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Introducing the *Grant's* Supermodel Credit Portfolio

Credit is what we are bullish on—cast-off residential mortgage-backed securities, senior bank loans, convertible bonds and corporate debentures, high-rated and middling. And it's credit that fills the new *Grant's* model portfolio. Expectantly, we call it our Supermodel Portfolio. May it deliver superior returns for 2009 and beyond. No guarantees, of course. However, at the least, we expect it will outearn the corresponding portfolio control group, an assortment of long-dated, "supersafe" (as a certain newspaper habitually calls them) U.S. Treasurys. Whoever coined the phrase "return-free risk" to apply to government securities at these ground-hugging yields was a sage as well as an aphorist. Barring a deflationary collapse, the Treasury market will surely have its comeuppance.

The investments that stock the Supermodel Portfolio have had their comeuppance already. They deserved it. Credit had a heart attack last year on account of its scandalously loose living during the bubble years. Still remorseful and weak as a kitten, the institution of lending and borrowing is gathering strength for the next cycle. A not-bad time to invest, we think.

The portfolio, in the hypothetical sum of $10 million, is apportioned among RMBS, secured bank loans, investment-grade corporates, convertibles and junk (or should we say "high-yield"?) bonds. We set aside no cash reserve. This is not to say, however, that we refuse to entertain the possibility that even better credit opportunities will present themselves in 2009. They well might. If they do, we'll just have to raise some more imaginary millions to scoop them up.

No need to say much on high-yield (see the prior issue of *Grant's*), except to explain its presence in what is intended to be a safe and cheap portfolio. Rarely, if ever, has junk been junkier, to judge by the ratings mix of the bond crop or the likely sky-high prospective default rates. Then, again, we believe, never have yields to maturity been so high—22% on the Merrill Lynch Master II Index. Come the cyclical turn, junk bonds will shine. The question is, from what level will they begin to glimmer? There can be no assurance, to steal a phrase from the junk-bond prospectuses, that it won't be from prices much below even these. The fact is that, at this point in the cycle, junk is hugely speculative. The iShares iBoxx $ High Yield Corporate Bond Fund (HYG on the Big Board), our junk-bond trading vehicle, holds a position in 51 liquid issues. At a price of $64.81, the fund pays monthly dividends to produce a current yield of 13.5%; indicated yield to maturity is 18.7%. Its market cap is $1.02 billion. Given the risks, we assign to high yield an allocation of just 5%. We view it as a portfolio seasoning, an herb.

A little less speculative is the investment-grade component of our Supermodel Portfolio, though investment-grade yields in relation to government yields imply a looming deflationary disaster even for better-rated debt. At 616 basis points, the spread between the Moody's Baa-rated corporate index and the 10-year Treasury is the highest since at least 1962. Indeed, according to Deutsche Bank data recently quoted in these pages, the gap is probably wider than at any point since the Great Depression (when—let us not forget—the nominal GDP was sawed in half). Moody's relates

Treasury portfolio

security	price	investment
4 1/2s of May 2038	128-06	$2.0 million
4 3/8s of February 2038	125-03	2.0
5s of May 2037	135-15	2.0
4 3/4s of February 2037	130-08	2.0
4 1/2s of May 2036	123-27	2.0
Cash*		0.0
Total		$10.0

Grant's Supermodel Credit Portfolio

security	price	investment
iShares iBoxx $ High Yield (HYG)	63.75	$ 0.5
iShares iBoxx $ Investment Grade (LQD)	92.14	2.0
Nuveen Floating Rate Income Fund (JFR)	5.03	2.5
Calamos Convertible Fund, Class B (CALBX)	15.69	2.5
GSAA 2005-12, Class AF-3	50	1.25
Popular 2007-A, Class A-3	32	1.25
Cash *		0.0
Total		$10.0 million

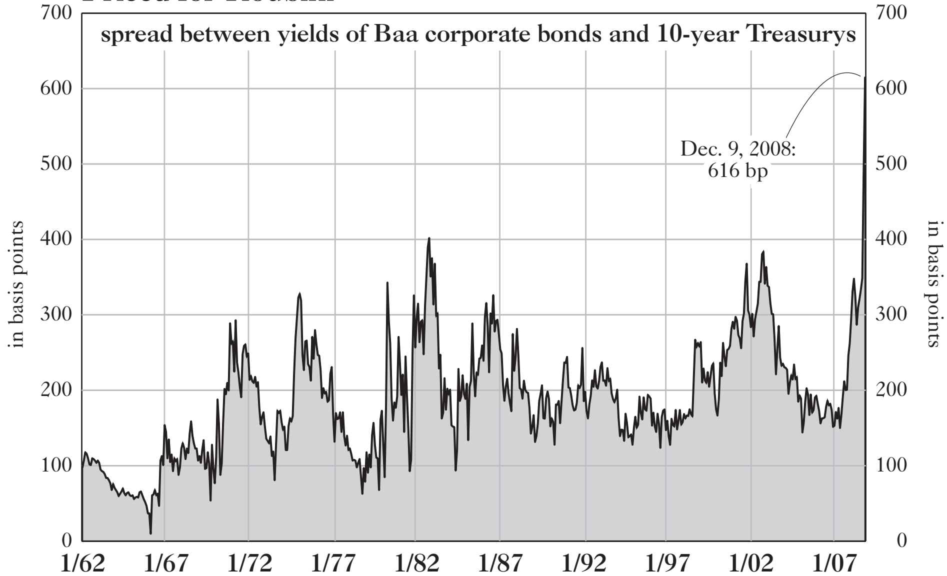
*cash earns 1%.

that the investment-grade default rate never topped 1.6% in any Depression year, while the average annual default rate for investment-grade bonds from 1920 to 2006 was just 0.146%; the high was 1.55%, recorded in the recession year 1938. For what it's worth, the Moody's Baa index has actually been rallying these past few weeks, trading to 8.75% from 9.5%, yet such high-quality issuers as Caterpillar and Hewlett-Packard had to dangle 100 basis-point concessions (in relation to the yields assigned to their own outstanding issues) in order to place new securities last week.

Senior loans, in the shape of a $2.5 million allocation to the Nuveen Floating Rate Income Fund (JFR on the Big Board), are the third item in the portfolio. "Leveraged loans" is what the adepts call these instruments. They are secured claims—tradable bank loans—on leveraged companies. True, such leverage was typically excessive, but the senior secured lenders stand to come out of the experience in a relatively strong position. The trouble is that leveraged loans attracted leveraged buyers; they yielded a pittance over Libor. To enhance the return, loan investors—e.g., hedge funds and collateralized loan obligations—borrowed liberally against the leveraged collateral. Come the great margin call, they sold (and continue to sell) just as liberally. "All told," according to the definitive chronicler of the loan market, Standard & Poor's LCD, "the [loan] index is down 25.5% over the past three months, leaving returns for the first 11 months of the year at a soul-destroying negative 27%, all but ensuring that 2008 will produce the first annual loss for the index, which dates to 1997."

"Soul-destroying"? An editing error, probably; LCD must have meant "wealth-destroying" and, therefore, "opportunity-creating," though the opportunity thereby created seems not yet to be widely perceived. Supply keeps coming out of the woodwork, and the public continues to yank its money from loan mutual funds. Motivated sellers put out calls for bids, i.e., "bids wanted in competition," and they are the bane of the market. BWICs in the sum of $3.3 billion set a monthly record in October. Another $1.3 billion of BWICs rattled the market in November. (These days, OWICs, i.e., "offerings wanted in competition," are only a dim, gauzy memory.) "While these figures are tiny in relationship to the institutional loan universe of $595 billion," LCD observes, "they are daunting in the absence of any new funding sources." Loan funds have suffered net outflows in 16 of the past 17 weeks, for a year-to-date total of $4.5 billion. Assets under management have dropped to $7.5 billion from $15.9 billion.

Priced for Roubini



source: The Bloomberg

There are, according to the *Barron's* Weekly Closed-End Funds roundup, 19 loan-participation funds. As you know, closed-end funds issue a fixed number of shares, and with the proceeds from the sale of those shares, they acquire assets. The funds are exchange-listed and the prices at which they trade may or may not mirror the value of the underlying assets. The universe of listed loan-participation funds trades at a large discount to NAV—at last report, an average of 17.2%.

"Investors are getting a double discount," colleague Dan Gertner points out. "The price of the loans held in the portfolios has fallen below par value. And the funds are selling at a discount to the underlying NAV because so many investors are selling. Elliot Herskowitz, president of ReGen Capital, has studied the discounts at which the closed-end funds are trading. He finds that the funds are trading between 30 and 60 cents on the dollar of the underlying par value of the loans. Herskowitz told me, 'It really points out that, based on the way these things are trading, you can buy into loans at 50 cents on the dollar—I mean the senior loans. And I think it's just an unbelievable opportunity out there.' Herskowitz cautions that the market is thin and prices can move erratically. 'But if you're careful about getting in or out, it's just an unbelievable opportunity. It is very rare for the retail investor to actually get a better deal than that which exists for the institutional clients,' he says. 'But in this particular area, at this particular time, given the way these things are trading, it's just a glaring example.'"

We chose the Nuveen Floating Rate Income Fund to carry the leveraged-loan flag for a number of reasons. For one thing, JFR has redeemed 59% of its auction-rate preferred securities ($235 million out of $400 million), and Nuveen says it intends to redeem the balance. For another, 93.6% of the fund's portfolio is allocated to variable-rate loans and short-term investments (many funds have heavy junk-bond exposures). Finally, the fund is quoted at a discount to a discount. Thus, as of July 31, the portfolio encompassed $954 million of loans and bonds. Assuming no change since the reporting date, the underlying assets are trading at 47 cents on the dollar, based on the decline in the disclosed NAV. Then, too, at the current price of $5.03 a share, the fund is trading at an 18.7%

discount to its $6.19 NAV. Multiply one discount by the other, and a new JFR investor winds up owning the assets at 38 cents on the dollar. The fund shows these characteristics of diversification by industry: media, 18%; hotels, restaurants and leisure, 7.3%; health care, 6.4%; and chemicals, 4.8%. Typically for the group, JFR is leveraged 42%, with preferred stock and borrowings. The current yield is 14%. In order for JFR to pay a common dividend, the value of its assets must be 200% greater than the value of the leverage-providing preferred stock and borrowings. As of November 28, the ratio stood at 239%, compared—for reference—to 243% in January. (Consult www.etf-connect.com for current information on closed-end funds.) Open-end funds provide unleveraged access to the bank loan market. Among three of the largest are Fidelity Floating Rate High Income, Eaton Vance Floating-Rate Fund and Franklin Floating Rate Daily Access Fund.

As to convertibles, we laid out the story line in the previous issue of *Grant's*; suffice it to say that they are still not the fixed-income market's favorite flavor. We choose the Class B shares of the open-end Calamos Convertible Bond Fund (CALBX) for the Supermodel Portfolio. The B stock has a deferred sales charge that shrinks by a percentage point in every year that an investor chooses not to redeem—from 5% in year one to zero percent in year six. The fund's annual operating expenses are 1.88%, and the average credit quality is triple-B. Assets total $462 million. Information technology is the top sector weighting (24.4%), followed by health care (20.3%) and consumer discretionary (13.2%). The Calamos fund, founded in 1985, had been closed to new investors since April 2003. It reopened on October 7, with John P. Calamos Sr., co-chief investment officer, recalling the persistent knocking on its door by some would-be investors. "[O]ur response has always been 'not until we identify a significant opportunity that may be advantageous for both new and existing investors,'" he said. "Well, we think we have found one." Nick P. Calamos, co-CIO, added, "According to our research, we believe the global convertible market is significantly undervalued today." So do we.

Last but not least come residential mortgage-backed securities, the hardest of the credit markets' hard cases. In particular, we tap for inclusion in the Supermodel Portfolio a pair of structures we first reviewed in our September 19 issue. They are the GSAA Home Equity Trust 2005-12 and the Popular ABS Mortgage Pass-Through Trust 2007-A. At the time, the slices on which we particularly focused—Class AF-3 of GSAA and Class A-3 of Popular—traded at 69 and 59, respectively. Today's prices are 50 and 32.

At inception, the GSAA Home Equity Trust was stocked with Alt-A residential mortgages, 2,919 of them. All were fixed-rate and first-lien and all had maturities of 30 years or less. The average FICO score, LTV and loan size were 690, 79.1% and $194,740, respectively. Thirty-nine percent of the dollar value of the mortgages was secured by houses in California, Florida and New York.

Oddly enough, the deal hasn't performed badly. The principal balance has been reduced by 43% and the number of loans by 39%. Troubled loans (60 days or more delinquent) stand at 13.8% of the outstanding balance, and cumulative losses amount to just 0.85% of the original balance. We thought that the Class AF-3 was cheap at 69. We like it more—exactly 28% more—at 50. AF-3 pays a fixed coupon of 5.07%, and its credit enhancement has grown to 12.3% from 7.4% as the top of the structure has melted away. It is the third-pay bond, i.e., third in line to receive principal payments. But it might as well be second, because the first bond in the structure has paid down 95.8% of its original balance.

In our post-Labor Day review of the RMBS field, Gertner spoke to Bryan Whalen, managing director of Metropolitan West Asset Management. Whalen obligingly came to the phone again last week. He told Gertner that, in a base case, the AF-3 bond would yield 29% to a five-year maturity. Even a modified Nouriel Roubini disaster scenario would permit a 14% yield, he said. In such a setting, the conditional (i.e., steady-state) prepayment rate would slow to 3% from the current 8.2%, 84% of the remaining pool would default (compared to 13.8% of the deal that is currently troubled) and loss severities would reach 70% (up from 50% at present, which is ghastly enough).

And if interest rates should happen to rise, what then? Not much, probably. At 50 cents on the dollar, the AF-3 is trading on credit quality and liquidity, not on interest rates. "I have a hard time believing that this bond would sell off even with a few hundred-basis-point Treasury sell-off," Whalen told Gertner. "In fact, prices may go up in that scenario if the market is indicating that credit is improving and the economy may be improving and reinflating."

Our final investment, the Popular

Buyers, please call your office

source: The Bloomberg

ABS Mortgage Pass-Through Trust, will absorb our last imaginary $1.25 million. Your hand may quaver when you write the check (if you are following along at home), as the Popular bond—triple-A-rated Class A-3—houses subprime mortgages. The wrinkle is that the mortgages are overachieving ones, though priced as if they were slugs. For one thing, adjustable-rate loans constitute just 49% of the 2,779 mortgages in the pool, the rest being fixed-rate. Usually, ARMs occupy a much bigger share of a subprime RMBS. For another thing, the collateral is widely distributed, with just one bubble market—Florida—in the top five.

On the face of it, our Popular investment will win no quality-assurance awards. Its troubled loans stand at 21.6% of the outstanding balance, while cumulative losses total 1.5% of the original balance. But it shines in comparison to an especially rotten field. In the 07-2 portion of the tradable ABX subprime mortgage index, for instance, troubled loans amount to 35.7% of the outstanding balance, while cumulative losses foot to 4.9%. That ABX subindex last traded at 33.6, a slight premium to the plainly superior Popular bond.

Though the Popular deal references slightly more fixed-rate mortgages than it does ARMs, the Class A-3 bond pays a floating-rate coupon: Libor plus 31 basis points. That fact, of course, makes it more sensitive to interest-rate movements than the preceding AF-3 model, but only to a degree. At 32 cents on the dollar, the market is plainly more worried about solvency than about Libor. Whalen's base case would produce a yield to maturity of 21% and an average life of eight years. The stress case—a 3% prepayment vs. an observed 14.7% rate, and 93% of the remaining loans defaulting with a loss severity of 70%—still results in a 14% yield to maturity.

"The mark to market over the past couple of months has been brutal," Whalen tells Gertner, "but if you can put the emotions aside and keep your eyes on the horizon, and not on short-term volatility, investors should be drooling over today's prices."

Pass the napkins and reach for the "buy" tickets. May the *Grant's* Supermodel Credit Portfolio be worthy of its name.

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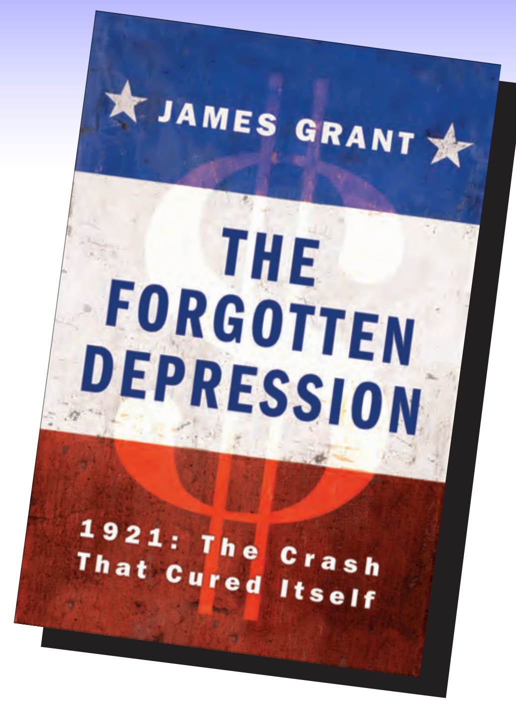

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