
THE FIXED INCOME CONTRARIAN COMPENDIUM

August 2012

Featured Companies

American International Group, Inc. (AIG)
CenturyLink, Inc. (CTL)
Arch Coal Inc. (ACI)
Vanguard Extended Duration Treasury ETF (EDV)



*Exclusive Marketers of
The Fixed Income Contrarian Report*

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Murray's Musings

THE CREDIT CRISIS OF 2012

The subject of the *Musings* is the credit crisis of 2012. Everyone is familiar with the credit crisis of 2008 which, defined from the perspective of the borrower, meant that they generally could not obtain credit; even very creditworthy borrowers couldn't obtain funding. That situation had obvious implications for the economy, because the credit markets stopped functioning.

In the credit crisis of 2012, the credit markets are functioning remarkably well. Virtually anyone desirous of obtaining credit is able to do so on very good terms, which is positive when viewed from the perspective of the borrower. However, it's negative when viewed from the perspective of the lender, because it's very difficult to obtain an adequate rate of return on the money that is lent. Why shouldn't that qualify as a credit crisis?

Suppose one invested in a portfolio of high-yield bonds yielding 6% with a six-year average maturity, which would not be very different from a high-yield index. Let's say that the process of selecting these bonds is truly excellent and that the investor's analysis is right four times out of five. In the ensuing first year, then, 80% of the bonds prove to be credit-worthy. Let's also assume that 20% of the bonds, while not necessarily problematic credits, nevertheless become credit downgrades to the extent that the market value of the bonds declines by 20%. For the one time in five that the investor is wrong, there would be a 20% loss on 20% of the names, which would be a 400-basis-point loss from a 600-basis-point yield. That portfolio would then be yielding 2% not 6%.

In other words, in order to achieve a reasonably respectable yield of 6% in the world of high yield, the loss ratio has to be relatively insignificant. If the loss ratio were only 10%, meaning that the credit analysis of the investor in question was correct 90% of the time—a truly extraordinary intellectual achievement—it still wouldn't be enough to generate more than a 5% rate of return, and that's for high yield.

That example illustrates the problem with bond investing. It simply doesn't offer a high rate of return, even in high-yield, and all the investment-grade securities are far beneath that. Of course, money market funds and short-term securities offer nothing, in general. The real rate of return achievable after taxes is less than inflation. Over time, money is literally going to be transferred, in real terms, from bond portfolios to borrowers. Unless something radically changes, there's very little that bond investors can do about it other than decline to invest in bonds, which they clearly choose not to do.

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Another way to understand the financial crisis of 2012 is to look at the basic characteristics of the iShares Barclays Aggregate Bond Index (AGG). The reason the AGG metrics are very useful is that this index purports to represent the entire investment grade U.S. bond market. Even though individual bond investors might have characteristics very different from AGG, collectively, all the bond investors in the country look essentially like this index.

Table 1: iShares Barclays Aggregate Bond Fund (AGG)

Average Yield to Maturity	1.41%
Distribution Yield	2.44%
Weighted Average Coupon	4.23%
Average Maturity	6.23 years

Imagine if one deposited \$10,000 in a bank account and left it there for six years, receiving an annual rate of return of 1.41%. That would be equivalent to the stated yield to maturity for the AGG, which is the best estimate of its future rate of return. However, the Form 1099 received for an investment in AGG would state that the fund paid 2.44% annual interest and one would be taxed on that amount.

From the point of view of the depositor, the concern is the after-tax rate of return. Assuming New York City tax rates, that after-tax rate of return would be around 19 basis points per year. That is the dilemma of the bond investor. An investor in this index is taxed on a distribution yield of 2.44%, so what's essentially happening is that one is converting principal into taxable income. If the bonds trade above par, ultimately they will gravitate to par, because they will mature, be called, or be tendered.

It's a little bit worse than earning 19 basis points a year, because it's not really a bank account. AGG is a bond fund and, because the bonds gradually but inexorably gravitate towards par, the end value will certainly fall. Let's imagine that the current premium to par 6 years hence were to erode merely to par; a \$10,000 investment would have a principal value of \$8,500. That's the dilemma of the bond investor and that's really the best measure of the financial crisis of 2012.

Another problem is that as the higher coupon bonds either mature or are called, the coupons inexorably gravitate lower, and the convexity increases. Convexity, the inherent risk of this portfolio, is inversely proportionate to the coupon: the lower the coupon, the higher the convexity. Therefore, the risk of this fund is increasing.

A given individual investor might be sufficiently sensible to avoid this fate but, as a whole, what will happen to the nearly \$37 trillion of bond capital that exists in this country?¹ The

¹ Securities Industry & Financial Markets Association *Outstanding U.S. Bond Market Debt*
<http://www.sifma.org/research/statistics.aspx>

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situation that was just described regarding AGG is ultimately going to happen to that \$37 trillion.

As unpleasant as that trend might be, one might think a greater danger would result if rates increase. It's only a different danger. Even though the market value of those bonds would decline if rates increase, at least the coupons would be higher and there would be some compensation. At the end of the day, there are actions one can take in such a circumstance if one is sufficiently prescient to anticipate the problem.

Some examples of actions one could take include shortening the average maturity, selling short zero coupon bonds, buying options, or one buying interest rate swaps. There are ways of hedging oneself against that circumstance, were it to occur, but there's nothing to be done if the coupons keep gravitating lower, because the opportunity set is based on what exists. One can't create higher coupons from an opportunity set of low coupons. That is the issue of reinvestment rate risk.

Almost all of the academic literature on bonds deals with the question of how to control the volatility of the bond portfolio in the event that interest rates rise. There's really nothing to speak of that deals with the issue of reinvestment rate risk. The world of bond investors and the academic world are completely unprepared for the circumstance in which the low coupons remain low for a very long period of time.

To make matters still worse, neither the individual investor nor the institutional investor can compete effectively with the banks in bond investing. For example, if an individual buys a 10-year Treasury at 1.49%, assuming rates don't rise, that rate of return is obviously unsatisfactory. The bank, however, might buy the 10-year Treasury at 1.49% and leverage that investment 10x with zero cost funding from its deposit base. A bank could buy the 10-year Treasury at 1.49% and actually earn nearly 15% a year, but it's not possible for an institution to engage in that strategy.

Even if it were possible for an individual or an institution to treat a 10-year Treasury with a 1.49% return in the manner that a bank could, if rates were to rise, unquestionably the individual institution would pay some margin call. The banks can legally carry the bonds at par. That differential is the reason why the current credit crisis is so serious and has such far reaching implications.

Industry Thoughts

THE MOST DANGEROUS FIXED INCOME SECTOR: FINANCIAL PREFERRED

Among the panoply of industries, from the point of view of fixed income, there are only the dangerous and the more dangerous. One of the more dangerous is that subset of the fixed income sector known as the financial preferreds. These are preferred stocks issued by banks at various points in time—most of them in the last 4 or 5 years—with the objective of enhancing their capital base and permitting them to continue leveraging their capital tenfold.

For some banks that have improved their creditworthiness and are in a position to improve their asset portfolio, the preferred itself isn't problematic except for the fixed income investor, because ultimately that preferred will be retired. From the point of view of the banks whose balance sheets *are* problematic, the preferreds won't be retired, but then their value is questionable.

To illustrate, let us consider the Banco Santander Credit Finance 10.5% preferreds. Given the condition of Banco Santander and the financial climate of Spain, it's fairly obvious why Banco Santander had to issue 10.5% preferreds at some point. Banco Santander's balance sheet is more or less sensibly arranged and it is not an immediate credit risk, so the preferred in question trades at approximately 40% above par and, consequently, yields 6%. There are really only two possibilities. The first is that at some point Banco Santander is going to find the opportunity to refinance that preferred, in which case the investor will receive something like par value plus a tiny call premium. In that case, therefore, there'll be a fairly substantial principle loss. Alternatively, Banco Santander will find itself in problematic circumstances, in which case, if the preferred merely trades at par value or slightly below, it would likewise cause a big capital loss.

From the point of view of the investor, there are very few winning scenarios. There are only different degrees of losing scenarios. From the point of view of Banco Santander, in order for that preferred to trade near par, only a very minor cloud needs to surround the corporation. Of course, if a bigger cloud surrounds it, circumstances would be worse.

There are many examples of such preferreds and they all have the same trading characteristics, so I will list only four, all of which trade above par:

1. Goldman Sachs Series GSC3, the 6% preferreds
2. Fifth Third Capital Trust V, the 7.25% preferreds
3. Citigroup Capital Trust XI, the 6% preferreds

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4. Barclays PLC, 8.125% preferreds (despite all the problems that surround Barclays, given the LIBOR rate fixing scandal)

There are a number of preferred indices that are dominated by financial preferreds for obvious reasons. They are dangerous and should be avoided, because very little good can come of them.

Facts & Figures

HISTORICAL TOTAL U.S. BOND MARKET TRADABLE DEBT

The table below shows the historical total U.S. bond market debt outstanding as reported by the Securities Industry and Financial Markets Association (SIFMA).

Table 2: Total U.S. Outstanding Bond Market Tradable Debt
(*\$ in trillions*)

1980	\$2.5	1991	\$8.4	2002	\$20.0
1981	2.8	1992	9.1	2003	21.9
1982	3.2	1993	9.9	2004	24.4
1983	3.6	1994	10.4	2005	26.6
1984	3.9	1995	11.2	2006	29.4
1985	4.6	1996	12.0	2007	32.2
1986	5.2	1997	13.0	2008	33.6
1987	5.8	1998	14.3	2009	34.6
1988	6.4	1999	16.0	2010	36.3
1989	7.0	2000	16.9	2011	36.8
1990	7.6	2001	18.5	1Q 2012	39.8

Source: <http://www.sifma.org/research/statistics.aspx>

Some commentary is required to understand these numbers. From the point of view of SIFMA, the industry is only interested in calculating or tabulating the tradable debt, so the Federal debt here is not the same number as the one presented on the Federal Government's balance sheet. The portion of the Federal debt issued to the Social Security Trust Fund is not part of the bond market debt, but it is part of the aggregate Federal debt. If one were to include the non-tradable Social Security Trust Fund debt, one would add approximately \$6.5 trillion to the \$39.8 trillion figure for the first quarter of 2012 to arrive at a more accurate figure. There are other forms of debt that are not tradable either, so the actual debt in the country is much larger. That nearly \$37 trillion figure is only the total *tradable* debt of the United States as tabulated by SIFMA.

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That figure for 1980 is \$2.5 trillion. Looking at this data, one can observe that rarely is there a year in which the total tradable bond market debt in the United States did not rise by 10%, although there are years in which the increase was less than that.

One of the more fascinating years is 2004, because bond market debt increased from \$21.9 trillion in 2003 to \$24.4 trillion in 2004. In merely 12 months, \$2.5 trillion of debt was issued in the United States, which is about \$200 billion per month. It's an incredible figure.

It's reasonable to assume that iShares Barclays Aggregate Bond Index (AGG) represents the true character of the bond market and that the average maturity of this \$37 trillion of tradable debt is indeed 6.3 years. Let us further assume that the maturities are evenly spaced, which may be a bad assumption, because there are probably more than \$900 billion worth of bonds maturing every month. It's a very bad assumption because, just looking at AGG, one can see that the average maturity is a result of a barbelled approach; there are many short-term bonds. Thus, it might well be that more than \$900 billion of bonds are maturing every month and that makes no reference to bonds being called and bonds being tendered. If the average coupon in AGG is over 4%, those coupons are rapidly disappearing.

Another somewhat frightening point that emerges when looking at these figures is that the vast increases in debt represent capital that is either consumed or invested. In the last year and a half, there has been only a fraction of the historical level of debt issuance simply because the markets can't absorb it, or choose not to absorb it for reasons that will be clear later when we examine the next table. If economic growth really comes from entities or individuals borrowing money and they are either unwilling or unable to borrow that money, how are we ever to attain what we otherwise thought were the normal characteristics of the economy between 1980 and 2007?

It is also disturbing to note that if current trends remain in place and the average coupon gravitates to something less than 2%, after inflation the average bond investor will be realizing a negative real rate of return. How is the financial market to function properly if \$37 trillion of capital earns a negative rate of return? That situation has certain implications.

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HISTORICAL COMPONENTS OF THE BOND MARKET TRADABLE DEBT

The next table breaks down the bond market components.

Table 3: Historical Components of the U.S. (Tradable) Bond Market²
(\$ in billions)

	Municipal	Treasury	Mortgage Related	Corporate Debt	Fed. Agency Securities	Money Markets	Asset- Backed
1980	\$399.4	\$623.2	\$110.8	\$458.6	\$164.3	\$780.0	N/A
1981	443.7	720.3	126.4	489.2	194.5	837.0	N/A
1982	508.0	881.5	176.3	534.7	208.8	882.8	N/A
1983	575.1	1,050.9	242.7	575.3	209.3	982.1	N/A
1984	650.6	1,247.4	286.2	651.9	240.4	798.0	N/A
1985	859.5	1,437.7	396.7	776.6	261.0	847.0	\$1.2
1986	920.4	1,619.0	552.3	959.3	276.6	877.0	11.3
1987	1,012.0	1,724.7	704.5	1,074.9	308.3	979.8	18.0
1988	1,080.0	1,821.3	812.9	1,195.8	370.7	1,108.5	27.9
1989	1,129.8	1,945.4	1,024.1	1,292.5	397.5	1,192.2	41.9
1990	1,178.6	2,195.8	1,278.1	1,350.3	421.5	1,156.8	75.8
1991	1,272.1	2,471.6	1,605.8	1,454.6	421.5	1,054.3	109.8
1992	1,295.4	2,754.1	1,940.3	1,557.0	462.4	994.2	136.4
1993	1,361.7	2,989.5	2,156.4	1,674.6	550.8	971.7	154.5
1994	1,325.8	3,126.0	2,276.0	1,755.6	727.7	1,034.7	190.8
1995	1,268.2	3,307.2	2,352.7	1,950.6	924.0	1,177.3	257.0
1996	1,261.6	3,459.7	2,486.1	2,126.5	925.8	1,393.9	369.5
1997	1,318.5	3,456.8	2,680.2	2,359.0	1,021.8	1,692.8	516.0
1998	1,402.7	3,355.5	2,955.2	2,708.5	1,302.1	1,977.8	647.7
1999	1,457.1	3,266.0	3,334.3	3,046.5	1,620.0	2,338.8	950.5
2000	1,480.7	2,951.9	3,565.8	3,358.4	1,853.7	2,662.6	1,085.0
2001	1,603.4	2,967.5	4,127.4	3,836.4	2,157.4	2,587.2	1,230.3
2002	1,762.9	3,204.9	4,686.4	4,132.8	2,377.7	2,545.7	1,381.5
2003	1,900.4	3,574.9	5,238.6	4,486.5	2,626.2	2,519.8	1,507.4
2004	2,850.3	3,943.6	5,387.9	4,801.6	2,700.6	2,904.2	1,814.7
2005	3,044.0	4,165.9	6,160.0	5,089.7	2,616.0	3,433.7	2,112.1
2006	3,212.4	4,322.9	7,085.4	5,461.9	2,634.0	4,008.8	2,701.6
2007	3,448.1	4,516.7	8,161.3	6,064.9	2,906.2	4,170.8	2,951.9
2008	3,543.4	5,774.2	8,396.4	6,317.1	3,210.6	3,790.9	2,613.8
2009	3,698.0	7,249.8	8,508.4	6,991.6	2,727.5	3,127.2	2,333.8
2010	3,795.9	8,853.0	8,516.8	7,643.0	2,538.8	2,866.5	2,044.2
2011	3,743.4	9,928.4	8,439.5	7,921.2	2,326.9	2,572.2	1,824.5

²Securities Industry and Financial Markets Association, *Outstanding U.S. Bond Market Debt*, <http://www.sifma.org/research/statistics.aspx>; cm-us-bond-market-outstanding-sifma.xls.

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The three most interesting debt components are municipal, Treasury, and mortgage related. The current publicly traded Treasury debt which, as noted before, is not the same as the total debt of the United States, is \$9.928 trillion. That doesn't count the \$6-plus trillion in Social Security debt. In 1980, the tradable Treasury debt was \$623 billion. Therefore, the current \$9.928 trillion represents a 9.34% compound annual rate of increase since 1980.

When examining U.S. Treasury debt increases, it's worth remembering that debt, as stated, is nominal and that nominal debt needs to be compared to nominal GDP, not real GDP. Real GDP characteristics and growth trends are irrelevant when it comes to examining the economy's ability to manage a high debt load. It's nominal GDP that counts, because people pay back debt in inflation-adjusted dollars. Nominal GDP is a number that is rarely quoted in the media, but it's an important factor to consider.

Another interesting category is mortgage related debt and it should come as no surprise that since 2008, mortgage related debt in the U.S. has not been increasing. As of the most recent reckoning, it is \$8.4 trillion. Again, that's publicly traded mortgage debt, not all the mortgage debt in America. It could be that someone buys a home and takes out a \$300,000 mortgage from the owner; a mortgage of that type would not be included in this figure.

In 1980, the mortgage related debt was \$110.8 billion. From 1980 to 2007, the mortgage related debt increased at a compound annual rate of 17.3%. That's a more interesting number than the rate we would calculate if we included the last four years, during which the number hasn't really grown. Clearly, a 17.3% compound annual rate of increase just wasn't sustainable.

The number for 2007 is very interesting. In 1980, Treasury debt was 6 times mortgage debt, and by 2007 mortgage debt was 1.8 times Treasury debt, which is an incredible accomplishment given the rate at which the United States government spends money. This discussion all relates to the economics of Wall Street as opposed to the economics of the country. It was highly profitable for Wall Street to issue this paper and, therefore, the paper was issued.

Of concern is how the capital markets are to return to normalcy if normalcy is represented by 1980 to 2007. How can we possibly return to a mortgage related debt figure that grows at 17% per annum? It's just not realistic. In fact, how can we even sustain a Treasury related debt figure that grows at over 9% per annum? It's also not sustainable.

Turning to municipal debt, we see that at the end of 2011 it was \$3.7 trillion. In 1980 it was \$399.4 billion, slightly less than \$400 billion. That increase is not as vast as the Treasury or the mortgage market but, nevertheless, it is a fairly robust rate of increase. It's also beyond the power of the municipalities to continue that rate of increase. It's important to note that a lot of the U.S. infrastructure spending is done by municipalities, including

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roads, bridges, schools, water purification plants, and so on. That level of funding via debt issuance is simply not going to continue.

It's conceivable that the problem of low interest rates will be with us for a very long period of time. If one accepts the proposition that the bond market is not academically or psychologically prepared for that circumstance, certain conditions will follow. Many of the individual bond recommendations in this report pertain to bonds with very long maturities which, in the world of high yield, are not usually popular. However, it's one of the few ways that one can temper reinvestment rate risk, although ultimately any bond can be refinanced, and even a non-callable bond can be tendered for.

Featured Companies

AMERICAN INTERNATIONAL GROUP, INC. (AIG)

American International Group (AIG) has many issues of debt that mature over the course of 60 or 70 years and have pretty good yields. These yields are unobtainable anywhere else, for the simple reason that AIG is a debt outlier, in part because it nearly became insolvent in 2008. As a consequence, few funds are willing to have much, if any, AIG paper in their portfolios. The company still carries the pejorative connotation of credit unworthiness.

One of the reasons why AIG hasn't lost that negative association is that the United States government has yet to fully exit from its equity position in the company. Therefore, it is perceived as tainted and somehow remaining under the U.S. Treasury custodianship which, in a sense, is true.

Some of this phenomenon affects the AIG stock, which trades at a large discount to book value, and it also affects the bonds. Here are several examples:

- *AIG Junior Subordinated Debentures, 6.25%, maturing March 15, 2087, trading at 90.* A 6% yield is becoming a rarity; soon it might become an endangered species. This piece of paper might one day be extraordinarily valuable.
- *AIG/International Lease Finance Junior Subordinated Debentures, 5.03%, maturing on December 21, 2065, trading at 67.* This credit is to International Lease Finance Corporation, not AIG, the parent and, therefore, it's a weaker credit. It might become a very interesting piece of paper one day because, as far as anyone can tell, International Lease Finance is creditworthy. It's merely tainted with the circumstances of AIG from 2008 to the current day.

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- *AIG Senior Notes, a 144A issue, 8%, due May 22, 2068, trading at about 97.* These notes are Euro denominated and people might not be willing to take the Euro risk. On the other hand, that risk is hedgeable.

There are many other AIG issuances of long dated paper, and this corporation is one of the few one can find with a plethora of long dated issues. They might not be a bad way of populating a portfolio. Therefore, they're commended to one's attention.

CENTURYLINK, INC. (CTL)

CenturyLink's 7.6% bonds maturing September 15, 2039 were a \$400 million issue. They trade at 94.5. The company has some other senior notes that were used to finance the acquisition of Savvis, a provider of cloud computing.

CenturyLink is the third largest telephone company in the United States. It operates in 36 states and, with the acquisition of Savvis, it now has 68 data centers. It operates everything from local access to long distance to cellular, and is involved in every aspect of telecommunications. The company finds its earnings under pressure, because many people are abandoning their local access lines in favor of cellular. When people choose not to have local access lines, the company still must absorb the expense of maintaining those lines for those people who do use them. There's a negative economy of scale as local access line usage falls. As a result, the margins of CenturyLink have been under pressure, and it's not entirely clear what its profit margin will be.

At the moment, the stock yields 7.1% and it's not certain that the company will make enough money to sustain that level of dividend. Nevertheless, other aspects of the business are growing. From the creditworthiness standpoint, earnings before interest and taxes (EBIT) are about 6 times the interest expense, and this is not a problematic credit at all. Given the low rates, one can understand the reluctance of investors to buy a 27-year piece of paper, albeit with a 7.6% coupon, and it explains why the bonds trade at current levels. On the other hand, what would happen if rates remain low for a very long period of time? Then this piece of paper would be valuable.

In terms of its balance sheet, there are some other modestly problematic aspects of CenturyLink. The main concern is that over the years the company has grown by acquisition and, therefore, there is an enormous amount of goodwill on its books. Subtracting the intangibles from the balance sheet equity reveals yet another example of a company without any tangible equity whatsoever. It has earnings and it has cash flow but no tangible equity. It has \$1.3 billion in cash, \$20.6 billion of long-term debt, and \$2.2 billion of short-term debt. All indications are that it's able to sustain its debt load quite

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comfortably. It may not be able to sustain its dividend, although that in itself is open to question.

This bond may ultimately be valuable. It may become a rare species and, therefore, it's commended to the attention of the reader.

ARCH COAL INC. (ACI)

The Arch Coal 7% bonds are due June 16, 2019 and are currently yielding over 10%. This is more a classical high yield name. Arch Coal is one of the largest coal suppliers in the world and it sells, believe it or not, 14% of all the coal in the United States, so it's a huge coal company.

The company has two problems. The first is that U.S. coal consumption has declined in recent years. Much of that decline is due to the economy, but not all of it. The second problem is competition from natural gas. Not only does natural gas provide competition in the sense that it burns cleaner, but natural gas prices in the last year have essentially collapsed. Consequently, there is intense price competition from natural gas vis-à-vis coal.

Arch Coal also exports coal all around the world. To some degree, exports might be able to fill the vacuum that is created for the company by competition with natural gas in the United States.

At the moment, the company operates at break even, and its EBIT is 2x its interest expense. It has about \$4 billion of debt, most of it resulting from acquisitions. The stock, however, trades below book value. There's a modest dividend, and one might say that it is probably vulnerable.

The saving grace of the company is its coal reserves, which are located all across the United States, including Wyoming, Colorado, Utah, Illinois, Kentucky, Virginia, and West Virginia. Its Black Thunder Mine is the largest surface coal mine in the world, and it has 3.1 billion tons of coal reserves. The current spot coal reference price is \$87 per ton, but that figure is misleading since there are different grades of coal. Coal prices vary by type and by geography because, like cement, they're very heavy to carry. Still, any reasonable fraction of the \$87 coal reference price for 3.1 billion tons of coal is a lot of value. The company should be able to manage its debt load by opportunistically selling some coal reserves, which it is able to do from time to time.

Arch Coal would not be a problematic company even if it were to have problems in the cash flow sense, which is not the case at the moment. It's always possible that natural gas prices could rise and the circumstances could reverse themselves.

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This is a reasonable credit. It's not without risk, but it's one of the few examples of a 10% yield that is obtainable with a reasonable asset backing. This situation makes creditworthiness of this Arch Coal bond the likely circumstance, which is why it is called to the readers' attention.

VANGUARD EXTENDED DURATION TREASURY ETF (EDV)

Given these remarks about bonds, one would be remiss if one didn't include a short sale recommendation. The short sale investment of choice at the moment in the world of bonds would have to be the Vanguard Extended Duration Treasury ETF (EDV). This instrumentality tracks the 20-30 Year Treasury Strips Index.

If one is concerned about rising interest rates, clearly if Treasury rates were to rise at the long end of the maturity spectrum, this ETF would suffer mightily. It has a 13 basis point expense ratio and trades at a modest premium to net asset value, as amazing as that happens to be. Even though shorting the zero coupon is not a negative carry instrumentality, de facto, this particular ETF really is. The reason is that the ETF distributes the taxable income generated by the accretion of the zero coupons themselves.

The distribution yield of EDV is 2.65%. Therefore, to carry this is to carry a 2.65% distribution. It doesn't necessarily mean that one ultimately pays it if rates rise, and rates might rise. Of course, rates would have to fall to at least 2% on the long Treasury end before one would have meaningful losses in such an instrumentality. Therefore, the risk-reward of shorting this ETF is highly asymmetrical. All its successes depend on rates rising and it's not inconceivable that rates will rise even if the economy doesn't recover, because in the next 24 to 36 months, the U.S. bond market, especially the Treasury end, will have its moment of truth. There will be a point in time when the creditworthiness of the United States will be put into question if it keeps burning money at its current pace, and rates might rise even in a weak economy.

If the Treasury decides that it's not going to borrow a trillion dollars a year, and of course Congressional sanction would be required for that, it's not inconceivable that the economy might remain very weak and rates might remain very low for some period of time. However, if the borrowing continues, it is highly likely that rates might rise just from the creditworthiness standpoint. In that case, this ETF might be the vehicle of choice.

Post Musings

THE FUTURE OF DEBT ISSUANCE

Let us return to the figures on debt issuance in the Facts & Figures section and consider how unlikely it is that there will be a continuation of the debt issuance circumstance that existed between 1980 and 2007. The most likely scenario, consequently, is that we will have low rates for some period of time.

For those who don't accept that as the most likely scenario, let us consider the alternative. Let's assume a 100 basis point rate increase affecting the totality of the \$37 trillion bond market.³ From the point of view of the economy, that would entail a \$370 billion increased funding cost, not counting the Social Security debt. Can a \$14–\$15 trillion economy sustain \$370 billion of increased funding cost? That amount is 2.5% of GDP, and it only considers a 100 basis point increase in interest rates, which is fairly mild. A 200 basis point increase in interest rates, which would be no less than \$740 billion of increased debt carrying cost for the economy, not counting the non-publicly traded debt, but including the Social Security Trust Fund, would be a disaster from the point of view of the economy.

How is it sustainable? It isn't. Therefore, one might need to solve the problem of collecting a reasonable rate of return on one's debt capital in a world of low rates that might continue for decades. If one reflects upon that notion and considers it from the point of view of individuals, it's nearly insoluble. From the point of view of foundations, it's also a problem that is nearly insoluble. From the point of view of pension funds, it's not merely an insoluble problem, it's very dangerous indeed because there are many examples in the S&P 500 of corporations with large, unfunded pension liabilities and very large commitments to the bond market. Those companies are unlikely to earn the funding gap. Instead, they will have to contribute from their earnings or from their existing capital, which will be very painful for many companies.

On the equity side of the pension funds' portfolios, many of these companies have chosen to invest in index funds. Companies with unfunded pension liabilities are included in the indices on which those funds are based. Thus, we have the self-reference paradox in which underfunded pension funds are investing in indices containing companies with underfunded pension funds.

³ Securities Industry & Financial Markets Association *Outstanding U.S. Bond Market Debt*
<http://www.sifma.org/research/statistics.aspx>

THE FIXED INCOME CONTRARIAN COMPENDIUM

The logic of investing in the S&P 500 is to be diversified, but if enough companies with unfunded pension obligations are included in the index, the investing companies would not be diversifying; they would actually be undiversifying and increasing their risk. Companies will ultimately come to recognize that situation and realize that they need to drastically change the manner in which they invest in both fixed income and equities.

THE FIXED INCOME CONTRARIAN COMPENDIUM

Money Manager Index

From Jan 1983 to Jul 2012

Year													Annualized return			
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49	85.67	90.79	99.97	101.69	107.32	107.36	110.94	115.01	2009	115.01	69.4%	19.7%
2010	106.84	110.32	118.13	114.91	100.18	88.17	97.65	89.64	103.59	108.29	108.64	119.58	2010	119.58	4.0%	19.1%
2011	122.80	128.28	127.94	127.97	126.06	121.03	115.49	104.25	91.32	102.44	103.79	103.98	2011	103.98	(13.1)%	17.8%
2012	109.46	120.12	125.37	121.64	108.44	114.12	113.56						2012	113.56	9.2%	17.7%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	AMG us equity	Affiliated Manager	\$22,947	1377	11/30/1997	153,638
2	ALNC us equity	Alliance	\$7,633	491	4/30/1994	17,238
3	BLK us equity	BlackRock	\$23,205	1658	9/30/1999	282,208
4	WDR us equity	Waddell & Reed	\$27,513	1587	3/31/1998	46,571
5	EV us equity	Eaton Vance	\$2,641	3998	1/31/1986	106,837
6	TROW us equity	T. Rowe Price	\$2,423	2014	4/30/1986	122,341
7	BEN us equity	Franklin Resources	\$908	1263	4/30/1985	145,197
8	LM us equity	Legg Mason	\$1,000	462	8/31/1983	11,333
9	FII us equity	Federated Inv	\$26,381	2206	5/31/1998	44,364
10	FIG us equity	Fortress Investment Group	\$102,249	3389	2/28/2007	12,811
11	PZN us equity	Pzena Investment Management	\$122,426	6317	10/31/2007	24,321

THE FIXED INCOME CONTRARIAN COMPENDIUM

Index Constituent Changes: 1. Everest Financial Group Limited (EFG AU) was delisted from the Australian Security Exchange effective 7/19/2011 and has been removed from the index. The divisor has been adjusted accordingly. 2. RAB Capital Plc (RAB LN) was delisted from the London Security Exchange effective 9/2/2011 and has been removed from the index. The divisor has been adjusted accordingly.

International Money Manager Index

From Jan 1983 to Jul 2012

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Annualized return	
															Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	16.76	55.4%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(15.8)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63	22.82	23.73	26.14	27.05	28.41	28.53	28.69	29.83	2009	29.83	89.0%	15.8%
2010	28.50	27.58	29.90	29.58	25.53	24.72	27.82	26.74	30.36	33.68	31.85	34.52	2010	34.52	15.7%	15.8%
2011	34.91	36.17	36.51	39.63	37.86	35.31	35.83	32.76	29.28	32.04	31.23	30.59	2011	30.59	(11.4)%	14.7%
2012	32.12	34.36	35.67	35.08	31.03	32.92	32.66						2012	32.66	6.7%	14.5%

S.No.	Ticker	Name	Initial Amount Invested	Shares Purchased	Date of Investment	Current Index Value
1	IGM CN Equity	IGM Financial Inc	\$1,000	73	31/11/1986	2,878
2	FCAM LN Equity	F&C Asset Management Plc	\$1,203	485	5/31/1989	669
3	IVZ US Equity	Invesco Plc (Previously Amvescap)	\$1,357	1,153	1/31/1991	12,753
4	SDR LN Equity	Schroders Plc	\$1,208	505	3/31/1991	10,150
5	RAT LN Equity	Rathbone Brothers Plc	\$1,208	736	3/31/1991	14,869
6	ADN LN Equity	Aberdeen Asset Mgmt Plc	\$1,208	1,827	3/31/1991	7,396
7	CIX CN Equity	CI Financial Corp.	\$2,585	3,224	6/30/1994	71,998
8	EMGLN Equity	Man Group Plc	\$2,862	6,344	10/31/1994	6,018
9	AGF/B CN Equity	AGF Management Ltd-CI B	\$3,343	1,346	1/31/1996	16,333
10	8739 JP Equity	Spax Group Co Ltd	\$11,762	108	12/31/2001	7,098
11	HGG LN Equity	Henderson Group Plc	\$14,447	8,666	12/31/2003	10,607
13	AZM IM Equity	Azimit Holding Spa	\$21,908	4,977	7/31/2004	47,651
15	CCAP LN Equity	Charlemagne Capital Ltd	\$36,848	22,300	3/31/2006	3,407
16	PGHN SW Equity	Partners Group-Reg	\$36,848	578	3/31/2006	105,638
17	INRE LN Equity	Invista Real Estate Inv Mngt	\$36,589	21,540	9/30/2006	4,936
18	ASHM LN Equity	Ashmore Group Plc.	\$36,688	9,873	10/31/2006	50,073