

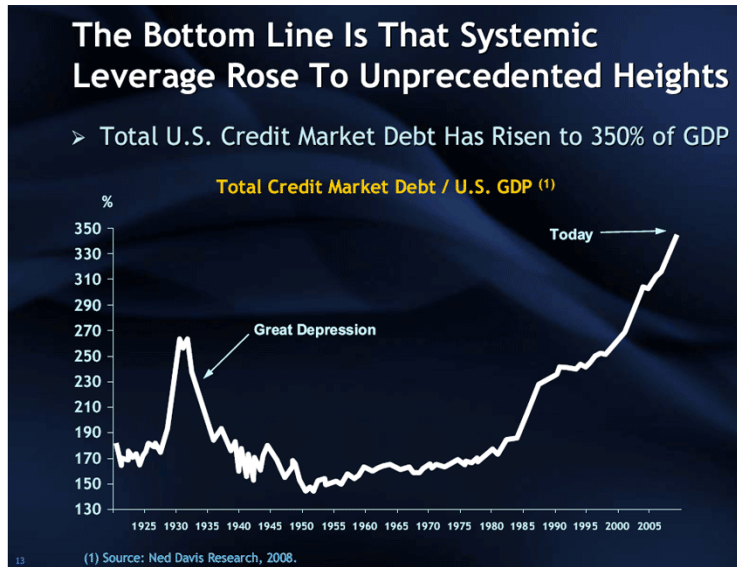


# The Argument for Corporate Debt

December 2008

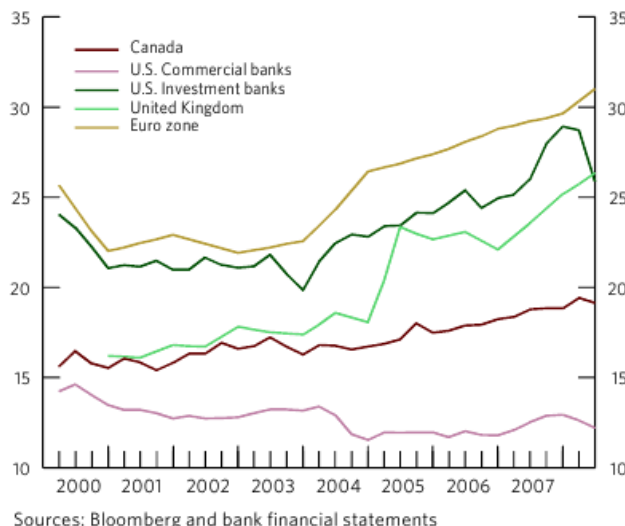
This past quarter the US economy has experienced what appears to be the crescendo of a credit crisis that has been building for well over a year. The causes of the turmoil have been discussed at length; this paper will instead review its consequences and the potential opportunities for investors.

By way of context, the US came into 2008 with historic levels of debt:



The US was not alone in this regard as witnessed by the leverage concentrated in the banking system (UK, European, Canadian as well as US) and in the “shadow banking system” (hedge funds and special purpose vehicles), as demonstrated in the chart below. Keep in mind that leverage levels above eight times should be considered extremely risky.

**Chart B**  
**Banking Sector Leverage**  
Assets as a multiple of capital



The forced selling that accompanied the unwinding of this leverage has resulted in a re-pricing of assets in almost every category. Below are the charts of various asset classes that help demonstrate the effects:

World Equity Markets down almost 47% as measured by the MSCI World Index:



Commodities, down almost 62% as measured by the Goldman Sachs Commodities Index:

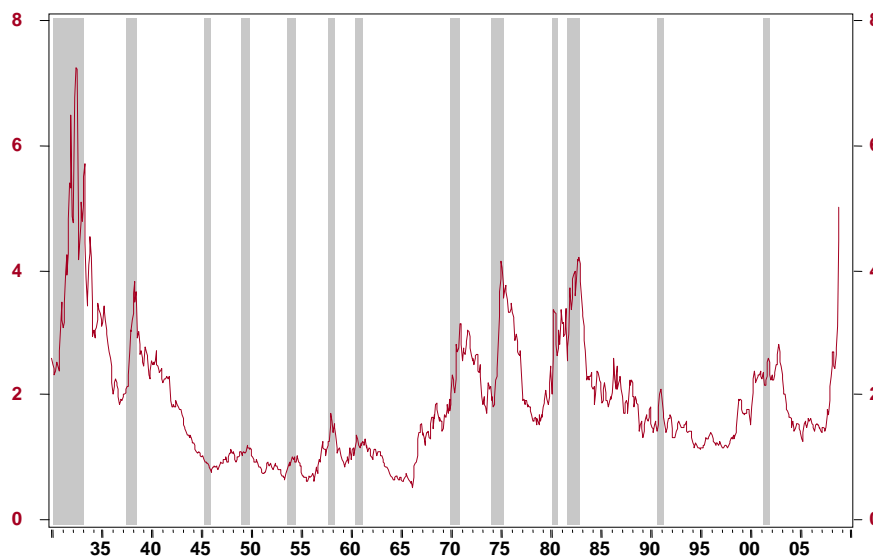


Real Estate, as demonstrated by US residential home prices down more than 20% measured by the Case-Shiller composite Index:

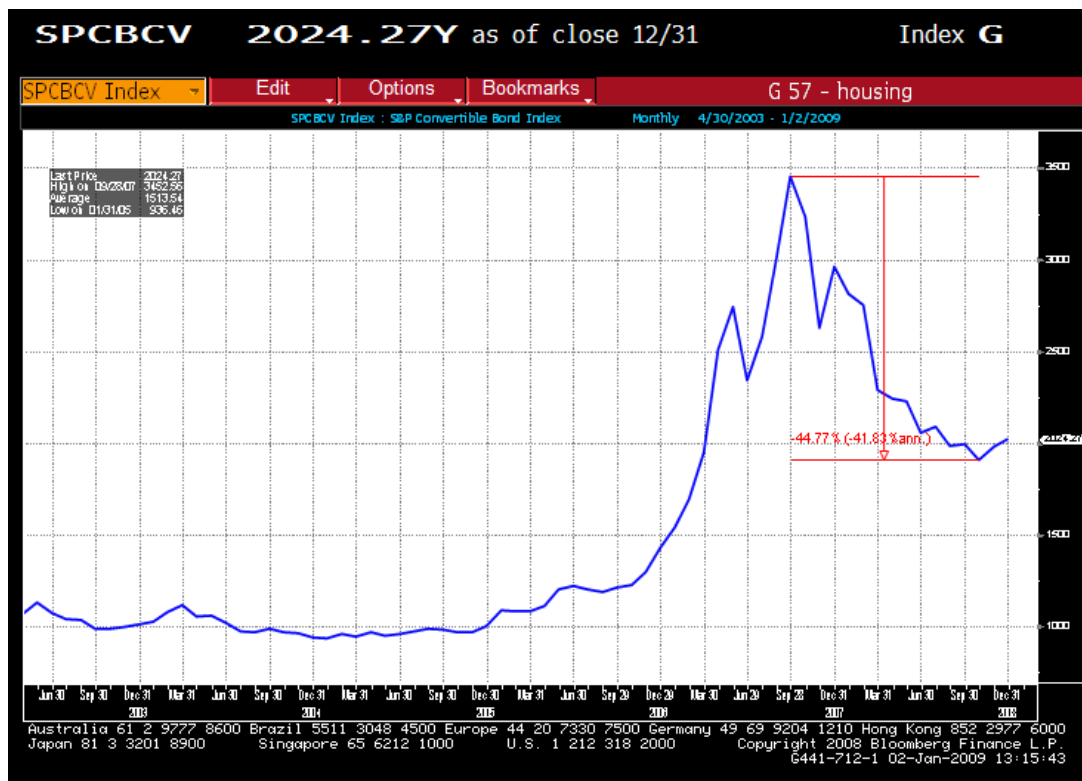


In the fixed income markets, price dislocation is measured most commonly by spread rather than yield. Although the short term money markets have been repairing themselves, high yield bonds are trading at record spreads over Treasuries (over 2000 basis points) and investment grade bonds are at the widest spreads since the Great Depression:

### Baa Corporate Bond Yield minus Treasury Yield



While we believe that the default cycle will begin to be effected by this downturn, we do not anticipate the level of defaults that occurred during the thirties. Rather, we feel that the forced selling in corporate bonds have provided an opportunity for the discerning buyer. This is especially true in the convertible space, as the vast majority of these bonds are held by hedge funds that deploy leverage to enhance their returns. The chart below shows that the S&P Convertible Bond Index was down over 44% from the peak, a dramatic sell-off for a fixed income instrument.



Alternative assets have been hit as well, as hedge funds of all types have suffered from forced selling caused by margin calls and the effects of investor redemptions. The various hedge fund indices are down between 15 to 20%, but understate the damage done to some of the marquee fund families, some of which are down twice that much and more.

It was not just asset prices that felt the effects of the credit crunch; economic activity has suffered as well, as we appear to be entering a synchronized global downturn, albeit with different levels of severity. The uncertainty of the economic backdrop further clouds the “fair value” of many assets and complicates the already difficult investment landscape. The slowing of the US economy is palpable, and economists are looking for a contraction of up to 6% for the fourth quarter of 2008 (on an annualized basis), which would be its worst performance in over 25 years.

The positive side of all of this turmoil is that such a dramatic change in the investment environment and severe price corrections, some of which were forced, likely leave some asset classes selling below any normalized representation of fair value. The key to taking advantage of this opportunity is to buy the right asset at this point in the economic cycle that has the potential to provide meaningful upside, but that offers downside protection should the outlook darken.

### Our Assessment:

It appears that the more liquid assets, i.e. equities, publicly traded debt and commodities have taken a disproportionate amount of the pain as investors have sold what was easier to monetize. It is among those

asset classes where the best investment opportunity likely lies. So while real estate has declined by historic amounts, the price adjustment process generally takes longer to run its course, and we expect further price declines in this asset class (both residential and commercial).

Equities and high yield debt perform best when the economy is reaching its trough and investors have begun to sense a turn for the better. That point may be two to four quarters away (if not longer). In any event, given the unprecedented amount of uncertainty and the economy's lack of response so far to historic government stimulus and intervention, we would choose to take a more defensive posture and wait to swap into more risk based assets until leading indicators turn for the better.

On the other hand, investment grade debt historically has outperformed both equities and high yield debt during and until the end of the economic recession. Currently, as mentioned above, the economy is decelerating at a fairly rapid pace. Projections for the depth and duration of the downturn have a fairly wide dispersion. We believe most market participants have bought into the fact that the economy will contract in a meaningful way. What are still left for debate are the duration of the downturn and the swiftness of the recovery. CWA believes the recovery will be more muted and not the V-type snapback we have witnessed in the last two down cycles. Our reasoning is based on the debt overhang that exists on consumer balance sheets, the relatively lengthy process entailed in repairing those balance sheets and the potential difficulty in accessing credit in general in the new financial landscape.

So we favor investment grade corporate bonds and convertible bonds over equity given the above and the following:

- Corporate bonds are trading at near historic spreads to Treasuries and have discounted an economic environment similar to that of the Great Depression
- There is an advantage in being higher up on the capital structure of a company's balance sheet as economic problems escalate; corporations do not need to grow to pay back debt.
- Deflationary pressure could put more strain on earnings growth than on balance sheets, thereby preventing equities from gaining any meaningful traction near term
- Policymakers are more sensitive to strains in the credit markets and are thus more likely to intervene
- Deleveraging should favor credit over equity
- Nonfinancial corporate balance sheets are in reasonably good condition and entered this recession with relatively low levels of leverage
- Current real rates of return are very high, and the potential total return outlook is very favorable (equity like) in the intermediate time horizon. For example, a bond rated BBB+ with a 7% coupon, currently trading at a dollar price of 88.5 offers a yield to maturity of 8.65%. If the markets and the economy recover, and the bond trades at par in two years, the total return will be roughly 25% over that time frame.

### **Conclusion:**

We believe that while the equity and high yield markets have built in an economic recession that is worse than the 1990-1 and 2001 cycles, they may have further downside if the recession persists **longer** than those occurrences. In general, yields on fixed income securities rise in anticipation of defaults and losses to follow as the economy enters a recession. With investment grade debt trading at spreads not seen in over 70 years, we believe that the level of losses implied by the market is overstated and may simply be the result of risk aversion and forced liquidation. In that scenario, investment grade corporate bonds offer among the best risk/reward opportunity available given our outlook and the diversity of economic outcomes we currently face.

*A copy of Constellation's Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail [philip@constellationva.com](mailto:philip@constellationva.com).*

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