

## July—September 2007

Dear Investor

We are writing to give you an update on your Funds, to explain the extraordinary market events that have affected the Funds, from June into September, and to give you our thoughts and insights into where we're headed from here.

Before we look at specific events, we would like to address some of the inaccuracies about Basis Capital's Funds that you may have seen, heard or read in the media.

---

Pac-Rim Fund weathers storm  
and takes decisive action

---

### The Basis Pac Rim Fund

For the multi strategy Fund, it is business as usual to the extent possible, despite the extreme financial strains that asset markets globally are currently experiencing. The Pac Rim fund has:

- Met all margin calls;
- Fully paid all repurchase agreement (repo) financing lenders;
- Reduced debt to a level in line with conditions imposed on the fund by both the market and the Fund's two prime brokers;
- Sold approximately \$400 million worth of Asian and global high-yield securities, and unwound high-yield credit hedges (including CDX/ITRAXX and US Treasury short positions);
- Sold over \$US100 million worth of collateralised debt obligation (CDO) positions; and,
- Maintained our policy of marking to market CDO assets on a monthly basis, despite major disruptions in credit markets and despite our belief that many other funds are resisting adopting this approach.

High yield trading profitable but Structured Credit hurt

From a trading perspective, the impact of the \$US400 million high-yield selling and trading activity on the portfolio has been profitable for the Fund through July and August, despite the dislocated and illiquid market conditions. By contrast, the sale of the CDO positions crystallised significant losses, yet brought in much needed liquidity to meet margin calls and to weather the deteriorating conditions in global credit markets. Importantly, the Fund's trading activity in CDO assets has provided a clear and objective reference point for marking the remaining CDO assets in the portfolio.

Basis Yield Alpha in provisional liquidation

**The Basis Yield Alpha Fund**

As outlined in earlier Disclosure Notices, Joint Provisional Liquidators have been appointed to the Yield Alpha Fund. This step was taken by the Directors to protect the Fund's assets, and to maximise for Investors any surplus that might remain after the Fund's creditors have been paid.

Unfortunately, since the Joint Provisional Liquidators were assigned to the Fund, we are no longer able to provide commentary or information regarding the Fund's current or likely future situation. We must rely on updates provided to us by the Joint Provisional Liquidators, and we will forward to you any information we receive from them.

The Basis team remains united and is working hard, reassessing the changing state of markets and managing the investments of the Basis Pac-Rim Fund, all the while remaining mindful of the risks that currently prevail in credit markets.

Credit spreads blow out in Asian credit markets

**Specific events**

What follows is an account from the Fund's perspective of the events that have engulfed and seriously disrupted credit markets, and global financial markets generally.

**High Yield Asian and Emerging Markets Credit.**

The chart below highlights the cost of funds of a typical benchmark sub investment grade index of corporate borrowers, as measured by the credit spread over and above prime bank cost of funds. For illustrative purposes, we have used an index of Europe's liquid benchmark high yield credit borrowers (the index is the European crossover contract, ITRAXX series 6).



Source: Bloomberg Data

Investor confidence collapses and...

The Chart shows a doubling of credit spreads through July, which was a global phenomenon, where liquidity in high yield credit all but dried up, resulting in a massive flight to quality. US Treasury Bonds rallied hard, as investors and traders reallocated risk. A key focal point was July 12, when Rating Agencies S&P and Moody's downgraded sections of the outstanding ABS secondary market securities. Market sentiment collapsed as a result – further exacerbating the already severe retraction of liquidity from global markets.

liquidity evaporates

In Asia, liquidity in cash bonds evaporated in July – and the universe of BB and B rated issuers sold off measurably on little real volume. A case in point is the liquid 5-year Philippine Sovereign Credit Default Swap (CDS), which traded from a credit spread of 100 basis points, out to a high of 248 basis points.

To meet margin calls on structured credit holdings, the Pac Rim Fund responded by liquidating a substantial portion of its high yield cash investments and associated credit hedges.

CDO Investment part of a large and sophisticated structured credit market

#### **Structured Credit Markets**

In terms of the Fund's investments in Structured Credit and to provide some context of recent events, it's worth revisiting the scale of the CDO market:

- Greater than \$US2 trillion<sup>1</sup> of securities on issue; and
- Approximately \$US500 billion of new securities issued last year.

Orderly markets prevailed up until July

During the 2nd quarter of 2007 we saw strong performance from CDOs and CLOs with confidence returning after the February market disruptions in the ABS asset class particularly. Market activity was dominated by the inability of those that heavily shorted the ABS markets to realize (or monetise) their short positions. Reasonably orderly markets existed into June. However, once the market absorbed the extent of the dealer devaluations on CDOs and structured credit in July, accompanied by the retraction of dealer-provided liquidity and a lessening of investor confidence, market conditions deteriorated significantly.

BSAM a catalyst

**This is where the world turned on a dime – what appears to have started as one significant fund's (BSAM) need to raise capital to meet margin calls ended up being the catalyst that turned the market on its head. Normally, credit premia are the rewards for the risk of an asset. We now have a situation where liquidity premia dominate and have driven all asset prices dramatically lower regardless of quality.**

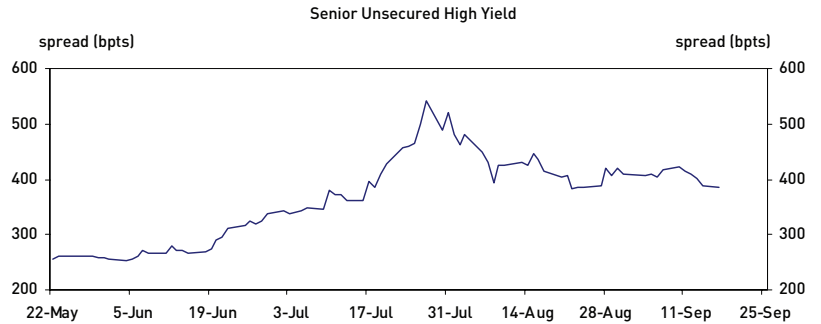
CDO equity prices indiscriminately marked lower

By way of example,<sup>2</sup> CLO equity, which had been trading at levels as high as 90c to 100c in the dollar in June were, by July, trading at 50c to 70c in the dollar – even though there had been no change in the level of corporate default rates. The ratings agencies report that the lagging 12 month corporate default rate remains around 0.2 per cent per annum.

1. Citigroup Fixed Income Strategy and Analysis, "Snap, Crackle Pop", September 2007

2. These examples are indicative only due to the diversity and specific characteristics of individual deals.

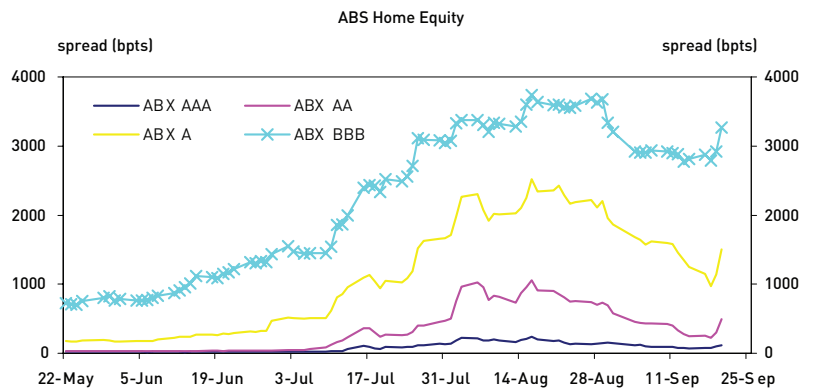
Rating downgrades trigger liquidity crisis



Source: JP Morgan Research

CDO equity of Asset Backed Securities (ABSs) that had traded at 70c to 80c on the dollar during May suddenly became completely illiquid, eventually being marked down to the 10c to 20c on the dollar levels that we see today. However, unlike CLOs, the fundamental credit valuations of certain pools – or “vintages” – of CDOs of ABSs had, in fact, declined. The rating agencies downgraded more than \$17 billion dollars worth of ABS bonds in one day. However, the downgrades primarily targeted sub prime loans originated in 2006. Nevertheless, even the prices of CDOs without these exposures were marked down.

Structured Credit Markets are not just about sub prime



Source: JP Morgan Research

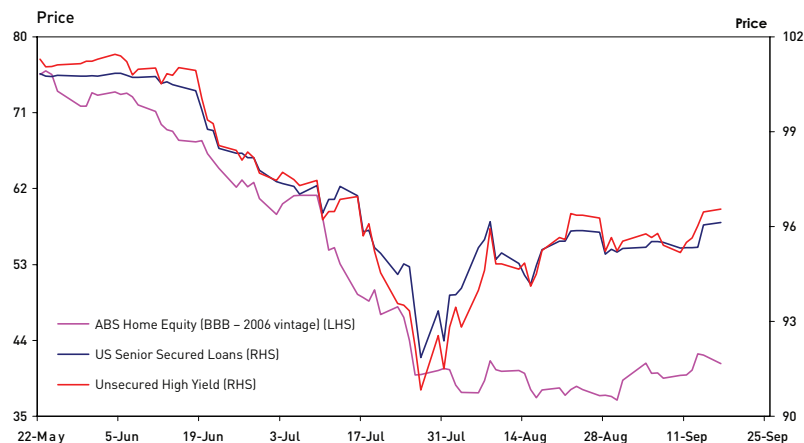
The press has thrown the sub-prime blanket over the whole structured credit market. Sub prime loans may have been the catalyst for the sell-off, but a global, general repricing of risk has overtaken this. Contagion has spread to many markets, including fixed income, foreign exchange and equity markets, right around the world.

Basis Funds were diversified but...

The Basis Capital Funds held a range of structured credit assets across various asset classes whose performance historically had low correlation. Importantly, Basis Capital Funds did not invest directly in sub prime mortgages or mortgage bonds. Any exposure to the mortgage market was via CDOs created and managed by experts – including groups such as BlackRock, TCW and Credit Suisse Alternatives. These entities are highly competent in the task of ensuring exposure to a diversified pool of assets and in the monitoring and managing those assets.

benefits of diversification overcome by contagion as...

However, the benefits of diversification and exposure to lowly correlated assets was overtaken, once contagion took hold, and once pricing became indiscriminate in the treatment of credit risk premia versus liquidity premia. All CDOs were thrown into a single basket, and devalued as if identical parts of one bigger whole. The chart below helps you appreciate the sudden convergence of price action across markets that had displayed historically low correlation amongst each other.



Source: JP Morgan Research

banks retracted liquidity and pulled down prices sharply...

Faced with a large volume of paper, the investment banks pulled prices down and turned to other customers that they were funding and lowered prices there, too. This triggered a wave of margin calls that Basis Capital's Funds, and funds managed by other firms, had never before experienced. In instances where Basis Capital had negotiated term financing arrangements with investment banks they reduced their exposure by aggressively and somewhat unilaterally marking down securities.

and destroyed the very markets they created

The CDO structured securities market, which had been created by the investment banks, was almost destroyed overnight by those same dealers. They became, in effect, judge, jury and executioner when it came to structured credit markets, placing themselves in the powerful position of marking, bidding and pricing securities for lending purposes where they deemed fit and devaluing the same assets that they themselves had created only weeks and months earlier.

It also seems that several of these dealers had taken short positions over the market and may have arguably exploited the position they were in – and banks started hoarding as much capital as they could.

CDO pricing is currently very difficult

Pricing and liquidity for CDO risk has all but vanished in the financial system, and the pricing of many assets remains disorderly, making values difficult to estimate.

Even holders of highly rated debt have been affected

It was not just CDO equity – or the first loss tranche – that has suffered. Even holders of CDO bonds including credit and high yield funds and in some instances Local Government Authorities in this country have seen:

- AAA-rated securities issued at 100c (par value) now valued at 90c to 95c in the dollar;
- BBB-rated securities issued at 100c (par value) now valued at 50c in the dollar or less, and
- A-rated securities issued from a Special Investment Vehicle purportedly valued at zero.

Contagion spread globally...

### The spillover

Conditions quickly started to deteriorate in late July and into August for assets that were not directly associated with the mortgage sector. By mid-July, the situation was so bad that it started to resonate across the globe. If one looks at major market indices, it's clear that contagion had started to take a grip – asset classes began to show high levels of correlation as many tried to either sell or at least hedge their risks, and reduce debt.

and more participants were affected

As more and more participants began to reveal the problems they faced, it just fuelled the problem. Asset managers like ourselves faced new challenges and dilemmas almost daily, as we tried to combat the seemingly irrational and illogical actions of investment banks.

Commercial paper markets have been hit...

The spillover, or contagion, became so severe that even investors in asset-backed commercial paper (ABCP), which is an extremely liquid short term market, went on a buying strike. By early August there was basically a complete blockage in risk financing.

and the Bank of England has acted as lender of last resort

The contagion spread to the UK, where the 8th biggest bank, Northern Rock, required support from the Bank of England, the UK financial system's lender of last resort. As recently as a month ago, market forecasters were expecting the US Federal Reserve to raise official interest rates to keep inflation in check. But on September 18<sup>th</sup> the Fed instead cut rates by 50 basis points to 4.75 per cent – the first rate cut in four years and a move it hoped would ease the financial crisis and pour some cold water on the global meltdown we find ourselves in the middle of.

Fed provided greater liquidity than after September 11

It's sobering to realise how much liquidity central banks have pumped into the financial system. In one day alone, the Federal Reserve injected twice as much liquidity into the system as it did on the day the markets reopened after the September 11<sup>th</sup> attacks.

---

Difficult to identify catalyst for recovery but...

### 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 returns to the system quickly. This time it may be different and we find it difficult to identify a catalyst that will likely restore confidence quickly.

value is emerging

Even so, some value is beginning to emerge in markets, and it is experienced asset managers who will be best placed to take advantage.

**Disclaimer:** The information contained in this Market Summary is for information purposes only and is not to be relied on as a recommendation or forecast by Basis Capital Funds Management Ltd (Basis Capital) or any related party. Basis Capital and its affiliates assume no liability for any inaccurate, delayed or incomplete information, nor for any actions taken in reliance thereon. Under no circumstances will Basis Capital and its affiliates be liable for any loss including, but not limited to direct, indirect, incidental, special or consequential damages caused by using the information. Nothing in this Market Summary should be construed as either an offer to sell or a solicitation of an offer to buy or sell any investments in any jurisdiction. Fund risks are outlined in the current Confidential Information Memoranda.