

THE NEW FACE OF LEVERAGE IN THE FINANCIAL SYSTEM

In the past two decades, the capital markets have grown immensely in their complexity and sophistication. The growth and evolution of the derivatives markets, of securitized products, and of CDO markets have created new risk-transfer mechanisms that have had immeasurable impacts on the ability of investors to isolate and manage various forms of risk. These advancements have vastly improved liquidity in the capital markets, easing financial conditions for investors, businesses, and consumers alike. However, these new financial products have also helped create the means for various entities to assume large amounts of leverage, and to do so relatively inexpensively. The degree of leverage built into the financial system today has created its own unique risks, some of which have recently begun to reveal themselves to investors.

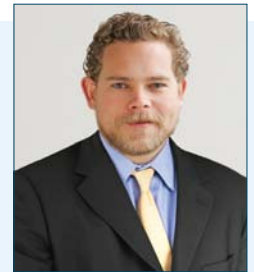
To a corporate credit analyst, leverage is generally defined as a company's debt-to-equity ratio, and, by that measure, leverage in the corporate bond market today is near its lowest level in decades. Earnings growth has been strong, and many companies have reduced outstanding debt. Indeed, in the past several years we have seen impressive improvement in the balance sheets of American corporations, and this is a large part of the reason that credit spreads have recently approached their tightest levels in a decade. However, this trend may now be in the process of reversing itself. The pace of leveraged buyouts has become fast and furious in recent months, with \$188 billion worth of LBOs announced just in the first quarter, according to Bloomberg. Meanwhile, numerous companies have announced or expanded stock buyback programs, some of which have been financed with debt, as these companies seek to increase shareholder value. While most corporate bond investors still agree that corporate balance

sheets have the strength to withstand modest increases in leverage, nobody likes to see it actually occur.

Other parts of the U.S. economy have shown much less restraint. Consumers, for example, have been on a massive shopping spree that has sent the personal savings rate into negative territory every month since April 2005, according to the Bureau of Economic Analysis. Many have purchased homes they can't afford, while countless others have refinanced their mortgages into higher-proceeds loans in order to monetize accumulated equity. Thus far, the spending habits of consumers have been supported by personal income growth arising from tight labor markets, but the income gains haven't kept up with expenditures. According to the Federal Reserve, household debt payments have risen to nearly 15% of disposable income, higher than at any time since the Fed began compiling this data.

Inasmuch as the intended purpose of leverage is to increase the profit potential for a given venture, the consequence of leverage is a sharp reduction in the margin for error. Individuals seeking to profit from the housing boom during the first half of this decade had taken out large amounts of debt to maximize their real estate holdings. The recent spike in mortgage defaults is in no small part a symptom of increased leverage among consumers.

Investors have become acutely aware of the risks that leverage poses to the consumer sector: homebuilders and consumer finance companies were among the worst performers in the financial markets during the first quarter. Concerns that a troubled mortgage industry and a weak housing market will threaten the health of the overall economy also caused stock markets to falter, volatility to spike, and credit spreads to widen from their recent tightness.



Derrick Wulf, CFA
Sector Portfolio Manager

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- ▶ It was a different form of leverage, however, that caused the most damage during the first quarter, and this kind of leverage has many investors worried about greater risks to the financial system.

The securitization of assets, such as mortgages or other receivables, has drastically expanded the market for loans and has created an efficient means by which issuers can manage portfolio risk and investors can share in the earnings. Securitization has vastly improved liquidity for such assets, broadening the range of financing options for lenders and ultimately lowering the cost to borrowers. The tranching of securitized debt has also created a credit enhancement mechanism that allows significant portions of a deal to be cushioned from the risk of losses in the underlying collateral. In fact, the senior classes of securitized products have proven to be extremely safe and stable investments. The subordinated classes, however, particularly those near the bottom of the capital structure, have in recent months experienced a great deal of volatility.

The most subordinated tranches of an asset securitization are in effect highly levered to the performance of the collateral pool. Investors who own the very bottom of the capital structure of an asset-backed deal can lose their entire principal, even if the vast majority of the loans never become delinquent. These types of classes caused the most pain for investors in the subprime mortgage market as defaults rose in the first quarter.

Likewise, collateralized debt obligations (CDOs) buy debt securities, pool them together, and issue new securities backed by the pool of debt. In the asset-backed market, CDOs have typically purchased mezzanine classes of asset-backed deals, specifically the tranches rated BBB by the rating agencies. Some CDOs even buy the mezzanine tranches of other CDOs (those deals are often referred to as

“CDOs squared”). The diversification achieved by purchasing bonds from different deals sold by different issuers, coupled with a senior/subordinated tranching structure, allows these CDOs to create large senior classes of securities rated AAA. But the lower-rated classes are again levered to the performance of the underlying collateral—in this case, securities that are themselves already a form of leverage. And if correlation in an asset class is high, the diversification doesn’t help much.

Because of their relatively high yields, these types of securities have become quite popular among investors, particularly among hedge funds that may themselves employ various forms of leverage in their portfolios. The demand for these securities has pushed spreads significantly tighter over the past several years. Improved pricing efficiency has increased the CDOs’ demand for asset-backed securities, which in turn has driven the pricing on the assets used to create these securities. These forces have contributed to the decline in underwriting standards that many now blame for the significant rise in defaults in the subprime mortgage market. Similar trends in underwriting have also been seen in commercial mortgages, where the average underwritten loan-to-value ratio, a measure of leverage on secured loans, has been driven to all-time highs.

One can see where this is going. Leveraged investors buy levered bonds, which are backed by different levered bonds, which are backed by levered assets. This scenario leaves a razor-thin margin for error. But while financial innovation has amplified some of the risks associated with traditional investing, it has also created the means to hedge those risks. Credit default swaps, for example, allow investors to buy protection against defaults on the

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- ▶ securities they own. As the mezzanine classes of CDOs and asset-backed securities plummeted during the first quarter, credit default swaps referencing those types of securities soared.

When leverage is taken on recklessly, significant losses are likely to follow. But when leverage is used to improve financial flexibility within the context of a disciplined risk-management process, it can be a powerful tool. The key to successfully navigating the complexities of the modern financial system is a thorough understanding of these tools, the risks they present, and the opportunities they create. ■

*Written by Derrick Wulf
Sector Portfolio Manager*

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For more information:

Fixed Income & Stable Value

Greg Prisk
Executive Vice President
802.383.4104
gprisk@dwright.com

David Richardson, CFA
Managing Director
802.383.4024
drichardson@dwright.com

Insurance

Donald Hill
Senior Vice President
802.383.4062
dhill@dwright.com

John Loud

Vice President
802.383.4047
jloud@dwright.com

Consultant Relations

Lisa Trubiano, CFA
Senior Vice President
802.383.4066
ltrubiano@dwright.com

Anicia Mendez

Vice President
802.383.4067
amendez@dwright.com

100 Bank Street
Suite 800
Burlington, VT 05401
802.383.4000

One SW Columbia
Suite 1720
Portland, OR 97258
800.929.4427

www.dwright.com