

TEXPERS 2008 SUMMER FORUM:
THE ROCKY ROAD TO INVESTING



Fixed Income 130/30 &
Absolute Return Strategies:

*Enhancing Upside from an
Asset Class with Limited Downside*

August 18, 2008



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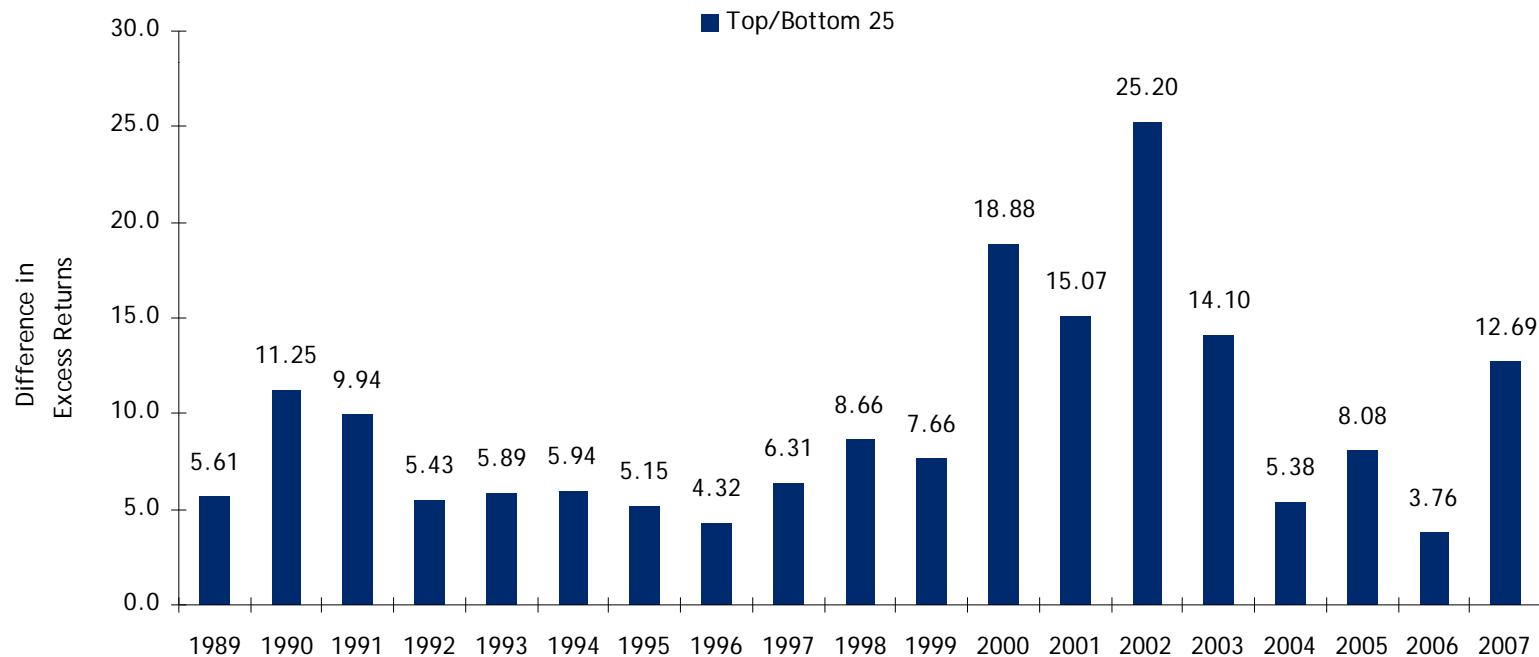
Objectives

- Understand fixed income opportunity set
- Overview of instruments used in fixed income absolute return
- What makes fixed income distinct from equity
- Risk management—as important as ever!
- Review the fixed income market and opportunities over the past 12 months
- Future opportunities



Opportunities for Alternative Strategies in Fixed Income

Top/Bottom 25 Excess Return Variances for the Investment Grade Market



Vertical bars represent the difference in excess return (over similar term Treasuries) of the top performing securities and the bottom performing securities. Proxy used for the current environment is the Lehman Brothers Investment Grade Credit Index. Data shown is from December 31, 1988 to December 31, 2007. Data Source: Lehman Brothers Index Returns.

Understanding the Fixed Income Opportunity Set

Common Instruments & Strategies

GEOGRAPHY	ASSET CLASSES	STRATEGIES	INSTRUMENTS/ SECURITIES
Global	Investment grade	Directional (Long or short)	Cash bonds
	High yield	Curve	Credit derivatives
	Convertible/ hybrid	Pair	Interest rate futures/derivatives
	Government	Volatility	Non-US dollar derivatives
	Structured	Capital structure arbitrage	Structured securities
	Distressed	Quantitative strategies	Bank loans
	Non-US dollar	Correlation	Equity/equity options



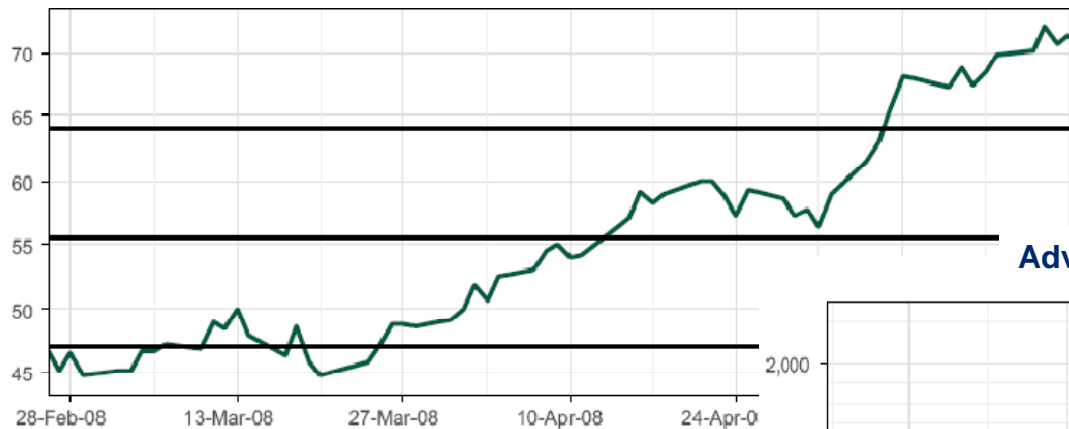
Why Fixed Income Can Work for Absolute Return

Asymmetrical Return Distribution

Myth: Shorting credits is similar to shorting equities or commodities

Reality: Worst-case credit downside is quantifiable—credit spreads are historically rarely negative

Drilling Company Stock



Advertising Company Credit Spread

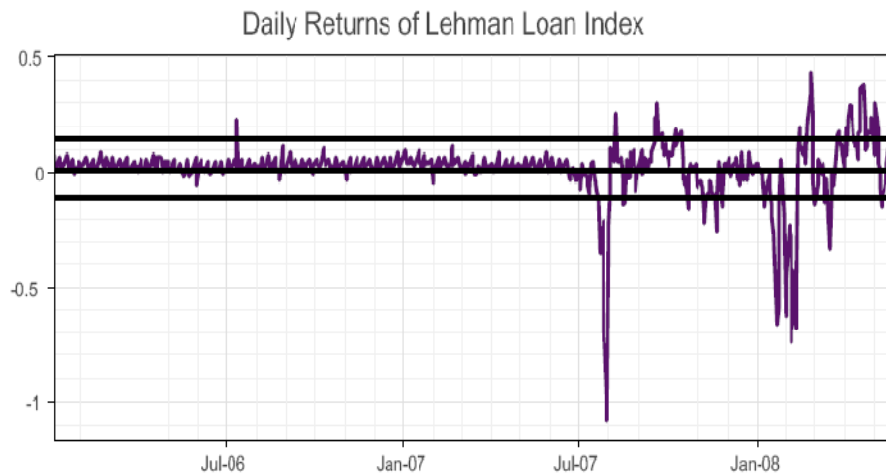


This example is highlighted for illustration purposes only. This is not a recommendation to buy or sell this security.

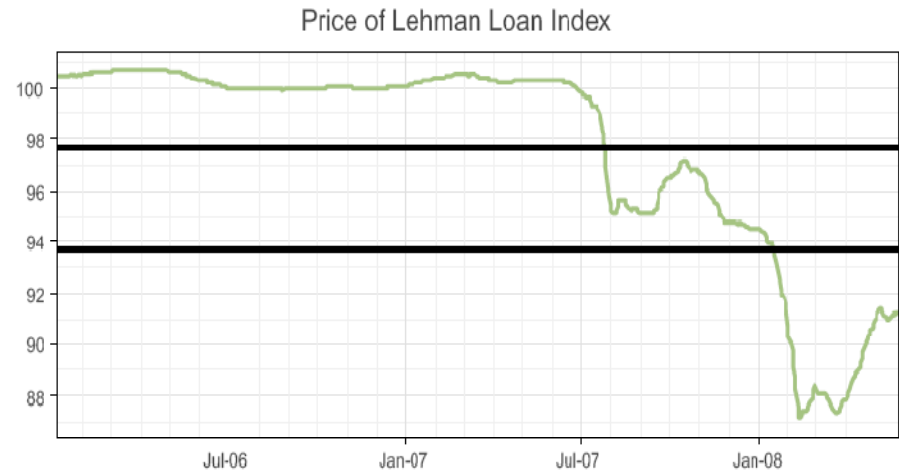
Investor Considerations

Leverage:

If an asset class exhibits 3% annual volatility and is more senior in the capital structure, should an investor be 10X levered to seek large favorable annual returns?



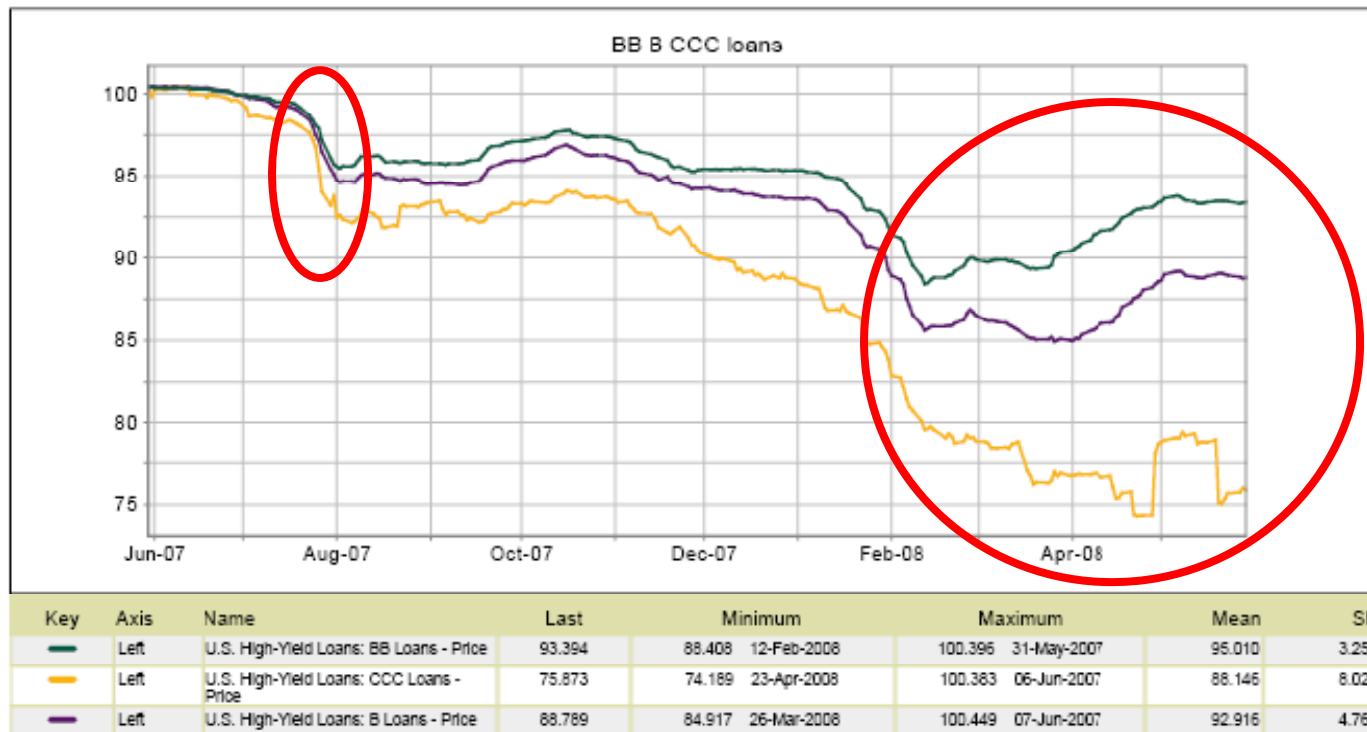
Source: Lehman



Source: Lehman



Investor Considerations



Source: Lehman

Concentration:

Historically, when risk increases, correlation increases.
The market becomes indiscriminate!



Risk Management

The “30” in 130/30 Can Help a PM Manage Risk

- Absolute return strategies seek to deliver positive performance in both up and down markets
- The numerator: for many investors wanting to limit leverage, 130% can be a reasonable guideline
- The denominator: for investors with a long-only plus objective, 30% is a reasonable guideline
- For investors who seek that their managers deliver returns in both up and down markets, rethink the denominator!



Risk Management

Other Ways To Measure Risk

Nominal measurements

- Gross long/gross short
- Sector and industry
- Country and currency
- Interest rate (duration)
- Quality rating
- Individual issuers

Volatility/ risk based measurements

- Credit spread risk
- Interest rate curve
- Volatility/correlation
- Historical simulation/
covariance
- Scenario testing and
stress testing



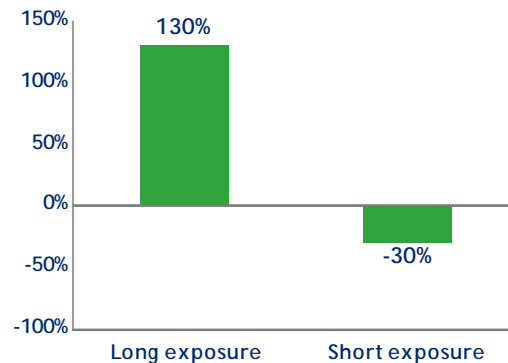
Credit Portfolio Positioning

VIEW OF CREDIT MARKET

PORTFOLIO POSITION

TOOLS

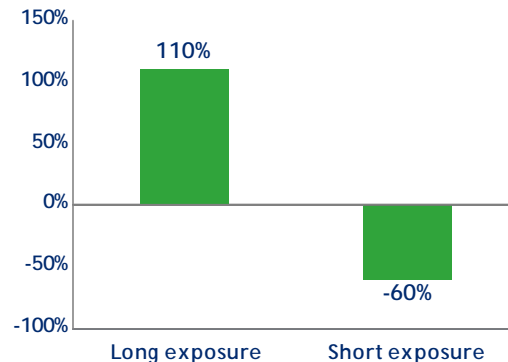
Positive Market Bias



Credit beta = 0.70

- Long cash alpha ideas favoring:
 - Lower quality cash IG bonds
 - HY bonds
- Short selected CDS- company specific

Negative Market Bias



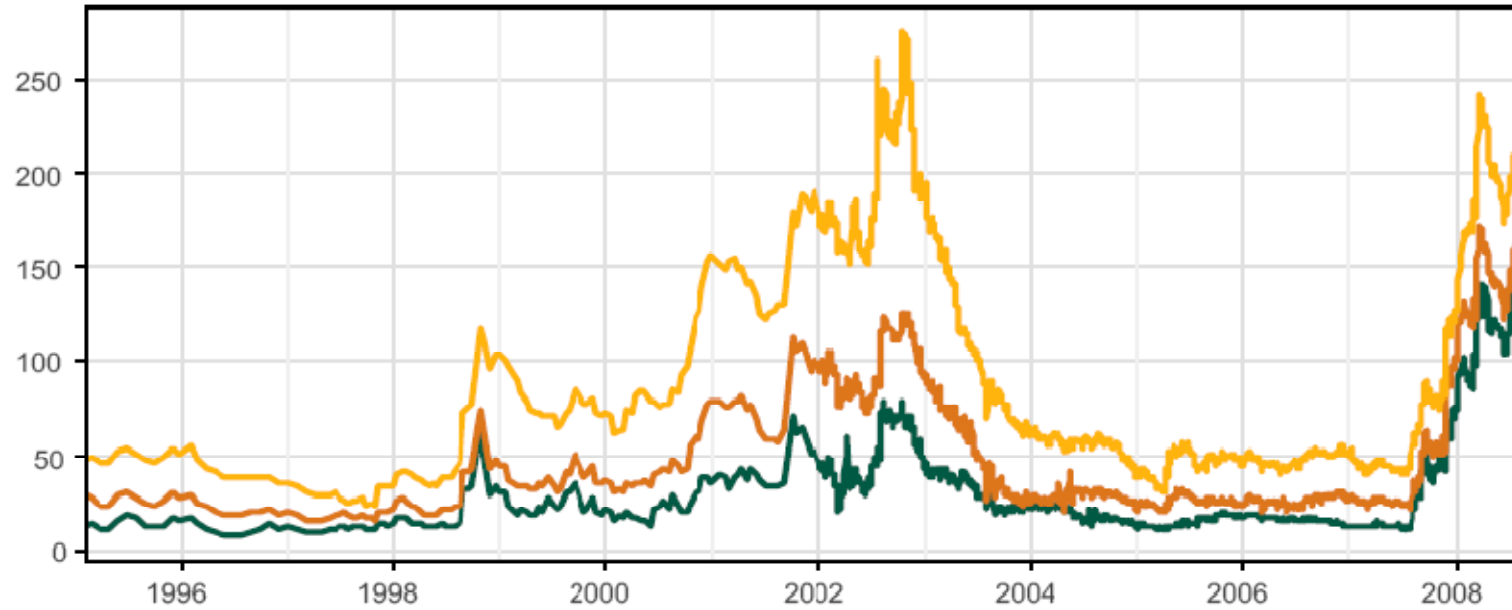
Credit beta = 0.00

- Long cash alpha ideas favoring:
 - Investment grade credits
 - Multinational companies with strong fundamentals
 - Secured bonds or loans
- Short CDS
 - Index
 - Company specific



Market Review & Opportunities

Long Term IG Spreads



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	AA All 5Yr/40% Fitted Bond-Implied CDS	156.024	7.663 05/31/1996	157.327 08/01/2008	33.612	30.185	2.510
—	Left	A All 5Yr/40% Fitted Bond-Implied CDS	157.640	15.265 10/31/1997	172.261 03/18/2008	52.842	38.732	2.655
—	Left	BBB All 5Yr/40% Fitted Bond-Implied CDS	211.747	22.385 10/31/1997	275.906 10/10/2002	94.434	62.840	3.455

Opportunity:

IG market is priced wide to historical stressed default rates



Market Review & Opportunities

BSC

IG9 Graph



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	CDX.IG 9/5.0 Ind/Ask/CDS	139.000	91.250 05/01/2008	193.000 03/10/2008	132.763	23.478	5.995

Systemic Risk/Fear:

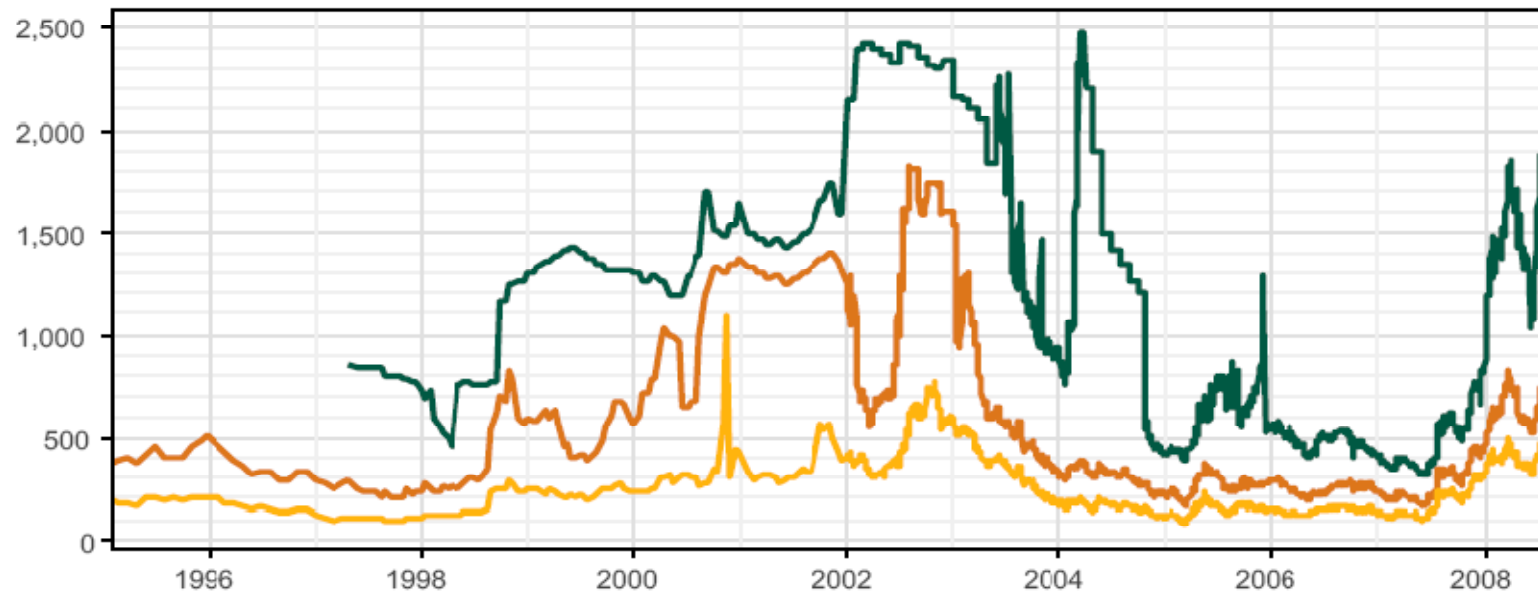
Spreads gapped out to over a 15% cumulative default rate at the height of the Bear Stearns/JPM event



Source: LehmanLive

Market Review & Opportunities

Long Term High Yield Spreads



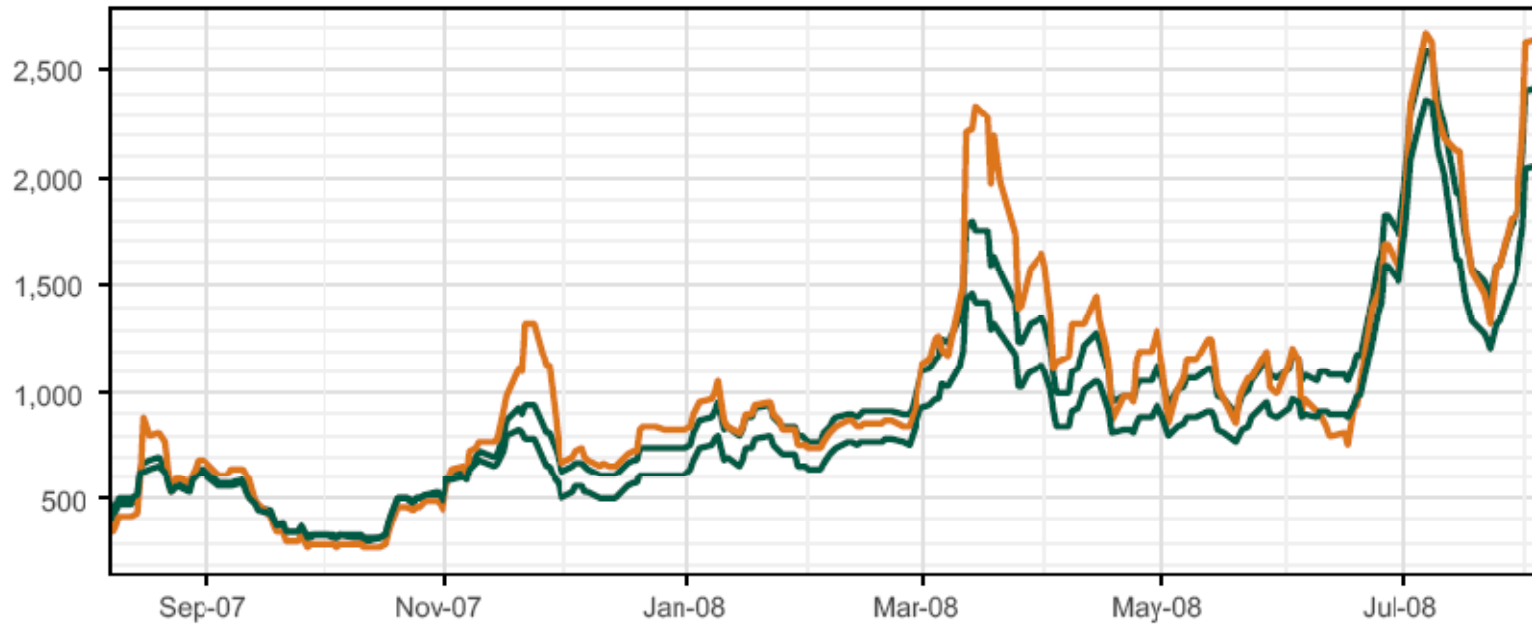
Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	CCC All 5Yr/40% Fitted Bond-Implied CDS	1621.920	311.855 06/05/2007	2476.190 03/16/2004	1176.426	722.351	55.823
—	Left	B All 5Yr/40% Fitted Bond-Implied CDS	734.420	167.070 06/01/2007	1832.070 07/30/2002	522.514	412.644	27.677
—	Left	BB All 5Yr/40% Fitted Bond-Implied CDS	420.137	83.275 03/09/2005	1093.980 11/15/2000	257.896	152.586	26.185



Source: LehmanLive

Market Review & Opportunities

gmac curve



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	GMAC/5Y SENIOR MODRE/SPREAD/NYC	2068.63	315.00 10/11/2007	2584.55 07/07/2008	980.03	404.26	74.42
—	Left	GMAC/1Y SENIOR MODRE/SPREAD/NYC	2162.38	280.00 10/11/2007	2675.00 07/07/2008	1015.75	529.73	117.55
—	Left	GMAC/10Y SENIOR MODRE/SPREAD/NYC	1743.03	320.00 10/11/2007	2360.91 07/07/2008	847.97	402.54	67.53



Market Review & Opportunities

SWAP SPREADS



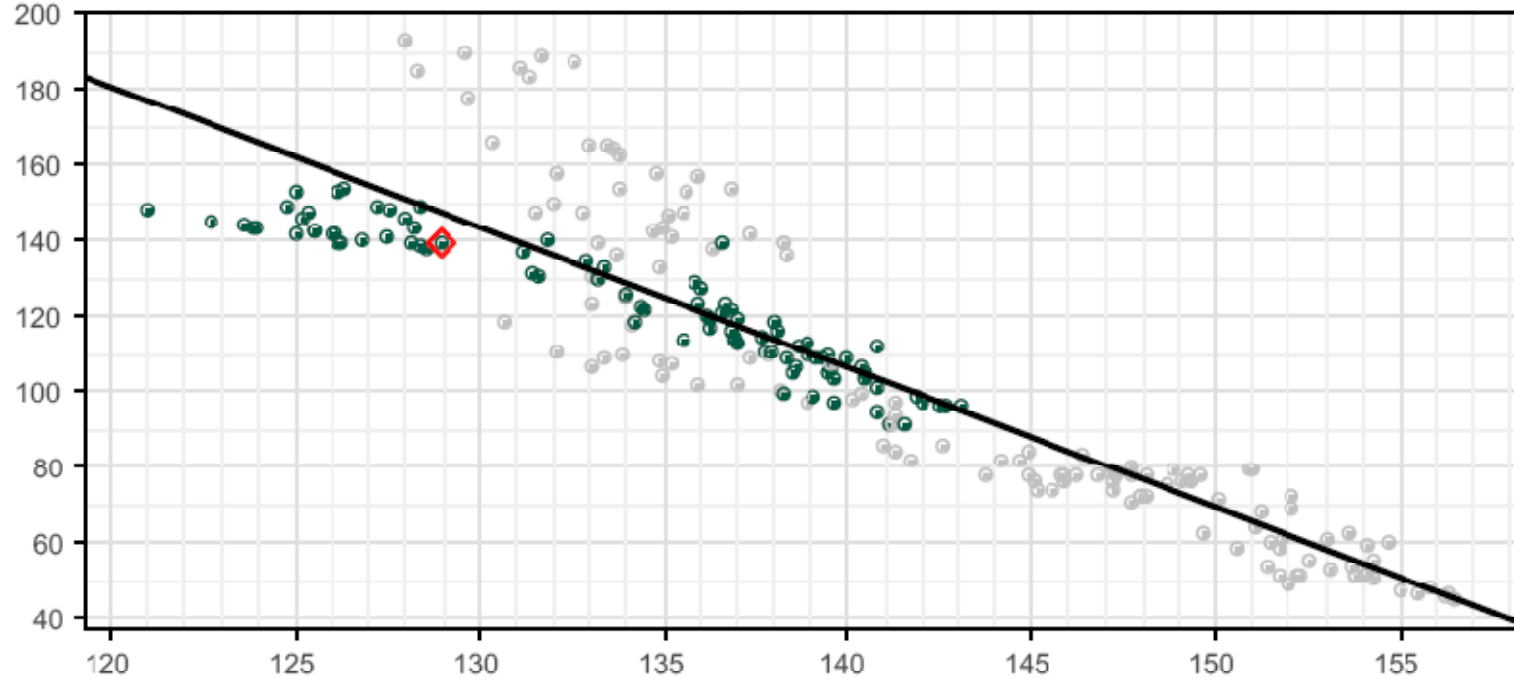
Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
—	Left	USD SWAP 2Y rate	94.200	14.200 10/22/1996	110.500 03/06/2008	45.990	17.499	1.698
—	Left	USD SWAP 5Y rate	97.000	17.700 12/26/1996	111.500 03/06/2008	56.719	20.721	1.609



Source: LehmanLive

Market Review & Opportunities

IG9 vs S&P



Key	First	Last	R-Square	Std. Error	Last Error
● ● ●	09/20/2007	08/06/2008	0.821	15.092	-8.128
Key	BestFit				Durbin Watson
● ● ●	$Y = 626.248 + -3.716 * x$				0.128



Source: LehmanLive

Summary

- Fixed income markets hold opportunity for absolute return strategies
- Investors can choose from single strategies to multisector approaches
- Strategies may use complex instruments with different risk/return profiles than equity products
- Risk measurement & management are keys to generate consistent absolute return
- Leverage & concentration should be managed carefully
- Absolute return investors should concentrate on a manager's exposure to several market factors, not strictly nominal exposure



Disclosure

All indexes are unmanaged, do not incur fees and it is not possible to invest directly in an index.

All spread and price information is from the Lehman Live Fixed Income Database. Loan data is based on the Lehman U.S. High Yield Loan Index, and its various sub-component indices. Credit spread data is based on the Lehman Credit Index and or the Lehman US High Yield Corporate Index or sub-component indices based on these indices. Credit spread comparisons between the cash bond market and credit default swaps are based on equivalent credit quality bonds on an interest rate duration neutral basis.

This presentation is for informational purposes only. It should not be construed as investment advice. Outlook as presented reflects subjective judgments and assumptions of the portfolio manager as of May 2008, and unexpected events may occur. There can be no assurance that developments will transpire as stated. Opinions expressed will evolve as future events unfold.