

October — December 2007

Dear Investor

Below is a market commentary and update on the Basis Pac-Rim and Basis Yield Alpha Funds for the December Quarter of 2007.

The commentary also includes an overview of the structured credit securitisation process and highlights how the Basis Funds attached to CDO investments.

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From credit crunch to a potential systemic meltdown...and the US Fed is forced to step in.

General Market Commentary & Themes

As the global credit crunch gained momentum, many commentators focused on what is now a systemic issue in which:

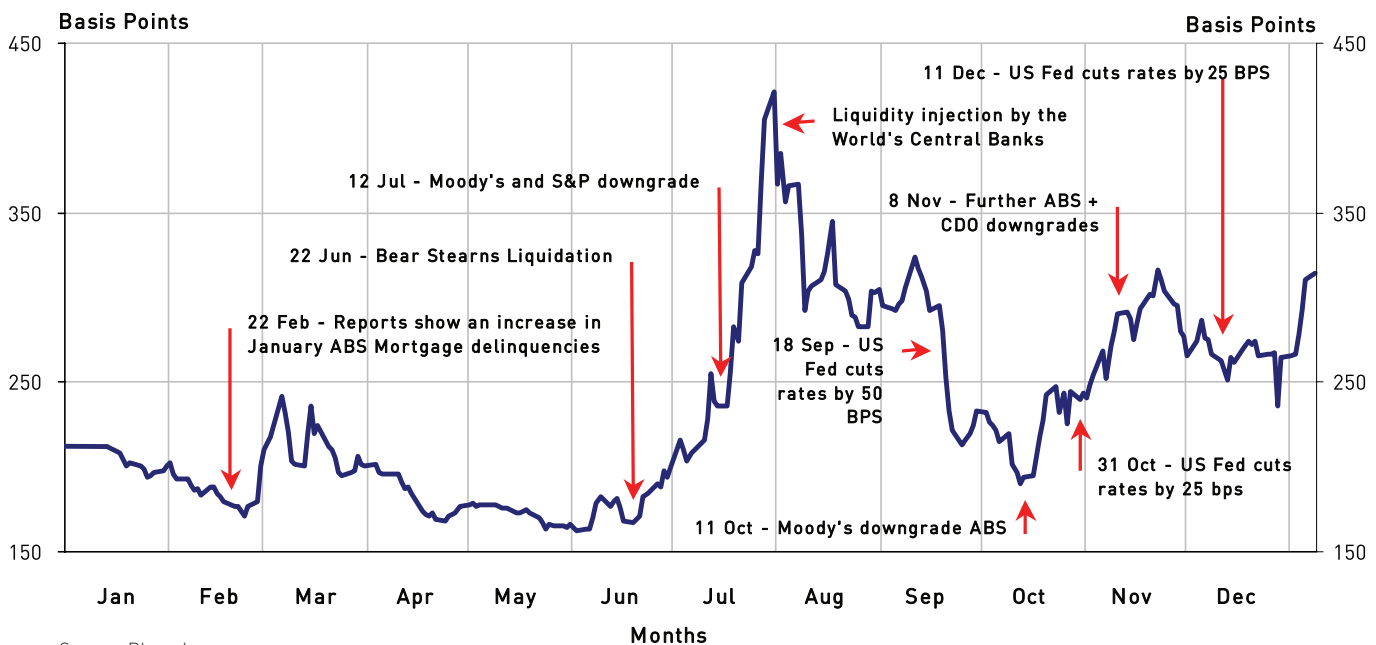
- Credit investors adopted a "flight to quality" mentality which saw US Treasuries rally across the curve and caused credit spreads to widen;
- Banks effectively stopped trusting each other and normal market inter-bank functions all but ceased to exist;
- Banks realised unprecedented portfolio losses, as structured credit-related assets on balance sheet were substantially marked down in value;
- Access to credit and liquidity became so scarce that central banks around the world were forced to inject co-ordinated and unprecedented amounts of liquidity into the financial system;

- Many borrowers attempting to access the capital markets have had their liquidity tap turned off as Banks focused on their own liquidity problems;
- The US Federal Reserve lowered official interest rates by 100 basis points, despite stated concerns regarding inflationary pressures;
- The Rating Agencies, Banks and Insurers came under pressure as the financial system began to display major cracks;
- Fear of a full-blown US recession became very real as the US economy began to show signs of slowing, weighed down by a depressed housing market and falling investor confidence;
- Market liquidity dried up for all credit-related cash instruments.

Cost of funds increasingly volatile.

The chart below highlights the cost of funds for a typical benchmark index of sub-investment grade corporate borrowers, as measured by the spread over and above prime bank cost of funds.

For illustrative purposes, we have used an index of Europe’s liquid benchmark of high yield borrowers (approx 4 years’ duration), the ITRAXX crossover series 6. Please note, the current series of ITRAXX series 9 trades some 100 basis points wider than series 6.



The chart shows credit spreads for the quarter pushing out from an October low and remaining volatile. It also serves to highlight some of the significant dates upon which announcements were made and/or actions were taken by the global Central Banks and Rating Agencies.

Pac-Rim reduces leverage.

Basis Pac Rim Fund:

Throughout the quarter, the multi strategy Fund has:

- Sold upwards of \$100 million of Asian and global securities from the portfolio, to bring additional liquidity to the Fund and to reduce its financing commitments;
- Actively reduced net leverage to 1.2 times NAV in light of deteriorating liquidity, credit and systemic conditions;
- Maintained a policy of marking to market CDO assets on a monthly basis, despite major disruptions in credit markets;
- Positioned itself to potentially split the Fund into its two primary asset classes: Asian Yield Strategies and the Fund's now dislocated and illiquid Structured Credit Investments;
- Assigned a manager's estimate of two cents on the dollar on its investment in the Basis Yield Alpha Fund (BYAF). This estimate is based solely on the Pac Rim Fund's own internal valuation policies and has taken into account BYAF's official liquidation status, its uncertain value and uncertain timing of potential value. The estimate is NOT reflective of any official value or NAV of the BYAF. Please refer to the BYAF section for more information.

Asian Yield strategies performed positively but structured credit performed poorly.

From a performance attribution perspective and despite difficult trading conditions and ongoing risk reduction throughout the 4th quarter, the Fund's more liquid and high yield strategies continued to maintain capital and deliver positive returns. Conversely and amidst the market's severe repricing of risk-based assets, the Fund's CDO investments continued to drag down overall portfolio performance.

Fund applications and redemptions remain frozen.

As a result of the unprecedented and escalating dislocation in the Structured Credit space, which makes up a material part of the Fund's investments, the Fund's existing freeze on Applications and Redemptions remains in place.

Basis Yield Alpha Fund now in Joint Official Liquidation: no NAV calculated.

Basis Yield Alpha Fund

The Basis Yield Alpha Fund (BYAF) invests predominately all of its cash into the Basis Yield Alpha Master Fund (Master Fund) which is currently in the hands of Joint Official Liquidators, being certain representatives of Grant Thornton. Consequently, no NAV is being calculated for the Master Fund and in turn the BYAF and Basis Yield Fund. Official liquidation proceedings began with a hearing on December 19th 2007. For further information on BYAF and the Basis Yield Fund please refer to www.basiscap.com.au.

Basis Funds do not invest directly in sub prime mortgages.

A Few Words on Investing in CDOs

The Basis Funds held a range of structured credit assets across various asset classes including the corporate, bank, consumer and mortgage sectors whose performance historically had low correlation and whose premise was to achieve a Fund of Funds type of portfolio (please see below regarding the asset manager of a CDO). Importantly, Basis Funds did not invest directly in US sub prime mortgages or mortgage bonds. Any exposure to the mortgage market was via CDOs.

CDOs buy pools of securities with broad exposure to different asset classes.

Securitisation involves many steps and is driven largely by the credit models and assumptions of Rating Agencies.

CDOs are described in many ways.

CDOs are managed by well respected and focused collateral managers.

Example of the collateralisation process.

Regarding mortgages, the CDOs, where relevant, typically bought pools of bonds rated investment grade that in turn may have exposure to prime, mid-prime and sub-prime mortgage pools.

The typical asset production, Rating Agency and Fund Management process involves the following steps:

- Mortgages are pooled into a bond trust which issues bonds and an equity — or 'residual' — piece;
- These bonds are assigned ratings by the Rating Agencies using their credit models and default assumptions;
- Investment Grade bonds are chosen by an Investment Manager and pooled into a CDO;
- A CDO issues bonds and an equity piece;
- Again the Ratings Agencies assign ratings to these bonds;
- Basis Funds and other investors seek to take advantage of the diversification, asset selection of the Investment Manager of the CDO and the non-recourse capital markets financing of the CDO;

The CDO is variously described as like:

- a managed account with strict investment guidelines;
- a Fund;
- a Special Purpose Company;
- a "Virtual Finance Company" as it owns loans and mortgages and can finance itself by issuing rated bonds and an equity piece in the capital markets. The equity size is driven by the ratings of the assets held, much like various types of financial institutions.

Additionally, a CDO has a Collateral Manager/ Investment Manager, which, on behalf of the CDO's debt and equity holders, is a fund manager choosing the assets and ensuring compliance with the CDO's Trust Deed.

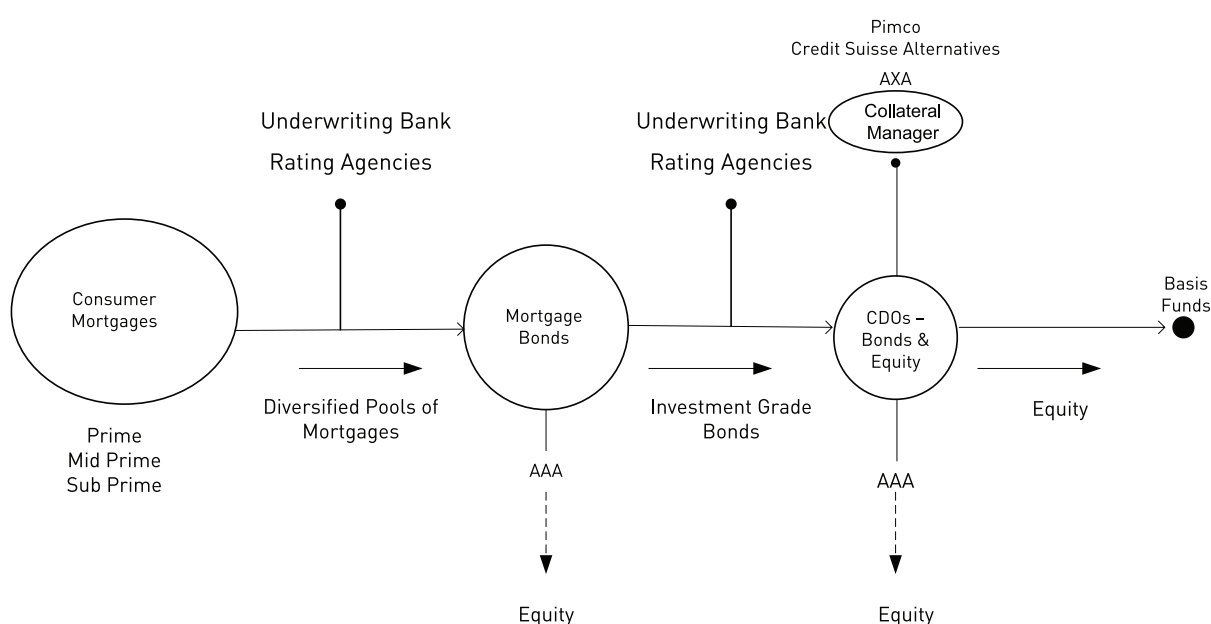
CDO securities of choice were created and managed by asset class experts. The Fund's CDO Investment Managers include groups such as Pimco, Credit Suisse Alternatives and AXA . These entities are highly competent in the task of ensuring exposure to a diversified pool of assets and in the monitoring and managing of those underlying assets.

The diagram on the next page is designed to help you understand the sequence of steps involved in the securitisation process (please note again: the example is purely of CDOs of Asset Backed Securities and not CLOs which are corporate backed securities that Basis Funds also invested in.) It is to be read conventionally from left to right with each circle representing a different step in that process. Whatsoever, each step is a market unto itself, and the relative size of the circles represent the relative value of each of those markets. There are a few important points to note in this diagram:

- Basis Funds are not investing directly in consumer mortgages or mortgage bonds but are involved via the re-securitisation processes;
- The repeated participation of Rating Agencies in the investment assessment process well before Basis Funds attached to any exposure to structured credit;

- Basis Funds' use of a collateral manager to attach to structured credit assets that is recognized as an expert in a particular type of CDO credit exposure;
- **The ABS CDO equity pieces into which Basis Funds invested were themselves backed primarily by the Investment Grade Bonds of Asset Backed Securities.**

Additionally it must be stated that whilst this diagram references mortgage pools by way of providing an example, CDOs invest in pools of assets across the entire spectrum of economic activity: from mortgages and other forms of consumer debt to corporate and bank obligations. Contrary to claims in the popular press, CDOs are NOT vehicles that invest solely in sub-prime mortgage backed assets.



Loss expectations jump...

...impacting on other credit ratings ahead of defaults.

Structured credit continues to face challenges.

A word on losses on US mortgage pools

S&P¹ has revised their expectation of cumulative losses of the underlying 2006 sub-prime mortgage pools to 19% and state that actual realized level of losses is 1.13%, while delinquencies are at 29%.

S&P use the latter as a leading indicator of future losses alongside house price assumptions amongst other things. This revision from much lower loss expectations is what has impacted the credit ratings of other securitisations which in turn has driven down the valuation of many securities — not necessarily with any exposure to the housing sector— as the market takes stock of the Rating Agency projections of loss.

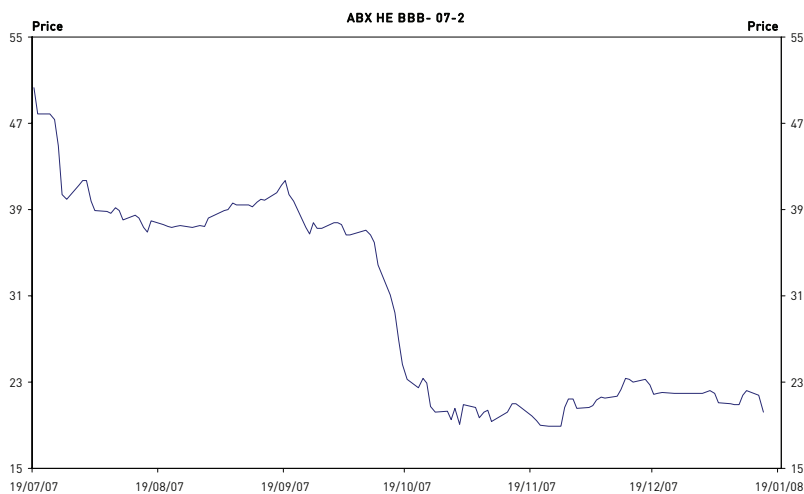
Structured Credit Comment

Over the last 3 months the structured credit market has continued to face challenges as the financial system has moved from a liquidity crunch to what now is starting to look more and more like a full-scale credit crunch. Many market commentaries focus on the problems in the US sub-prime mortgage sector but this risks missing the broader issue that we see which is an accelerated

1. refer to their 15 January press release

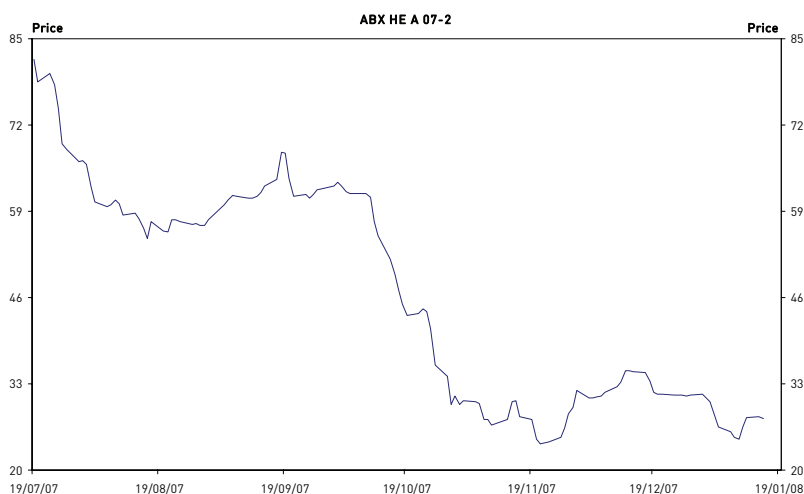
Markets experience systemic issues...	<p>deleveraging of the banking system, the effects of which are permeating to all corners of the financial markets including:</p> <ul style="list-style-type: none">→ A USD200bn backlog of corporate loans yet to be placed;→ Declines in Asset Backed Commercial Paper;→ A widening in credit spreads across most products including the spread of Libor (where banks lend to each other) against Federal Funds rates; and,→ The impacts on money market funds holding AAA-rated securities whose ratings have been slashed well beneath investment grade.
...leading to a run on a UK bank.	<p>The knock-on effect led to the first run on a UK bank for 150 years as investors queued for days to withdraw their savings from Northern Rock. In Australia the share prices of Listed Property Trusts have been marked down severely as global liquidity concerns curtail their ability to access the debt markets.</p>
Magnitude of ratings downgrade stunned investors.	<p>We did see some signs of capital returning to the market in September and early October to buy cheap/distressed assets but the repeated waves of rating downgrades took away the buying interest. What has stunned investors is not only the sheer volume of rating actions (around 20,000 separate downgrades in 2007, versus approximately 2,500 for 2006 according to Deutsche Bank), but also the degree to which rating downgrades are affecting the highest rated universe of securities - i.e. those initially rated AAA . This has sidelined many investors and the question of the survival of securitisation vehicles such as Special Investment Vehicles has returned to the spotlight.</p>
Illiquidity leads to SIV losses.	<p>It's worth revisiting the concept of a Structured Investment Vehicle or "SIV". These investment pools were created and for many years ran as a funding arbitrage, where the vehicle borrowed short term and invested long term in AAA-rated securities. The managers of these SIVs never intended them to be credit risk vehicles and many of them did not buy into sub-prime mortgage risk, either directly or indirectly. The holders of the short-term liabilities issued by the SIVs now find themselves in a potential loss situation as the underlying assets of the SIVs have been marked down heavily.</p>
Losses affect all parts of the CDO capital structure.	<p>What started as downgrades and price erosion on lower rated mezzanine / subordinated debt tranches has now migrated up the capital structure to the point where major banks, money market funds and Monoline insurers are writing down their AAA "super senior" holdings – a class of bonds that were perceived to be completely risk free, as they sat above other levels of AAA-rated securities. In a typical CDO issue these bonds were held on balance sheet by a bank or insurer because, at the time of issue, the credit spread was too low to attract external investors. The banks and insurance companies who hold billions of dollars of these previously innocuous bonds are now looking at potential write-downs of 30 to 40 cents on the dollar.</p>
Markets show severe price declines in structured credit.	<p>The charts on the next page show the price history for the BBB, A and AAA rated tranches of the ABX index. The price movement on the latter from mid-October is dramatic to say the least.</p>

The ABX BBB- index fell 60%



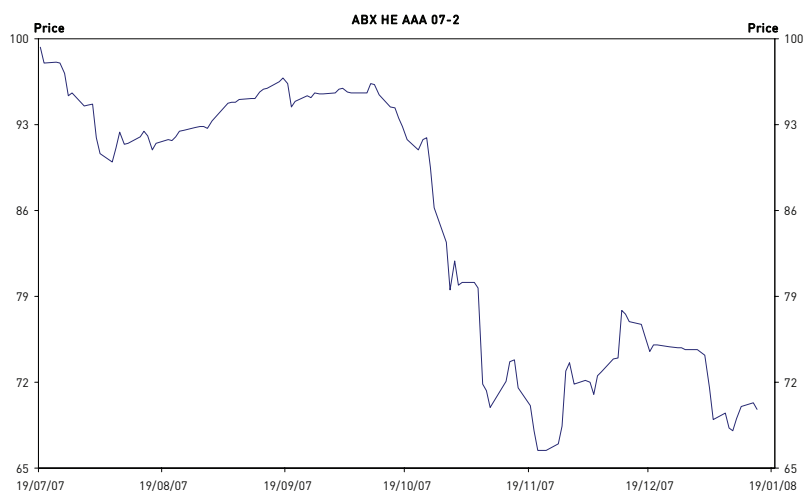
Source: Markit

The ABX A index fell 66%



Source: Markit

The ABX AAA index fell 30%



Source: Markit

Corporate credit remains relatively resilient, however...

Whilst the ABS market searches for support, we continue to see relatively resilient performance in the corporate loan sector. The rating agencies have signalled an expectation of higher corporate default rates across the coming year, which has been accompanied by widening credit spreads on loans. CLOs represent the bulk of the structured credit portion of the PacRim Fund and the cash flows from these holdings have remained stable over the last 6 months. The rolling 12 month default rate on secured corporate loans remains at historic lows of less than 0.5%. (The default statistic for 12 months ending December is 0.14% of US loan issuers as measured by Moody's).

...higher credit costs threaten balance sheets.

Looking forward we do see potential for stress on corporate balance sheets via higher credit borrowing costs (albeit mitigated somewhat by rate cuts) and the emerging probability of a recession. We continue to monitor the market and our portfolio for signs of deterioration.

Magnitude of market failure calls US Government to action but...

The final topic to touch upon is the long debated US Government bailout of the sub-prime borrower market. For many months commentators viewed as being too high the moral hazard risk faced by the US government if it bailed out the market. However, as the contagion risk has spread to all corners of the financial markets and now threatens the broader economy, the noise surrounding a concerted rescue package is increasing in a bid to address how best to assist those at risk of losing their homes. Whilst of concern to the regulators is the extension of credit to borrowers, it is becoming clearer that investors who relied on the rating agencies and the underwriting banks need confidence restored in the market before we see any signs of recovery.

...outcomes of rescue package unknown.

The outcome of the package heralded by US Treasury Secretary Henry Paulson will not be known for many months or even years and we would not be surprised to see a second round as the US moves into an election year. We have seen mixed reactions from the market as some participants see the package as a sign of genuine support from the Government, whilst others feel it will only delay the inevitable.

Looking ahead

Very few people foresaw the ferocity, magnitude and extent of the 2007 market meltdown. Capital markets have a long history of short, sharp shocks, but liquidity and confidence usually return to the system quickly. This time it may be different given the adverse systemic issues that prevail - and we find it difficult to identify a catalyst that will likely restore confidence quickly.

We will keep you informed of developments.

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