DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

October 2015

Greece…what Greece? It is all about China now, or so it would appear at times over the course of the 3rd quarter. It was largely ghost quiet on the fronts of the macroeconomic shocks that defined the 2nd quarter, namely: Greece, Puerto Rico, Chicago pensions, and the Petrobras scandal and flailing Brazilian economy. To be clear, none of these problems went away; they are all still out there. Even so, the markets more or less moved on, swapping old problems for new ones. Chief among these new problems was a Chinese economy and market in full-blown crisis mode, and the consequential crash in commodities and global growth concerns that followed suit.

And then, of course, there was the Fed. This Federal Reserve seems to redefine Newton's Third Law to something along the lines of 'for every **inaction**, there is a disproportionately large and unpredictable reaction'. By citing "developments abroad", Chairman Yellen & Co. punted on raising rates in September and took a step away from data-dependency in the process. This inaction, along with a China-led spike in global volatility, left investors decidedly less confident and triggered a large-scale flight to quality. Money flowed out of equities and riskier bonds and into Treasuries. As it did, the S&P 500 experienced its first correction since 2011 (declining 12.5% peak to trough), corporate spreads widened, and Treasuries rallied. The 2-Yr, 5-Yr, 10-Yr, and 30-Yr Treasury finished at .63% (-3bps), 1.36% (-17bps), 2.04% (-14bps), and 2.85% (-5bps), respectively.

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	1Q15	2Q15	3Q15	YTD
Doucet Fixed Income Composite	1.70%	1.01%	-0.63%	2.16%
Barclays US Aggregate Bond	1.61%	-1.68%	1.23%	1.13%
+/- Benchmark	0.09%	2.69%	-1.86%	1.03%

*Note: Stated Benchmark is Barclays US Agg Bond TR
Source: Performance calculated using Morningstar Office

Whereas it was at the right place at the right time in the 2nd quarter, the positioning of our FI Strategy Composite did not do us any favors in the 3rd quarter. As a result, the Composite gave some back and returned -0.63% compared to 1.23% for the benchmark. In a complete reversal, our short duration stance held us back this time around, as the long-end of the curve outperformed. Our credit exposure (particularly in the Energy space) did not help us either, as Governments outperformed just about everything else. Still, some quarter-to-quarter volatility is to be expected with all that is going on in the global economy, and we continue to believe our positioning sets us on the right course. **Year-to-date the Composite has returned 2.16% versus 1.13% for the benchmark, for outperformance of 103bps.**

Bond Market At-a-Glance

What was a boon for Governments proved to be somewhat of a bust for high-yield, which posted a -4.90% return for the quarter. High-yield and leveraged loans were the places to be for most of the year; however, they both took it on the chin during the 3rd quarter. According to Morningstar, the High Yield Bond and Bank Loan categories saw net asset flows from open-end mutual funds and ETFs of -8.97B and -4.85B, respectively. This sent high-yield spreads to their widest level since late 2011, at +724bps. Speaking of high-yield, Morgan Stanley said the following in their October 2nd *Leveraged Finance Insights: 2B or not 2B*, "Price action of late has certainly resembled the capitulation phase of a selloff. Markets have seemed to be in 'sell-and-ask-questions-later' mode, where any piece of negative news can quickly reprice entire capital structures and sectors." We agree with this statement 100%, and find that downward price action in the corporate bond market, as a whole, is further exacerbated by a general lack of liquidity, thanks in part to Dodd-Frank making it more difficult for large firms to step in and smooth volatility by taking down inventory.

In credit, it was not just high-yield that witnessed spread widening. Investment grade, too, saw spreads widen to multi-year highs. In fact, year-to-date, all corporate sectors have widened on an option-adjusted spread (OAS) basis. According to Morningstar, Bank/Finance has widened the least (+20bps YTD OAS change) and is the year's best performer, while Basic Industries has widened the most (+88bps YTD OAS change) and is the year's worst. As of the end of the quarter, the three cheapest sectors were Basic Industries (+281bps), Energy (+279bps), and Gas Pipelines (+274bps).

Elsewhere in fixed income, yields for quality assets within the securitized debt and municipal spaces tended to tighten in tandem with Treasuries. There really was not a lot going on in those areas; they just more or less trudged along, grinding a little tighter. The headline risk that plagued the municipal market last quarter all but went away. There were some grumblings here and there about Puerto Rico and Chicago, but fears abated of any systemic risk posed by such situations.

Figure 2: Year-to-Date Market Returns

	3Q15	YTD
Broad Market Equity Indexes		
DJIA	-6.98%	-6.95%
S&P 500	-6.44%	-5.29%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	1.23%	1.13%
Bank of America Merrill High Yield	-4.90%	-2.53%
Morningstar Core Bond	1.35%	1.43%
Morningstar Short-Term Core Bond	0.38%	1.19%
Morningstar Intermediate Core Bond	1.46%	2.29%
Morningstar Long-Term Core Bond	2.35%	-0.72%
Bond Indexes by Sector		
Morningstar Corporate Bond	0.49%	-0.09%
Morningstar US Govt Bond	1.78%	1.81%
Morningstar Mortgage Bond	1.49%	2.18%
Morningstar TIPS	-1.14%	-0.95%
Barclays Municipal	1.65%	1.77%

Source: Morningstar

Figure 3: Total Bond Market Spreads by Sector

Source: Bloomberg

Figure 4: U.S. Treasury Market Snapshot

	US Treasury Actives						
	3Q15	*2Q15*	*3Q14*	*Qtr change (bps)*	*Qtr Change (%)*	*Yr Change (bps)*	*Yr Change (%)*
2-Yr	**0.63%**	0.66%	0.57%	(3)	-4.55%	6	10.53%
5-Yr	**1.36%**	1.53%	1.76%	(17)	-11.11%	(40)	-22.73%
10-Yr	**2.04%**	2.18%	2.49%	(14)	-6.42%	(45)	-18.07%
30-Yr	**2.85%**	2.91%	3.20%	(5)	-2.06%	(34)	-10.94%

Source: Bloomberg

Figure 5: Municipal Market Snapshot

Muni Yields							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*9/30/15*
2-Yr	0.73%	0.90%	0.58%	0.44%	0.48%	0.55%	0.60%
5-Yr	1.87%	1.87%	0.98%	0.98%	1.57%	1.38%	1.30%
10-Yr	2.96%	3.27%	1.95%	1.84%	2.93%	2.10%	2.09%
30-Yr	4.04%	4.73%	3.61%	2.76%	4.23%	2.92%	3.16%
Curve Steepness (2s-30s)	331 bps	383 bps	303 bps	232 bps	375 bps	237 bps	256 bps
Muni Taxable Equivalent Yields							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*9/30/15*
2-Yr	1.29%	1.59%	1.02%	0.78%	0.85%	0.97%	1.06%
5-Yr	3.30%	3.30%	1.73%	1.73%	2.77%	2.44%	2.30%
10-Yr	5.23%	5.78%	3.45%	3.25%	5.18%	3.71%	3.69%
30-Yr	7.14%	8.36%	6.38%	4.88%	7.47%	5.16%	5.58%
Curve Steepness (2s-30s)	585 bps	677 bps	536 bps	410 bps	662 bps	419 bps	452 bps
Muni %UST							
	12/31/09	*12/31/10*	*12/31/11*	*12/31/12*	*12/31/13*	*12/31/14*	*9/30/15*
2-Yr	64%	151%	242%	177%	126%	83%	95%
5-Yr	70%	93%	118%	135%	90%	83%	96%
10-Yr	77%	99%	104%	105%	97%	97%	103%
30-Yr	87%	109%	125%	94%	107%	106%	111%

Source: Bloomberg

Looking Ahead

Over the course of the 3rd quarter, we extended the duration of the Composite from 1.89 years to 2.20 years (remaining <50% of the benchmark), added coupon, and picked up yield and spread in the process. We upped our corporate and preferred exposures just a bit by re-deploying funds away from securitized debt and municipals.

Figure 6: Doucet Asset Management FI Strategy Composite Characteristics

	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	4.20	6.78	*-2.58*	62%	50%
Coupon Rate	5.51	2.92	*2.60*	189%	>100%
Modified Duration	2.20	5.03	*-2.83*	44%	50%
Yield to Worst	5.11	2.00	*3.11*	256%	>125%
Yield to Maturity	5.89	2.00	*3.89*	295%	>200%
Current Yield	5.99	2.80	*3.19*	214%	>100%
Convexity	0.18	0.62	*-0.44*	29%	50%
OAS	397.95	59.96	*337.99*	664%	>200%
Rating	A-	AA			
Corporate Debt	36.40%	36.89%	*-0.49%*		35.0%
Government Debt	0.10%	43.43%	*-43.33%*		0.0%
Preferred Shares	9.84%	0.00%	*9.84%*		7.5%
Securitized Debt	5.29%	18.88%	*-13.59%*		7.5%
U.S. Municipal Debt	48.37%	0.79%	*47.58%*		50.0%

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

Despite our underperformance in the 3rd quarter, we are leaving our targets intact and are very happy with our current positioning. We expect that Energy and other commodity related names will remain volatile for the time being, oscillating between being leaders and laggards in the portfolio. Still, we are diversified in those areas and stand behind the rationale for the positions we own there. We are not speculators in the space, but rather longer-term investors anticipating an eventual reversion to some sort of historical mean. While that mean may not be the same as it was in a

$100/bbl oil environment, we believe that it will ultimately be higher than it is today. Until this happens, the bonds have enough carry and roll down potential to justify taking on the interim volatility in our minds.

In the last *Fixed Income Quarterly*, we noted that we would like to add some BB-rated corporate names in the 5-7 year area should a spread widening event occur. Well, a spread widening event did, in fact, occur; however, we are taking a decidedly more reserved approach in adding exposure here, as we see there being more room for spreads to widen. We still believe that high yield has potential to significantly outperform due to its higher credit spread, lower duration, and the fact that default rates are expected to remain manageable. Again according to Morgan Stanley, "First, we think markets are experiencing a growth scare, not the start of a broad-based default cycle. We believe the US economy will muddle along. Second, while the world does feel like a risky place, it is crucial to focus on what is already in the price. If this is just a scare, a double-digit return in high yield over the next year no longer requires aggressive assumptions." We agree with them wholeheartedly on this. Nonetheless, in a risk-off market, credit risk matters more than interest rate risk, and the low correlation to interest rates thesis broke down somewhat this past quarter as investors abandoned ship and ran for cover. With a Fed hike in December being far from a sure thing, we do not see it as being necessary to rush into the trade, and believe that patience is a virtue in putting money to work.

Last but not least, we continue to love municipals for taxable accounts that can take advantage of the tax-exemption. And, in some situations, we think a case can be made for crossover buyers, too. While we see the new issue market as being efficient to a 'T', opportunities do still exist in the secondary market for investors willing to look at inefficiently trading names and small deals/block sizes, and do a deep dive on the credits. In such circumstances, we believe that taxable-equivalent yields represent some of the best risk/return propositions across the fixed income landscape today.

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.