
◆ Distressed Securities Report Compendium ◆

February 2009

Featured Companies:

PowerShares Listed Private Equity (PSP)
First Trust Specialty Finance & Financial Opportunities Fund (FGB)
Formerly Known as First Trust/Gallatin Specialty Finance & Financial Opportunities Fund
Warner Music Group (WMG)
Finova (FNVG)
PowerShares Emerging Markets Sovereign Debt (PCY)

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Murray's Musings

Opportunities in the Credit Market

The entire credit spectrum is one of those great opportunities to make investments that probably come, at best, once in a generation, maybe even once in a lifetime. In addition to listing a number of distressed bonds, in this *Compendium*, I'll broaden subject matter by giving an overview of the larger aspects of the credit spectrum. I believe that there are opportunities in every aspect of it, and we'll examine some of them.

First, I'll touch on some of the basics of high-yield arithmetic. Some number of months ago, when yields in non-investment grade paper, or let's call it risk-based paper, approached, then exceeded, 15%, it was an arithmetical transformation in the yield market. One of the reasons should be arithmetically self-evident. The average coupon on the existing bonds might be 7.5%; therefore, if the paper yields 15%, it's probably trading at 50% of proof of claim, or 50% of par value. In principle, if one assembled a bond portfolio that was trading at approximately 50% of par value, and if half of the portfolio went bankrupt, meaning that the portfolio had a default rate of 50% with no recovery value whatsoever, and the other 50% ultimately matured at par, the portfolio would have a positive rate of return. One would be paid 7.5% interest on the half of the portfolio that ultimately paid. The fact that 50% of the bonds appreciated to the par value would directly equilibrate the 50% of the bonds that went to zero.

Of course, that example is entirely unrealistic, because most bonds have some recovery value. That value may vary depending on the instance, and reasonable minds may differ as to what the recovery value is, but there would be some value. Beyond that, there is no historical parallel to a 50% default rate; a 5% default rate would be high by historical standards, especially in a one year period. One presumes, although one does not know, that with better credit selection, perhaps the default rate in one's portfolio would be less than 5%.

Let's examine the purchase of a bond portfolio at 60% of proof of claim. If 5% of that genre of bond were to default with an average recovery value of 30¢ on the dollar, then 5% of the portfolio would lose 50% or 250 basis points, and 95% of the portfolio presumably would return 15%. Multiplying 15% times 0.95 results in 14.25%, and then subtracting the 250 basis points lost from the defaults, one would still get an 11.75% rate of return.

The fact that the high-yield market achieved some degree of stabilization in late December and early January is no accident, because the numbers discount a very high default rate. Even if one bought baskets of high-yield securities, as one would in the case of exchange traded funds, the returns are likely to be positive for index-based buyers. That being the case, it is worthy of note that last month there was a resurgence of high-yield issuance. It

was nothing dramatic by historical standards, and the market needs much more in the way of refinancing than the 10 high-yield issues in the amount of \$5.6 billion that was achieved in January 2009; nevertheless, it was the most in a single month since the middle of last year.

If we accept the basic premise that the yields reached in late December provide some type of high probability of a positive rate of return, then we have a situation in which the credit spreads are completely out of historical order. If high-yield securities are going to provide a double digit rate of return, even for an index buyer, and even assuming an historically high default rate in a terrible economy, the spread relationship of high-yield to Treasuries is far outside the norm.

That yield relationship will narrow at some point, and it could do so in a variety of ways. It could narrow if the absolute rate of return demanded by the high-yield investor diminishes as capital is attracted to that market. The spread could diminish if the absolute rate of return demanded by the high-yield investor were to remain constant, or even rise, and the absolute real rate of return demanded by the Treasury investor rose by even more basis points, thereby causing the spread to narrow. I think the latter has a high probability of occurring in the next several months. Narrowing the spread is one of the necessary preconditions to restoration of a properly functioning credit market.

There are anecdotal telltale signs that the coping mechanism of history is at work with regard to the fixed income investor. That mechanism enables the fixed income investor to deal with a very low yield environment for low-risk fixed income investments. The current situation is essentially intolerable for insurance companies. For a life insurance company that has real long-term liabilities, because death is certain for everyone, and the company has to pay out for that event, to place too much of its portfolio in Treasuries would be a liability problem that the regulators simply would not tolerate. The investment management world, ever fertile and imaginative, is designing products to attract fixed income investors to sectors other than Treasuries.

On February 3, Van Eck's Market Vectors launched a very intriguing exchange traded fund (ETF) called the Pre-Refunded Municipal Index ETF (PRB). Pre-Refunded municipal papers are municipal bonds that have been refinanced by the issuers, but remain in the marketplace. What typically happens is that the municipality in question raises money for the purpose of retiring a bond. In the case of callable bonds, until such time as the bond becomes technically callable, the municipality places capital in an escrow account that will be used to fund the repayment of the original issues. Since that escrow account is invariably invested entirely in Treasuries, the pre-refunded bond is essentially 100% backed by Treasuries and, by definition, is AAA rated.

Until the call date, an investor in the Pre-Refunded Municipal ETF earns the tax-free municipal bond rate for the duration of the instrument, but with the Treasury risk, which makes it a very interesting product. Students of municipal bond funds will note that it is

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not uncommon for a typical municipal bond fund to have 20% or 30% of its holdings in pre-refunded status. That segment of the portfolio is yielding much more than Treasuries, but has with the same sort of risk.

Market Vectors decided to take advantage of that situation, and has essentially created a Treasury fund with a higher yield than Treasuries. One could be long the ETF, and short a portfolio of comparable Treasuries to lock in a spread. Over time, the yield on pre-refunded municipal paper will probably drop and, eventually, will be completely consistent with Treasuries for the same maturity spectrum.

At the moment, there is clearly a fixed income arbitrage; however, it would be difficult to execute independently. Though it wouldn't be difficult to sell short Treasuries, one would have to assemble a portfolio of municipal bonds in pre-refunded status. Usually, only the specialists would have the expertise to be able to do that, but Market Vectors is making it possible for anyone to do it, even a retail investor. One could say, in a matter of speaking, that arbitrage between pre-refunded municipal bonds and Treasuries is now being democratized.

It's a unique event in history, just as many occurrences of the last several months have been. In my opinion, this one will change fairly substantially the low-risk end of the fixed income landscape. It'll eventually have implications for all sorts of municipal bonds, because AAA rated municipal bonds in non-pre-refunded status trade at a yield that is more or less comparable to pre-refundeds. If the pre-refundeds drop in yield, chances are the AAA bonds will drop in yield. If the AAA bonds drop in yield, that would open up a yield spread between AAA and AA, which means that ultimately AA would drop. If the AA yield spread goes back to historical levels even after it opens up, there would be a spread between A and AA, and so on and so forth.

One can see the logical consequences of this seemingly insignificant ETF launch begin to work its way through the system. In history, it's truly fascinating to observe how seemingly insignificant events can have great historical import. This report is not a treatise on history, but I'll give one example. The inspiration behind the Italian Renaissance in the 15th century was the rediscovery of classical learning, primarily of the Greeks. Translations of the Latin classics, including Ovid and Terrence, were always maintained in Medieval Europe. It was the knowledge of the Greeks that was almost entirely lost. An author like Thucydides became available to European scholars in the 15th century. Just the addition of books like Thucydides's *History of the Peloponnesian War* to the libraries of 15th century scholars caused a tremendous expansion of the historical sweep of that time and inspired a new era. Similarly, the investment landscape of the yield-based investor is changing. The change described in this section is but one example of many; there will be others described later in this report.

Industry Thoughts

Bankruptcy Investing

As I do periodically, I'm going to make up an industry: bankruptcy investing. We're now at the stage at which the market has correctly discounted defaults, and defaults are beginning to occur. A number of interesting defaults have occurred in the last several weeks, including Tribune Corporation, Smurfit-Stone Container, Lyondell Petrochemical and related companies like Millennium. The common denominator for the bankruptcy of these three companies lies in the necessary assumptions that have to be made about what the normalized course of business will be, given the changes in each of their industries.

Tribune Corporation

In the case of Tribune Corporation, the ultimate asset that stands behind it, which is the *Tribune* newspaper, is a deteriorating franchise. It's going to be a very complex bankruptcy, because the deterioration of its business is not merely due to the economy, although that's clearly a factor. It's because there continues to be a secular shift away from newspapers as a source of advertising. The newspaper has to reinvent itself. The bankruptcy could presumably last for years. With changes in the character of newspapers occurring so rapidly, it's not entirely clear that one could use the historical statistics for the earnings and cash flow of Tribune Corporation to make some assertion of what the normalized course of the business might be, and restructure the company accordingly.

Smurfit-Stone Container

For Smurfit-Stone Container, it's surprising that, in theory, its capital structure is not very adverse to the senior unsecured creditors. I say "in theory" because, in practice, it might be very adverse to them. In the debt structure there's only \$787 million worth of term loans, and the senior unsecured bonds are a little bit less than \$2.3 billion in face amount proof of claim. That amount equals two-thirds of the capital structure as far as the balance sheet debt is concerned. It might seem reasonable to assert that Stone Container, as an enterprise, must be worth more than \$787 million.

There's also \$295 million of specific revenue bonds that were issued against various projects. At first glance, it seems that the unsecured bonds should have considerable value; therefore, it's surprising, that the unsecured bonds are trading at 11¢ on a dollar. I'll list the issues along with their stated maturity dates, though those dates are meaningless since the company filed bankruptcy. The issues are the 8.375% due July 1, 2012, the 8.25% due October 1, 2012, the 7.5% due June 1, 2013, the 7.375% due July 15, 2014 and the 8% due March 15, 2017.

Even during the so-called good times for the economy, Smurfit-Stone Container was never very profitable. As the management would no doubt point out, part of the reason was that,

for at least a decade, the company was not properly capitalized. While that situation had some impact on their profitability, a deeper problem is that the basic business has become far more commoditized. The business deteriorated in its basic forecastable operating margin. If one were to say that the bondholders for the \$787 million of term loans and \$295 million of revenue bonds would be made whole, it would be difficult, even in a better economy, to see how the enterprise value could be made high enough for the bondholders to recover a huge amount, given an anticipated low operating margin.

The bondholders are more likely to receive some type of equity which, given that the bonds are trading at 11¢ on a dollar, might ultimately prove to be very valuable. The market value of nearly \$2.3 billion of debt is about \$250 million. The market is applying a very high discount rate to the Stone Container unsecured. It is true that Stone Container is likely to have a low operating margin for a very long period of time, but it is also true that the market more than adequately discounts that likelihood. There may be an opportunity in that type of debt.

Lyondell

There's a similar opportunity in Lyondell debt. Lyondell is more of a classical cyclical. It's not entirely clear that the Lyondell fundamentals are permanently eroded. Lyondell certainly has far too much debt for the business structure that it engages in. It does, however, have \$30 billion of revenue. In a good year, it might earn anywhere from 3-5% net after taxes. \$10 billion of its debt is bank debt. The lower grade creditor is not in a very good position, but the market appears to have more than adequately discounted that situation.

Featured Companies

PowerShares Listed Private Equity (PSP)

Though PowerShares Listed Private Equity is not, technically speaking, a high-yield bond, it trades like one, so it is effectively a high-yield bond. I find this security uniquely fascinating. It has a 17.5% yield and trades at a 6% premium to net asset value, interestingly enough. PSP is an Exchange Traded Fund (ETF) that holds shares in various private equity investors that many people refer to as being members of the, so-to-speak, shadow banking system. Included in the portfolio of PowerShares Listed Private Equity are Leucadia National, American Capital Strategies, BlackRock, Kelso, Capital Source, Apollo Investment, SVB Financial, Ares Capital, Blackstone, Fortress, Capital Southwest, Compass Diversified, Kohlberg Capital, MVC, Fifth Street Finance, Tortoise Capital, Harris & Harris, NGP, TICC, Pennant Park, Kayne Anderson, Patriot, Gladstone Capital, Affiliated Managers Group and Safeguard Scientifics.

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The common denominator of virtually all of these companies is that they make collateralized loans to various private businesses, similar to what the banking system might do. In many cases, these companies are leveraged buyouts, and are highly leveraged companies. Typically, the private equity firms get back either a first or second lien loan and some warrants.

Rather than analyze each and every constituent element of this ETF, I'll use Kohlberg Capital (KCAP) as a representative sample. It has a \$69 million market capitalization and, at the moment, it yields 33%. The market is forecasting many defaults, and the market might be right. This company has equity capital of \$276 million deployed in the lending market, and borrowings of \$270 million. Kohlberg Capital has a debt to equity ratio of roughly one-to-one, and it has \$40 million in cash. As of September 30, 2008, the stated value of the assets at mark-to-market fair value was \$525 million. Kohlberg Capital does not currently carry these securities at face value; there have already been markdowns.

Clearly, the market believes that there'll be more markdowns. Using the various metrics that were just cited, one can arrive at the idea that, given the current market capitalization of the company, the market is essentially saying that the assets are worth no more than 60¢ on the dollar, and perhaps not even that. That view is not inconsistent with what you'd find in a typical high-yield fund since, at the moment, a typical high-yield bond fund has bonds that trade at about 60¢ on the dollar.

Part of what makes Kohlberg Capital interesting is that it certainly isn't in a position to make any new loans, and its colleagues in the industry are in the exact same position. The shadow banking system has completely shut down, which is a major contributory factor to what is happening in the economy. This group of companies is in no position to provide any kind of meaningful financing; nevertheless, Kohlberg Capital recently announced that it intends to repurchase \$5 million worth of its own shares. Given that the company has a \$69 million market capitalization, \$5 million worth represents a fair quantity of the stock that publicly trades.

The way to approach this company, I believe, is exactly the way one would approach the high-yield sector. One could assign a certain default rate to the underlying securities under the following assumptions: that there's a 17.5% yield, that the paper trades at 50¢ on the dollar, and that there will be a recovery of value since, for the most part, the loans in question are first tier and second tier secured loans. Each company in question has a diversified portfolio, so one would be buying a portfolio. To merely state that this particular fund trades at a 6% premium to net asset value would be misleading, in a certain way, because many of the companies in question trade at large discounts to net asset value. MVC, for example, trades at an over 40% discount to net asset value. Capital Southwest and Tortoise Capital also trade at a discount to net asset value as do many others.

Some of the companies listed here, including Leucadia National, SVB Financial, Capital Southwest and Affiliated Managers Group, are not likely to go bankrupt. This particular

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portfolio does not have the sudden death attribute of buying merely one bond. It is a well-diversified portfolio of senior credits. Time will tell what it's worth, but in the meantime, it's paying a dividend.

First Trust Specialty Finance & Financial Opportunities Fund (FGB)

Formerly Known as First Trust/Gallatin Specialty Finance & Financial Opportunities Fund

The portfolio of First Trust Specialty Finance & Financial Opportunities is similar to PowerShares Listed Private Equity ETF but, in contradistinction, First Trust Specialty Finance is a somewhat leveraged closed-end fund, not an ETF. The fund has a 24.75% yield, is 25% leveraged and trades at a 7.50% discount to net asset value. The investments in its portfolio include Ares Capital, Apollo Investments, Enerplus, Prospect Energy, MVC Capital, Gladstone, NorthStar Realty Finance, NGP Capital, GSC, MGC, Hercules Technology, Medallion Financial, Wells Fargo (interestingly enough), INVESCO, Highland Distressed, Annaly Capital, Redwood Trust and iStar. The latter three are mortgage REITs.

This fund is an example of the democratization of this type of arcane, esoteric investment. Let's presume that one took the position that these companies are badly flawed, and the recovery value is far below the level that I've been given to posit. In that case, a logical trade would be to buy PowerShares Listed Private Equity, which is the unleveraged version, and sell short First Trust Specialty Finance, which is the leveraged version. The difference in yield is roughly 7%, so there would be a negative 7% carry. Looked at another way, there would be a 7% cash cost to having an infinite option on the complete dissolution of these companies. Obviously, the leveraged company would fare worse than the non-leveraged company in the current environment.

It's important to note that each of these funds is an agglomeration of businesses, which themselves are agglomerations of businesses, because each one of these companies has a portfolio of loans making it a portfolio of portfolios. If one took the position that there is an investment opportunity here, because the value is too low, and the yield is too high, then one would engage in the reverse of the strategy described above. One would sell short PowerShares Listed Private Equity, and buy an equivalent dollar amount of First Trust Specialty Finance. This strategy would give one a positive carry with a little bit more than 7%, not giving any effect to the idea that the First Trust Specialty Finance is at a discount to NAV, and the PowerShares is at a premium to NAV. Of course, one also has the benefit of leverage.

The market is effectively saying that the recovery prospects are so low that a synthetic call option on recovery of the private equity business basically generates a positive 7% yield. There's a positive carry on taking that bet, which is truly incredible. If destiny has it that they both dissolve, then chances are that the leveraged First Trust Specialty Finance would dissolve before the unleveraged PowerShares fund, but one would be collecting a 7% yield

along the way. Since the most you can lose on a long is 100%, and assuming that both funds go to zero, as long as they can struggle along for a little over three years while you collect your 7% carry, you'll have a rate of return.

Perhaps it could be argued that, because First Trust Specialty Finance is leveraged, it would reach its demise before PowerShares Listed Private Equity. One could also take the not unreasonable position that, because of the inclusion in PowerShares Listed Private Equity of a 10% position in Leucadia National, and since Leucadia National, whatever its deficiencies might be, is unlikely to go bankrupt, then one might presume that the PowerShares fund would survive. At least that element would be likely to survive, and probably others as well. Personally, I would recommend buying both securities.

Q: Are the companies within the funds leveraged?

A: Some of the companies within both PowerShares Listed Private Equity and First Trust Specialty Finance are leveraged. The difference is that First Trust Specialty Finance, the fund itself, employs 25% leverage.

Q: Is there a danger of default on loans made by Medallion Financial?

A: Medallion Financial is one of the companies in the First Trust Specialty Finance. It primarily makes loans against taxicab medallions. The only other business that it has is advertising. It places ads on video screens both inside taxicabs and on their roofs. There is virtually never a default resulting in a loss on a taxi medallion. In New York City, which is where Medallion Financial is, there are a relatively fixed number of taxi medallions, and the city rarely issues new ones. When a medallion needs to be seized, it's not difficult, because it merely entails invalidating the status of the defaulting owner. Once seized, the medallion's ownership reverts back to the Medallion Company, which then sells it to someone else, and the prices are usually going up.

Warner Music Group (WMG)

Warner Music Group is a more conventional opportunity. We've now examined enough of high yield to understand what the market's presumptions are regarding bankruptcies, pre-refunded municipals and private equity. With that as a backdrop, Warner Music has to have very low valuations because, irrespective of whatever unique attributes it may or may not have, it has to trade in line with the industry valuation metrics.

If one took the Warner Music debt at face value, and the equity at market value, the enterprise value to EBITDA, calculated at the nominal debt level, is 6.6x, which corresponds to an interest rate of roughly 15%. One can see how that number is arrived at, given the valuations we've seen. If one undertook to calculate the enterprise value to

EBITDA using not only the market value of equity, but also the current market value of the debt, the enterprise value to EBITDA would be 3x, which indicates a 33% yield.

Warner Music has a term loan of just under \$1.4 billion at the top of its capital structure. In relation to that term loan, the amount of subordinated paper is not large. There's a 7.375% note due in 2014 with a \$465 million face value, a 9.5% discount step-up note with a \$231 million face and an 8.5% sterling note due in 2014 with a \$184 million face amount. It's important to note that sterling has collapsed against the dollar. Since Warner Music's earnings are primarily in U.S. dollars, the ability of the company to repay the sterling note is enhanced when the value of sterling drops compared to the U.S. dollar. The market, however, gives Warner Music no credit for that change.

The term loan matures in February 2011, and the problem lies therein. The company currently has over \$400 million of cash on the balance sheet, and is building its balance sheet cash at a rate of \$40 million dollars or more per quarter. It's essentially two years until February 2011 so, even under the most generous assumptions, it is not likely that Warner Music will be able to repay the nearly \$1.4 billion of term loans with balance sheet cash. Though it could certainly repay some of it, the rest would need to be refinanced. The market is assuming that it won't be possible to refinance, which gives Warner Music this incredible yield.

The equity has a price-to-cash earnings ratio of 1.8x, which translates into an equity yield of over 67%. The market assumes that the equity has no value. It's interesting to examine this company, not only as a mere investment opportunity, but also as a valuation exercise because, in a former incarnation, Warner Music was a leveraged buyout. Its emergence into the public domain is merely the emergence of a leveraged buyout into the public domain, and it retains much of the leveraged buyout balance sheet character. This example should give one a relatively good notion of how the equity warrants on the various companies included in the two private equity ETFs are actually valued. They're valued as if they will essentially have no value. Warner Music is also valued as if it has no value.

If it ultimately were to have value, it might trade at 10x cash flow. The coefficient of expansion on the equity, if one went that route, would be 6.75x. That figure assumes that the cash flow won't increase, but it might do so if the company keeps building cash, and manages to pay down its debt. It could happen. I think that Warner Music is an interesting opportunity.

Finova (FNVG)

Finova is another company that was recommended in the past, and is now at an opportune moment for buying. The Finova bonds are in liquidation and the company practices liquidation accounting. The bonds literally trade at the value of the cash that's on the balance sheet. The company has about \$4 per bond of balance sheet assets based upon its

carrying value. Those are the last assets that will be liquidated, and the market assumes that they have no value. If the market is right and one bought Finova senior notes at their current value, one would essentially be taking no risk. The market is basically offering a free call option on that value. That's not the only call option that's being granted by the marketplace; there are two more.

There is another set of assets that has a balance sheet carrying value of zero, and that may be an accurate value. Those assets have yet to be liquidated. The market assigns them zero value, because it may not be possible to liquidate them. That, however, may not be a proper assumption. Lastly, there is a very large tax-loss carry forward, to which the market gives no value, because it is assumed to be unrealizable. That assumption might be a poor one.

Essentially, for a cash investment that will have a rate of return not inferior to a money fund, one is granted three call options for free, and they're infinite call options, without expiration. Finova is a massively undervalued security. The fact that the market is offering those three call options for nothing gives one an idea of how high the discount rate is on the various segments of so-called high yield.

PowerShares Emerging Markets Sovereign Debt (PCY)

This report hasn't covered the emerging markets sovereign debt in the past because, in a normal environment, they are considered to be investment grade securities, which places them outside the scope of this report. At the moment, however, they're clearly not investment grade securities. The emerging sovereign debt market is making very severe distinctions among countries' ability to pay debt. The market may be right to differentiate in that way, but if it has not properly discounted what might be a default of a certain sovereign debt credit, there may be an arbitrage opportunity.

The ETF called the PowerShares Emerging Markets Sovereign Debt yields 6.28% and it trades at a 6.25% premium to NAV. In the world of emerging sovereign debt, the exposures of this fund are the more benign. They include Chile, Hungary, Philippines, Poland, Russia, Uruguay, Panama, Bulgaria, Peru and South Africa. An actively managed closed-end fund, which is unlevered and traffics in the same area, is the Templeton Emerging Markets Income Fund (TEI). This fund yields 10.17% and trades at a 12.08% discount to NAV, but that's not the entire measure of value. In order to understand the difference in value, many of the bonds in the PowerShares Emerging Markets Sovereign Debt portfolio trade at not very large discounts to par value, because they're presumed to be able to repay principal at maturity.

There is a spread of several hundred basis points vis-à-vis U.S. Treasuries, and that spread has widened from its historical level, but it has not widened tremendously. The Templeton Emerging Markets Income Fund has undertaken to invest in the credits that arguably have

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a very high default risk, including countries like Argentina, Iraq, South Korea, Egypt, Bosnia and Brazil. The Templeton fund includes some municipal credits; for example, the fund bought bonds issued by the City of Kiev in the Ukraine.

There's a reasonably good probability of some type of default in Argentina, and that paper is trading at 25¢ on the dollar. South Korean paper trades at 60¢ on the dollar. Kiev paper trades at 60¢ on the dollar. Egyptian paper trades at 20¢ on the dollar. Bosnian paper is 60¢ on the dollar. And Brazilian paper is 35¢ on the dollar. In a sovereign default, what ultimately happens is that the old bonds are exchanged for new bonds with lower interest rates and lower par values. Generally, one finds that the market is sufficiently versed in this area to more than adequately discount the risk of default. Some, but not all, of these credits will default. The bonds generally trade at a discount to their recovery value, because there's a time value of money aspect to it. It's not unlike bankrupt paper that trades at a large discount to its value prior to the entry into bankruptcy.

The idea would be to sell short the PowerShares Emerging Market Sovereign Debt portfolio, and to buy long the Templeton Emerging Markets Fund. That strategy includes a nearly 400 basis point positive carry; a short of a premium to NAV, which usually is not sustained for very long; and a long of a discount to NAV, the total spread there being 18 percentage points. Assuming that there is more value in the more dangerous bonds than is granted by the marketplace, one doesn't need a very large improvement on recovery value. Alternatively phrased, if only some, not all, of the countries ultimately default, the fact that the debt of some countries will mature at par equals a substantial amount of potential appreciation.

Q: Is there anything inherent in the business development of the fund's structure that warrants a discount to NAV?

A: Yes, there is. With some rare exceptions, the assets are not tradable. If any of the companies were to realize that they made a mistake, and I'm sure some of them have made mistakes, the only liquidity that they'll obtain would be from natural liquidity events. A natural liquidity event could be the payment of interest, which would help the companies but little, because it would be distributed to the shareholders. It's good for the shareholders, but it doesn't help the company at all. Another natural liquidity event would be the repayment of bonds at maturity, but the maturities in most of the instruments are still some years away. It's a very large portfolio holding many securities when viewed in the aggregate.

There are always some maturities occurring, and occasionally there's a prepayment for whatever reason, perhaps refinancing. Basically, however, it's a portfolio that, in aggregate, is more or less immobile, more or less the way that bank portfolios are immobile. For the most part, the discount is the liquidity discount which, when applied, is generally the most severe discount possible. A buyer basically has to buy on the premise

that the assets will not be sold for many years. One can't know exactly when the markets will accommodate a refinancing; therefore, the liquidity discount in itself is sufficient.

The default statistics, such as we have them, do not justify that discount. The investment community has never been very good at distinguishing between a discount originating from a default probability and one originating from a liquidity problem. The natural impulse is to seek liquidity from receipt of interest payments but, given the structure of the company, the bulk of that income needs to be paid out. There's very little liquidity to be achieved through that route.

The second path to liquidity is to raise more equity which, in a normal environment, would be possible, but may not even be possible currently. If it were possible, it would be frighteningly dilutive; therefore, the companies don't wish to undertake it. A third liquidity possibility would be to sell an investment; however, while there may be the odd case for which that would be possible, it would be rare. Even if any could be sold, there would be a sizable illiquidity discount applied to it, so the company may not wish to choose that route.

Last, but not least, is a natural liquidity event of these companies paying back. There are very few companies with scheduled maturities in the next 12 months, although there might be a few. Generally, even for a scheduled maturity, the companies in question would have to obtain new financing which, until recently, was unobtainable. That's what the market charges for illiquidity. We see a laboratory example in the price.

Personally, I'm prepared to hold and earn the rate of return. I believe that instruments like these are ideal investments for foundations, because they can achieve a well-diversified portfolio and get the cash flow. Ultimately, there'll be appreciation, but even not allowing for any, those instruments will yield, let's say, 7% to 7.5%. One can see that the appreciation is likely to be very substantial.

Relative to the risk, the appreciation available for that investment has a risk/reward that is superior to any high-yield bond I can think of, because it's a portfolio within a portfolio. By definition, any high-yield bond always has the possibility of sudden death, meaning bankruptcy, though there's likely to be some recovery value. This portfolio is diversified to the extent that it's hard to imagine bankruptcy of, so to speak, the entire fund. Its price could certainly go down, and go down a lot, but so could a high-yield bond. It's hard to imagine a sudden death scenario for these funds.

◆ Distressed Securities Report Compendium ◆

APPENDIX A

Money Manager Index

From Jan 1983 to Jan 2009

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Annualized return	
															Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51												2009	57.51	(15.3)%	17.2%

Name	Amount Invested
Affiliated Manager	\$ 22,947
Alliance	\$ 7,633
BlackRock	\$ 23,205
Waddell & Reed	\$ 27,513
Eaton Vance	\$ 2,641
T. Rowe Price	\$ 2,423
Franklin resources	\$ 908
Legg Mason	\$ 1,000
Federated Inv	\$ 26,381

Name	Amount Invested
Pzena Investment Mgt	\$ 122,426

◆ Distressed Securities Report Compendium ◆

APPENDIX B

International Money Manager Index

From Jan 1983 to Jan 2009													Annualized return			
Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62												2009	14.62	(7.4)%	12.8%

Name	Amount Invested	Name	Amount Invested	Name	Amount Invested
IGM FINANCIAL INC	\$1,000	HENDERSON GROUP PLC	\$14,447	BLUEBAY ASSET MANAGEMENT/UNI	\$37,469
F&C ASSET MANAGEMENT PLC	\$1,203	RAB CAPITAL PLC	\$24,603		
INVESCO PLC (PREVIOUSLY AMVESC	\$1,357	AZIMUT HOLDING SPA	\$21,908		
SCHRODERS PLC	\$1,208	AUSTRALIAN WEALTH MANAGEMENT	\$27,789		
RATHBONE BROTHERS PLC	\$1,208	EVEREST FINANCIAL GROUP LIMITED	\$23,437		
ABERDEEN ASSET MGMT PLC	\$1,208	NEW STAR ASSET MANAGEMENT	\$27,700		
CI FINANCIAL INCOME FUND	\$2,585	CHARLEMAGNE CAPITAL LTD	\$36,848		
MAN GROUP PLC	\$2,862	PARTNERS GROUP-REG	\$36,848		
AGF MANAGEMENT LTD-CL B	\$3,343	INVISTA REAL ESTATE INV MNGT	\$36,589		
SPARX GROUP CO LTD	\$11,762	ASHMORE GROUP PLC.	\$36,688		