Value Investor INSIGHT

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March 31, 2009

The following excerpt, reprinted with permission, is from a feature interview with Jason Brady that appeared in the March 31, 2009 issue of *Value Investor Insight*.

INVESTOR INSIGHT

Jason Brady, CFA
Thornburg Investment Management

"It comes down to putting your views on the business model, leverage and asset value against the market's offered return."

Your focus is pretty much all bonds all the time. How would you characterize the potential upside in credit markets today?

Jason Brady: Any discussion of relative value clearly has to take into account why we are where we are. There are certainly plenty of legitimate reasons why corporate bonds have gotten so much cheaper, the most obvious being that the risk of default has gone up as the economy has hit a wall.

But there have also been many less fundamental reasons why bond prices have gone down that have, in our opinion, made fixed income as an asset class more attractive today than it has been in a long time. For example, the relatively low volatility in recent years, the stable economy, and the relatively steep yield curve made fixed income a great place to try to lever returns. People could borrow short and lend long and had no trouble finding places to finance their doing so. Of course when people started missing mortgage payments and LBO companies started missing interest payments, this game started to reverse itself quite quickly. People who were 10x levered had to go immediately to not levered at all and it didn't matter when the point of fundamental value was hit in a lot of securities – prices just kept going down because so many people needed to sell. That type of thing has created opportunity.

It's improved somewhat since then – not a lot – but in December high-yield corporate bonds by our estimation were pricing in annual default rates of 25% over a long period of time. For perspective, in the last two big bear markets for bonds – in the early 1990s and earlier this decade – high-yield default rates in the worst year peaked around 12%. Things could certainly get worse than they were then, and even twice as bad as the previous worst years, but it's hard to imagine them staying at such a depressed level for years on end, which is what today's pricing implies.

In 2005-06, roughly 10% of the Income Builder balanced fund I co-manage was in fixed income. Today that number is 42%.

Describe your analytical process for corporate fixed-income securities.

JB: In analyzing corporate bonds you don't need a particularly nuanced view of the company's future growth prospects. The best-case scenario in a bond if you hold to maturity is that you're going to get what you were promised in terms of yield. So by necessity, the focus has to be more on the downside risk of default, and if there is a default, what recovery value you would get.

For a typical business, that means assessing the stability of the business model, how levered the company is relative to what it earns, and what the value of the assets underneath you are should things go horribly wrong. There are plenty of specifics to look at with respect to covenants and call terms and all that, but decisions essentially come down to putting your views on the business model, leverage risk and asset value against the return the market is offering you and making a judgment call if it's worth it.

In what particular areas of the market today are you finding ideas that pass your research muster?

JB: We see a few different general categories of opportunity. The first may not sound very exciting, but is in companies like utilities that provide essential, regulated services and whose paper currently trades with 7-8% yields. In a world in which cash is earning next to nothing, we consider the risk/reward on a lot of these securities to be quite compelling.

An example of what we own are the bonds of **National Rural Utilities Cooperative Finance Corp.**, which is essentially a financing vehicle for its owner utility and telecom companies that are too small to access capital markets on their own. The cooperative issues debt backed by first-lien mort-

gages on the operating units of its owners, which gives it a very diversified asset base and a first call on assets if one of its members doesn't pay on its loans.

In October of last year the company sold $1 billion in new 10-year debt securities, rated by all the ratings agencies as a high A, that was priced to yield 10.5%. At the time, the spread over the 10-year Treasury was 680 basis points. That spread has tightened to around 525 basis points and Treasury yields have come down, so at a current price of around 116, the yield to maturity on these bonds is around 8%.

While your equity-investor readers might not get too worked up about that level of return, we're very happy to have a chunk of our portfolio in things with that kind of return potential, especially given how low we consider the risk of default when you're dealing with a non-discretionary, regulated business that has first-lien positions against its loans.

How about an idea that might get our equity-focused readers a bit more worked up?

JB: One offering a much higher yield to maturity, but with a different risk profile, is **NII Holdings**, which used to be known as Nextel International. It's a publicly traded company (ticker symbol NIHD) that provides cellular telephone service in Central and South America. In 2007 they issued 3.125%-coupon convertible bonds maturing in 2012. At the time there was some option value in the bond because the stock was trading at $80 and the conversion price was $118. But with the stock now at $15, this is essentially just a bond.

These converts now trade at 68 cents on the dollar, offering a yield to maturity at par of 16%. The issue then comes down to an assessment of the default risk. Over the last 12 months, the company earned EBITDA of $1.2 billion, versus total debt of $2.3 billion. That makes the ratio of total debt to EBITDA – the bond equivalent of a P/E – 1.9x. Could we imagine them selling the business for at least 1.9x EBITDA and making us whole as a debt holder? Absolutely.

Other big positives for bond holders are the company's $1.3 billion in cash and $2.5 billion in current equity value, which would have to get burned through before our yield was impaired. The risk of the business collapsing enough for that to happen over the next five years is not zero, but we believe that a well-established telecom business like this shouldn't be subject to anywhere near the cyclical downturn that would imply. Given that, we think people would be hard pressed to find elsewhere a 16% annual return in securities carrying comparable risk to these.

Is currency risk an issue here?

JB: Yes. While most of the company's operating expenses are in the same currencies as its revenues, it could be an issue because the interest costs are in dollars. That's particularly a concern when the dollar has appreciated as aggressively as it has against Latin American currencies in recent months. Based on our analysis, though, the company would still be able to pay its interest in dollars out of cash flow even if the value of the currencies in which they earn deteriorated at twice the rate of the most recent quarter. Given that that's unlikely to happen over an extended period of time – and that they have that $1.3 billion in cash – we don't consider the currency situation overly problematic.

We haven't spoken much about Treasury securities. Are you in the camp that considers them significantly overvalued?

JB: A 2.7% nominal annual yield for 10 years – with potentially ugly inflation on the horizon – is not at all interesting. But I would caution against an emphatic embrace of that position while the government's printing presses are at the ready to print money in order to buy Treasuries. As long as that remains the case, it's hard to envision a sell-off any time soon. In any event, we've got plenty of other things to do without trying to play that. VII

Disclosure

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A basis point is a unit equal to 1/100th of 1%. 1% = 100 basis points (bps).

Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share.

EBITDA is an indicator of a company's financial performance which is calculated as follows: EBITDA = Revenues - Expenses (excluding interest, tax, depreciation and amortization).

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Yield to maturity (YTM) is the rate of return anticipated on a bond if it is held until the maturity date. If a bond's coupon rate is less than its YTM, then the bond is selling at a discount. If a bond's coupon rate is more than its YTM, then the bond is selling at a premium. If a bond's coupon rate is equal to its YTM, then the bond is selling at par. "At Par" is a term that refers to a bond, preferred stock or other debt obligation that is trading at its face value. Bonds are quoted at 100 when trading at par.

Nominal yield is the coupon rate of a fixed income security, which is a fixed percentage of the par value. Unlike current yield, it does not vary with the market price of the security.

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2300 North Ridgetop Rd. Santa Fe, NM 87506 800-847-0200 www.thornburg.com TH1913