

Ironies and Opportunities

Credit Market Thoughts

November 2011

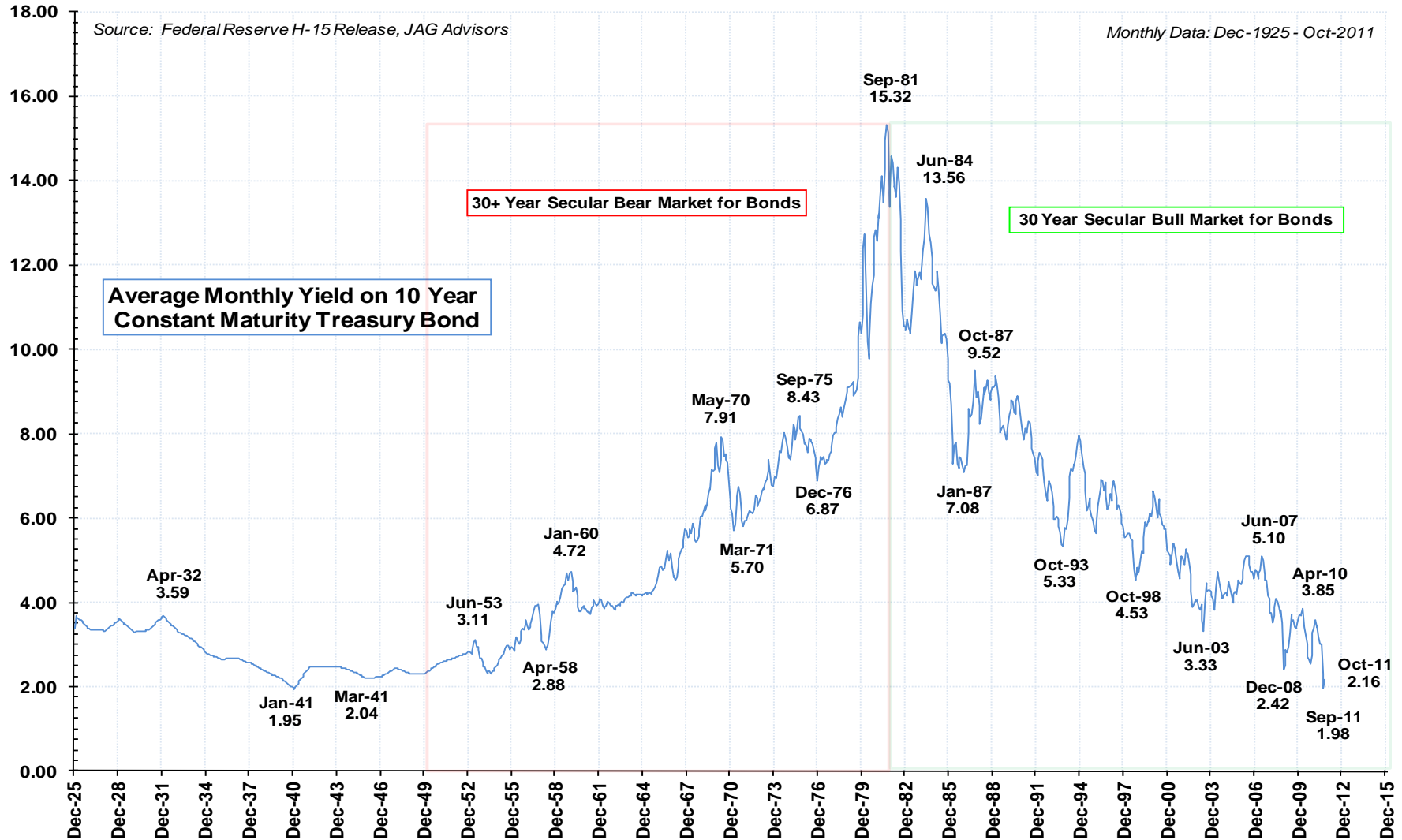


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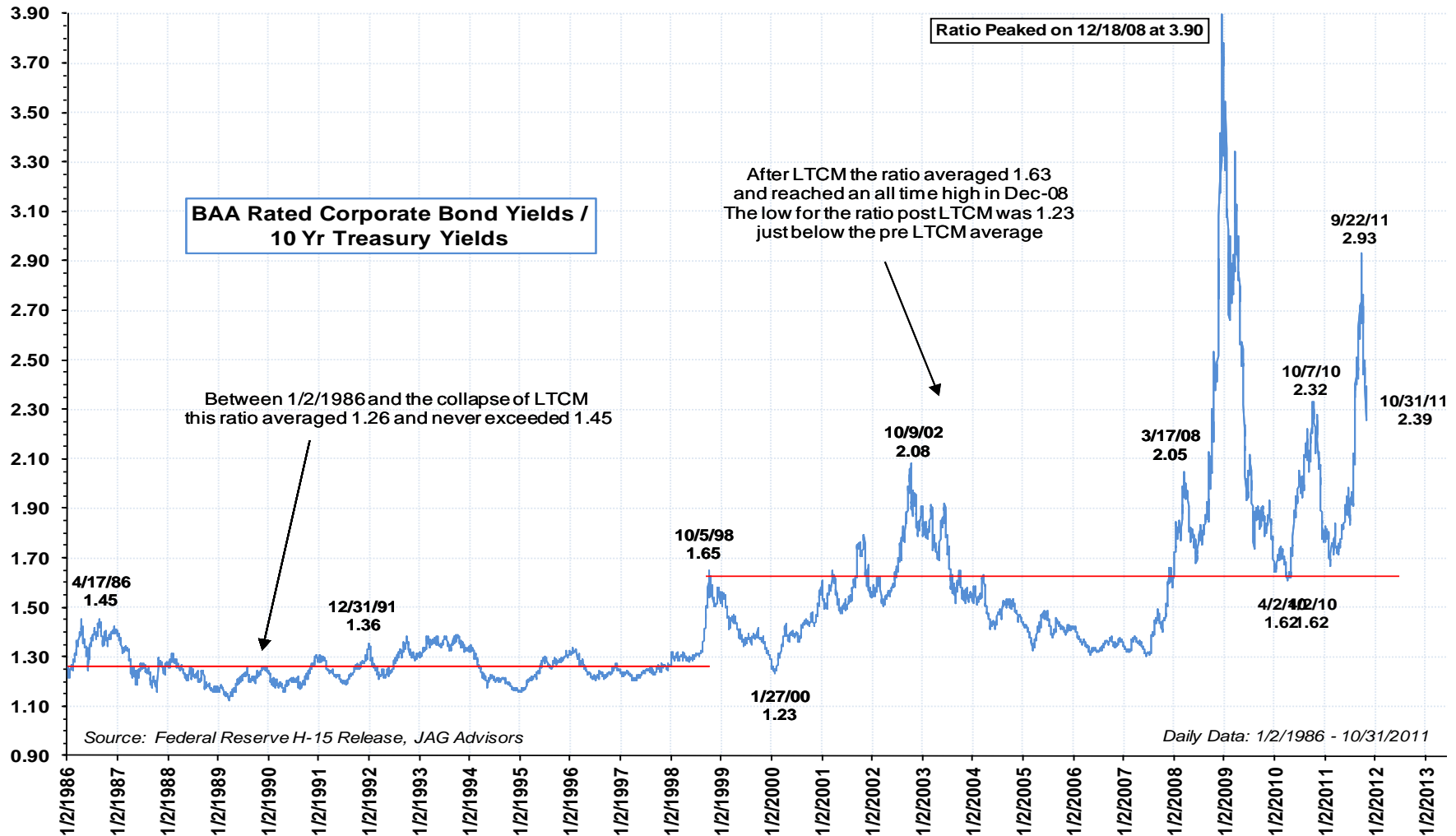
Bond Market Ironies

1. Demand for Treasuries has remained strong in 2011... despite historically meager yields and cloudy deficit/inflation outlook
2. Demand for corporates (both IG & HY) fell sharply last quarter...despite strong corporate fundamentals, low default rates, and more competitive yields
3. Appetite for duration risk remains high... in spite of dubious risk/reward potential for long-duration assets
4. Appetite for credit remains suspect... in spite of improved risk/reward potential for corporate sector

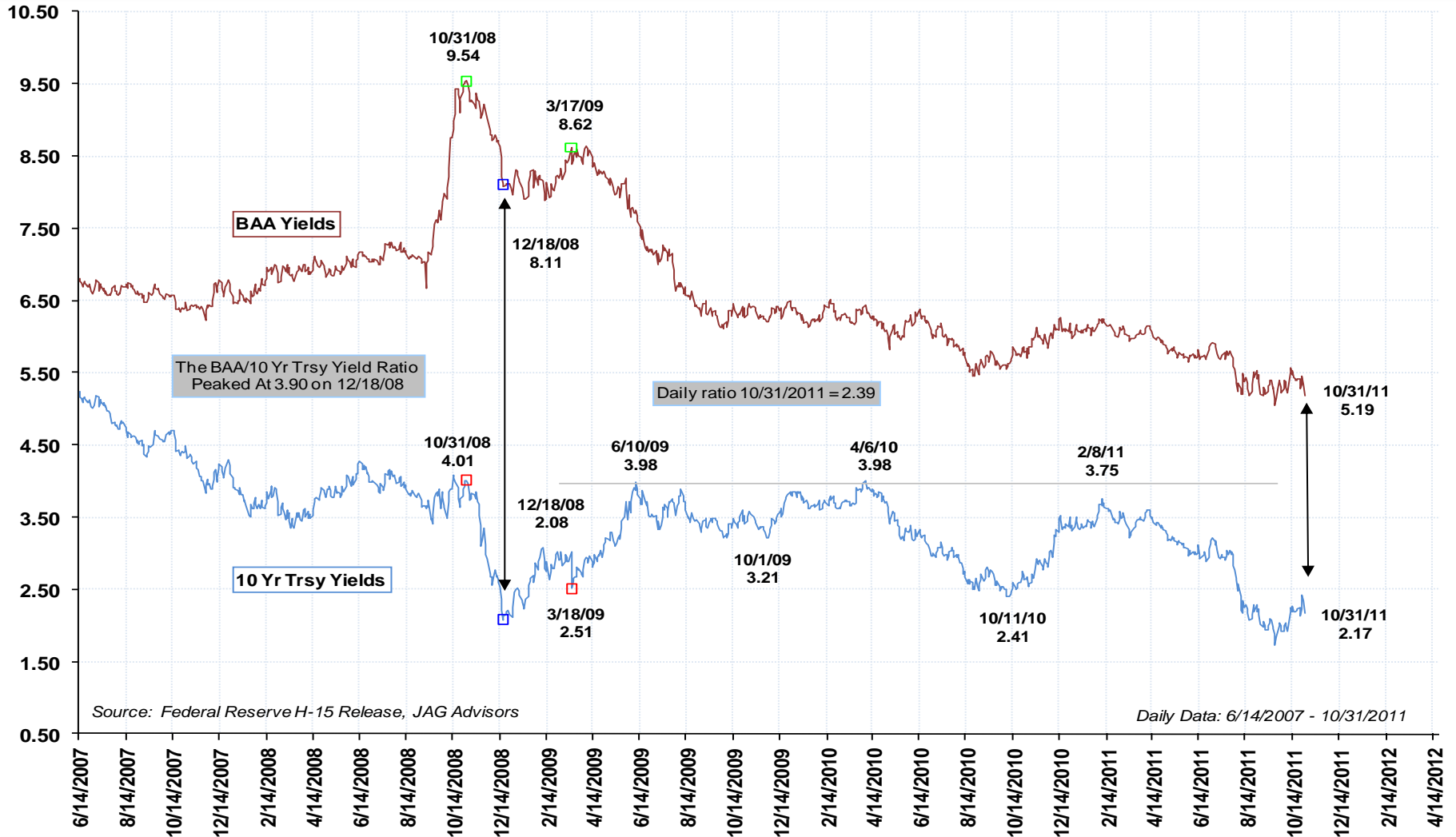
“Risk Off” Trade Collapsed Treasury Yields



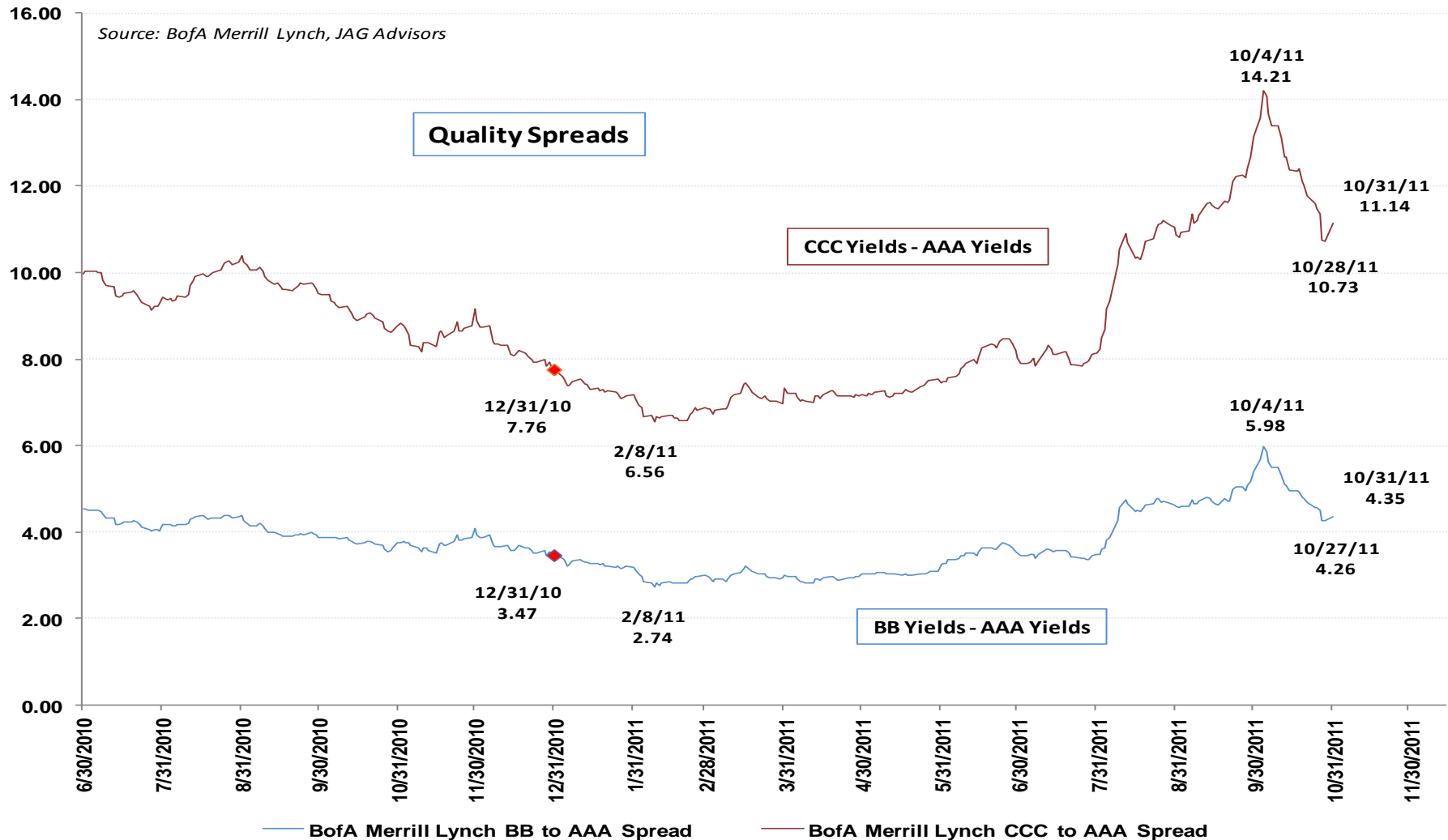
“Risk Off:” BAA/10 Yr Ratio Spiked to 2009 Levels



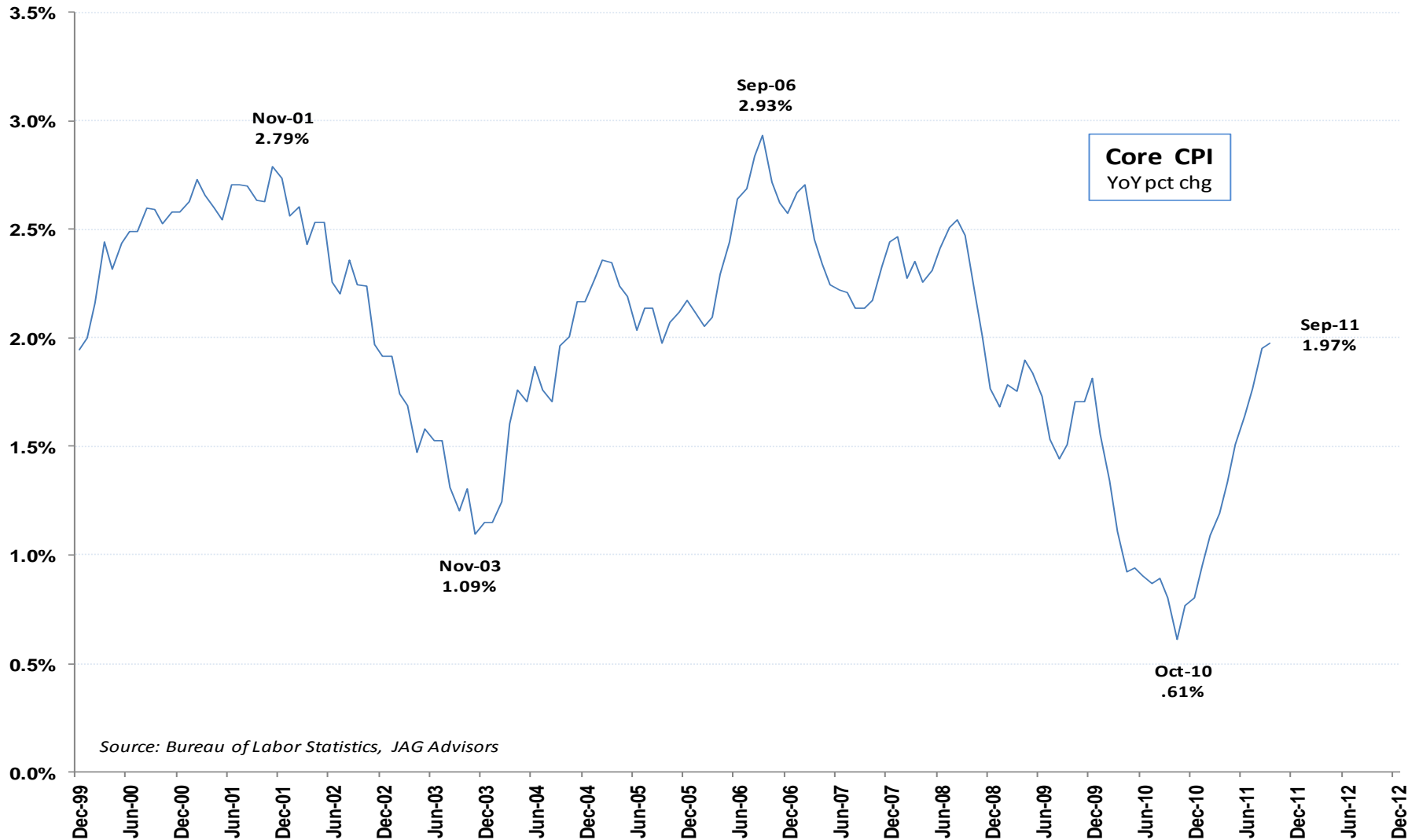
“Risk Off”: BAA/10-Year Yields Diverged in 3q 2011



“Risk Off”: BB’s and CCC’s Widened Versus AAA’s



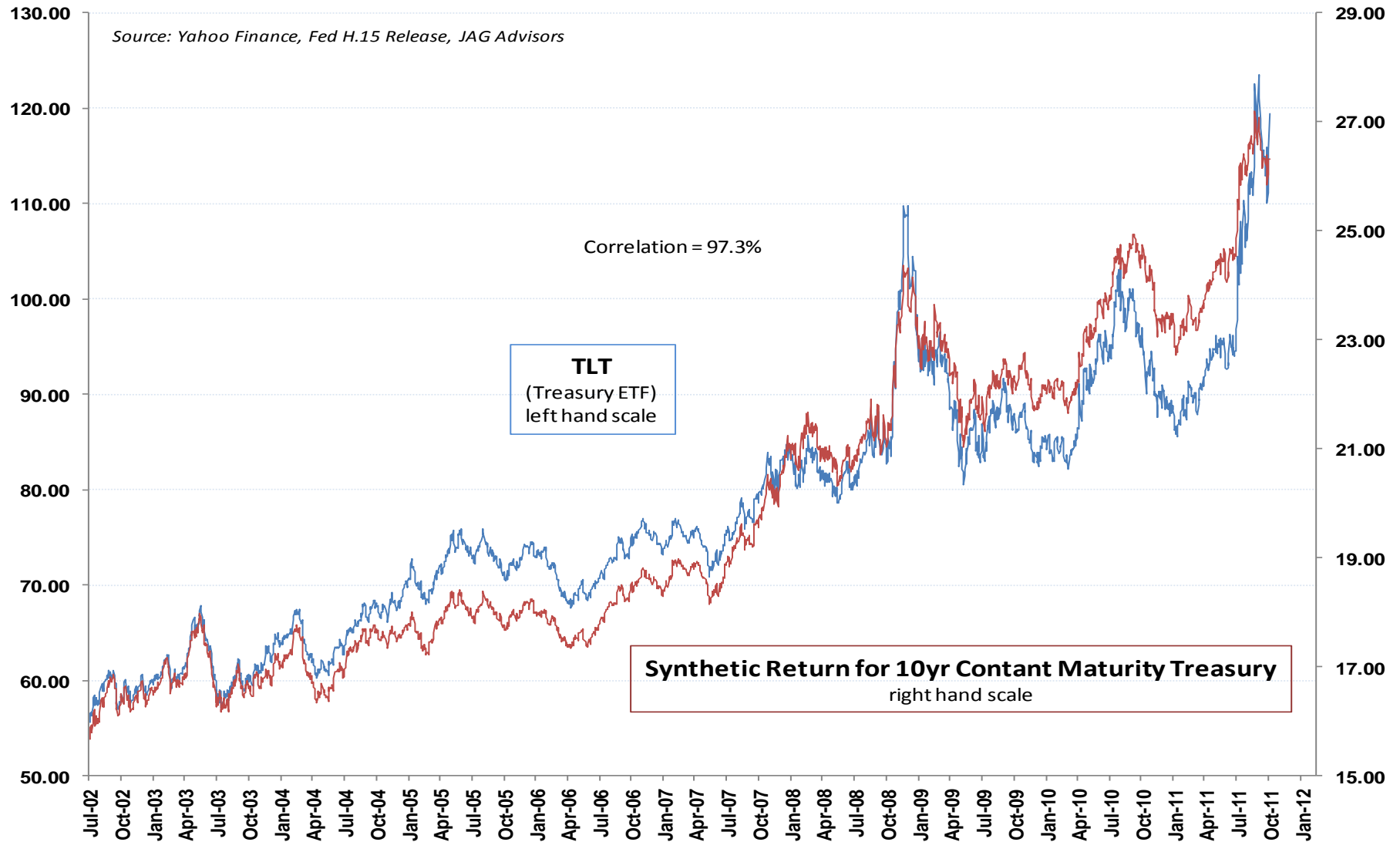
Core CPI Heats Up



Notes Regarding Potential Return Calculations

1. To estimate potential returns we first calculated the average yield spread between a particular bond index and the core CPI.
2. We then assumed that 3 years from now core CPI would be running at a 2.0% rate.
3. By adding our core CPI assumption of 2.0% to the average spread we had an estimated yield for each bond index 3 years hence.
4. Our calculations assume the gap between current yields and the estimated yield would close in a linear fashion over a 36 month interval.
5. Using the estimated yields, we calculated synthetic prices for each index from which total returns could be derived.
6. To check the reasonableness of our synthetic total returns we compared them to actual prices for TLT, the treasury bond ETF. As the following chart shows, the two series are closely correlated (over 97%). Given the strong correlation, we believe our synthetic returns provide a reasonable estimate of actual potential returns.

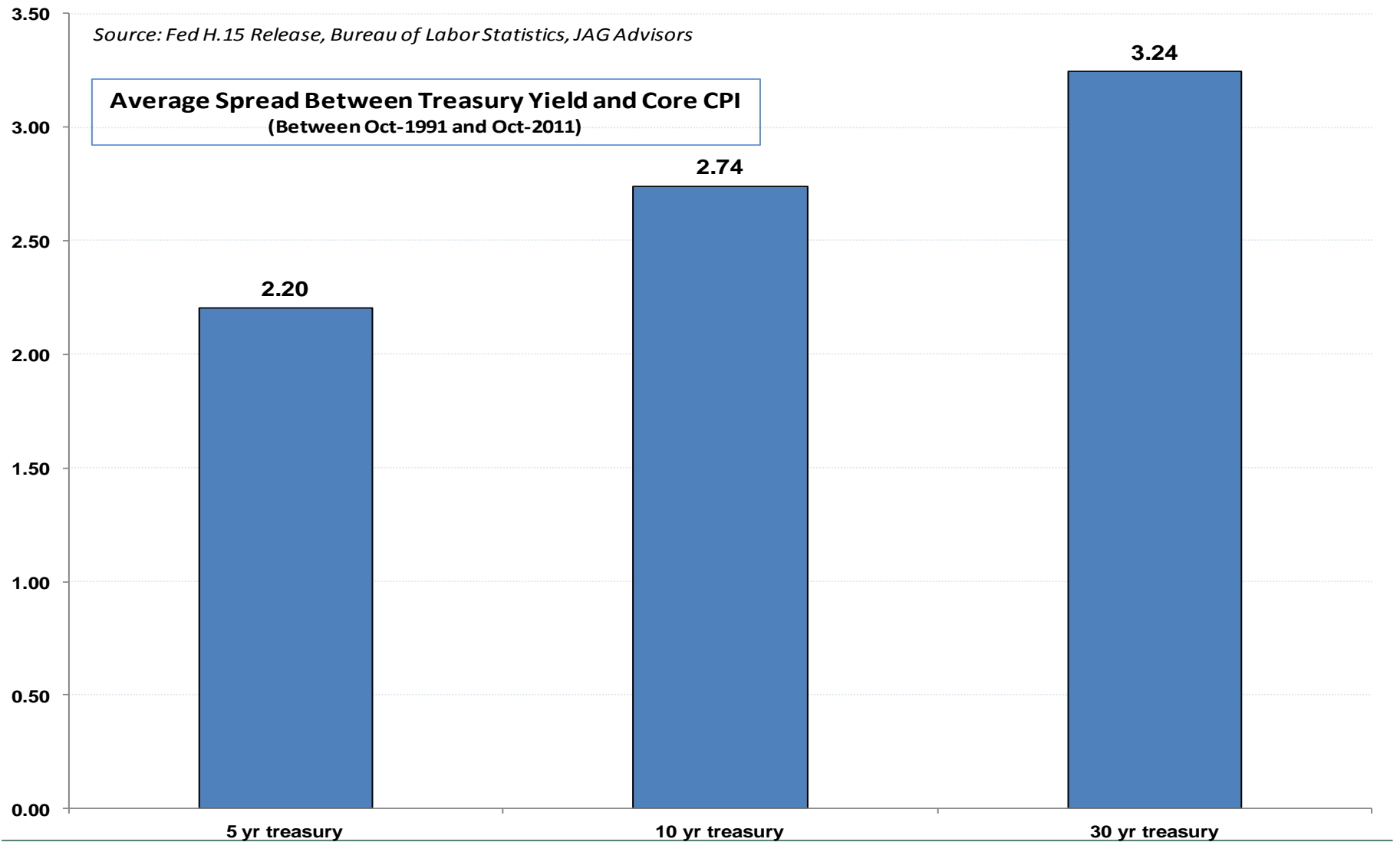
TLT vs. Synthetic Returns for 10 Year Constant Maturity Treasury



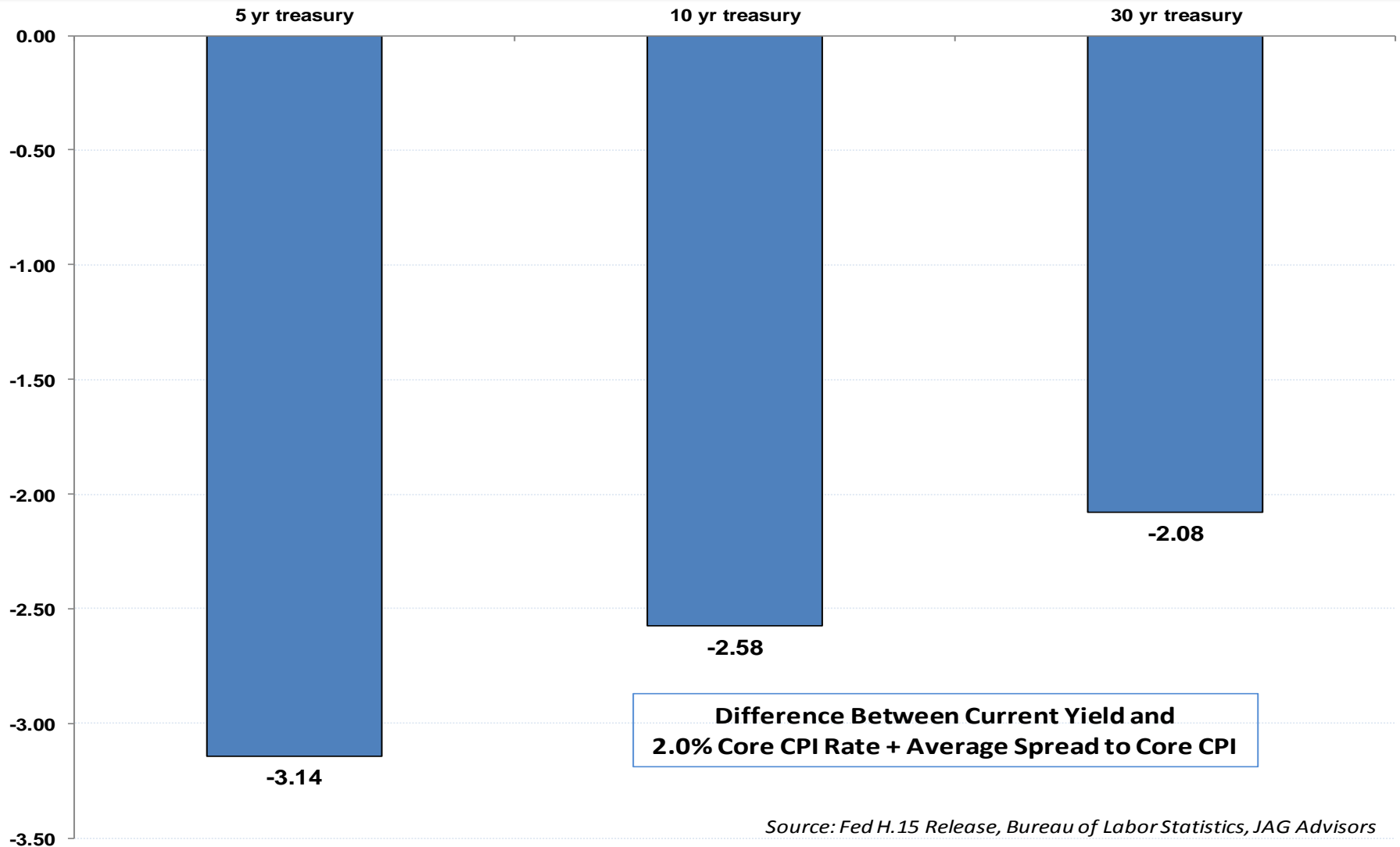
Average Spreads vs. Core CPI For Treasury Bonds by Maturity

					Current	Difference
<i>Spread between core CPI and:</i>	Average	Median	Max	Min	10/31/2011	(current - average)
5 yr treasury	2.20	2.09	5.18	-1.07	-0.94	-3.14
10 yr treasury	2.74	2.62	5.21	0.00	0.16	-2.58
30 yr treasury	3.24	3.27	5.29	1.11	1.16	-2.08
<i>Summary statistics calculated for period between 10/31/1991 and 10/31/2011</i>						

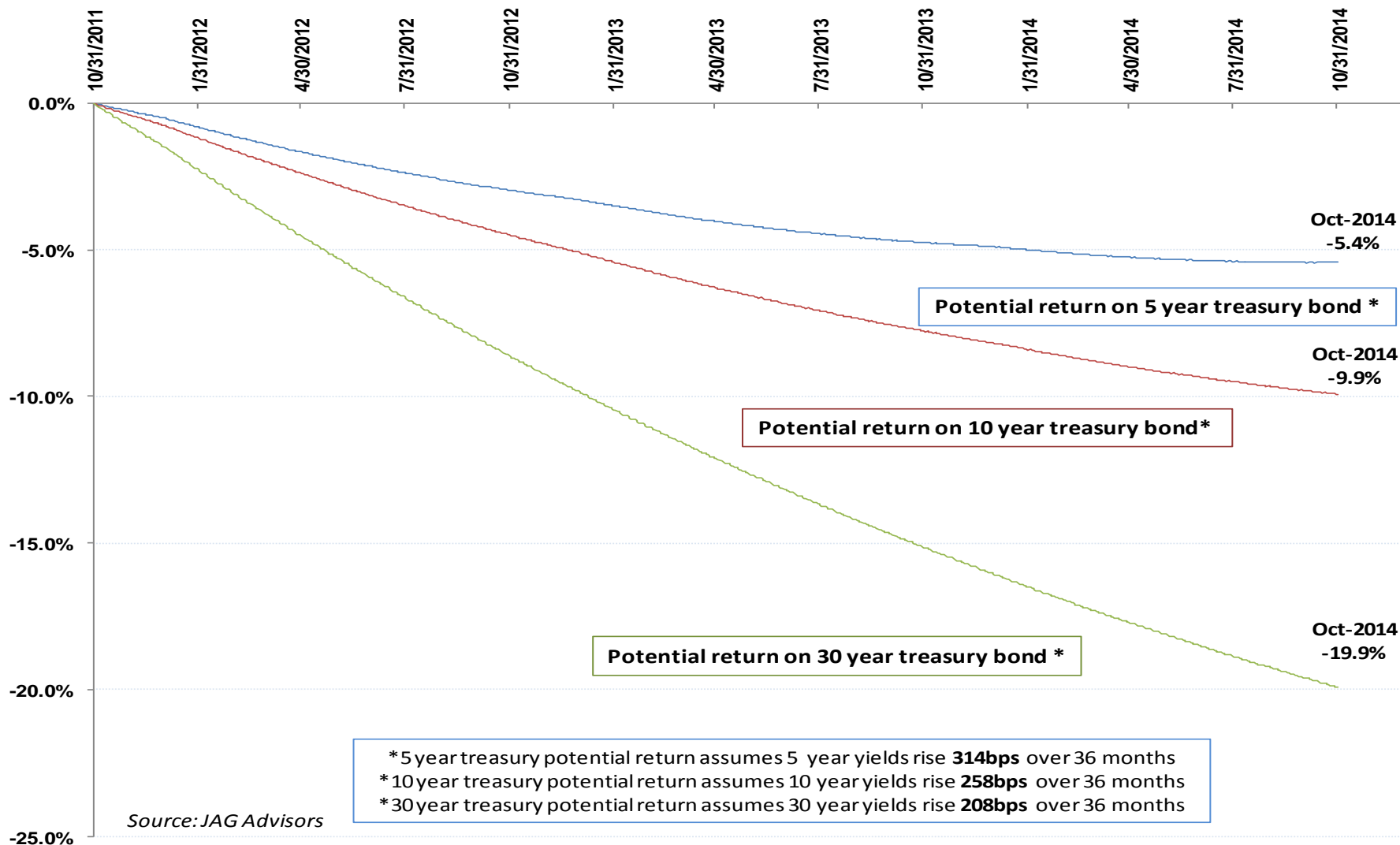
Average Spreads vs. Core CPI by Maturity



Difference Between Current Yields and Average Yield to Core CPI Spread + 2%



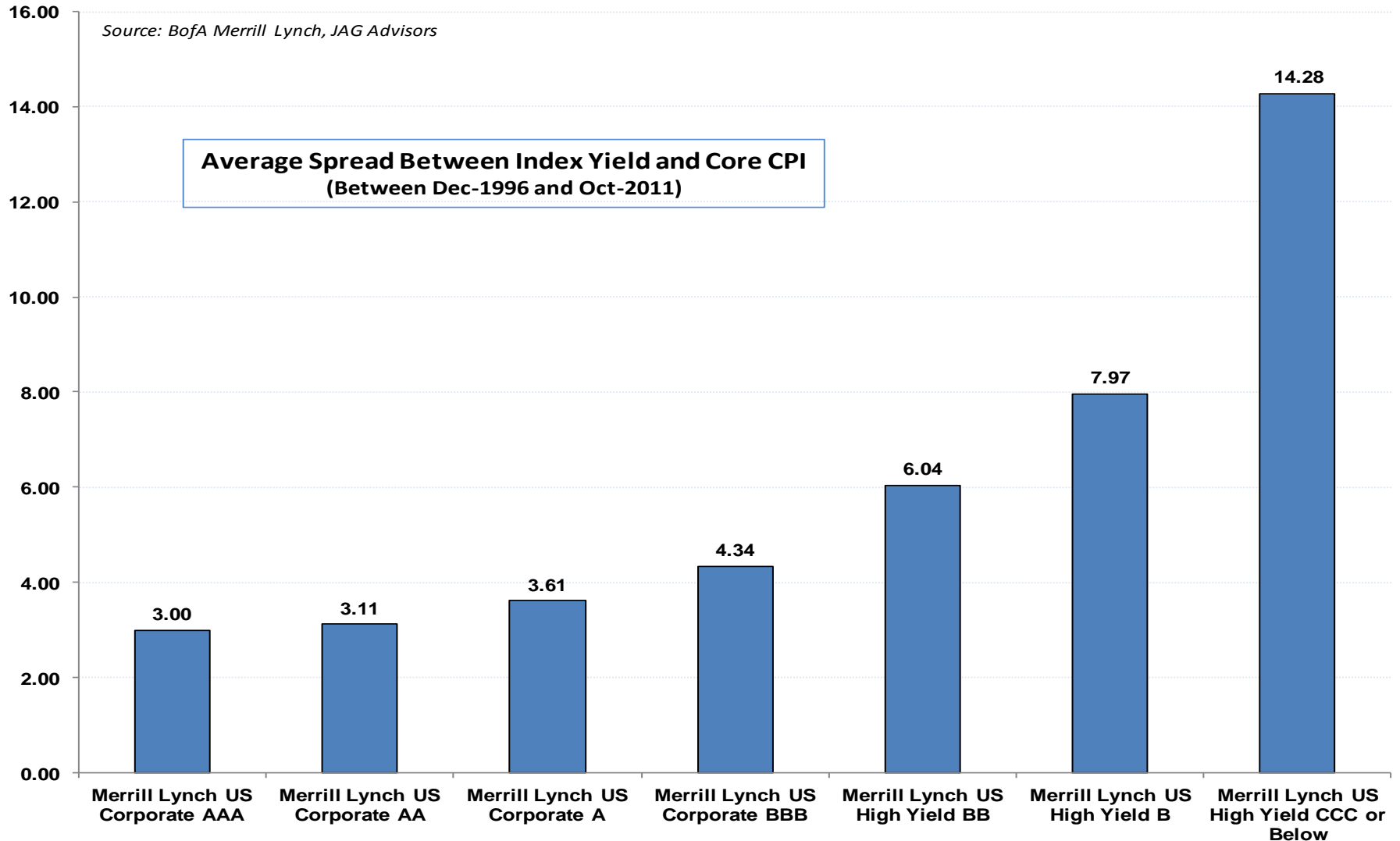
Unappealing Risk/Reward Profile for Treasuries



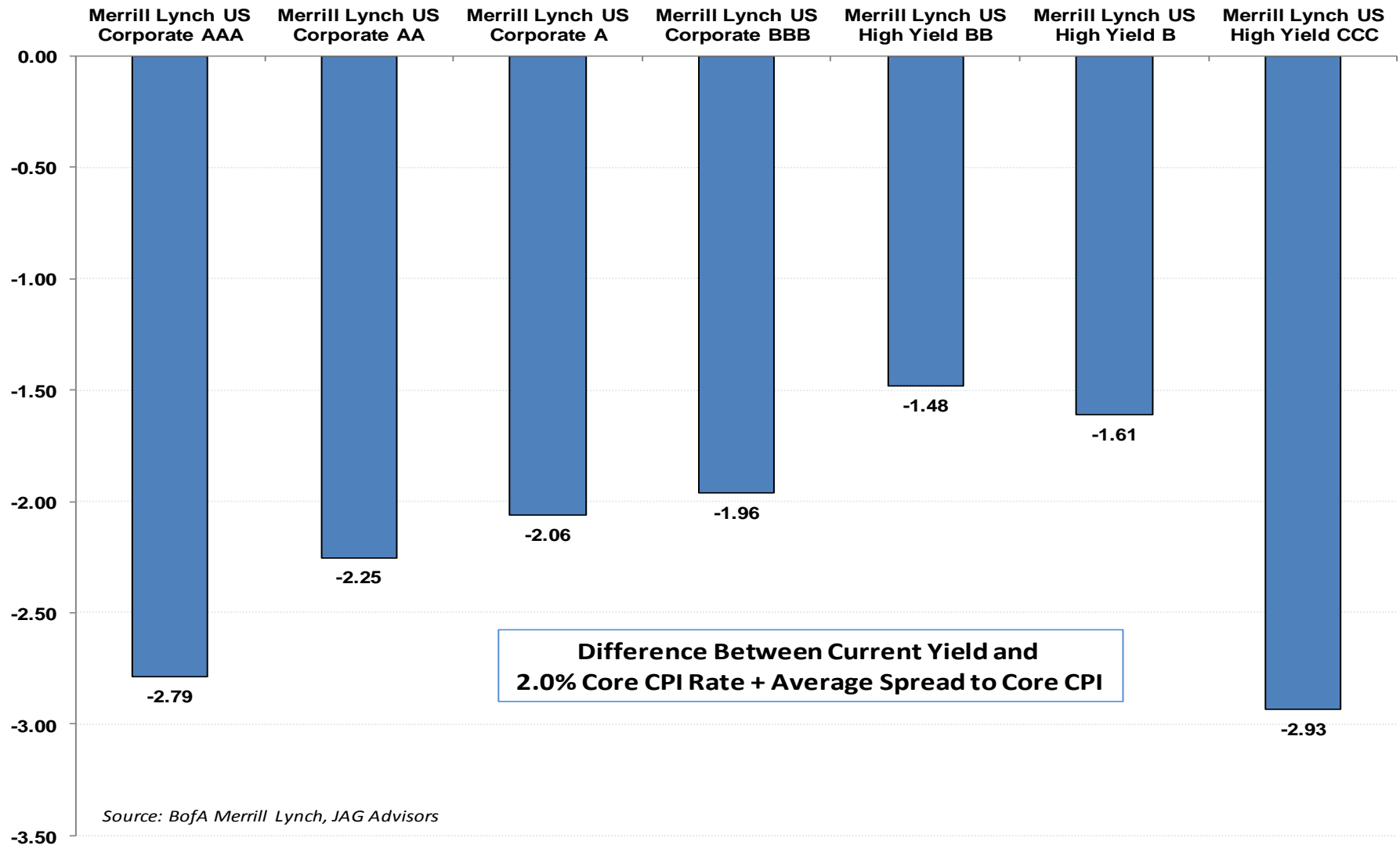
Average Spreads vs. Core CPI by Bond Rating

					Current Spread	Difference
<i>Spread between Core CPI and:</i>	Average Spread	Median	Max	Min	10/31/2011	(current - average)
Merrill Lynch US Corporate AAA	3.00	2.85	5.49	0.21	0.21	-2.79
Merrill Lynch US Corporate AA	3.11	2.91	5.58	0.86	0.86	-2.25
Merrill Lynch US Corporate A	3.61	3.35	7.16	1.55	1.55	-2.06
Merrill Lynch US Corporate BBB	4.34	4.16	8.01	2.37	2.38	-1.96
Merrill Lynch US High Yield BB	6.04	5.77	13.99	3.55	4.56	-1.48
Merrill Lynch US High Yield B	7.97	7.37	18.58	4.43	6.36	-1.61
Merrill Lynch US High Yield CCC	14.28	11.66	36.34	6.62	11.35	-2.93
<i>Summary statistics calculated for period between 12/31/1996 and 10/31/2011</i>						

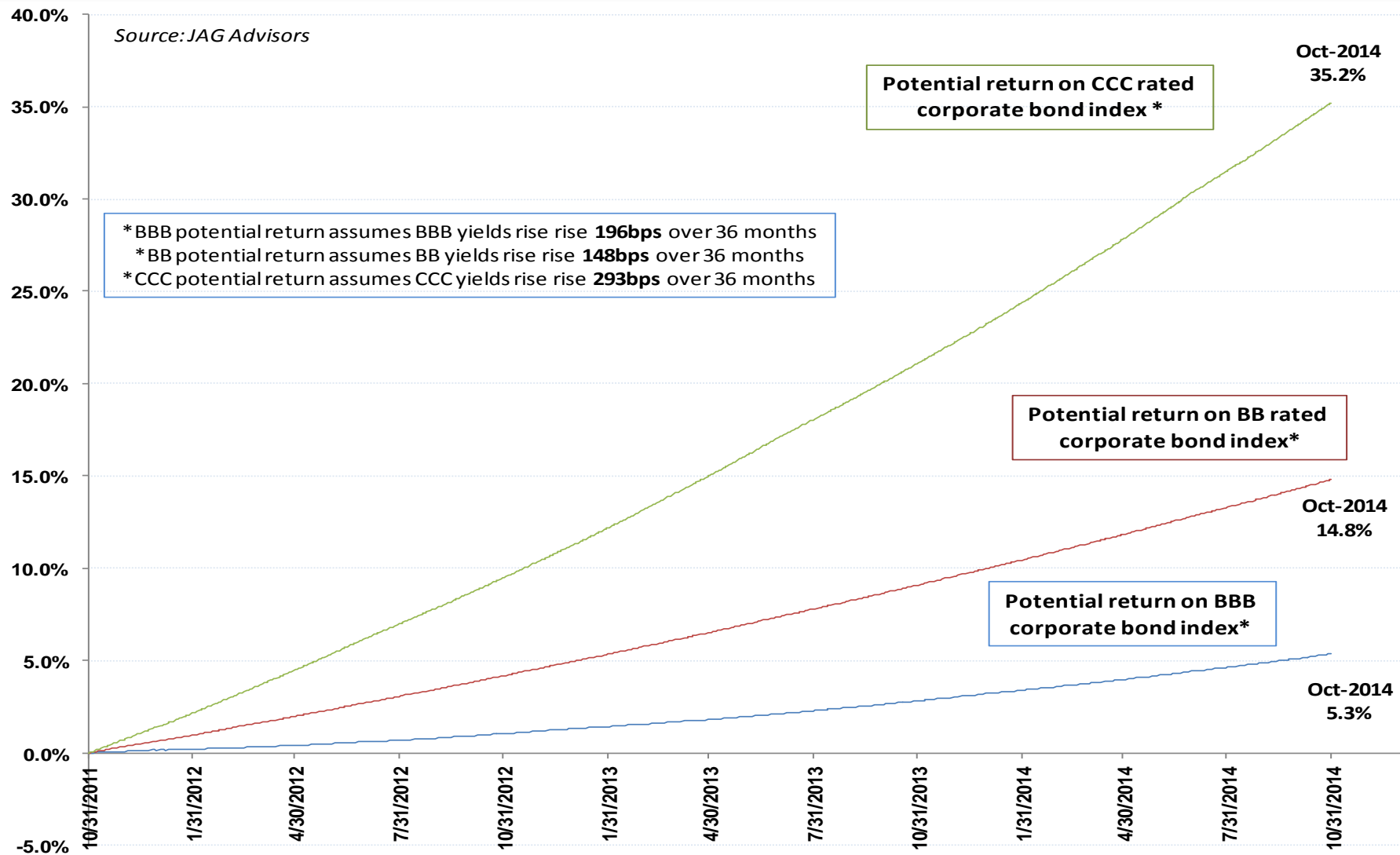
Average Spreads vs. Core CPI by Bond Rating



Difference Between Current Yields and Average Yield to Core CPI Spread + 2%



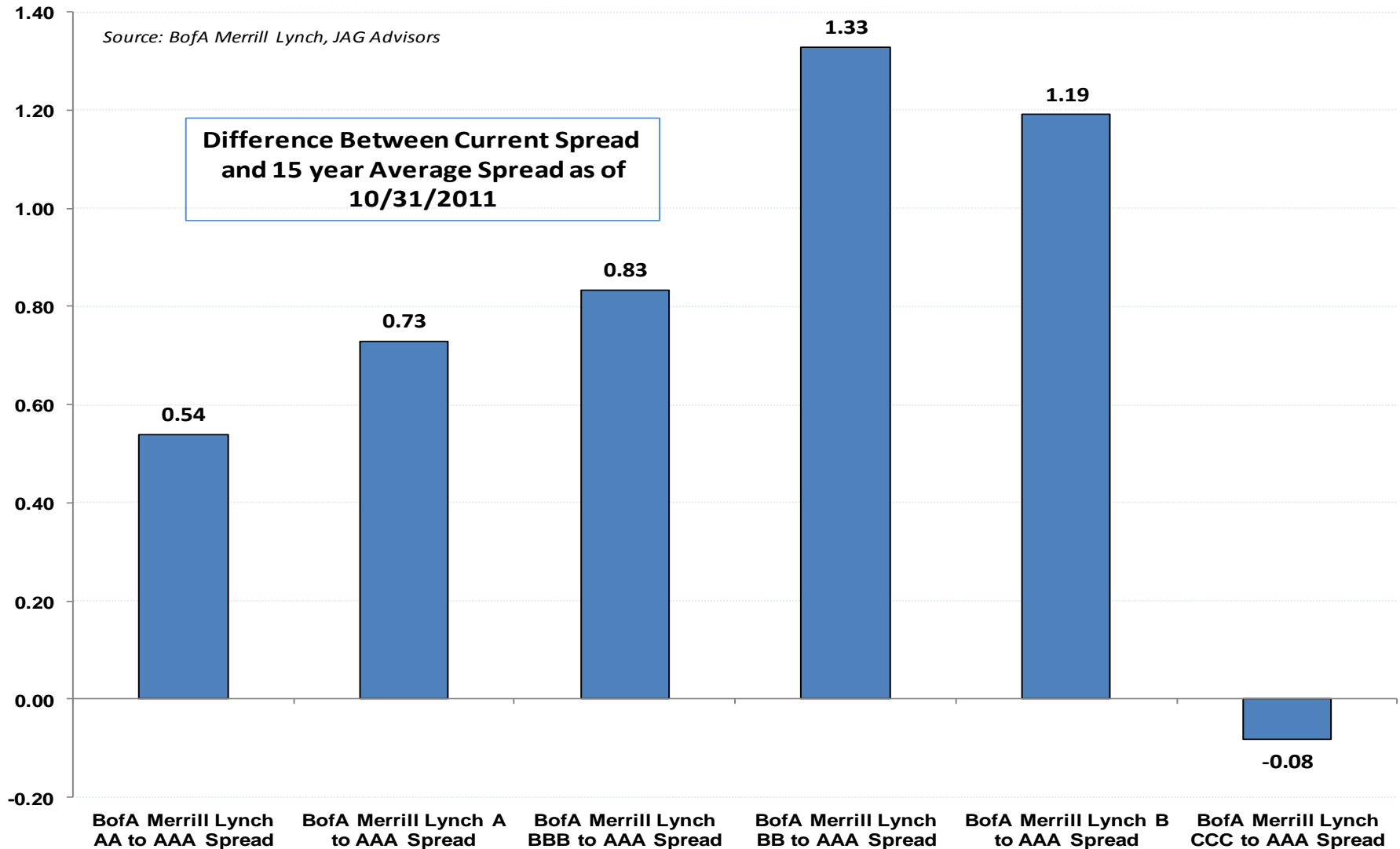
Appealing Risk/Reward Profile for Credit



Quality Spreads

					Current Spread	Difference
<i>Spread between AAA yields and:</i>	Average Spread	Median	Max	Min	10/31/2011	(current - average)
Merrill Lynch US Corporate AA	0.11	0.08	1.31	-1.94	0.65	0.54
Merrill Lynch US Corporate A	0.61	0.38	2.90	-0.42	1.34	0.73
Merrill Lynch US Corporate BBB	1.34	1.10	4.73	0.42	2.17	0.83
Merrill Lynch US High Yield BB	3.02	2.77	10.82	0.99	4.35	1.33
Merrill Lynch US High Yield B	4.96	4.61	16.86	1.72	6.15	1.19
Merrill Lynch US High Yield CCC	11.22	9.47	39.53	3.50	11.14	-0.08
<i>Summary statistics calculated for period between 12/31/1996 and 10/31/2011</i>						

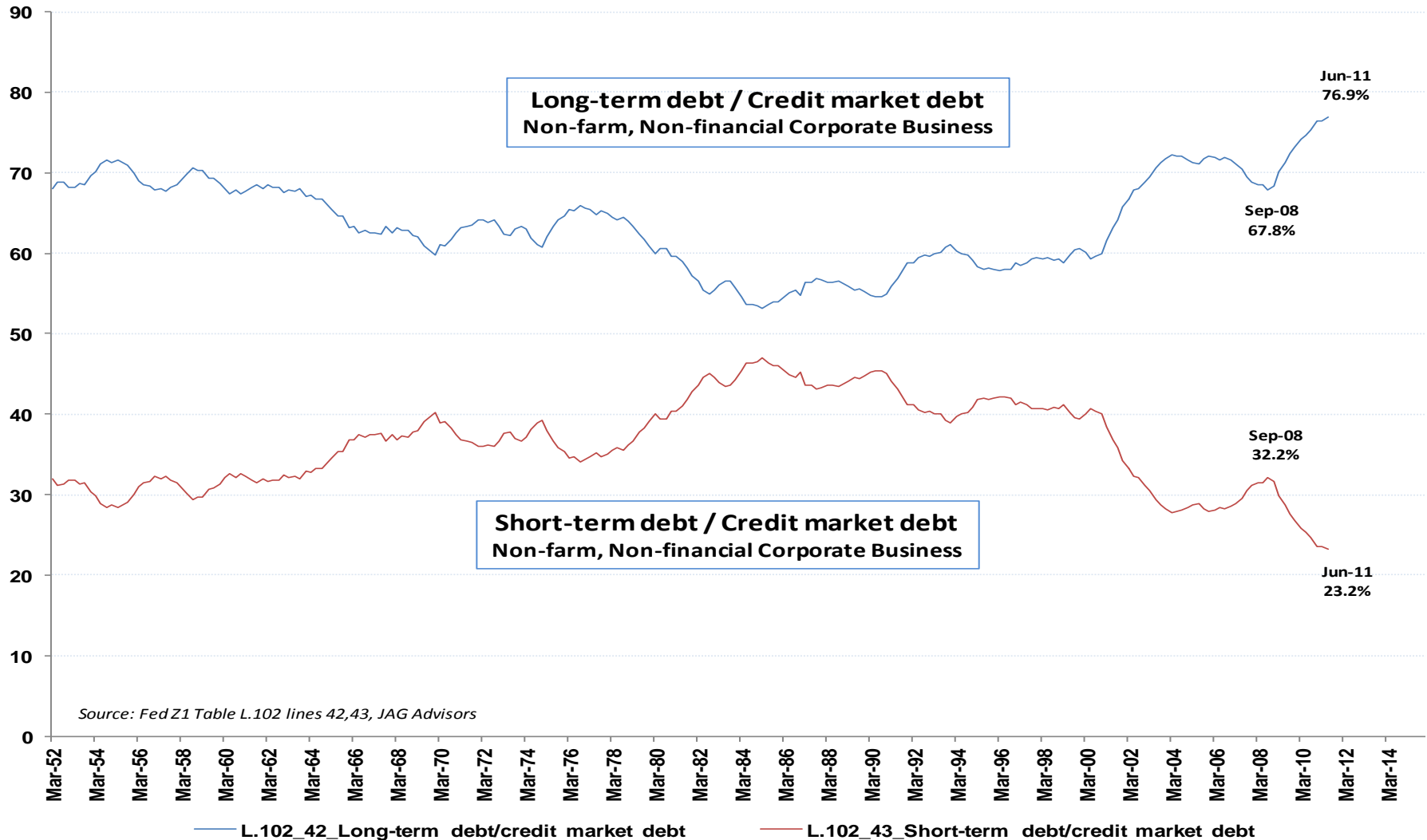
Current BB to AAA Spread Shows Largest Deviation From Long Term Average



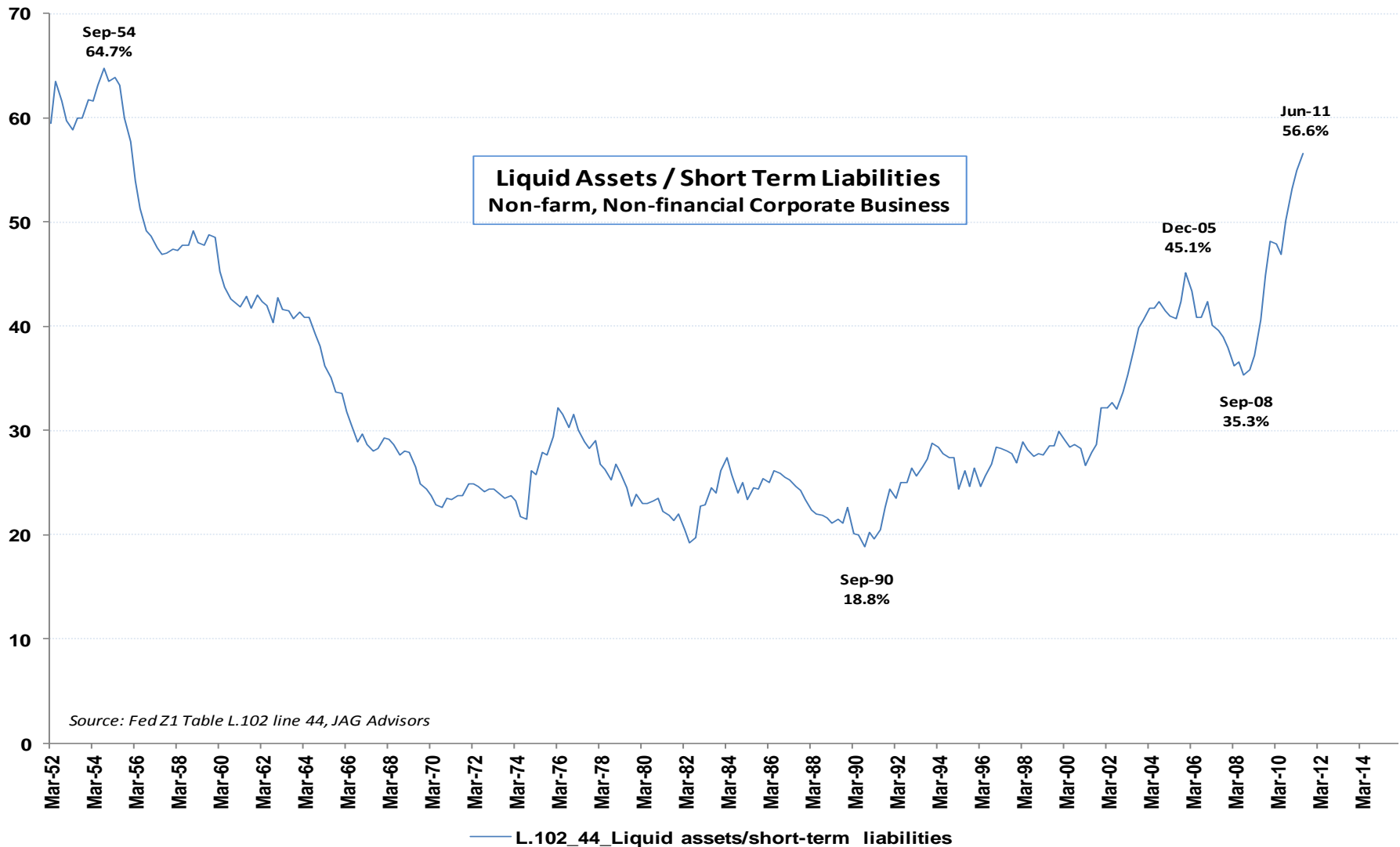
Corporate Credit Fundamentals

- **Liquid assets** on balance sheets soared to over \$2 trillion for the 1st time and are up 24% over the past year.
- The ratio of Total Liquid Assets to Short-Term Liabilities rose for the 4th quarter in a row to 56.6% from 54.9% in Q1, and 46.9% 1 year ago....One has to go back to **1955** to find the last time this ratio was as high as it is today.

Corporate Credit Fundamentals Very Strong



Corporate Credit Fundamentals Very Strong



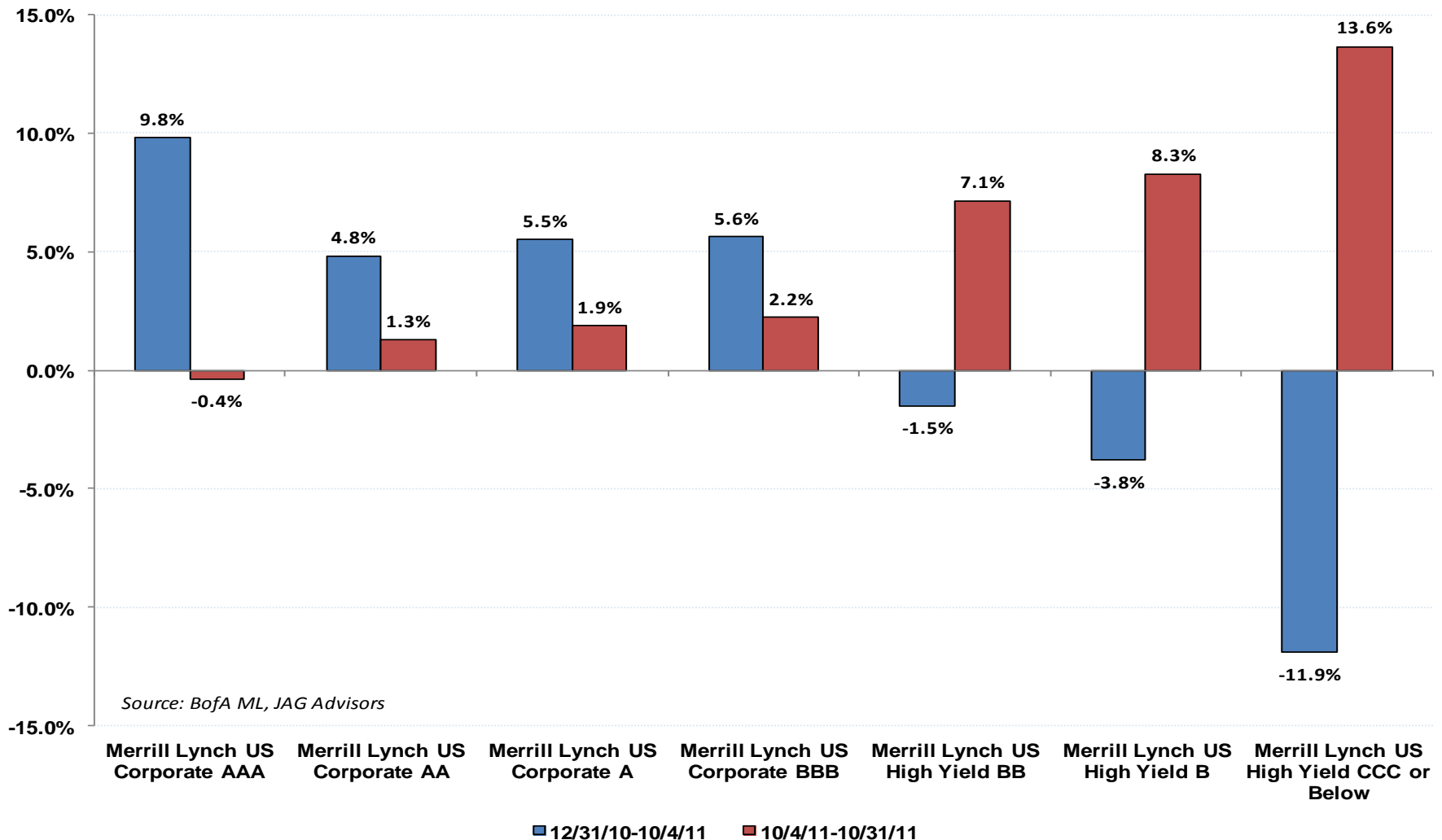
More on Corporate Credit Fundamentals

- The ratio of long-term debt to total outstanding debt rose for the 11th straight quarter to stand at a record high 76.9%, from 76.5% in Q1 & 74.6% a year ago.
- The corporate sector has continued to use this period of ultra-low interest rates to “re-liquify” their balance sheets – paying down short-term debt and refinancing at longer terms and lower rates.
- The overall level of short-term debt has been pared by 20% over the last 3 years.

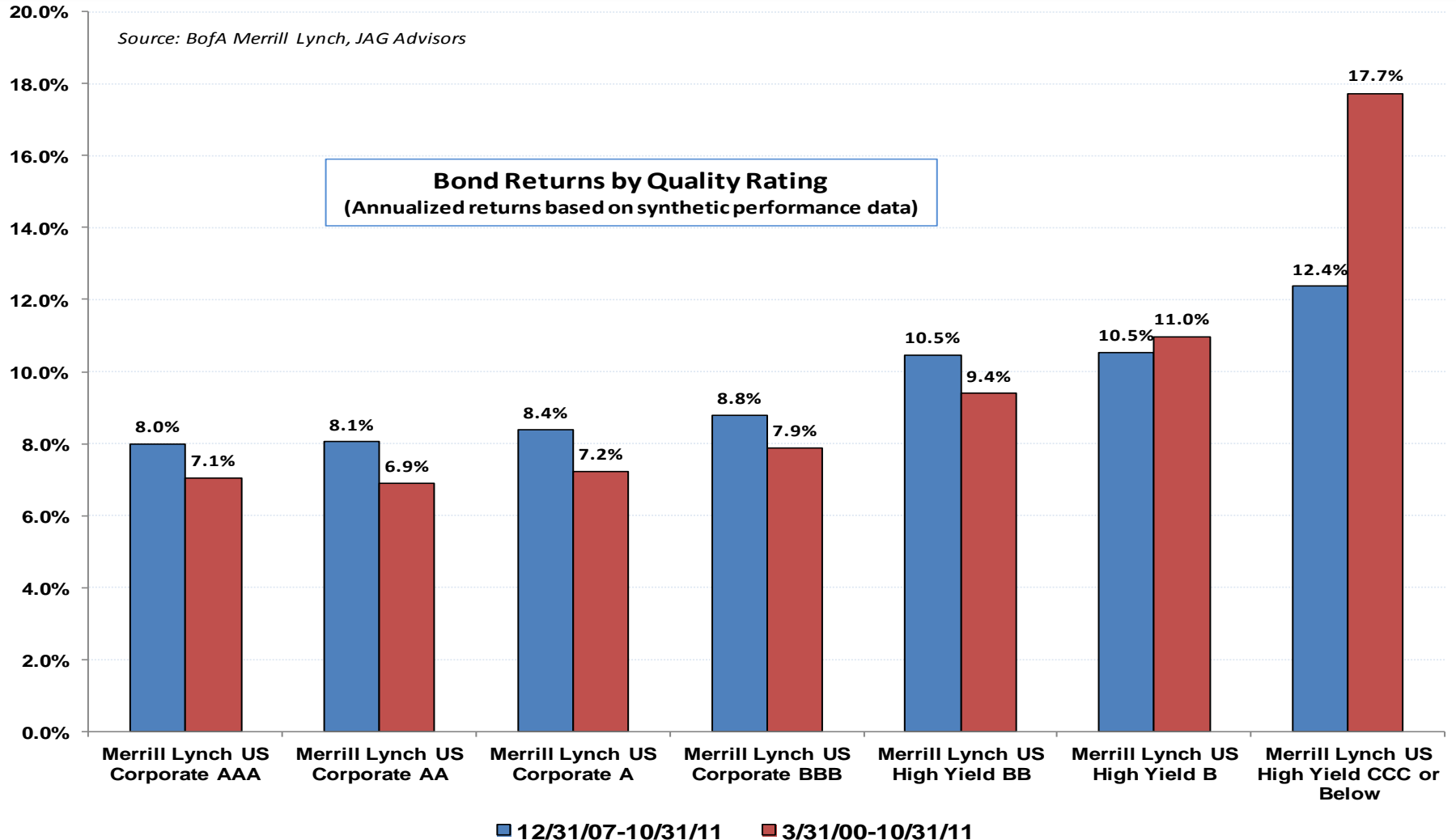
We Believe High-Yield Sector Offers Value

- **High yield spreads** currently c. **700** bps
 - Spreads are historically consistent with **7.3%** default rate
 - But August 2011 default rate (Moody's) was **2.1%**...Which is historically consistent with **350** bps spread
 - Either spreads or default estimates are wrong... we believe it is the former
- **Maturity wall** has been chopped down...
 - HY bonds and loans set to mature through 2014: **\$413 billion**
 - At the end of 2008, this wall was **\$1.1 trillion** high (!)
 - Refinancing has represented more than 66% of issuance since 2008

Bond Returns by Quality Rating: 2011



Bond Returns By Quality Rating: Long Term



Conclusions

- “Ironically” we like credit
 - Corporate fundamentals are strong
 - Wider spreads = better risk/reward potential
- Also, optionality favors credit-focused investors
 - Treasury/Duration bets “pay off” only in worst-case outcome
 - Worst Case... Eurozone collapse, Deflationary Spiral, Social Unrest, etc.
 - Credit-based bets could “pay off” in a much broader array of potential outcomes
 - Base Case... Eurozone muddles through, economy bumps along, no recession or mild recession, etc.
 - Best Case... Eurozone solves problems, economy re-accelerates, GDP growth exceeds expectations, etc.

Indicative Stats for JAG ECFI & CFI as of 10/31/11

Summary Statistics*	Enhanced Core Fixed Income Model Portfolio	Barclays Intermediate Government / Credit	Corporate Fixed Income Model Portfolio	Barclays Intermediate Corporate
Yield to Worst (%)	3.19%	1.58%	4.50	3.16
Maturity	5.29	4.41	4.94	5.21
Quality	A3/A-	Aa2	Baa2/BBB+	A3
Coupon (%)	4.44%	3.28%	5.63	5.13
Modified Duration	4.05	3.96	3.98	4.47

*All statistics are on a weighted average basis

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