



Merganser Investment Memorandum

Stressing CMBS Structures to Understand the Risks

Winter 2010

As the credit crisis slowly unwinds, many of our clients are understandably concerned about exposure to the deteriorating fundamentals of the commercial real estate (CRE) sector. Our Spring 2009 quarterly investment memo discussed where we see value in commercial mortgage backed securities (CMBS). We discussed CMBS as having lower delinquencies plus higher credit support relative to other structured sectors, and CMBS structures offering tranches that behave very differently depending on where they are in the capital structure. We concluded that with rigorous attention to a bond's specific structure and loan-level detail, we could identify attractive bonds that are robust enough to withstand even the most draconian of stress test scenarios.

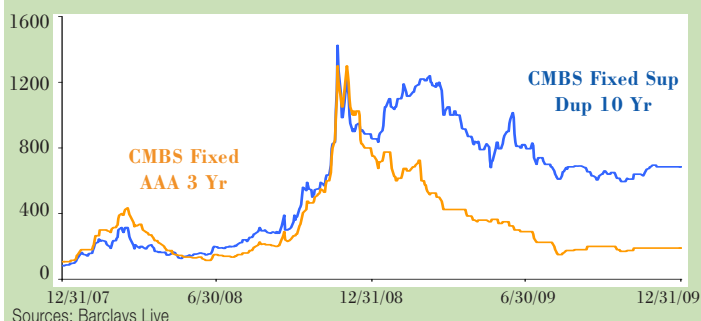
This investment memo complements our Spring 2009 memo, and we will begin with a review of the events of 2009 before we look to the future and discuss in greater detail why we consider certain highly select CMBS to be well protected against losses.

The Importance of Market Technicals

After a 2008 characterized by fear as investors struggled to recalibrate their expectations, CMBS spreads reached a tipping point at the end of 2008, as traders gained confidence in their loss estimates at the various levels in the capital structure. The bonds with the most credit-enhancement, the "AAA Super-Dupers," tightened in dramatically throughout the year, with the top of the capital structure "3 year" bonds tightening the most, reflecting their lower risk. On the other hand, tranches with less credit enhancement, such as AMs, AJs and subordinated pieces have remained at wide levels.

2009 was not a steady ride (see Exhibit 1), rather a series of fits and

Exhibit 1. CMBS Spreads



Migrating Duck Returns to Pond

Matthew R. Carson, CFA has rejoined Merganser, effective January 11, 2010.

Matt originally joined Merganser in 2002 after graduating from the Harvard Business School. He was a member of the investment team, with responsibilities including research, trading and portfolio management.

Since leaving Merganser in 2006, Matt has worked as a senior analyst and portfolio manager at State Street Global Advisors. He has also engaged asset managers, plan sponsors and governmental entities as a capital markets advisor, most recently with LoanPerformance.

Matt's new role will be Director, Investments and Business Development. He will contribute to the investment process while engaging in frequent dialogue with investment consultants and plan sponsors.

We are very excited to have Matt with us again, both personally and professionally.

starts as rallies were upset by negative headlines. Some of the most noteworthy stories of 2009 were:

- TALF and PPIP programs supported the CMBS market
- ratings volatility, such as S&P's new rating methodology, added uncertainty to the market and undermined the effectiveness of TALF
- headlines, bankruptcies and lawsuits involving many high profile players further roiled the CMBS markets

Ironically, with the ongoing stress, credit analysis becomes more clear and risk can be assessed with greater confidence, which buoys the CMBS market.

The Importance of Loan Level Stress Testing

Our models apply stresses to each individual loan, and we see how the tranches respond to these bottom-up tests. We stress all loans under much

Exhibit 2. Highest CDR & Losses, Historical vs. Predicted

	2000-2009	Expected Peak	We stress up to:
Delinquencies (CDR)	4%	7%-12%	95% (100% on 'weak' loans)
Loss Severities	55%	65%	85% (100% on 'weak' loans)

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harsher conditions than even the market’s current worst-case predictions. Exhibit 2 contrasts Merganser stress test parameters versus the historical worst-cases and against the expected peak predictions of the broker community. We test ‘normal’ loans to stresses beyond anyone’s worst-case expectations and automatically scale up the stress even further on the loans that we flag as possibly ‘weak,’ based on a host of metrics including poor financials, an economically depressed geographical region, or placement on any servicer watch list, etc.

In addition, we also tune our stress test suite to incorporate custom-built cases for loans that have the most impact on tranches we hold, such as any large loans or loans with balloon payments affecting our principal window.

As a result, we carefully select only the most robust bonds – ones that can survive and pay in full under some of the harshest scenarios such as our test at a 95% annual default rate and a 60% loss severity (95% CDR test.)

But how is it possible to find any bonds that pay in full under such circumstances? The answer is that deal structure is crucial; not all tranches are built alike!

The Importance of CMBS Structure

To understand how the bonds at the top of the capital structure are protected against principal loss, bear in mind that in general:

- principal payments flow sequentially, from the top down
- losses flow from the bottom up

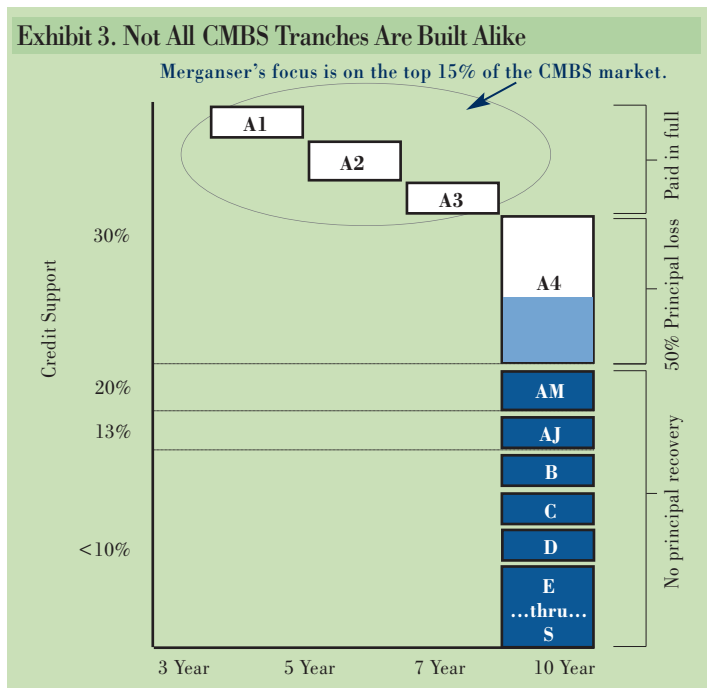


Exhibit 3 helps illustrate the structure. All recovered principal pays first to the A1 tranche until it is completely paid off, then to the A2 and A3 tranches in sequence.

The recovered principal includes not only scheduled amortizations, but also *all recoveries from liquidated properties*. This means that any liquidations will register as a loss to the subordinated tranches, but will flow as an early principal pre-payment to the top of the capital structure.

As illustrated, liquidated properties do not affect all tranches equally – what hurts the subordinated tranches can paradoxically strengthen the position of the front-pay tranches.

Exhibit 3 illustrates this graphically using the case we discussed earlier, our 95% CDR test, represented by blue highlighting. Stated plainly, this test causes a 60% principal loss to the deal and only 40 cents on the dollar is recovered. Understandably, such dire conditions will result in significant losses to the deal’s tranches, typically:

- all subordinated tranches (B and lower) and also the junior and 20%-enhanced AAA tranches (AJ and AM respectively) would suffer 100% principal loss (colored dark blue in Exhibit 3)
- in this extraordinarily dire case, even the 10 year ‘Super-Duper’ tranche (A4 in exhibit 3) could take some losses
- however, the 3, 5 and 7 year tranches (A1 through A3 in Exhibit 3) take no principal loss at all. As seen from the perspective of these tranches, the above distress translates into early principal repayments in full.

How can the A1-A3 tranches avoid any losses in such an extreme case? Consider that all these tranches typically comprise the top 25% of the deal, so with a 40% recovery rate it makes intuitive sense that these bonds be paid in full. In summary, these bonds enjoy a very high degree of protection offered by the CMBS deal structure.

Conclusion

CMBS at the top of the capital structure is well-protected against loss. This part of the market represents less than 25% of all issuance, and Merganser is uniquely positioned to capture the relative value in these bonds due to our boutique size and extensive relationships with the regional broker community. Our team has been covering and trading this sector since its inception, and we have developed proprietary surveillance systems and sophisticated stress tests. We believe an allocation to high quality CMBS, as part of a diversified bond portfolio, may be the best way to take advantage of one of the few remaining market dislocations.

Merganser Investment Team

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