

The Contango Difference

A Disciplined Approach to Fixed Income

Contango's fixed-income strategy is made up of four layers, which may be used independently or in combination in a client portfolio, based on that client's specific objectives.

Long-Term Asset Allocation

At the heart of Contango's fixed-income strategy is our asset-allocation strategy. Here, we assess the client's overall portfolio goals to determine the assets to be allocated to fixed income. That determination represents the "core" level of allocation, driven by our overall views on correlations of fixed-income assets and of other assets. That overall allocation may change when our views on these long-term relationships change.

Once we have determined the assets to be allocated to fixed income as a whole, we then assess the percentages to be invested in:

- Taxable securities
- Tax-exempt securities

Alongside this analysis we also determine the portfolio mix in terms of fundamentals, such as:

- Duration
- Credit quality
- Geographic
- Sector

Once we've developed a "profile" of the portfolio we then determine:

- The specific securities to be acquired;
- The frequency with which the allocation should be reviewed (above and beyond our ongoing oversight) and, possibly, rebalanced.
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Tactical Yield Enhancement

After the core portfolio is developed, we determine if and how yields can be enhanced. In situations where we believe that yield-enhancement strategies will not increase portfolio volatility, we use them on *all* fixed-income portfolios for which they are economically appropriate and permitted by our clients and applicable regulations.

All of our yield-enhancement strategies are subjected to quantitative due diligence conducted on a forward-looking basis as well as “backtested” against historical data. This step helps to ensure that the benefits sought are likely to be realized. Yield-enhancement strategies are not macro bets on the overall direction of rates or credit but rather take advantage of market inefficiencies among different securities or classes of securities.

We enhance yields on the core fixed-income portfolios in a variety of ways:

- Through internal active management of the securities, for example, municipal bonds;
- By using outside active managers to handle portions of our client portfolios;
- By taking specific futures positions to hedge or leverage specific securities.

We employ active management techniques only when we believe that they can consistently deliver more value than the added costs they incur. In some areas of the fixed-income markets, active management can deliver consistently more than it costs, even on a risk-adjusted basis. Our analytic processes attempt to identify these market areas and often enable us to enhance yields on the core fixed-income allocation.

Macro Repositioning

Yield curves and credit spreads move in cycles, driven by monetary policy, economic events and other factors. Forecasting the direction of these changes is difficult; timing them is even tougher. Nor is simply staying the course always easy: Even strategies that ultimately prove to be prudent and/or attractively profitable may undergo periods where they appear to be neither.

But while we are proponents of investing for the long term, we are not advocates of ignoring reality. Where we find the facts and their analysis compelling, we may endorse macro repositioning of fixed-income portfolios within the context of repositioning the entire portfolio.

Macro repositioning can be implemented:

- By transacting in individual securities; for example, buying or selling specific bonds within the portfolio;
- By using overlay transactions, whether in individual securities such as Treasury zeros or through futures or options trades that create “pure” bets on the yield curve or on credit quality.

We typically prefer overlay transactions, which don't affect the portfolio's internal structure or generate unnecessary transactions in individual securities. Before embarking on either strategy, however, we:

- Explain to the client the economic reasoning behind our conclusions as well as the implications for their specific portfolio strategy;
- Provide a pro forma model of the benefits if our analysis proves correct, as well as what could happen if current market trends prevail – thus enabling the client to make an informed choice;
- Describe the ongoing triggers for confirmation or rejection of our views and explain the economic and portfolio review processes we use to manage the risks related to following or not following our advice.

Extraordinary Return Opportunities

Extraordinary return opportunities, as the name implies, appear to have the potential to earn above-market returns. Because they entail added volatility, we undertake such strategies only when we believe that the additional volatility is justified by the potential return. There is no free lunch. All such strategies not only increase volatility, but also typically involve varying constraints on liquidity, other risks, and substantial fees and costs to implement.

These opportunities typically take the following forms:

- Exploitation of temporary market anomalies through investment in specific securities. An example is the bank trust-preferred collateralized debt obligation (CDO), a security class that had been unavailable to private investors. As with this example, once these anomalies become widely recognized, they quickly disappear.
- Total-return strategies pursued by active managers. These strategies aim to make money regardless of the cyclicity of the market by constantly identifying yield-enhancing, macro-repositioning and anomaly opportunities, or by adding leverage to create extraordinary returns.

Where we identify unusual return opportunities, as in bank trust-preferred CDOs, for example, we discuss our analysis, and the assumptions and data that underlie them, with the client. We will also explain how we monitor the opportunities and the trigger events that will confirm or refute our beliefs – and what we will do in the latter case.

Whenever we favor the use of outside managers, whether in a fixed-income portfolio or elsewhere, we discuss our reasoning with the client. We explain the due diligence process we used to filter and select the managers, and the ongoing review to assess results.

And finally ...

We recognize that your goals and your aspirations, as well as your specific financial and family situation, are yours alone. That's why we work closely with you to understand and assess your requirements – and to develop a portfolio that directly addresses those needs.

IMPORTANT NOTE:

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