

### Propane – 1,2,3, triyl trinitrate (Nitroglycerin)

It is extremely dangerous as a result of its instability, as shown in numerous “appalling catastrophes.”

### Elements\el e ment\- a part that can be separated from or attached to a system

What is and what creates instability of debt instruments? Historically we could describe instability as a rare event because the ability to pay one’s debt is a slow and drawn out process caused by a deteriorating asset- to-debt ratio precipitated by adverse competition, failure to keep up with product and productivity innovation, or escalating labor and raw materials costs.

We generally look at asset-to-debt coverage of 2:1 however rating agencies now regard investment grade names down to 1.4:1. *What has been slow and drawn out is investor and rating agency views of what constitutes a good credit to lend to.*

We believe that recently a slow deterioration trend was then shocked creating instability. There are different colors of instability though.



## The Colors of Instability

### **1970 60 Years in the Making:**

After 60 years of over-regulation and rising labor costs Penn Central declared bankruptcy.

### **1985 “Nuclear Option”:**

Pennzoil felt as if it had been dealt with unfairly and immediately filed a lawsuit against Texaco alleging that Texaco had interfered illegally in the Pennzoil–Getty negotiations. Pennzoil won the case; in late 1985 it was awarded \$11.1 billion, the largest judgment ever in the U.S. An appeals court reduced the judgment by \$2 billion, but interest and penalties drove the total back up to \$10.3 billion. James Kinnear, Texaco’s CEO, had said that Texaco would file for bankruptcy if Pennzoil obtained court permission to secure the judgment by filing liens against Texaco’s assets.

### **2001 A Hot Summer:**

Pacific Gas & Electric (PG&E) and Southern California Edison file for bankruptcy after a hot summer and 34 days of rolling blackouts caused energy supplies to soar in cost.

### **2002 Business and Product Failure:**

Kmart, after having begun in 1899 attempted to close as many as 700 stores to consolidate and reduce expenses affecting 275,000 workers. Kmart had \$10.2 billion in debt and reflected a larger social cost than financial at the time.

### **2005 Katrina:**

Delta and Northwest file for bankruptcy with \$28 and \$17 billion in debt respectively as oil prices soar after Katrina.



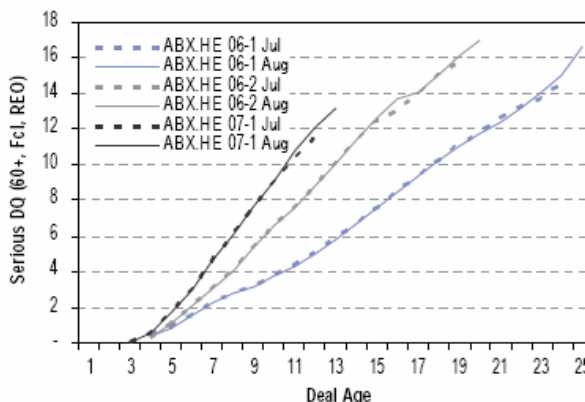
## NITRO-\Ni”tro-\ A combining form

While history shows long protracted deterioration of debt quality or a “nuclear” self imposed declaration of inability to pay; current events are a case of both of these elements combined simultaneously within a short time period. There are two compounds that have mixed, in effect, bankrupting a large segment of the US economy. The first issue or characteristic is that on an equity-to-debt ratio basis, if we isolate home ownership, it is at junk levels for many households who bought home(s) in 2005, 2006, and even 2007. The debt that households issued through a conduit such as a mortgage broker to investment banker to a securitized debt instrument in your portfolio is junk by any conventional measure. The problem is compounded by illiquidity of the asset. The only solace is Washington’s political will if you bought debt instruments manufactured by GNMA, FNMA, VA, or FHLB.

The second characteristic is that the current events leveled a shock against the debtor. Structures came out of unusually low interest rates and engineering to enable less than investment grade issuers to float debt through a complex conduit to buyers whom are largely institutions. The debt structures had, in many cases, interest rate adjustments that raised payments by the borrower as well as triggers that *suspended principal (not interest payments as we would normally expect) payments* to the creditor, again, institutional investors.

What happened when “it all came together?” See the chart of recent home price data and the chart of the Average 60+ Day Delinquencies by Age (of mortgage in months) for July and August as measured by the Asset Backed Home Equity contract. The percentage of “Serious Delinquencies” soars within months as interest resets occur with insufficient liquid assets to cover the debt obligation.

Average 60+ Day Delinquencies by Age, July and August



### June S&P/Case-Shiller Home Price Survey

|                        | Current       | Previous      | 3-Mth         | YoY%          | Index         |        |
|------------------------|---------------|---------------|---------------|---------------|---------------|--------|
|                        |               | MoM%          | MoM%          | Annual%       | Change        |        |
|                        |               |               |               |               | Level         |        |
| <b>US Composite-20</b> | <b>-0.39%</b> | <b>-0.27%</b> | <b>-3.50%</b> | <b>-3.49%</b> | <b>199.18</b> |        |
| Denver                 |               | 1.30%         | 1.08%         | 12.11%        | -0.98%        | 138.09 |
| Charlotte              |               | 1.22%         | 1.09%         | 14.90%        | 6.78%         | 135.05 |
| Dallas                 |               | 0.81%         | 0.59%         | 11.22%        | 1.61%         | 126.53 |
| Atlanta                |               | 0.80%         | 0.57%         | 9.00%         | 1.57%         | 136.12 |
| Seattle                |               | 0.65%         | 0.95%         | 12.29%        | 7.94%         | 191.92 |
| Portland               |               | 0.30%         | 0.90%         | 9.19%         | 4.52%         | 185.76 |
| Boston                 |               | 0.20%         | 0.80%         | 6.74%         | -3.71%        | 171.30 |
| Chicago                |               | 0.17%         | -0.11%        | -2.56%        | -0.68%        | 165.96 |
| Cleveland              |               | 0.10%         | 0.84%         | 2.92%         | -3.57%        | 118.54 |
| Minneapolis            |               | -0.03%        | -0.23%        | -2.94%        | -3.84%        | 164.35 |
| San Diego              |               | -0.19%        | -0.36%        | -3.24%        | -7.30%        | 231.37 |
| Los Angeles            |               | -0.41%        | -0.06%        | -3.67%        | -4.06%        | 262.12 |
| Detroit                |               | -0.47%        | -2.36%        | -19.01%       | -11.01%       | 109.57 |
| Phoenix                |               | -0.66%        | -0.51%        | -7.77%        | -6.55%        | 212.52 |
| San Francisco          |               | -0.67%        | -0.27%        | -3.02%        | -3.96%        | 209.48 |
| New York               |               | -0.77%        | -0.80%        | -7.02%        | -3.39%        | 208.52 |
| Washington DC          |               | -0.78%        | -0.35%        | -5.94%        | -6.96%        | 233.52 |
| Tampa                  |               | -1.21%        | -0.92%        | -12.13%       | -7.70%        | 219.37 |
| Las Vegas              |               | -1.30%        | -0.82%        | -11.20%       | -5.09%        | 221.86 |
| Miami                  |               | -1.72%        | -1.47%        | -16.24%       | -4.79%        | 264.89 |

Source: Case-Shiller Survey (Table Courtesy of Bloomberg)



## Summary

We expect a continued combination of two elements, lack of adequate assets to debt coverage and shock, that create “nitroglycerine” in investment grade portfolios, CDO’s, CLO’s, CDS, Money Market Funds, and securities lending collateral funds. The debt instruments that came out of this credit cycle have many complex capital sub-structures that mean that ***bond portfolios have equity risk***; that is, debt instruments have asymmetrical risk. It can pay at 100 cents on the dollar or not at all.

When, not if, the economy slows there is the possibility that the same chemicals mix for corporate and commercial loans. **There is an under-appreciation by investors and rating agencies of the difficulty in paying one’s debt** compounded with shocks such as bad bond structures, terrorism, and weather.

***All bond structures have risk that is asymmetrical.*** They either pay or distribute some recovered asset value net of liabilities. The markets are digesting a new metric in risk that has permeated debt, equity, private equity, and real estate in a way we have not seen before; that is called ***securitization***. **These structures create a wider band of outcomes for investors**

*While we are awed by the beauty of stock buy-backs by corporations during halcyon days we would have preferred reduction of debt for the rainy days by both corporations and individuals.*

*It will take another **36 month reset cycle in mortgages to fully re-liquefy** the debt markets. We need to **decompose the compound mixture that has created an unstable nitroglycerine like asset class**. This is evidenced by the remarkably low returns for the fixed income asset class at a time of flight-to-quality. This would normally cause extraordinary bond returns. Year-to-date returns for the Lehman Aggregate as of August 29, 2007 3.21% and Month-to-date for August 1.37%. Nearly 43% of the market returns for the year have occurred in August. Absent the recent move we regard returns as dismal for such an environment as further evidenced by Treasury bond returns at 4.28% and 1.55% respectively. Stay tuned.*

-jkm