraged loans, which have been used for debt-funded merger and acquisition activity, are in a tailspin, while even high-quality commercial mortgage-backed securities (CMBS) are getting hammered. And the auction-rate preferred market has collapsed, with many municipalities and hospitals facing double-digit interest rates on their short-term borrowings.



It seems that every day brings more. More misery. More angst. More hand-wringing. It just can't get any worse for bond investors, can it?

Sure it can! Defaults on bonds (which were at their lowest levels in more than 20 years in 2007) are projected to go up substantially this year, partially due to weaker economic growth, partially due to a number of "bad deals" priced over the past couple of years, and partially due to the fact that lenders and investors just aren't as willing, in this environment, to accept renegotiated terms with weak borrowers. Meanwhile, the ratings agencies are taking a hard look at some of their ratings methodologies (great timing!), which is almost certain to lead to a new rash of downgrades, at least in the structured product areas of our market.

Yet, despite the massive pile-up of bad news and the funereal pall that hangs over the bond market, we feel pretty good about the future. Yes, you read that correctly; we're beginning to believe that 2008, before it's all over, may end up being pretty good for astute bond investors.

Supporting our optimism (or at least a refusal to throw in the towel) is the belief that investment fundamentals, not sentiment, are the primary drivers of bond prices. But we also recognize that our market is a giant opinion machine, reflecting the collective interests of millions of investors. It doesn't weigh those opinions equally, however. There are a very few, very powerful participants who, because of the giant pools of money they have at their disposal, carry much more weight than the rest of us. In the current market, the relative prices (if not the absolute levels) of bonds are being most influenced by the banks and the brokers.

To understand how a few participants can have an outsized impact compared to the vast multitudes, it may be helpful to step back and examine some of the mechanics of the high-grade US bond market.

Unlike the stock market, the futures market and most other large, organized markets, the $10 trillion US high-grade bond market does not have market makers or even a trading floor where participants regularly transact trades. All trades are executed either over the phone, or through one of the internet-based online trading systems that were developed in the past half-dozen years. While this ad-hoc system works fairly well most of the time, it is subject to the violent mood swings of the brokerage firms and their willingness to commit capital. As we all know, right now the market's mood has swung into a deep depression.

What this means operationally is that there are times when the high grade US bond market, perhaps more than any other global market of comparable size, moves to extreme valuation levels based on sentiment. It can also lead to the bond market getting pushed around by a relatively small number of trades. This didn't used to be the case—as recently as ten years ago, the major Wall Street firms had a vested interest in keeping the markets more-or-less liquid, as they main-

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tained large inventories of bonds, and proprietary desks armed with their smartest people to protect their inventory. This began to change when these same young traders left to join the ranks of the hedge funds, where they could take positions, long or short, on any bond (or stock, or currency, or…you get the idea) that struck their fancy. Collectively, these funds, with their voracious appetite for risk and their high degree of leverage multiplying their actual capital, today far outweigh Wall Street's interest in taking on risk. In other words, volatility has increased in the high-grade bond market over the past decade, as speculators are a key driving force, and brokerage firms are far more skittish when things get tough.

The mercurial nature of the modern day investment grade bond market can be seen most clearly in the movements of high grade corporate bond yield spreads—the difference in yields between corporates and like-duration benchmark Treasuries. The chart on the front page shows how much incremental yield investors have demanded above Treasuries over time. Fundamental credit analysis teaches us that yield spreads indicate the amount of perceived risk of default for a particular class of bonds at that time. The period from 1998-2002 was marked by one near-disaster after another, from the Asian currency crisis to the Long-Term Capital Management meltdown, to the dot-com bust, to recession, to the credit defaults and malfeasance perp-walks of 2002. We had a nearly five-year period of relative stability after that, but the last nine months are looking like the beginning of a replay of the bad old days of 1998 in many respects.

Except for a few essential differences, and these are important. The main difference is that we're not experiencing a traditional credit downturn where companies find themselves, near the end of the business cycle, with too much debt on their balance sheets in a slower economic/cash flow environment. Today's problems really get down to a fundamental lack of trust in the way risk has been pieced out, or in today's parlance, the way risk has been "structured." Many securities that were rated "AAA" by the ratings agencies are now proving to be far less than what that rating implies. Models that the ratings agencies used to rate subprime loans in 2002 were still being used in 2007, despite the fact that lending standards had become far more lenient ("Don't worry, you can still afford that house with one of our interest-only loans!") and US housing prices were highly inflated. We now know that many of these structured bond deals were much too optimistic in their assumptions, especially for loans made at the top of the market in 2006 and 2007.

For structured bonds with risky collateral, the level of defaults will make or break the deal. AAA-rated classes are dependent on the lower-rated subordinate classes; high-yield "support" bond holders take the brunt of any delinquent payments or foreclosures on the mortgages. A deal that is structured to protect AAA bondholders under a 6% default rate completely collapses if defaults actually come in at 15%. Once the subordinate bond holders are completely wiped out, the senior holders in these structured deals experience pain they never thought possible.

The massive errors in the modeling of these deals, and the assumptions that underpinned these models, have shaken the foundations of the global credit markets and, in the minds of some, called into question the validity of all structured products. Huge writedowns have been taken in anticipation of expected losses, and credit has been refused where it was once readily available. As mentioned earlier, whole parts of the high grade US bond market have ground to a halt. For many types of bonds, simply getting a price quote is difficult, and getting a dealer to actually bid a bond for their own inventory is like playing Whack a Mole at the carnival. Worse, borrowers who depended on the structured products markets are out of luck for the foreseeable future. In January, there were no commercial MBS deals priced—none! This, from a half-trillion dollar market where the underlying collateral has essentially zero connection to the residential housing market (although many believe the commercial real estate market is due for a "correction").

Any parent of a teenager will attest that trust, once broken, takes a mighty long time to rebuild. We expect the same in our market. The recognition and marking-to-market phase of this credit crisis appears to be well-advanced, as holders of bogus securities have had to face reality. And while it's impossible to know exactly when the dominoes will stop knocking each other over, we're feeling increasingly confident that much of the bad news has been incorporated into the prices of the types of high-quality bonds we buy for our clients.

As the chart on the front page demonstrates, like corporates, incremental yield spreads for US Agency-backed pass-through securities are at their most attractive levels in recent memory and commercial mortgage-backed securities are in the stratosphere. Pass-throughs, along with high-quality corporate bonds, with careful selection, can be purchased at extremely wide yield levels, allowing us to pack excellent yield into our clients' portfolios. Despite the near-total lack of marketability, CMBS with "super senior" structures (where defaults need to be near 30% before the bonds are impacted) provide tremendous yield without taking on meaningful default risk. For managers who can accept some liquidity risk and who are willing to examine the underlying collateral, super senior CMBS are poised to produce outsized returns over the next couple of years.

This market is testing the resolve and commitment of many investors, and has put more than a few careless managers into a ditch they may not be able to drive out of. We remain committed to the notion that "Yield Wins Over Time," but, as always, only for bonds that are truly credit worthy, and only for those bonds with a margin of safety that encompass real world, worst case scenarios.