Walking Down the Fixed Income Balance Beam

The first quarter of 2011 saw a continued prevalence of the risk trade which occurred in 2009 and 2010. Risk aversion seemed to disappear at times. Although this search for yield is somewhat reminiscent of 2006, the market may have squeezed most of the "juice out of the lemon" to the point where very little capacity now exists for making lemonade.

With March going down in history as one of the months with the largest amount of new corporate debt issuance, it is quite obvious that there is a rush by corporate treasurers to issue debt as soon as possible. In our opinion, this is an effort to lock in lower all-in rates but also an attempt to do it while the market is still receptive. This March was different from this month in years past in that of the new issues, a high percentage consisted of extremely low quality issuers. This appears to be an adroit move by the issuers of these risky companies- if they can ultimately service the debt. However, the continuing reach for yield without considering the potential risk is quite troubling from an investors' point of view. We were surprised on some occasions to learn of new issues of relatively obscure companies that either we did not think could issue debt or we had previously never heard of the companies.

However, we know that the market is what it is- a clearing level where someone is willing to buy and someone is willing to sell. Unlike several investors, we are fully aware that there is no guarantee that the market will seem, or even come close on occasions, to being rational. We accept the market for what it is and include this awareness in our decision making process which is focused on potential return per unit of risk incurred. We have never deviated from this philosophy and have no plans to do so in the future. History has shown that managers, who fear being left behind in a momentum market and ultimately change from their relative value philosophy, will often capitulate and make the change at exactly the worst time and ultimately get whipsawed by the market. Many times, this violent underperformance is something from which the manager can never recover. Plus, today's current fixed income market leads us to believe that the future, looking solely at credit spreads in the market, has a potential relative return distribution that is very asymmetrical. In simpler terms, the potential downside of relative underperformance (or opportunity cost) by not participating in a yield reaching manner is considerably less than the potential upside of relative outperformance. Our internally-generated stress tests have consistently shown this type of potential return distribution pattern for the past couple of months.

On the other hand, corporate balance sheets as a whole look very healthy with high levels of cash on hand. The difficult dilemma that we now find is trying to determine which corporate issuers will use this cash to improve or maintain their credit rating versus those that will use cash and bond proceeds in an equity-friendly effort to stabilize or improve the company's stock price. Of course, the latter always comes at the expense of bondholders. To address this dilemma, we have tried to hold higher quality names that we believe will not be active in the mergers and acquisitions (M&A) market. This can be very difficult as knowing which companies will be active in this area is impossible to know with certainty. However, we like to look at the history of the company's management to see whether they are more bondholder friendly or equity friendly in their past corporate actions. We also like to examine the maturity schedule of debt and its distribution for a company to see how much debt will be maturing in the next year or two. Another item evaluated is generation of free cash flow and the trend of this value. It seems somewhat contradictory but we like companies that have strong and improving free cash flow generation- but not companies with extraordinarily high free cash flow generation and high cash on hand. The latter group will be under extreme pressure from equity holders and may take actions that ultimately harm bondholders.

If these items were not enough for a bond manger to consider, we have the circus known as U.S. politics becoming a large influence in the possible direction of rates. On one hand, the government needs to stop (or at least reduce the rate of increase) in spending. On the other hand, raising the limit on the debt ceiling is being discussed between members of the two major political parties. If the debt ceiling is raised, it allows for more spending. Yet if it is not raised, the country's growth could be hampered and lead to a double-dip recession. For lack of a better term, "between a rock and hard place" is where we find ourselves in the U.S. However, we can thank our political leaders on both sides of the aisle and in numerous administrations for letting this problem develop and grow over the years without anyone having the fortitude to make the necessary changes- regardless of how unpalatable they may seem to be. Neither an ostrich with his head in the sand or Nero fiddling while Rome burned has anything on our political system and leaders.

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And let us not forget one extremely important market influencer. We have our omniscient, prescient Federal Reserve doing so much behind the scenes to effectively "print more money" which has and will result in a devaluation of the U.S. dollar. With many commodities (crude oil, timber, precious metals, etc.) around the world priced in U.S. dollar terms, there has to be an inflationary influence. At the risk of being overly snide, we must say that we feel quite at ease when the Fed Chairman tells us that he has "100% confidence" that the Fed can be proactive and make the necessary moves to prevent higher than desired inflation from developing. Seriously, what is really worrisome to us is that we think that the Fed really does believe that it can be this proactive. This type of rhetoric is coming from an entity that could not see numerous asset bubbles develop right in front of their eyes over the past two decades. If a blind man was also looking for inflation and/or asset bubbles, I'd place even odds that he would see these things coming before the Fed would.

So what we end up with is a very unstable, precarious situation for not only fixed income but all asset classes. Will inflation become too high (or become hyperinflation) or will inflationary pressures lead to pressures on corporate margins and consumer spending and ultimately throw us back towards or into another recession? Or will there be a combination of these possible scenarios and we find the U.S. in a stagflation environment? What adds to the difficulty in making portfolio decisions is that several factors which are involved include actions by government entities. These actions are extremely unpredictable.

We, at Congress Asset Management, currently believe that select corporate credits on specific parts of the yield curve remain attractive in relative terms. Although we are overweight in corporate debt, we have pared some of our risk in this area and moved higher in quality. We also have maintained our underweight position in U.S. Treasuries and Agency debentures- a positioning that we have had in place for the past nine months. Residential mortgage-backed securities, although aided by decreased supply over the past two years, are deemed unattractive on a spread basis but are also subject to very significant extension risk. We continue to underweight these securities while maintaining exposure to extremely seasoned (2001-2004 vintages), short average life, commercial mortgage-backed securities with low overall LTV ratios and very high collateral support from the subordinated tranches.

While adhering to our historical investment philosophy focusing on relative value, risk-adjusted returns, and capital preservation, we believe that our ability to select the "attractive" securities from the "unattractive" securities will help us successfully navigate through the coming months and year.

In our opinion, all fixed income managers should take this approach. But as history has shown, many managers are willing to incur a tremendous amount of risk in an attempt to gain an insignificant increment in return. As stated previously, this usually ends up badly for these types of managers and their clients. We at Congress Asset Management are investing for the benefit of our clients—which we hope to retain for a very, very long time. With all the potential market and economic pitfalls mentioned above, we will remain cautious and vigilant in today's environment. We will try to carefully walk down the fixed income balance beam.

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