DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

January 2016

From a macro perspective, 2015 was a year that challenged conventional wisdom that "no news is good news". The tone was so somber at times that even *no news* (as evidenced by a year's worth of Fed inaction) was interpreted as being *bad news*. In terms of actual news, forget about it! You had Greece, China, a collapse in commodities, an emerging market meltdown, a runaway dollar, the largest migration crises since World War II, and the ECB lowering their deposit rate to -.30% from -.20% and extending their asset purchase program in an effort to spur economic growth in Europe, just to name a few. Across the board, headlines just seemed to be universally dismal; even the Super Bowl had taint on it from the Deflate-gate cheating scandal. Simply stated, it was ugly out there.

Of course, maybe this perception has something to do with the fact that we, as market participants, are exhibiting a little bit of recency bias after riding a wave of euphoria from a 7-year bull market that seems to be turning. There were, as always, some positives, including: further improvement in housing, continuing improvement in the employment picture, and a steadily (although slowly) growing domestic economy. Even so, stories like these were not the loudest voices in the room, and were overshadowed by the bad ones.

As a result of this tone, 2015 was a year where the fixed income market rewarded conservatism and penalized risk-taking. It was a good year for municipals, short-to-intermediate duration, and investment grade quality. It was a bad year for high yield credit and long duration. Despite our underperformance in the second half of the year, where our energy positions detracted from overall performance, our considerable overweight in municipals, short duration, and contained high yield exposure carried us to a year of modest outperformance in an exceedingly difficult market environment where volatility was rampant. **Compared to a .55% return for the Barclays Agg, the Doucet Asset Management Fixed Income Strategy Composite returned .79%, for total outperformance of 24bp.**

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	1Q15	2Q15	3Q15	4Q15	YTD
Doucet Fixed Income Composite	1.70%	1.01%	-0.63%	-1.37%	0.79%
Barclays US Aggregate Bond	1.61%	-1.68%	1.23%	-0.57%	0.55%
+/- Benchmark	0.09%	2.69%	-1.86%	-0.80%	0.24%

*Note: Stated benchmark is Barclays US Agg Bond TR
Source: Performance calculated by Morningstar Office

Bond Market At-a-Glance

Given the melancholy mood on the Street, it is really quite remarkable that yields stayed pretty much the same and that equity markets finished essentially flat for the year, especially considering that the Fed finally did pull the trigger on raising rates. By the time they did get around to it, however, it was fairly anticlimactic, as much of the move was already 'in the price' and there were enough cross-currents around the world to keep it in check. With both Treasuries and municipals, yield curves did flatten marginally as short-term rates increased. Even so, these changes were more of a tweak than a sea change, and the overall yield curve environment was largely unchanged. The 2-Yr, 5-Yr, 10-Yr, and 30-Yr Treasury finished at 1.05% (+38bp), 1.76% (+11bp), 2.27% (+10bp), and 3.02% (+27bp), respectively, for a 2s-30s steepness of 197bp. And the 2-Yr, 5-Yr, 10-Yr, and 30-Yr AAA benchmark municipal finished at .74% (+19bp), 1.32% (-6bp), 2.00% (-10bp), and 2.90%, (-2bp), respectively, for a 2s-30s steepness of 216bp.

Figure 2: U.S. Treasury Market Snapshot

	US Treasury Actives						
	4Q15	*3Q15*	*4Q14*	*Qtr change (bp)*	*Qtr Change (%)*	*Yr Change (bp)*	*Yr Change (%)*
2-Yr	**1.05%**	**0.63%**	0.67%	42	66.67%	38	56.72%
5-Yr	**1.76%**	**1.36%**	1.65%	40	29.40%	11	6.67%
10-Yr	**2.27%**	**2.04%**	2.17%	23	11.27%	10	4.60%
30-Yr	**3.02%**	**2.85%**	2.75%	17	5.96%	27	9.81%

Source: Bloomberg

Figure 3: Municipal Market Snapshot

Muni Yields							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*12/31/15*
2-Yr	0.73%	0.90%	0.58%	0.44%	0.48%	0.55%	0.74%
5-Yr	1.87%	1.87%	0.98%	0.98%	1.57%	1.38%	1.32%
10-Yr	2.96%	3.27%	1.95%	1.84%	2.93%	2.10%	2.00%
30-Yr	4.04%	4.73%	3.61%	2.76%	4.23%	2.92%	2.90%
Curve Steepness (2s-30s)	331bp	383bp	303bp	232bp	375bp	237bp	216bp
Muni Taxable Equivalent Yields							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*12/31/15*
2-Yr	1.29%	1.59%	1.02%	0.78%	0.85%	0.97%	1.31%
5-Yr	3.30%	3.30%	1.73%	1.73%	2.77%	2.44%	2.33%
10-Yr	5.23%	5.78%	3.45%	3.25%	5.18%	3.71%	3.53%
30-Yr	7.14%	8.36%	6.38%	4.88%	7.47%	5.16%	5.12%
Curve Steepness (2s-30s)	585bp	677bp	536bp	410bp	662bp	419bp	381bp
Muni %UST							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*12/31/15*
2-Yr	64%	151%	242%	177%	126%	83%	70%
5-Yr	70%	93%	118%	135%	90%	83%	75%
10-Yr	77%	99%	104%	105%	97%	97%	88%
30-Yr	87%	109%	125%	94%	107%	106%	96%

Source: Bloomberg

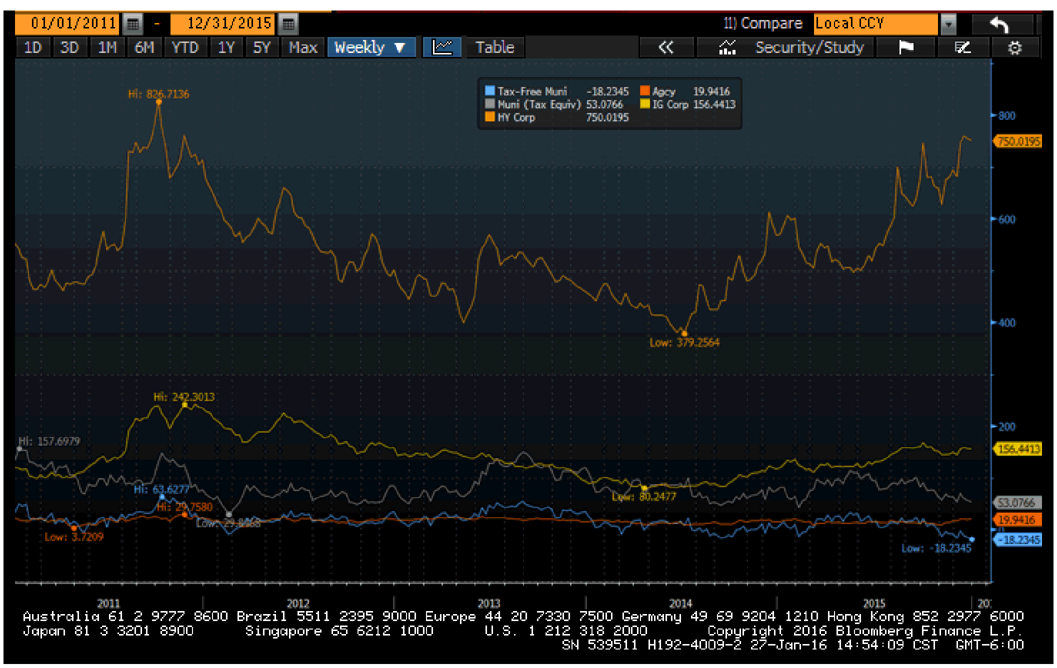
Looking at the major sectors across the fixed income landscape, good, old boring municipal bonds (3.30% 2015 return) edged out most others, including the more high-flying, exotic sectors, like CLOs (-.69%) and high yield credit (-4.64%). It was a tough time all around for U.S. credit, where both investment grade and high yield posted negative returns as spreads widened. On the year, investment grade credit saw spreads widen 36bp (from 120bp to 156bp), while high yield witnessed 179bp of widening (from 571bp to 750bp). According to Morgan Stanley's U.S. Credit Strategy: 2015 Performance Recap, "While all IG sectors ended the year with wider spreads, Financials (+16bp), Healthcare (+18bp), and Consumer (+19bp) widened the least in 2015. Unsurprisingly, Energy (+101bp) and Basics (+121bp) were the worst performers in IG. In HY, Retail Food & Drug (7.1% total return), Food/Beverage/Bottling (6.9%), and Lodging (5.1%) outperformed, whereas Metals/Mining (-30.5%), Energy (-24.9%), and Paper & Forest Products (-16.4%) performed worst."

Figure 4: Index Returns

	4Q15	YTD
Broad Market Equity Indexes		
DJIA	7.70%	0.21%
S&P 500	7.04%	1.38%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	-0.57%	0.55%
Bank of America Merrill High Yield	-2.17%	-4.64%
Morningstar Core Bond	-0.45%	0.98%
Morningstar Short-Term Core Bond	-0.40%	0.79%
Morningstar Intermediate Core Bond	-0.32%	1.96%
Morningstar Long-Term Core Bond	-0.84%	-1.55%
Bond Indexes by Sector		
Morningstar Corporate Bond	-0.37%	-0.46%
Morningstar US Govt Bond	-0.89%	0.91%
Morningstar Mortgage Bond	0.05%	2.23%
Morningstar TIPS	-0.65%	-1.60%
Barclays Municipal	1.50%	3.30%

Source: Morningstar

Figure 5: Fixed Income Spreads by Sector



<u>Final Recap and Look Ahead</u>

Over the course of 2015, the Doucet Asset Management Fixed Income Composite extended workout date and duration, while still remaining well short of its benchmark. Furthermore, coupon, yield, and OAS were added, while the overall credit quality declined two notches, from A+ to A-. Not only did these metrics change in aggregate, but they also increased on a percent of benchmark basis. The biggest changes occurred within the sector allocation, where the overall percentage of corporate debt owned increased 24.98% and the percentage of municipal debt decreased 28.01%.

As for targets, we are amending our workout date and modified duration targets from 50% of the benchmark to 65%. This is a fairly nominal change, and does not express a real change in opinion on curve posturing. Rather, it reflects our ongoing belief in a 'lower for longer' yield curve environment, where the Fed is likely being overly optimistic in their stated plan of rate hikes. We are also increasing our target allocation to corporate debt and securitized debt, while decreasing the allocation to preferreds and municipals. Again, these are not huge changes, but are rather tweaks to better align the targets with the current composition of the portfolio, which we continue to believe is prudently structured to best take advantage of the current market environment.

Figure 6: Doucet Asset Management Fixed Income Composite Characteristics

	Composite Characteristics			% of Benchmark			Targets
	YE2015	**YE2014**	***YoY Δ***	**YE2015**	**YE2014**	***YoY Δ***	**New**
Workout Date	4.38	3.05	*1.33*	58%	42%	*16%*	65%
Coupon Rate	5.57	4.61	*0.96*	172%	139%	*33%*	>100%
Modified Duration	2.34	1.91	*0.43*	41%	37%	*4%*	65%
Yield to Worst	5.96	3.31	*2.65*	236%	188%	*48%*	>125%
Yield to Maturity	6.64	4.27	*2.37*	262%	243%	*19%*	>200%
Current Yield	6.32	5.04	*1.28*	202%	162%	*40%*	>100%
Convexity	0.19	0.18	*0.01*	26%	26%	*0%*	50%
OAS	461.09	201.78	*259.31*	696%	633%	*63%*	>200%
Rating	A-	A+					
Corporate Debt	43.16%	18.18%	*24.98%*				40.0%
Government Debt	0.16%	0.16%	*0.00%*				0.0%
Preferred Shares	10.22%	3.10%	*7.12%*				5.0%
Securitized Debt	4.23%	8.30%	*-4.07%*				10.0%
U.S. Municipal Debt	42.26%	70.27%	*-28.01%*				45.0%

Note: Stated Benchmark is Barclays U.S. Agg Bond TR
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics

So now for the $64,000 question of where value will be in fixed income in 2016. In some respects, we think it will be a very similar year to 2015. Once again, we anticipate choppy markets with widening credit spreads and limited liquidity, where quality and an intermediate curve posturing outperform. We see a bias from growth to value on the equity side and see similar changes in bonds if we get a stabilization in commodity prices. With that said, we do believe that oil prices have likely bottomed in the mid-high $20s, and that energy paper is due to catch a pop, at least for those companies that will be the eventual winners within the space. It will be tempting to add exposure there, but our current allocation of 13.97% to the sector does not provide us with a lot of extra headroom. One possible exception is midstream MLP paper, to which we have very minimal exposure. It will be equally tempting to add high yield credit; however, we think patience outweighs urgency. At some point it will be a great trade, but we think it has further to go before adding a broad-based allocation.

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.