

Securities and Issues for Taxable Portfolios

An Introduction to Asset Backed Securities

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Merganser Capital Management LP

99 High Street Boston, MA 02110

Edward R. Bedrosian
President

Douglas A. Kelly
Senior Vice President

Merganser Capital Management LP

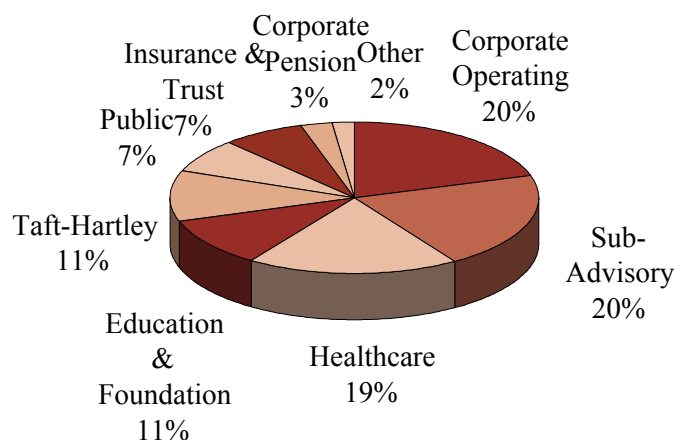
Who Are We?

- Fixed Income Investment Managers Exclusively
- \$5 Billion of Assets Under Management
- 100% Employee-Owned (24 Employees/ 9 Principals)
- In Business Since 1985
- Plan Sponsor Background

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Firm Overview

Client Profile



Assets Under Management (AUM)

<u>Products</u>	<u>Duration Target</u>	<u>AUM</u>
Core Bond	4.2 years	\$285 Million
Intermediate Bond	3.6 years	\$860 Million
Short Term Bond	1.7 years	\$4,145 Million
Cash Enhancement	1.0 year	\$265 Million
Money Market	0.2 year	\$35 Million
Total		\$5,590 Million

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West Coast Clients

The Aerospace Corporation.....	El Segundo, California
Applied Materials, Inc.....	Santa Clara, California
Children's Hospital Medical Center.....	Oakland, California
Conexant Systems, Inc.....	Newport Beach, California
Lam Research Corporation.....	Fremont, California
Metropolitan Water District of Southern California.....	Los Angeles, California
Network Equipment Technologies, Inc.....	Fremont, California
Russell Investment Group.....	Tacoma, Washington
SCAN Health Plan.....	Long Beach, California
Wind River Systems, Inc.....	Alameda, California

Merganser's Asset Backed History

- Currently hold \$1.8 billion of ABS (32% of total AUM)
- Early champion – evolved from MBS market
- Merganser's first purchase in 1986
- Doug Kelly is a leading ABS practitioner

Definition: Asset Backed Security

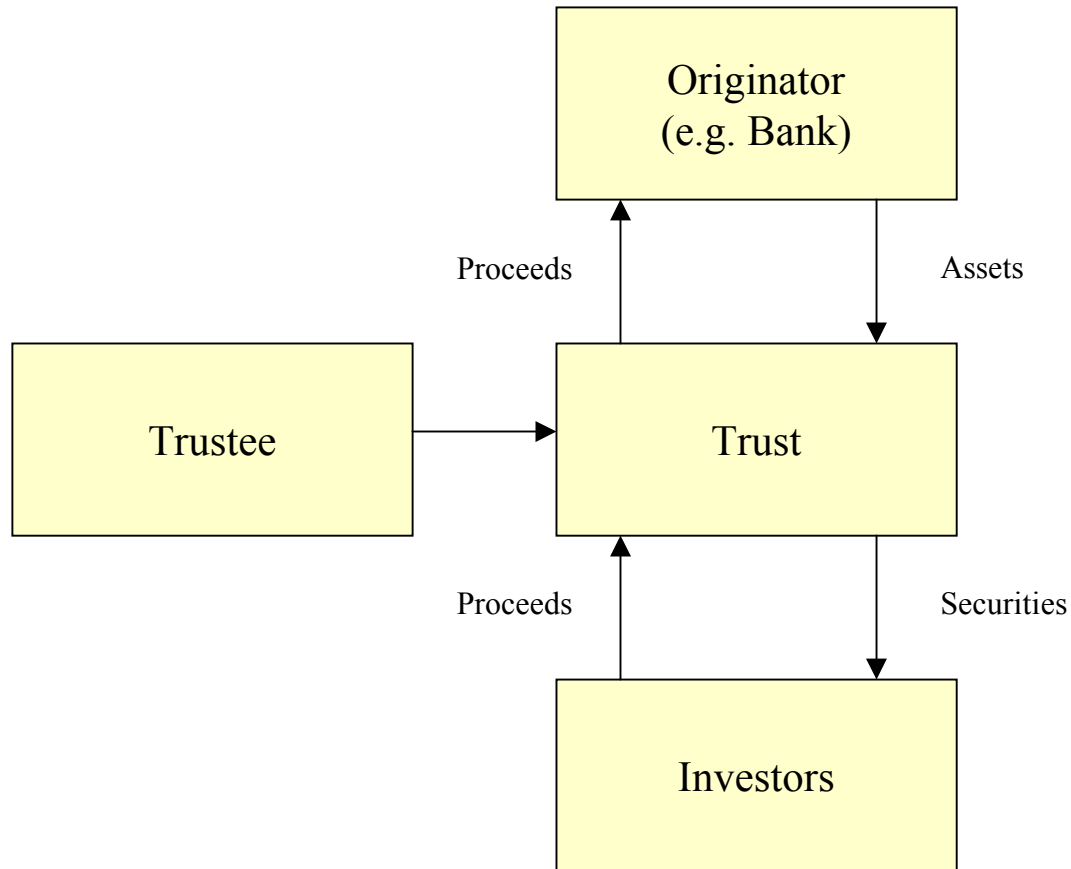
- A fixed income security that derives its credit support from the performance of a segregated collateral pool...not from the sponsor/originator of the underlying assets.
- Collateral normally includes consumer assets (e.g. credit card receivables, auto loans, student loans, etc.) or commercial assets (business equipment, agricultural and construction loans, etc.). First mortgages are generally excluded from the definition.

Note: See page 24 for ABS “Sample Investment Guidelines”

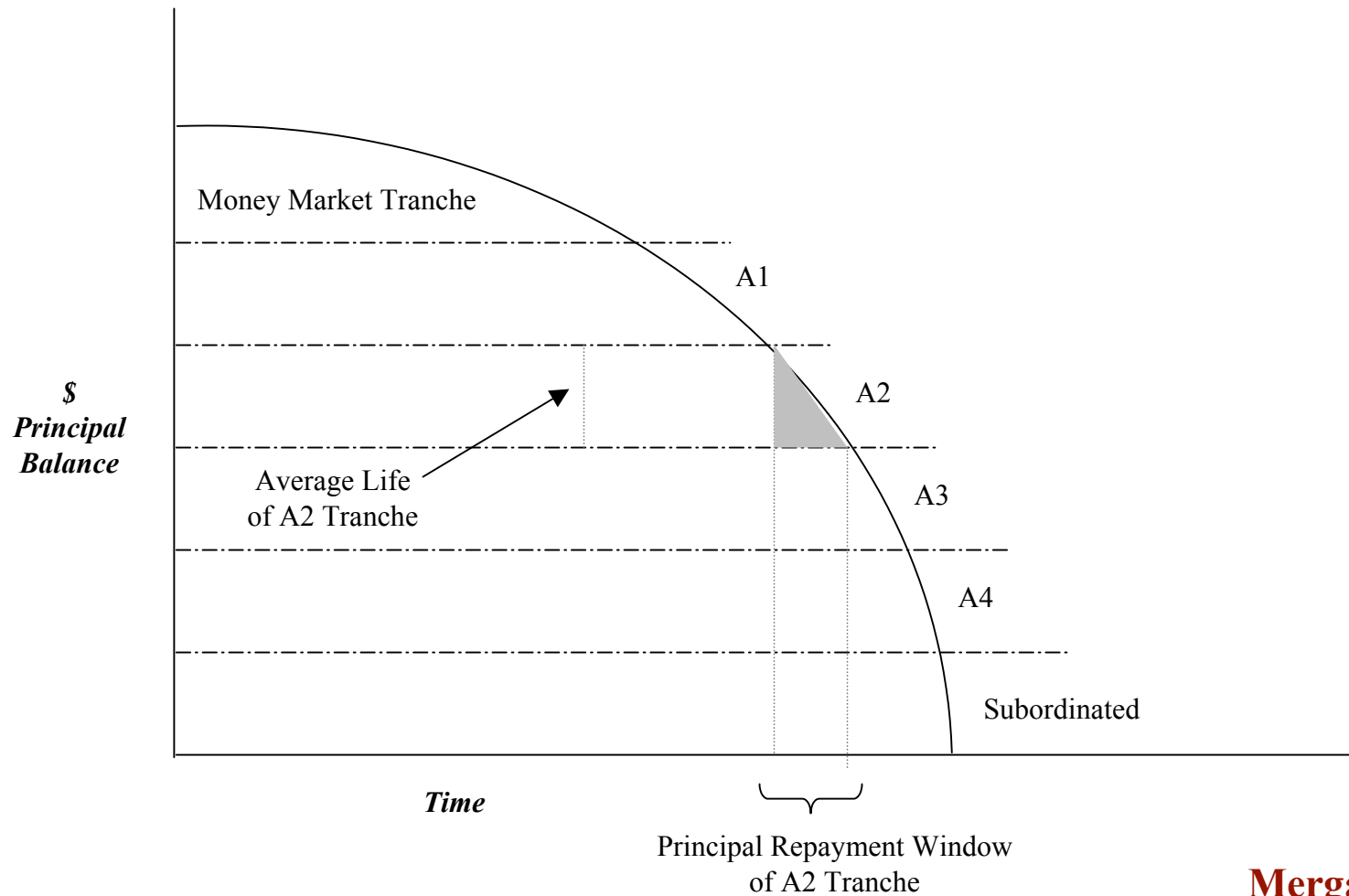
Asset Backed Securities Attributes

- Assets are placed in a trust or special purpose vehicle that insulates investors from seller insolvency.
- Credit enhancement is provided internally (via subordination or cash reserve) or externally (via third party guarantee), and is sized to ensure timely payment of principal and interest at the desired rating level.
- Independent Trustee ensures that all parties comply with indenture.

Asset Backed Securities Structure Overview



Asset Backed Securities Amortizing Structure (e.g. Auto Loans)



Asset Backed Securities Attributes

- Attractive nominal yield and event risk protection relative to corporates
- Generally low prepay risk relative to MBS
- Excellent liquidity in certain sectors (e.g. bank credit cards)

Market Overview

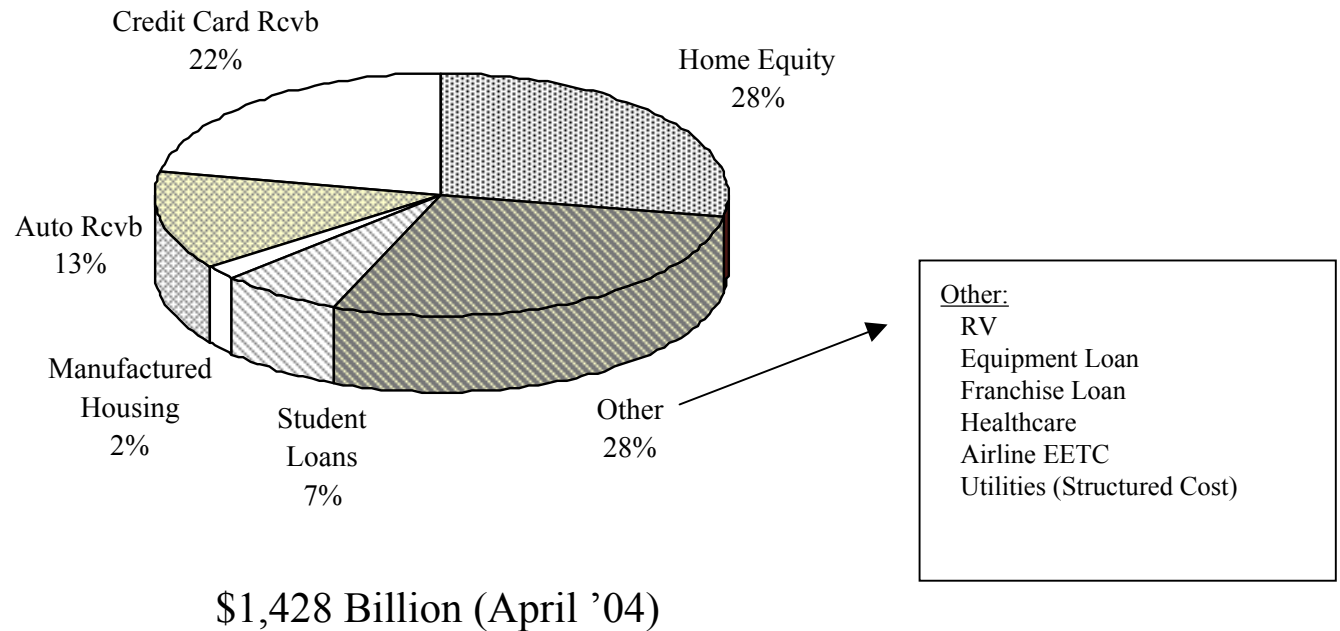
- Current Outstandings: \$1,428 billion
- First Issuance: 1985 – Sperry Lease Finance
- Maturities: Money Market to approx 15 Yrs
- Most ABS securities (85 – 90%) are rated triple-A by Moody's and S&P

* Bloomberg estimate April '04

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Market Overview

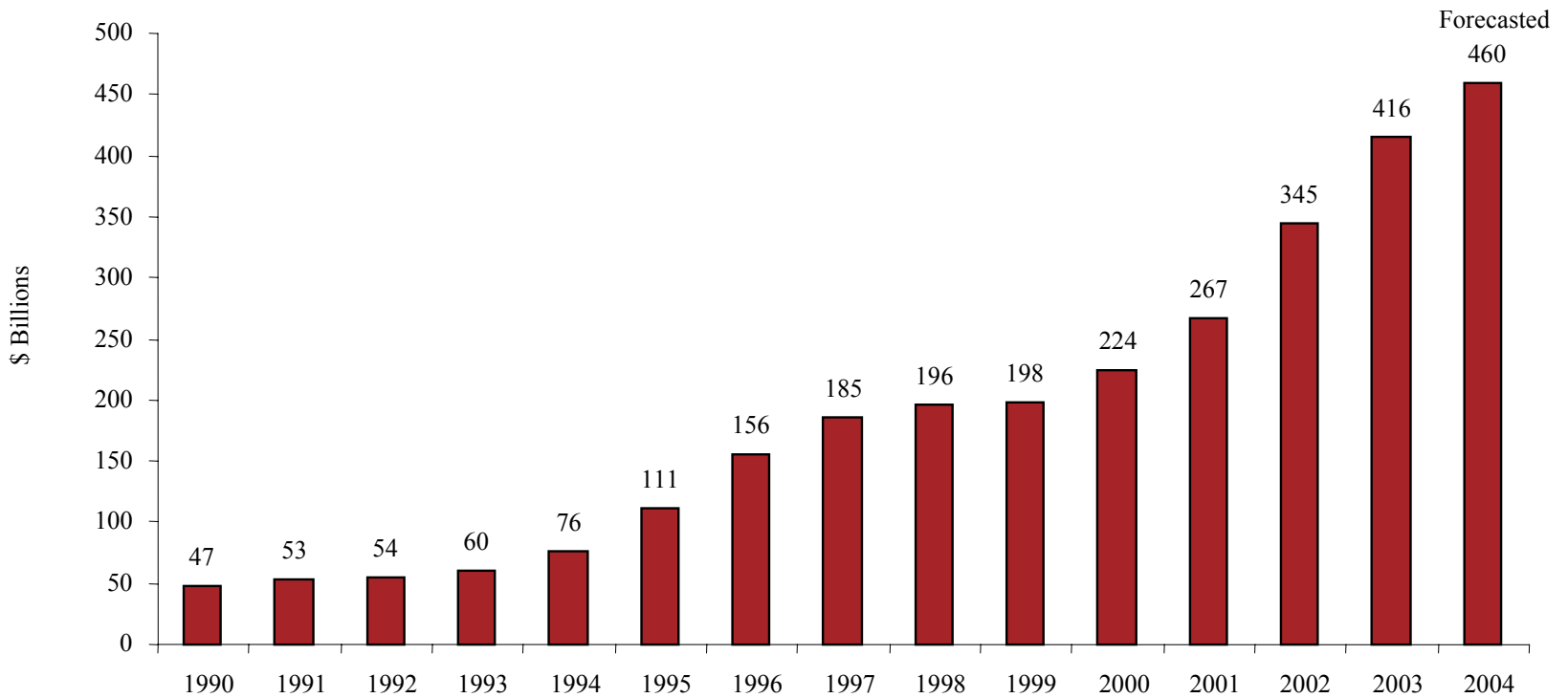
ABS Current Outstandings By Collateral Type



* Source: Bloomberg

Market Overview

US Public ABS Annual Issuance



* Source: Bank One Capital Markets

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Market Overview

Largest U.S. Credit Card Portfolios 2002

	<u>Managed Receivables (\$Billion)</u>
1. Citigroup	\$ 118
2. MBNA America	79
3. Bank One	74
4. American Express	54
5. JP Morgan Chase	51
6. Discover	49
7. BoA/Fleet	48
8. Capital One	43
9. Provident	20
10. Household	16

* Source: Barclays Capital

Note: All rated AAA (Senior Class)

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Market Overview

Top Ten Auto ABS Issuers 2003

		<u>(\$Billion)</u>	<u># Deals 2003</u>
1.	GMAC (CARAT)	\$ 9.0	3
2.	Honda	8.0	5
3.	Nissan	6.3	3
4.	WFS (Independent Fin Co.)	5.8	4
5.	Ford	5.7	2
6.	JP Morgan Chase	4.5	3
7.	Capital One	4.2	4
8.	AmeriCredit (Independent Fin. Co.)	3.9	4
9.	Daimler-Chrysler	3.8	2
10.	Toyota	3.6	2

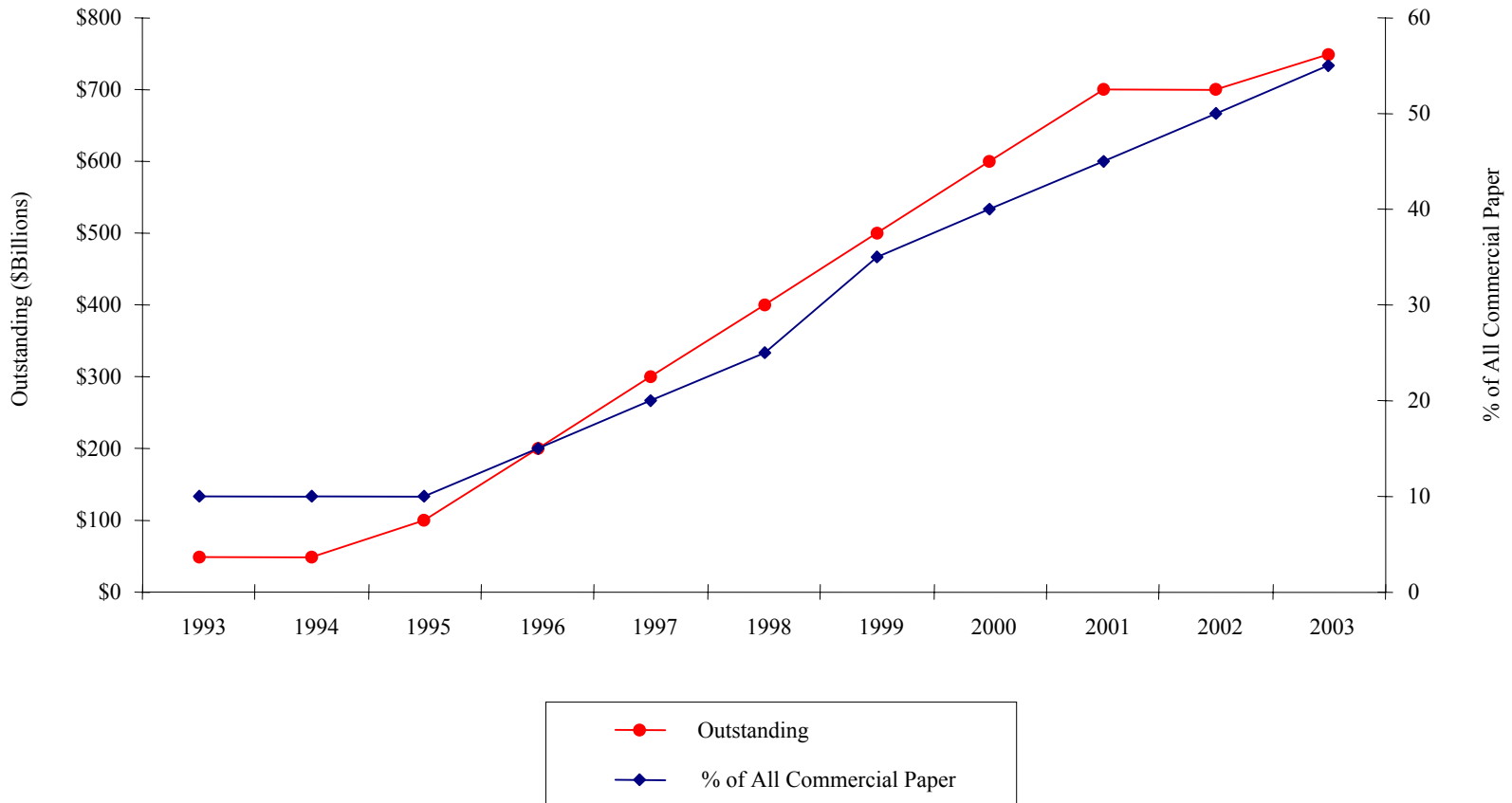
* Source: Barclays Capital

Note: All senior classes rated AAA

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Market Overview

ABS Commercial Paper Outstanding (U.S. only)



Asset Backed Securities Stable Credit Ratings

- ABS have historically demonstrated superior rating stability relative to corporates.
- Bankruptcy-remote Special Purpose Vehicles and rating agency methodology have been well established for over 20 years.
- Deterioration in ABS tends to occur slowly over time. Few issues encounter problems in the first three years post issuance.

Asset Backed Securities

S&P Rating Transition Matrix: 1982-2003

	<u>From/To:</u>	<u>Rating at the end of the fifth year</u>					
		<u>AAA</u>	<u>AA</u>	<u>A</u>	<u>BBB</u>	<u>BB</u>	<u>B</u>
Initial Rating	AAA	99.5	0.3	0.1	0	0.1	-
	AA	8.7	83.5	6.5	0.5	0.1	0.2
	A	3.3	2.4	91.1	0.7	0.1	1.2
	BBB	6.2	3.1	1.1	73.7	1.5	1.9
	BB	2.7	4.7	0.7	1.3	70.5	6.7

* Source: S&P Rating Transition Study 2003

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Corporate Bonds

S&P Rating Transition Matrix: 1982-2003

<u>From/To:</u>	<u>Rating at the end of the fifth year</u>					
	<u>AAA</u>	<u>AA</u>	<u>A</u>	<u>BBB</u>	<u>BB</u>	<u>B</u>
AAA	56.9	20.6	4.3	1.2	0.1	0.1
AA	2.0	54.0	22.7	3.7	0.5	0.4
A	0.2	6.2	55.3	14.7	2.4	1.0
BBB	0.2	1.0	12.3	46.7	8.9	2.8
BB	-	0.3	2.0	13.4	28.0	10.4
B	-	0.1	0.7	2.5	10.2	21.9

* Source: S&P Rating Transition Study 2003

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Asset Backed Securities

Recent Problem Areas

Autos

- Mitsubishi Motors Credit of America
 - Poor collateral performance (balloon loans, deferred pmt loans) caused downgrade of 14 sr classes.
- AmeriCredit
 - Headline risk due to poor collateral performance. “Excess spread triggers” exacerbate liquidity crisis.
- Leases
 - Concerns regarding unfunded pensions and vicarious tort liability.

Credit Cards

- 3 Early amortization events in 2003
 - (Conseco bankruptcy, Spiegel, Fingerhut)
- 2 Close calls
 - (JP Morgan Chase, Fleet—both remedied)

Other

- Manufactured Housing
- Franchise Loans
- Airline EETC
- Healthcare (Fraud and poor underwriting)

Asset Backed Securities

Checklist: Items to Consider

Assets:

- Are there substantial geographic and industry concentrations?
- What are historical losses, yields, prepay rates, delinquencies, recoveries?
- Is the trust exposed to residual value risk (leases)?
- Are LTV's adequate?

Structure:

- What level of losses does the enhancement cover?
- What are amortization events/triggers?
- What exposures are there to 3rd parties?
- Servicing considerations
 - Mgt experience/reputation
 - Origination strategy/underwriting criteria
 - Collection/charge off policies
 - Hot back-up in place

Asset Backed Securities

Factors Affecting Trading

- Supply
 - Often are quarter end pressures—risks and opportunities
- Type of Issuer
 - Large, frequent Issuers enjoy more favorable trading levels because of the promise of more liquidity and strong information flow
- Type of Collateral
 - Newer asset-types offer spread premium
- Beware of clean-up calls in rising rate environment
 - May not get exercised
- Technical Factors
 - Yield curve shape can affect trading levels, especially for amortizing securities. So can swap spreads.

Asset Backed Securities

Conclusion

Due diligence is required when purchasing ABS investments, however:

- Securitization technology is time tested (dates to early 1970's)
- Demonstrated superior rating stability
- On-the-run sectors offer excellent liquidity
- Offer higher spreads than equivalent or lower rated corporate bonds

Asset Backed Securities

Sample Investment Guidelines

Operating Funds

Eligible asset-backed security investments

- Must be rated AAA by at least 2 nationally recognized ratings agencies (Moody's, S&P or Fitch);
- Must have a weighted-average life of 3 years or shorter at the time of purchase;
- May be fixed on floating, but no imbedded caps on floors
- Must be a senior-tranche (no mezzanine or subordinate classes);
- Must be publicly issued (no 144-A) with a minimum initial deal size of \$100Million (not individual tranche size);

Pension Funds

Eligible asset-backed security investments

- Must be rated investment grade (BBB-) or higher at the time of purchase;
- May include ERISA eligible senior, mezzanine or subordinated tranches;
- May include up to 20% of total ABS holdings in 144-A private placements

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