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Agincourt Capital Management, LLC

INVESTMENT UPDATE

Here at Agincourt Capital Management's world headquarters in Richmond, Virginia, our veteran team of credit analysts have been burning the midnight (or at least the ten PM) oil as they wrap up the periodic, but always arduous, task known as "quarterly earnings." For those of you not familiar with this seasonal cycle, it involves a lot of listening to conference calls and reading press releases and sifting through financial statements. It also, importantly, involves the forming of opinions on these companies, as we keep tabs on their financial performance and compare how they're doing relative to our expectations.

In this, we are not alone. This process goes on in hundreds of investment management and brokerage firms across the globe, and has been going on for decades, as analysts scrub the data, ask questions, and make recommendations to their clients or the other members of their investment management teams. Spreadsheets are updated, reports are written, decisions are made, stocks and bonds are bought and sold.

And that is how it should be. We do our own analysis here at Agincourt, and we're pretty good at it: Gathering as much "raw" data as we can from public sources, and digging up additional information from conference calls with companies (who are no longer able to talk with investors one-on-one due to SEC regulations) and conversations with analysts who work for Wall Street firms and the ratings agencies.

Oh yeah—the ratings agencies. The guys (in the case of Standard & Poor's) who just downgraded the debt of the US Treasury and other US government agencies. The same guys who rated Lehman "single-A" right up to the point they declared bankruptcy (and then, a couple of days later, wrote a four-page piece defending their rating, blaming short-sellers and temporary factors for Lehman's demise). The same guys who awarded "AAA" ratings to all sorts of financial nightmares which had been dressed up as high-quality bonds; ratings that were predicated on S&P's all-too optimistic models of the US housing market. And while it's a stretch to blame the ratings agencies for the near-collapse of the global financial system, it's no exaggeration to characterize them as feckless, at best.

Thank goodness that S&P also recently downgraded Fannie Mae and Freddie Mac. Only thing is, they were three years too late. It was 2008 when the mortgage giants crashed against the rocky, ragged shore of the subprime crisis, only to be resuscitated by the federal government, which has since allocated $400 billion dollars in capital to keep them solvent. These mortgage behemoths were days—maybe hours—from being unable to pay their bondholders in 2008, and yet they never lost the triple-A rating on their senior bonds. Now that they're lashed to the mast of the Treasury, Fannie and Freddie have been taken down to AA+.

Of course, the reason for the downgrade, at least according to S&P, was not that the US was facing the imminent insolvency of the Treasury, it was because, in S&P's own words:

> *The prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process.*

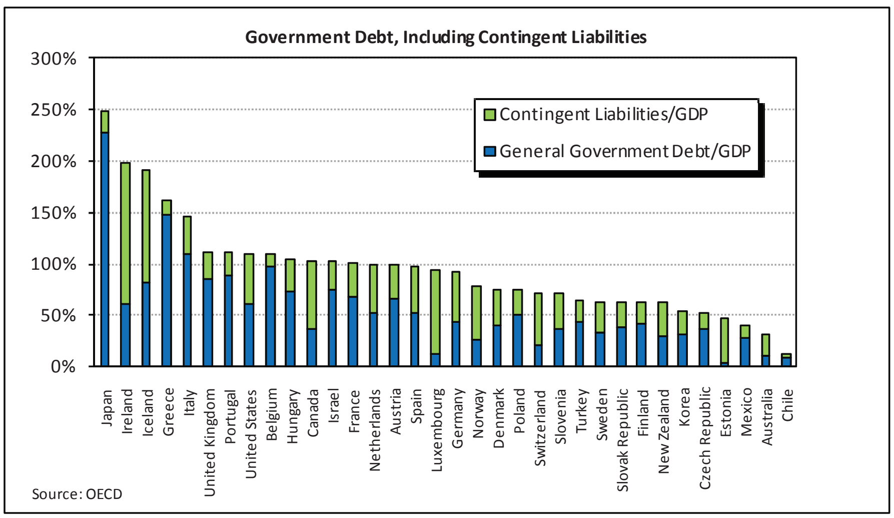
In other words, S&P didn't like the way Congress was acting. Fair enough; we didn't either. But if your job is to inform investors about the underlying strength of a bond issuer, and downgrade those whose creditworthiness is in question, where is the fundamental credit research? Where is the US balance sheet and income statement analysis? What criteria, S&P, did you use to back up the negative assessment of financial strength of the US? Since none was provided, investors are left to guess. Evidently, certain estimates of long-term liabilities that they did bother to show to the Treasury (in private discussions) were off by $2 trillion. Another job well done, S&P!

When the announcement was made that the US had been downgraded, what was the collective reaction of global investors? They bought US Treasury securities, of course. Prices shot up on Treasuries of all maturities, and yields fell to their lowest levels since the dark days of the recession. Investors voted with their wallets and sought, in a time of stress, safety. Despite S&P's opinion, the safest haven of all remains US Treasury bills, notes and bonds.

Now, let's be clear: we are mighty unhappy with the naked partisanship on display over the past few weeks in Washington. The idea that a vocal minority of representatives would actually consider reneging on payment of our debt is more than irresponsible, it's unconscionable. Likewise, the notion that our fiscal troubles would disappear if we just eliminate tax breaks for corporate jets (just one well-flogged example) is insulting to anyone with a passing knowledge of where our tax revenue really comes from.

The sad facts are that the US is suffering from the same fate as many other developed economies; namely, too much government debt in a time of declining tax revenues. In the Eurozone, there is considerable, and justifiable, worry about whether the so-called "PIGS" (Portugal, Ireland, Greece and Spain) will be forced to either default or renegotiate the terms of their outstanding government bonds. So far, the European Economic Commission has stepped in to provide assistance to Portugal, Ireland and Greece, and these countries have had to accept unpleasant medicine in the form of austerity measures.

The most recent sovereign flare-up in the Eurozone concerns Italy, which is the world's third largest issuer of government bonds (behind only the US and Japan). Italy is an entirely different kettle of fish; a potential default in Italian bonds would have a massive impact on the world bond market, and has the potential to take down certain European banks. What's worse, it's unlikely that there is either the political will or necessary funds to prop up Italy if it indeed finds itself unable to service its debt. It's instructive to note that in recent weeks, Italy's bond prices have sunk, while those in the US have risen dramatically; both countries are rated "double A" by S&P.



Now the European Central Bank has started buying Italian and Spanish government bonds to show its support and to bolster investor confidence in these countries' fiscal strength. This marks the first time the ECB has made outright purchases of debt. Like the previous loan programs they helped arrange for Portugal, Greece and Ireland, the bond purchases came with strings attached; in order to win the support of the northern European countries (read "Germany"), Italy and Spain had to agree to austerity measures. Bottom line: the ECB is now shaping domestic policies for major member countries, not just the Euro periphery.

Even before the financial crisis began, countries were making promises they were going to have trouble keeping; since 2008, with the addition of recapitalization of the global financial system, there has been a significant shift in financial obligations away from the private sector to the public sector. According to the Barclays Treasury Index, publicly-traded US Treasuries outstanding have grown from a face value of $2.5 trillion at year-end 2008 to more than $4.7 trillion today, a 92% increase. Over the same period, the face value of high-grade dollar-denominated corporates grew by just 28%, from $2.2 trillion to $2.8 trillion. Both here in the US and around the globe, the burden of risk has been shifted to the public sector. As the chart on this page shows, including direct and indirect obligations, US federal debt is now greater than 100% of our annual GDP.

Here in the US, in addition to the federal debt, we have had a massive issuance of long-dated taxable and non-taxable municipal bonds over the past 18 months, including "build America bonds" (AKA "BABs"). BABs have been issued by state and local governments, as well as government agencies and private enterprises, taking advantage of the low-rate environment, and in some cases, federal subsidies. They are varied in size and scope, from the state of California to the East Baton Rouge Sewerage Commission. With all the recent issuance, BABs and other taxable municipals now represent more than 13% of the Barclays Long (10+ years) Credit Index.

Which brings us back around to our opening comments. We have a considerable degree of skill and experience examining corporate bonds and determining their credit quality. We get audited financials for these companies every year on a timely basis. Each quarter, we get detailed financial updates on the companies' operations, with commentary from management and the ability to ask tough questions about their firm in conference calls. These companies are required to file paperwork within strict time parameters with the SEC and other regulators, providing additional insight into their operations. Few, if any, of these factors apply to sovereign credits, or to municipal issuers. Financial information is not as timely, or as detailed, for these entities. They don't have to register with the SEC when they issue bonds, and aren't subject to the same disclosure requirements. And of course, these issuers are subject to considerable political risks that places their source of revenue (whether it's direct tax revenue, cash flow from tolls or fees, or a line-item appropriation) at risk at any time.

Now, we don't mean to imply that all corporate bonds are attractive and all government bonds are poor. Obviously, there are very high quality government bonds out there just as there are corporations whose bond holders are in imminent danger of not receiving a coupon or principal payment that is due to them. The difference is that, in the current environment, where debt has been shifted to the public sector where revenue dollars are a highly coveted commodity, and where we cannot rely on any outside agency to provide reliable credit work, corporate credits are the better long-term investment.