

Observation Deck

November 2007

SIVs Take Center Stage

Ninh Chung, *Portfolio Manager*

Just as the market was navigating out of this summer's credit and liquidity crunch, a new event injected further concern into the stability of the credit markets. This time it was not the large mortgage debt market (\$4.7 trillion) that garnered the attention of the press, but the much smaller \$400 billion Structured Investment Vehicles (SIVs) market that had investors fearful. These developments left us asking: Are these concerns justified and what should investors do in times like these? This month's *Observation Deck* provides information to our clients on how to best address these questions given their specific investment objectives and risk tolerance.

SIVs were created in the late 1980s with a CDO-style structure and limited liquidity back-stop. They were designed to generate investment returns through yield curve arbitrage by acquiring low cost funds from the issuance of short-dated asset-backed commercial paper (ABCP) and medium-term notes, while simultaneously purchasing high grade medium- to long-term fixed income assets. Riding the yield curve and "rolling" commercial paper is a very lucrative source of income for banks and financial institutions — as long as ABCP investors continue to come back into the market.

Recent shrinkage in the ABCP market has placed tremendous stress on SIVs' ability to repay maturing liabilities. Adverse market conditions could cause outright defaults, as evidenced by this month's casualties of Cheyne Capital Management Ltd. and IKB Deutsche Industriebank AG. Further, defaults may

ABCP Outstanding



Source: Bloomberg, SVB Asset Management

lead rating agencies to take downgrade actions, thus leading to a worst case scenario of forced liquidations of SIV assets.

A consortium including Citigroup, Bank of America, and JP Morgan has proposed a rescue plan to address the illiquidity impacting the SIV debt market, agreeing in principal to create a master liquidity enhancement conduit (M-LEC). Public information is not yet available, although the conduit — dubbed SuperFund — is expected to provide liquidity to participating SIVs through purchases of SIV assets at market value. Several sources have estimated \$100 billion in maturing debt will come due in the next 6 to 9 months, which adds tremendous economic benefits for the SuperFund to be established as quickly as possible.

While SVB Asset Management has not directly invested in any of the 30 SIVs, some of the money market funds we utilize do hold a small percentage of SIVs in their portfolios. As part of our fiduciary responsibilities, we have been in regular contact with the fund complexes SVB Asset Management utilizes and are very comfortable with the respective funds' ability to meet the following essential components:

- Maintain their \$1.00 NAV regardless of the limited exposure to SIVs
- Maintain their credit ratings
- Provide immediate and on-demand liquidity
- Maintain their current competitive return

In times of uncertainty, we encourage you to review your investment portfolio thoroughly and understand the risk profile of your assets. Additionally, your portfolio manager and portfolio advisor welcome the opportunity to discuss your portfolio in detail with you.

Markets

Treasury Rates

3-Month	3.91%
6-Month	4.07%
2-Year	3.95%
3-Year	3.92%
5-Year	4.17%
10-Year	4.47%

October Total Returns

ML 3-Month Treasury	0.30%
ML 6-Month Treasury	0.40%
ML 12-Month Treasury	0.31%
S&P 500	1.59%
Nasdaq	5.89%

Source: Bloomberg, as of 11/01/07

Economic Vista

Minh Trang, *Portfolio Manager*

The housing market continued its slump as September existing home sales fell 8 percent over the previous month. Durable goods orders declined 1.7 percent in the month, after a 5.3 percent drop in August. Accordingly, consumer confidence fell to a 2-year low of 95.6 in October. However, the two bright spots in the economy have been steady employment and retail sales. The economy produced 110K jobs in September and August was revised up to 89K. Advance retail sales in September rose 0.6 percent, exceeding expectations.

Though inflationary indices have moderated, commodities and energy prices rose into record territory in October. Gold continued its upswing well past \$775/oz., while crude shot over \$90/barrel.

The Fed's 25 bps ease to 4.5 percent on Halloween was widely anticipated. The FOMC commented that "the upside risks to inflation roughly balance the downside risks to growth." It seems the Fed is hoping that the cut will be enough to forestall some of the adverse effects from the slumping housing market. The Fed's next and final meeting for the year will be in December.

Credit Vista

Melina Hadiwono, *Manager of Credit Research*

Continued market volatility and the disappearance of liquidity for many hard-to-trade securities have motivated investors to focus closely on how financial companies are valuing the assets on their balance sheet and their trading profits or losses. Financial firms facing this scrutiny are arguing that the absence of liquidity creates distressed sale situations and that the quotes they receive do not represent fair value. Big Four accounting firms, bolstered by guidance from the Center for Audit Quality, are taking the stance that lack of liquidity does not represent a distressed sale situation and that observable quotes represent fair value.

Stepping in to address the dispute, FASB's new fair value accounting guidance FAS 157, becomes effective for fiscal years beginning November 15, 2007 and seeks to standardize the way the companies arrive at the estimate of the fair value.

These disclosures require all assets and liabilities measured at fair value to be based on a three-level hierarchy of pricing input. Level 1 represents the most observable prices via active markets, Level 2 includes prices derived for similar, not identical, items and Level 3 utilizes 'unobservable inputs' when active quotes do not exist. While designed to support uniformity of practice for financial companies, we are concerned that the extremely variable conditions under which the valuations are being made at Level 3 may not result in companies using the same valuation methodologies and assumptions. Although these disclosures are an improvement over previous disclosures, we recommend that all companies require multi-factor independent pricing sources from their asset managers and brokers and that this pricing methodology be vetted by a Type II SAS 70 at least annually.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

Spreads have started to normalize on high-quality financial issuers, but we are still seeing wider spreads on issuers that have any involvement in mortgages. Commercial paper yields have steadily declined as Fed funds futures are pricing in a 50 bps cut by year's end. Yields started the month in the 5.08 percent to 5.20 percent range and ended the month at 4.55 percent to 4.80 percent, both peaking in the 90-day area. Money funds have slowly declined as securities in their portfolios have been resetting lower and LIBOR rates have dropped 40 bps across the curve. A-rated corporate bonds in the one- to two-year range have been hovering at a spread of 90 to 100 bps over the 2-year Treasury benchmark. Though yields are dropping due to the impending Fed cuts, solid investment opportunities in term securities still exist.

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