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Dear Investors,

Over the past few months, we have seen the exacerbation of the Subprime problem accelerate at a precipitous pace. Wait a minute…I thought the Subprime problem was neatly contained in a nice little box of risk that the Fed had put it in? After many meetings and conversations with the various leaders of brokerage firms and asset managers, I don't think the Subprime problem is as contained as many would like for you to believe. To understand the massive ripple effects of the Subprime problem, you have to look deeply into who owns the eventual risk and furthermore, how it will affect their behavior going forward.

The Greatest "Bait and Switch" of ALL TIME

I recently spent some time with a senior executive in the structured product marketing group (Collateralized Debt Obligations, Collateralized Loan Obligations, Etc.) of one of the largest brokerage firms in the world. I was in Roses, Spain attending a wedding for a good friend of mine who thought it would be an appropriate time to put the two of us together (given our shared interests in the structured credit markets). This individual proceeded to tell me how and why the Subprime Mezzanine CDO business existed. Subprime Mezzanine CDOs are 10-20X levered vehicles that contain only the BBB and BBB- tranches of Subprime debt. He told me that the "real money" (US insurance companies, pension funds, etc) accounts had stopped purchasing mezzanine tranches of US Subprime debt in late 2003 and that they needed a mechanism that could enable them to "mark up" these loans, package them opaquely, and EXPORT THE NEWLY PACKAGED RISK TO UNWITTING BUYERS IN ASIA AND CENTRAL EUROPE!!!! He told me with a straight face that these CDOs were the only way to get rid of the riskiest tranches of Subprime debt. Interestingly enough, these buyers (mainland Chinese Banks, the Chinese Government, Taiwanese banks, Korean banks, German banks, French banks, UK banks) possess the "excess" pools of liquidity around

the globe. These pools are basically derived from two sources: 1) massive trade surpluses with the US in USD, 2) petrodollar recyclers. These two pools of excess capital are US dollar denominated and have had a virtually insatiable demand for US dollar denominated debt…until now. They have had orders on the various desks of Wall St. to buy any US debt rated "AAA" by the rating agencies in the US. How do BBB and BBB- tranches become AAA? Through the alchemy of Mezzanine-CDOs. With the help of the ratings agencies the Mezzanine CDO managers collect a series of BBB and BBB- tranches and repackage them with a cascading cash waterfall so that the top tiers are paid out first on all the tranches – thus allowing them to be rated AAA. Well, when you lever ONLY mezzanine tranches of Subprime RMBS 10-20X, POOF…you magically have 80% of the structure rated "AAA" by the ratings agencies, despite the underlying collateral being a collection of BBB and BBB- rated assets... This will go down as one of the biggest financial illusions the world has EVER seen. These institutions have these investments marked at PAR or 100 cents on the dollar for the most part. Now that the underlying collateral has begun to be downgraded, it is only a matter of time (weeks, days, or maybe just hours) before the ratings agencies (or what is left of them) downgrade the actual tranches of these various CDO structures. When they are downgraded, these foreign buyers will most likely have to sell them due to the fact that they are only permitted to own "super-senior" risk in the US. I predict that these tranches of mezzanine CDOs will fetch bids of around 10 cents on the dollar. The ensuing HORROR SHOW will be worth the price of admission and some popcorn. Consequently, when I hear people like Kudlow on CNBC tell their viewers that the Subprime problem is "contained", I can hardly bear to watch.

The Moral Hazard of HOT Potatoes

The key reason the Subprime problem exists as it does today has to do with the wanton disassociation of risk inherent in the machine that churns out Subprime loans. Unlike the S&L crisis of the 1980s, the mortgage lenders of today aren't taking their own balance sheet risk when underwriting loans. These brokers get paid for quantity REGARDLESS of quality. The balance sheet risk is transferred through three entities in less than 90 days from origination. The originator will originate ANYTHING he can sell to a whole loan buyer to pass the hot potato on. Whole loan buyers are simply the aggregators of loans at the Wall St. firms that aggregate, package, tranche, and sell as quickly as they possibly can to the clueless buyer. This transference of risk is the crux of the Subprime situation. Just think about it…if you were a 20-something making mortgage loans in California using someone else's balance sheet and being paid per loan (with no lookback to performance of the loan), how many dubious loans would you underwrite?

Buyers are now BEWARE

During and after the rout these investors are about to shoulder, how excited do you think they are going to be to purchase the next "AAA" rated piece of structured finance paper?!!?!?!? These same investors and global pools of liquidity have been funding the Leveraged Buyout (LBO) boom by purchasing the debt that funds the Collateralized Loan Obligations (CLOs) which in turn, buy 60%+ of the LBO debt used to finance these transactions. I also recently spent some time with one of the largest CLO issuers in the world. They had just returned from Japan where they were marketing a new CLO in order to be one of the buyers for new LBO debt. Needless to say, their marketing efforts fell on deaf ears. They were told by the Japanese investors that they have lost confidence in the ratings agencies (you think?) and that in an election year there is too much uncertainty. They basically said, "No more." If there is not a CLO bid from Asian and Central European banks, where do you think the $290 billion in announced LBOs will go to sell their debt? I actually have no idea how to answer that question myself. We have seen the bank-loan index drop from 100.5 to 90.5 in 5 short weeks, and a widening in investment grade as well as non investment grade credit. In the immediate absence of liquidity, there will be many casualties of levered funds and firms. There will be a "re-pricing" of risk on a global scale that will mean more credit funds being carried out the door feet first.

Latest Casualties

Just today, the latest firm to suffer the wrath of too much leverage and mis-priced risk was Sowood Capital. What is truly remarkable about this particular situation is the fact that Jeff Larson, the former manager of the $30 billion Harvard Endowment, is the principal Manager at this firm. Sowood was renowned as being a "best-in-class" fund. If the former manager of the Harvard endowment managed to lose 57% of his fund (more than $1.7 billion in losses) in just 30 days, how are the "other" credit funds out there doing? How are they calculating Value-at-Risk? This afternoon, brokerage firms were sending collateral calls to other funds positioned similarly to Sowood. They joined the ranks of the two Bear Stearns funds managed by Cioffi, Australia's Basis Capital, Absolute Capital, and Macquarie Fortress Funds as well investments by Korea's Woori Bank, and London's Caliber Fund by liquidating and eventually returning what is left to investors. Not to mention the downfall of the poster child of the levered "positive carry" industry, United Capital Market's Horizon Fund – managed by John Devaney, owner of the aptly titled 142ft yacht, the *Postive Carry* (which is incidentally now for sale, all enquiries can be directed to http://www.iyc.com/featured_yachts.cfm?mn=1).

I have recently discovered the insightful writings of someone with whom I have not had the pleasure to speak or meet in person. Howard Marks is the Chairman of Oaktree Capital Management and he recently sent a letter to his clients entitled, "It's All Good". Mr. Marks had a most astute observation with regard to the recent investing environment:

> "…investors' recurring acceptance that it's different this time – or that cycles are no more – is exemplary of a willing suspension of disbelief that springs from glee

> over how well things are going (on the part of people who're in the market) or rationalization of the reasons to throw off caution and get on board (from those who have been watching from the sidelines as prices moved higher and others made money). In this way, the bullish swing of the investment cycle tends to cause skepticism and risk tolerance to evaporate. Faith, credence and open-mindedness all tend to move up – at just the time skepticism, discrimination and circumspection become the qualities that are most needed."

Credit Markets and Where we are today in Subprime

Last week, I spent some time in the "Inland Empire" of California on a diligence trip to survey the actual damage. As many of you already know, 55% of all Subprime loans were made in California and Florida. The inland empire of California can be described as the central valley that extends from the southern part of the state all the way to the northern part of the state at least 1-hour inland from the coast. Let me start by saying it is MUCH WORSE than even I thought it could be. I met with various mortgage lenders, originators, economists, and capital markets professionals. The overriding theme that I got from them was that "Everyone committed fraud and everyone is responsible for the problem". They told me that they believe that 90% of all Subprime loans that were made contained some kind of **fraud**. Either borrowers lied about their incomes or mortgage brokers fudged numbers on the applications to make them pass muster with the needed ratios in order to get loans approved. They also said that of the borrower frauds, 50% of applicants overstated their income by MORE THAN 50%!!! As Kindleberger put so well in his book, **<u>Manias, Panics, and Crashes</u>**:

> The implosion of an asset price bubble always leads to the discovery of frauds and swindles. The supply of corruption increases in a pro-cyclical way much like the supply of credit. Soon after a recession appears likely the loans to firms that were fueling their growth with credit declines as the lenders become more cautious about the indebtedness of individual borrowers and their total credit exposure. In the absence of more credit, the fraud sprouts from the woodwork like mushrooms in a soggy forest.

In California today, home prices are down between 25%-40% in the central valley. From San Bernadino to Stockton, home prices are in free-fall and their physical condition is actually worse than their price decline. The borrowers are locked out of the financing market and there is no logical buyer for these homes outside of the original borrower. The foreclosure wave will hit these neighborhoods like the Asian Tsunami. If you plug in 15% depreciation in housing prices and 50% loss severities into our Subprime model, the capital structure is wiped out all the way to the "AA" tranches.

In the Subprime Credit Strategies Funds, we continue to hold our initial positions and have not taken any profits yet. In Hayman, we are short credit in the US (both Subprime RMBS and corporate credit) and long non-US equities and debt. We are short US consumer based equities, preferreds, and debt. I think the world is going to begin to

decouple from the US and realize that currency appreciation coupled with the globe's best growth is an attractive alternative to fraudulent ratings, US dollar depreciation, and financial inventions used to export risk.

Sincerely,

J. Kyle Bass
Managing Partner