DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

October 2016

With the Federal Reserve once again on hold, the only hike in the 3rd quarter was of the *hut-hut-hike* variety. It was, in many ways, a quarter of seasonal change as football season got underway, summer faded into fall, and election season reached a crescendo. As for a new season in yields…well, not so much. Domestic yields did inch up a bit, but remained largely depressed for all the same reasons: Fed inaction, negative yields abroad, tame inflation, and lackluster economic growth, to name a few. Even so, U.S. fixed income continues to look like a relative bargain compared to the rest of the developed world. In recognition of this fact, money has continued to flow into the asset class. So strong has the demand been for dollar-denominated U.S. fixed income that some large investment banks have even begun to publish their municipal bond research in Japanese. This is truly remarkable given that the key attribute of municipal bonds is their tax-exempt status, a feature from which a Japanese investor would receive no benefit.

Amid this backdrop, it has been a good year for U.S. bonds and a very good year for the Doucet Asset Management Fixed Income Strategy Composite. The 3rd quarter held true to this theme, although returns were somewhat tempered compared to the first half of the year. The Composite posted a 1.91% return, besting its benchmark (the Barclays Agg) by 145 bp. This brings our year-to-date performance to 9.57%, compared to 5.80% for the Agg and 7.84% for the S&P 500.

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	YTD	3Q16	2Q16	2015	Since Inception
Doucet Fixed Income Composite	9.57%	1.91%	5.44%	0.79%	5.14%
Barclays US Aggregate Bond	5.80%	0.46%	2.21%	0.55%	3.60%
+/- Benchmark	3.77%	1.45%	3.23%	0.24%	1.54%

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

Bond Markets At-a-Glance

Whereas you could almost have blindly thrown a dart and hit a winning sector in the 2nd quarter, fixed income index returns were more uneven and case-by-case in the 3rd quarter. Once again, high-yield was the clear winner, with the Bank of America Merrill High Yield Master II index returning 5.49% for the quarter. This brings its year-to-date return to a whopping 15.32%, almost twice that of the S&P 500. Among the other major sectors we track, only investment-grade credit and TIPS returned more than 1%, with the Morningstar Corporate Bond and Morningstar TIPS indices returning 1.49% and 1.01%, respectively. Municipals and U.S. Government bonds actually saw marginal declines, with the Barclays Municipal and Morningstar U.S. Govt Bond indices posting -.30% and -.23%, respectively.

In terms of curve positioning, the flattening theme continued as the long-end again outperformed both the short-and-intermediate parts of the curves. The Morningstar Long-Term Core Bond, Intermediate Core Bond, and Short-Term Core Bond indices returned 1.02%, .51%, and .06%, respectively. As a result, the 2-30 Treasury curve spread finished at 156 bp, compared to 171 bp last quarter and 222bp a year ago.

Bond Market At-a-Glance

Figure 2: Index Returns

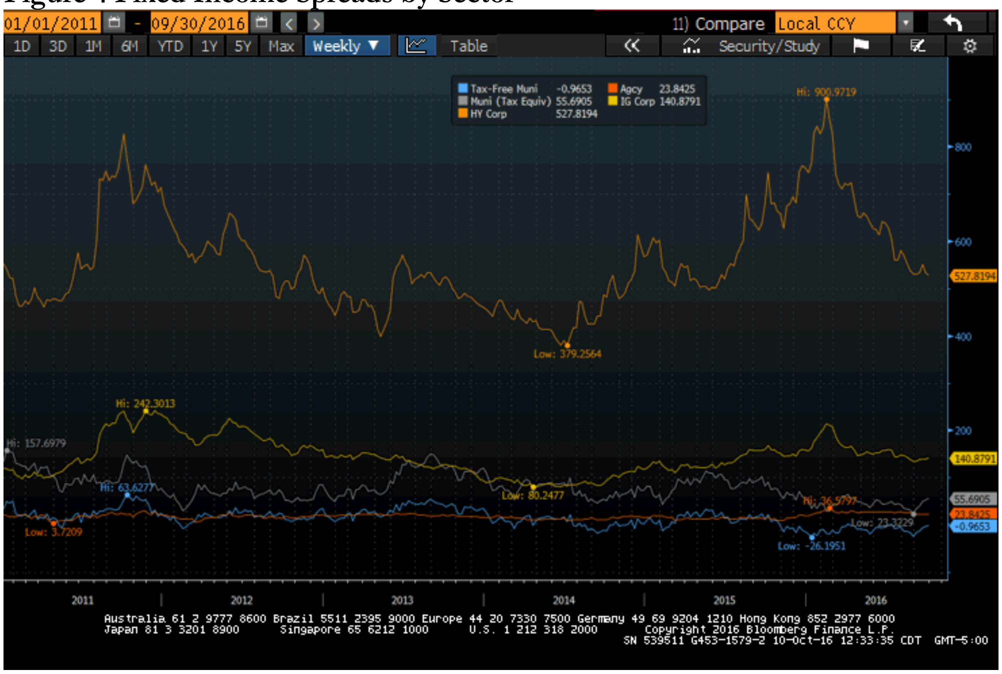
	3Q16	YTD
Broad Market Equity Indexes		
DJIA	2.78%	7.21%
S&P 500	3.85%	7.84%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	0.46%	5.80%
Bank of America Merrill High Yield	5.49%	15.32%
Morningstar Core Bond	0.52%	5.88%
Morningstar Short-Term Core Bond	0.06%	2.17%
Morningstar Intermediate Core Bond	0.51%	4.65%
Morningstar Long-Term Core Bond	1.02%	12.87%
Bond Indexes by Sector		
Morningstar Corporate Bond	1.49%	9.01%
Morningstar US Govt Bond	-0.23%	5.07%
Morningstar Mortgage Bond	0.68%	4.14%
Morningstar TIPS	1.01%	7.39%
Barclays Municipal	-0.30%	4.01%

*Source: Morningstar

Figure 3: U.S. Treasury Market Snapshot							
	US Treasury Actives						
	3Q16	*2Q16*	*3Q15*	*Qtr change (bp)*	*Qtr Change (%)*	*Yr Change (bp)*	*Yr Change (%)*
2-Yr	**0.76%**	**0.58%**	0.63%	18	31.03%	13	20.63%
5-Yr	**1.15%**	**1.00%**	1.36%	15	15.00%	(21)	-15.44%
10-Yr	**1.59%**	**1.47%**	2.04%	12	8.16%	(45)	-22.06%
30-Yr	**2.32%**	**2.29%**	2.85%	3	1.31%	(53)	-18.60%
Source: Bloomberg							

Turning to credit spreads, both high-yield and investment-grade saw spreads narrow on the quarter. High-yield spreads came in 114 bp to finish at 528 bp, while investment-grade spreads narrowed 19 bp to finish at 141 bp. According to Morgan Stanley, the three best performing corporate sectors year-to-date have been: Metals/Mining (-224 bp), Gas Pipelines (-161 bp), and Oil and Gas (-85 bp). The worst performers have been Independent Finance (+17 bp) and Banking (+6 bp). As of quarter-end, the three cheapest sectors were: Oilfield Machinery (304 bp), Property/Real Estate (245 bp), and Gas Pipelines (238 bp). [1]

Figure 4 Fixed Income Spreads by Sector



Source: Bloomberg

Final Re-cap and Look Ahead

Figure 5: Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	2.63	7.68	*-5.05*	34%	65%
Coupon Rate	5.03	3.09	*1.95*	163%	>100%
Modified Duration	1.61	5.90	*-4.29*	27%	65%
Yield to Worst	3.48	1.97	*1.51*	177%	>125%
Yield to Maturity	4.48	1.97	*2.51*	227%	>200%
Current Yield	5.24	2.91	*2.33*	180%	>100%
Convexity	0.12	0.76	*-0.64*	16%	50%
OAS	241.76	50.46	*191.30*	479%	>200%
Rating	A	AA			
Corporate Debt	32.28%	27.52%	*4.76%*		40.0%
Government Debt	0.04%	42.03%	*-41.99%*		0.0%
Preferred Shares	3.40%	0.00%	*3.40%*		7.5%
Securitized Debt	5.55%	29.55%	*-24.00%*		7.5%
U.S. Municipal Debt	58.73%	0.89%	*57.84%*		45.0%
Note: Stated Benchmark is Barclays U.S. Agg Bond TR					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

Over the course of the quarter, the Composite took on a decidedly more conservative stance, with the overall rating going from BBB+ to A and both the workout date and modified duration coming in. As we have said time and again, we are shorter than we would care to be; however, we continue to believe the risk in extending outweighs the reward. The move to higher overall quality, on the other hand, was intentional. In fact, it is a move we would like to continue for the remainder of the year. Along with this more conservative stance comes less yield and option-adjusted spread, but we are fine with this trade-off in the short-term. Having handily outperformed our benchmark year-to-date and expecting an uptick in volatility, we like the idea of locking in some gains and de-risking in the process. With spreads in, defaults up, interest coverage and recoveries down, we believe now is a good time to do so.

Regarding asset allocation, we are leaving all of our targets intact. We have deviated from these targets somewhat as our allocation to municipals has increased while our allocation to corporates and securitized debt has declined. This is in large part due to the fact that we have seen more municipal money coming in and our de-risking sells have been concentrated on the credit side. With securitized debt, the decline has more to do with roll-off and the fact that sourcing paper remains fairly difficult. We expect to see the Composite move closer to our targets over time, but for now we are satisfied with the positioning.

Footnotes:

[1] Morgan Stanley, *US Corporate Chartbook,* October 3, 2016

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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