“Crazy Happens”

The Fixed Income Markets in December 2008

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Macroeconomic Backdrop

- NBER on 12/1/08: Recession started in 12/2007
- Economy contracted 0.5% in 3q 2008
- November 2008 CPI fell 1.9%, following October's decline of 1.0% (November's decline is the largest monthly decline since 1932)
  - Deflation?
- FOMC minutes: lower growth, lower inflation, more rate cuts possible
- Bernanke battling the slowdown with lower Fed Funds
  - 0% target rate (lower end of the range) came a month earlier than we expected.
- Case-Shiller data: median home prices -18.0% over past year (a record).
- Unemployment rising
- Etc.

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Credit Market Comments

- Dislocation reigns in the credit markets
  - Yield spreads widest since 1930’s (some spreads are actually higher than in the 1930’s-depending on the type of spread-more on this later)
  - Absence of natural buyers + deleveraging + risk aversion = illiquidity
  - Wide bid/offer spreads (10-20 points not unusual)
  - “Your great-grandfather’s bond market”
- Default rates heading up (Moody’s projects 7.9% in 2009)
- Deleveraging/liquidity problems likely more important than credit quality right now
- Risk aversion is the dominant trade
- Inflation fears are nowhere to be found

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Current Yields

Treasurys

1-Year	2-Year	3-Year	5-Year	10-Year	30-Year
0.33%	0.77%	0.97%	1.55%	2.21%	2.68%

Source: Bloomberg. As of Dec. 31, 2008

Corporate Bond Yields by Rating

AAA	5.07%
AA	5.82%
A	7.45%
BBB	9.67%
< BBB	22.95%

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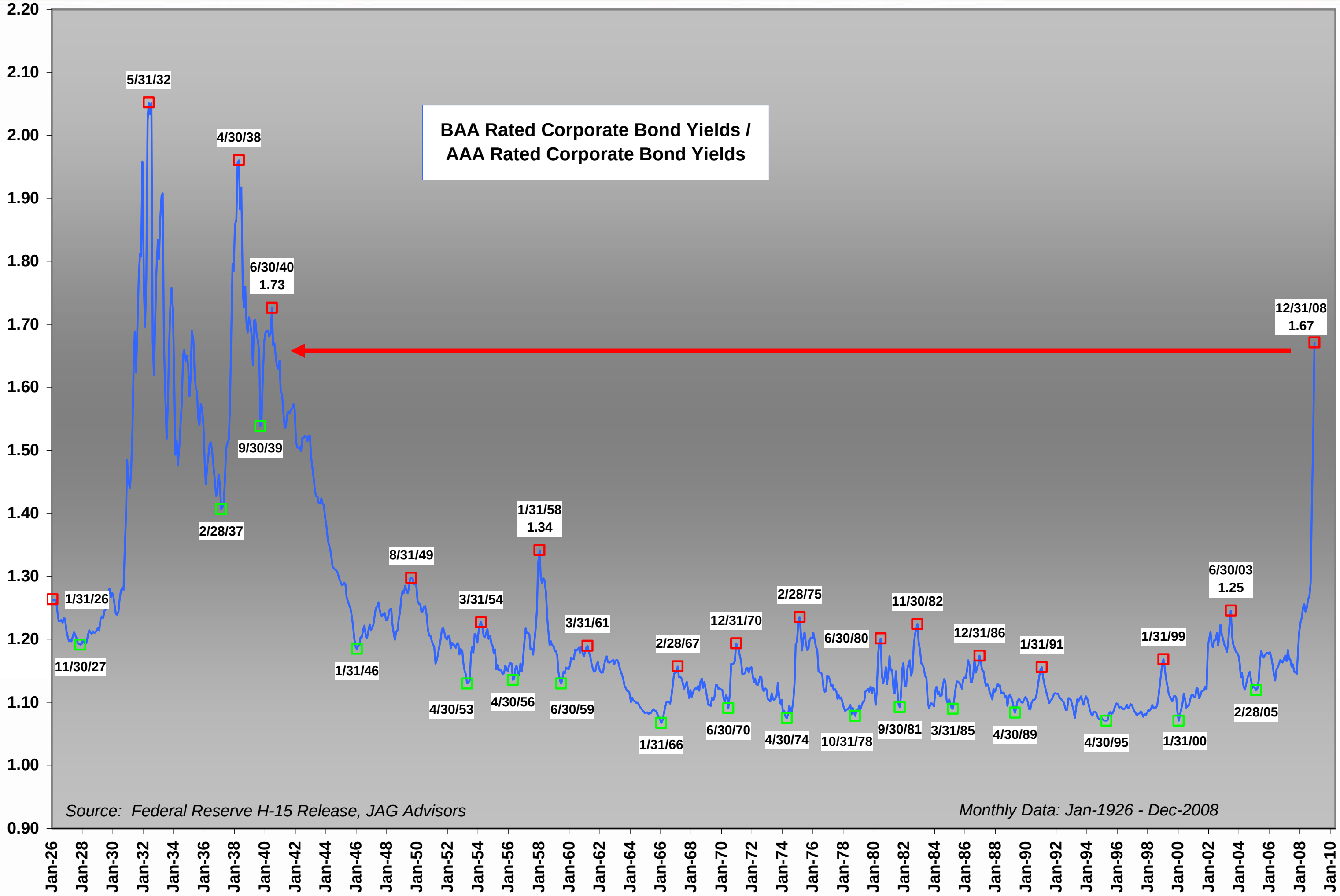
BAA/AAA Yield Ratios: Highest in 60+ Years



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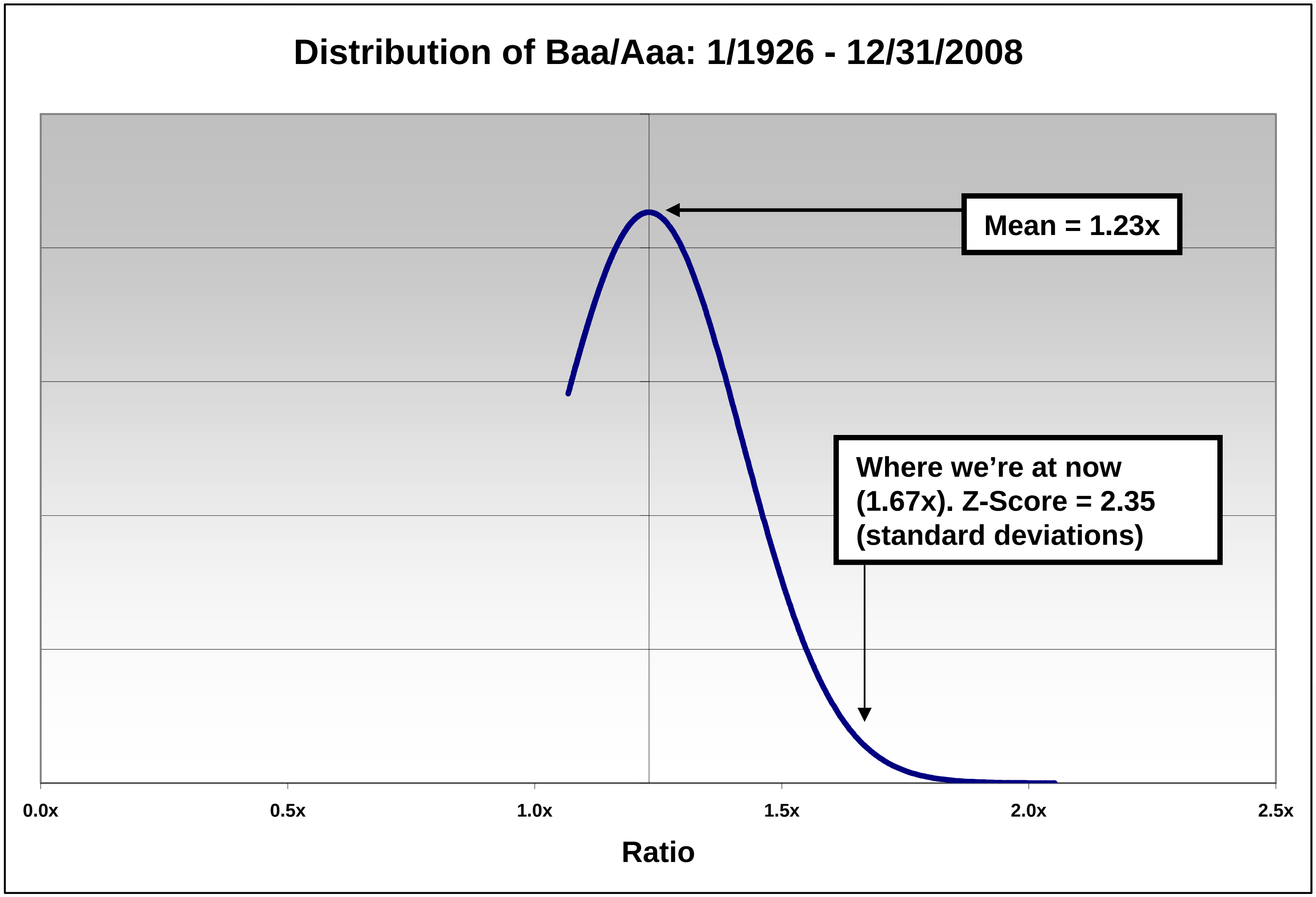
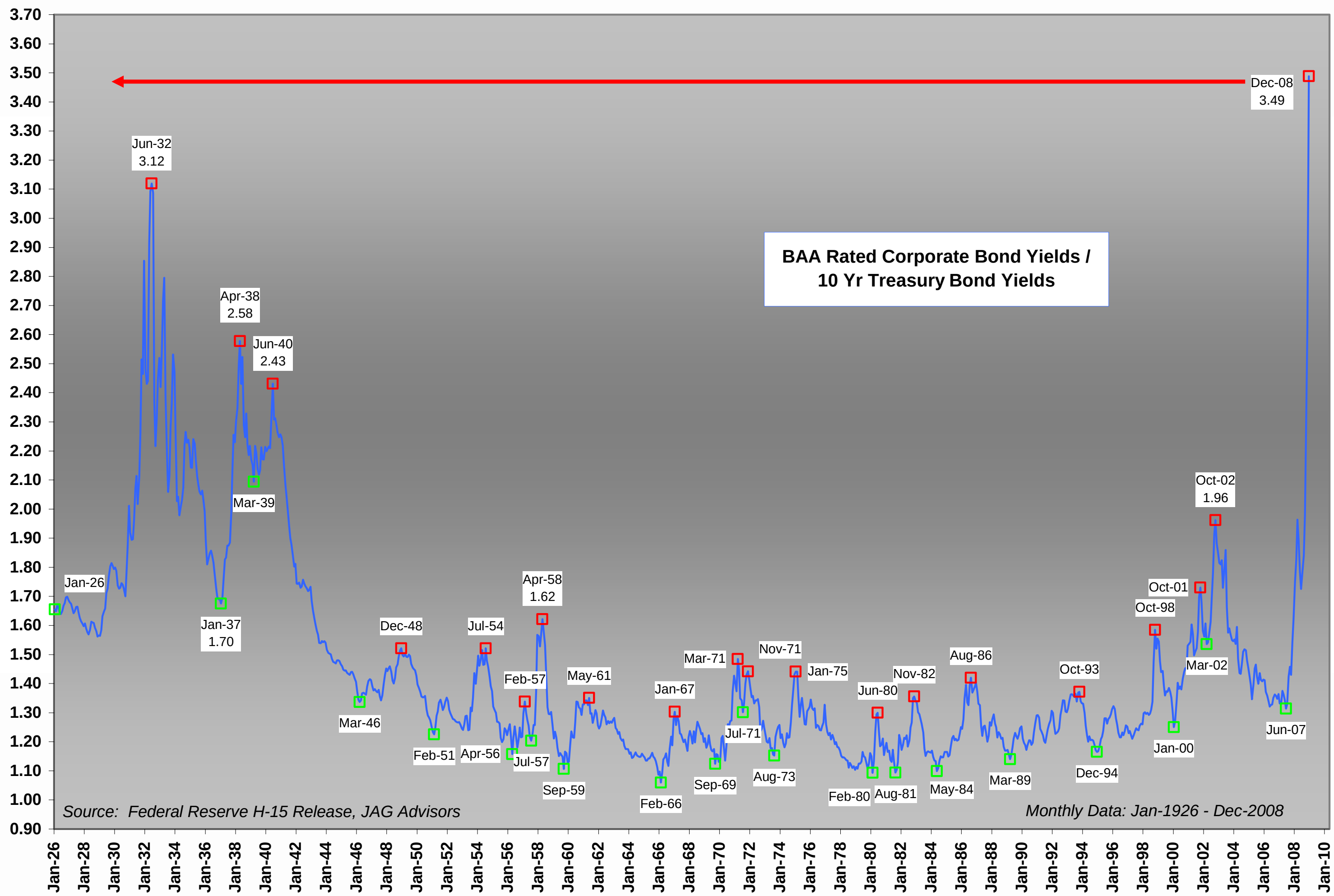
BAA/AAA Yield Ratios: Abnormal



BAA/Treasury Yield Ratios: Currently Exceeds Levels Attained During Great Depression



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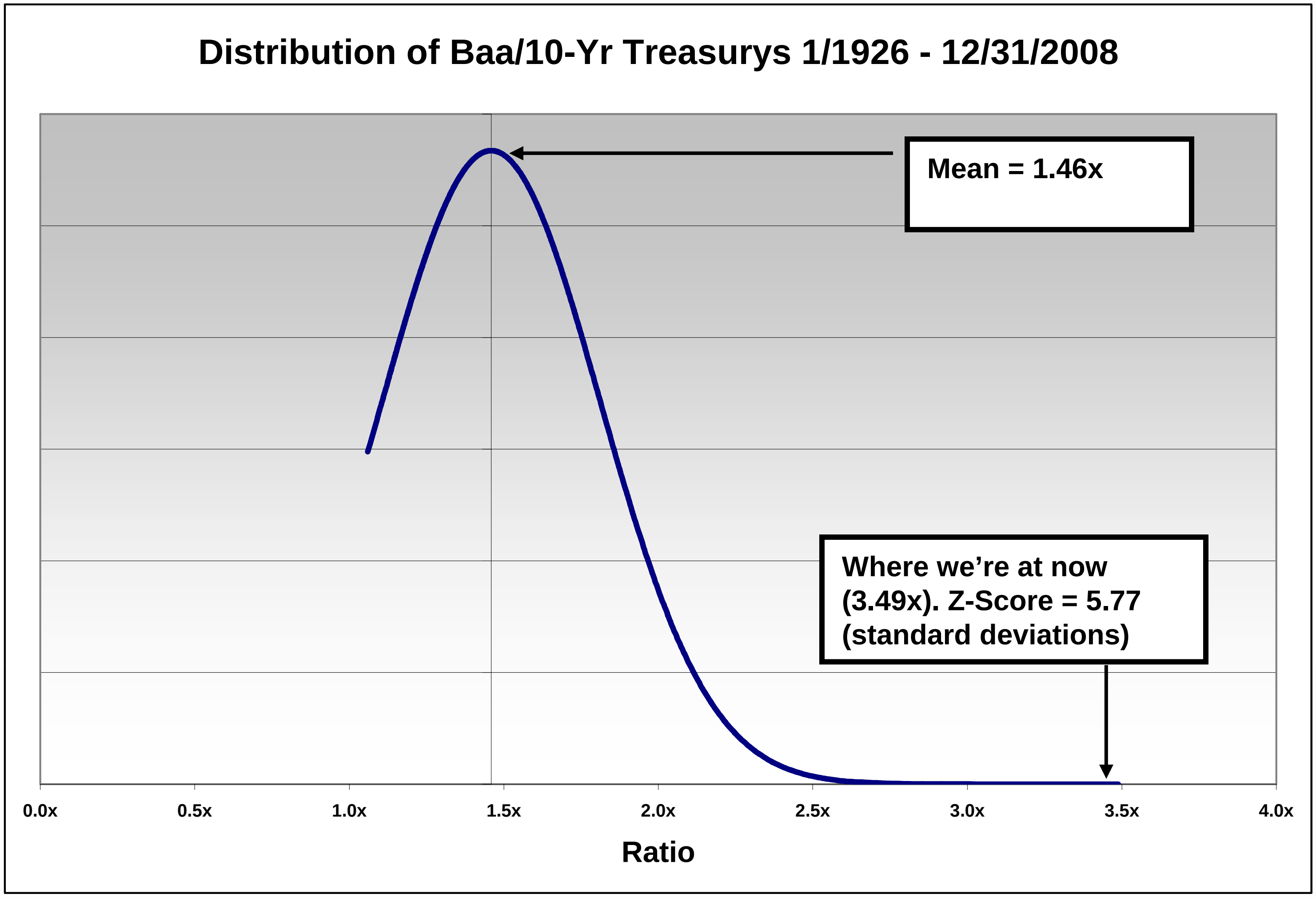
BAA/Treasury Yield Ratios: "WOW"



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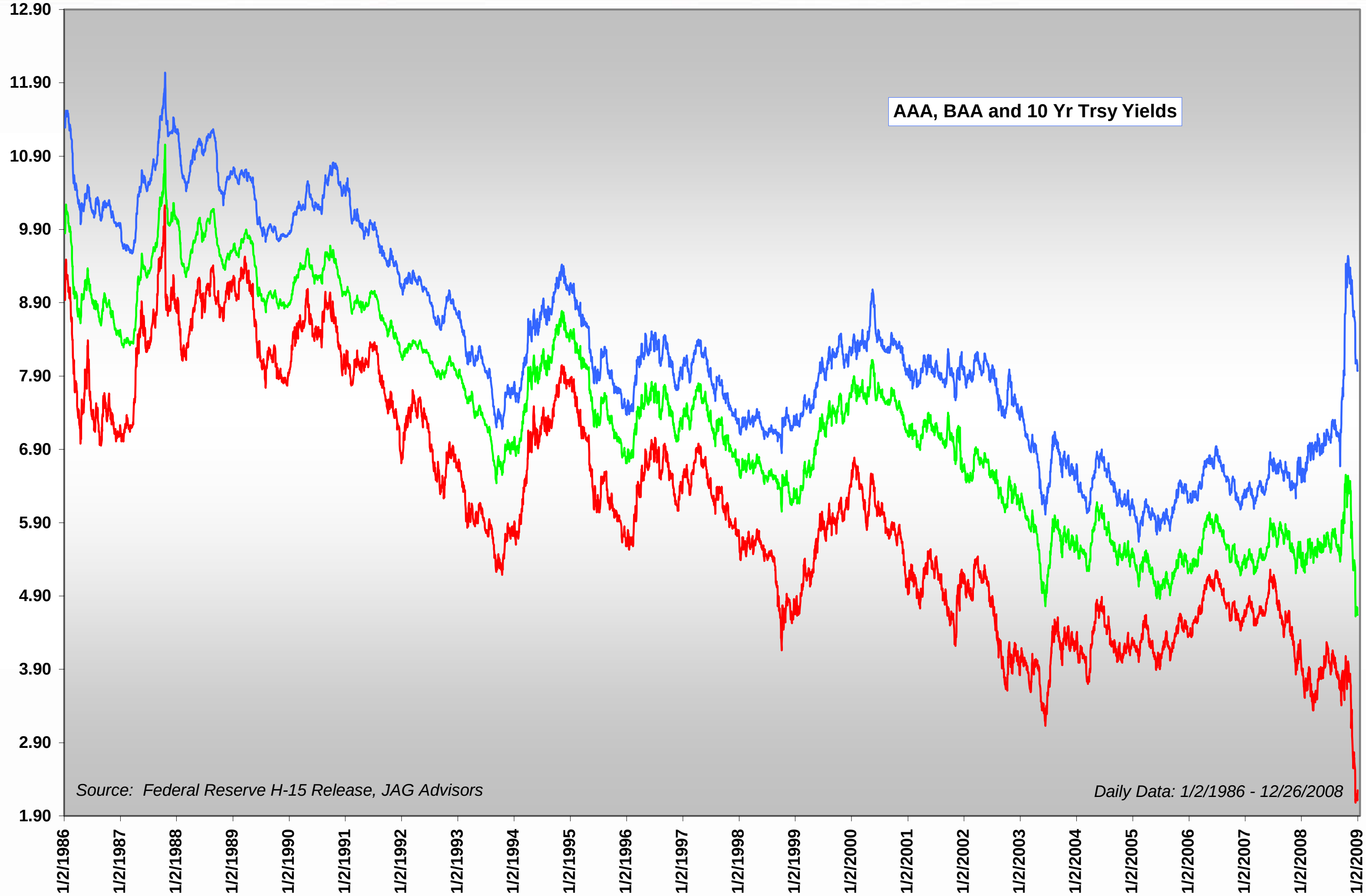
Yields: 1986 thru 2008



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Which Door to the Future?

Door # 1:
Depression

Door #2:
“Just” a deep recession,
with a recovery in the
not too distant future?

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Arguments *for* Door #1

- Against the backdrop of a severe economic decline, we have a new administration that embraces protectionism, wants to raise taxes on the “movers and shakers” of the economy, etc. (but see comments on next slide).
  - i.e. Capitalism is dead
- Trillions of dollars of toxic assets will drive continued deleveraging
- Negative deflationary feedback loop
  - Prices fall
  - Purchases delayed
  - Prices fall further
  - Asset values collapse
- Large banks & large insurance companies are still teetering
- Consumer in a tailspin with no end in sight

Arguments *Against* Door #1

- We have a much more sophisticated Federal Reserve system than we did before and during the Great Depression.
  - Massive Fed balance sheet increase is “different” than 1930-1933.
  - Government has recognized the problem sooner.
- Unemployment is much less than even the 10.8% reached in 1980s.
- Obama has hired a what appears to be a strong, centric economic team.
  - Corporate and individual tax rates remain a question mark.
  - Protectionism will likely be muted… Obama “gets it.”
- Productivity is much higher than it was back in the 1930’s because of automation and technology.

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Arguments *for* Door #2

- See "Arguments *Against* Door # 1"

Arguments *Against* Door #2

- See “Arguments *for* Door #1”
- Situation is binary

JAG's Outlook

- We think Door #2 is the more likely outcome.
- However…

Implications of Depression Scenario

Yikes!

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Implications of a Depression Scenario

- If you believe that we are in for a depression anywhere near the magnitude of the Great Depression, then you would want to invest only in U.S. Treasurys (and possibly sovereign debt of other advanced countries).
- This scenario would likely result in spread-product defaults at cataclysmic levels.
- During 1929 to 1933, approximately 21% of corporations defaulted on their debt (source: the U.S. Bureau of Economic Analysis).
- At one point in 1932, BAA debt was yielding more than 3 times 10-Year Treasury Yields (and we're at that level again, but much of the magnitude this time appears to be from deleveraging).

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Implications of the Recession Scenario

- You quite possibly have an excellent opportunity to earn “equity-like” returns via investment grade debt.
  - “Get paid while you wait”
  - Enjoy more seniority in capital structure
- Opportunity is created by the delta between market prices and economic outcome
  - Corporate debt is priced for depression
  - If depression does not arrive, debt spreads must tighten significantly – and this will happen quickly
  - *While there would likely be some isolated defaults associated with certain issuers currently rated in the investment grade arena, the gains earned over time from contracting spreads should overwhelm the loss from any defaults—in an adequately diversified portfolio.*

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Conclusions & Opinions

- Corporate bonds are priced as though a depression is imminent. We haven’t seen spreads of this nature since the 1930’s (In fact, some spreads are in excess of those experienced in the 1930’s).
- We (along with most financial professionals) believe a depression is unlikely (in fact, much of the enormity of spreads can be explained by liquidity issues and deleveraging).
- If you agree that a depression is not in the near-term future, then you would probably agree that the corporate bond market is *likely* poised to experience unusually high returns.
- Scariest trade in the world right now: long-term Treasurys.
- Credit-focused portfolios could provide a “happy medium” between cash equivalents and equities.
- Remember the KISS principle!

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Representative Example

- Several examples of potential total returns can be presented under certain corporate-bond/benchmark spread scenarios, particularly given that there is more than one moving part: Treasury yields will change AND corporate bond yields will change.
- For simplicity's sake, we present one example:
    - Using a Treasury yield of 2.19%
    - We examine a fictional, ten-year corporate bullet bond with a 5% coupon.
    - Assume that the bond is priced at $845.83, which offers a spread of 500 bps (implying a yield of 7.19%).
    - Assume that, subsequently, the Treasury yield increases by 200 bps and that the corporate bond's spread to the Treasury moves to 300 bps (implying a 6.19% yield on the corporate bond).
- First, let's look at a table of possible one-year returns…

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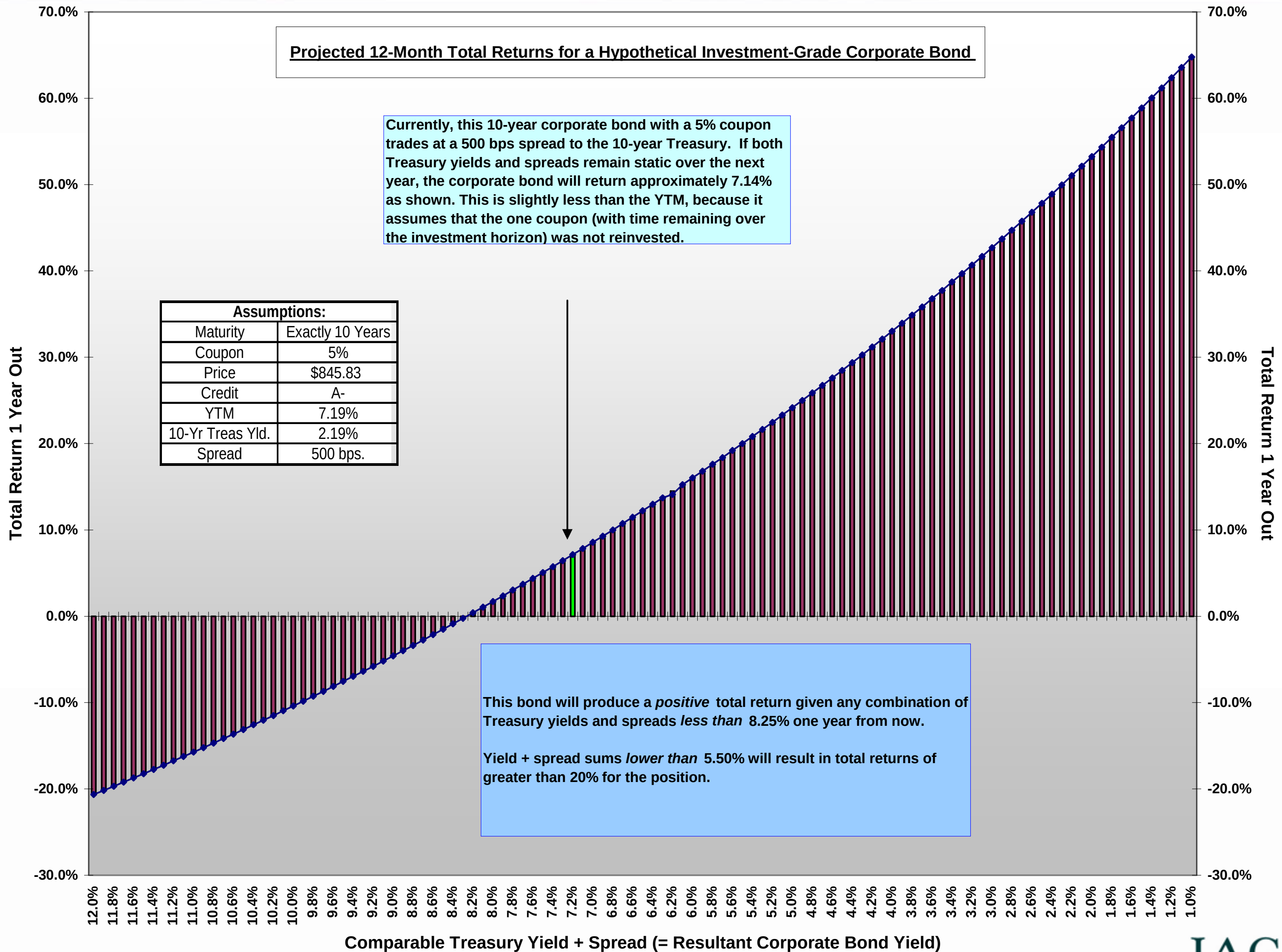
Illustration of Potential One-Year Total Returns



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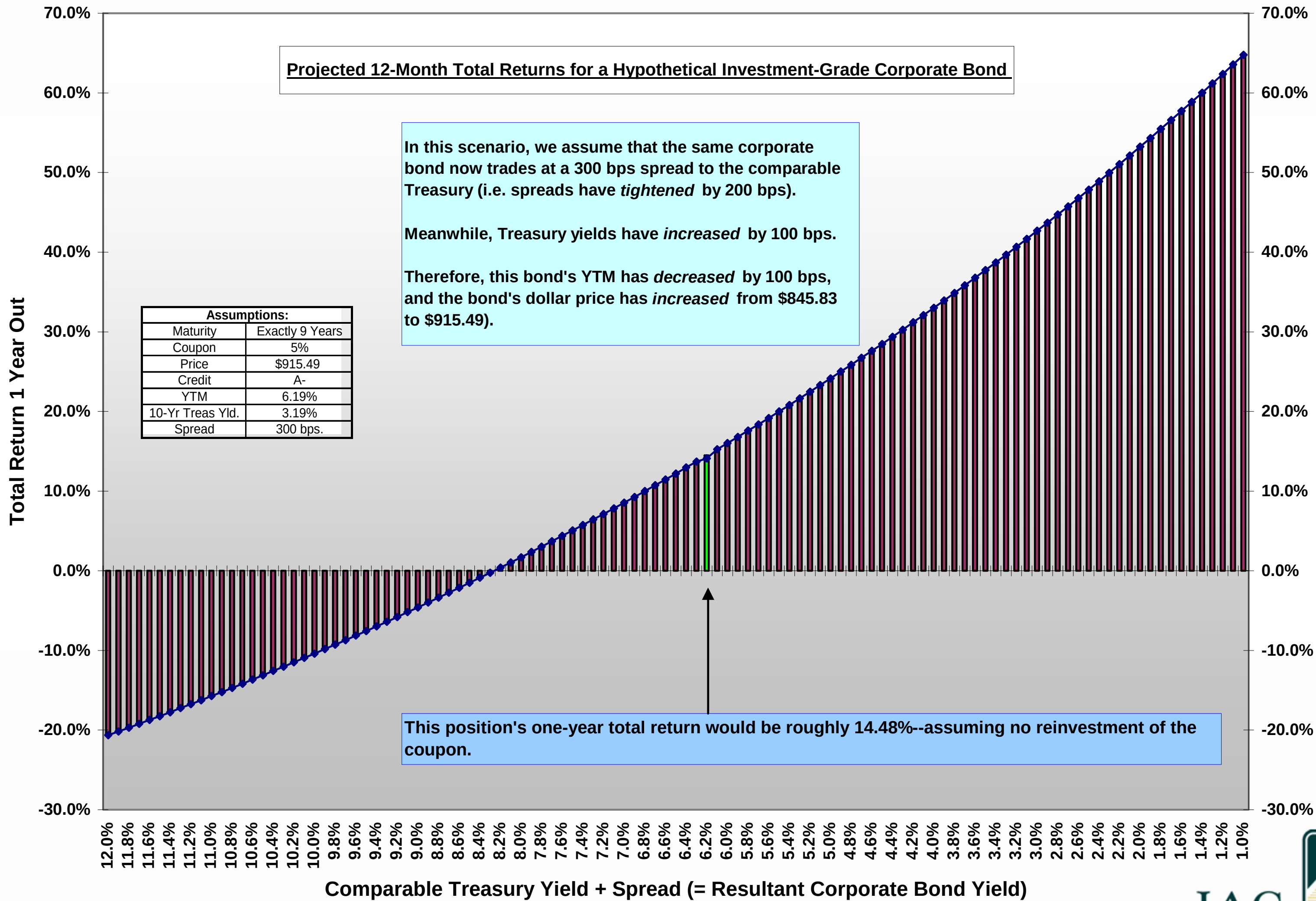
An Example One-Year Total Return Using the Aforementioned Assumptions



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JAG Style Notes

- We overweight corporate debt relative to the benchmark in an effort to enhance returns over the long term.
- Our current weightings in our model portfolio versus two indexes:

	JAG Model	Barclays Int. Govt/Credit	Barclays Aggregate
Cash	2.40%	0.00%	0.00%
Finance:	25.70%	13.92%	7.15%
Industrials:	23.00%	14.09%	8.86%
Utilities:	16.90%	2.91%	1.99%
Treasurys:	17.00%	41.91%	22.94%
U.S. Govt. Agencies	15.00%	20.07%	12.87%
Mortgage Backed	0.00%	0.00%	36.88%
ABS	0.00%	0.00%	0.72%
CMBS	0.00%	0.00%	4.60%
Sovereign	0.00%	1.51%	1.10%
Supranational	0.00%	2.23%	1.03%
Foreign Local Govt.	0.00%	0.80%	0.69%
Foreign Agency	0.00%	2.56%	1.17%
Taxable Muni	0.00%	0.00%	0.00%
Total	100.00%	100.00%	100.00%
Total Corporate	65.60%	30.92%	18.01%
As of December 31, 2008			

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JAG Style Notes

JAG Enchanced Core Fixed Income Selected Statistics

As of December 31, 2008

	JAG	BIGC	BAGG
Average Coupon	5.89%	4.84%	5.32%
Yield to Worst	6.19%	4.56%	5.27%
Modified Duration	3.71	3.82	3.71
Effective Duration	3.85	3.81	3.94
Convexity	0.29	0.20	-0.37
Current Yield	6.10%	4.53%	5.11%

Note: BIGC = Barclays Intermediate Gov/Credit Index (formerly Lehman)
BAGG = Barclays Aggregate Index (formerly Lehman)

- Please note the following characteristics of our ECFI composite versus the Barclays Intermediate Government/Credit and Barclays Aggregate indexes:
  - Higher yield
  - Greater convexity

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Comments on JAG's Style

- If our assumptions are correct, our management style should be poised to capture very competitive returns when/if credit spreads contract to more normal levels (or near-normal levels).
- Bond portfolios that are heavily postured toward corporate debt could stand to earn unprecedented returns in the fixed income arena.
- Investors would be better served by pursuing these returns via a professional manager rather than haphazardly accumulating bonds in a regular retail account.
- Do you have clients who could benefit from such a posture?

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One More Idea: TIPS

- TIPS may provide a unique opportunity in the coming months.
  - They are priced as though deflation will continue for quite some time.
- Massive infusion of governmental capital will likely reignite inflation within the next 12-24 months (but not immediately).
- If this assumption is correct, TIPS should outperform fixed-coupon Treasuries.
  - We are actively evaluating the TIPS markets for opportunity.
  - Focus is on tax-deferred and tax-exempt mandates.
  - Timing is important.

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TIPS Example

- 1.375% TIPS due 7/15/2018.

  Given where the bond was priced at on 11/20/2008 (87.761 plus accrued interest), the following are the yields we calculated given various inflation assumptions (the returns are rough calculations):

  - 2% inflation: 4.87%
  - -2% inflation: 2.68%
  - 4% inflation: 6.83%

- Currently, fixed coupon Treasuries with approximately the same maturity are yielding 2.7% to maturity.

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