VANDERBILT Ave. ASSET MANAGEMENT

Emad A. Zikry, President and Chief Executive Officer

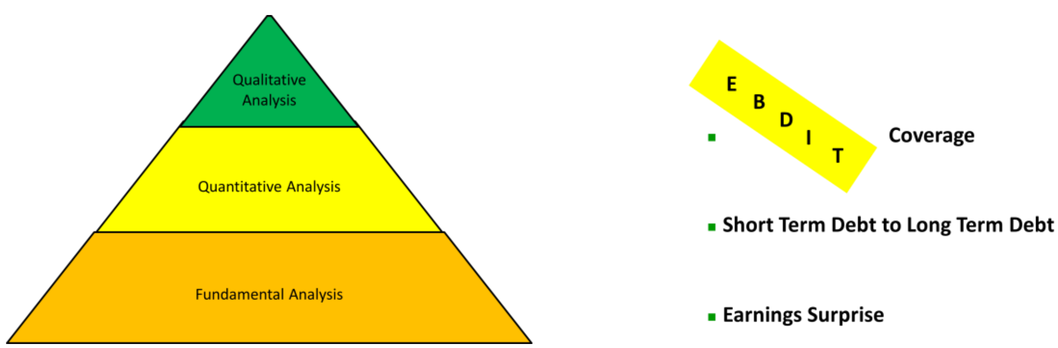
What's A Nice Bond Like You Doing With An Investor Like Me?

A Case For Covered Bonds

Portfolio managers at Vanderbilt Avenue Asset Management analyze bonds daily, looking for relative value across sectors and securities. Within each sector we weigh the attributes of various security types. While readjusting the ideal combination of securities to outperform a portfolio's benchmark, we strictly adhere to the portfolio's guidelines. In so doing, we employ a combination of U.S. Treasuries, U.S. Agency Securities, Corporate Bonds, Asset Backed and Mortgage Backed Securities, an optimal combination of which we arrive at only after analyzing markets, statistics and spreads. But herein lies the potential for a roadblock.

Each of our clients sets different guidelines. Some, for example, request that we invest in AA-rated securities at a minimum, while others ask that the portfolio as a whole have an investment grade rating. We layer these guidelines to our in-house corporate process, which is comprised of three fundamental screens, beginning with evaluation of coverage and leverage ratios versus a security's peer group. We follow with an analysis of the company's short term debt to long term debt. The final step is assessment of earnings, whereby we measure reported earnings versus the consensus and have a strict policy to sell at the first negative earnings surprise. With our rigorous process in hand, we must now conform to our clients' requests and attempt to reconcile our research-driven targeted investments in order to optimize their returns and maintain consistency across accounts. This places us at a crossroads to establish a solution that allows the allocation of like securities into unlike accounts. Enter "covered bonds".

Corporate Bond Selection Process begins with Fundamental Analysis:



Recently, for example, we had determined that Australia and New Zealand Banking Group ("ANZ") offered positive relative value versus the Corporate Bond benchmark. Our research had indicated that the Banks sector was still undervalued and ANZ in particular offered the potential for solid total return. The rating for ANZ corporate debt was AA-. Before we execute a trade in any account, we determine the impact to the account as a whole. While some account guidelines easily accepted this security, others would not permit it because its rating was below AAA or because its AA- rating pulled the account's average rating below a certain threshold. In order to accommodate these other accounts, we instead considered investing in the ANZ *covered bonds*, which happened to be rated AAA.

Covered bonds are corporate bonds that are issued by the corporate institution, typically a bank. Unlike traditional corporate bonds, however, covered bonds are collateralized or covered by a specified pool of assets, usually mortgages on the institution's balance sheet. So while a bank's corporate debt may be rated AA, its covered corporate debt is rated AAA, because it is collateralized by mortgages. In order to earn a higher credit rating, covered bonds offer slightly lower yields to investors (table 1). However, they afford investors an opportunity for exposure to a security that they would normally not be able to invest in. So in the case below, investors can purchase AAA rated securities versus AA rated securities for a give of only 7 basis points.

Table 1

		Coupon / Maturity	Duration	Rating	Yield
ANZ	Covered	2.40% / 11/23/16	1.53	AAA	0.78%
ANZ	Uncovered	1.25% / 01/10/17	1.68	AA-	0.85%
Difference:				**Higher Rating**	**Give 0.07%**

If we take the analysis a step further, however, and compare the yield of the BofA Merrill Lynch1-3 Covered Bond Index to that of the BofA Merrill Lynch 1-3 AAA Corporate Index, we find a generous pick-up in yield (table 2). Therefore, by analyzing the AAA covered bond in the context of AAA corporate peers, we find a clear yield advantage to investing in covered bonds.

Table 2

	Duration	Yield
BofA Merrill Lynch 1-3 Yr *Covered Bond* Index	1.88	1.01%
BofA Merrill Lynch 1-3 Yr *AAA Corporate* Bond Index	2.06	0.84%
Difference:		**Pickup 0.17%**

To many fixed income money managers, this investment radiates a mortgage-backed security ("MBS") aura. While covered bonds, are collateralized by the bank's mortgages, they are in fact, critically different from MBS. In packaging MBS, an institution removes the mortgage loans from its balance sheet, sometimes only retaining a marginal percentage stake in the loans. However, a bank that issues covered bonds, keeps every single mortgage that collateralizes the covered bonds on its balance sheet. In fact, to be eligible, the loans covering the bonds have to maintain a certain level of credit worthiness. Consequently, the performance of those mortgages impacts the bank's performance and the rate at which it will be able to issue all of its subsequent debt.

As it turns out, European banks have been issuing covered bonds since the 1700s. These securities tend to be fixed rate with a typical maturity ranging between one and 30 years. Covered bonds are attractive to investors who seek a combination of the excellent liquidity of a corporate bond coupled with the AAA-rating without prepayment risk. The United States has been slow in issuing covered bonds, primarily because banks have been able to offer investors exposure to mortgage loans at low risk levels by selling loans to GSE (Government Sponsored Enterprise) programs. These U.S. agency programs pool mortgages and issue securities with a government agency guarantee, such as FNMA and FHLMC. However, when compared to U.S. Agency securities, covered bonds exhibit considerable value. Take for example, FHLMC 0.841% 11/25/16. When comparing the ANZ AAA-rated covered bond to the AA-rated U.S. Agency security, investors of the ANZ bond would not only gain a higher rating, but they would earn significantly more yield as well.

Table 3

		Coupon / Maturity	Duration	Rating	Yield
ANZ	Covered	2.40% / 11/23/16	1.53	AAA	0.78%
FHLMC	U.S. Agency	0.841%/11/25/16	1.58	AA+	0.56%
Difference:				**Higher Rating**	**Pickup 0.22%**

Therefore, although investors interested in the superior AAA quality and yield advantage of covered bonds would likely need to research banks that are across the ocean, in the long run, their portfolios will thank them for it.

Vanderbilt Research Team

Emad A. Zikry

Chief Executive Officer
Vanderbilt Avenue Asset Management

Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as *The Journal of Forecasting*, *The American Economist* and *The Journal of Fixed Income*. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.