

Congress Asset Management Company



Fixed Income Outlook

Tumultuous Times for Fixed Income

First Quarter, 2012

Our 3Q-2011 outlook was titled, “Volatility: Accept It Because It Is Likely Here to Stay.” I must admit that when that was written six months ago, I had no idea of the magnitude of fixed income turmoil that lay ahead for the remainder of 2011. As we start a new calendar year, I do not think that we will underestimate the potential problems that lie ahead. We have no crystal ball here at Congress Asset. However, we do look at various factors, events and possibilities in an attempt to picture the potential outcomes and risks that lie ahead of us. In the fixed income markets, there are currently so many potential problems which could provide large negative effects on the global markets and economy.

At the risk of sounding obvious, the Euro crisis is still at the forefront of problems. The technocrats associated with the European Central Bank and European countries continue to try their best to avoid addressing the critical problem (solvency). Instead, their focus has been on the resultant symptoms (liquidity). This avoidance goes against a common-sense lesson that most everyone learned in Kindergarten. That is, the best time to fix a problem is early, *before* the problem becomes larger. Many believe that Europe’s hesitancy in fixing their problems will likely lead the region into a recession with the potential lead the global economy into a recession.

Related to Europe, but located back at home, another worry has recently arisen. The Federal Reserve is now doing a back-door bailout of European banks via a reduction in the dollar swap rate. At a time when the domestic economy is showing signs of stabilizing, this could be quite detrimental in many ways. First, the Fed action will cause a loss of potential earnings that could have been received at the higher swap rate via the

massive inflows from Euro-related regions. Second, the political and social risks associated with this are very high. At a time when the “Occupy” groups and many Americans are vociferously voicing their opposition to the bailout of American banks for the risky behavior in the past few years, the Fed turns around and attempts to bail out European banks with American taxpayer money. If the fear at the Fed is that a failure among one or more European banks will eventually cause the failure of one or more U.S. banks, why not save this monetary tool to stabilize the domestic banks if it will eventually be needed? Europe has shown absolutely no ability to wisely use the funds it has already received from the IMF, World Bank, et al. to stabilize the situations in Greece, Italy, etc. The Fed is a frustrating entity to investment professionals and the general populace here in the U.S.

Here at Congress Asset, we have learned from many years of experience that we should look at all the potential market factors collectively. While cognizant of the risk associated with each factor, a failure to consider all factors collectively can often be harmful to portfolio returns.

Credit markets have just ended an exhausting quarter of extreme volatility in spreads. The Barclays U.S. Credit Index ended the last quarter of 2011 with an excess return to Treasuries near 0%. However, that figure fails to reflect the extreme movements in spreads throughout the period. Both October and December experienced relatively healthy positive excess returns. However, a very harsh negative excess return in November completely offset these two other months’ performances. For the one-year period, the Credit Index experienced a poor excess return of near -3.0%.

At the beginning of the fourth quarter, we had recently completed a significant reduction in our exposure to U.S. banks and finance companies. Those securities in this sector that we hold are in relatively low-beta, highly-rated issuers. This did help reduce the volatility in excess returns which occurred in this sector during the fourth quarter. We are comfortable in foregoing some incremental yield in this sector for a greater comfort level in our holdings.

Although there is some room for interest rates to go lower, there is a floor below yields which will keep them from falling but so far. Unlike short-maturity Treasury issues, the 10-year nominal Treasury note is unlikely to ever experience a negative yield. The Fed would print enough money to prevent such an extreme liquidity crunch. There are currently quite a few “yield grabbers” in the investment grade universe who fail to understand- or choose to overlook- the risk associated with a potential market crisis and the resulting flight to quality. In this sense, the high grade fixed income market environment feels very similar to that of 2006-2007. What many investors fail to recognize- or remember- is that at some point in a “risk-off” scenario, the potential returns associated with a stressed bond become binary. In other words, a security under duress can reach a level where the assumed outcome by the market is that the security will return its principal at maturity *or* the security will default. The price in the latter scenario will

then be associated with an assumed recovery value basis which may be 40%- or much lower- of the face value of the security. Our view of investment grade fixed income portfolio management is that we should try our best to keep our clients’ funds safe and maximize the *risk-adjusted* returns, not to maximize return without a consideration of the risk incurred.

We are continuing to favor higher quality corporate bonds, short/intermediate maturity U.S. Treasuries and select short average life commercial mortgage-backed securities (CMBS) in our client’s portfolios. The sensitivity of Agency pass-through residential mortgage-backed securities (RMBS) continues to offer very little *risk-adjusted* return—but lots of risk. We believe that maximizing the risk-adjusted returns for our clients is the prudent action in *every* environment. Given what we believe is a current market environment that offers little potential upside and substantial potential downside, we will focus on making sure that our client’s funds are liquid and the capital is safe.

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