



**Longbow Asset Management Company
Quarterly Investment Note
November 1, 2004**

Investment grade corporate bonds are an attractive and potentially highly rewarding investment class that should neither be overlooked nor summarily dismissed. Some investment managers argue – we believe incorrectly – otherwise. They declare, typically under the banner of risk aversion or preservation of capital, corporate bonds off limits and unilaterally restrict their clients’ fixed income investments to government issued or backed securities. In effect, they blindly truncate an investor’s opportunity set and impose their own risk tolerance upon the client. We believe this blanket approach is both unnecessary and ultimately a disservice to their clients.

A more rewarding approach is to examine each client’s unique circumstances, explain an asset class’s characteristics, potential benefits, as well as its additional hazards, and then design a tailored investment solution to achieve their singularly defined investment objective. As always, this investment process should occur within the confines of the client’s overall risk tolerance framework and without interference from unjust prejudice or bias.

Our firm’s responsibility is to explore rather than ignore opportunities for our clients. Risk is reduced by diversification, not by mere omission, and value is found by critically assessing economic data through a quantitative lens. Corporate bonds, like all investments, offer a measured tradeoff between risk and reward. Their risk profile is similar to government bonds, but heightened by the addition of credit risk. The most devastating component of credit risk is default risk, or the uncertainty surrounding a firm's ability to service its debts and obligations. Fortunately, default is a deceptively rare event.

For example, Moody’s KMV¹ calculates the probability of a firm with a AAA rating defaulting are only about 2 in 10,000 (0.02%) per annum. A single A-rated firm has a probability of around 10 in 10,000 (0.10%) per annum of default. Finally, at the bottom of the ratings scale, a CCC-rated firm’s probability of default is only 4 in 100 (4.0%). (See Table 1 below for investment grade credit rating definitions.)

Table 1	Standard and Poor’s Credit Rating Definitions for Investment Grade Bonds
Credit Rating	Description
AAA	The obligor's capacity to meet its financial commitment on the obligation is <u><i>extremely strong</i></u> .
AA	An obligation rated 'AA' differs from the highest rated obligations only in small degree. The obligor's capacity to meet its financial commitment on the obligation is <u><i>very strong</i></u> .
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still <u><i>strong</i></u> .
BBB	An obligation rated 'BBB' exhibits <u><i>adequate</i></u> protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

Furthermore, it should be recognized that default triggers a substantial, but not a complete loss. According to Moody’s KMV, the typical loss rates in the event of default for senior secured bonds, subordinated bonds, and zero coupon bonds are 49%, 68%, and 81%, respectively.

Corporate bonds are attractive because they offer greater yields than treasuries. This difference in yield, called the credit spread, expands and contracts in step with the business cycle. In prosperous times it narrows, resulting in outperformance, while in lean or uncertain times it widens, resulting in underperformance. Currently, the spread is 0.66% (within the 1 to 10 year maturity range according to the Merrill Lynch Bond Index), with treasuries and investment grade corporate bonds yielding 2.95% and 3.61%, respectively.

¹ Moody’s, like Standard and Poor’s, is a rating agency. Rating agencies gather and analyze a variety of financial, industry, market and economic information, synthesize that information and publish independent, credible assessments of the creditworthiness of securities and issuers thereby providing a convenient way for investors to judge the credit quality of various alternative investment options.

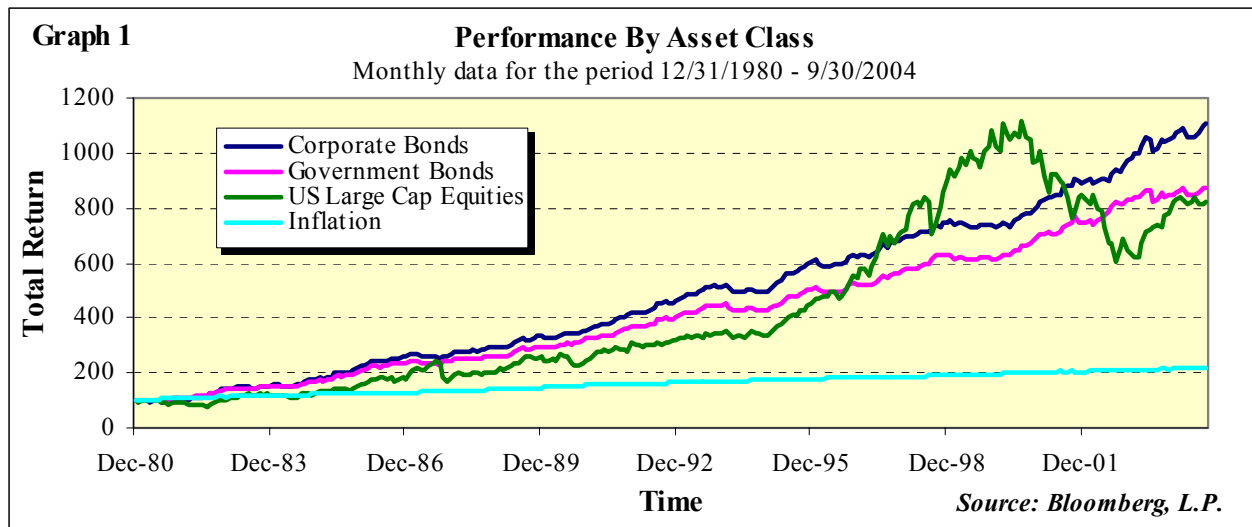


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During 2004, credit spreads, driven by respectable U.S. economic growth (measured by GDP or Gross Domestic Product) and strong corporate profitability, have continually tightened. According to Standard & Poor's, GDP is expected to increase by 4.5% in 2004 and a further 3.5% in 2005. GDP is highly correlated with credit performance. The rising tide of expanding GDP lifts all ships as demand for virtually all goods and services increases.

Corporate profitability has also increased markedly. Productivity gains continue and low interest rates have reduced financing costs. The result is a sharp increase in cash in corporate coffers. According to Standard & Poor's, cash and equivalents held by industrial members of the S&P 500 have nearly doubled since 2000, to \$590 billion from \$329 billion. Cash is now 38.6% of long-term debt, compared with only 20.4% ten years ago, at the same point in the last economic expansion. These factors: an expanding economy, rising profitability, and cash on the balance sheet, make corporate bonds an attractive alternative to government bonds.

Long-term wealth accumulation occurs through compounding. Over time, the additional yield offered by corporate bonds can accumulate to become substantial, as shown in Graph 1:



In annual terms, for the period December 31, 1980 to September 30, 2004, corporate bonds returned 10.6%, government bonds 9.6%, U.S. large cap equities 9.3%, and inflation 3.4%. For the same period, the annualized standard deviation (or risk) of corporate bonds, government bonds, and U.S. large cap equities was 6.6%, 5.3%, and 15.2%, respectively.

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Each of our firm's clients is unique and each has different investment goals. We work efficiently and in a disciplined manner to design investment solutions to meet our clients' needs. We invite you to call our office at (918) 295-9929 if you have any questions or need assistance anytime. We are always available to help and we appreciate your trust and confidence.