



Comment on Recent Events in Credit Markets

Due to the ongoing turmoil in the subprime mortgage market, highlighted by the recent widely publicized losses by two hedge funds managed by Bear Stearns Asset Management (“BSAM”), we felt that a brief discussion of the current environment and potential impacts on our portfolio would be of interest. At the outset, we want you to know that Prisma has not invested with BSAM or any leveraged asset-backed funds that contain subprime mortgage loans. The small minority of our managers that focus on this space have net short exposure to subprime mortgages (the opposite of currently troubled levered long funds) and, thus, are likely to benefit from recent market turmoil. The note below gives a short background and details the issues facing the market.

Background

Subprime mortgages are issued to lower credit quality borrowers by banks and other financial institutions. These loans are typically sold by the financial institutions to efficiently use their capital and transfer risk from their balance sheets. The loans are packaged into portfolios that are diversified by geography and other risk characteristics. These portfolios are then held as collateral in an SPV that issues various debt obligations commonly known as a collateralized debt obligation (CDO). CDOs are issued in various tranches with different risk levels ranging from AAA (safest) to equity (riskiest). This allows investors to choose the appropriate tranche based on their desired risk/return profile. When there are defaults by any of the underlying bonds or loans that collateralize the CDO, losses are first borne by the lowest rated (equity) tranche. More highly-rated tranches only experience losses as the level of defaults increases and lower-rated tranches get wiped out. Lower rated tranches pay a higher rate of interest to reflect the additional risk. If the default rate rises well beyond initial expectations, losses could eventually cascade all the way up to the AAA tranche.

There are three structural issues that make CDOs backed by subprime mortgages unique:

1. CDOs allow risky loans, like subprime mortgages, to be placed in a structure that diversifies the risk and lets investors choose the appropriate tranche based on their desired risk/return profile. This facilitates funding to less creditworthy borrowers because a single issuer is not required to carry the entire default risk on its books. Subprime lenders profit from fees and selling loans to CDOs, so volume is paramount. This can create perverse incentives, as poor underwriting standards and the resulting higher default risk are not necessarily felt by the original lender. This risk is supposed to be dealt with in the CDO structure and taken into account by the rating agencies, but it appears that it may have been seriously underestimated.

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2. CDOs, and derivatives based on CDOs, are highly complex securities. The underlying mortgage pools that act as collateral for CDOs are divided into multiple tranches that have exposure to a wide variety of different geographies, borrower types, etc. Once a number of these pools of mortgages are placed into a CDO, which is then further divided into tranches, it can be exceedingly complex to accurately assess the underlying risk factors. In addition, the composition of CDOs made up of mortgage securities can sometimes change after the CDO is purchased, and the composition of CDOs is not standardized. While there are sophisticated players who believe they can accurately model CDO risks, we believe that some market participants purchased CDOs without truly understanding these risks.
3. Moreover, each CDO is unique and not fungible with other CDOs. CDO tranches are generally purchased by “buy and hold” investors. These two facts make the secondary market in CDOs illiquid, so a current market price may be very subjective and possibly stale. By contrast, indices that reference large CDO deals (and derivatives on these indices) are much more liquid and tend to reflect changes in market sentiment and current information more rapidly.

Against this backdrop we wanted to make the following comments about the activity taking place in the market.

What led to the losses for BSAM's Hedge Funds?

It has been widely reported that two hedge funds managed by BSAM (the High Grade Structured Credit Strategies Enhanced Leverage Fund and the High Grade Structured Credit Strategies Fund) recently suffered losses and are now being forced to liquidate significant portions of their portfolio in order to meet margin calls by their prime brokers. According to news reports and industry sources, these BSAM funds held large positions in CDOs backed by subprime mortgages and financed with significant leverage. Beginning in January and February, default rates among subprime borrowers increased dramatically. The dramatic rise in defaults led to problems for lenders and other financial institutions which specialize in subprime loans, most notably New Century Financial, which recently filed for bankruptcy protection. As a result of this turmoil, the ABX index, which reflects the value of the BBB tranche of CDOs backed by subprime mortgages, declined by almost 40% between early January and late February.

However, as described above, there is a disconnect between the pricing of the index and the CDOs themselves. While the index reflected the poor repayment potential at the end of February, this was not fully reflected by the CDO market. According to one dealer with whom we spoke, even today, indices and derivatives that reference CDOs and trade readily in the market are implying a 35 to 55 percent loss rate for the lowest rated tranches of subprime mortgage-backed CDOs, while the CDOs' prices imply a significantly lower loss rate. The lack of liquidity and the ability to borrow the securities make it difficult to arbitrage these two related instruments.

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According to media reports, BSAM's funds held long positions in CDOs with exposure to subprime mortgages, which were partially hedged via short positions in the ABX index. In recent weeks, the ABX index rallied while CDOs held by BSAM did not, according to sources. This led to losses for BSAM, which were magnified due to their significant leverage of the funds. The lenders, including Merrill Lynch and JP Morgan, are now trying to recover their loans to BSAM's funds by selling collateral in the market. This is likely to put additional pricing pressure on CDOs with exposure to subprime mortgages.

What is the likely impact on other hedge funds?

There may be some other funds coming under similar pressure to BSAM in the coming days and weeks, as many subprime mortgage securities get repriced for the month and quarter end. According to industry sources, however, many other funds buying similar securities are not as highly levered as BSAM's funds. In addition, other holders of CDOs are "buy and hold" investors, so the selling pressure on CDOs may be contained. At this stage we do not expect a huge contagion problem. However, it is likely that the risk appetite in the market for these instruments may diminish, impacting the availability of cheap credit.

The key question that everybody is asking, and which has yet to be answered, is whether this turmoil will eventually spill over into other parts of the credit market, such as high yield corporate bonds. Spreads on all types of risky credit remain at historically low levels. If there is a significant widening of credit spreads across the board, this will have a dramatic impact on a wide range of market participants.

Stay tuned...

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