DOUCET ASSET MANAGEMENT, LLC
*Fixed Income Quarterly*
*July 2017*

## Roll the Dice Quarter

Argentina declared its independence from Spain in 1816. Since then, the country has been in some version of default on its government debt over 33% of the time. (Source: This Time is Different, Reinhart and Rogoff). The country's eighth default in its 200-year history just occurred in 2014. But despite that minute detail, there was little recency bias in the minds of investors as Argentina issued a 100-year government bond which was gobbled up by yield-starved fixed income investors. While other governments such as Mexico and Ireland have issued "century" bonds, Argentina marks the first junk-rated sovereign to successfully float a 100-year bond. Even serial defaulter Greece is being welcomed back to the bond market with open arms and an expected 4.75% yield on five-year euro-denominated bonds! This is just a sampling of the many negative side-effects of too much central bank bond buying and how sometimes truth is actually much stranger than fiction.

It should not be surprising that the 2nd quarter of 2017 was highlighted by investors' willingness to roll the dice on both credit and maturity risk. As a general rule, the longer the maturity and the lower the credit rating in one's fixed income portfolio, the better the portfolio performed during the second quarter. Short term rates rose while long term yields declined resulting in a slight flattening of the yield curve. Additionally, credit yield spreads narrowed to a level only seen once since the 2007-2008 period.

**Figure 1: Doucet Asset Management FI Strategy Composite Performance**

| | YTD | 2Q2017 | 2016 | 2015 | Since Inception |
|---|---|---|---|---|---|
| Doucet Fixed Income Composite | 1.90% | 0.80% | 10.64% | 0.73% | 5.13% |
| Barclays US Aggregate Bond | 2.27% | 1.45% | 2.65% | 0.55% | 2.19% |
| +/- Benchmark | -0.37% | -0.65% | 7.99% | 0.18% | 2.94% |

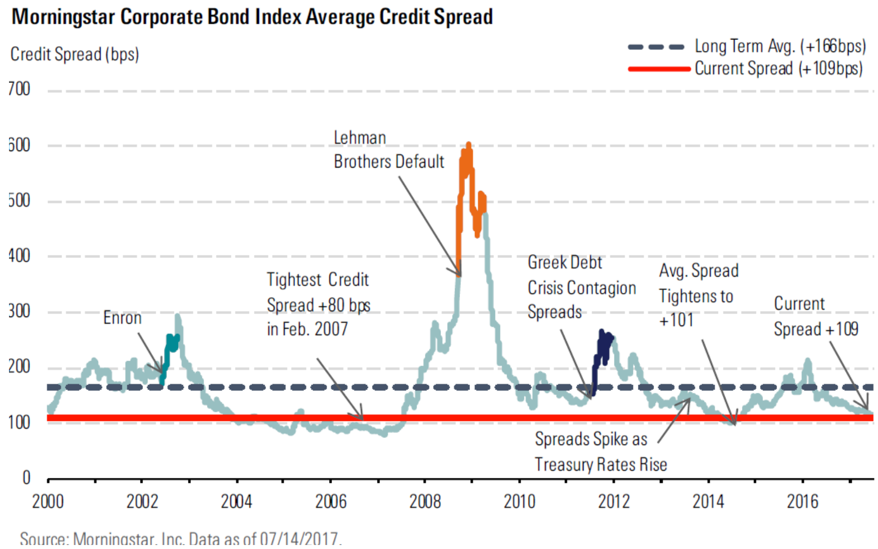
*Performance calculated by Morningstar Office, periods over 1 year are annualized

With a modified duration 1.9 years and an average credit quality of an A-rating (see figure 4), the Doucet Fixed Income Composite was up 80 basis points for the quarter and 1.9% for the first half of 2017 versus the Barclays US Aggregate Bond Index which was up 1.45% and 2.27% respectively. (see figure 1) While disappointed by the underperformance in the quarter, we vehemently believe the combination of historically low volatility, a flattening yield curve and anemically low credit spreads is not exactly the perfect recipe for taking on excessive risk to realize a few extra basis points in yield.

## Good Credit, Bad Credit, No Problem!

Fixed income investors have simply become too complacent about credit risk. Credit spreads, or the yield differential between Treasuries and debt securities with the same maturity but lesser quality, narrowed to their lowest levels since 2007, with the small exception of September, 2014. According to Morningstar, "since the beginning of 2000, the average spread of the Morningstar Corporate Bond Index has registered below the current level only about 20% of the time." (see figure 2) Being in the bottom 20th percentile in anything is not good, but Morningstar suggests the spread is actually a bit less positive than at first blush. The index is "a full notch" in the average credit quality versus a "single A for much of the time" since the index was established suggesting credit spreads have narrowed to very low levels even though the index is now rated lower than it has been in the past.

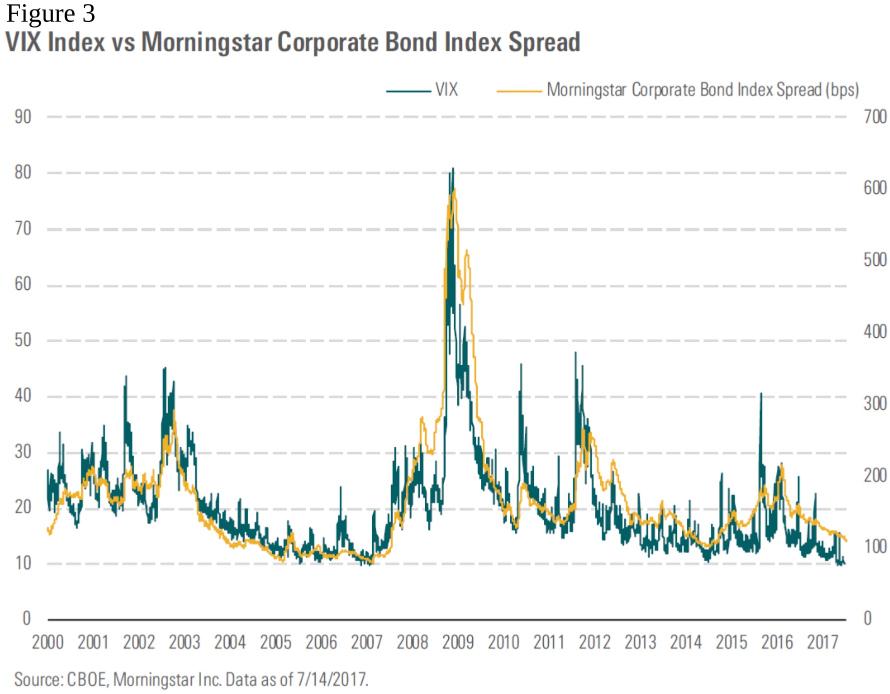
Figure 2




## Fearless Bond Investors

It is important to note that there is a high correlation between bond spreads and market volatility. (see figure 3) As a matter of fact, "the Morningstar Corporate Bond Index and the VIX (otherwise known as the fear index) have an r-squared of about 85%. What this means is when the market is volatile, the difference between Treasury yields and all other yields will typically widen; when the market is complacent, spreads between Treasuries and other credits tend to narrow. As we noted in our most recent quarterly newsletter, The Gutenberg Market the VIX is currently trading at its lowest level since 1993. Despite record levels of debt around the world, historically high multiples, a luke-warm economy, loan delinquencies on the rise, a flattening of the yield curve, and the start of quantitative tightening by several major central banks around the world, investors are more complacent today about risk taking in their portfolios than at any other time in the past 23 ½ years.

Figure 3




## What To Do in a Low Yield, High Risk Market

All of these elements present a daunting landscape for fixed income investors, especially when you take an opportunistic approach to finding relative value within the fixed income market like we do. Simply put, when the 10-year Treasury yields 2.3% and credit spreads narrow, it is difficult to produce alpha in fixed income portfolios without taking an inordinate amount of risk. In the absence of value, our default position in our bond portfolios is to remain short in duration and high in credit quality until real reversion to the mean opportunities present themselves. Currently, the average life in our Composite is only 1.9 years and we do not expect a significant change until market volatility increases and spreads widen which we believe could happen any day now. If we are wrong, the downside is boredom and the loss of only a few basis points versus the benchmark. But if we are right, our portfolios are well positioned to benefit from any market dislocation that may occur in the near future.

**Figure 4: Doucet Asset Management Fixed Income Composite Characteristics**

| | Portfolio | Benchmark | +/- | % of Benchmark | Target |
|---|---|---|---|---|---|
| **Workout Date** | 6.84 | 7.95 | *-1.11* | 86% | 65% |
| **Coupon Rate** | 5.11 | 3.06 | *2.06* | 167% | >100% |
| **Modified Duration** | 1.90 | 6.06 | *-4.16* | 31% | 65% |
| **Yield to Worst** | 3.78 | 2.56 | *1.22* | 148% | >125% |
| **Yield to Maturity** | 4.73 | 2.56 | *2.17* | 185% | >150% |
| **Current Yield** | 5.27 | 2.97 | *2.30* | 177% | >150% |
| **Convexity** | 0.16 | 0.77 | *-0.61* | 21% | 50% |
| **OAS** | 196.23 | 36.90 | *159.33* | 532% | >200% |
| **Rating** | A | AA | | | |
| **Corporate Debt** | 33.06% | 26.98% | *6.08%* | | 25.0% |
| **Government Debt** | 0.02% | 42.01% | *-41.99%* | | 0.0% |
| **Preferred Shares** | 7.56% | 0.00% | *7.56%* | | 5.0% |
| **Securitized Debt** | 6.70% | 30.34% | *-23.64%* | | 10.0% |
| **U.S. Municipal Debt** | 53.66% | 6.70% | *46.96%* | | 60.0% |

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

Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics

Sincerely,

Chris L. Doucet

Chris Doucet

## Firm News

Chris was recently featured in the *The Bond Buyer* discussing Jefferson County, AL's historic return to bond markets after their 2013 bankruptcy.

**Footnotes:**

[1] Morningstar Corporate Credit Research Highlights, *Second Quarter Fixed-Income Index Review*, July, 2017

**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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