

Observation Deck

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Why We Invest in Financials: A Credit Perspective

Melina Hadiwono, *Manager of Credit Research*

The subprime mortgage maelstrom swirling around major financial institutions for the past month is continuing unabated heading into December. While major firms like Citigroup Inc. and Merrill Lynch & Co. grapple with multibillion dollar write downs from failed mortgage security investments, major ratings institutions have moved to downgrade these and other high profile firms. Understandably, this sparked concerns about the creditworthiness of the financial sector as a whole.

Because of this we wanted to share our interpretation of the recent events, why we don't invest in RMBS, CDOs, ABCP and auction rate securities and further explain why we do invest in the financial sector more regularly than other sectors.

The credit markets have been challenging for most financial companies with exposure to U.S. subprime related assets. The main hits to earnings were related to valuation losses on residential mortgage backed securities (RMBS) and related CDOs, driven by securitization warehousing or ineffectively hedged trading exposures. The credit performance associated with the housing and mortgage sectors are the underlying factors for these products and valuations. Furthermore, the leveraged finance liquidity crunch in June 2007 left dealmakers with significant pipelines of hung deals that also had to be written down. Although liquidity has gradually returned to the leveraged finance market since September, reducing the potential need for additional write-downs, exceptional market volatility in RMBS and CDOs creates concerns about the adequacy of recent asset valuations.

Even though many financial institutions are facing earnings pressure, most of these firms still have solid financial fundamentals. In the previously benign credit environment, these major financial institutions enjoyed satisfactory profitability, a bolstered capital base, diversified funding sources, stronger liquidity positions and improved risk management capabilities. In addition, their business and international diversification helped mitigate weaknesses in any other areas. In general, financial companies have a vested interest in maintaining strong credit ratings in order to have access to cheaper funding and broad funding alternatives. In addition, the financial companies are heavily regulated entities which need to meet the requirements set by the regulators to preserve public confidence in the banking system and securities markets.

To address the current challenges, financial companies have taken proactive measures such as increasing their loss provisions, scaling back mortgage business, making changes in management, internally restructuring, cost rationalization and scaling back on share repurchases or dividends.

Markets

Treasury Rates

3-Month	3.14%
6-Month	3.35%
2-Year	3.00%
5-Year	3.38%
10-Year	3.94%
November Total Returns	
ML 3-Month Treasury	0.47%
ML 6-Month Treasury	0.68%
ML 12-Month Treasury	1.00%
S&P 500	-4.18%
Nasdaq	-6.84%

Source: Bloomberg, as of 12/03/07

We expect to see continued market dislocation and that certain sectors of the capital markets may remain depressed for an extended period. This potential adverse effect may negatively impact the earning levels of financial companies for the next several quarters. If market conditions further deteriorate or if economic prospects weaken materially, the credit ratings for financial companies could be exposed to broader downward pressures.

It is clear that the market is in a downward credit cycle; however, the good news is that compared to previous cyclical dips the majority of financial companies are far stronger financially.

The financial sector is the primary issuer of debt in the short term space. By far, they simply dominate the landscape. When there is an opportunity to invest on a non financial issuer, the yields offered are typically 10 basis points or so lower.

One of the ways we mitigate risk is by limiting the exposure to any single issuer to around 3 percent. In addition, we mitigate default risk by maintaining portfolio investments in high-quality (rated A or better), investment-grade securities with shorter maturity cycles. Finally, we are continuously reviewing ratings for our approved issuers to ensure we can react quickly to a credit event, such as a watch or downgrade.

Thus, even though there may be more headline announcements for financial companies going forward, we expect that the probability for nonpayment and principal risk is extremely low.

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 with you in detail.

Economic Vista

Joe Morgan, CFA, Head of *Portfolio Management*

Economic data released this month continues to show an economy demonstrating flashes of strength despite decaying fundamentals stemming primarily from the housing sector. Employment growth bounced back as evidenced by October's 166,000 increase in nonfarm payrolls while building permits and average home prices declined indicating continuing slowdown in the housing sector.

Meanwhile, the Fed released their first three-year economic forecast along with the minutes from Halloween's Fed meeting. While this forecast is certainly not to be taken as a target, one may assume that three years from now is far enough into the future to indicate where the Fed would prefer the economy to be as there will have been plenty of time for Fed actions to take effect.

In essence, the Fed sees inflation at 1.6 to 1.9 percent and growth between 2.2 and 2.7 percent in 2010. These estimates agree with our view that the Fed prefers inflation to remain lower than 2 percent and that growth will be lower than the 3.3 percent average during the Greenspan era. But we remain dubious about their view the economy will recover slowly in 2008 and 2009, as this will necessarily require a clear rebound in the housing sector, an event that remains hard to pinpoint unless the Fed continues to aggressively cut interest rates. This also seems unlikely unless consumable prices such as oil and copper moderate quickly.

Credit Vista

Melina Hadiwono, *Manager of Credit Research*

Following an exceptionally slow summer for U.S. bond market supply, the investment grade bond issuance roared back in September and was joined by an increase in high yield issuance in October. Having sat largely on the sidelines for three months, investors have money that needs to be put to work and with all the turmoil surrounding the structured investments market, the traditional cash bond market has been in great demand. Based on Thomson Financial data, the total fixed-rate bond supply for October came in at \$97.2 billion, which was up over 103 percent from October 2006. Year-to-date through October, bond volumes increased by 46.7 percent to \$668 billion compared with the same period in 2006 when investment grade issuance reached \$528.7 billion. On a year-to-date basis, high-yield volumes reached \$139.3 billion, up 13.3 percent compared to the same period in 2006 after lows in July and August 2007. In terms of maturity schedule, there was an increase in volumes falling into the 5-year maturity bucket, with an offsetting decrease in those deals with a 30-year maturity.

Year-to-date corporate bond issuance has reached the following volumes: 9 percent for maturity below 5-year, 26 percent for 5-year maturity, 45 percent for 10-year maturity and 21 percent for 30-year maturity. In terms of breakdown by sector, the issuance statistics within the investment grade sector were largely in line with the usual distribution. Financials continue to make up the bulk of the volumes with year-to-date issuance representing 51 percent. Despite headline news which has roiled the investment grade market, demand for new issues remained strong as investors continue to soak up the paper. Consumer, utilities, and industrial sectors represented 14 percent, 13 percent, and 5 percent respectively. While demand has been drying up in certain structured credit markets such as SIVs and asset-backed commercial paper (ABCP), the demand for primary traditional cash bond market continues to be strong in the current credit crisis environment.

Trading Vista

Debi Hanson, *Portfolio Manager*

As financial institutions continued to announce subprime driven write-downs in their investment portfolio, spreads between Treasuries and LIBOR widened further as the market and investors continue to find risk in the market. Three-month LIBOR rose 24 basis points from 4.89 percent to 5.13 percent this month and is a whopping 198 basis points over the 3-month Treasury Bill. As a result of this, commercial paper levels have risen in this maturity. Three-month maturities currently offer the highest yields available as the curve inverts going out to one year. One-year LIBOR is at 4.46 percent.

Corporate spreads have also continued to widen and liquidity is scarce in the secondary markets. One-year, single-A corporates in the banking and finance sector have widened from LIBOR plus 10 basis points to LIBOR plus 30 or more depending on the name. Credit card ABS spreads have also widened this month and are currently trading at about LIBOR plus 25 to 35 basis points.

At this time we do not see signs of any real stabilization in spreads, nor any let up in the flight to quality rally in the treasury markets. We continue to watch for data up to the December 11 Federal Open Market Committee (FOMC) meeting and any news that may increase the probability of another rate cut.

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