Basis

Investor Update – Recent Developments In Sub-Prime Markets

There's been some discussion over the last few months regarding events associated with the US Sub-prime loan market. In particular, recent headlines have focused on the fate of a Bear Stearns Asset Management fund which held large exposures to sub-prime mortgages and we thought it timely to review those events.

In February we saw credit markets reassess the likelihood of future defaults and losses in the US Sub Prime Debt market. In particular loans originated in 2006 were afforded the greatest level of scrutiny on account of some poor lending practices by some mortgage originators throughout the year.

For CDO equity it was a case of guilt by association, which resulted in a broad mark down of prices with little or no regard to underlying quality, or vintage of the collateral. These indiscriminate revaluations resulted in the Basis Yield Alpha Fund reporting a negative return in February despite continued strength in cash flows from the Fund's underlying investments largely on account of there being very little incidence of realised default impairment in the assets of the Fund. The subsequent rebound in pricing for Basis' underlying investments in March, April and May demonstrated the speed with which those same dealer banks recognised the Yield Alpha Funds underlying strength and its limited exposure to Sub-Prime Loans originated in 2006.

As recently as this week, a market-wide repricing of the highest rated (AAA through A) tranches of sub prime and CDO deals has created large mark-to-market losses for funds that held these bonds like the one offered by Bear Stearns. Compounding the issue was the large amount of leverage – between 10 and 25 times – that Bear Stearns applied to its Fund that magnified those initial mark-to-market losses.

On account of that leverage, the revaluation losses led to the investment banks making margin calls on the loans they had extended to Bear Stearns' fund and when they were unable to pay, the banks retracted their lines of liquidity. The subsequent collateral auctions have severely interrupted the market and liquidity in the sector remains limited resulting in a re-pricing of CDO equity akin to that experienced in February.

In short, the problem has essentially been one of adverse movements in bond prices magnified by excessive amounts of leverage causing concern and a shortage of liquidity.

It's fair to ask how this event has impacted upon Basis' exposure to Asset Backed Securities. At this stage the extent to which we can comment is to say that it will impact negatively. However, due to the illiquid nature of the assets, it takes a while for us to receive valuations from the banks so we can't say what the extent of that impact will be but will keep you availed of developments as they come to light.

It's worth bearing in mind though that the Basis Funds' exposure to structured credit is not solely about sub-prime Asset Backed Securities: Basis also has exposure to prime asset backed securities, corporate-backed loan obligations (CLOs) and bank-backed debt obligations (CDOs). Additionally, diversification amongst

managers and individual obligors as well as portfolio seasonality all contribute to the long-term impact of a single market event like this being muted.

One final point to note is the part of the capital structure that has been impacted upon most this time around. As briefly mentioned above, it is spreads on the AAA –to A – rated bonds that have increased from around 50 basis points above the cash rate to around 300 basis points which has inflicted real capital losses on the holders of those bonds.

Basis invests in the equity piece of the capital structure. What happens to the bond spreads during the life of the CDO does not really concern the equity pieces: the Yield Alpha Fund has already locked in the interest rate spread that it receives as cash flow.

The sub prime story continues to unfold and new investment opportunities that represent appropriate levels of return for risk are limited. As such we have reduced our exposure and continue to remain cautious in our approach.

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