



# Merganser Investment Memorandum

## Expanding Opportunities in the Credit Sector

Spring 2010

Merganser is always looking for areas with attractive relative value in order to increase the investment choices for our clients' portfolios. Two areas in which we are expanding our activities include high yield and taxable municipals. Each of these areas presents an attractive relative value and an opportunity for clients to add yield to their portfolio with a thoughtful risk/return evaluation. In this memo we will present Merganser's thoughts on these sectors.

### Research-Driven High Yield Exposure as Return Enhancer

Merganser still views the investment grade credit market as attractive from a relative value and credit improvement standpoint. However, a relatively small tactical allocation to high yield bonds in core and core-plus accounts can improve expected risk-adjusted return. Merganser engages in rigorous fundamental analysis in order to identify issuers that exhibit investment grade-like credit metrics, or that we expect to do so in a reasonable time period. In spite of spread tightening, some high yield issuers still offer compelling risk/return profiles when viewed in the context of a core mandate, and with a forward-looking view of credit improvement based on fundamental research.

High yield spreads have tightened from a peak of about 2000 basis points to 550 basis points since the end of 2008. For investors benchmarked to the high yield index, excess return in a tightening market is generated by adding exposure to the lower quality segment of the high yield market. In this "beta grab," those bonds deemed "too safe" for high yield investors are orphaned, creating relative value for high quality managers like Merganser. In other words, we are able to generate excess return relative to the Barclays Capital Aggregate Index in bonds that pure-play high yield investors may find too conservative and unattractive. Further, many of these names have the potential of an upgrade to investment grade and the subsequent technical support from indexed buyers.

In addition to potentially higher returns, the significant negative correlation of returns between high yield and Treasuries is attractive. This provides the potential to out-perform in a rising rate environment, thus adding an implicit interest rate hedge to clients' portfolios.

Merganser begins its analysis by utilizing a top-down view on relative valuation between non-investment grade issues and their investment grade brethren. We then evaluate an issuer's industry, sub-sector and management in order to form a fundamental opinion. Following this exercise, we utilize the same bottom-up security selection process that has been the hallmark of Merganser's management style by assessing relative value across peers and between structures. Merganser looks for sectors and companies that exhibit several characteristics, such as defensiveness, quality physical assets, high barriers to entry, industry leading positions,

### Merganser Welcomes Newest Duck

Henry Peabody, CFA joined Merganser in March of 2010 as a Research Analyst working with the credit sector team.

Before joining Merganser, Henry worked at Emerson Investment Management as a Senior Analyst/Trader. He covered high grade and high yield credit and led the Core Investment Grade management team. In addition to credit research and portfolio management responsibilities, Henry also traded fixed income securities. Henry is currently pursuing his M.B.A. at Boston College.

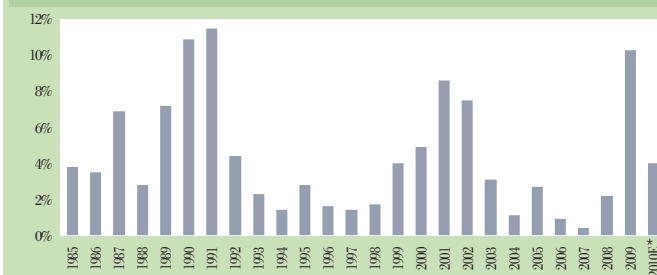
Henry holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Boston Securities Analyst Society.

We are very pleased to welcome Henry to the Merganser family.

stable or improving free cashflow generation and management teams that control leverage.

Merganser expects to see a decline in the default rate and improvement in recovery rates from levels seen during the credit crisis. The historical and our expected 2010 default rates are pictured in Exhibit 1. These important inputs to high yield valuation, coupled with the improvement in corporate balance sheets and terming out of debt, support current spreads and leave room for further improvement. These factors support our fundamental bullishness on select high yield issuers.

Exhibit 1. Default Rate



Source: JPMorgan. \*Merganser estimate for 2010

While high yield supply has been in the headlines recently, much of it has been issued with a goal of improving liquidity not leveraging balance sheets. This can be seen on the next page in Exhibit 2, which depicts the improvement in the maturity distribution of the Bank of America Merrill Lynch High Yield Index.

Merganser focuses on the same pillars of relative valuation, security selection and fundamental analysis in our approach to high yield bonds as we do in the

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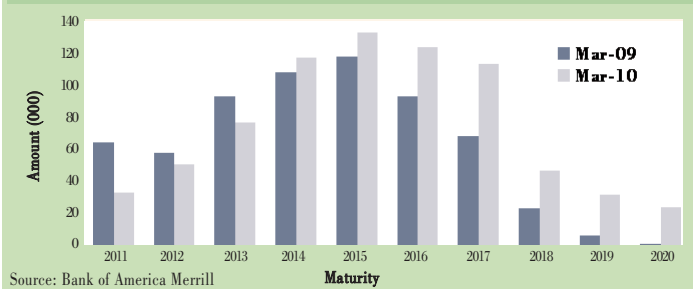
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Exhibit 2. Intermediate Term Maturities



investment grade arena. Using these tools, it is our belief that clients who can accept the associated marginal volatility should be rewarded with higher long term returns.

### Taxable Municipals - Growing in Importance

Taxable municipal bonds, specifically a subset known as Build America Bonds (BABs) offer a compelling new sector for clients with a long-duration mandate. The current yield advantage of approximately 25 basis points makes BABs an attractive alternative to similarly rated corporates. The benefits of increasing our exposure to and becoming active in the trading of taxable municipals are:

1. Current spread levels in the sector are higher than similarly rated corporate issues, though historical data suggest a lower default rate among municipal issuers, offering appealing total return potential.
2. The sector will become a meaningful percentage of the credit index, dictating that Merganser have some exposure to minimize tracking error in our clients' portfolios.

Taxable municipals first became a part of Barclays Capital (formerly Lehman Brothers) Aggregate Index in October 2003 and are classified under the Government-Related Local Authorities sector. More recently, the US Congress created the BAB program in 2009, under which municipalities could issue taxable debt in the market and receive a 35% subsidy from the federal government on the interest payments associated with that debt. The subsidy is designed to equate to the difference between tax-exempt and taxable interest rates. Congress also recently proposed an extension to the BAB program, which modestly reduces the subsidy from the current level of 35%, stepping down annually to 30% in 2013.

Exhibit 3. Cumulative Historic Default Rates (%)

Ratings Category	Moody's		S&P	
	Muni	Corp	Muni	Corp
Aaa/AAA	0.00	0.52	0.00	0.60
Aa/AA	0.06	0.52	0.00	1.50
A/A	0.03	1.29	0.23	2.91
Baa/BBB	0.13	4.64	0.32	10.29
Ba/BB	2.65	19.12	1.74	29.93
B/B	11.86	43.34	8.48	53.72
Caa-C/CCC-C	16.58	69.18	44.81	69.19
<b>Investment Grade</b>	<b>0.07</b>	<b>2.09</b>	<b>0.20</b>	<b>4.14</b>
Non-Investment Grade	4.29	31.37	7.37	42.35
All	0.10	9.70	0.29	12.98

Source: Moody's and S&P

As of March 2010, there were 130 taxable municipal bonds with a total market value of \$69.8 billion, making up 0.50% of the US Aggregate and 2.22% of the credit index. Issuance in 2010 alone is forecast to be \$150 billion. Of the year-to-date issuance of approximately \$32 billion, \$27 billion (84.4%) were BABs. Barclays Capital projects that BABs will account for between 4.5 and 5.0% of the credit index by year-end 2010, and more than 15% of the long credit index. If the proposed extension to the BAB program mentioned above does not receive congressional approval, there may well be significantly more 2010 supply.

Municipal bonds have a default rate that is a fraction of the corporate default rate. Over the 30 years ending 2006, the annual investment grade default rates published by Moody's and S&P for municipal issuers were 0.07% and 0.20%, respectively, compared with corporate rates of 2.09% by Moody's and 4.14% by S&P (see Exhibit 3).

The current financial condition of many states and municipalities is poor, highlighted by California and Illinois, which both face significant budget deficits and the potential for ratings downgrades. That said, there has not been a default on a state-level general-obligation issue, which rely primarily on the taxing power and the overall creditworthiness of the issuer, since the 1930s. Careful selection of investments obviously mitigates some of the state-specific fiscal risks, but including revenue bonds issued by municipalities that are tied to essential services offers another opportunity within the BAB market. Although debt service support for revenue bonds is limited to a specific project or service, the issuer typically has rate-setting freedom to ensure debt service is maintained and covenants are not breached. Merganser recently added a long taxable municipal bond issued by a major metropolitan water supplier, swapping out of another state's general obligation bond and picking up more than 30 basis points of yield for a similarly rated issue.

According to data compiled by Barclays Capital, long-dated BABs have an option-adjusted spread advantage of 25 basis points over the Barclays Capital US Long Credit Index, while being rated an average of one notch better than the index. In fact, first quarter 2010 excess returns on BABs are more than twice that of the credit index, coming in at 2.56%. We believe that excess return potential for long-dated BABs will continue as market prices adjust to the relative risk profiles of taxable municipals versus corporate debt, states act to bolster their budgetary issues and more investors participate in the growing sector.

### Conclusion

Constructing a well-diversified, high risk-adjusted return portfolio requires a constant search for the best relative value investment. High yield corporates and taxable municipals provide another source of additional yield and potential excess return when judiciously incorporated into a core mandate. The combination of supportive fundamentals and continued investor interest in higher yielding alternatives portend continued excess returns to high yield securities. As a relatively new component of the Aggregate Index, taxable municipals offer a yield advantage to corporates, with a better risk profile. Merganser continues to move into these sectors in an effort to provide consistent superior risk-adjusted returns to our clients.

Merganser Investment Team



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