

# Lazard Insights Conference Call Series

## How the Credit Crisis is Creating Potential Opportunities for Fixed Income Investors

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# Agenda

- What Happened
- What To Monitor
- Opportunities

# What Happened?

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The current environment is the result of three different crises.

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- Credit Crisis

- Mortgage securities and loans were “overrated”
- The stage was then set for an enormous write-down of balance sheet assets

- Liquidity and Deleveraging Crisis

- Balance sheet write-downs destroyed the capital base of the entire financial system
- Write-downs caused a massive contraction in available credit
- The lack of available credit triggered margin events on all levered strategies

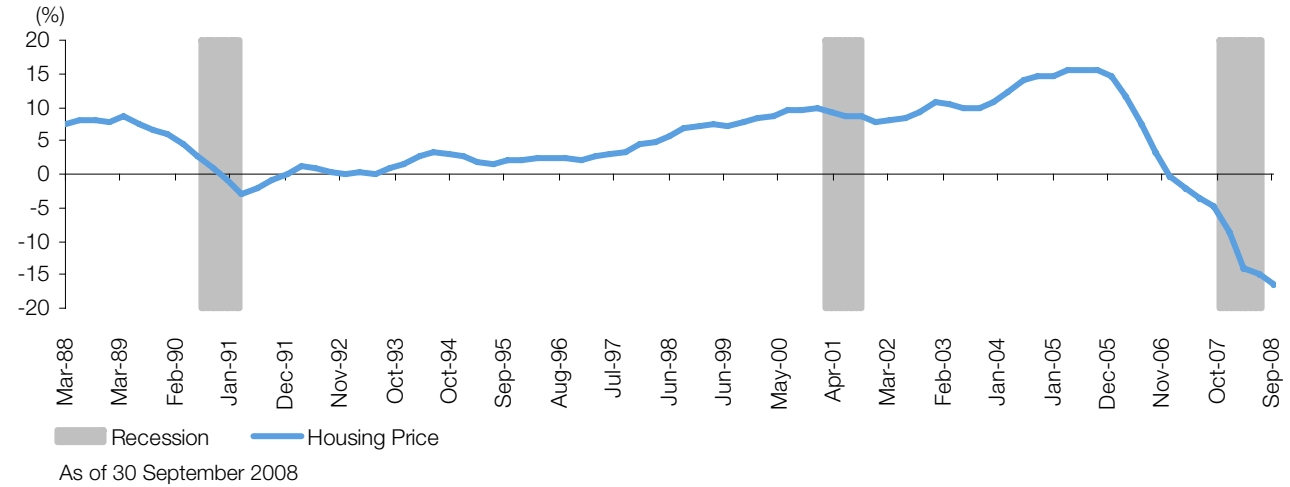
- U.S. Macroeconomic Demand Crisis

- The combination of an unresolved credit, liquidity, and deleveraging crisis impaired all lending activity
- Even healthy consumers and businesses were impacted

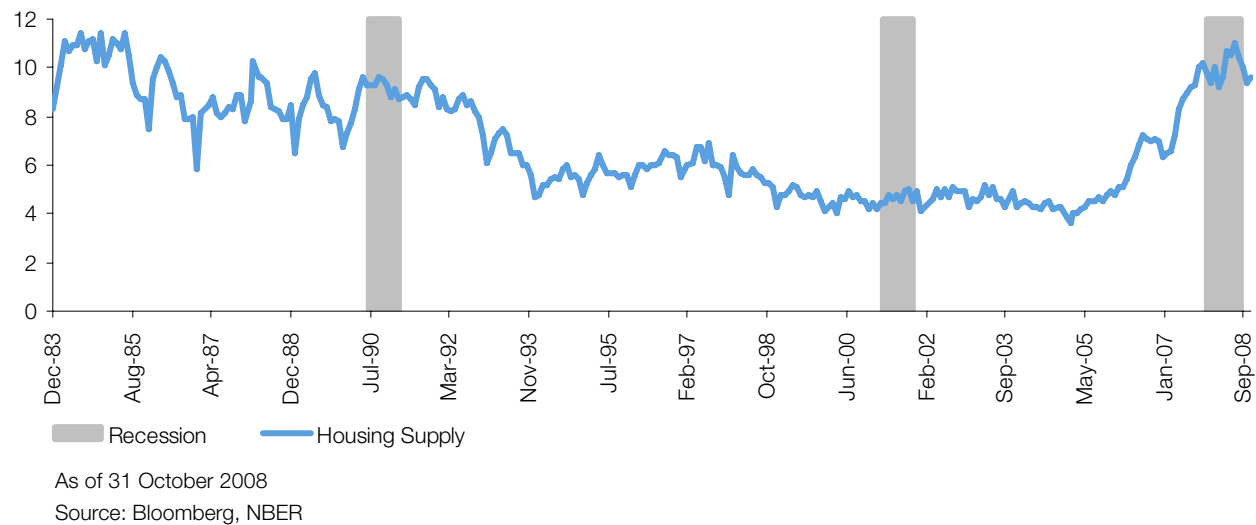
# What to Monitor

## Credit Crisis

### Housing Price (% Change Quarterly)



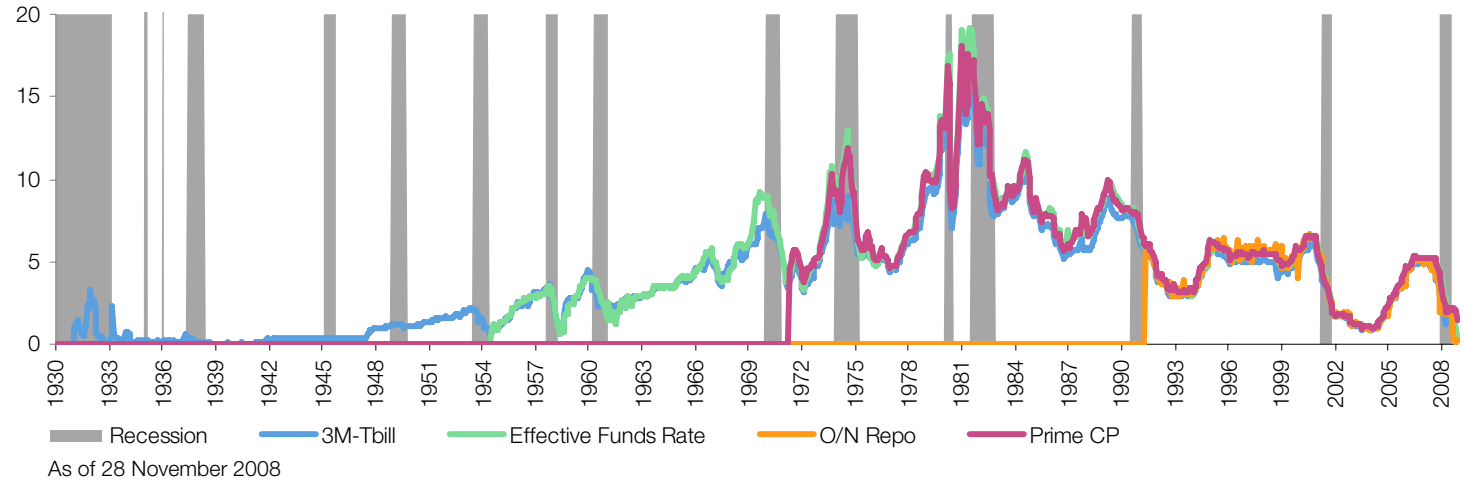
### Housing Supply (Monthly)



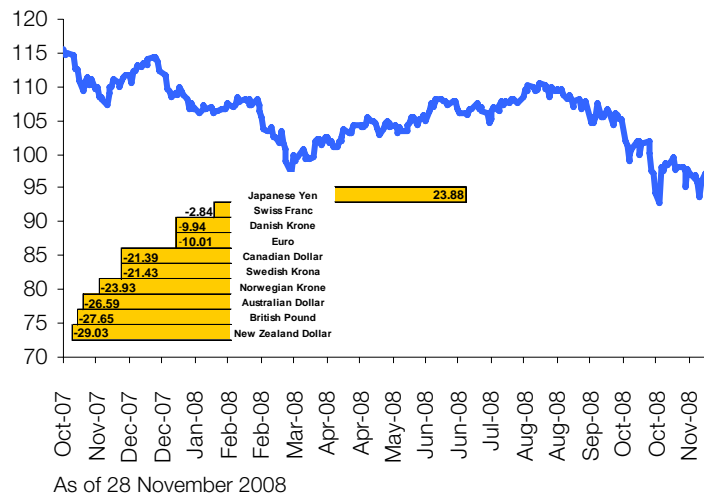
# What to Monitor

## Liquidity and Deleveraging Crisis

### Money Market Yields



### Japanese yen / U.S. dollar Exchange Rate



### 30-year U.S. dollar Swap Spread



Source: Bloomberg, NBER

# What to Monitor

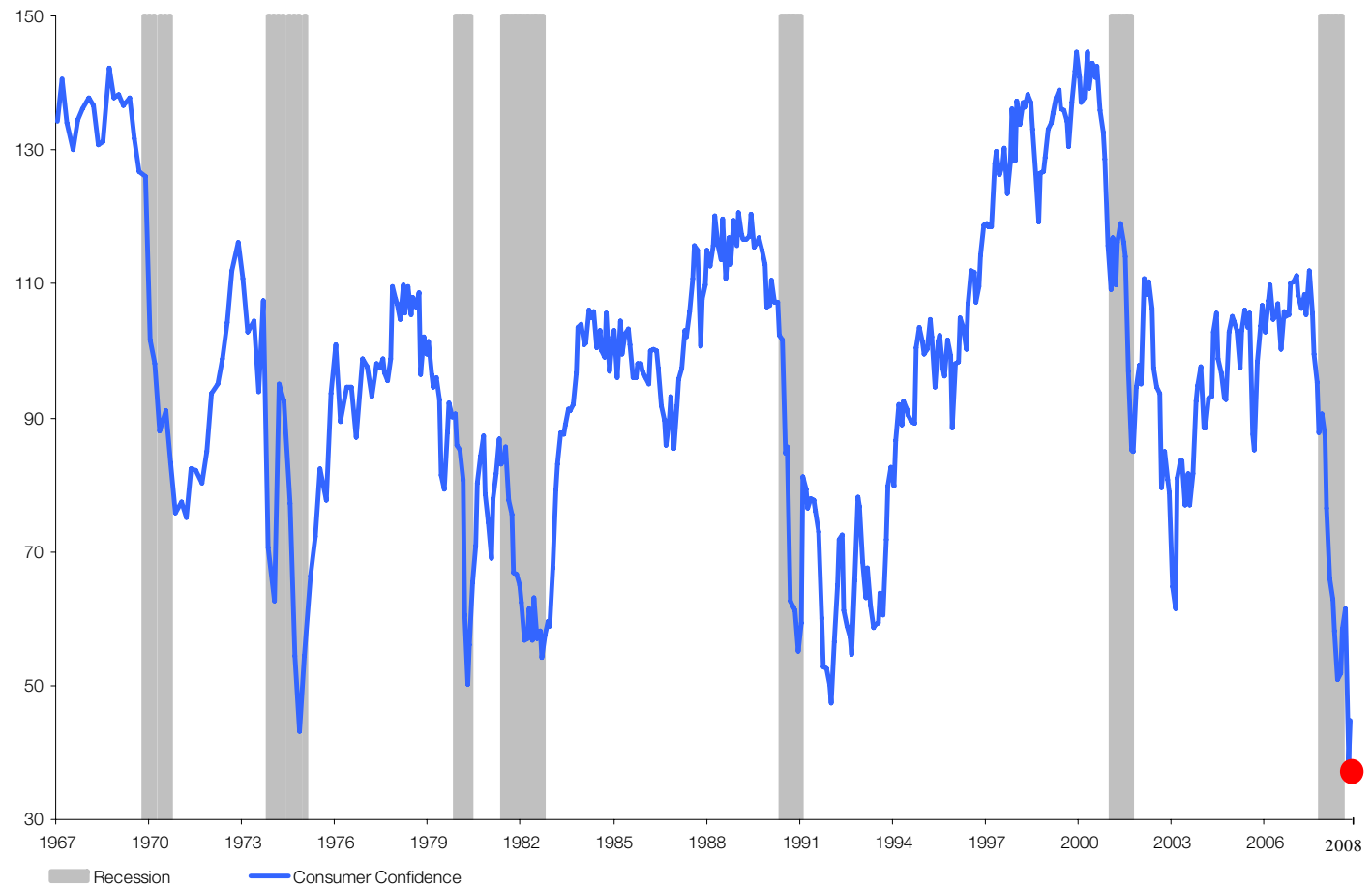
## U.S. Macroeconomic Demand Crisis

“Every good cause  
is worth some  
inefficiency.”

-Paul Samuelson

**We believe a government response is needed to stimulate demand**

### Consumer Confidence

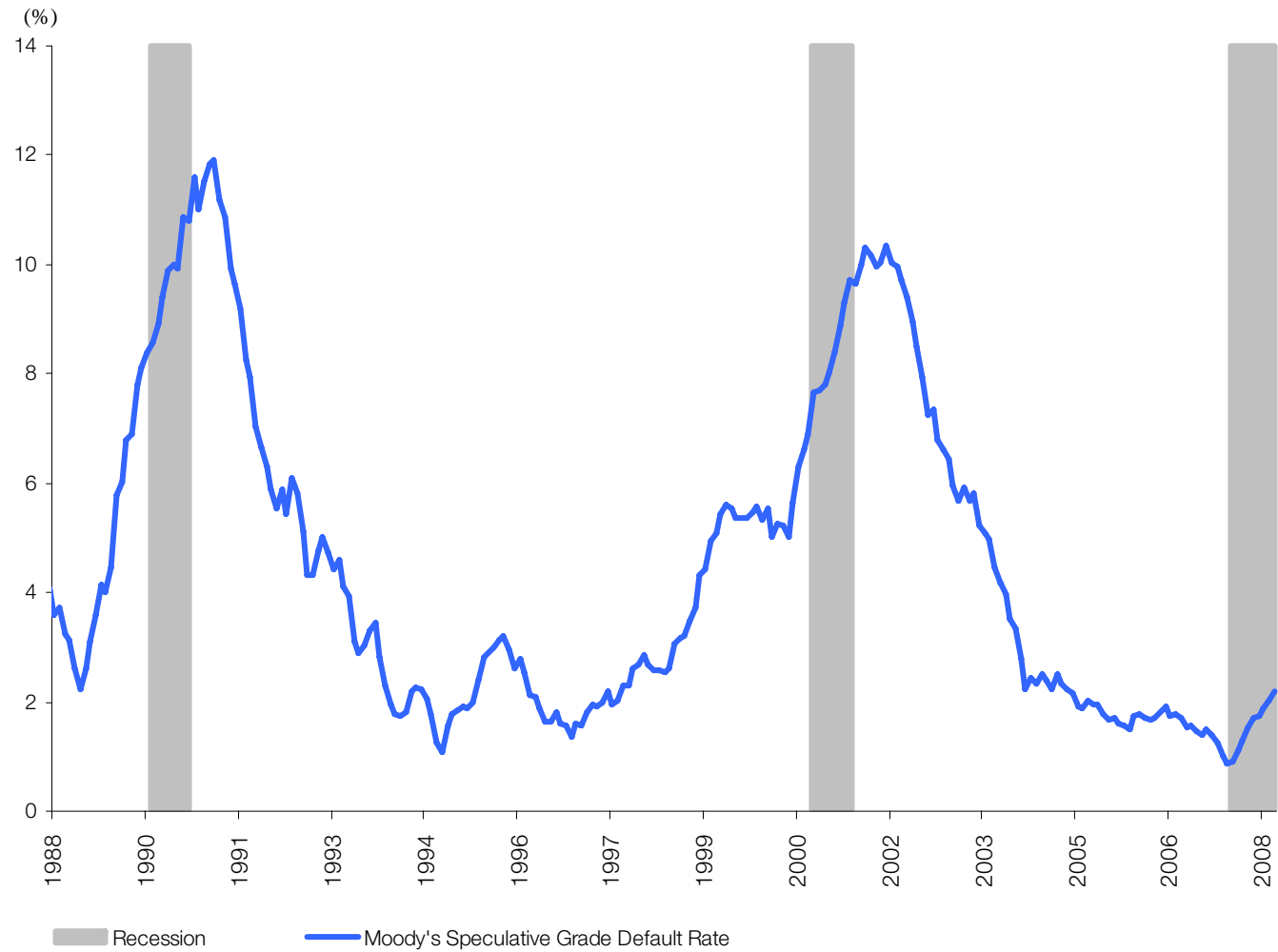


As of 28 November 2008

Source: Bloomberg, NBER

# What's Next?

## Rising Corporate Bankruptcies



As of 31 August 2008

Source: Moody's, NBER

# What does life look like after the crisis?

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“In the middle of every  
difficulty lies  
opportunity.”

-Albert Einstein

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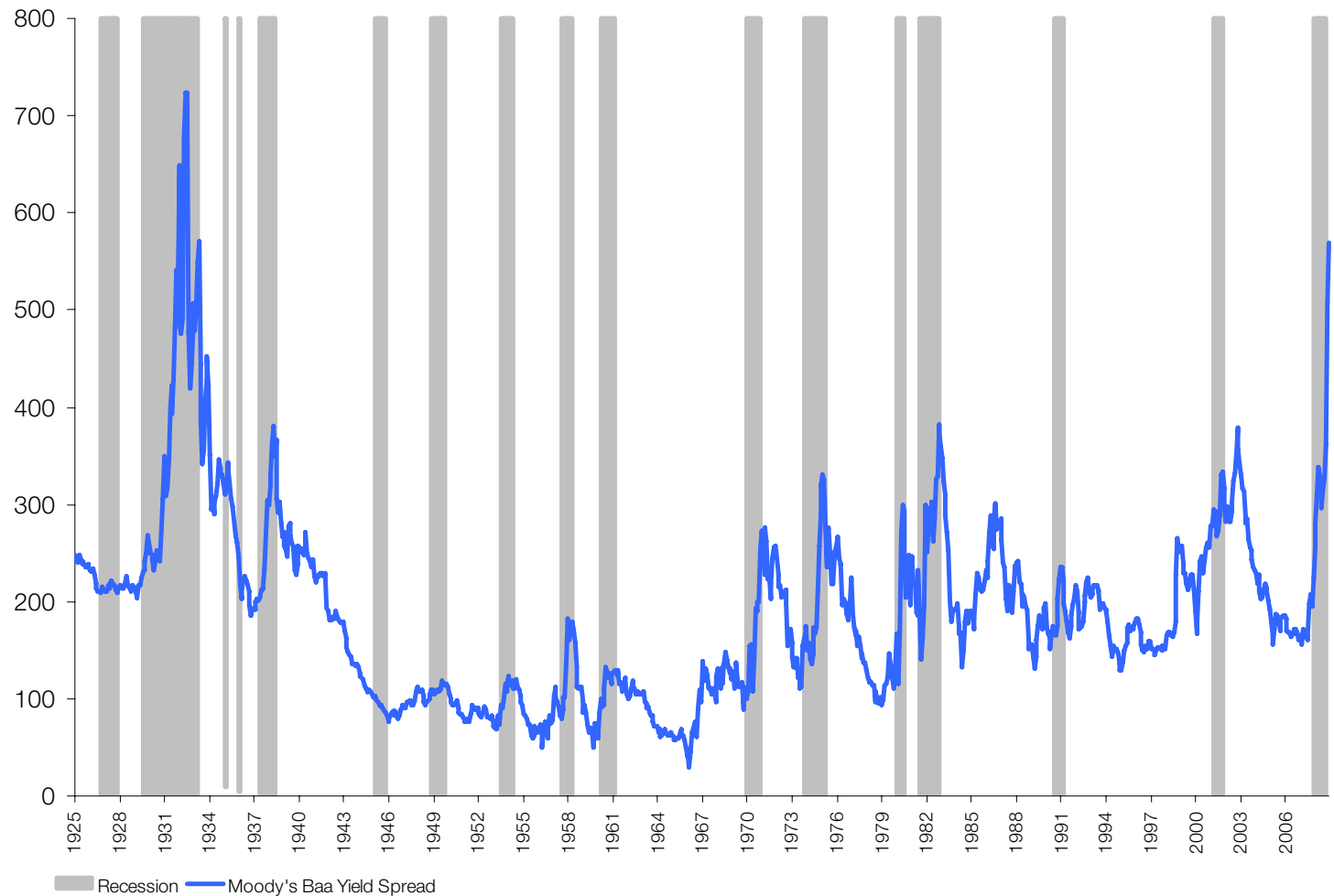
*“I want my bubble back.”*

# Greatest Investment Opportunity since the Great Depression

“We simply attempt to be fearful when others are greedy and to be greedy when others are fearful.”

-Warren Buffett

## U.S. Credit Spreads – Long-Term Triple-B Spreads (bps)



As of 28 November 2008

Source: Federal Reserve, Moody's, NBER

# Avoiding Permanently Impaired Credits

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We believe that, while market values can not be determined, a disciplined, fundamental approach addresses the feasibility of the return of invested capital.

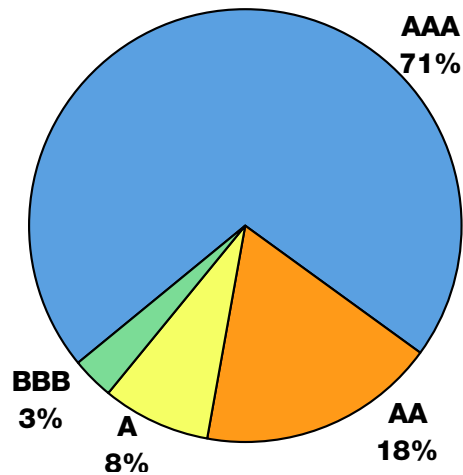
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- Toxic assets are hidden across most fixed income categories
- Investors need to differentiate between impaired assets and non-impaired assets
- Credit impaired assets are not coming back
- Fundamental analysis focused on the drivers of return is the only way to differentiate credit impairment
- Analysis must be forward looking and focused on the drivers of insolvency - sources and uses of cash

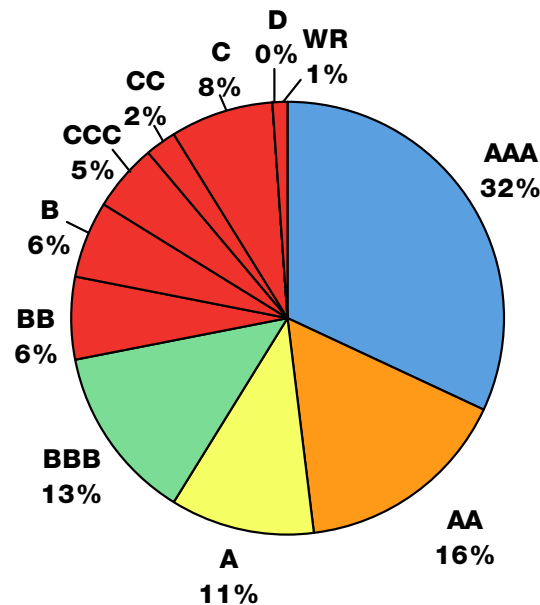
# Identifying Impaired Assets

## Floating Rate RMBS

**September 30<sup>th</sup>, 2007**



**November 30<sup>th</sup>, 2008**



### AAA Ratings Transition Static Universe – Par Weighted Percents

|                      | <u>September 2007</u> | <u>November 2008</u> |
|----------------------|-----------------------|----------------------|
| AAA                  | 71%                   | 32%                  |
| AA                   |                       | 16%                  |
| A                    |                       | 11%                  |
| BBB                  |                       | 13%                  |
| Non-Investment Grade |                       | 28%                  |
| <b>Total</b>         | <b>71%</b>            | <b>71%</b>           |

### Investment Grade Market Value Changes

|                  | <u>12/31/06</u> | <u>9/30/07</u> | <u>11/30/08</u> |
|------------------|-----------------|----------------|-----------------|
| Market Value     | \$645 billion   | \$610 billion  | \$221 billion   |
| Par Weight Price | 100.167         | 92.767         | 62.003          |
| Average Quality  | AAA             | AAA            | AA1             |

OVERRATING OF RMBS securities led to an unprecedented and ongoing negative ratings transition.

Source: Merrill Lynch R0FH Index, Lazard Asset Management

# The Case for Active Management

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Investing is science,  
not engineering.

Correlation and beta  
are conditional  
variables subject to  
their own distributions.

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- Active fundamental management led to dramatically differentiated positive results
- The current crisis challenges the assumptions behind efficient market strategies
- Crisis environments have historically debunked previously established investment yardsticks and dispersed the market valuation of individual securities
- Lack of reliable yardsticks decreases the relevance of index investing:
  - individual assets unpredictably dominate return patterns
  - hedge-driven risk management techniques fail
- The opportunity set for active managers has been enlarged

# Looking Ahead

## Guiding Investment Principles

- Focus security selection on individual security solvency and macroeconomic essentiality
- Be realistic about bankruptcy and liquidity expectations
- Current Opportunities – balancing risk and reward
  - U.S. Agency Debt
  - U.S. Agency MBS
  - Investment Grade Industrials and Utilities
  - U.S. High Yield Corporates
  - Distressed U.S. RMBS

This is not a recommendation or solicitation to purchase or sell any security.

# Crisis has Increased Investment Opportunity Set

## High Yield Example

### Industrials and Utilities - Rated B to BB

|           | <b>January 1, 2007</b> |                     | <b>November 30, 2008</b> |                     |
|-----------|------------------------|---------------------|--------------------------|---------------------|
|           | <u>Yield (%)</u>       | <u>Spread (bps)</u> | <u>Yield (%)</u>         | <u>Spread (bps)</u> |
| Yield     | 7.32                   | 258                 | 18.62                    | 1,666               |
| Std. Dev. | 1.29                   | 129                 | 10.15                    | 1,043               |

Source: Merrill Lynch, Lazard Asset Management

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