

FGFOA 2008

Investment Pre-Conference

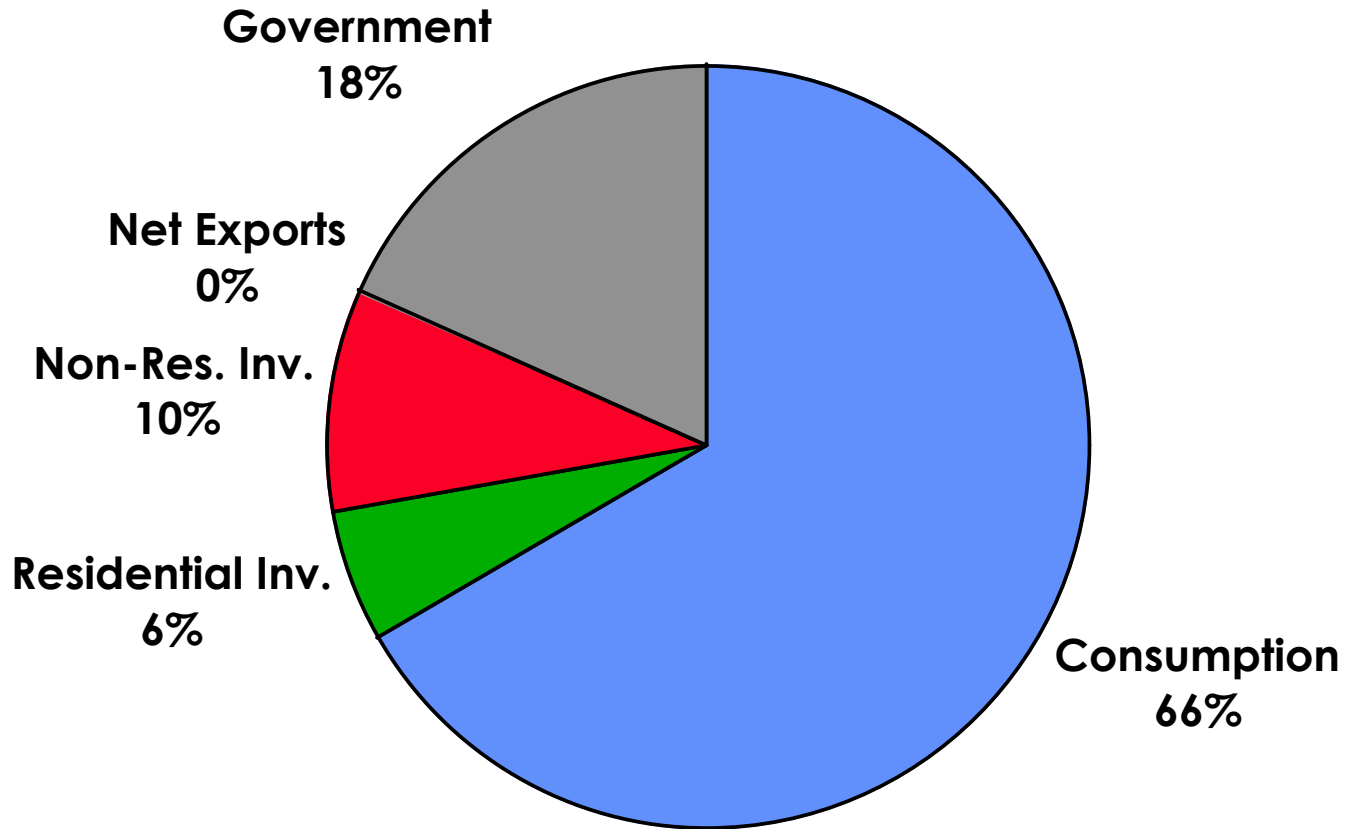
**The Current Investment Market:
What it is and how did we get here?**

May 17, 2008

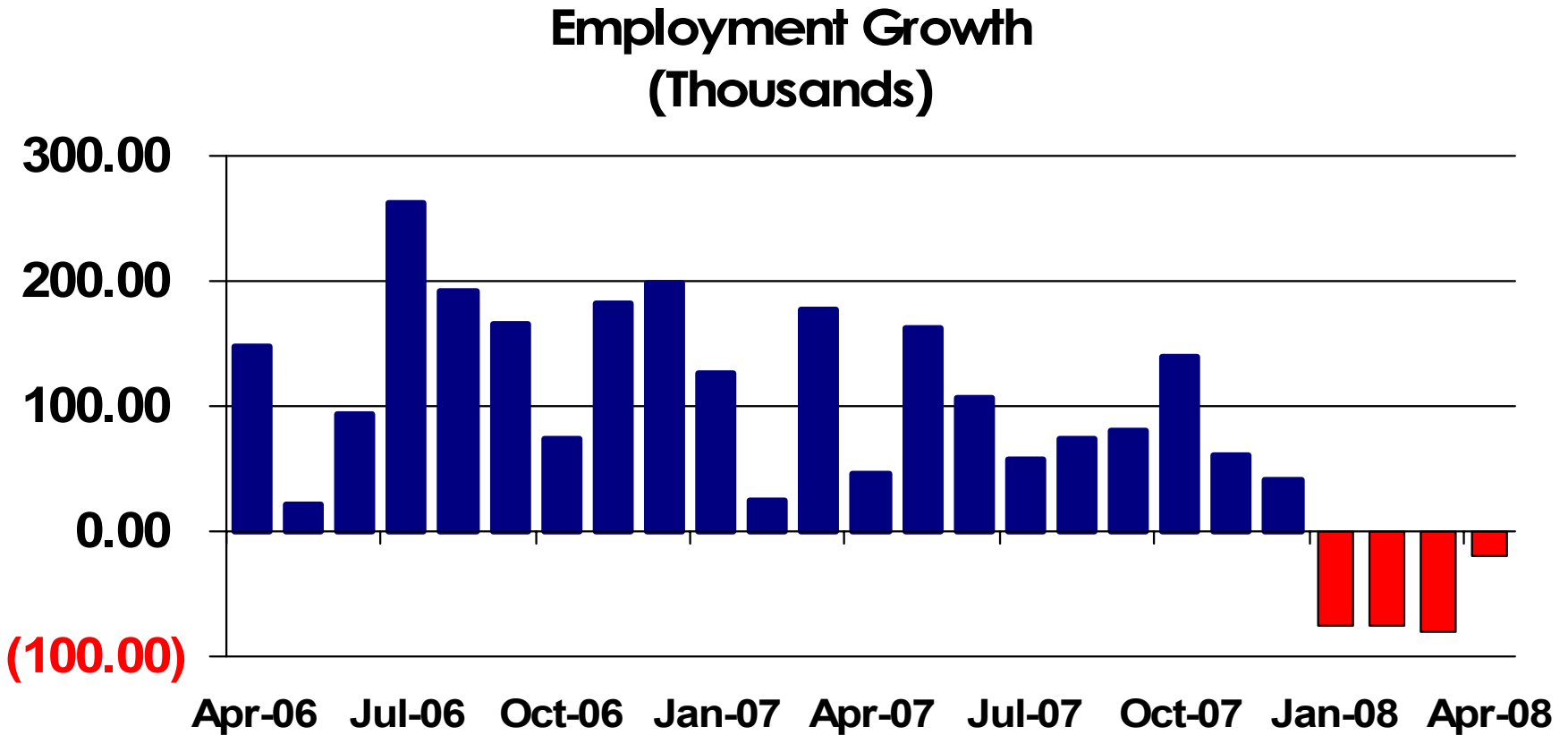
Chris Blackwood
Managing Director
Davidson Fixed Income Management

FLSAFE Portfolio Manager

What Makes the Economy Tick? (GDP Composition)

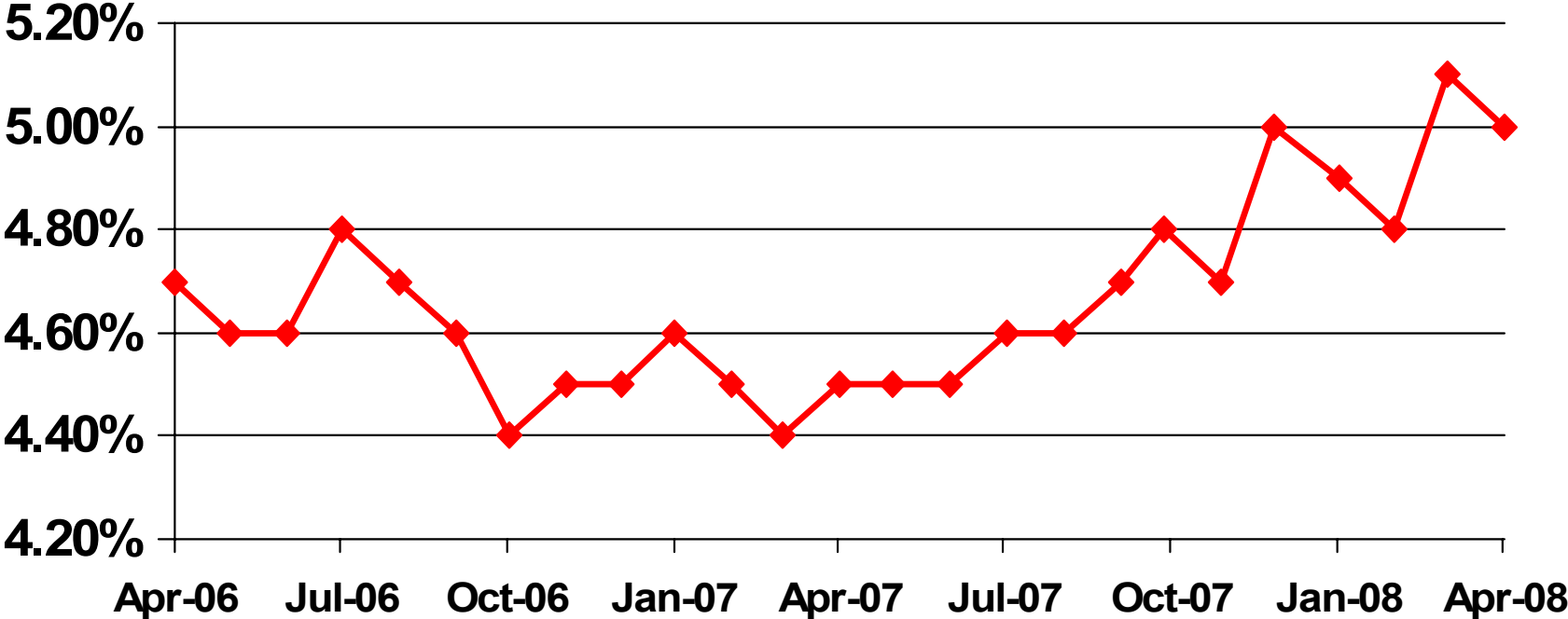


Payroll employment is reflecting a growing recession



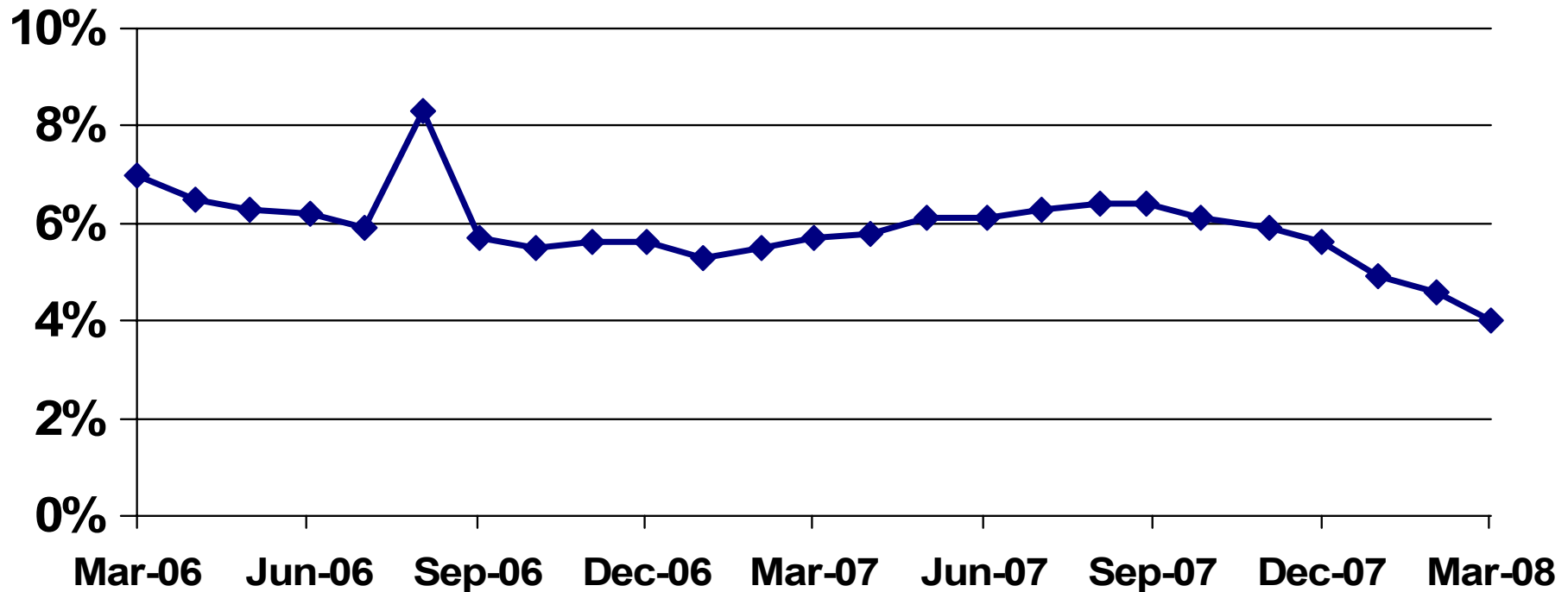
Unemployment is rising

Unemployment Rate (Percent)



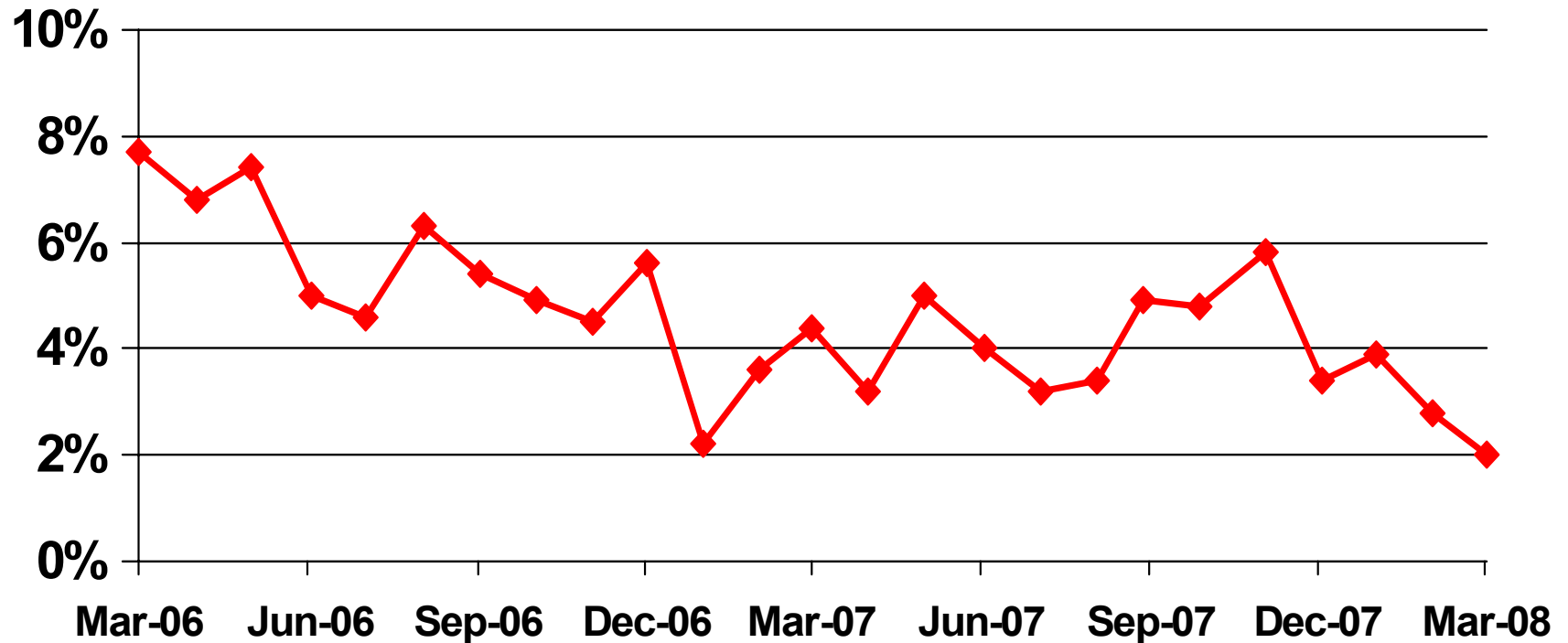
Personal income growth is weakening

Personal Income
(YOY Percent Change)

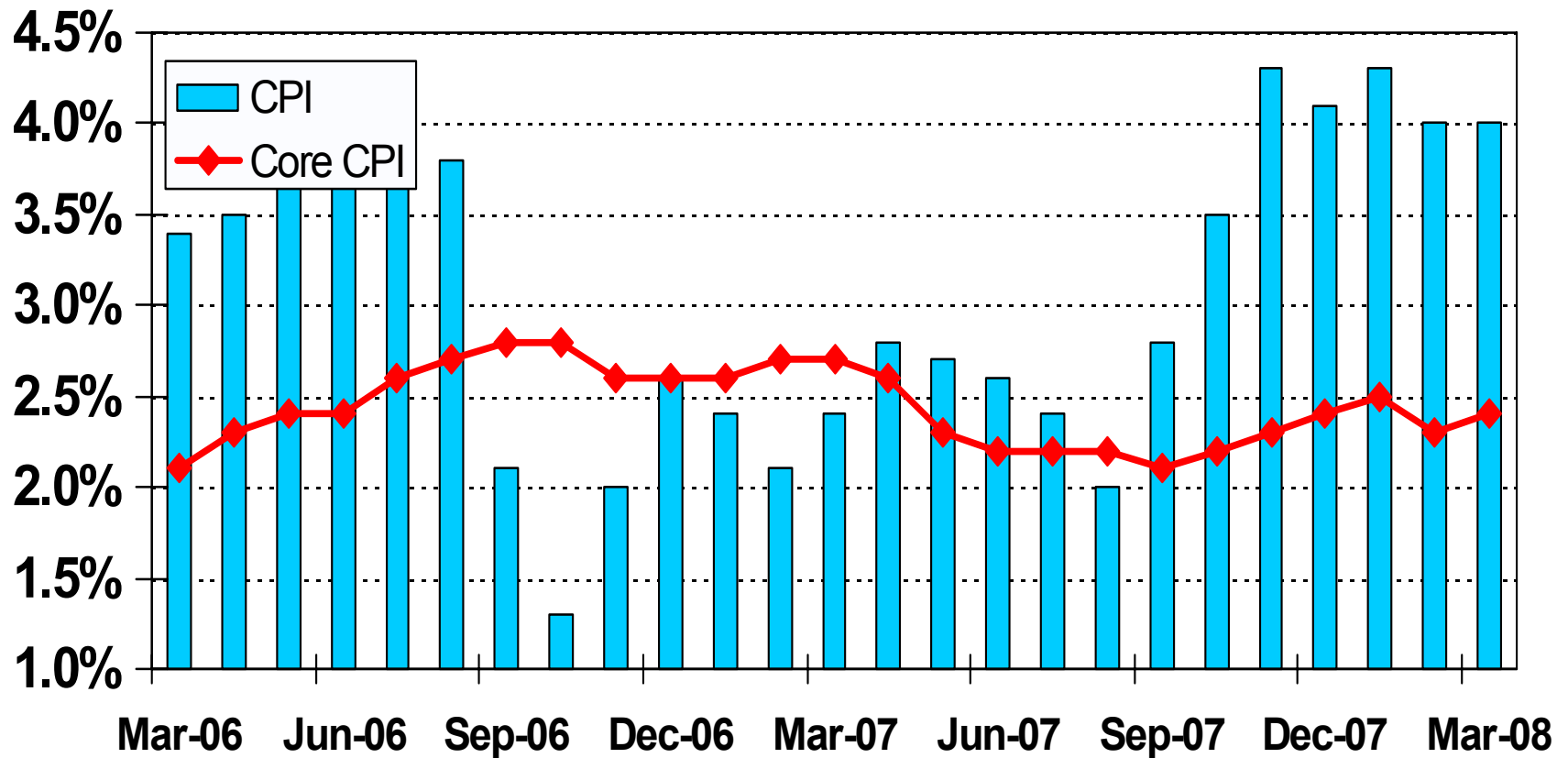


Consumer spending is slowing

Retail Sales
(YOY Percent Change)

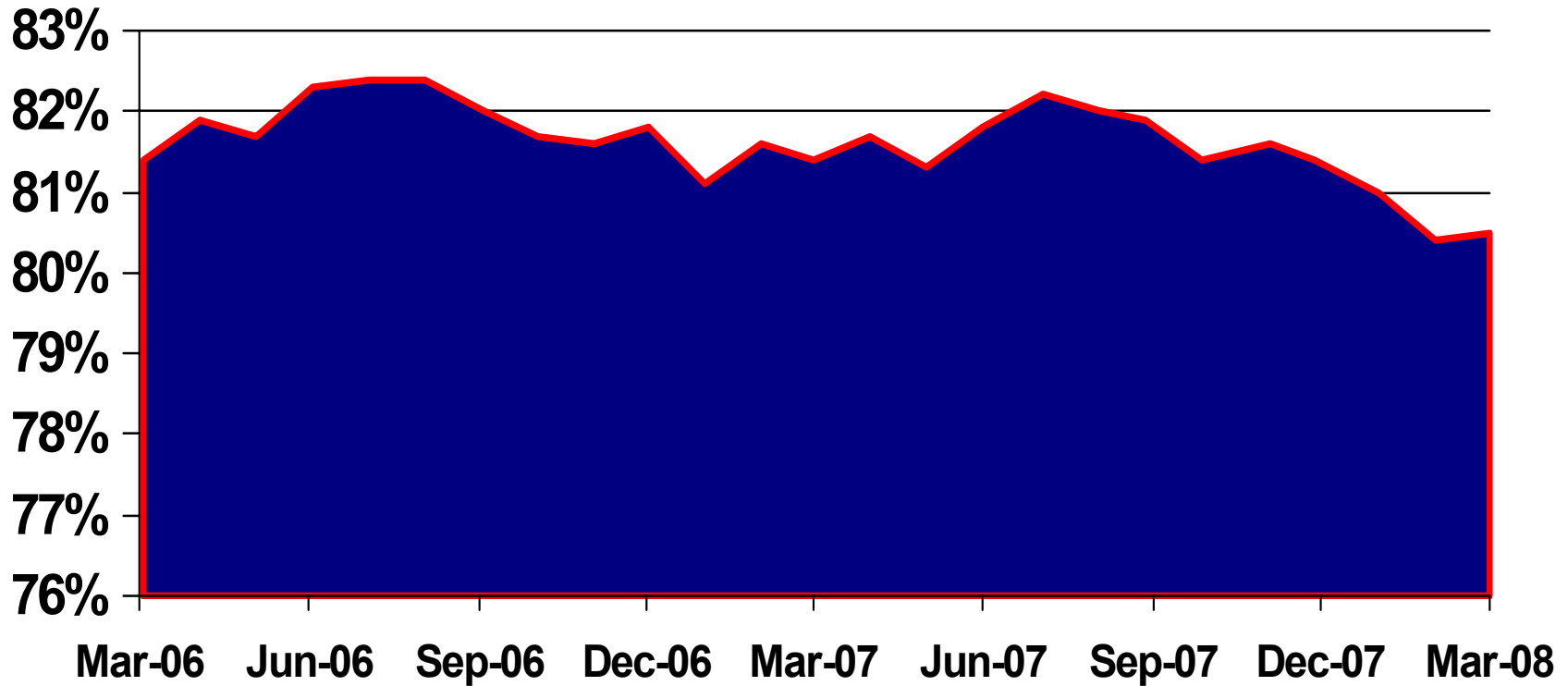


Inflation is accelerating



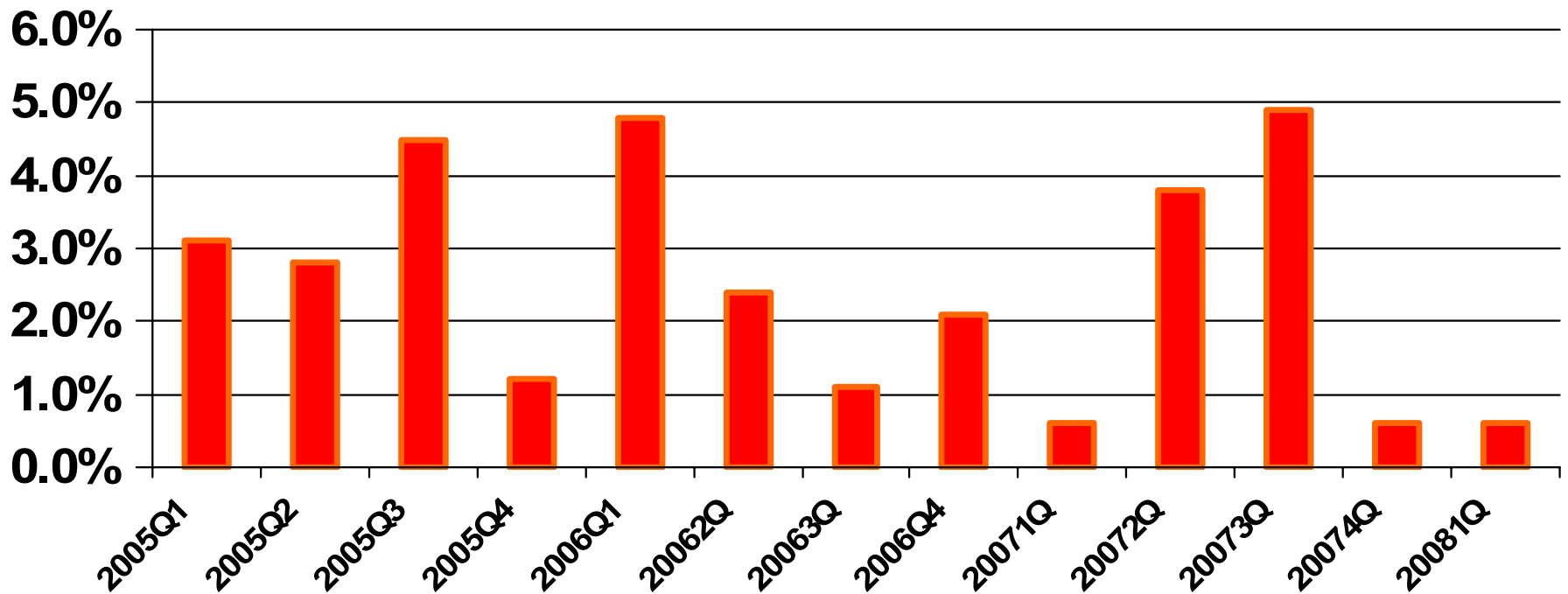
The nation's factory output has peaked.

Capacity Utilization Rate
(Percent)



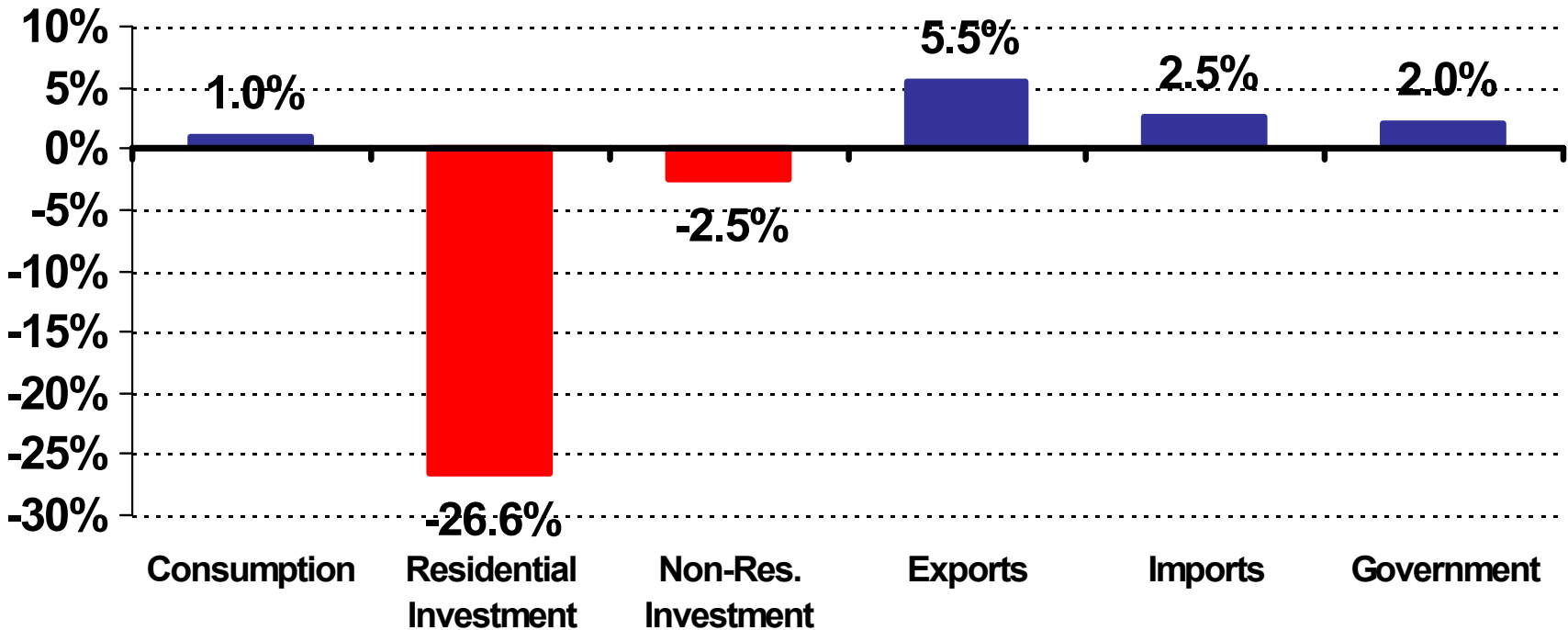
The U.S. economy moved toward recession in the 1st quarter

Gross Domestic Product
(Annualized Percent Change)



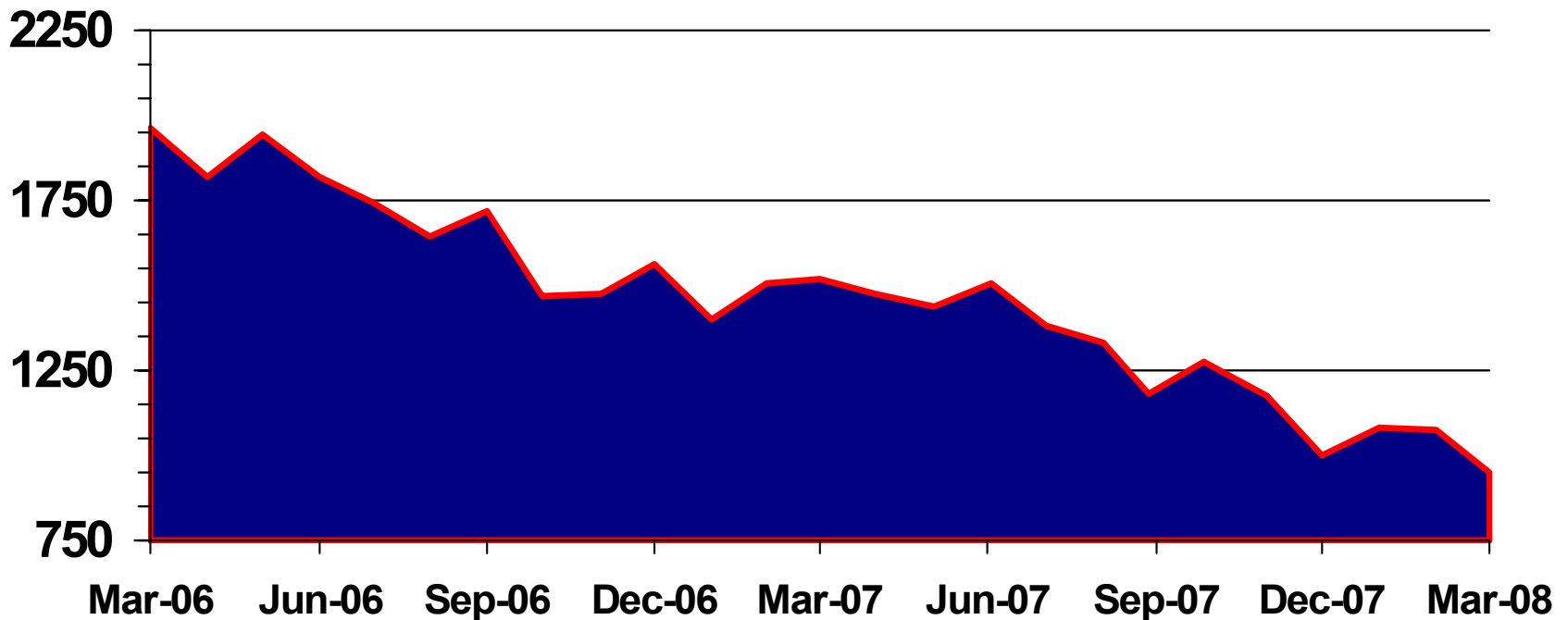
Housing is a negative on GDP growth

GDP Growth by Component
Annualized Percent Change from Prior Quarter



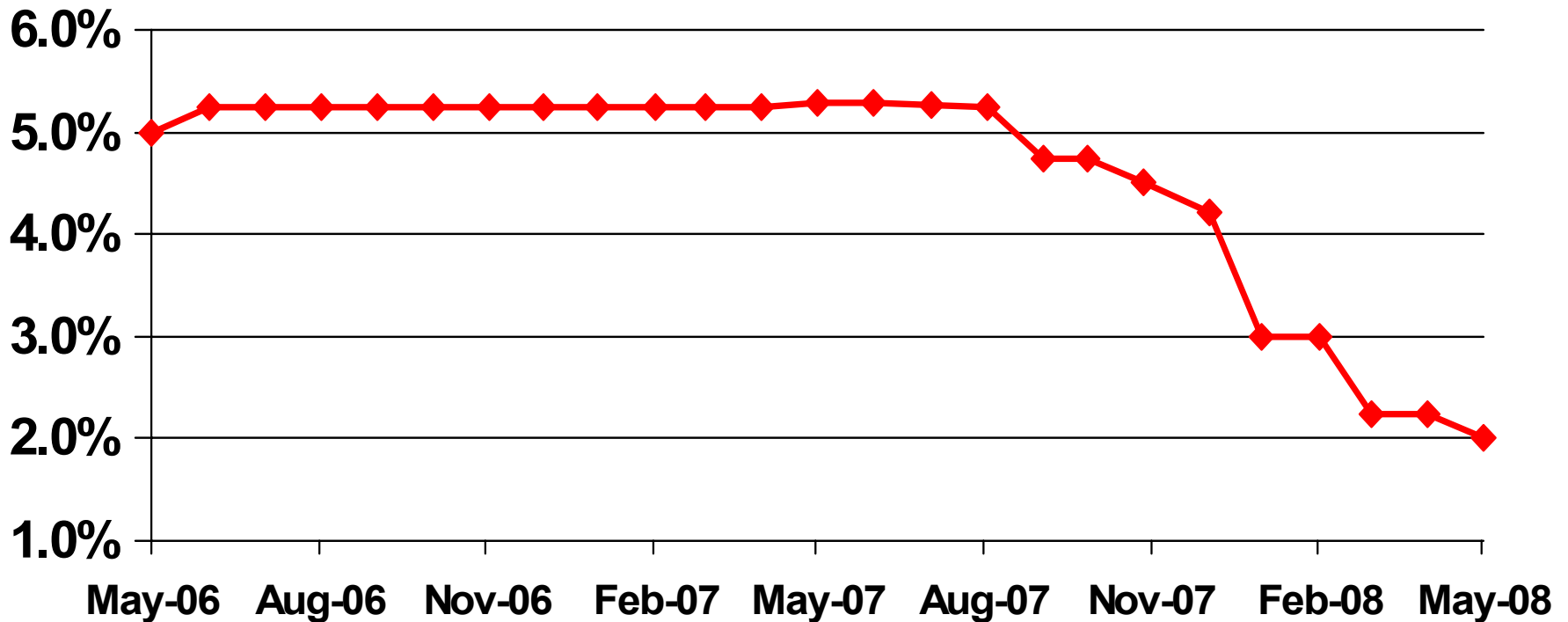
The housing market continues to be THE problem.

Housing Starts
(Thousands)



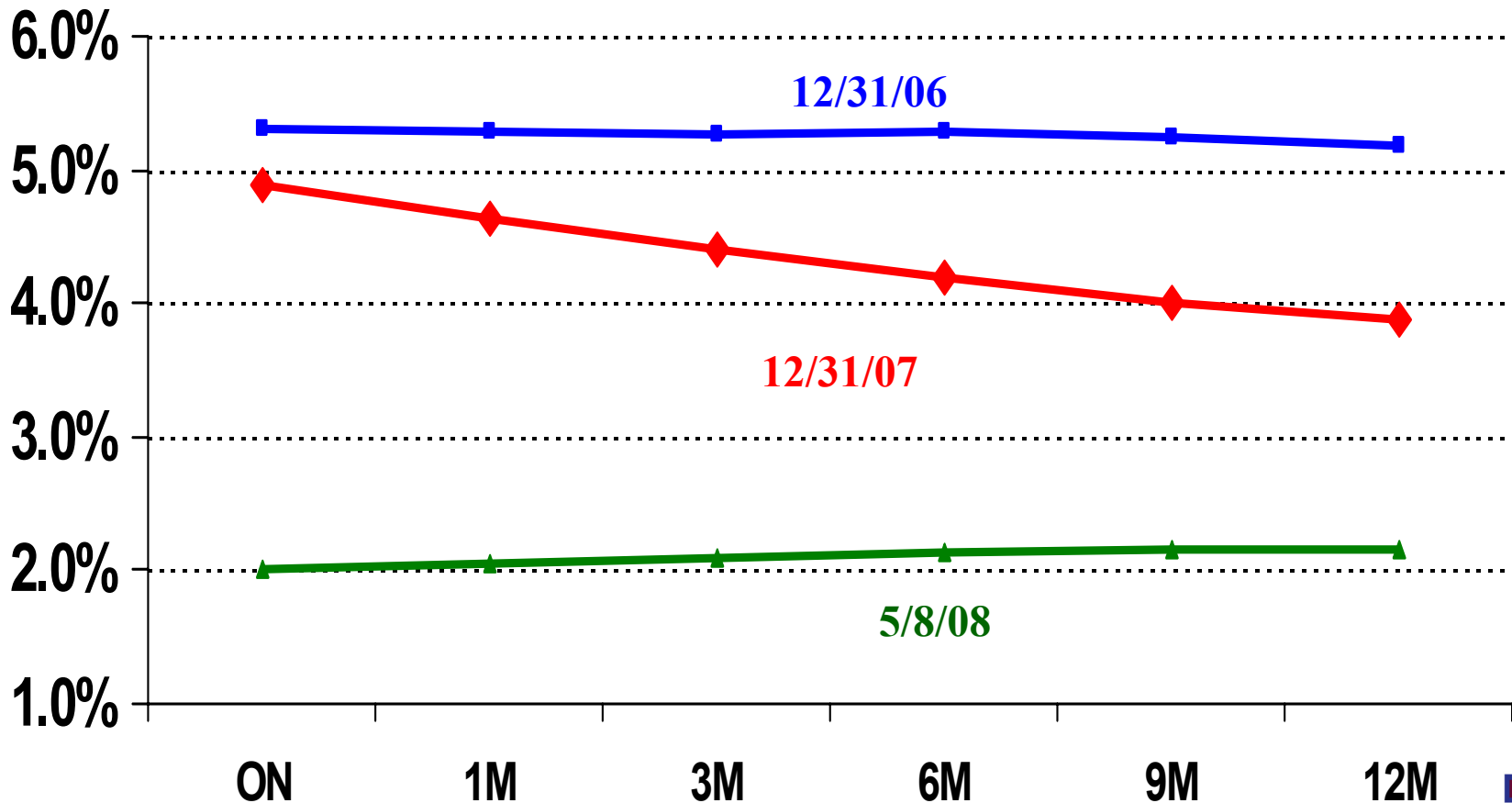
The Fed is working to stop the economy from falling into recession

Fed Funds
(Percent)



It is tough to make money today

Discount Note Yield Curve (Percent)

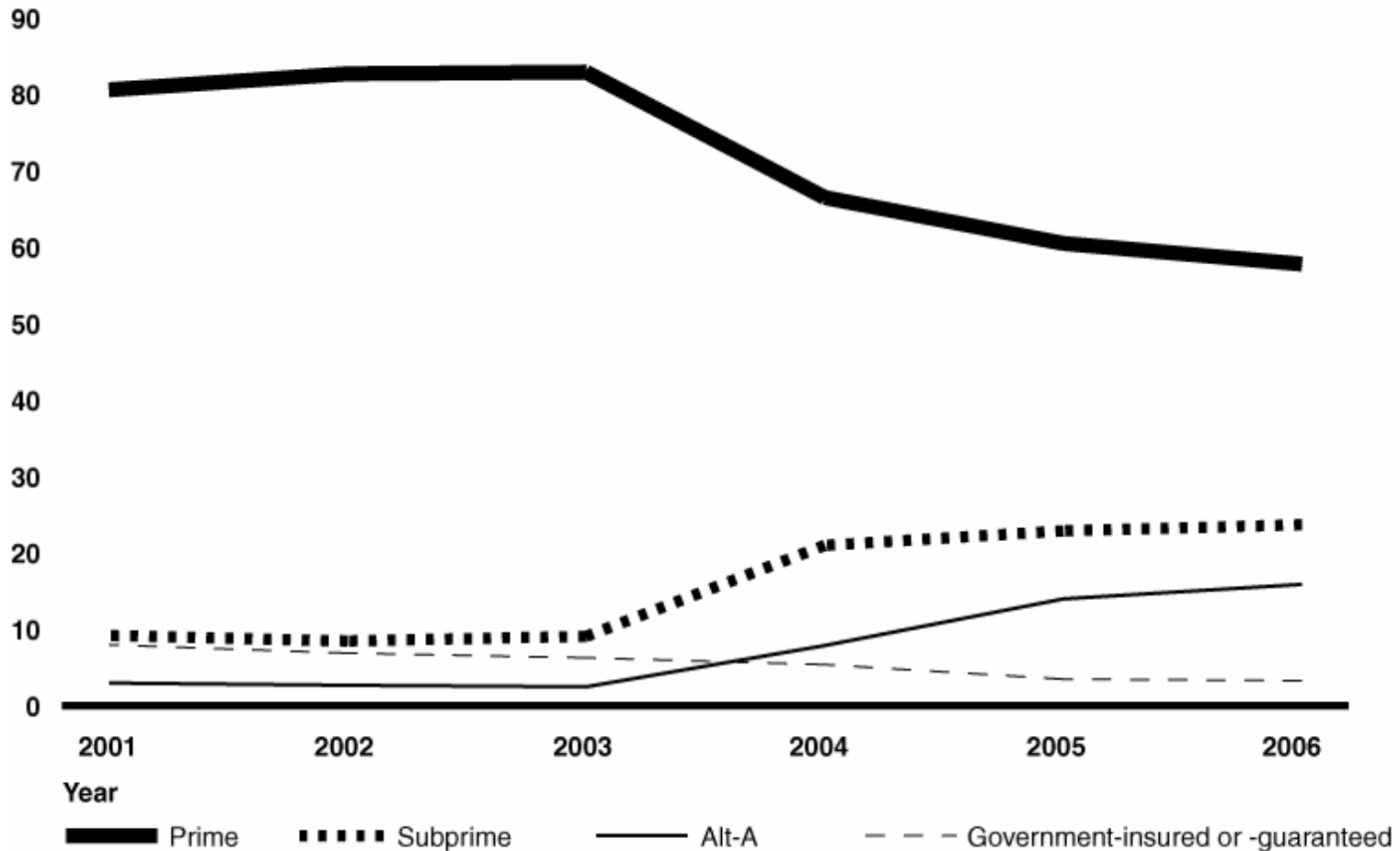


How the Subprime Problem Emerged

- **Mortgage lending standards allowed easy credit**
 - No/low doc loans
 - Subprime loans
- **New products emerged**
 - Interest only loans
 - Reverse amortization loans
 - Piggyback loans
- **Mortgage loans are securitized**
 - Tranches created
 - Subprime
 - Alt-A
 - Prime
 - Bonds are created
 - SIV
 - CDO

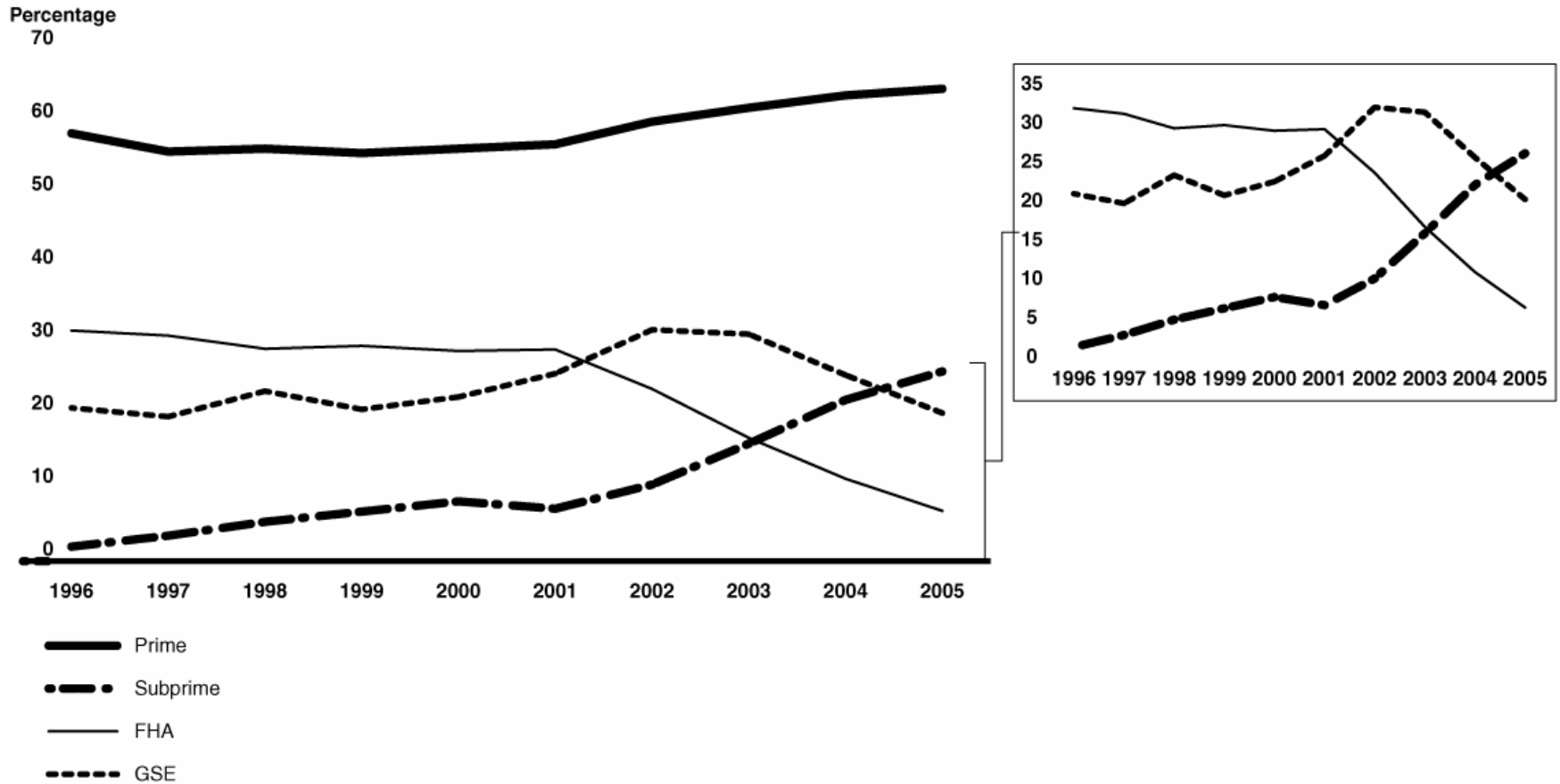
Background

Percent of mortgage originations (in dollar terms)



Source: GAO analysis of data from Inside Mortgage Finance.

Background

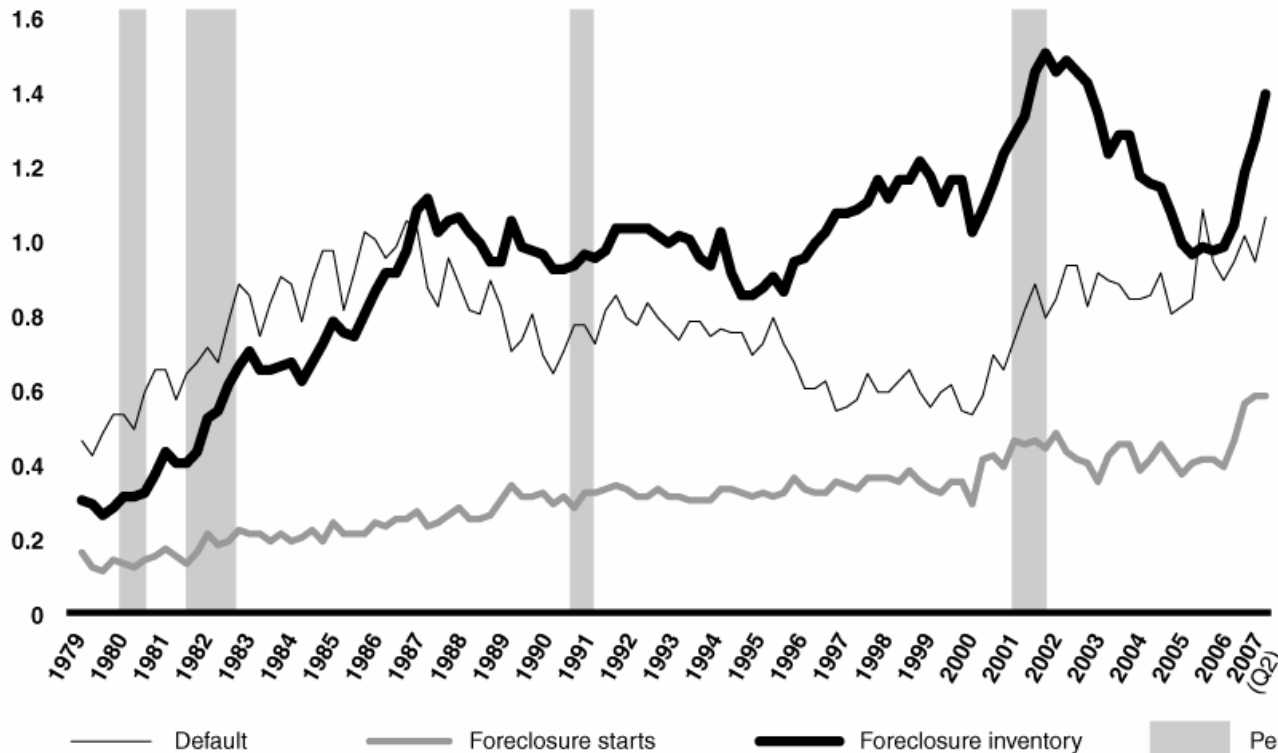


Source: GAO analysis of HMDA data.

Default and Foreclosure Trends

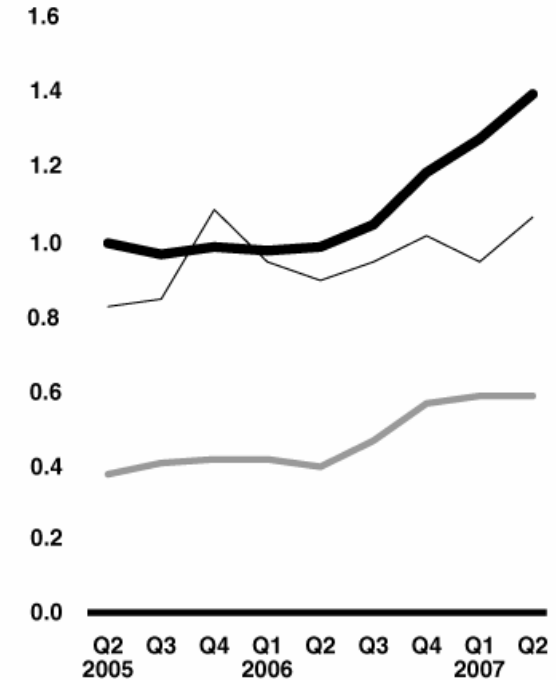
Q1 1979 – Q2 2007

Percentage



Q2 2005 – Q2 2007

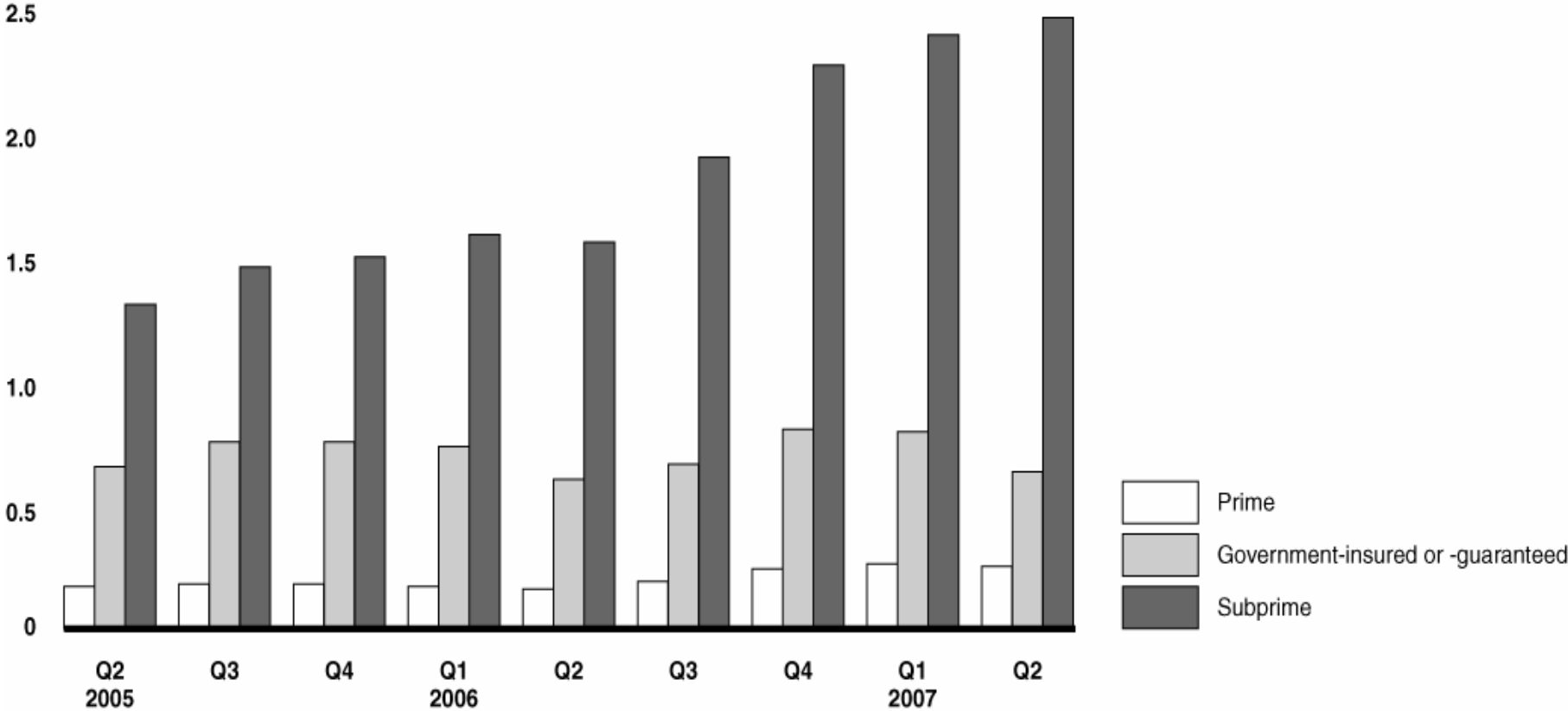
Percentage



Source: GAO analysis of MBA data, National Bureau of Economic Research.

Default and Foreclosure Trends

Foreclosure start rate



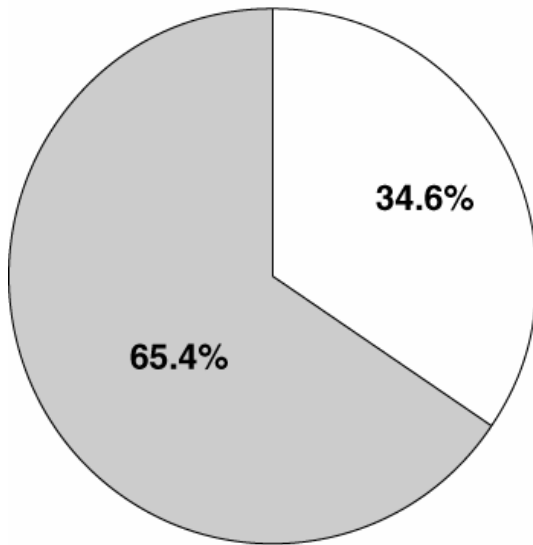
Source: GAO analysis of MBA data.

Default and Foreclosure Trends

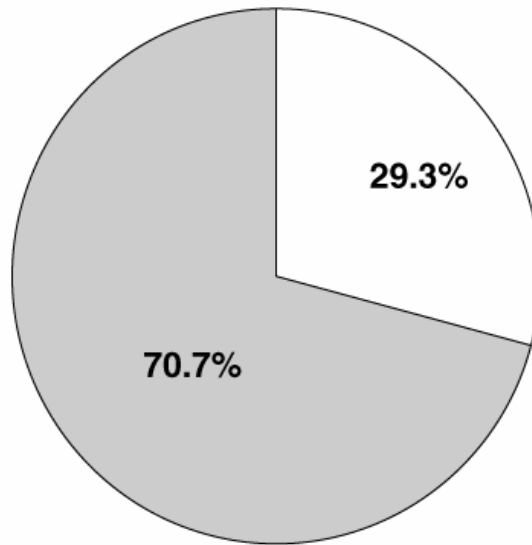
(Q2 2005 – Q2 2007)

Prime and subprime portions of default and foreclosure increases

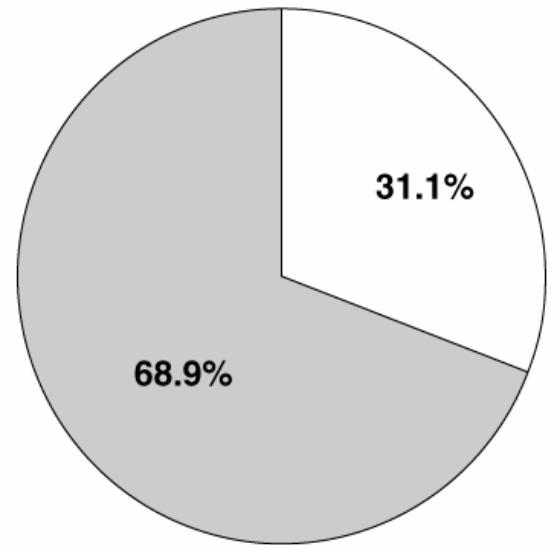
Increase in number of defaults



Increase in number of foreclosure starts



Increase in foreclosure inventory

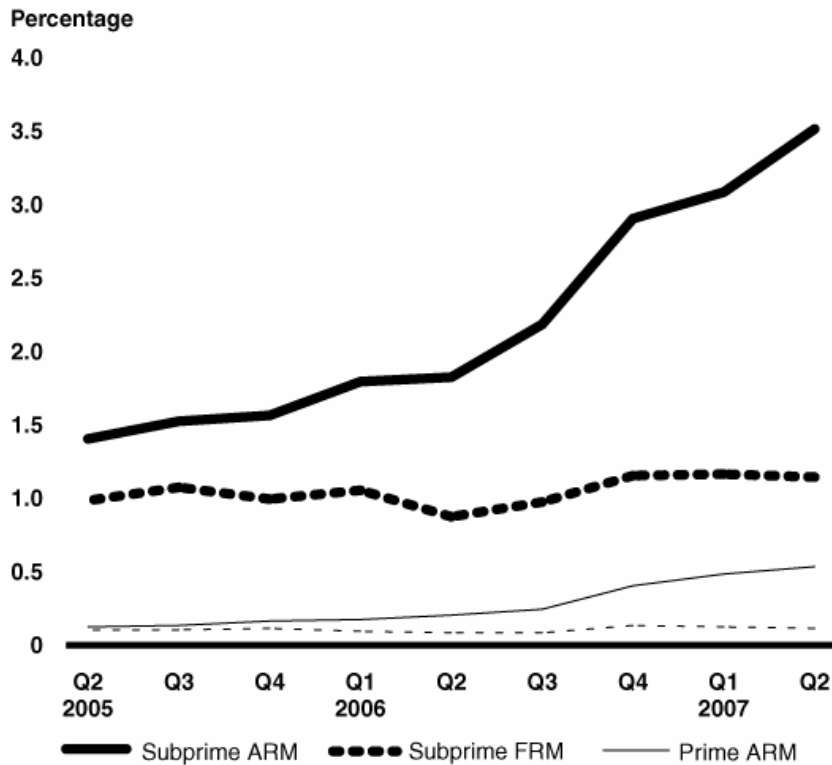


□ Prime portion of increase
■ Subprime portion of increase

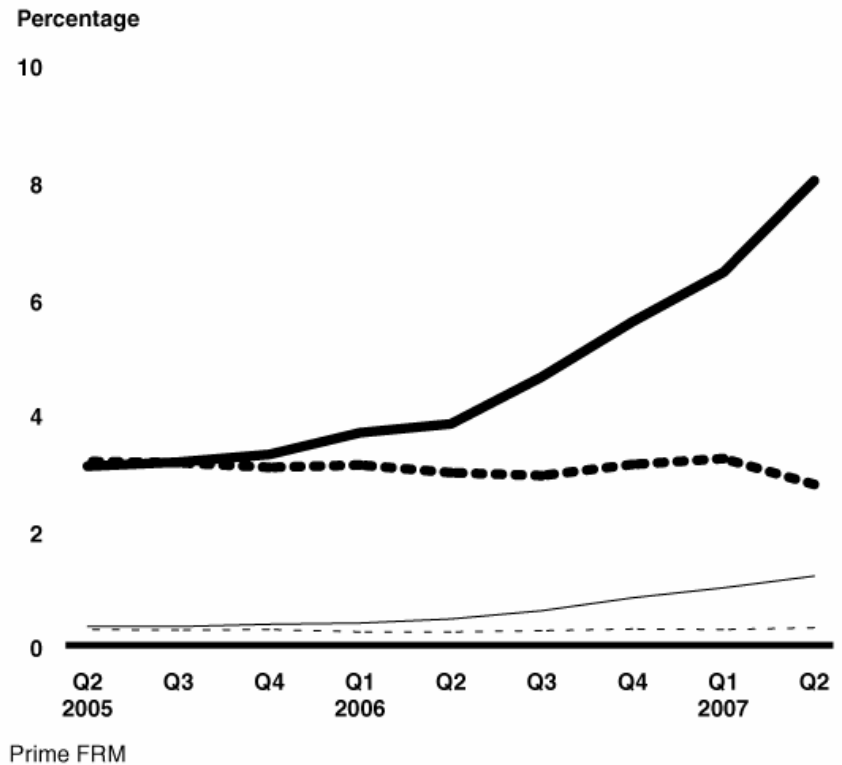
Source: GAO analysis of MBA data.

Default and Foreclosure Trends

Foreclosure start rate

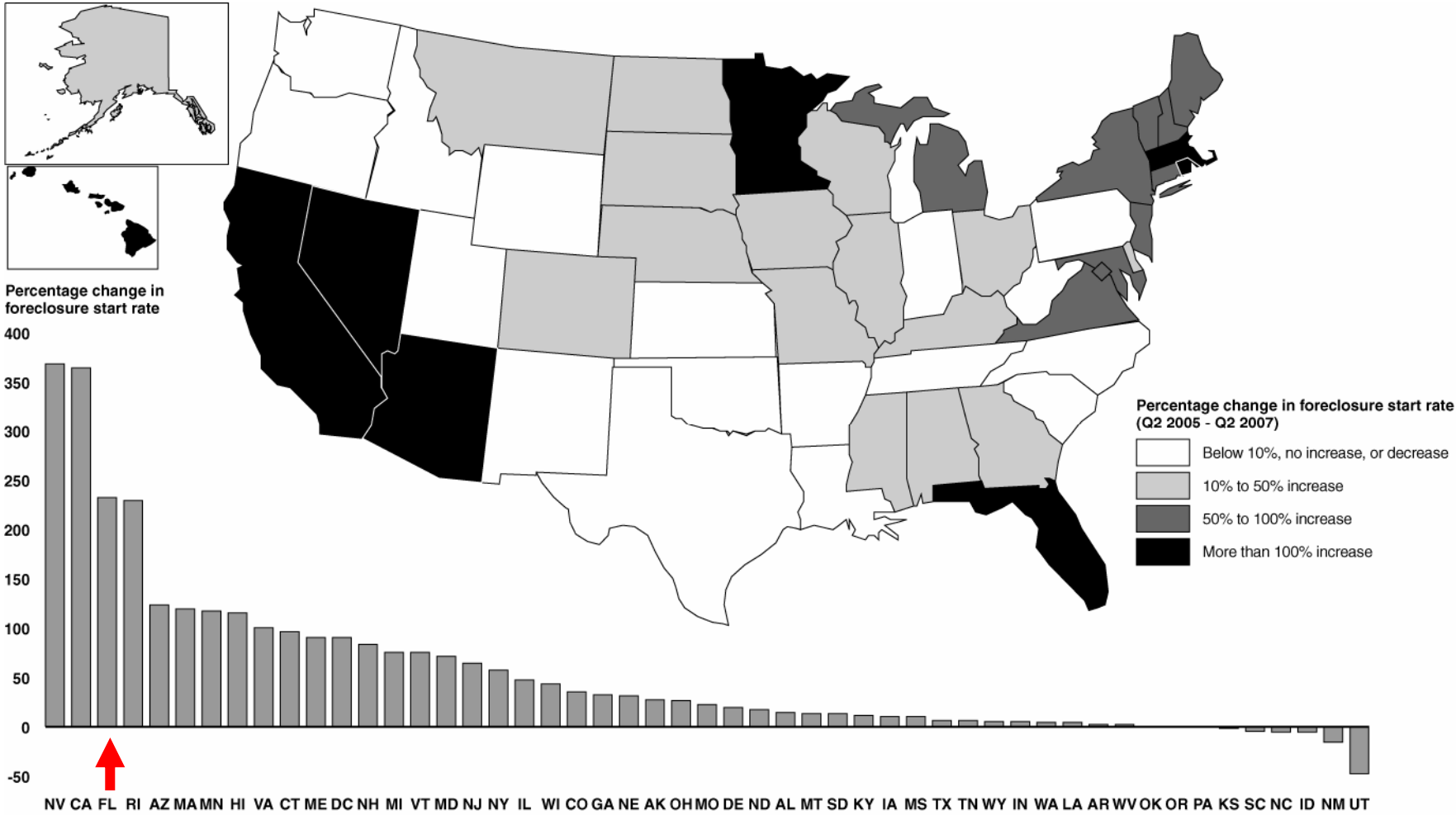


Foreclosure inventory rate



Source: GAO analysis of MBA data.

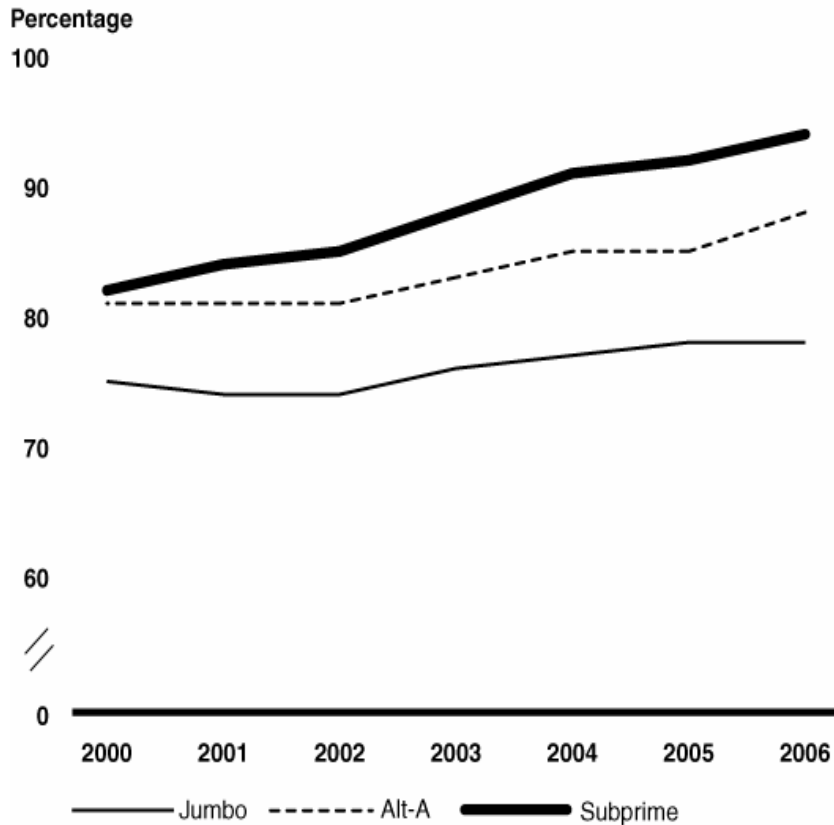
Default and Foreclosure Trends



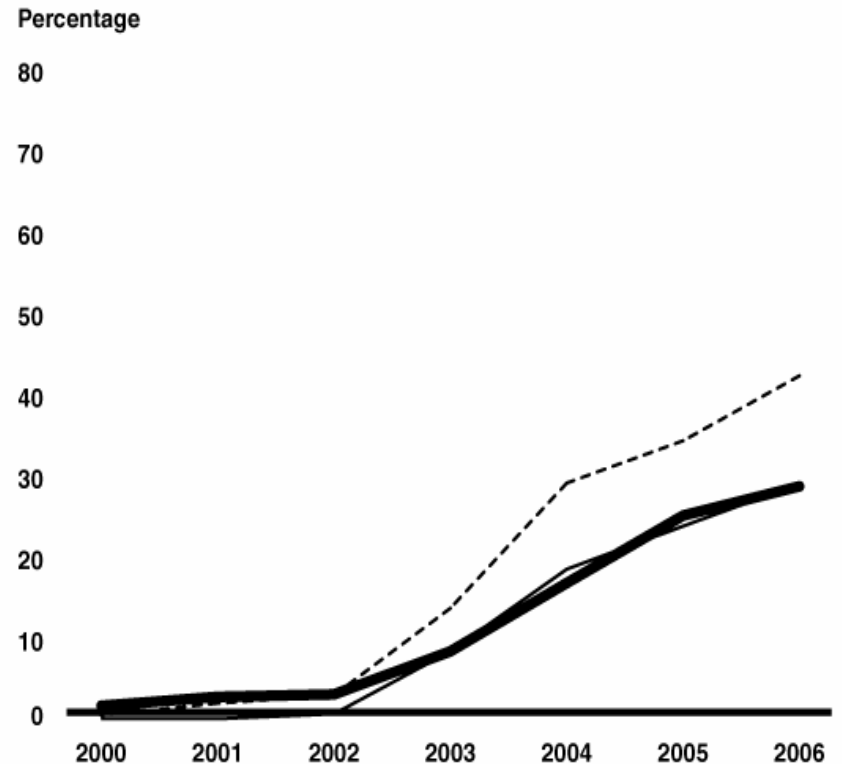
Sources: GAO analysis of MBA data; Art Explosion (map).

Piggyback Loans Accelerate

Average CLTV ratio (purchase loans only)



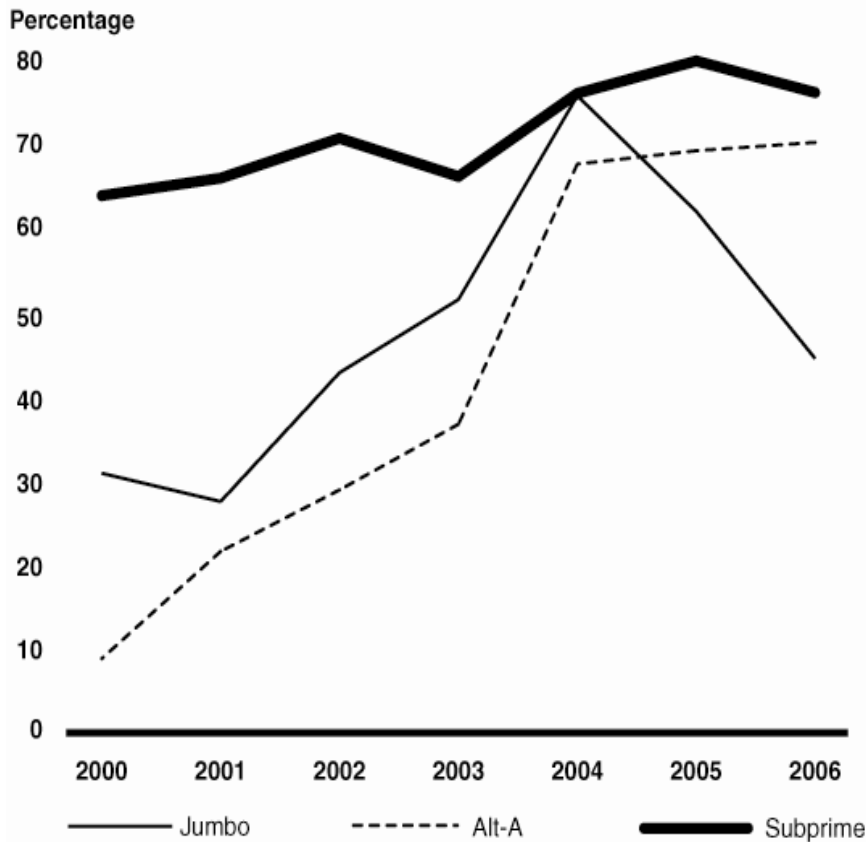
Percentage represented by mortgages with piggyback loans



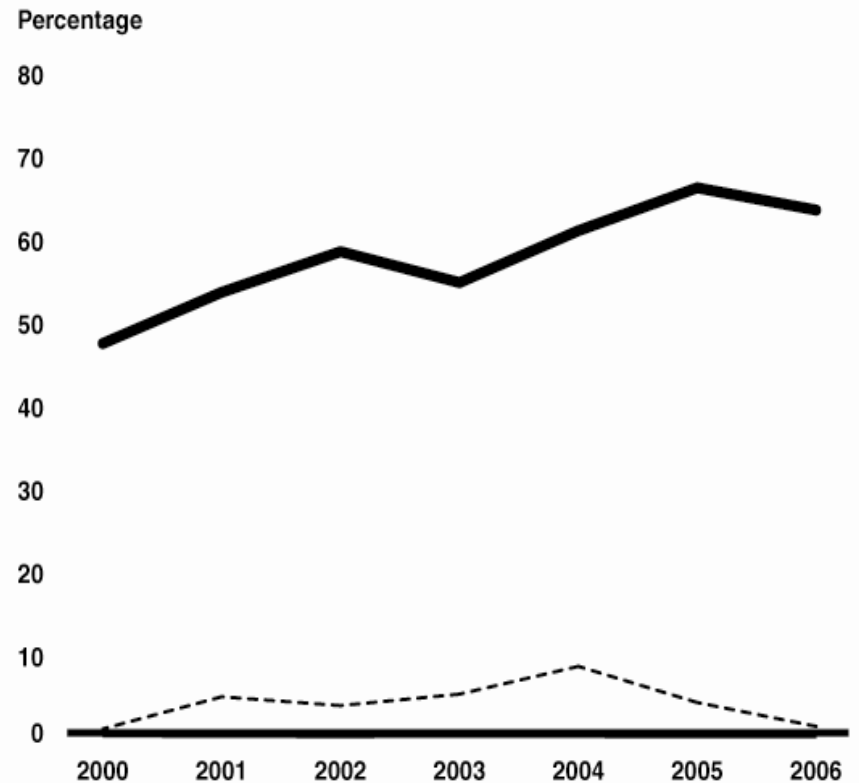
Source: UBS analysis of data from LoanPerformance.

Easing of Underwriting Standards and Wider Use of Certain Loan Features

Percentage represented by ARMs

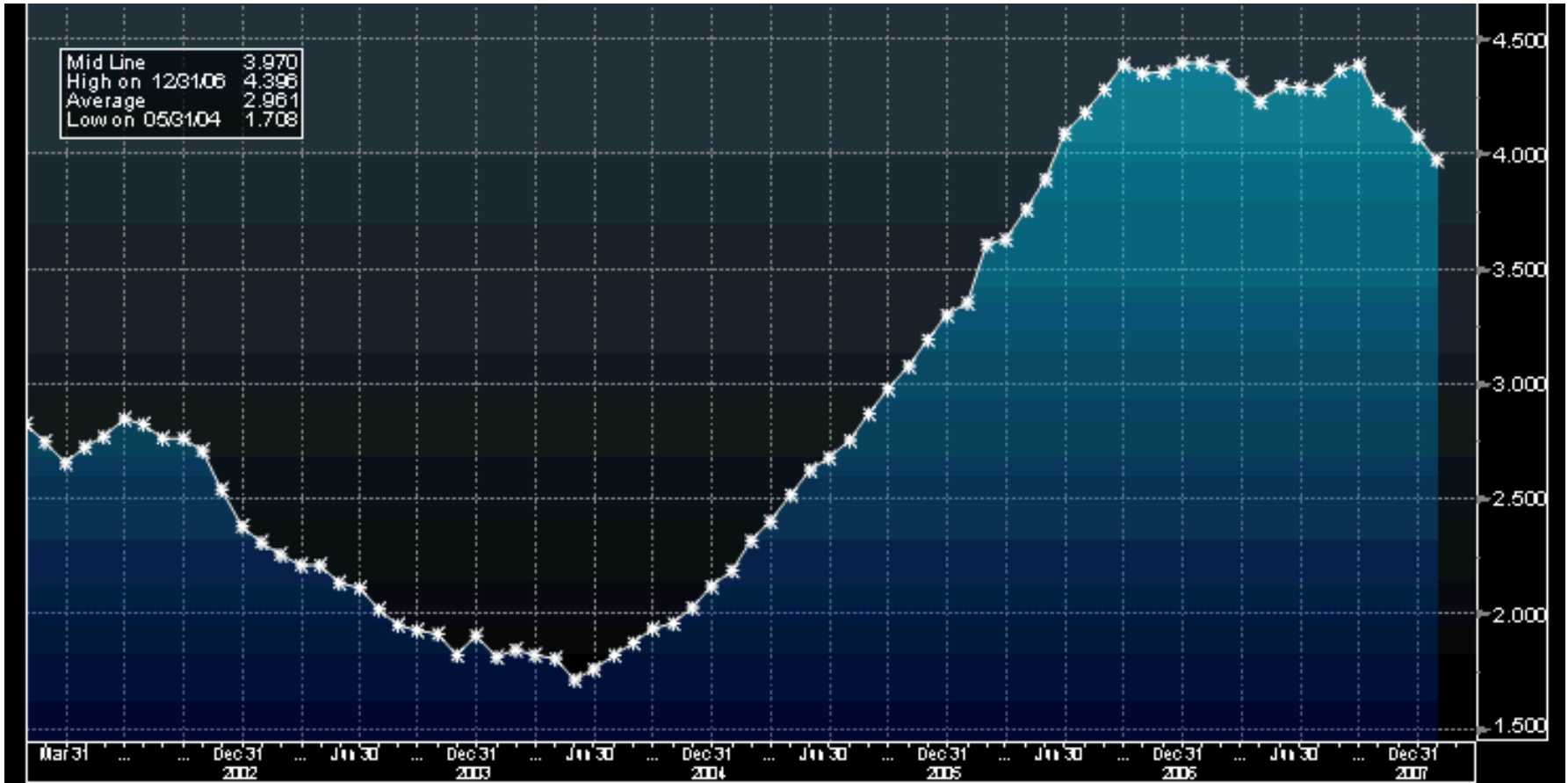


Percentage represented by 2/28 hybrids



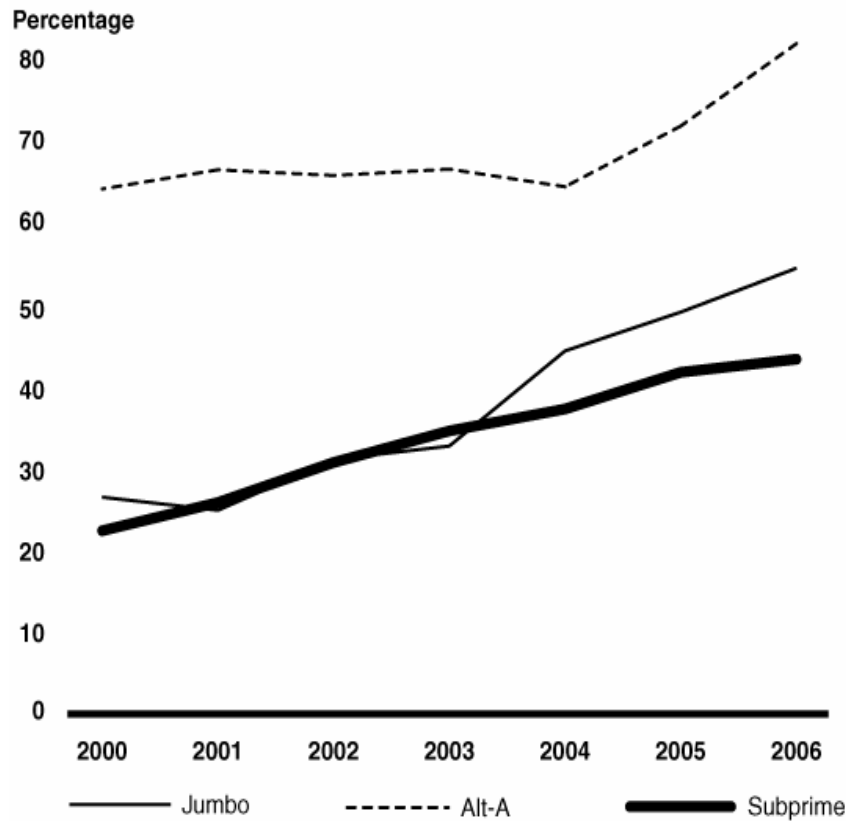
Source: UBS analysis of data from LoanPerformance.

ARM Cost of Funds

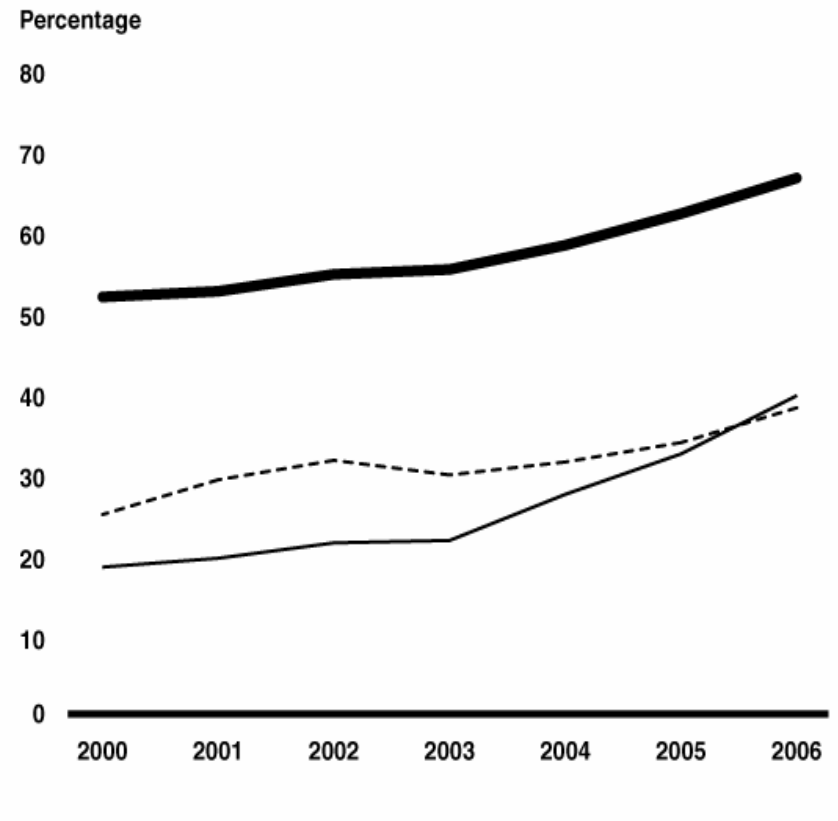


Easing of Underwriting Standards and Wider Use of Certain Loan Features

Percentage represented by loans with no or low documentation



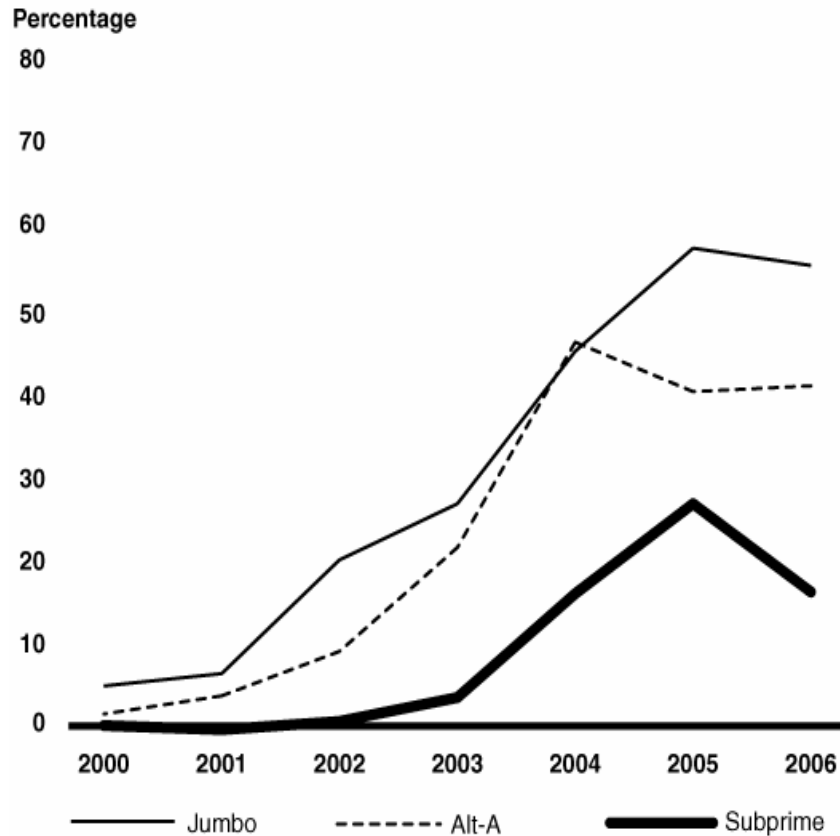
Percentage represented by loans with debt service-to-income ratios >40%



Source: UBS analysis of data from LoanPerformance.

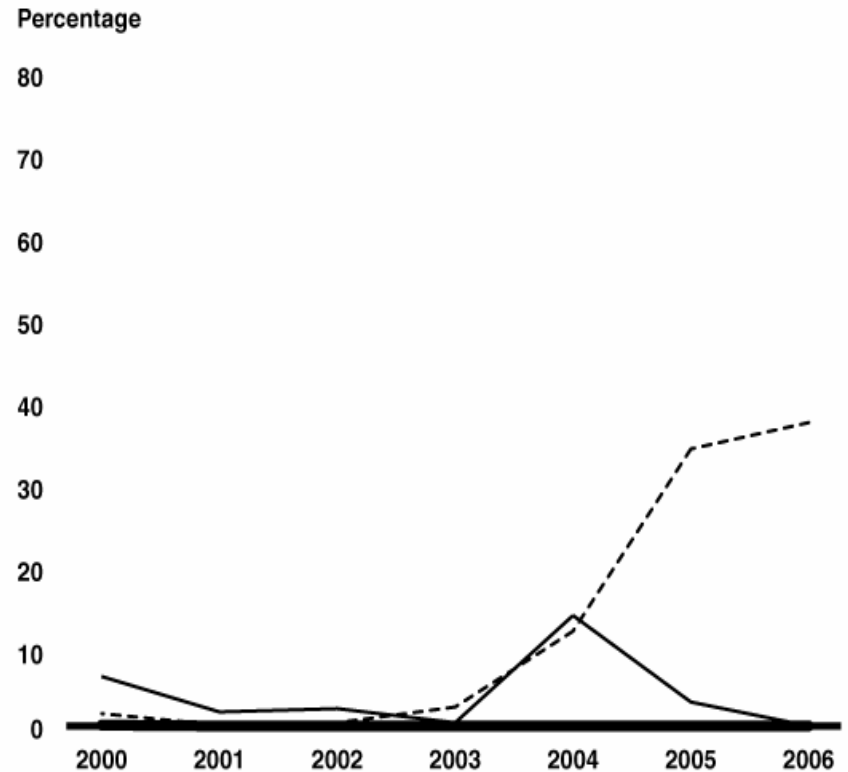
Easing of Underwriting Standards and Wider Use of Certain Loan Features

Percentage represented by interest-only loans



Source: UBS analysis of data from LoanPerformance.

Percentage represented by loans with negative amortization feature



SIVs, CDOs and other Problematic Bond Products

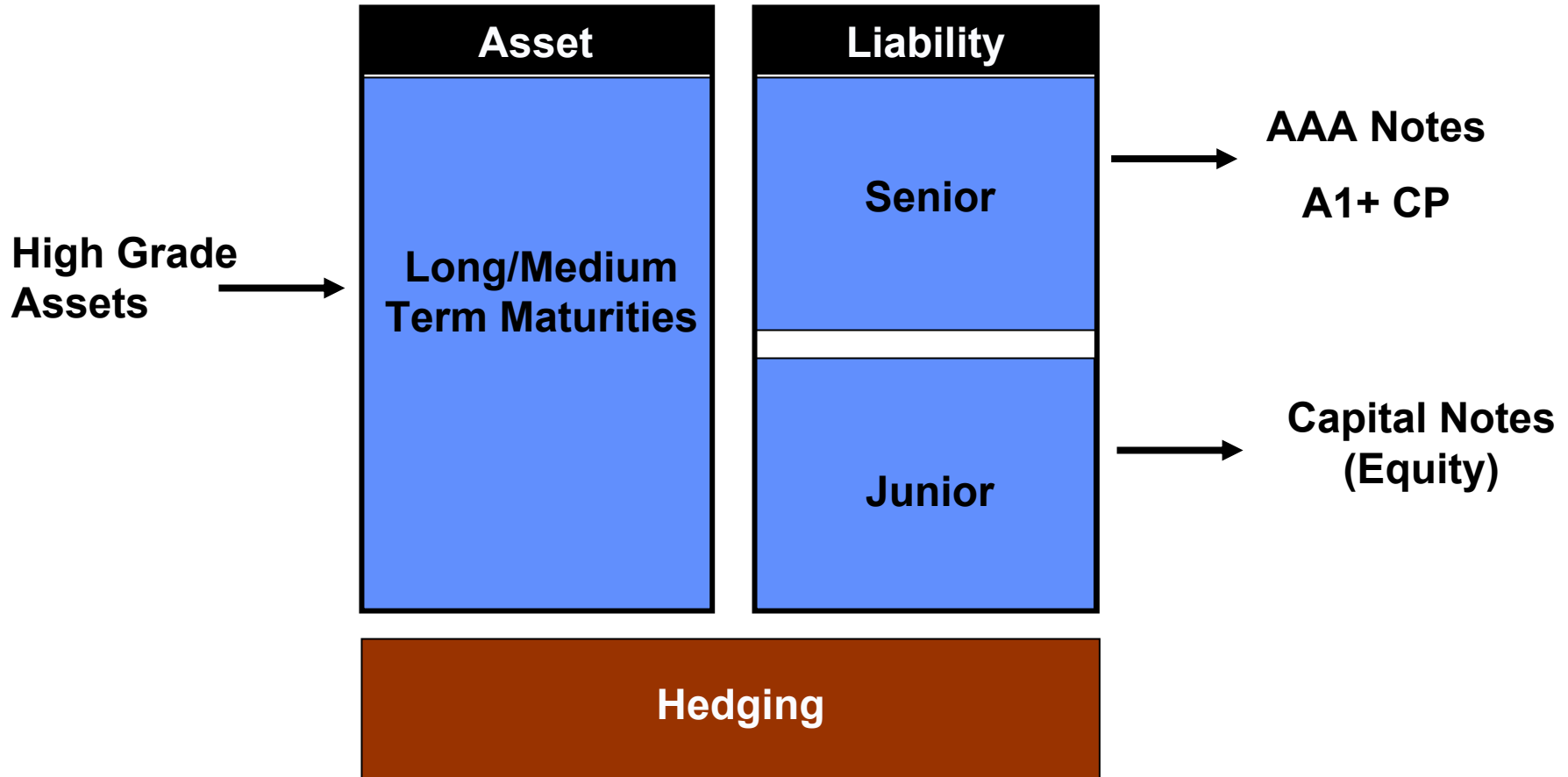
Structured Investment Vehicles

- **SIVs**
 - **Bankruptcy remote**
 - **Use CP to fund operations**
 - **Are continuously funded**
 - **Use leverage to increase returns**
 - **No maturity date**
 - **Risks is hedged, both currency and interest rates**
- **Hedge Funds – use leverage and make directional and sector bets**

Structured Investment Vehicles

- **CDO**
 - **Bankruptcy remote**
 - **Uses hedging to mitigate risk**
 - **Purchase lower rated securities**
 - **Are not focused on liquidity**
 - **Can be rated, but are not under the same scrutiny as SIVs**

SIV Balance Sheet



The Subprime Problem Intersects with the Florida SBA LGIP

SBA Facts

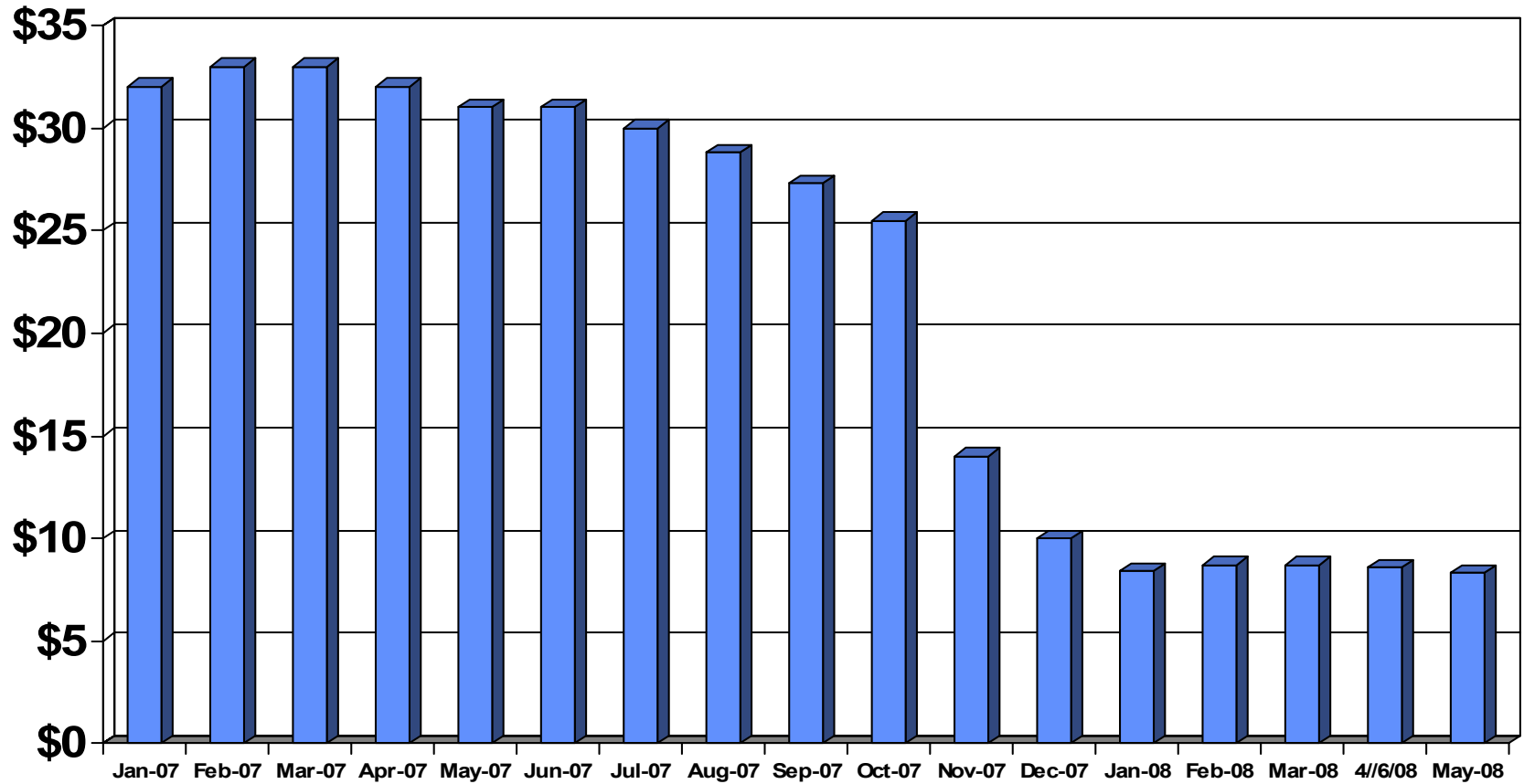
- **With \$33 billion in assets in January 2007, the SBA pool was the largest investment pool in the nation**
- **The pool was operated by the State Board of Administration**
- **The Board of Trustees included the Governor, the CFO and the Attorney General**
- **The SBA pool had 995 Participants and over 2000 accounts**
- **No Participants were on the Board of Trustees**

SBA Facts

- **The SBA pool was non-rated**
- **The State of Florida does not provide a credit back stop to the SBA Pool**
- **The SBA primarily owned corporate bonds and commercial paper.**
- **Fees were low, only 1.5 basis points**
- **Interest rates on the SBA pool exceeded that of even the largest national money market funds**

SBA Investment Pool Assets

\$ Billion



SBA Chronology

- **July 2007 - SBA purchased \$780 million in SIVs – Ottimo, KKR and Axon – all rated A1+/P1**
- **August 2007 – SBA purchases \$150 million in SIVs – \$260 million of KKR Pacific and Atlantic – all rated A1+/P1 – all rated A1+/P1**
- **August 16, 2007 – Countrywide downgraded to BBB/Baa3**
 - Decision made to hold until maturity even though the investment was in non-compliance with the investment policy
 - Countrywide security given a compliance exception
- **August 30, 2007 – Ottimo downgraded to A2**
- **October 24, 2007 – Axon and KKR downgraded to A2/NP**

SBA Chronology

- **November 2007 - it was becoming well known that the SBA owned**
- **\$756 million in distressed securities**
- **November 2007 - A run on the pool starts, redemptions hit \$14 billion**
- **November 29, 2007 – The SBA pool closed**
- **November 30, 2007 - BlackRock retained**
- **The SBA Executive Director resigns**
- **December 6, 2007 - The SBA pool reopens – spilt into two funds, Fund A and Fund B**
 - **Fund A has \$12 billion of the “good” securities**
 - **Fund B has \$867 million of the “bad” securities**
- **December 7, 2007 – Redemptions drop Fund A to \$10.2 billion**

SBA Chronology

- **December 6, 2007 – SBA reopens**
 - Redemptions restricted to \$2 million per day per Participant
 - 2% redemption fees imposed on Fund A
- **December 21, 2007 – New investment policy drafted**
 - S&P AAAM rating issued to Fund A
- **December 2007- It is announced that November 2007 interest will be withheld from all Participants – even those that withdrew funds before the closure of the pool**
- **December 2007- SBA hires PR firm**
- **February 2008 – Federated is retained as the manager of the SBA pool**

SBA Chronology

- **February 7, 2008 – A new investment pool, Florida Surplus Asset Fund Trust (FLSAFE) opens**
- **March 17, 2008 – It disclosed the Fund A owns Bear Stearns Corporate Notes**
- **April 29, 2008 – Clifton Gunderson releases performance audit**
- **May 5, 2008 – Bond Buyer reports SEC investigation**
- **May 5, 2008 - Assets in Fund A = \$8.4 billion**

Structural Problems

- **Board of Trustees**
 - No participant representation
 - Political issues
- **Local government concentration**
 - State had no money in the pool
- **SBA was nonrated**
 - No third party oversight
- **Permitted investments were very broad**
- **Fees were low/yields were unusually high**
- **SBA legislative declaration stressed yield**
- **Interest was allocated monthly**
- **Portfolio was not market priced - NAV unknown**
- **Transparency was low**

Thank You

Chris Blackwood
Managing Director
Davidson Fixed Income Management

Orlando Office
3452 Lake Lynda Drive, Suite 365
Orlando, FL 32817
866-999-1215