

November 23, 2011

**High-Grade Bond of the Week: Caterpillar Financial (CAT) (A2/A) 2.65% of 2016
at +67/5-yr Treasury**

- **Bellwether of the industry**
- **Change of work rules in the 1980's started the company back to its current renaissance**
- **Worldwide mining industry is booming**
- **CAT sales accelerated in October; its worldwide global construction machinery sales rose 31% year-over-year**
- **Rating is conservative at A2/A/A because all raters fear cyclicity**
- **Due to short duration (4.1 years) Option-Adjusted Spread (OAS) is 85 basis points (bps)**

This is a formerly-cyclical credit which has actually been a model of solid growth for the decade, while other companies have floundered. For example, most stocks are at their lowest points in 11 years. At nearly \$100/share CAT's stock is five times its average 2000 level, bringing the value of its equity to a whopping \$58 billion! In the last year its equity volatility of only 36% is in the top decile (lowest volatility) of its industry (per Bloomberg). This is important because it vastly reduces the chance of a stock crash which would, according to Merton models, theoretically increase the chance that the value of assets would be nearing the value of liabilities.

Caterpillar Financial is a typical captive financial, really just the financing arm of the parent. The receivables of machinery companies are so good-quality that in bad times the financial bonds trade better than the parent bonds due to the quality of the receivables. This isn't true today since times are good for machinery & construction firms in general.

Despite fears that China is pulling back its too-loose lending, CAT is nicely diversified across the world and in Asia. It actually has a smaller exposure to China than Komatsu. 35% of CAT's \$16 billion in 3Q11 sales were to North America; 15% to rapidly-growing Latin America; 25% to Asia and 25% to Europe and the Middle East. Can't get much more evenly divided across the world than that!

Buy CAT Financial 2.65% of 4/1/2016 at about \$104.64 = 1.54%, +67/5-yr Treasury. I rate this bond AA-, since I do not dock it for cyclicity as the raters traditionally do. Its diversification has already seen it through the Great Recession in fine form, and therefore will see it through the European Crisis as well.

Good luck and good investing,

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Stephen Smart is an in-house research analyst and former portfolio manager. Recommendations in this report are based on an independent evaluation of particular bonds and do not necessarily represent the views of CCM or its representatives. This is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. Returns and yields are not guaranteed and may be subject to change. Neither CCM nor its affiliates own or position the recommended security. CCM is an independent, non-positioning fixed income broker/dealer providing execution and research to their clients on a fully compliant and transparent platform. The views expressed in the research report accurately reflect Stephen Smart's personal views about the subject securities and issuers and no part of his compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the

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