

Trading & investing during the credit crunch

Alternative Investment Summit - 2008

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VALERE CAPITAL PARTNERS

London, October 20th 2008.

How did we get here?

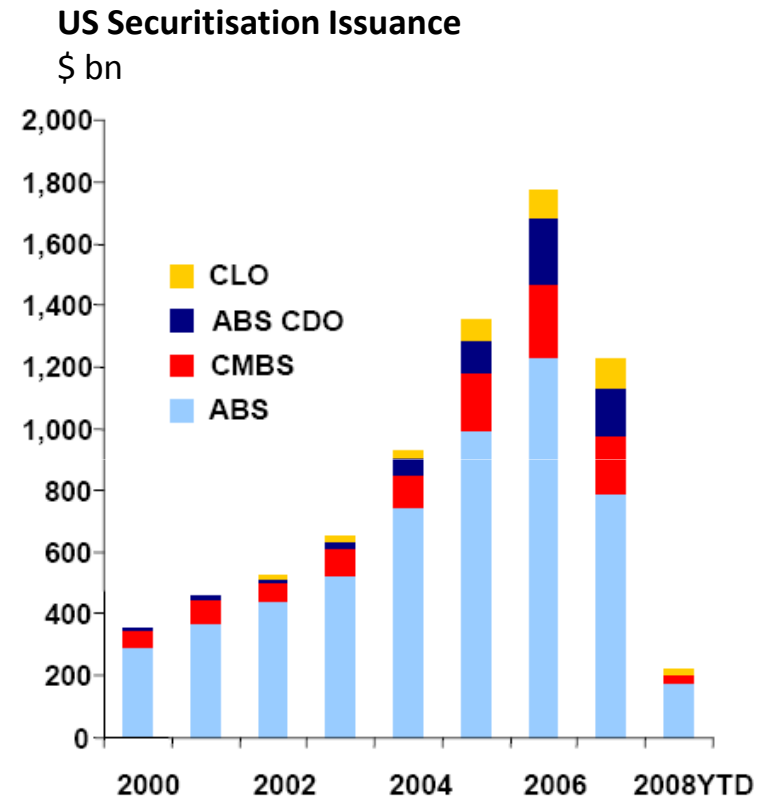
1st phase: *The securitisation bubble*

- Everything ended up securitised:
 - Subprime
 - ALT-A, Prime
 - Commercial Mortgages
 - Leveraged Loans
 - Consumer debt
 - ABS

- Principal driver: *Regulatory arbitrage*

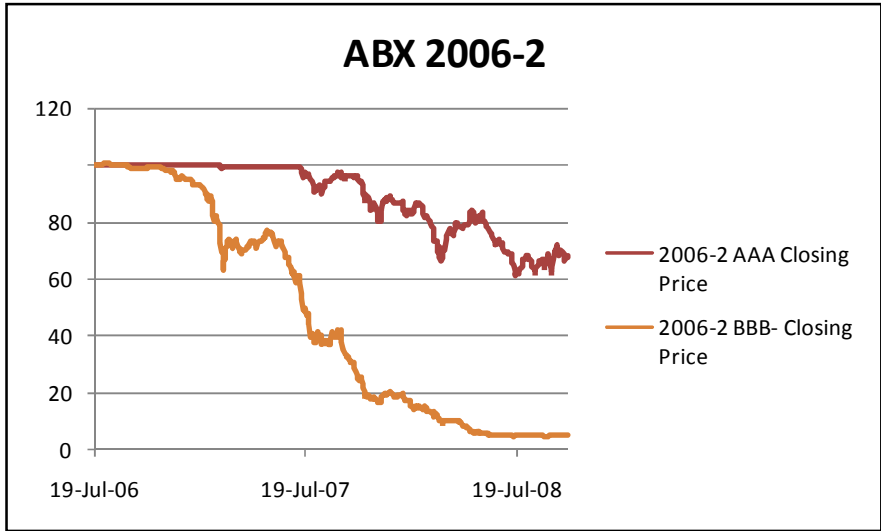
- A significant portion ended up off-balance sheet

- Principal driver: *Regulatory arbitrage*



Source: Citi

How did we get here?



1st phase: Feb 07, subprime collapse ...

... and the contagion hits structured credit, Jul 07

- As writedowns bite, banks raise capital
- But capital-raising fails even to fully offset writedowns: principal banks raise \$420bn capital but suffer \$635bn of writedowns.

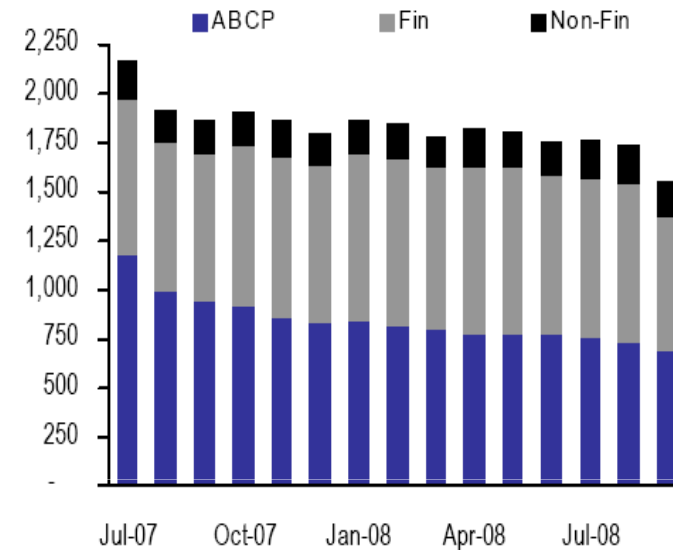
IMF Writedown Estimates (\$bn)	Total	Of which banks
Subprime	50	35-40
Alt-A	35	20-25
Prime	85	25-30
CRE	90	60-65
Consumer	45	30-35
Corporate	110	80-85
Leveraged	10	5-10
Total Loans	425	255-290
ABS	210	100-110
ABS CDOs	290	145-160
Prime MBS	80	20-25
CMBS	160	80-90
HG corp	130	65-75
HY corp	80	45-50
CLOs	30	15-20
Securities Total	980	470-530
Total	1,405	725-820

How did we get here?

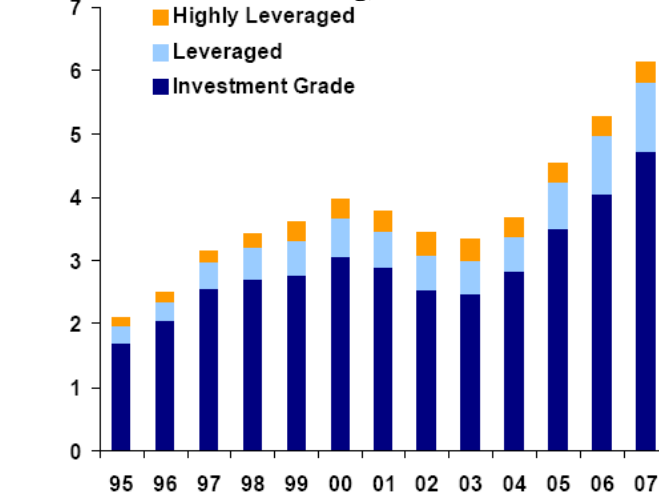
2nd phase: Aug 07 onwards, the collapse of the shadow banking system, the freezing of the money markets, and the Oct 08 financial crisis.

- With confidence gone in structured credit, investors withdraw support for short-term financing. The SIVs collapse and the conduits are implicitly or explicitly consolidated.
- As the money markets dry up, the banks look at potential funding commitments of \$2tn of CP financing (many programmes underwritten by banks through 360-day backstops) and \$6tn of undrawn loans.
- Cash-hoarding leads to a liquidity crisis at the same time as writedowns are hitting capital.
- Forced deleveraging of hedge funds combined with other firesales depresses asset prices further.

Commercial paper outstanding, \$bn



Undrawn loans outstanding, \$tn



Sources: JPM, Citi

How did we get here?

3rd phase: Propagation to the real economy

- Bank lending constrained (even post-bailout)
- 2009 re-financing calendar puts pressure on banks and corporates:
 - IG corporate bond market has doubled since 2000.
 - Up to 2007 market was able to absorb substantially more issuance than maturing deals.
 - In Q1-Q3 2008 issuance has just kept pace with maturity.
 - 2008 and 2009 are record years for amounts maturing.
- Unemployment is rising and consumer confidence is falling: US retail sales fell 1.2% in September; Q3 as a whole is now showing the worst drop in retail sales since the survey began in 1967 (JPMorgan).

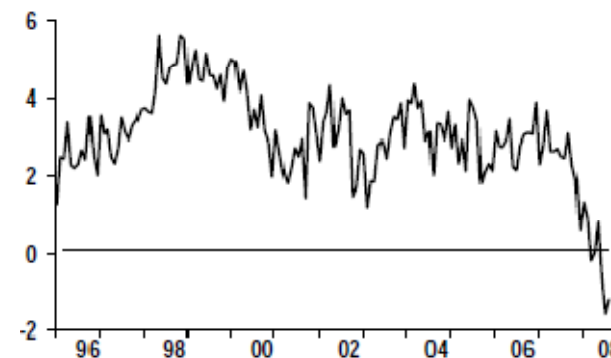
Size of Investment Grade Corporate Bond Market
Corporate redemptions at maturity and new issuance
USD billions

	Matured	Issued	Outstanding
2000	220	493	2193
2001	293	654	2554
2002	315	538	2777
2003	368	589	2998
2004	343	582	3238
2005	410	586	3413
2006	462	777	3729
2007	484	884	4138
2008	711	(*)	4294
2009	655		

(*) 2007 issuance Q1-Q3: 569

Developed market retail sales volumes

%oya; Data through Aug08



Sources: JPM, Thomson Financial, Bloomberg

TARP and other bail-out programs

TARP and other government initiatives

- Bank recapitalisations
- Asset purchase programs
 - Government purchase of complex assets (TARP)
 - Purchase of straight mortgages (Fannie Mae, Freddy Mac, FHA)
 - Direct CP purchases by the Fed
- Liquidity provision by central banks
- Bank debt guarantees

Summary of principal European initiatives

	UK	France	Germany
Bank capital	£50bn	€40bn	€100bn
Liquidity	Additional £100bn	ECB offers unlimited liquidity at window	
Guarantees	£250bn	€320bn	€400bn
Retail deposit insurance	£50,000	€50,000	€50,000

TARP and other bail-out programs

What do these achieve?

- Resolve bank insolvency questions
- Provide a floor price for targeted assets: mortgages and complex credits
- Indicate a commitment to eliminate financial sector stress
- May re-establish some lending capacity

Liabilities	\$bn	Support Sources	\$bn
Deposits	7,889		
Checkable & Small Time/Savings	4,447	FDIC	5,100
Non-Interest Bearing Deposits	1,104	TLGP	700
Large Time Deposits	2,338		
Short Term Liabilities	3,609		
Short Term Borrowing	3,149		
Commercial Paper	722	CPFF	722
Other ST Borrowings	2,428	FHLB (Short term portion)	356
		TAF, Discount Window	950
Other ST Liabilities	459		
Long Term Liabilities	1,625		
Maturing Next 3 Years	406	TLGP	406
Rest	1,219	FHLB (long term portion)	558
Total Liabilities	13,123	Total Support Sources	8,792 (67%)

Source. BOA

What do they fail to address?

- They do not alleviate the impact of deleveraging the real economy.
- The recent crisis has dealt a blow to consumer confidence that will not readily be forgotten, especially as unemployment rises.
- Expect delinquencies and charge-offs to spike
- The process of corporate recapitalisation is about to start for those able to do so.
- As for the others, expect defaults to rise ...

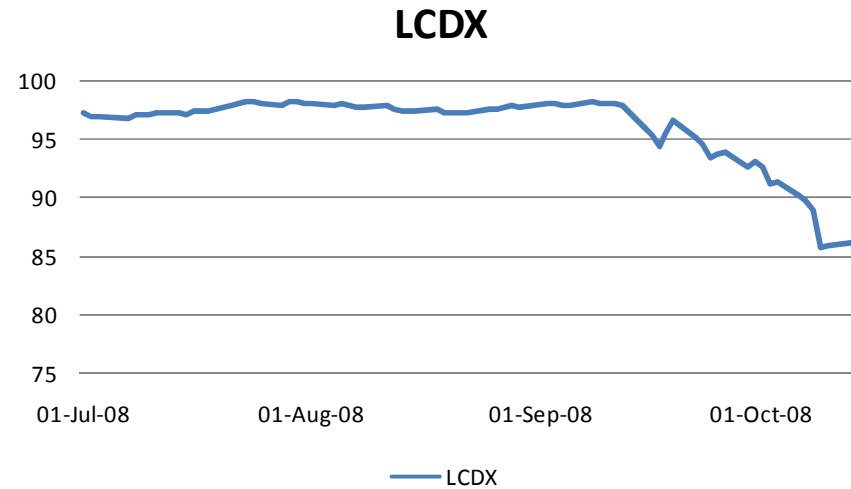
What we look for in these distressed markets:

- **Senior risk:** The fundamental outlook is poor, so stick with securities which are able to withstand substantial stresses.
- **Low leverage:** The stresses in the banking system are alleviating but have not disappeared yet; any fund which uses short-term financing to achieve leverage is exposed to the terms or indeed availability of that financing changing at short notice. This is a risk we are not yet fully comfortable with.
- **Short-dated:** Although we believe the structured credit market is about to turn, we remain more attracted to short-dated paper than long-dated. Long-dated paper is a directional play on spreads; but with a heavy calendar of corporate issuance overhanging the market, it is not clear that vanilla credit spreads are immediately heading tighter. Short-dated paper will pull to par even in a bear market (as long as it survives to the redemption date).
- **Securities:** TARP is likely to focus initially on securities, ie, bonds and notes (and perhaps CDS); financial institutions will mostly have these already marked to estimated market levels, so selling them is capital-neutral (or even capital-accretive). Loans and commitments pose more difficulty and are likely to be left until later; pricing is harder and there will be a wide range of levels at which banks carry these assets on their balance sheets.

Implications on investing and trading in a stressed market

US and European AAA CLOs

- Leveraged loan prices have hit an all-time low recently...
- Trading north of L+800bps.
- These prices would imply loss rates of around 25%.
- 2009 Moody's speculative grade default forecast is just below 8% or loss rates of 4% to 5%.



- CLOS spreads secondary and primary spreads have also reached a all-time high. Secondary AAA spreads have traded recently north of 400 bps.

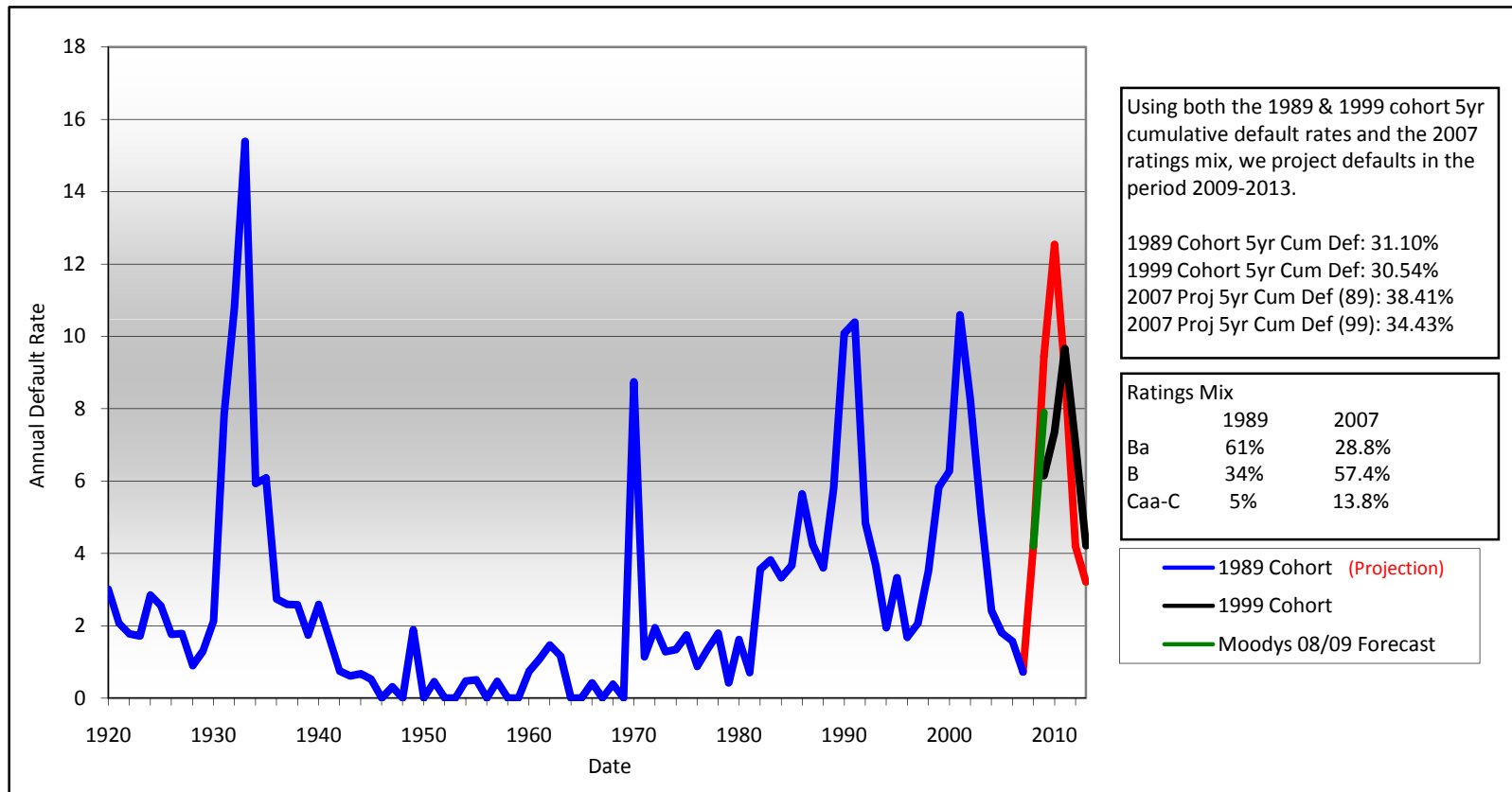
US CLOs

Spread to Libor (basis points)

Sector	WAL	Current Spread	Changes YTD
AAA	6-8	375	280
AA	7-10	750	540
A	8-10	975	665
BBB	9-11	1300	850
BBB	9-11	2000	1200

US and European AAA CLOs

Projected Speculative Grade Default Rates Based on Current Moody's Ratings Mix



Implications on investing and trading in a stressed market

US and European AAA CLOs

Year	Sr			Sr		Jr Sub Bonds	All Bonds
	Sr Sec Bank Loans	Sr Sec Bonds	Unsecured Bonds	Sr Sub Bonds	Sub Bonds		
1982	NA	\$72.50	\$35.79	\$48.09	\$29.99	NA	\$35.57
1983	NA	\$40.00	\$52.72	\$43.50	\$40.54	NA	\$43.64
1984	NA	NA	\$49.41	\$67.88	\$44.26	NA	\$45.49
1985	NA	\$83.63	\$60.16	\$30.88	\$39.42	\$48.50	\$43.66
1986	NA	\$59.22	\$52.60	\$50.16	\$42.58	NA	\$48.38
1987	NA	\$71.00	\$62.73	\$44.81	\$46.89	NA	\$50.48
1988	NA	\$55.40	\$45.24	\$33.41	\$33.77	\$36.50	\$38.98
1989	NA	\$46.54	\$43.81	\$34.57	\$26.36	\$16.85	\$32.31
1990	\$75.25	\$33.81	\$37.01	\$25.64	\$19.09	\$10.70	\$25.50
1991	\$74.67	\$48.39	\$36.66	\$41.82	\$24.42	\$7.79	\$35.53
1992	\$61.13	\$62.05	\$49.19	\$49.40	\$38.04	\$13.50	\$45.89
1993	\$53.40	NA	\$37.13	\$51.91	\$44.15	NA	\$43.08
1994	\$67.59	\$69.25	\$53.73	\$29.61	\$38.23	NA	\$45.57
1995	\$75.44	\$62.02	\$47.60	\$34.30	\$41.54	NA	\$43.28
1996	\$88.23	\$47.58	\$62.75	\$43.75	\$22.60	NA	\$41.54
1997	\$78.75	\$75.50	\$56.10	\$44.73	\$35.96	\$30.58	\$49.39
1998	\$51.40	\$48.14	\$41.63	\$44.99	\$18.19	\$62.00	\$39.65
1999	\$75.82	\$43.00	\$38.04	\$28.01	\$35.64	NA	\$34.33
2000	\$68.32	\$39.23	\$23.81	\$20.75	\$31.86	\$15.50	\$25.18
2001	\$66.16	\$37.98	\$21.45	\$19.82	\$15.94	\$47.00	\$22.21
2002	\$58.80	\$48.37	\$29.69	\$23.21	\$24.51	NA	\$30.18
2003	\$73.43	\$63.46	\$41.87	\$37.27	\$12.31	NA	\$40.69
2004	\$87.74	\$73.25	\$54.25	\$46.54	\$94.00	NA	\$59.12
2005	\$82.07	\$71.93	\$54.88	\$26.06	\$51.25	NA	\$55.97
2006	\$76.02	\$74.63	\$55.02	\$41.41	\$56.11	NA	\$55.02
2007	\$67.74	\$80.54	\$51.02	\$54.47	NA	NA	\$53.53

Source: Moodys

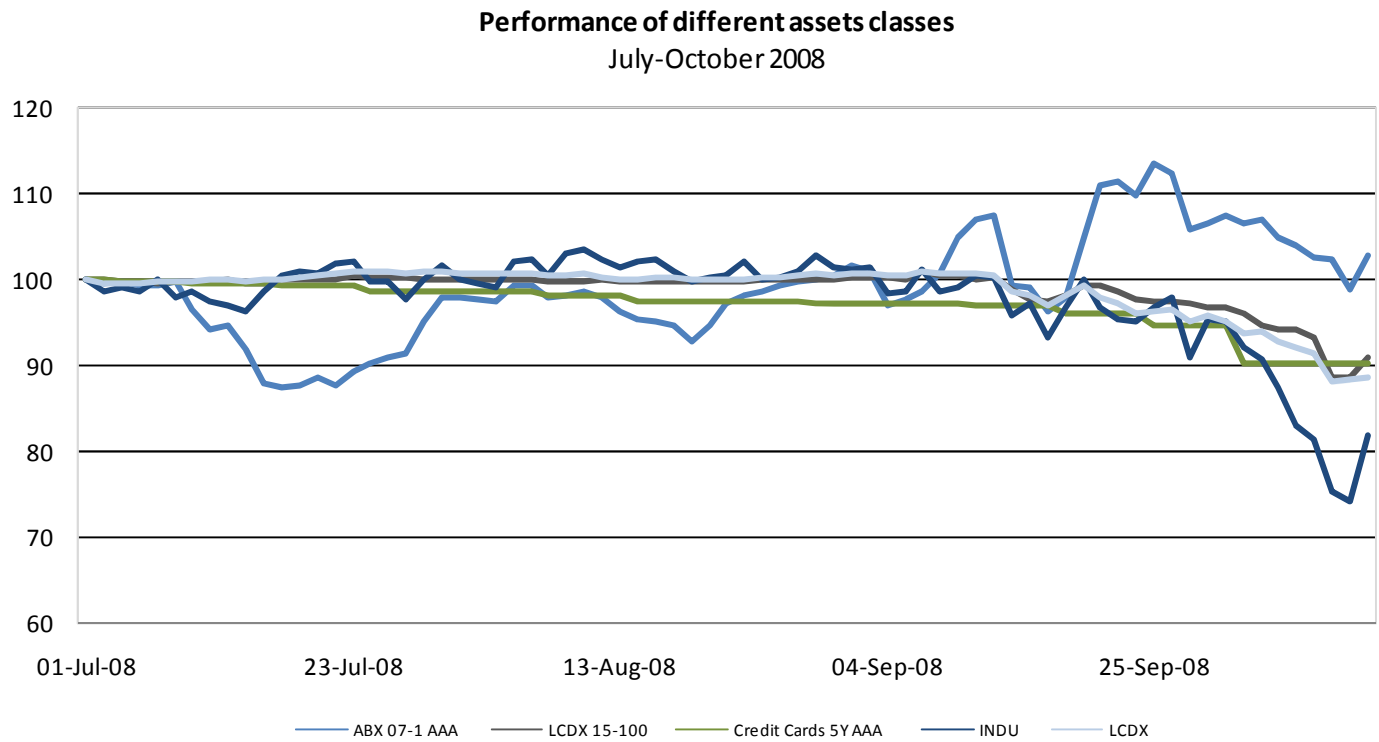
US and European AAA CLOs

- *We like the seniority of AAA CLOs*
 - Not all are the same
 - Almost impossible to break
- *Leverage loan buyers are few:*
 - CLOs were 70% of the market
 - Bank proprietary trading desk are no longer buying
 - Hedge funds have suffered very large if not terminal losses as a result of the leverage
 - TARP and other similar programs will most likely not target leveraged loans
- *Senior CLO buyers have evaporated:*
 - SIV/conduits are no longer
 - Hedge funds cannot get the necessary leverage to achieve the desired returns
 - Banks are facing significant regulatory changes around the corner
- *Junior CLO buyers have evaporated too*
 - Hedge funds and were significant buyers
 - Banks (ME and Asian institutions have pulled back completely)

IN CONCLUSION, WHILE WE BELIEVE THAT WHILE IT WOULD BE HIGHLY UNLIKELY THAT AAA CLOS WOULD SUFFER WRITEDOWNS, DEMAND IS NOT EXISTENT FOR NEW PRODUCT AT THIS TIME.

Implications on investing and trading in a stressed market

US Subprime: Outperformer?

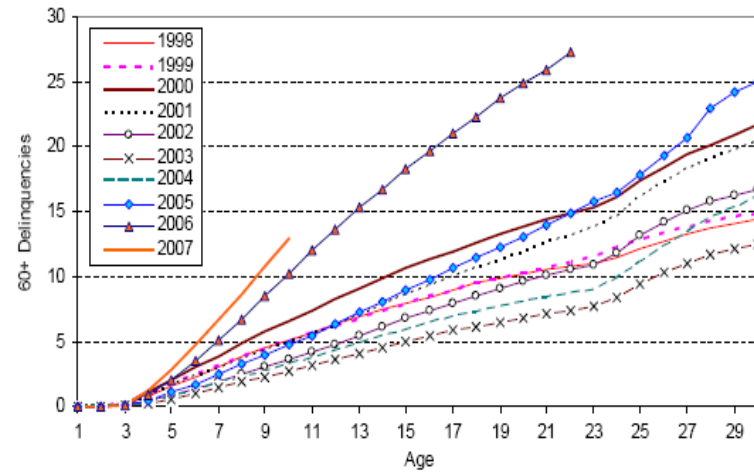


Implications on investing and trading in a stressed market

US Subprime – Still not a Pretty Picture...

Delinquencies for recent vintages are horrific...

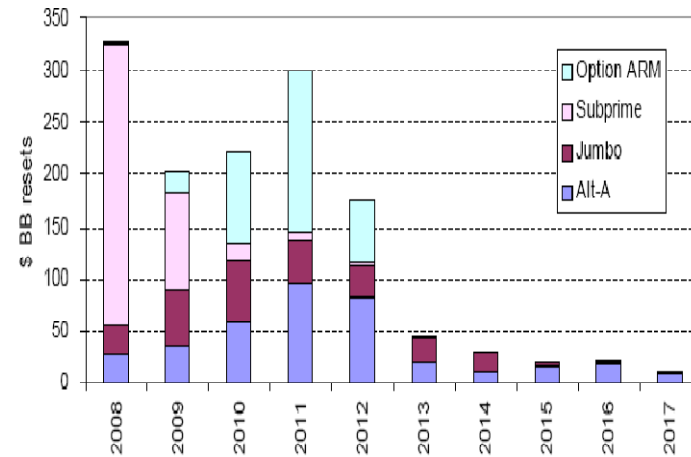
While the delinquencies rate of growth has tapered over the last couple of months, they are still rising at unseen levels. The impending US recession will compound the problem.



Source: BOA

... and will probably not get better anytime soon.

Recent rate cuts have removed a significant portion of the price shock on reset that was implied recently in 2x28 and 3x27 ARMs. As a result, the affordability issue which paralyzed the ABS market for all of last year is probably no longer as important. Affordability has now most likely been replaced by negative equity which could trigger yet more profound delinquency. Foreclosures will most likely carry on rising as a result.

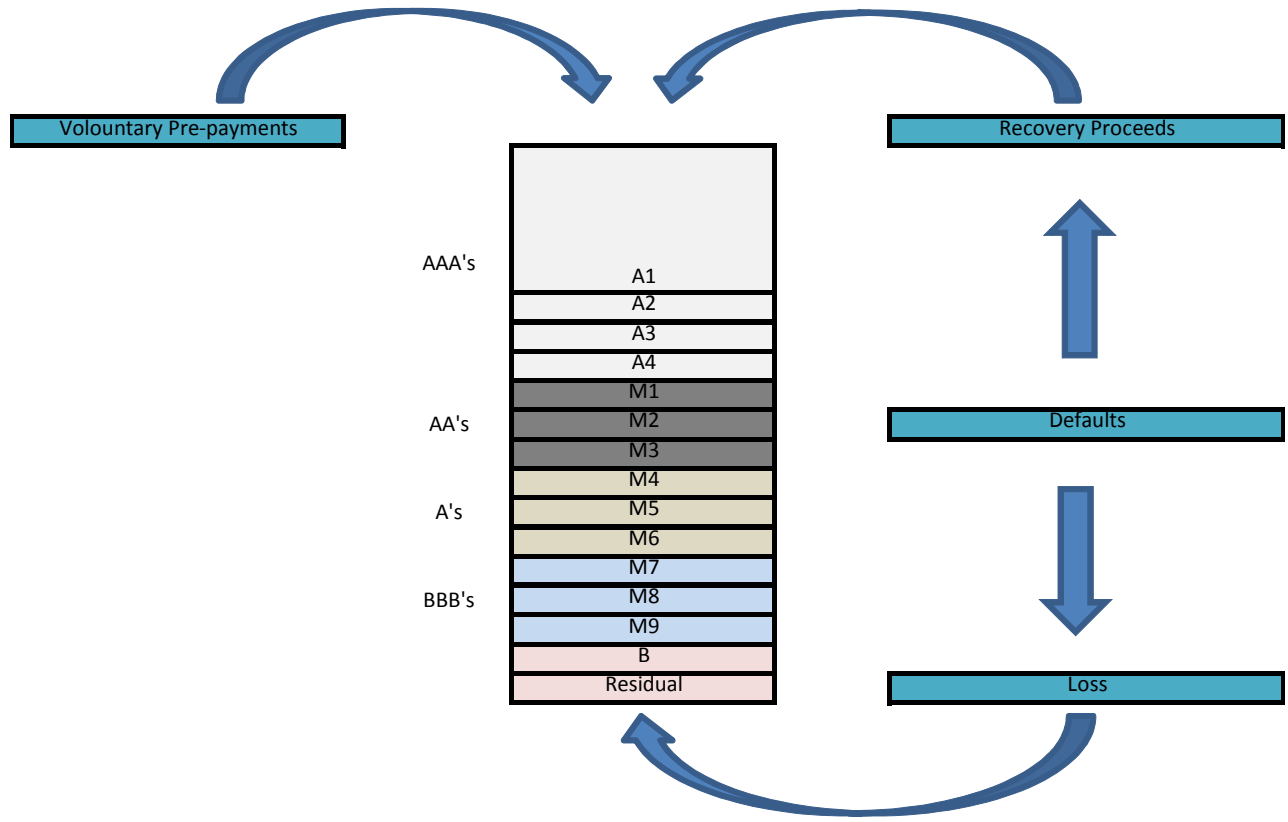


Source: UBS

Implications on investing and trading in a stressed market

Defaults accelerate involuntary pre-payments...

When the losses are realized following foreclosure of the individual mortgage, the recovery proceeds like pre-payments flow back to the top of the capital structure which benefit senior investors.



IN SHORT THESE VERY SENIOR POSITIONS ARE VERY HARD TO BREAK AND THEREFORE FUNDAMENTALLY VERY SOUND. IN ADDITION, THESE TYPES OF ASSETS ARE EXACTLY THE ONES THAT WILL BE TARGETED BY TARP.

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