Doucet Asset Management

Fixed Income Strategy Quarterly

January 2015

2014 was supposed to be the year that yields were finally going to break out from near their all-time lows and return to more normalized levels. Of course, 2013 was supposed to be the year before that, and 2012 the year before that, and so on. You get the point. Since yields bottomed out following the financial crisis in 2008, calling for higher yields has become an annual event. But 2014 was to be different. The economic recovery seemed more and more solidified (nevermind whether the recovery was real or bought), unemployment was finally in check, and most importantly, the Fed was in full-fledged taper mode and near-universally expected to exit all QE by the end of the year (which they did by the way). A funny thing happened, though; not only did yields not climb, but rather, they actually declined precipitously. Just about every sector of the bond market seemingly defied logic and rallied like crazy, posting gangbuster returns.

How many times are forecasters going to fall into this same trap? No doubt, it is an enticing bet, much like betting black on a roulette that has hit red seven times in a row. Ultimately, the broken clock will be right twice a day and forecasters will get it right. Until then, it has the feel of a lab mouse going back to the electrified cheese over and over again.

The purpose here is not to lambast those who called for higher rates in 2014; there are plenty of reasons why making that call was rational and sound logic. What forecasters missed in 2014, however, is that even with the Fed off the table and the domestic economy on sure footing, there are even more catalysts out there acting to keep a lid on rates. We referred to these as 'proxy Feds' in our 4Q newsletter (Doucet Newsletter 4Q14).

Even in an increasingly globalized economy, the U.S. bond market remains the world's safe haven to which capital flows when it attempts to flee from danger to safety. And 2014 was a year that saw more than enough danger in the world to go around. A wobbly EU and Japan with activist central banks of their own, a slowdown in China and much of the developing world, the advance of ISIS in the Middle East, a disastrous Russia, and an outright crash in the price of oil are all major geo-political events that placed downward pressure on interest rates here at home. Add to these geopolitical dangers, that on the domestic front, inflation is a non-event, the stock market hasn't taken a real breather in 6 years, and the fact that there remains a hoard of cash on the sidelines looking for a home, and you have a recipe for the lower yield scenario that played out in 2014 and may play out for a while longer.

Bond Market At-a-Glance

As Figure 1 shows, 2014 was a year when an investor could have just about thrown a dart at a list of fixed income sectors, subsectors, and durations and made money regardless of where it landed, especially if they were willing to accept the risk of going out on the long-end of the yield curve. Of the major fixed income sectors, municipals were the big winner, posting a 9.05% return. In fact, according to Bloomberg and Bank of America Merrill data, munis showed gains every single month of the year, which is the first time that has happened since at least 1989. High yield credit, which saw spreads widen (Figure 3) due largely to the massive sell-off in oil, was among the few disappointments, but even that sector posted a positive return. Still, it was the worst performance year for high yield since the financial crisis began in 2008.

Across sectors, longer duration performed better than shorter duration, with intermediate falling in between. To give a sense of just how much of a role duration played, according to Sridhar Natarajan of Bloomberg, "Treasuries with maturities of 10 years or more returned 25 percent, while notes with one- to five-year maturities gained 1.2 percent." One would expect longer duration to perform better in a falling rate environment, but wow, a 25% return in Treasuries?! While this may sound mildly outrageous, consider the data in Figure 4. The 10-Year lost 86 bps, or declined 28% in yield, and the 30-Year shed 122 bps, for a 30% decline in yield. The 2-Year had a big move of its own, adding 28 bps, for a percent change in yield of 76.32%. However, the low duration of that security served to mute the market return for the front-end of the curve.

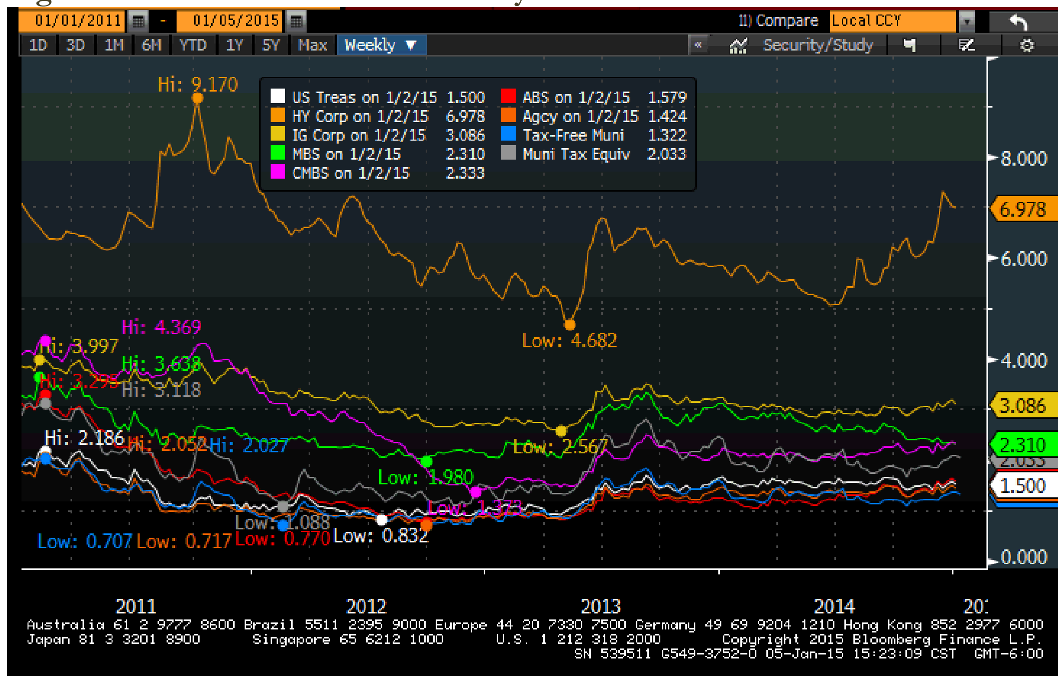
At the end of the day, 2014 left a trail of great performance, the lowest yields in about 2 years (Figure 5) and the flattest curve since 2008 (Figure 6).

Figure 1: 2014 Market Returns

Broad Market Equity Indexes	
DJIA	10.04%
S&P 500	13.69%
Broad Market Bond Indexes	
Barclays US Aggregate Bond	5.97%
Bank of America Merrill High Yield	2.50%
Morningstar Core Bond	6.07%
Morningstar Short-Term Core Bond	1.04%
Morningstar Intermediate Core Bond	5.56%
Morningstar Long-Term Core Bond	15.10%
Bond Indexes by Sector	
Morningstar Corporate Bond	7.20%
Morningstar US Govt Bond	5.08%
Morningstar Mortgage Bond	6.36%
Morningstar TIPS	3.95%
Barclays Municipal	9.05%

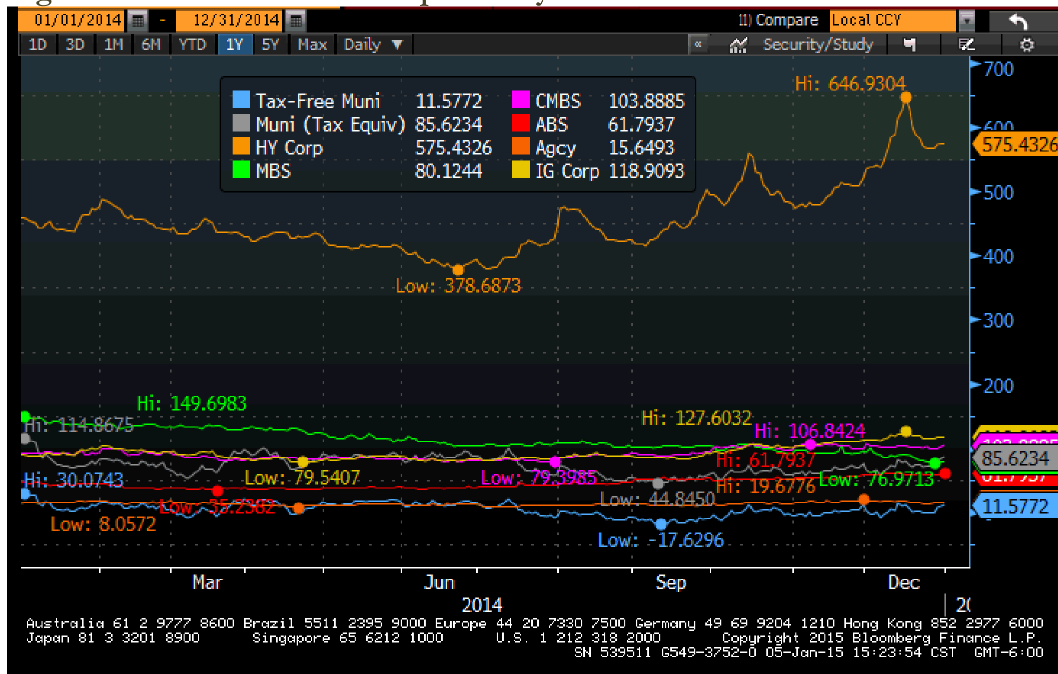
Source: Morningstar

Figure 2: Total Bond Market Yields by Sector



Source: Bloomberg

Figure 3: Total Bond Market Spreads by Sector



Source: Bloomberg

Figure 4: US Treasury Market Snapshot

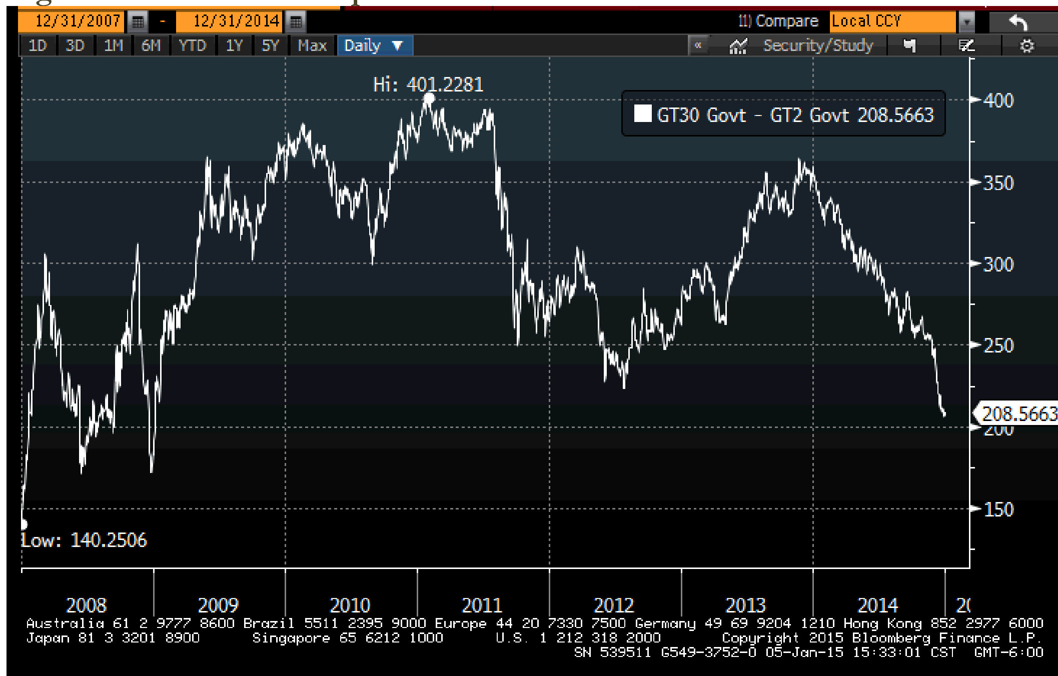
	US Treasury Actives						
	4Q14	*3Q14*	*4Q13*	*Qtr change (bps)*	*Qtr Change (%)*	*Yr Change (bps)*	*Yr Change (%)*
2-Yr	**0.67%**	0.57%	0.38%	10	17.54%	28	76.32%
5-Yr	**1.65%**	1.76%	1.74%	(10)	-6.25%	(9)	-5.17%
10-Yr	**2.17%**	2.49%	3.03%	(32)	-12.85%	(86)	-28.38%
30-Yr	**2.75%**	3.20%	3.97%	(45)	-14.06%	(122)	-30.73%

Source: Bloomberg

Figure 5: UST Active Yields since Financial Crisis:

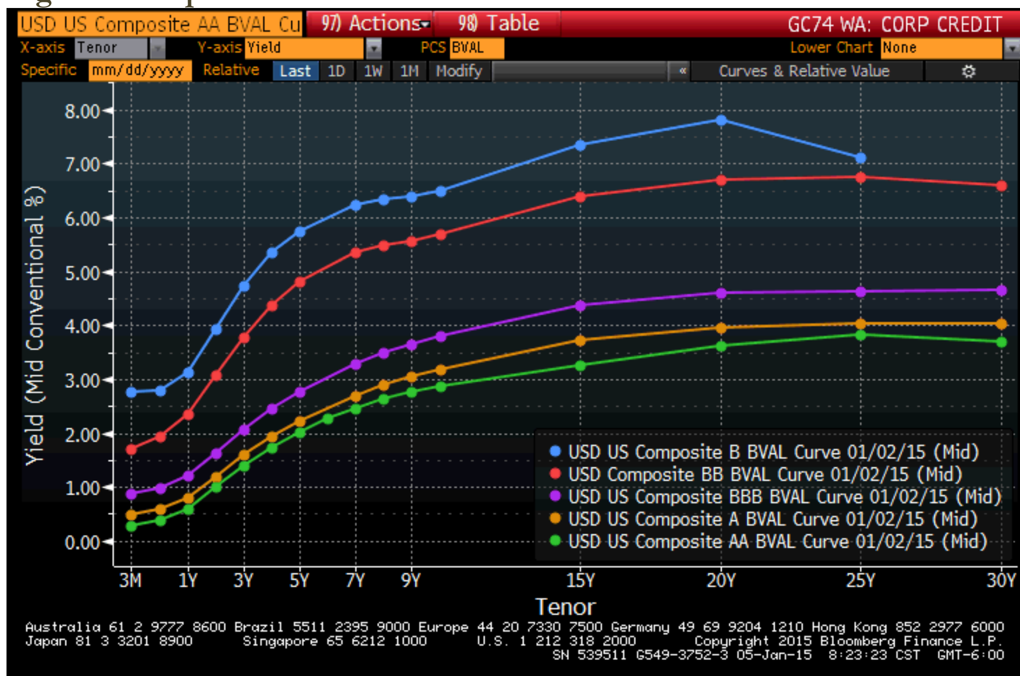
Source: Bloomberg

Figure 6: UST Curve Steepness since Financial Crisis:



Source: Bloomberg

Figure 8: Corporate Credit Curves



Source: Bloomberg

Figure 9: Municipal Market Snapshot

Muni Yields						
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*
2-Yr	0.73%	0.90%	0.58%	0.44%	0.48%	0.55%
5-Yr	1.87%	1.87%	0.98%	0.98%	1.57%	1.38%
10-Yr	2.96%	3.27%	1.95%	1.84%	2.93%	2.10%
30-Yr	4.04%	4.73%	3.61%	2.76%	4.23%	2.92%
Curve Steepness (2s-30s)	331 bps	383 bps	303 bps	232 bps	375 bps	237 bps
Muni Taxable Equivalent Yields						
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*
2-Yr	1.29%	1.59%	1.02%	0.78%	0.85%	0.97%
5-Yr	3.30%	3.30%	1.73%	1.73%	2.77%	2.44%
10-Yr	5.23%	5.78%	3.45%	3.25%	5.18%	3.71%
30-Yr	7.14%	8.36%	6.38%	4.88%	7.47%	5.16%
Curve Steepness (2s-30s)	585 bps	677 bps	536 bps	410 bps	662 bps	419 bps
Muni %UST						
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*
2-Yr	64%	151%	242%	177%	126%	83%
5-Yr	70%	93%	118%	135%	90%	83%
10-Yr	77%	99%	104%	105%	97%	97%
30-Yr	87%	109%	125%	94%	107%	106%

Source: Bloomberg

Doucet Portfolio Positioning

As represented by the newly created Doucet FI Strategy Composite, our current fixed income portfolio positioning and targets are as follows (as of 12/31/2014):

Figure 7: Doucet Asset Management FI Strategy Composite Characteristics

	Portfolio	**Benchmark**	**+/-**	**% of Benchmark**	**Target**
Workout Date	3.05	7.30	*-4.25*	42%	50%
Coupon Rate	4.61	3.30	*1.30*	139%	>100%
Modified Duration	1.91	5.14	*-3.23*	37%	50%
Yield to Worst	3.31	1.76	*1.55*	188%	>125%
Yield to Maturity	4.27	1.76	*2.51*	243%	>200%
Current Yield	5.04	3.12	*1.92*	162%	>100%
Convexity	0.18	0.69	*-0.51*	26%	50%
OAS	201.78	31.86	*169.92*	633%	>200%
Rating	A+	AA			
Corporate Debt	18.18%	25.76%	*-7.58%*		20%
Government Debt	0.16%	45.37%	*-45.21%*		0%
Preferred Shares	3.10%	0.00%	*3.10%*		10%
Securitized Debt	8.30%	27.97%	*-19.67%*		10%
U.S. Municipal Debt	70.27%	0.90%	*69.37%*		60%

*Note: Stated Benchmark is Barclays US Agg Bond TR
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics

Simply stated, our goal in positioning the portfolio is to beat the return of the broad, domestic fixed income market, as represented by our chosen benchmark (Barclays US Agg Bond TR index), with less risk. With a comparable overall rating, a workout date and modified duration less than 50% of the benchmark, and a coupon rate, yield-to-worst, yield-to-maturity, current yield, and option-adjusted spread (OAS) well in excess of 100%, we are very happy with our current positioning heading into 2015.

Being so short in workout date and modified duration (both measures of interest rate risk), could very well expose the portfolio to underperformance should yields fall dramatically as they did in 2014. This risk, however, is somewhat mitigated by the considerably higher coupon rate, OAS, and yield measures. Nonetheless, we would like to slightly increase the workout date and modified duration of the portfolio to around 50% of the benchmark over time through selective purchases.

Ultimately, though, we are not market timers when it comes to the fixed income side of our business and are not typically swinging for the fences unless there is a unique dislocation in the market, as there was in 2009-11 with non-agency mortgages. As a firm, we tend to employ a modified core-plus approach, with the fixed income portion of portfolios providing a stable core and alpha generation coming from the equity and special situation sides of our business. So while the prospect of falling rates remains a real possibility, in our opinion, there is simply too much risk to being far out on the curve with a long duration and workout date, especially given the current flatness of the curve and uncompelling credit curve dispersion (Figure 8).

Lastly, regarding the sector allocation of the portfolio, you will notice that we are currently heavily underweight Governments and overweight municipals. While we would like to add to our allocation of corporates, preferreds, and securitized debt somewhat over the upcoming quarters and year, we do not envision significantly changing our underweight and overweight to Governments and municipals, respectively. Thanks to their relatively inefficient market nature and the 3.8% tax increase on investment income for those in the highest bracket following the Affordable Care Act in 2010 (taking the max overall Federal rate to 43.4%), even with its run-up last year, it is our opinion that no other sector of the fixed income market offers as attractive a return/risk proposition as that of municipals. As the data in Figure 9 illustrates, for those investors able to take advantage of their tax-exemption, municipals offer a very compelling value when viewed on a taxable-equivalent basis. Even for those investors unable to take advantage of their tax-exemption, yields for intermediate municipals often exceeds 100%UST meriting their inclusion in tax-free accounts.

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.

The above views are those of Doucet Capital and Chris Doucet, and are not necessarily the views of Institutional Securities Corporation.
Doucet Asset Management, LLC is independent of Institutional Securities Corporation (ISC).
Chris L. Doucet is a Registered Representative of ISC. Past performance does not guarantee future returns.

REGISTERED INVESTMENT ADVISORY SERVICES PROVIDED BY DOUCET ASSET MANAGEMENT, LLC. SECURITIES OFFERED THROUGH INSTITUTIONAL SECURITIES CORPORATION, DALLAS, TEXAS, MEMBER FINRA, SIPC (214)520-1115. THIS NEWSLETTER IS FOR INFORMATION PURPOSES ONLY. NOTHING IN THIS NEWSLETTER CONSTITUTES AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY SECURITY, OR IN ANY INVESTMENT VEHICLE MANAGED BY DOUCET CAPITAL, LLC OR DOUCET ASSET MANAGEMENT, LLC, OR ANY OF THEIR AFFILIATES. NOTHING IN THIS NEWSLETTER CONSTITUTES PROFESSIONAL OR FINANCIAL ADVICE, OR RECOMMENDATIONS TO PURCHASE OR SELL A PARTICULAR SECURITY. CERTAIN INFORMATION DISCUSSED IN THIS NEWSLETTER MAY CONSTITUTE FORWARD-LOOKING STATEMENTS WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS "MAY," "WILL," "SHOULD," "EXPECT," "ANTICIPATE," "TARGET," "PROJECT," "ESTIMATE," "INTEND," "CONTINUE" OR "BELIEVE," OR THE NEGATIVES THEREOF OR OTHER VARIATIONS THEREON OR COMPARABLE TERMINOLOGY. DUE TO VARIOUS RISKS AND UNCERTAINTIES, ACTUAL EVENTS OR RESULTS OR THE ACTUAL PERFORMANCE OF ANY OF THE INVESTMENTS DISCUSSED HEREIN MAY DIFFER MATERIALLY FROM THE EVENTS, RESULTS OR PERFORMANCE CONTEMPLATED BY SUCH FORWARD-LOOKING STATEMENTS. ALTHOUGH DOUCET ASSET MANAGEMENT, LLC BELIEVES THAT THE EXPECTATIONS REFLECTED IN SUCH FORWARD-LOOKING STATEMENTS ARE BASED UPON REASONABLE ASSUMPTIONS AT THE TIME MADE, IT CAN GIVE NO ASSURANCE THAT ITS EXPECTATIONS WILL BE ACHIEVED.