DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

April 2016

Fresh off the heels of a year when the Doucet Asset Management Fixed Income Strategy Composite bested its benchmark (the Barclays US Aggregate Bond Index) to the tune of 24bp by returning 79bp, **the first quarter of 2016 saw the Composite return 2.18%, nearly three times its 2015 tally**. Still, this was not enough to edge out the Barclays Agg for the quarter, which returned 3.03%. While these performance numbers appear similar at first glance, digging deeper into the composition of both the Composite and the Barclays Agg[1] tells a very different, and interesting, story.

Though it may not always be the best 'fit' as a benchmark, the Barclays Agg is the most widely accepted and best representation of the taxable bond market, as a whole. Its make-up is indicative of that of the broader fixed income market, and it does not seek to overweight sectors or make duration bets. Think of it as the S&P 500 for bonds. With that said, as of quarter-end the Barclays Agg had roughly a 47% allocation to US Government Securities and duration of 5.87 years. Compare this to the Composite, which had a .09% allocation to Governments and duration of 2.38 years.

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	YTD	1Q16	2015	Since Inception
Doucet Fixed Income Composite	2.18%	2.18%	0.79%	2.39%
Barclays US Aggregate Bond	3.03%	3.03%	0.55%	2.87%
+/- Benchmark	-0.85%	-0.85%	0.24%	-0.48%

*Performance calculated by Morningstar Office, periods over 1 year are annualized

So what does this tell you about the state of the market, in general, and why we lagged the benchmark even after posting a robust quarterly return of 2.18%? Short answer, Treasuries and the long-end of the curve had a heck of a quarter, both staging improbable rallies. To put it in perspective, with its 47% allocation to Governments, the Barclays Agg has only bested its 3.03% return in 4 of the previous 36 quarters. This goes all the way back to the beginning of 2007 and covers the entirety of the height of the so-called bond market bull run, which has been 30-plus years in the making.

Figure 2: U.S. Treasury Market Snapshot

	US Treasury Actives						
	1Q16	*4Q15*	*1Q15*	*Qtr change (bp)*	*Qtr Change (%)*	*Yr Change (bp)*	*Yr Change (%)*
2-Yr	**0.72%**	**1.05%**	0.56%	(33)	-31.43%	17	28.57%
5-Yr	**1.21%**	**1.76%**	1.37%	(55)	-31.25%	(16)	-11.68%
10-Yr	**1.77%**	**2.27%**	1.92%	(50)	-22.03%	(15)	-7.81%
30-Yr	**2.61%**	**3.02%**	2.54%	(41)	-13.58%	7	2.76%

Source: Bloomberg

This is truly remarkable, yet understandable when you consider that though the Federal Reserve has backed away from its stimulus bonanza, the rest of the world is going at it full throttle. We are still in a world of very loose monetary policy where there is a shockingly large amount of negative yields around the world that have only moved out further on the curve. The Japanese 10-Year (-.035%), German 5-Year (-.329%), and Swiss 10-Year (-.359%) are all firmly in negative territory, and half the *PIGS* (the *I* and the *S*) are yielding less than US Treasuries at the 10-year mark.

Not only have US Treasuries offered no-brainer relative value compared to other developed country sovereigns, but they have also offered safe-haven exposure to the US Dollar, which has been on a multi-year tear. With this being the case, the Fed has taken a giant step away from its data-dependency mandate and has become increasingly outward looking. Not surprisingly, their statements have taken on a decidedly more dovish stance of late. Consensus opinion

has moved away from 4-5 rate hikes in 2016 to maybe 1 or 2. Lower-for-longer is no more an outlying opinion, but rather has become the base case.

Bond Markets At-a-Glance

This, however, does not give us cause for concern about our Composite positioning or make us want to reshuffle the deck, in terms of its composition. In fact, it does quite the contrary. What all of this tells us is that there is more risk in the market, as approximated by the Barclays Agg, than its AA-rating and heavy allocation to conservative US Government Securities would indicate. The composition of both the Barclays Agg and the Composite require a modicum of stability in order to perform. Whereas the stability that the Composite is banking on is mean reversion and the bottom not falling out, the "stability" that the Barclays Agg requires is the persistence of a historical anomaly of negative yields throughout the developed world, never-ending global stimulus, a permanently sidelined Federal Reserve, and an ever-increasing US Dollar. This situation may exist in the short-term, but is not sustainable long-term. We, too, subscribe to the lower-for-longer thesis, we just don't believe in lower-forever, which is the only way the Barclays Agg wins long-term.

Figure 3: Index Returns

	1Q16	YTD
Broad Market Equity Indexes		
DJIA	2.20%	2.20%
S&P 500	1.35%	1.35%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	3.03%	3.03%
Bank of America Merrill High Yield	3.25%	3.25%
Morningstar Core Bond	3.06%	3.06%
Morningstar Short-Term Core Bond	1.28%	1.28%
Morningstar Intermediate Core Bond	2.60%	2.60%
Morningstar Long-Term Core Bond	6.20%	6.20%
Bond Indexes by Sector		
Morningstar Corporate Bond	3.87%	3.87%
Morningstar US Govt Bond	3.15%	3.15%
Morningstar Mortgage Bond	2.22%	2.22%
Morningstar TIPS	4.52%	4.52%
Barclays Municipal	1.67%	1.67%

*Source: Morningstar

Overall, it was a good quarter for bonds, with most sectors and spots on the curve experiencing healthy returns and beating their equity index counterparts. The long-end dramatically outperformed both the short and intermediate parts of the curve. The Morningstar Long-Term Core Bond Index, Intermediate Core Bond Index, and Short-Term Core Bond Indices returned 6.20%, 2.60%, and 1.28%, respectively. Outside of Governments, municipals and mortgages (and really securitized products, in general) lagged, while still producing positive returns. The Barclays Municipal Index and the Morningstar Mortgage Bond Index were up 1.67% and 2.22%, respectively. TIPS were a real bright spot, as a rebound in oil and pullback in the US Dollar placed upward pressure on inflation expectations; the Morningstar TIPS Index returned 4.52%.

In credit, the year started off in full-fledged fear mode, but found its footing over the course of the quarter. This was in large part thanks to stabilization in commodities, oil in particular. Still, Investment Grade outperformed High Yield, with the Morningstar Corporate Bond Index returning 3.87% versus 3.25% for the Bank of America Merrill Lynch High Yield Index. CCC-rated bonds were the exception, as many borderline credits pulled back from the brink as oil staged an impressive rally from around $27 to $40 a barrel. According to Morgan Stanley's quarter-end US Corporate Credit Strategy Chartbook,

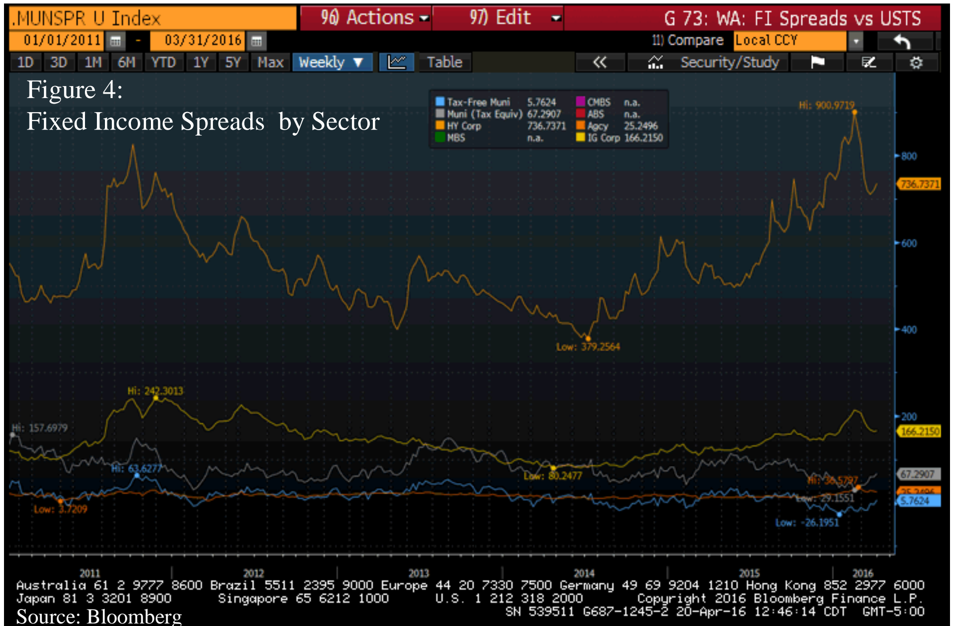


Figure 4:
Fixed Income Spreads by Sector
Source: Bloomberg

total returns by rating cohort were: CCC (5.74%), BBB (4.17%), IG Corp (4.04%), A (3.99%), AAA (3.86%), AA (3.77%), HY Corp (3.33%), BB (3.13%), and B (2.74%).

After breaching levels generally associated with preceding a recession, corporate credit spreads narrowed a good bit. Investment Grade spreads retreated from 213bp to 166bp, returning to more normalized levels. High Yield spreads came in from 900bp to 736bp, but remain somewhat elevated. Not to beat the same drum here, but oil was an especially big factor in High Yield, which has traded, and will likely continue to trade, with a heightened correlation to the price of oil. According to Morningstar, the three best performing corporate sectors on an option-adjusted spread (OAS) basis were: Basic Industries (-103.5bp), Gas Pipelines (-24.7bp), and Telecom (-13.9bp). The worst performers were: REITs (+24.4bp), Insurance (+19.5bp), and Banks (+18.2). And finally, the three cheapest sectors at quarter-end were: Gas Pipelines (357.5bp), Basic Industries (267bp), Energy (235bp).

Final Recap and Look Ahead

As total return focused fixed income managers, our first priority is and will always be to not lose money. On top of that, our goal is to *beat* the market, not *be* the market. Our strong suit has always been deploying capital in way where we can tactically take advantage of dislocated sectors and inefficiently priced securities. As such, the Composite will not likely look like the Barclays Agg in the way that it is constructed. In quarters where Treasuries and the long-end rally to the extent that they did in the first quarter, we are bound to lag. But as stated, we do not feel the need to pull the rug out from under our composite positioning. In fact, we are leaving our targets unchanged, aside from a slight 2.5% allocation from securitized debt to preferred shares.

Figure 5: Doucet Asset Management Fixed Income Composite Characteristics

	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	4.74	7.78	*-3.04*	61%	65%
Coupon Rate	5.52	3.20	*2.32*	173%	>100%
Modified Duration	2.38	5.87	*-3.49*	41%	65%
Yield to Worst	6.06	2.10	*3.96*	289%	>125%
Yield to Maturity	6.72	2.10	*4.62*	320%	>200%
Current Yield	6.19	3.02	*3.17*	205%	>100%
Convexity	0.22	0.75	*-0.53*	29%	50%
OAS	473.26	67.59	*405.67*	700%	>200%
Rating	BBB+	AA			
Corporate Debt	46.89%	28.62%	*18.27%*		40.0%
Government Debt	0.09%	47.93%	*-47.84%*		0.0%
Preferred Shares	7.76%	0.00%	*7.76%*		7.5%
Securitized Debt	4.36%	22.61%	*-18.25%*		7.5%
U.S. Municipal Debt	40.92%	0.83%	*40.09%*		45.0%

Note: Stated Benchmark is Barclays U.S. Agg Bond TR

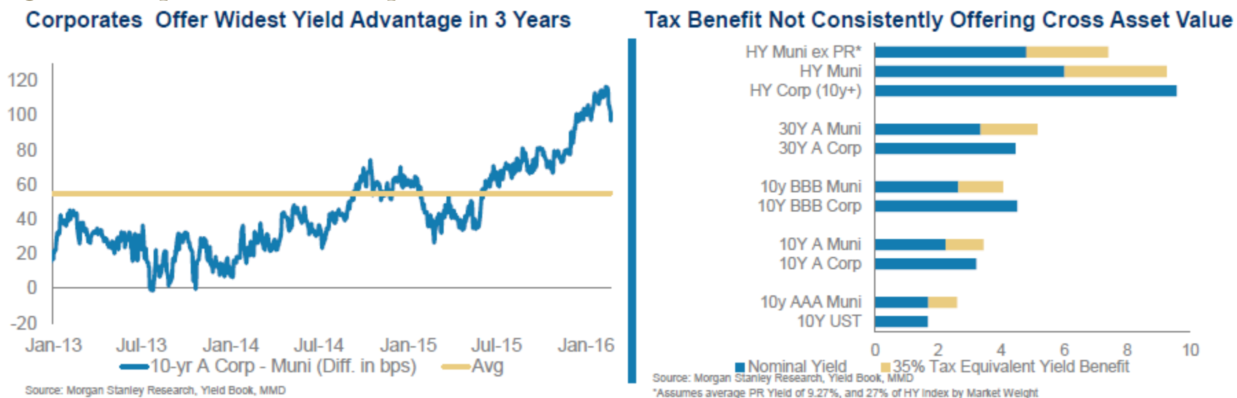
Source: All characteristics calculated using Bloomberg Portfolio & Risk Anaiyitics

In regards to duration, we are shorter than we would like to be. What we do not want to do, however is to extend for the sake of extending. We agree with the logic behind being more neutral in duration, but we simply are not seeing enough incremental pick-up in yield by going out on the curve to lead us to abandon our short posturing, altogether.

We continue to like municipals and corporates as the bedrocks of our Composite construction. It should go without saying that the decision about sector allocation between the two sectors depends on how sensitive an account is to taxes. For those that are not, municipals do not make a lot of sense in most cases, and our corporate allocation target will be much higher. For those that are tax-sensitive, where and how we deploy capital within each sector largely depends on such factors as maturity and rating. In the case of 10 year, A-rated corporates, they have recently been offering their widest yield advantage compared to municipals in 3 years. However, when viewed on a taxable equivalency basis, 10-year, A-rated corporates yield less than their municipal counterparts. On the other hand, 10-year,

BBB-rated corporates are yielding more, even after taking the municipal tax benefit into consideration. For this reason, we like municipals for the higher quality portion of accounts, and corporates for BBB-rated or less exposure.

Figure 6: Corporates vs. Municipals



Source: Morgan Stanley

Re-enforcing this stance is the fact that liquidity within the corporate bond market is a fraction of what it was a few years ago, especially with lower-rated paper. This lack of liquidity is a double-edged sword, for sure. But for those accounts that can withstand the volatility, the lack of liquidity can provide opportunities in terms of entry levels.

Lastly, as oil has rebounded, we would like to take a little energy exposure off the table. Overall the Composite has approximately a 16% exposure. While this percentage does not give us heartburn, we do feel that energy bonds have gotten a little too efficiently priced, too quickly. We would not be surprised at all to see an opportunity to re-enter names or purchase different ones at much lower prices before it is all said and done. Even if we are early, we think this is a good chance to de-risk and await the next opportunity.

Figure 7: Corporate Bond Market Liquidity

Source: Morgan Stanley

Footnotes:

[1] Keep in mind that one can not invest directly into an Index, the Barclays Agg is our benchmark for comparison.

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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