Merganser Investment Memorandum

An Update on Dislocation and Recovery in the Bond Market

Summer 2009

Our clients and consultant friends will remember that we began beating the drum in late 2008 about the incredible opportunities we were seeing to earn equity-like returns (yields in the mid-to-high teens) in selected sectors of the investment grade fixed income market. Thanks to unprecedented intervention by governments around the globe and a slowly improving economic landscape, credit spreads have tightened enormously in the last four months. Bond investors, who at the end of 2008 were just dipping their toes in, have now dived back into the risk waters head first. In this memorandum, we will review the actions that we took to capture opportunities, and we will share where we are finding value now. Finally, we will offer some thoughts about what may lie ahead.

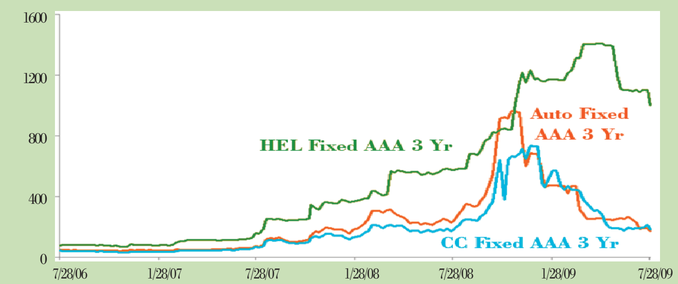
The Credit Crunch

Beginning in the early summer of 2007, we took several steps to preserve our clients' capital during what we thought would be a difficult environment to come (how little we knew about how bad things would get!). First, we pruned the riskiest corporate holdings from our portfolios. These securities included banks, brokers and financial companies that we felt were most exposed to the subprime lending market. Next, we triaged our asset backed security (ABS), commercial mortgage backed security (CMBS) and non-agency mortgage backed security (MBS) holdings into three categories: hold, sell and heightened surveillance. Finally, we began to direct cash flows from our portfolios into Treasuries, agencies and agency MBS in order to ensure adequate liquidity. For the most part, we maintained this posture for the next 18 months. By December of 2008, the wheels had come off the financial markets and spreads on all manner of fixed income instruments had widened to levels not seen in more than a generation (see Exhibits 1, 2 and 3). In our judgment, the markets had priced in a Great Depression economic scenario that we did not feel was justified. It was time to go on the offensive.

Exhibit 1. Credit Spreads

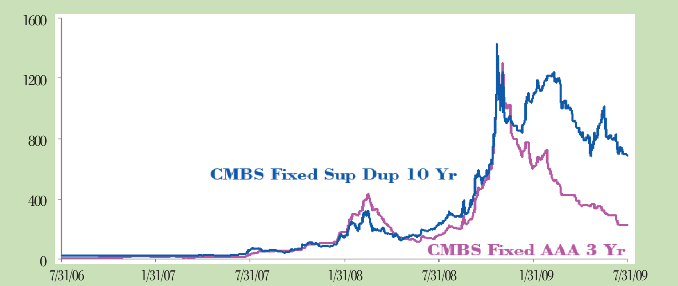
Source: Barclays Live

Exhibit 2. ABS Spreads



Source: Barclays Live

Exhibit 3. CMBS Spreads



Source: Barclays Live

Re-Committing to Risky Assets

Since November, our efforts to re-commit cash flows back to the spread sectors have been focused on non-financial corporates, asset backed, commercial mortgage backed, and to a more limited extent, non-agency residential mortgage backed sectors. While the main driver behind our sector and security selection has been first and foremost to maximize total return, an important consideration has also been to optimize the diversification of cash flows across portfolio sectors and sub-sectors. There are important differences among the sectors that relate not only to the structure of the securities and the nature of the underlying collateral, but also to the specific economic drivers that determine the timing of interest and principal cash flows and, ultimately, covariance of returns. It has also been imperative when rebuilding our portfolios to thoughtfully consider the ramifications of the many temporary government programs that have been put in place to inject liquidity back into the credit markets. The major programs include Term Asset Backed Loan Facility (TALF), Temporary Liquidity

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Guarantee Program (TLGP), Public-Private Investment Program (PPIP), Quantitative Easing (QE) and MBS purchases by the Fed and the Treasury Department, each of which has had profound impacts on the associated sectors.

Below are brief summaries of our recent investment activities in each of these sectors.

Corporate Credit

One of the important lessons learned by investors from the credit/liquidity crisis of 2007 to 2009 was the unexpectedly high covariance of returns for financial corporates with those for structured products. We have focused much of our credit work this year on non-financial companies that we consider to have "safe haven" characteristics such as solid credit ratings, strong balance sheets, stable revenues and cash flows and relative resiliency in an economic downturn. Examples of our credit sector purchases this year include securities from aerospace and defense, consumer non-cyclical, software/services and cable issuers. Although investment grade spreads have tightened handsomely, we retain our significant overweight in corporate credit. We now have a more defensive outlook, but we think that spreads, when adjusted for balance sheet quality, remain attractive.

Asset Backed Securities

Losses and delinquencies on consumer receivables such as autos and credit cards are highly correlated to the persistently bleak unemployment picture, but we have nevertheless remained consistently bullish on consumer ABS due to our conviction that the securities are well enhanced structurally. We also like equipment ABS, which offers favorable spread pickup as well as cash flow diversification to consumer ABS. In both sectors, TALF has provided cheap financing for levered investors, which in turn has jump-started the new issue market for the first time in well over a year. This heightened demand and the potential introduction of PPIP funds for ABS have pushed prices sharply higher, but yields still remain attractive compared to investment alternatives in other sectors. Interestingly, some of the best opportunities that we are currently finding are in selected non-TALF eligible securities (for example, subordinated and mezzanine tranches) which still suffer from a lack of investor sponsorship and thus remain severely dislocated.

Commercial Mortgage Backed Securities

Unlike the asset backed market, the new issue market for CMBS has remained dormant. The technical conditions in the CMBS market, however, have been very similar to the ABS market. The prospect of TALF and PPIP funding has driven spreads sharply tighter, despite extreme ratings volatility resulting from inconsistent analysis on the part of the ratings agencies. In an ironic dichotomy, over the past nine months we have continued to build a significant overweight in front-pay super senior CMBS in spite of our very negative fundamental credit outlook for commercial real estate. The logic behind this is based on several factors. Securities at the top of the capital structure have more than adequate credit support to withstand draconian deterioration of credit fundamentals. Further, the prices that we paid to acquire our positions have taken the deteriorating fundamentals fully into account. Finally, even at current (much tighter) spread levels, the bonds still offer several hundred basis points of incremental yield versus comparably-rated corporates, and they provide potentially better cash flow stability than some higher yielding alternatives such as Alt-A mortgage backed securities or high yield bonds. Very recently, we have begun to prune some of the more fully-valued CMBS from our portfolios to free up cash for more attractive opportunities elsewhere.

Non-Agency Mortgage Backed Securities

This is a sector in which we historically had scant interest, as it offered little incremental yield compared to agency mortgages. Our interest was piqued earlier this year when it was possible to buy securities that offered loss-adjusted yields in the 20% to 30% range. For accounts that can tolerate the expected ratings volatility, we have committed a modest allocation to these securities. After a ferocious PPIP anticipation rally, we are now more cautious on this sector. Given the uncertainty around loss severity and potential loan modifications, seemingly attractive yields can shrink very quickly.

Agency Mortgage Backed Securities

As the credit crunch manifested itself in earnest in early 2008, agency mortgage spreads began to widen, in large part due to concerns about the viability of the agencies themselves. As spreads moved out, we began to consistently increase our holdings in agency pass-through mortgages for our longer duration accounts. Due to its breadth, the mortgage pass-through sector was also one of the few to maintain deep liquidity throughout the crisis. More recently, the Fed's massive MBS purchase program has driven option-adjusted spreads into negative territory. In response, we have cut our holdings substantially to fund purchases in the aforementioned sectors, and now we are positioned with a significant underweight. We are unlikely to increase our holdings here until after the Fed exits the MBS purchase program and spreads normalize.

Outlook and Conclusion

Spreads in all sectors have narrowed considerably. Do they have room to tighten even more? Will the modest economic recovery that seems to be underway turn out to be a head fake? Will a large unexpected corporate failure cause a rush for the exits and a sharp sell off? We do not have a crystal ball, so these are questions that we dare not answer. There are, however, a few predictions that we can make with confidence. Looking forward, there will be more regulation in the financial markets, and government intervention will continue to impact market technicals in many sectors of the bond market for some time to come. It is unlikely that brokers and dealers will expand their balance sheets to pre-crisis levels anytime soon. There will be fewer dealers and underwriters, they will put less capital at risk and they will make wider bid-ask spreads than we could have ever imagined just a few years ago. Just as this was not a typical recession, the coming economic recovery is unlikely to follow a time-honored cyclical path.

Merganser Investment Team

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