

July 26, 2007

Contagion in Bond Land

The benign credit environment of the past several years and first six months of 2007 could best be described as “boring” to this veteran bond manager. Of course, boring means few credit events, but this has been rudely interrupted by the Private Equity Managers and shareholder “friendly” types such as Nelson Peltz and Carl Icahn. Their ideas, no matter how they are packaged, almost always involve borrowing more money, hurting existing bondholders and rewarding the stockholders. This game works as long as there are willing lenders of money at low interest rates.

And this month, all of a sudden this game of musical chairs has come to a sudden end. Commonly attributed to fall-out from the subprime home equity market, the bond market’s appetite for risk evaporated. The Corporate Leveraged Buy Out (LBO) deal machine has blown a fuse, forcing Wall Street investment banks to honor their bridge loan deals that they seemingly gave away during the “easy money” times. Greed has given way to fear, as it always does sooner or later. And a whole new gang of investment wizards learn a painful lesson as they experience this phenomenon for the first time.

The long term impact can be easily assessed by answering the following two questions:

1. Is this primarily a technical or fundamental issue?
2. Is my portfolio manager keeping his Buy or Sell tickets closest to him or her?

Let’s start with the first question. The truth is that none of us will know until after the fact, but we believe that this is more technical than fundamental. From a technical standpoint, the level at which risk markets such as high yield and emerging market bonds were trading prior to this month, with little to no yield for the incremental risk, made no sense and was all about technicals. We are still not back to normal yield increments for the risk in these markets. The domestic economy should still grow at 2+% and international growth should be stronger.

The housing market will continue to be weak, and the subprime lending business in the tank, but we do not believe that a recession is likely. Inflation is well contained no matter how many speeches Fed governors give.

The second question is more interesting to those of us in the investment management business, but really is the key concept to understand. Leverage to an investor is much like crack to an addict. It may seem like a good idea at first – a cheap high – but sooner or later the addiction leads to an unhappy ending. The portfolio managers with their Sell tickets at their side in a market such as this are almost always dealing with their leverage addiction. When their dealer cuts off their supply, they have to sell – not what they want to sell but what they can sell. Withdrawal is painful. The excess leverage in the financial system means the rehab centers will be filled beyond capacity.

Our investment thesis at AAM has been to invest in high quality bonds to earn above market yields while avoiding risk. We have our Buy tickets at our side and will look for opportunities to take advantage of forced liquidations. From a technical standpoint, spreads will widen and we may suffer short periods of under-performance relative to benchmark indexes. But, as long as our credit fundamentals remain in tact, we will earn back all of this technical movement. Thus, in this difficult environment, we remain keenly focused on fundamental credit work for the securities that our clients currently own – across all markets. And when the time is right, when it seems like everybody else is selling, we will muster up the conviction to use up our Buy tickets and invest in solid credits that will produce above-market yields for many years to come.

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