

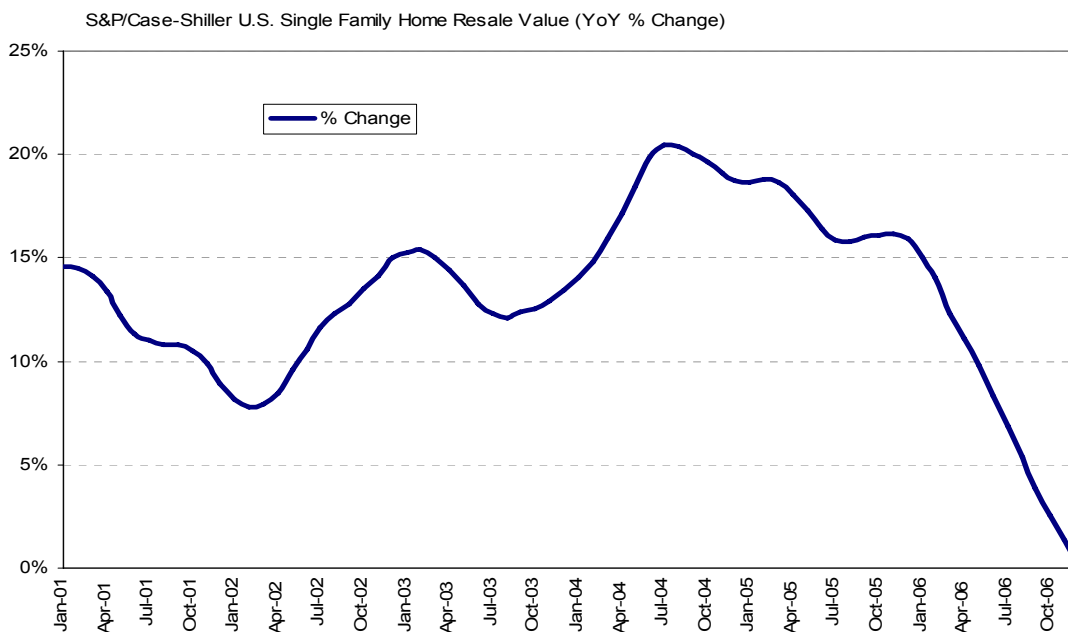
The Subprime Mortgage Market

Securitization is the process of converting pooled loans into packages of securities to sell to investors. The majority of mortgage loans in the United States are securitized either by private entities or government agencies. Government agencies require that the underlying loans adhere to strict underwriting standards as the agency guarantees the performance of the security; these securities are classified “prime mortgages” as they are issued to more credit worthy borrowers.

Subprime mortgages are mortgage loans issued to borrowers with impaired credit histories. These loans are not guaranteed and are pooled for resale in the secondary market by private companies as asset-backed home-equity securities. Most securitized subprime mortgages are either first-lien fixed or adjustable rate mortgages (ARMs). The majority of ARMs are fixed rate for either two or three years then float at the prevailing market rate, which is reset every six months. As interest rates rise, the rate an ARM borrower pays also rises. Adjustable rate mortgages are popular with subprime borrowers as the initial interest rate is lower than fixed mortgage rates, increasing home affordability. At the end of the fixed term of the loan most borrowers plan to refinance at a lower rate after either repairing their credit or seeing an appreciation in their home’s value. If neither of these happen the borrower potentially faces two problems; either finding the new, higher mortgage payment out of reach as the loan resets or being unable to refinance as the home’s value has either decreased or remained stable. In this case many of these borrowers become delinquent or default. This scenario has become more common and as such, the subprime market has deteriorated.

The current state of the Home Equity ABS market

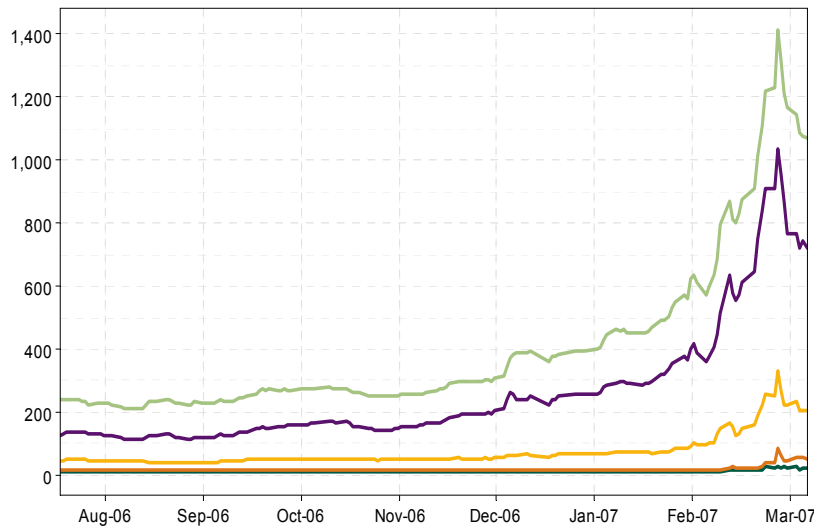
The residential mortgage market, specifically the subprime market, has recently been extremely volatile with subordinate spreads widening dramatically as evidence of poor credit performance grows and mortgage originators and servicers struggle to maintain profitability. In recent months delinquencies and losses with respect to subprime mortgages have increased and are expected to continue to increase for the foreseeable future. In addition, residential property values across the country have deteriorated or remained stable following an extended period during which property values appreciated. If home price appreciation continues to weaken going forward delinquencies and losses on residential mortgage loans, especially with respect to many subprime loans where the aggregate loan amounts are close to or greater than the related property values (i.e. high LTV), will remain high and potentially grow.



Source: Bloomberg

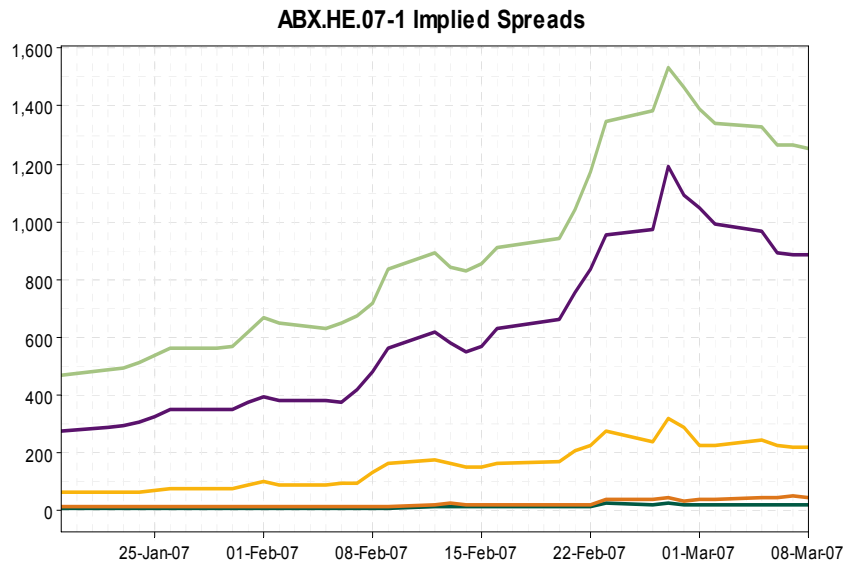
As the charts below show as early as August 2006 subordinate spreads (as measured by the ABX.HE Index) were around 200 basis points (2.00%) above LIBOR. The ABX.HE is a new tool consisting of a group of the 20 largest home equity deals' CDS and is used to gauge market opinion on the home equity sector. Since its inception there has been a dramatic increase in this spread, or extra yield demanded by investors to hold these securities, with substantial widening occurring at the beginning of 2007 and a recent ballooning out to more than 1400 basis points (spreads widen as price value decreases). This spread widening occurs as performance on the underlying loans in many subprime deals has deteriorated. Multiple factors, including continuing poor home price appreciation, rising interest rates and loose lending standards, have all contributed to the recent troubles of several mortgage loan originators generating enormous uncertainty in the market.

ABX.HE.06-2 Implied Spreads



Source: LehmanLive.com

Legend	Axis	Name	Last	Minimum	Maximum	Mean	StdDev
—	Left	AAA Implied Spread	22.000	9.000 19-Jul-06	29.000 23-Feb-07	10.355	3.889
—	Left	AA Implied Spread	53.000	14.000 19-Jul-06	84.000 27-Feb-07	17.500	10.106
—	Left	A Implied Spread	207.000	40.000 29-Aug-06	331.000 27-Feb-07	74.487	53.755
—	Left	BBB Implied Spread	720.000	114.000 08-Aug-06	1037.000 27-Feb-07	263.921	202.266
—	Left	BBB- Implied Spread	1072.000	212.000 11-Aug-06	1415.000 27-Feb-07	411.461	271.132



Source: LehmanLive.com

Legend	Axis	Name	Last	Minimum	Maximum	Mean	StdDev
—	Left	AAA Implied Spread	21.000	7.000 23-Jan-07	26.000 23-Feb-07	13.529	6.127
—	Left	AA Implied Spread	44.000	13.000 22-Jan-07	49.000 07-Mar-07	24.029	12.366
—	Left	A Implied Spread	223.000	64.000 19-Jan-07	319.000 27-Feb-07	156.147	74.091
—	Left	BBB Implied Spread	887.000	273.000 19-Jan-07	1193.000 27-Feb-07	618.000	276.424
—	Left	BBB- Implied Spread	1254.000	466.000 19-Jan-07	1535.000 27-Feb-07	903.147	335.757

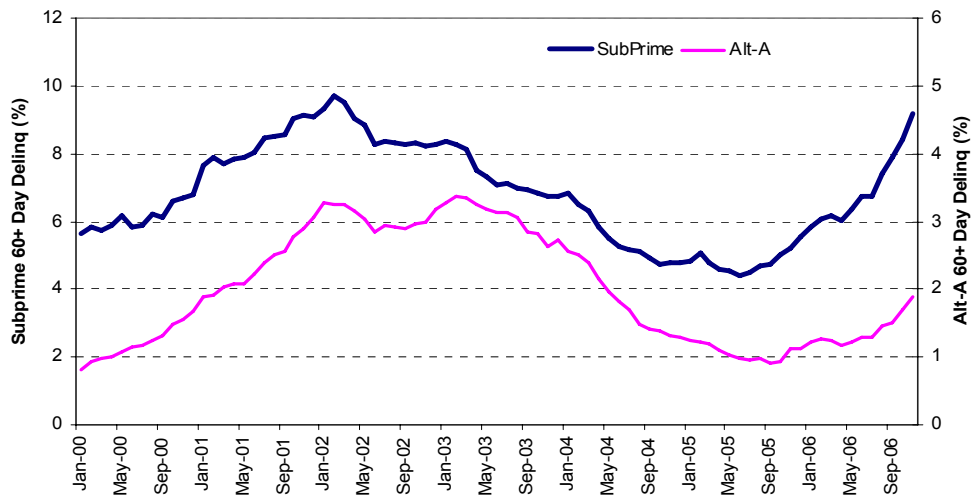
*The ABX.HE 06-2 rolled in January to the ABXHE 07-1 (Source: Lehman Brothers)

How did we get here?

As the housing market grew during 2005 and 2006 lenders relaxed their underwriting standards to remain profitable in this very competitive marketplace. To maintain volume and growth, mortgage loans were underwritten with initial “teaser” rates which, at the time, were 400 to 600 basis points lower than the fully amortized rate. These looser underwriting standards allowed a borrower to afford a much larger loan than if the loan had been underwritten at the fully indexed rate. A large majority of subprime loans are adjustable rate (ARM) cash-out refinancing mortgages, specifically 2/28 or 3/27’s, where the loan is fixed for the first two or three years then adjusts every six months thereafter. In addition to 2/28 and 3/27 loans, several subprime borrowers also wrote

interest only (IO) loans that generate negative amortization. In this situation the IO loans' minimum payment is not sufficient to cover the entire amount of interest due; the difference is added to the current principal balance, increasing the outstanding balance of the mortgage.

Any increase in prevailing market interest rates may result in increased payments for borrowers who have adjustable rate mortgages. Negatively amortizing IO's, however, can also reach their "negative amortization cap". When this happens the loans are required to amortize immediately and a borrowers' payments will increase even if rates stay flat. In these situations, again, borrowers would seek to avoid the increased monthly payments by refinancing their mortgages. However, due to recent market conditions, the borrower is having difficulty finding replacement loans they qualify for and can afford. Add to that the decline in housing prices and many borrowers are finding that they either have insufficient equity in their homes to refinance or, even worse, their loans have prepayment provisions that inhibit refinancing. All of this means that delinquencies, foreclosures and defaults have recently grown at higher than normal rates.



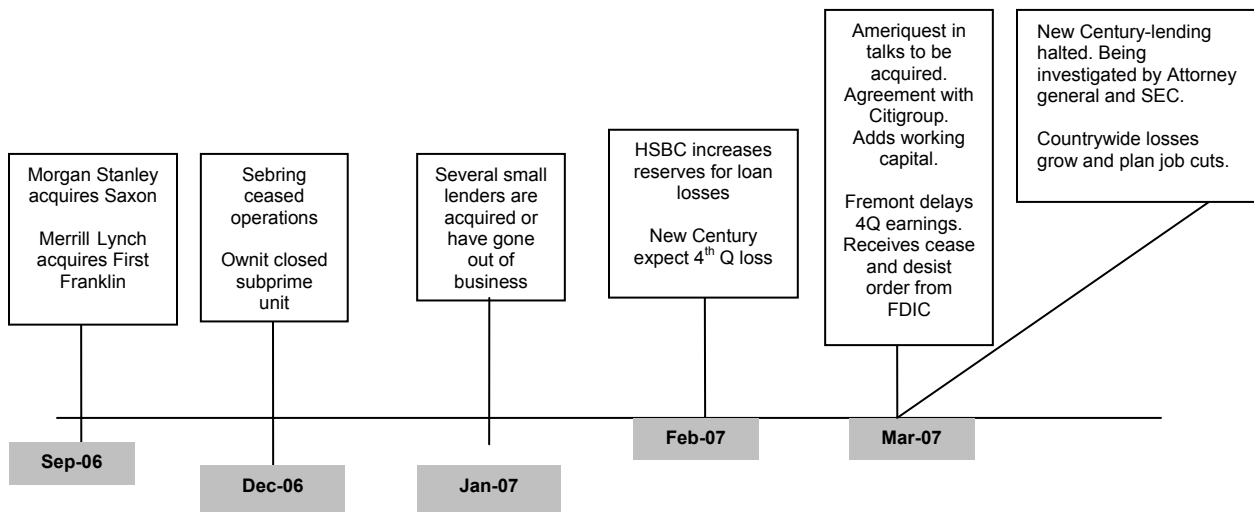
Source: UBS

As a result, many sub-prime residential mortgage loan originators have experienced serious financial difficulties and, in some cases, bankruptcy. This headline news is adding pressure to both cash and synthetic subordinate spreads. The difficulties that these lenders are facing are due not only to poor underwriting standards and the declining market for subprime loans but also from claims for repurchase of mortgage loans previously sold. Under some loan sale provisions the seller, or originator, is required to repurchase the loan in the event of early payment defaults or for material breaches of representations and warranties made on the loans. As the market for subprime mortgage loans has slowed and lenders margins are getting squeezed, there is insufficient capital to repurchase these loans, resulting in poor earnings or bankruptcy.

Toward the latter half of 2006 signs of trouble began to show as several small subprime lenders, Sebring and Ownit, either closed their doors or were acquired by larger issuers. In August of 2006 Morgan Stanley purchased Saxon for \$700 million; in September 2006 Merrill Lynch purchased First Franklin for \$1.3 billion. Since then several smaller firms have either gone bankrupt or been purchased and news that other large lenders are for sale is driving the risk profile of the home equity market wider. One of the largest lenders, HSBC, recently reported an \$11 billion write-off due to subprime mortgages and increased its reserves for bad loan losses. Ameriquest, another giant in sub-prime, entered into an agreement whereby Citigroup provides them with working capital. All of this means spreads are expected to continue to widen. Most recently Fremont received a regulatory order requiring them to stop giving mortgages to those that cannot afford them and the SEC announced a criminal probe of New Century, the third largest sub-prime lender, related to accounting errors and issues in trading of its securities. The net result was New Century has halted its lending operations. In addition to the poor underwriting and buyback loan provisions mentioned above, one dealer believes part of the problem may be due to fraud. Although it is difficult to

quantify fraud, there remains a strong argument that “there were significant misrepresentations on the original loan documents”, leading to significant levels of delinquencies and defaults.

Timeline:



Where are we headed?

The recent exit of several security lenders and agencies, all active participants in ABS home equity securities, is putting additional pressure on spreads. Freddie Mac’s recent press release stating that they would no longer purchase loans without improved underwriting standards, which essentially removed them from the subprime market, is a good example.

From a credit perspective, we believe that the senior classes in many deals will avoid more than a mild widening in spread activity as there is sufficient credit enhancement below these tranches. In the lower rated tranches however, (A to BBB-), spreads have widened considerably as hedge funds

have expressed their negative view of the subprime market by shorting the ABX.HE or selling their inventory.

In the short term, as the housing market cools and more adjustable rate mortgages reach their reset dates, there will no doubt be continued delinquencies and foreclosures in the subprime market with negative news dominating the headlines. This will contribute to an increase in housing inventories that will put pressure on home prices. However, we have yet to see the subprime problems impact the prime mortgage market. Subprime currently accounts for slightly more than 14% of overall mortgage debt (\$1.2 trillion¹ out of \$8.5 trillion total mortgage debt), which is not a large percentage to have a dramatic effect on the overall economy. In addition, the 4th quarter Mortgage Delinquency Report (Mortgage Banking Association) shows that the prime mortgage market has yet to be affected by subprime woes; subprime delinquencies hit a four year high with 13.33% of borrowers late on payments, whereas prime mortgage delinquencies are at 2.57%, well within expectations and certainly not indicative of a wide-spread contagion. However, there may be a slight flight to quality into treasuries and other asset-backed sectors such as autos, student loans and credit cards in the short run and liquidity will surely be hampered in the home equity asset-backed market.

As some subprime lenders disappear in the near future - either declaring bankruptcy or being purchased by larger firms - consolidation of the business will take place leaving fewer yet larger and better financed lenders. Eventually a majority of the bad loans in many subprime mortgage securities will be written off and the newer vintage deals (issued in 2007), underwritten with tighter standards, will offer value to those investors who had previously exited the market.

¹ Lehman Brothers

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