February 2003

DHJ&A
DAVIS HAMILTON JACKSON & ASSOCIATES

Tale of Two Bond Markets

"It was the best of times, it was the worst of times, …it was the season of Light, it was the season of Darkness, ..." Charles Dickens could have been writing about the fixed income markets in 2002!

As far as absolute performance goes, last year was the "best of times" for fixed income, as bonds had another good year. The LB Aggregate Index posted an excellent 10.26% total return last year. The "worst of times" was getting there-Enron, Worldcom, Tyco, suicide bombings in Israel, strikes in Venezuela, Iraq, and anthrax. All of this led to plunging consumer confidence, severe stock market losses and record volatility.

No fixed income sector was impacted more than corporate bonds. Many corporate issuers saw their yield spreads relative to comparable treasuries blow out to historically wide levels. Rating services responded with a surge in corporate downgrades, leading to a record number of companies falling from investment grade to junk status. For the year, corporate bonds, as measured by excess return, underperformed treasuries by a whopping 2.45%.

Thus, we were all painfully reminded last year what fixed income investing is all about-**Preservation of Principal**. Market practitioners re-learned many valuable lessons in the bond market. Here are three I find most relevant:

There's no such thing as a "little" risk. It's easy to be seduced into buying a short "unbelievably cheap" corporate bond for "extra yield." We've heard the pitches. "Don't you think they're going to be around next year?" "What could go wrong?" Plenty. Just ask those investors who bought short-maturity WorldCom bonds in early June last year. At that time, the company was under pressure and its bond prices had lost significant value. However, market consensus was that the company was still generating cash and would still "be around." When WorldCom finally collapsed, its bonds declined in value and converged to the same dollar price. In the example below, one can see that, from a dollar price and yield perspective; the short maturities actually suffered the most.

Date	Bond	Price	Yield
Early 6/02	WCOM 7.875% 5-15-03	84.33	23.5%
Early 6/02	WCOM 7.50% 5-15-11	48.56	18.9%
Late 6/02	WCOM 7.875% 5-15-03	15.00	406%
Late 6/02	WCOM 7.50% 5-15-11	15.00	47.5%

It's better to be first in line. Some investors reach for an extra 15 basis points in yield by going down the credit ladder and purchasing subordinated debt. Again, "what could go wrong with this strategy?" Everything. In a crisis, the market adjusts for the fact that senior debt is in a superior financial position relative to subordinated debt. Doesn't sound like much, but ask those investors who bought 10-year Duke Capital bonds instead of buying the higher rated 10-year Duke Energy bonds. Early last year, the spread difference between the two names was only 10 basis points. Now, Duke Capital yields approximately 175 basis points more than Duke Energy. Thus, instead of earning that "extra yield", Duke Capital investors saw their investment underperform higher rated Duke Energy debt by almost 15% last year.

What you see isn't always what you get. In their search for high quality, higher yielding securities, investors flocked to mortgage-backed securities last year. As a result, Wall Street reports that the mortgage market experienced significant out-performance. Judging by the 1.73% excess return over treasuries of the mortgage index, one would have thought that swapping treasuries for mortgages early in the year would have been a good decision. In actuality, selling treasuries last year in exchange for equal duration (interest rate sensitivity) mortgages hurt some managers. Below, one can see that the total return of last year's mortgage index was less than the total return of an equal duration treasury selected at the beginning of 2002.

Jan 2002	MBS Index	3.10 duration	
Jan 2002	3.5-yr treasury	3.10 duration	
Yr-end 2002	MBS Index	.94 duration	2002 return 8.75%
Yr-end 2002	3.5 yr-treasury	2.30 duration	2002 return 8.98%

So, where's the beef! It's in the negative convexity of mortgages. In a falling interest rate environment, as we had last year, longer duration securities appreciate in price more than shorter duration securities. However, mortgages experience a decrease in duration when interest rates fall due to higher prepayments. Therefore, mortgages do not experience as much capital appreciation as treasuries or other non-callable securities. Managers who switched at the beginning of the year from treasuries to mortgages with similar durations ended the year with much shorter portfolio durations than they intended. Thus, they lost out on a lot of potential appreciation as interest rates fell.

Dickens closes his masterpiece with "it is a far, far better thing that I do, than I have done; it is a far, far better rest that I go to than I have ever known." As money managers and trustees enter 2003, we will certainly rest better with our bond investments if we remember that one of the primary objectives of bond investing is the **Preservation of Principal. This is the very cornerstone of our management style here at Davis Hamilton Jackson & Associates.**

-Gilbert A. Garcia
February 10, 2003

A copy of our Form ADV, Part II is available upon request.

TWO HOUSTON CENTER 909 FANNIN, SUITE 550 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308