

Congress Asset Management Company



Fixed Income Outlook

This Isn't Your Father's Beta

Fourth Quarter, 2011

Three months ago, we released our 3Q- 2011 outlook which was titled, "Volatility: Accept It Because It Is Likely Here to Stay." Little did we know at that time how quickly our expectations would be fulfilled. The credit market took a quick turn for the worst in August as the month ended up being the third worst month ever for the relative return of credit (only two months in 2008 ranked worse). Although not as bad as August, September was also an extremely poor month for credit.

The impasse over the federal budget started in the first week of August. Once this fiasco was "resolved" (or pushed back a few months), the never-ending Greek debt crisis reared its ugly head again. Although Greek (and other European sovereign) debt is a very important problem with potential worldwide effects which we do not take lightly, seeing it continuously come to the forefront of the market's attention is akin to watching a looped infomercial on a one channel television. It is nauseating to watch over and over again yet you cannot tune into another program. Watching the European government and financial leaders continuously fail to fully address this problem actually makes the dysfunctional U.S. political system seem somewhat efficient. However, investors monitoring global bank stocks and credit spreads may feel like they are on a wild amusement ride.

Here at Congress Asset, we are constantly discussing fundamentals, relative valuations, technicals and market sentiment. We have learned many things during our decades of managing fixed income portfolios. One thing we have learned is to look at all of these items collectively and not to focus solely upon one. We believe that some other

bond management firms fail to do this as they "silo" analysts, traders and portfolio managers in separate areas with little interaction among the groups. The ability to respond in a timely manner to rapidly changing markets becomes constrained. We recognize this limitation and encourage each group to interact with the others on a daily basis.

At the beginning of the third quarter, we had an overweight to US money center banks in some accounts as we deemed the fundamentals and relative valuations to be attractive and this was consistent with our clients' objectives. Near the end of the quarter, we still thought that these names were attractive from pure operating and relative value perspectives. However, we noticed that some issues that we put out for bid only received limited bids. Sometimes the only bid received was from the firm who issued the bond—with some sell-side firms not even submitting any bid. The "quoted" bid/ask spreads were extremely wide. Although the valuation and fundamentals seemed attractive, the technicals and market sentiment were the "warning signs" that something bad was about to occur. We sold the high beta names in this sector just before these spreads exploded. We were able to reduce this risk position before it became inextricable. Our experience helped us recognize the warning signs and enabled us to take action in a timely manner. At time of this writing, we plan to continue monitoring this sector to see if an attractive point occurs for investing.

Internally, we often reminisce about past years in the fixed income markets and what we thought and experienced when past crisis events did happen. We are amazed when we hear pundits in the

financial media state that “nothing like that will ever happen again” or “I will never see that again in my career.” If you are retiring as an investor at the end of that day, that may be true. Having been in the investment business since the early 1990s, I am amazed at how many “six standard deviation” events we have been through. If you stay around long enough, you will likely see another one.

Examples from the past few decades:

- Rates skyrocket as Volcker raises overnight rates in effort to contain inflation
 - Stock Market Crash of 1987
 - Savings & Loan crisis
 - First Gulf War and resulting inflation and recession
 - The mortgage market blowup in 1994 when the Fed consistently raised rates
 - The Mexican Peso crisis
 - Asian Contagion / Thai Baht devaluation
 - Long Term Capital Management failure and Russian default
 - Y2K (lots of buildup for a dud)
 - Pop of the tech bubble
 - 9/11/01, subsequent recession and blowout of credit spreads
 - 2007-2008 Great Financial Crisis (or any other name that you would prefer)
 - Ongoing Greek and Euro sovereign and banking debt crisis
 - Ongoing U.S. Government budget/deficit problems
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Let’s just accept it: Volatility has always been around. Many folks tend to either block out or have no experience with these past events. Since the US has been living off of debt for the past few decades, the time for fiscal restraint and/or austerity is coming (or is already here). We expect that there will likely be a long period of fundamental adjustment - or the “new normal” as many financial talking heads now call it. As occurred in the 1930s, there will likely be mini bull markets and mini bear markets, in both equity and fixed income markets, as we go through this adjustment period. Although it is possible for the general level of interest rates to go lower, there is a floor below yields which will keep them from falling 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 a severe liquidity crunch. Given the possible directional movements in yields, it is quite apparent that there is much more room for yields to rise (no ceiling) than for yields to fall. This is especially so given the amount of money flooding the system from the Fed. With such a relatively low level of interest rates which now exists, the price sensitivity is much greater now than when rates were higher. With yields starting at low levels, there is relatively little income generated to offset the price depreciation associated with rising yields.

We are currently focusing on higher quality corporate bonds and select short average life commercial mortgage-backed securities (MBS) for our credit exposure in our client’s portfolios. The sensitivity of agency pass-through MBS offers little risk-adjusted return—but lots of risk. We think that trying to maximize the risk-adjusted returns for our clients is the prudent action in any environment—especially so in today’s environment. We will not attempt to generate annualized returns of 15-20%, given the low level of rates and inherent risks. We would suggest that if an investor is seeking returns in this range today, they should look to other asset classes beside investment grade fixed income. Because in today’s market, it is easy to see that this isn’t your father’s beta.

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