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Securitized Products State of the Market

Complacency, Panic, Uncertainty…Stability

In just four years, the US securitization market has migrated through some incredible territory: from obscure bond market sector populated by complacent investors happy with yields of less than 50 basis points over LIBOR in 2006, to market pariah blamed for the implosion of the U.S. economy with securities trading at prices below 50 cents on the dollar during 2008-2009, and then last year becoming a top-performing fixed income sector despite still being beset by fundamental skeptics.

The current questions: What is next? Are the skeptics right? Or, will the rally continue? We address these questions by reviewing how the securitized products market changed over 2010 and exploring the developments that we expect in 2011, both for the securitized products in general as well as for the specific areas of MBS, CMBS and ABS. In addition, we will address the topic of housing prices which is not only a driver of securitized MBS product returns but significantly impacts overall U.S. economic growth.

2010 Performance

Fundamental stagnation plus technical resilience equals significant rally

In parsing securitized products' performance for 2010, a number of key fundamental and technical developments stand out.

With respect to the underlying fundamentals of many asset classes within the securitized products markets, most notably real estate-based assets, stagnation (and sometimes worse) best describe 2010. This despite the combination of easy Fed policy and the passage of time - both of which served to boost the economy at large. In residential mortgages, current mortgages continued to become delinquent while delinquent mortgages rarely cured. Default rates generally increased in both residential and commercial mortgage-backed security collateral, while severities also rose, despite housing prices displaying a temporary uptick in the middle of the year. Rents for commercial properties across asset types rolled negatively with the exception of hotel room rates. The only significant exception to the continued fundamental negativity occurred in consumer debt, where delinquencies finally began to trend lower in credit cards and auto loans. Notwithstanding the essentially dreary fundamental performance in 2010, a dreary reality turned out to be significantly more benign than investors' initial disastrous expectations. In fact, the market seemed to breathe a sigh of relief that the catastrophic assumptions built into bond pricing did not materialize.

Another development was the differentiation between seemingly similar assets. At the beginning of the crisis, bond prices simply reflected the lowest possible price at which any buyer imagined he could convince a distressed seller to part with a particular asset. Subsequently, as the market bottomed, some very generic (and rather arbitrary) bond pricing conventions arose – e.g. "…the price of a Pay-Option ARM ("POA") should be equal to the amount of subordination below the bond". Through the beginning of 2010, many such conventions ruled the markets, and many securitized product sectors were trading on such a commoditized basis. During 2010, as it became apparent that demand for bonds was coming back and that investors generally would have to work a bit harder to find value, pricing conventions were replaced by fundamental scenario analysis. However, in many cases the scenarios still reflected disaster case assumptions that were not likely to occur. It was only toward the end of 2010 that some of these extremely onerous assumptions began to be replaced by more realistic ones. Overall, the migration from commoditized pricing to asset level analysis meant that by the end of the year, many assets which had been priced identically at the beginning of the year were now separated by price differentials of 10% or more.

With respect to market pricing, one of the most interesting observations concerns the comparison of volatility in securitized products with volatility in other financial markets. In 2010, the securitized products markets proved to be highly reactive to negative news but also extremely quick to recover from that news. At the first appearance of European instability in January, both the equity and corporate markets (as represented by the S&P500 and the Investment Grade series 13 Corporate CDS Index, "IG13", respectively) sold off, albeit lightly, from mid-January through mid-February. By comparison, securitized products (for example, as represented by ABX 06-2 AAA tranche) actually began selling off, also fairly lightly, almost a week in advance of the other markets. Subsequently, securitized products also stabilized more than two weeks before either equities or corporates did. Similarly, in May when the European sovereign crisis peaked, equities and corporate bonds sold-off for two full months while the securitized products space only sold off during the month of May.

In contrast to the mixed picture on fundamentals and the relatively positive picture on price volatility, the technical supply/demand picture for securitized products was completely rosy. First, investors' appetite for risk increased. The accommodative Federal Reserve Policy not only helped stabilize the macro-economy (as it was designed to do) but also drove the yields for risk-free assets to historically low levels. Investors were forced to take risk in order to generate returns. As a result, prices of financial assets rose in general (again as the Fed intended), and investors became more open to investing in asset classes that had been previously rendered almost taboo by the credit crisis, specifically securitized products including MBS, CMBS and ABS.

Second, as investor demand grew, it became apparent that supply would not step up to meet the demand. The demand/supply imbalance grew throughout the year as more bonds paid down than were issued such that supply was net negative for 2010 as a whole. The only (partial) offset to these technical positives appeared in the form of secondary supply as weak holders (who had bought bonds based on ratings) sold to stronger investors (who now buy based on deep credit work).

In conclusion, buyers were led to the financial markets by their growing risk appetite and then led into securitized products despite continuing weak fundamentals, because this weakness was not close to the catastrophic conditions that had been forecasted. When the buyers got to market they found little primary supply, but just enough secondary availability to inhibit the market's price appreciation. As a result, the securitized products markets rallied 5-15% on average across sectors.

2011 Outlook

Part 1: Economic drivers remain the same; credit spreads continue to tighten

In 2011, we expect the Federal Reserve will remain accommodative. As a result, the economy will likely continue its expansion, although this expansion seems set to be fairly tepid in nature and could be below the current level of expectations. Forecasts for the economy to recover back to long term trend real growth of 4% as soon as the fourth quarter of this year seem optimistic.

As the Fed keeps money easy and the economy stabilizes, demand for risk assets in general and securitized products specifically should continue to grow. In addition, supply should remain tight for two reasons. First, underlying loan growth should remain weak as consumers/homeowners deleverage. Without loan growth, new issue supply will be light. Second, newly promulgated securitization rules often make new securitizations an uneconomic exit strategy; especially in the case of certain banks and insurance companies. So, as a result of continuing demand and limited supply, we expect securitized products credit spreads to tighten further in 2011.

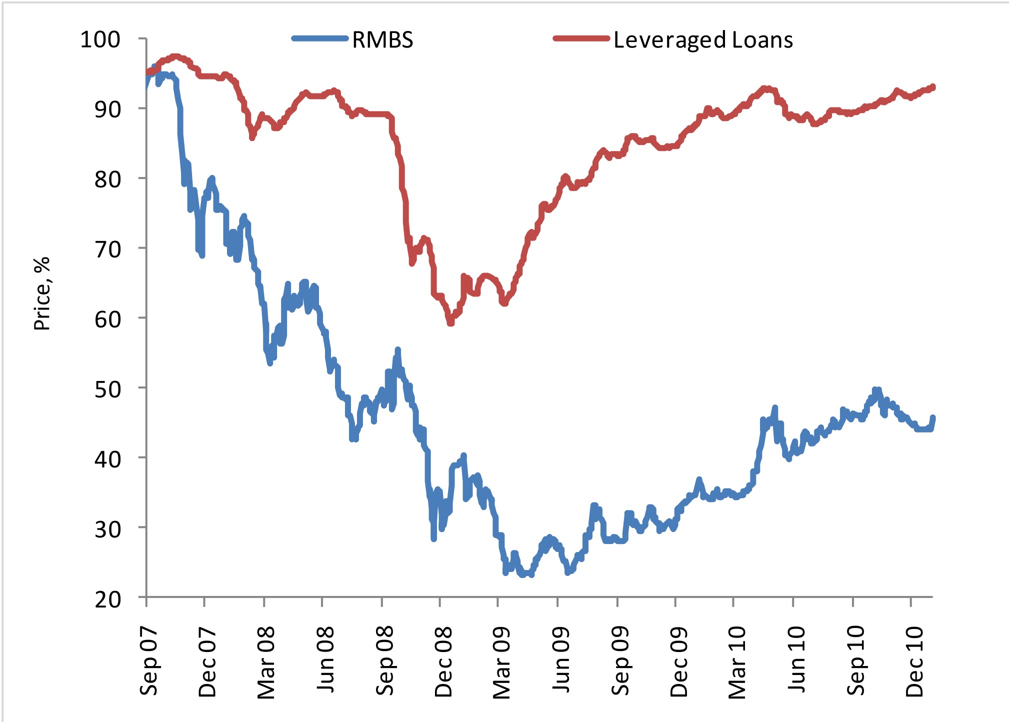
Part 2: …but asset selection is more important as fundamentals languish

As unemployment continues to flirt with double digits and GDP growth remains weak, fundamentals in securitized products such as delinquencies, defaults, asset values and recoveries are unlikely to improve significantly. While we have seen some near term positive signs in delinquency and housing price trends, we do not expect these to continue. Consumers remain skittish and in deleveraging mode and corporations, though flush with cash, are still not hiring. As a result, unemployment and default frequency should remain high. Despite scattered signs of bottoming in housing prices (as illustrated by the Case-Shiller Home Price Index) and the rise in financial asset valuations, housing prices and other real asset prices are likely to remain depressed for the foreseeable future. Therefore, recoveries on defaults within securitized products should remain at historically low levels.

So, if default frequency and subsequent loss severity both remain high , then how can investing in securitized products offer value in 2011?

First and foremost: Price. As we said earlier, during 2008-2009 when securitized products became a market pariah, their prices became extremely depressed. Despite performing very well in 2010, uncertain fundamentals and continued secondary supply from distressed sellers inhibited price appreciation. As a result, many sectors in securitized products still have significant price upside, even if dreary economic forecasts become a reality. While the corporate sector and many of the plain vanilla, AAA-rated consumer ABS (e.g. prime auto and credit card-backed deals) have almost completely regained pre-2007 trading levels, RMBS, CMBS and other less actively traded ABS sectors have only partially recovered (see chart below). Although fundamentals do not indicate that a full recovery back to par may ever occur, current prices still reflect extremely onerous default and recovery scenarios. Therefore, even though fundamentals may not improve year-over-year, bond prices can improve as it becomes clear to investors that the onerous scenarios are highly unlikely to occur.

While Some Sectors Have Fully Recovered,
RMBS Remain at Significantly Under-Valued Levels



Note: RMBS: ABX HE AAA 07-1
Leveraged Loans: S&P/LSTA US Leveraged Loan 100 Index

Second: Asset Selection. As investors abandon some of their most onerous scenario assumptions, these assumptions will have to be replaced with the aid of more complex modeling tools. The results of this improved analysis will be the continued understanding by investors that apparently similar assets are in fact highly likely to have divergent return profiles. For instance, looking at two subprime MBS bonds with similar loan-to-value ratios, FICO scores, geographic distributions (among other indicators) and securitization structures, could lead to a determination that the assets should have similar return profiles. However, the actual cross-relationships of each of these distributions (i.e. the characteristics of each individual loan) could lead to significantly divergent cashflows for each bond across a range of housing price and economic scenarios. As a result, one of the main drivers of returns during 2011 will be understanding the complexities of the various asset classes and being able to model these complexities in order to invest in the specific bonds which should outperform over time.

Part 3: Politics?... Asset Selection Reprised

The remaining event risk for securitized products is primarily political. Politicians have weighed in on the mortgage crisis from time to time, although markets have largely shrugged it off. Even at the height of the crisis and with a unified Congress, the administration was unable to implement policies that significantly changed the outcome for most mortgages. We doubt that there is the political will to attack what is now old news, especially with the mid-term elections behind us.

To the extent that there continues to be controversy about procedural missteps in the process of securitizing and servicing mortgages, the germane question is how they will be cured. We find it unlikely that any powerful constituency would conclude that these missteps should simply vitiate the mortgage obligations and lenders' rights. Therefore while we may continue to see delays in resolving delinquent loans, these issues should not change the fundamental outcome for delinquent mortgages (refer to our October 2010 white paper on the topic, "Foreclosuregate – what to worry about and what not to worry about").

However, various MBS bonds can perform differently under a variety of timeline scenarios. One bond may outperform if losses are crystallized in the near term but underperform if delinquencies are allowed to remain outstanding for extended periods. A second bond, although apparently similar, might perform equally well throughout a range of delinquency timeline scenarios. Again, the ability to model fundamental cashflow performance over a range of scenarios will be paramount for creating returns for investors in 2011.

A rising tide of demand should lead the beta returns for securitized products to be good in 2011 despite the continued weakness in underlying fundamentals. However, the ability to add alpha by selecting specific sectors and assets that are likely to outperform can make investing in securitized products a truly compelling investment this year.

<u>2011 Sector Outlook</u>

Credit MBS – Fundamentals Outperform Expectations

Non-Agency MBS (primarily Subprime, POA, Alt-A first lien mortgage-backed securities) are now poised for a second act in their comeback. With downgrades largely behind us and given the current makeup of the investor base, we do not anticipate a continuation of forced selling. On the contrary, as the bonds continue to pay down principal, investors are being "forced" to buy in order to maintain their allocation to the sector. With the new issue machine at a virtual standstill, and securitization economics still questionable for issuers, supply is again forecasted to be net negative.

Mortgages Have Bounced Back from "Depression Pricing" But Still Offer Some of the Best Yield Opportunities in Fixed Income

ABX.HE.AAA.06-2 is an index of a pool of AAA-rated subprime MBS issued in 2006.
Source: Markit a/o 1/5/2011

Fundamentally, there are some glimpses of better news in mortgages. The MBA reported in October that 10.2% of all mortgage borrowers are 60+ days delinquent. A discomfiting number, but the second quarterly decline in a row for that figure. Another positive indicator is the declining pace of "first time defaults", that is the number of borrowers who had always been current on their mortgage and miss a payment for the first time. These trends suggest that credit risk "burnout", the point at which the borrowers in the pool who are likely to become delinquent and eventually default have already done so, could be approaching.

However, these are just glimpses of improvement, and the problems remain sobering. 20-25% of homeowners with a mortgage now have negative equity, which is the single most important predictor of default. And for mortgages that do default, loss severities will get worse before they get better. The combination of longer timelines and further home price declines could raise loss severities by as much as 10 points.

However, the extension in timelines should begin to abate this year as the attempts to modify problem loans are starting to run their course. Government programs have slowed to a trickle, and many loans are just not easy candidates for modifications. Private bank modification programs, which are more encompassing than the government programs, are also slowing as most homeowners have already been contacted. As a result, by now, modifications have either been entered into, or have been abandoned. Therefore, servicers are just beginning to re-invigorate their efforts to push delinquent and foreclosed homeowners toward short sales and liquidations. By selling the property, even at discounted prices, a number of positives are created for MBS returns: servicing advances and legal expenses no longer build up, the borrower willingly leaves the home and the price of the house is crystallized at current levels instead of future levels, which we expect to be lower (see the Housing Price Index section below). Such a trend away from modifications toward short sales would significantly benefit most MBS bonds because of the discounted principal effect. As most MBS trade at reasonably deep discounts to par, faster than expected return of principal can significantly boosts yields.

As described above, asset selection will be a significant differentiator of returns in 2011, In this vein, the mortgage servicer has been a key variable. Over time, clear differences have emerged among loan servicers, and those differences can impact timing and amount cash flows to investors, which in turn will determine the yield of MBS bonds in investor portfolios. Investing in bonds serviced by certain servicers could dramatically improve the performance of an MBS portfolio.

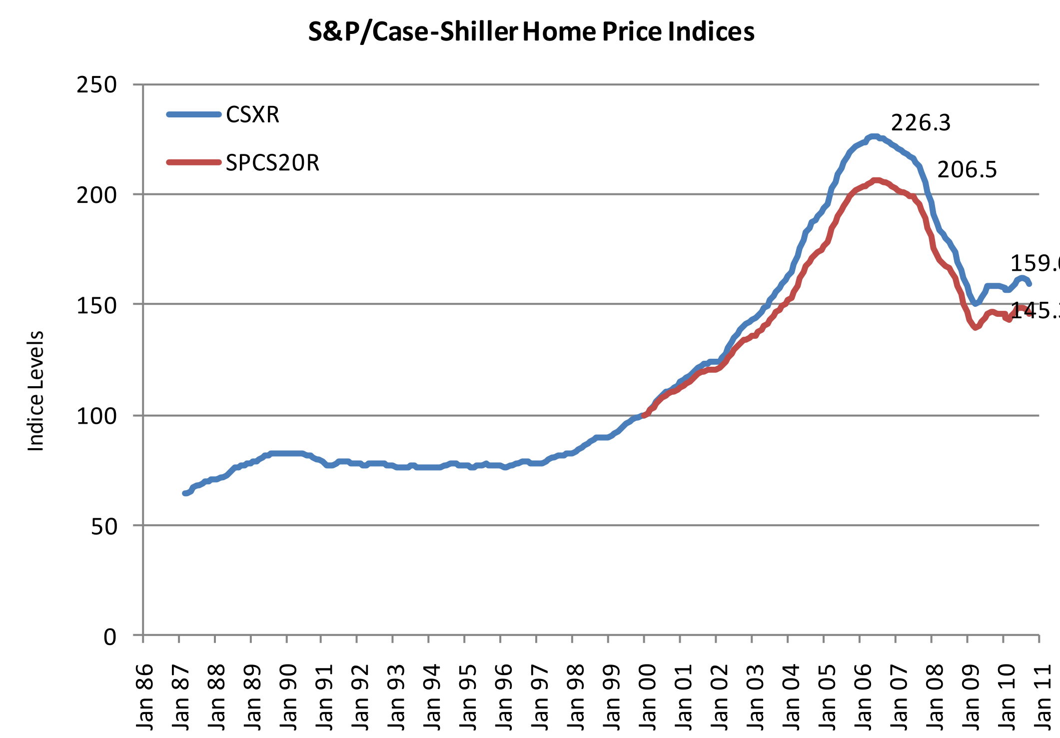
One final story to watch during 2011 relates to mortgage putbacks, i.e. the ability of holders of MBS bonds to force banks to pay full par for defaulted loans as a result of those loans being inappropriately placed in a securitization's collateral pool. The story has been evolving slowly, due to the difficulty of accessing information and establishing a buyback liability and because the terms vary by securitization. As a result, any upside from putbacks will be both idiosyncratic and slow in coming. In fact, we do not consider the possible upside from putting back delinquent mortgages in our MBS valuations. It will be pure upside if, and when, it materializes.

Home Price Index ("HPI") – It's Not Over Yet

While it may seem counterintuitive that we are bullish on returns for mortgages with credit risk *and* simultaneously are bearish on home prices, that is in fact the case. The key is identifying bonds that provide attractive cash flows even in scenarios in which the housing market continues to face challenges.

Throughout much of 2010, the Case Shiller Home Price Index bounced around a plateau, up or down less than 1% (annualized) per month. However, as we predicted earlier in 2010, the four most recent prints have been downward. Wall Street firms generally are calling for a further 6% decline in U.S. home prices in 2011, with a range from the "bullish" -3% forecasts to less optimistic -10% estimates. Our forecast is more pessimistic than most and in fact when we analyze bonds we assume declines of 10-12%. However, even more important than the headline average HPI, will be the changes in specific geographic areas and for the price tiers within each geography.

The Deep Plunge in Home Prices Was Halted; But the Recovery Was Illusory and In Fact we Expect A Moderate Double Dip



CSXR is the monthly composite price index of the top 10 U.S. housing markets, using a repeat-sales methodology, SPCS20R is a composite of 20 U.S. housing markets.
Source: S&P Home Price Index Levels dated 12/28/2010

While it is common for generalists to talk about "nationwide home prices," the figure is almost meaningless for the purposes of analyzing mortgages. The pools of mortgages backing MBS are unlikely to reflect the nationwide average, and must be looked at market by market and price tier by price tier. Granularity is king. For example, among the Case Shiller Index's top 20 largest markets, Dallas is down 3.2% from the peak, Vegas down 57.5%, and the New York MSA, somewhere in the middle at -20.7%. To average such figures and apply them to estimating mortgage defaults would grossly underestimate or overestimate risk, depending on the market. Even for those who look at housing by MSA (metropolitan area), the devil is in the details. Within the NY MSA housing market, for example, the highest price tier in the best zip code is down 12% from the peak, and the lowest price tier in the worst zip code is down 48% from the peak.

Like all assets, home prices should, eventually, reflect fundamental values. However, at any point prices can also be pulled one way or other by the simple power of momentum. While one of these influences may overshadow the other at certain times, today we see both depressed fundamentals *and* continued negative momentum.

The fundamentals that concern us include high unemployment, high housing inventory, and tight credit. High unemployment inhibits demand for housing, adds to mortgage defaults and is correlated to local home price declines. Combined with steadily increasing inventory, which has been rising for over a year and hit an all time high of 12.5 months of supply in July, downward HPA pressure is obvious. If shadow inventory, some 8 million loans that are delinquent, in foreclosure or in REO, is included, then the story gets worse. While the resolution of distressed inventory has been significantly more protracted than expected and has not, as a result, been as harmful as many feared, the shadow inventory will come to market at some point. This inventory could cause a shorter term precipitous fall or a longer term steady ramp down. In either case, 8 million homes waiting to be sold is not a positive.

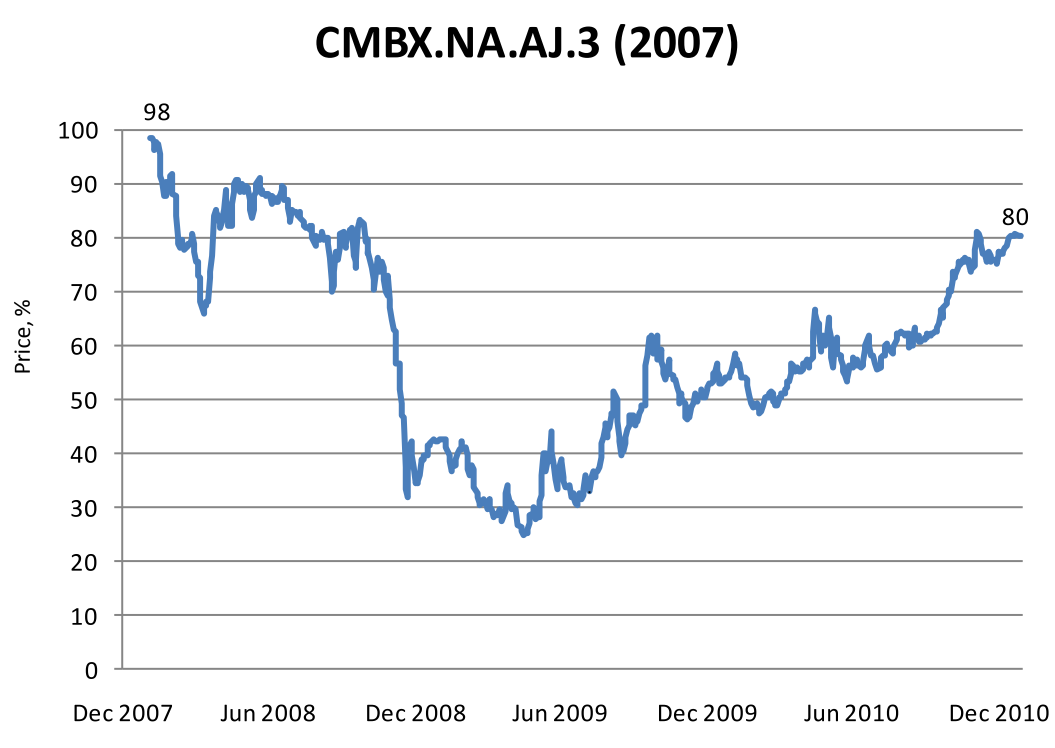
While mortgage rates remain attractive, after hitting a 40-yr low of 4.17% in the fourth quarter, they have not had the defibrillator-like impact that we usually see for two reasons: homebuyer's price expectations and tight credit. Homebuyers continue to be reticent in expressing their demand as they can see the steep overhang of homes on the market and continue to be willing to be patient while waiting for lower prices. In mortgage lending, we do not know yet what the new normal will be. But today's market appears much tighter for borrowers than at any time in the last 20 years. In particular, the disappearance of piggyback second mortgages as a way to reduce the cash needed for down payments is leaving out many potential borrowers. Move-up buyers are further constrained by high LTV's on their existing homes.

If all of this sounds terribly negative, we do give significant weight within our projection to a number of positive housing fundamentals. Affordability is at an historic high as home prices have dropped much farther than incomes and as rates are near historically low levels. In addition, home prices dropped dramatically during the economic crisis while rents remained relatively stable. As a result, the rent vs. buy equation, which almost demanded renting when home prices were peaking, is now more in balance than has been seen in over a decade. Second, household formations, which were suppressed by the recession, may have bottomed, as the current rate is just a little above half the long run average. Finally, homeownership rates, buoyed by easy credit during the pre-crisis bubble, have now largely returned to their long run norm.

In conclusion, the worst-case HPI scenarios that investors assumed only a year ago seem inappropriate. However, Wall Street forecasts, which have improved from down 10-20% a year ago to down 3-10% today, do seem optimistic to us. Our forecast, while improved from -19% a year ago, is still a hefty -10-12% today. Importantly, despite this negative outlook for housing prices, we believe that credit MBS is poised for compelling returns in 2011, both as a sector and even more so for the best bonds within that sector.

CMBS – Mixed Fundamentals but Very Favorable Technicals

With some tranches of the CMBX having generated mid-teen returns, CMBS clearly had a good year in 2010. The story is by now familiar: light supply (net negative issuance), a yield advantage, and investors willing to accept that catastrophic fundamentals are no longer likely. All these factors combined to tighten spreads and create one of the best performing sectors in fixed income in 2010. As with non-agency MBS, we expect 2011 to bring a continuing rally in the sector characterized by magnification in tiering and price discrimination.

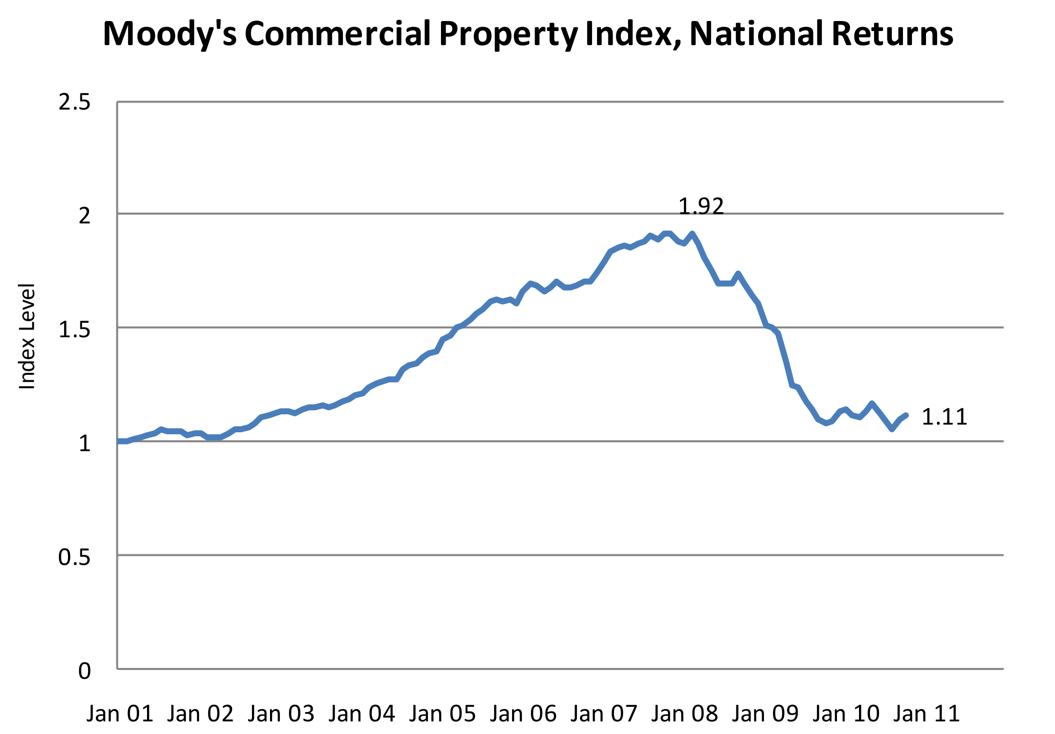


CMBX.NA.AJ.3 is a price index of a pool of AJ tranches from AAA-rated subprime CMBS issued in 2007.
Source: Markit

As with residential mortgages, all of this bond performance happened despite the collateral still being mired in recession. Weak consumer spending hit retail and hotel properties, while weak employment numbers dragged down office, industrial and warehouse markets. Multifamily properties may have benefitted from some housing market disarray, but low household formations have hurt the multifamily sector as they have hurt the single family markets. Despite this weak backdrop, some significant positives did appear. The rate of increase in CMBS mortgage delinquencies has eased. Also loan modifications, which have been a major source of uncertainty as they have in the residential sector, have been less widespread than investors had imagined and should continue to occur at a moderate frequency going forward.

With respect to following commercial property valuations, there are several commercial property indices. While their composition can lead to different results, the average can be fairly represented by Moody's Commercial Property Price Index, perhaps the most widely watched index, which is now down 42% from peak.

Moody's Commercial Property Index is Off Even More Sharply than Residential



The Moodys/REAL commercial property index (CPPI) is a periodic same-property round-trip investment price change index of the U.S. commercial investment property market.
Source: MIT Center for Real Estate dated 12/22/2010

As with residential property markets, broad assumptions about commercial property markets are misleading in CMBS valuations. For example, office properties in "trophy" cities have in many case seen valuations return to, or near to, pre-crisis levels. By comparison, most second tier office markets have not yet seen prices return, but have seen a normalization in vacancy rates accompanied by stability in property values. Because property types with shorter lease cycles, such as multifamily, tend to experience weakening cashflows first in an economic downturn, their valuations were the first to suffer at the onset of the crisis. However, the inverse has not been entirely apparent. While multifamily rents have begun to pick up as would be expected at the beginning of the economic recovery, valuations have not recovered as quickly as they have for some office properties. This is likely caused by the massive overhang of supply in the residential property market.

While many fundamentals are similar between CMBS and credit MBS, the technical supply/demand picture of the two markets is significantly different. This difference is primarily driven by the health of the new issue CMBS market. In 2010, new issue CMBS totaled approximately $11 billion. While this was infinitely more than the amount of issuance in the (moribund) credit MBS markets, $11 billion still represented a significant level of negative net issuance for the year. That situation is about to be rectified as new issuance is now poised to increase dramatically in 2011 to as much as $40-50 billion. As a result, net issuance should be neutral this year. Another significant difference between CMBS and credit MBS is that the investor base has moved farther along the expertise curve with respect to modeling. The disaster-case assumptions were replaced around the middle of 2010 with significantly more realistic economic scenarios. As a result CMBS prices are now much closer to par than for MBS bonds.

The combination of this change in modeling and the return of new issuance should create a very bullish scenario for CMBS returns in 2011. As investors compare tighter new issue spreads with more generous secondary spreads for seasoned CMBS product, investors will be motivated to invest more time, effort and eventually capital in the secondary product. So, while new issuance will serve to balance the supply/demand dynamic in the market, it will also serve to create a tight benchmark to incent investors to devote more capital to seasoned CMBS bonds. As a result, we anticipate CMBS spreads will experience a significant rally throughout 2011.

ABS – On its own again

The Asset-Backed Securities ("ABS") market has made an impressive recovery from near extinction in 2009. Like other securitized products, holdover crisis pricing, tight supply and a low yield environment all contributed 2010's strong performance.

But, unlike in mortgages, we are not just talking about recovery in bond prices. The new issue market is almost entirely back to pre-crisis levels, and the sector has accomplished this even while government assistance programs such as the Term ABS Lending Facility ("TALF") has expired. The reason for the level of recovery is very clear: almost the entire investor base is back, mainly centered around large entities which are looking to buy shorter duration, floating rate assets basically irrespective of spread level. As a result, spreads are also now close to pre-crisis levels on many asset classes. A second and very important driver of the spread tightening is that fundamentals have actually been improving. Credit card delinquencies and charge-offs and auto loan delinquencies and net losses are all down significantly. In credit cards, charge offs peaked at nearly 11% and are currently at approximately 8.5% and appear headed lower. In autos, net losses hit a seasonal low of 69bp in June, down from nearly 250bp in early 2009. Even though we expect unemployment to remain high, near 10%, as long as it does not go meaningfully higher, fundamentals should continue to improve in ABS.

With AAA-rated ABS once again being described as "Treasury surrogates" and some ABS now even government guaranteed (through the new National Credit Union Association securitization program), where are the "yieldy" opportunities? Generally, investors should not expect significant gains in senior, benchmark issues. But again, as investors continue to search for yield, we expect the levels for off-the-run asset types and subordinated securities to start to improve and reflect their (higher) fundamental values. We currently see opportunities in sectors like equipment, manufactured housing, subprime credit cards, student loans, structured settlements, and some CLOs.

Student loan ABS are one subsector that did not tighten significantly in 2010. Student loans are bifurcated into private and government guaranteed. The government guaranteed program, FFELP or "Federal Family Education Loan Program" was dismantled by the government in 2010. As a result some investors may migrate to private student loan ABS. While supply technicals may favor SLABS, weak collateral performance has dogged the sector. Student loan defaults are now coming in well above pre crisis market expectations, especially for proprietary schools. While there are implications for equity valuations and perhaps for policy, from the standpoint of bond valuations, many student loan bonds are very well protected and offer compelling risk-adjusted returns. For instance some investors have been disappointed with recent changes in loss estimation for 2009 and 2010 vintage bonds from approximately 15% (cumulative, net) to over 20%. As we viewed losses for these transactions to eventually reach 25-30%, we were not surprised or dismayed by the change in expectations – especially as the most compelling senior bonds are protected from losses reaching as high as 45%. So while sellers have come to market, recently more buyers seem to have done the work and soaked up the secondary supply such that spreads are just beginning to tighten. We expect this tightening to continue throughout 2011 as investors begin to understand the value of the structure within this less-followed asset class.

Conclusion: We're Bullish.

By dint of its sheer size, securitized products remain the greatest distressed asset opportunity in history. This complex and labor-intensive sector should continue to provide superior risk-adjusted returns that are not predicated upon economic recovery. As a result, the sector offers superior down side protection whether the economy experiences a true double-dip recession or just languishes in its current state of doldrums.   Therefore, investment capital should continue to flow into the securitized product sector, tightening spreads and generating a compelling return. In addition, while beta returns should be compelling, alpha strategies are also very important for investors in this asset class. Advanced modeling techniques combined with rigorous research can allow portfolios with superior risk/return profiles to be created in order to generate significant additional returns for investors.

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