Merganser Investment Memorandum

Realizing Value in a Dislocated Market

December 2008 ends a most dramatic and volatile year. The credit crunch has roiled the financial markets to a degree not seen in a generation, if ever. While we do not expect a quick turnaround in 2009, the market dislocation has presented attractive total-return opportunities within the investment-grade fixed-income universe.

From the Management Committee

Ed Bedrosian ◆ Doug Kelly ◆ Pam Ketchum ◆ Rich Woerner

Extraordinary Investing Opportunities

Top-performing assets in spread sectors have been battered due to market dislocations, not because of performance. With little new supply expected in the foreseeable future, trading will be done almost exclusively in the secondary market. Our expertise and experience analyzing securities as well as our extensive broker/dealer network makes us exceptionally well qualified to optimize the opportunities.

Please contact Pam Ketchum to discuss which of our products is best suited to help you take advantage of the opportunities currently available in the fixed-income markets.

No Safe Haven

The credit crisis began with a rapidly rising delinquency pipeline in the subprime mortgage market, but has since spread to all fixed-income sectors. Sentiment in asset backed securities (ABS) continues to be dominated by weak consumer spending and a rising unemployment rate. commercial mortgage backed securities (CMBS) face the prospect of precipitous commercial real estate price declines combined with tenant bankruptcies, declining rents and balloon loan extensions. Prime non-agency residential mortgages (RMBS) are reacting to loose underwriting standards, rising unemployment, housing price declines and the lack of a functioning private mortgage market. Corporate bonds are heading into a period of increasing bankruptcies, decreasing profitability and balance-sheet uncertainty. Given these headwinds, how can investors get comfortable buying anything? Fortunately for buyers, fixed-income markets have used a broad brush to price extremely difficult economic conditions into all asset classes. The opportunities available to investors with cash to spend are numerous, but require extensive experience analyzing these securities through various market cycles and a willingness to re-evaluate old models.

The Return of Risk Premium

The years leading up to the credit crunch were characterized by a declining risk premium. As demonstrated in Exhibit 1, the additional spread over a US Treasury demanded by investors declined through 2006. The period 2007 to 2008 marked a reversal in that trend. Risk premiums reappeared and investors demanded tremendous returns to compensate for the risk of owning spread product.

Exhibit 1. Risk Premiums: % Spread to US Treasuries

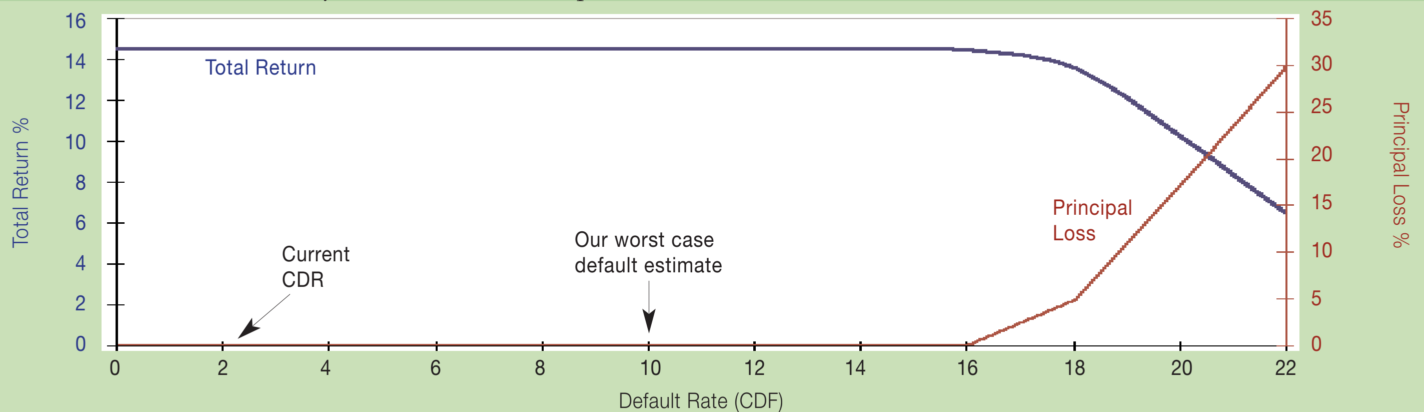
	2005	2006	2007	2008
Corporate Bonds	0.83	0.81	1.81	4.93
Agency MBS	0.54	0.37	0.87	1.45
ABS	0.63	0.51	2.42	9.55
CMBS	0.74	0.62	1.70	10.10

Source: Sectors of the Barclays Capital Aggregate as reported by Barclays. All securities are investment grade. As of year end. Non-agency MBS are not included in the Barclays Capital Aggregate.

It is clear that the risk premiums of 2005 were too low, but are the elevated levels of 2008 appropriate? No one knows for certain, but our belief is that there is a tremendous dispersion among the quality of investment-grade fixed-income securities, and almost all are trading at distressed levels. Certainly there is an opportunity for an institutional asset manager with a long history of successfully evaluating the risk of these securities to add value in this market.

In order to evaluate the true risk of structured product over the coming years, a few rules need to be followed: throw out all the old models, ignore the rating agencies, stress test continuously and strenuously, assume there will be principal losses on many structures, and invest for the long run. Statistical models that used historical data to forecast future probabilities are precisely what got the rating agencies into trouble. We are in a new world of risk, and the fundamental drivers are changing faster than the media can print them. The rating agencies were loose with their AAA ratings during the boom and are now reacting by taking many investments from AAA to junk in one fell swoop. Cash flow modeling must include a va-

Exhibit 2. Asset Backed Security Performance vs. Principal Loss



Analysis as of 1/12/2009. Assumes a 48 month holding period and 60% loss severity on defaults

riety of market scenarios that take into account the myriad of moving pieces that lead to delinquencies. Further, these cash flow models must assume that principal will be lost for many of the investment-grade (mostly AAA) structured securities analyzed. When bonds are trading at 65 cents on the dollar, there is a lot of room for principal loss before total return is negative. Exhibit 2 illustrates a representative auto loan transaction and shows how total return over a four-year holding period is impacted by increasing default rates (CDR). What is most interesting about this example is that this security does not incur losses until the default rate reaches more than 16%, far greater than both the current 2% CDR and our worst-case scenario of 10%. The reason for the strong performance is that 1) principal is paid at par monthly due to the amortizing nature of the security and 2) there is a reserve account that gets applied to this tranche as losses commence.

Finally, to invest in this market, participants must be willing to trade liquidity for return. In order to benefit from the lower prices (high risk premium), investors must not be forced to sell for any reason. If a AAA security gets downgraded to BB, it will very likely still be a total-return home run as long as it was purchased at an appropriate price and there is not a distressed sale. Greatly discounting the rating agencies served us well as we bought securities from 2000 through 2006, and it will again serve us well as we assess risk in 2009. There are times when a sale makes sense, but it is usually driven by a change of fundamental assumptions such as reported delinquencies versus expectations, macroeconomic deterioration or politically motivated market changes.

Common Characteristics

The majority of securities that we find compelling in this market have some common characteristics. The securities tend to be:

- the top performing assets in a battered sector or a misunderstood asset that has been punished inappropriately.
- currently traded almost exclusively in the secondary market. Many new issue markets have shut down as a result of the credit crunch.
- trading at a deep discount to par.
- very illiquid, resulting in a large bid/ask spread.

Once we get comfortable with the fundamentals of a security (cash flows, credit, collateral, etc.) we are able to take advantage of the illiquidity by buying from distressed lists or forced sellers at very attractive levels. The deep discount means that if we did our homework correctly, the price will amortize back to par over time. Even if there are losses on the collateral, the discounted price helps protect us from *invested* principal loss. Many of these benefits are lost if we become forced sellers as a result of a downgrade or client mandate, so it is essential the investment guidelines and client risk tolerance are consistent with a hold-to-maturity time horizon.

Conclusion

We will look back at 2008 as an extraordinary year and a challenging one in many ways. The markets were highly volatile and liquidity remained tight. The risk premium that had all but evaporated returned in full force, and those securities we avoided in 2007 and 2008 are now at attractive valuations. There are currently great opportunities in investment-grade fixed income for a wide range of investors.

Merganser Investment Team
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