

TOO GOOD TO BE TRUE?

TERM ASSET-BACKED SECURITIES LOAN FACILITY (TALF)

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Before delving into our discussion of the TALF program, we believe it prudent to make a few introductory comments regarding the design, focus, and goal of this paper. As one could imagine, the analysis of any government program could degenerate into a mind boggling and utterly confusing task. Therefore we believe the greatest value we can add in this regard is to stay focused on the big picture considerations of the TALF program from the standpoint of an institutional investor serving on a Board or Committee.

So the goal of this paper is not to delve into potentially vast specifics of the TALF program, but to provide the salient information necessary for fiduciaries to decide whether or not the TALF represents an appropriate investment opportunity for their fund. As such, we will provide a brief explanation for why the TALF exists, the basic mechanics of an investment in this program, an analysis of potential risks and how to mitigate them, and most importantly, how participation in the TALF could fit into portfolio structure.

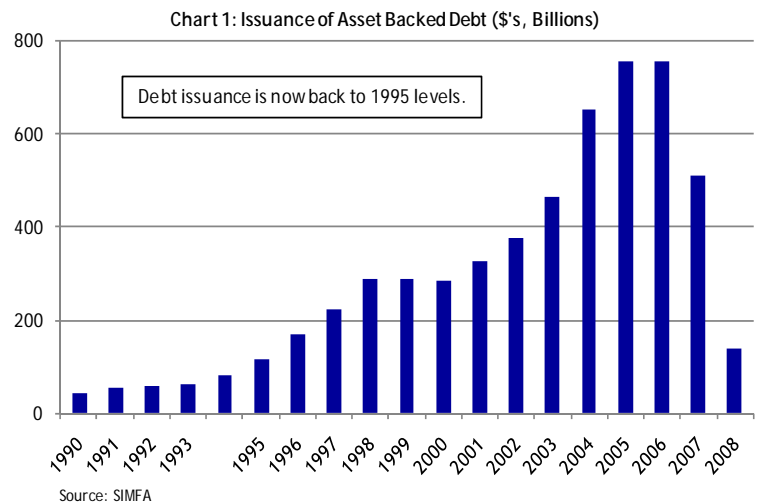
At the end of this paper we also provide some interesting philosophical interpretations of the TALF and its potential long term implications for the US economy. Though we would never ask our clientele to act on speculation, that does not mean such thoughts are uninteresting or devoid of any entertainment value. After all, there is no reason to make research boring if you don't have to.

What is the TALF & Why Does it Exist?

Without getting into the myriad of economic problems facing the US economy, there is one very clear reason for the existence of the TALF – to revive consumer lending through direct government stimulus of the asset-backed securities (ABS) market. This is necessary because the issuance of ABS plummeted in 2008 (*Chart 1 below*), making it very difficult for cash strapped consumers to continue spending. Furthermore, the TALF seeks to drive borrowing rates lower in order to decrease total interest costs to consumers. The TALF will apply to student loans, auto related loans and leases, small business loans, equipment loans, consumer credit cards, and commercial mortgages. It is important to note only newly issued AAA-rated securities will be eligible for inclusion in the TALF program, not existing ABS securities, and that the program is slated to end on December 2009.

The structure of the program is actually quite simple if you think about it from a big picture point of view. Essentially the Federal Reserve (Fed) is stimulating ABS issuance by offering two very powerful incentives to investors:

- 1) Highly levered loans to purchase ABS securities that are not subject to margin call, and
- 2) Substantial reduction of risk for the first three or five years¹ of the investment through a free “put” option to the Federal Reserve on collateralized assets.



More specifically, the Fed is willing to provide 6x-20x leverage (or loans) at rates well below the interest earned on the ABS security used as collateral, and will do so without margin calls for a period of many years. Thereafter investors can pay back the loans and hold these investments to fruition, or “put” the collateralized securities to the Fed should market conditions sour, thereby limiting potential losses to their initial investment and interest costs, as opposed to the entire value of ABS position.

In other words, if an investor is willing to use a little of their own money to purchase ABS securities, the government will provide cheap leverage to dramatically enhance the return potential on invested capital, while at the same time substantially limiting downside for period of time. This is why the title of the paper is “Too Good to be True.” This really is a rare and unique investment opportunity. It is not often investors get the opportunity to participate in the upside of leverage while at the same time being able to walk away from the downside and not having to worry about potential margin calls in the meantime. The actual mechanics of such an investment are outlined in the section below. Before we get into those details, let’s discuss how this program’s design should achieve its intended goals.

Recall the TALF’s first goal is to reinvigorate ABS issuance by drawing investors back into this marketplace, which should be accomplished through the combination of cheap and non-recourse leverage that is all but certain to attract investors. The government is essentially offering up free money (or excess risk adjusted returns) to potential investors, and there is no reason to believe this offer will be ignored. The real question is whether or not the TALF will simply provide a one-time stimulus to ABS issuance or whether it will get things back on track permanently.

The second goal of TALF is to lower borrowing rates for consumers, and we believe this is likely to happen given the structure of the program. This is due to the massive amount of leverage involved and its potential benefits to investors. We only need look as far as the hedge fund industry and our

¹ The duration of the TALF loan will depend on the specific ABS in question.

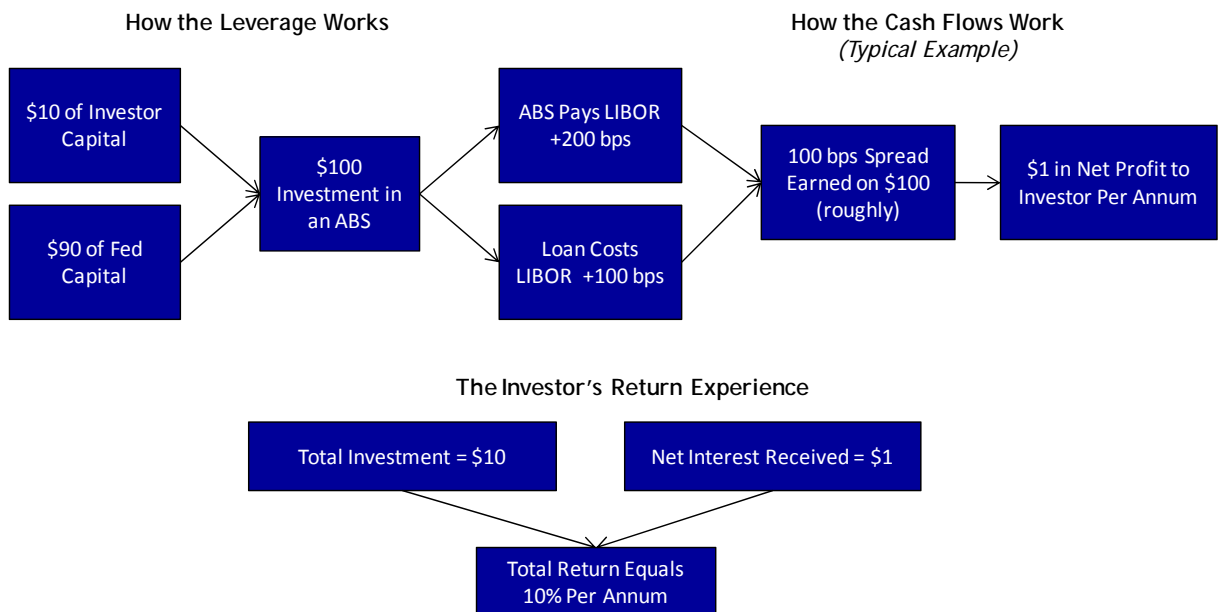
recent history in credit spreads to see how low yield premiums can fall when leverage is involved. The real difference now is the leverage is being provided by the Federal Reserve, as opposed to any banking institution that may or may not maintain this leverage or become insolvent should market conditions sour. So with cheap and effectively risk free leverage at their disposal, we can only assume investors will drive rates lower through increased demand for these securities.

The Mechanics of TALF – What Investors Need to Understand

As mentioned at the outset of this discussion, we are striving to describe the TALF in its simplest form. Albeit the specifics of any ABS investment under this program will vary dramatically due to associated lending costs and permissible levels of leverage, the graphic below describes the basic framework of this opportunity. Details beyond this level are best discussed if and when an investor is seriously considering an allocation to investment managers participating in this program. Although such details are important and should not be ignored, they are unnecessary for the purposes of understanding the TALF and determining if it is a worthwhile investment opportunity.

As you can see from the outline below, the driving force behind potential returns is the amount of leverage provided by the Fed. Basically the TALF allows investors to use a relatively small amount of capital to make a sizeable ABS purchase, which is subsequently financed by the Fed at rates lower than the interest received (*or at least expected to receive*). This leverage allows investors to make large returns on their invested capital, and when considering the non-recourse nature of these loans, it is an offer investors will likely find difficult to refuse.

Ironically speaking, this is about the same sort of “credit arbitrage” strategy formerly employed by many of the nation’s financial institutions and hedge funds that led to the current economic crisis. The big difference though is the Fed serves as lender, will not be making any margin calls, and has deeper pockets than any of those aforementioned institutions.



So the potential risks to this strategy are far smaller than working with private lenders subject to shifting conditions in capital markets. This is not to mean there are no risks to investors in this strategy.

The Risks

Before discussing the potential risk with a TALF investment, we must keep in the mind this program is designed to be as devoid of risk as possible in order to encourage rapid private investment into the ABS market. Of course participation in the TALF program does have potential downside.

Risk analysis can be broken into three broad categories. The first and most obvious is the risk associated with security due diligence and building a portfolio that is mostly duration matched to the lifespan of the TALF loans. Secondly the health of the US economy is a major risk factor, as it is not a great leap of logic to surmise that weakening household balance sheets would naturally lead to higher default and slower repayment of principal balances. The third risk is political in that the Fed is in complete control of the portion of this strategy that makes it so attractive - the leverage and put option of the TALF.

The risk on the investment management side of this proposition centers primarily on the quality and lifespan of the ABS security in question. For example, if an ABS is purchased that pays less interest or has greater defaults than expected, an investor could experience losses due to the interest costs on leverage. Additionally a manager could build a portfolio of ABS securities whose lifespan exceeds the life of the TALF loan either by design or through poor due diligence. In such an instance the investor would have to pay down the balance of the loan, which would not only reduce leverage and potentially require a cash infusion, it would also subject investors to far a greater level of risk as the put option to the Fed is only good for three or five years depending on the ABS in question. Both of these risks would be heightened should the US economy recede even further from current levels. These are significant risks to investors, but they can be materially mitigated through judicious security level due diligence and portfolio construction (*discussed in detail below*).

The other significant risk is political in nature, and is therefore essentially impossible to dimension. It is only natural that investors would question a financial arrangement with the Federal government, especially when the terms of this arrangement are so closely linked to what is becoming an ever increasingly political situation, or the whole distaste with government “bailouts” of private investors and institutions. Hypothetically speaking, the government does have the power to arbitrarily cease these agreements, change terms midstream, or enact any number of punitive tax and legislative measures against investors. Given the gravity of our economic turmoil and the fact this program is through the Fed (a non-partisan institution), political risks seem minimal. Moreover, the reputational damage to the government should they go back on their word midstream could very well be irreparable. Nonetheless, we simply cannot create financial models to dimension political risk. This is just something potential investors will have to bear in exchange for potential returns.

How These Risks are Mitigated

Mitigating the risks of poor due diligence can be materially accomplished through the selection of skilled investment management firms that are experienced in the ABS marketplace. Moreover, we believe much of the credit risk associated with TALF eligible investments (i.e., AAA-rated new issuances) is being mitigated by the credit rating agencies employed in this program...seriously. What is interesting nowadays with respect to ratings standards is that this industry has suffered a massive embarrassment resulting from the sub-prime crisis. As such the agencies being used for this program (Fitch Ratings, Moody's Investors Service and Standard & Poor's) are likely to be extremely conservative in their ratings of new ABS securities, lending more credence to the AAA-rating.

The other risk of mismatching asset lifespan with the duration of the TALF loans can be mostly offset through the stated portfolio strategy of the investment manager. The simple solution is to only allocate to managers that are targeting a portfolio lifespan of around three to five years. Of course some longer term assets will invariably be included by design or unforeseen circumstances, but given the potential magnitude of potential returns, this seems a reasonable risk to bear.

The risk associated with the health of the US economy is not something that should be addressed explicitly by investors within the context of an allocation to the TALF. Although this is a risk that should be considered at the total portfolio level, we believe it can be mitigated through the selection of a manager with a strong top-down research capability. We believe managers viewing the world from a top-down point of view are more likely to appropriately price assets in light of prevailing economic conditions.

Where Does TALF Fit?

The fact of the matter is TALF really does not fit into any sort of a convenient style box or asset class, but it does have a close cousin in the credit arbitrage strategy of the hedge fund universe. The key differentiating factor of course, is that hedge funds have to worry about margin calls and do not have a free put option on their holdings. So if forced to describe a TALF investment in a conventional sense, it would fall under the absolute return category. This is not only because the strategy emulates an absolute return hedge fund strategy, but also because the TALF is inherently designed to protect investors against significant potential losses. On the other hand, it could be classified under the "special situations" portion of a private equity allocation, as it has a finite lifespan and earnings will not be reinvested into the strategy.

In a more practical sense however, we must not confuse the TALF with anything other than what it really is, a unique and truly opportunistic investment offered up by the Fed. Do not forget the TALF is scheduled to end on December 2009. So this is not likely an enduring investment opportunity, but even if it is (*discussed in Appendix*), prospective returns will probably not remain this high over time.

Recommendations and Implementation Considerations

Wurts & Associates believes an investment in the TALF program offers an attractive and unique opportunity for institutional investors, and does so with reasonable downside risks that can be materially mitigated through appropriate due diligence and portfolio construction.

As mentioned above, manager selection is a primary source of risk for this opportunity. As such we recommend top-tier fixed income shops that are well experienced in the ABS marketplace. Moreover we prefer firms with a top-down research effort to increase the chance of appropriate due diligence in relation to potential economic events.

Most importantly though, this is not an occasion to get greedy and take unnecessary risks. The inherent leverage in this program is more than sufficient to garner robust returns. So there is little wisdom in reaching for even higher returns. Practically speaking this means working within the TALF framework and focusing on building portfolios that are duration matched to the lifespan of the TALF loans and the associated free put option to the Fed. Of course additional returns may be garnered, but they come at additional risk.

It makes no sense to turn an investment with minimal downside into one with significant downside in exchange marginal additional return. It is just impossible to create a superior risk adjusted return profile stepping outside the bounds of the TALF program, and any attempt to do so would be unwise.

To conclude, the TALF *is not* too good to be true, but it is one of the better opportunities available to investors in the current capital markets environment.

Appendix

Some Ruminations on TALF

The TALF program represents a rather fascinating precedent for the US economy as the Fed is stepping in as a lender and market maker of last resort where private markets have all but disappeared. Although the TALF is proposed to have a finite life span, one must wonder if this will actually be the case for a variety of reasons.

From a purely capitalistic point of view, it is in the collective best interests of investors to motivate the Fed to offer up riskless leverage for fixed income investment strategies. Now that the world realizes how vital the asset-backed securities market is to economic growth and that the Fed will step in and facilitate transactions, it is conceivable (*but not likely*) such attractive terms will induce collusive behavior on the part of market participants. Perhaps investors will become spoiled by these potential risk adjusted returns and will refuse future opportunities without government subsidy. Perhaps not, but who will step in and provide the leverage necessary to keep the ABS market running now that several major financial institutions have failed, those remaining are scaling back their leverage and balance sheets, and the government is apparently moving towards more, not less, financial regulation designed at stabilizing the economy. Fostering levered investment strategies for major corporations is contrary to this goal. So perhaps the Fed is the next logical (or only) purveyor of financial leverage.

Another reason this program may live beyond its stated lifespan is due to the economic influence it could potentially provide the government in maintaining economic growth and stability. The TALF could very well be the beginning of yet another arm of government fiscal and monetary policy. With recent political mandates to further regulate the US economy, another very powerful tool in the government's arsenal may be too attractive for policy makers to resist. Just consider the power the TALF could eventually wield over economic growth by manipulating interest rates for consumer lending, a tool which has historically been beyond the government's grasp.

What are the implications to institutional investors down the road? Well there are several if you assume the TALF will persist over time in some form or another. Most notably, this sort of market intervention implies a government guaranteed downside protection to investors; i.e., if things get bad enough the government will step in with as much liquidity as necessary. If investors know the government will always step in to avoid catastrophic loss, they will rationally seek higher returns as the more risk they take, the better their risk adjusted returns become. Going forward this could mean higher valuations for risky assets, or prospectively lower returns as investors load up on risk with access to seemingly limitless leverage. Sound familiar?

The worrisome thing about such an evolution in capital markets is that if the government is the purveyor of seemingly limitless leverage, what happens when it needs a bailout? It's not a pleasant prospect.

As the title of this section implies, this is just some food for thought. Don't take any of this too seriously.