

Past, Present, Future - ?

We started our first high yield fund in September 1990 in the throes of the financial crisis of that period. The name of the fund was Penates, which refers to the household gods of antiquity. Virgil's Aeneid describes the fall of Troy and the flight of Aeneas, the Trojan hero, from the ravaged city and the victorious Greeks. Putting his life at risk, Aeneas re-entered enemy occupied Troy in order to save the household deity, or Penates, of his family. There was something very much worth saving in the vanquished and plundered city. There was something of value in the ruins of ancient Troy.

At the end of the 1980's the high yield bond market was in ruins. It had suffered a very sharp price correction. There were, however, good quality credits that lay hidden in the rubble of the market. These were the financial Penates that were worth the investment effort.

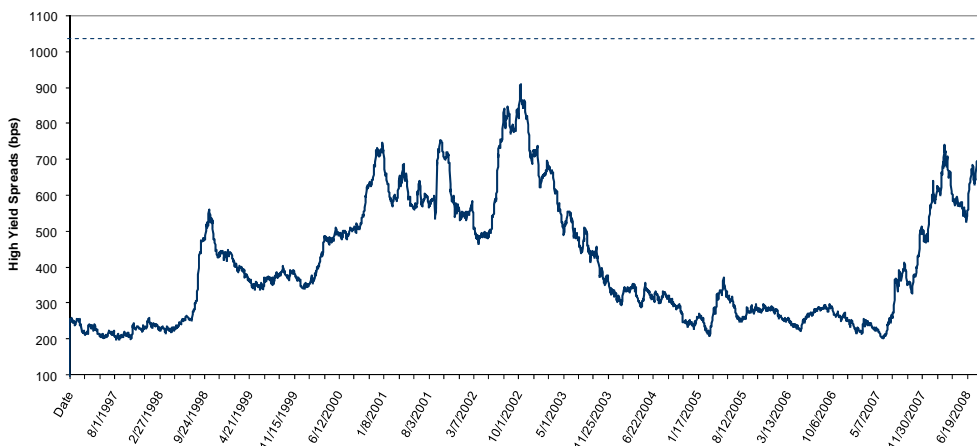
History never exactly repeats itself but financial behavior does tend to follow broadly repetitive cycles of excess. Fear and pessimism had taken hold of the markets eighteen years ago. Fear and pessimism are weighing on us again today. Eighteen years ago we could buy good quality credits at bargain prices. We can do so again today.

Eighteen years ago, we had a banking and real estate crisis. There were rumors that Chase and other large banks would not survive. Citibank's market capitalization reached a low of \$10 billion. More than a thousand savings and loan associations failed. Drexel Burnham Lambert filed for bankruptcy and Michael Milken would soon be imprisoned. Those were harrowing times, not unlike what we are experiencing today. In 1990 we did not have opaque derivatives hanging over us and the first CDO's had barely seen the light of day, but otherwise the gloom and doom are eerily similar.

In 1991, the S&P500 was up 30% and our newly created high yield fund was up 22%. Will 2009 be a wonderful year for the markets, similar to 1991? We do not know. We will not comment on the outlook for the stock market but we know that we are getting very good value in today's market for high yield corporate bonds. We are earning yields of well above 10% p.a. from companies with good strong fundamentals. Even if spreads do not tighten from near record current levels we will do very nicely just collecting the interest payments.

There are many reasons to be negative on the economy and the state of financial markets. It is possible that the economy slides into a steep recession. We think it is more likely, however, that we have several years of insipid economic growth. But the high yield market is already pricing in a sharp recession and is discounting default rates exceeding 16%. Spreads on B/BB bonds are over 1,000 basis points (i.e. yielding over 10% p.a. more than treasuries), which is an all time record. We do not know what the future brings but today's yields on good quality companies with limited refinancing risk are extraordinarily compelling. We have been managing money in high yield for 18 years and have never seen such attractive opportunities. The short term may very well prove to be bumpy, but over the next three years I believe we will do splendidly. And who knows, perhaps 2009 will be like 1991.

Spread History December 31, 1996 through October 2, 2008 B/BB Bonds



Source: Merrill Lynch U.S. High Yield Cash-Pay BB-B Bond Index (JUC4)

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