

Observation Deck

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Lawyers, Auctions, and Money

Adam Dean, CFA, President

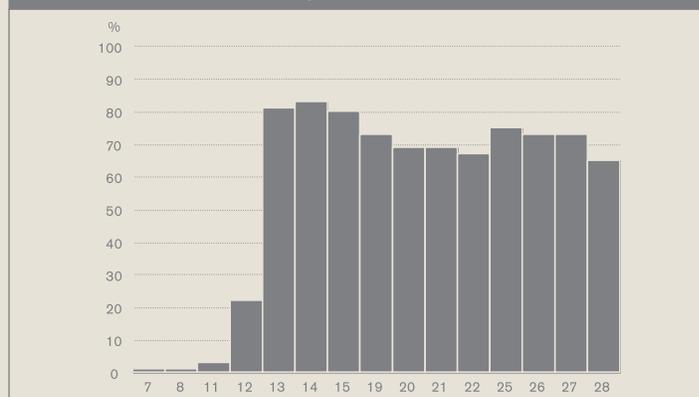
“I was gambling in Havana, I took a little risk
 Send lawyers, guns and money Dad, get me out of this...”
 Warren Zevon, *Lawyers, Guns, and Money*

Lawyers: As banks’ straight-faced explanations start rolling in of how clients’ most liquid assets, in the form of Auction Rate Securities turned into frozen assets, the lyrics of this song speak to us. We know ARS holders have lawyers; we can read that in the press and we hear it on the phone. From what we hear, those auction rate broker banks better get some too, and quick.

Auctions: The question so many of these investors have is a good one, and unfortunately it is one only the auction rate brokers can answer: *what did you know and when did you know it?* The premise being that these banks have known for months that their auctions were under pressure. There is now ample evidence that brokers have historically stepped in regularly to make these auctions whole. In February, when it was clear the tide against them would only continue to rise, they simply stopped stepping in.

And this is where the question gets interesting: *why didn’t you tell your client what was happening with these securities?* We know the answers are going something like this: We underwrite them, we run the auction, we sell them, but the failures caught us totally by surprise. If that doesn’t work, we understand that some investors have been told by their auction broker that they were only selling what their supervisors pushed them to.

Failed auction rate security auctions



Source: BoA, Reuters, DJ Newswire, Bloomberg, MarketAxess

Money: As in, when will investors get it back? This is one of the more frustrating questions because and we don’t have an effective answer here. We don’t believe anyone does. The situation today seems remarkably fragmented, right down to the issuer. While FFELP guaranteed student loans seem like particularly strong credits, nobody can say for sure if that means investors will get their money sooner, or if because the “penalty” rates are relatively low, later.

We understand that the offending brokers are offering their affected clients margin loans at the market rate as a replacement for the locked up cash. We also understand that being asked to pay interest to the broker who locked up your cash in order to get access to that cash makes for a heated conversation.

Our attention now turns back to whether we can expect another shoe to drop. We focus much of our credit energies today on the financial sector and whether we see the potential for credit downgrades to turn into credit defaults. For the credits our clients hold, our answer today is clear: No, we don’t see that potential.

SAM’s credit process is entirely independent from our Portfolio Managers’ trading decisions, allowing our Head of Credit Research to focus solely on creditworthiness. We feel the removal of any pressure to approve a credit because it is “cheap” plays a central role in our goal of avoiding any subprime or liquidity issues for our clients. We feel this analysis is time extremely well spent. While global investment banks have written down close to \$200 billion so far, there is a chance they are not close to done, and perhaps not even halfway there.

Markets

Treasury Rates

3-Month	1.84%
6-Month	1.82%
2-Year	1.62%
5-Year	2.47%
10-Year	3.51%

February Total Returns

ML 3-Month Treasury	0.15%
ML 6-Month Treasury	0.27%
ML 12-Month Treasury	0.52%
S&P 500	-3.25%
Nasdaq	-4.85%

Source: Bloomberg, as of 03/03/08

Economic Vista

Ninh Chung, *Portfolio Manager*

Existing-home sales in January showed a slight rebound as last month's figure dipped by 0.4 percent to 4.89 million, compared with market expectations for a larger decline to 4.80 million. Additionally, the prior month figure was revised slightly higher to 4.91 million from the previously reported figure of 4.89 million. Sales of previously owned homes however, are 32.6 percent below their September 2006 record high and 23.4 percent below their level of last year. Surprisingly, retail sales in the U.S. rose in January, despite the sluggish existing-homes sales of the same period. In January, retail sales increased by 0.3 percent as the Commerce Department reported that spending was led by purchases of automobiles, clothes and gasoline. Excluding the volatile automobile and gasoline components, purchases were unchanged from December 2006.

On the inflationary front, in January consumer prices increased more than forecast, sparking concerns that inflation may not be behind us. The 0.4 percent increase in the Consumer Price Index in January was led by a jump in food and energy costs. While inflation figures are viewed as lagging indicators and have largely been expected to decline as the economy continues to cool; these new readings will weigh in more as the decision on overnight rates is made at the Federal Reserve Open Market Committee meeting. The FOMC will next meet on March 17 and 18 and the consensus is for further cuts to the target overnight rate.

Credit Vista

Melina Hadiwono, *CFA, Manager of Credit Research*

The recent headlines regarding rising credit card delinquencies have understandably sparked concerns about the creditworthiness of asset-backed credit card securities. Because of this we wanted to share our interpretations of credit card performance. The overall credit card trust performance remains strong despite some weakening in performance.

According to the November 2007 Moody's Credit Card Index, the charge-off rates remain below 5 percent compared to the long-term average of 5.5 percent. Both charge-off and delinquency rates are expected to continue to increase in the coming months, relative to the exceptionally low levels reported in 2006. This is due to the new consumer bankruptcy law which makes it more difficult for consumers to discharge debt under Chapter 7. Effective in October 2005, this new law pulled forward many of the bankruptcy filings that would have occurred after the new law became effective. That change had a pronounced and sustained effect on delinquency and charge-off rates where in late 2005 the charge-off rates rose appreciably to above 7 percent, then fell dramatically to approximately

3 percent in the beginning of 2006. The expected rise in charge-offs will depend on what degree the economy slows.

The excess spread (i.e. yield less interest, the servicing fee and charge-offs) remained robust by historical standards. For 2007, the one month excess spread margin averaged 7.8 percent through November 2007. The long-term average excess spread is about 5.75 percent. This excess spread provides a cushion against portfolio deterioration and is a form of credit protection. It is a good proxy for the overall health of the trust.

One of the warning signs of a deteriorating credit card ABS security is when the excess spread is negative for three consecutive months. Under this scenario, the conduit would start paying down principal on the AAA tranches. The subordinated tranches would not receive any interest payments until principal is received by the AAA tranches. That is one reason why SAM chooses to invest only in the AAA tranches. Based on the above factors, we are comfortable with the quality of the asset backed credit card securities that we have invested in on behalf of our clients.

Trading Vista

Minh Trang, *CFA, Portfolio Manager*

Short-term yields held steady in February, after falling precipitously in the previous month. The 30-day LIBOR fell 3 bps to 3.11 and the one-year LIBOR declined 11 bps to 2.70. Traders were a bit more subdued during February, with many anticipating an additional 50 bps cut at the Fed's next meeting. Top-tier commercial paper traded at LIBOR minus 10-15 bps. Treasury bills cheapened up with the one-month T-bill yielding 2.04 percent at the end of the month, up 10 bps from January.

The two-year Treasury note remained flat, with yields hovering between 1.91 to 2.05 percent throughout the month. Spreads on corporate bonds in the one to two-year area have widened on financial names as negative headlines continue to hit monoline insurers and the failures in auction rate securities. One-year financials are trading at the 3.00-3.30 levels, while two-year financials are at 3.15-3.45 levels. We have seen spreads against LIBOR on credit card ABS widening to the +60 to +80 basis point range, with the bid/offer spread climbing to +50 to +80 bps.

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