

OUR PERSPECTIVE ON ISSUES AFFECTING GLOBAL FINANCIAL MARKETS

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Witness To History: 25 Years of Payden & Rygel and the Evolution of the Global Financial Markets

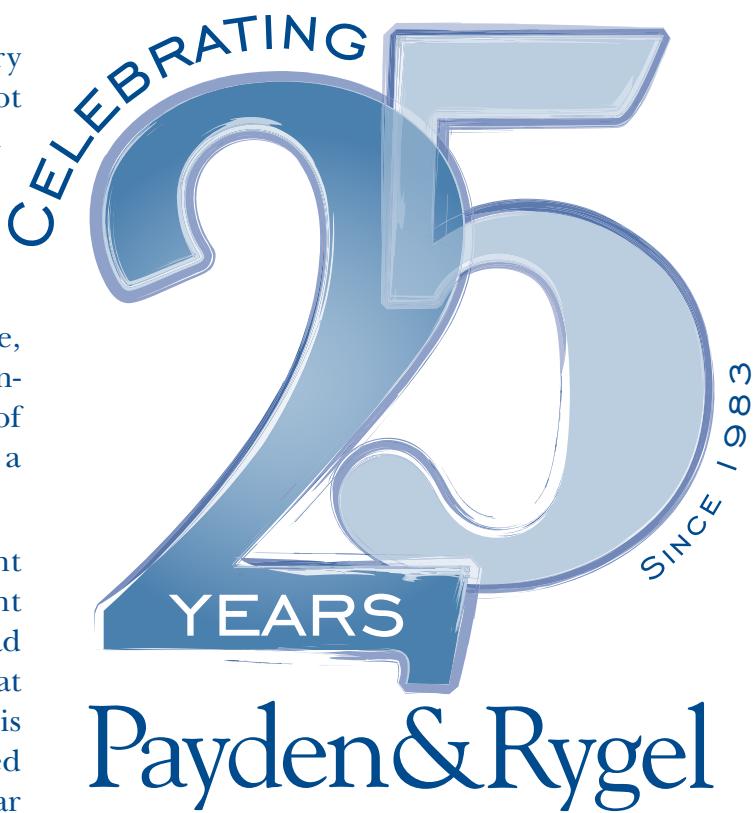
The commemoration of an anniversary serves as a call for reflection and celebration of milestones. This nostalgic affair typically focuses on a single organization or relationship. However, from our perspective, the evolution of the world around us has been just as fascinating and worthy of consideration.

Our firm has grown over the last quarter century from three people working in a 2,000 square foot office in Los Angeles to a global organization with 200 employees and offices in Europe and Asia. This growth has been paralleled by the financial markets. The dollar value of US stocks outstanding has risen tenfold since 1983 to more than \$19 trillion. Even more impressive, the derivatives market, which was virtually non-existent 25-years ago, currently has a value of nearly \$600 trillion. Indeed, we have been a witness to history.

We started with an idea we believed in: investment management is a personal service to help a client solve a problem. At the time, our first client had a significant amount of cash, but much of that was just sitting at the bank. Our idea was that this money could be managed differently, deployed in the short-term money markets in a similar

manner to how a long-term bond portfolio would be managed. From this seemingly simple idea, we became a leader in active management of short-term assets for corporations.

That first client is still with us today.



Then vs. Now

What else has changed over the last 25 years?

	1983	2008
World Population	4.7 billion	6.7 billion
Global Shipping Activity (Containers Shipped Worldwide)	12 million	141 million
Computing Speed (Instructions Per Second)	4 million	60 million
Financial News Networks	0	3 dedicated, 24-hour financial news channels
Over-the-Counter (OTC) Derivatives (Notional Value)	\$0	\$596 trillion
Credit Default Swaps (CDS) (Notional Value)	\$0	\$54 trillion
US Stocks (Value of Outstanding Shares)	\$1.8 trillion	\$19.3 trillion
US Treasury Market (Value of Outstanding Bonds)	\$1.2 trillion	\$5.3 trillion
US Agency-Backed Securities (Value of Outstanding Securities)	\$455 billion	\$7.9 trillion

Sources: Bank of International Settlements, Federal Reserve, and Census Department



Payden 25th Anniversary Black Tie Gala

We've seen some dramatic changes in the credit markets over the last 25 years. In the past, traditional banks and savings institutions played the dominant role in lending to consumers and businesses. Today, the majority of credit is allocated through markets, including the commercial paper market, the mortgage-backed security market, and the corporate bond market. The growth of Payden's investment strategies has enabled us to help our clients take advantage of this transformation.

A wave of globalization has ushered in unprecedented growth in world trade and financial integration. At Payden & Rygel we were pioneers in the global expansion in the late 1980s, eventually opening an office in London to meet clients' needs and partnering with Metzler, the oldest private bank in Germany, to provide services to clients across Europe. Our most recent venture, Payden Potomac, is headquartered in Hong Kong to service our clients in Asia.

Payden & Rygel has expanded its global presence as investors have gradually shifted their focus from investing domestically to investing globally, given the wide variety of options in world markets. In 1983, less than 3% of US equity assets were invested in overseas markets versus nearly 20% today. The comparable figures for most European countries are much higher with Germans investing more than 40% of their equity assets in foreign markets and the Swiss more than 55%.

This shift is not surprising when you consider the change in the composition of global economic growth. In the 1970s, two-thirds of the world's economic output was produced in the industrialized world. Today, about half of the world's output is from the industrialized world—the rest is contributed by emerging markets. The world continues to be transformed.

What do the next 25 years hold? Following their increasing role in global trade, emerging market



countries will begin to wield more influence in the capital markets, and a shift in the world financial balance-of-power is possible. Payden & Rygel remains optimistic about the prospects for global markets, especially since rising standards of living around the world will continue to create a new, vibrant consumer class. We also believe that our independence, flexibility and dedication to tailored investment management service will allow us to adapt to what the future holds. Indeed, these same tenets that helped launch the firm will guide us for the next 25 years, navigating the challenges and opportunities that may come. ■

The First Steps Toward Crisis Resolution

World financial markets are in the midst of their worst rout in decades after problems in the US subprime mortgage market morphed into an unwinding of leverage that has affected all asset classes. Stocks, bonds, currencies and commodities have all taken a hit as investors who borrowed money to invest in these assets are forced to liquidate positions. Even commodities, such as gold or oil, have seen their prices plummet as leverage is wrung out of the system. The US dollar has been one of the few beneficiaries of the chaos as investors seek safe haven from market volatility.

The financial turmoil prompted an unprecedented coordinated response from global policymakers in early October. The Federal Reserve, European Central Bank, Bank of England, Bank of Canada, Sweden's Riksbank, and the Swiss National Bank each reduced their benchmark policy rate in a joint move on October 8. The People's Bank of China followed suit by lowering its one-year lending rate. Governments in the US and Europe have also unveiled plans to recapitalize the global banking system in order to encourage banks to begin lending again to businesses and consumers, as well as other banks.

Global policymakers appear to have finally accepted that the credit crisis is not just a US problem. The interconnectedness of the world financial

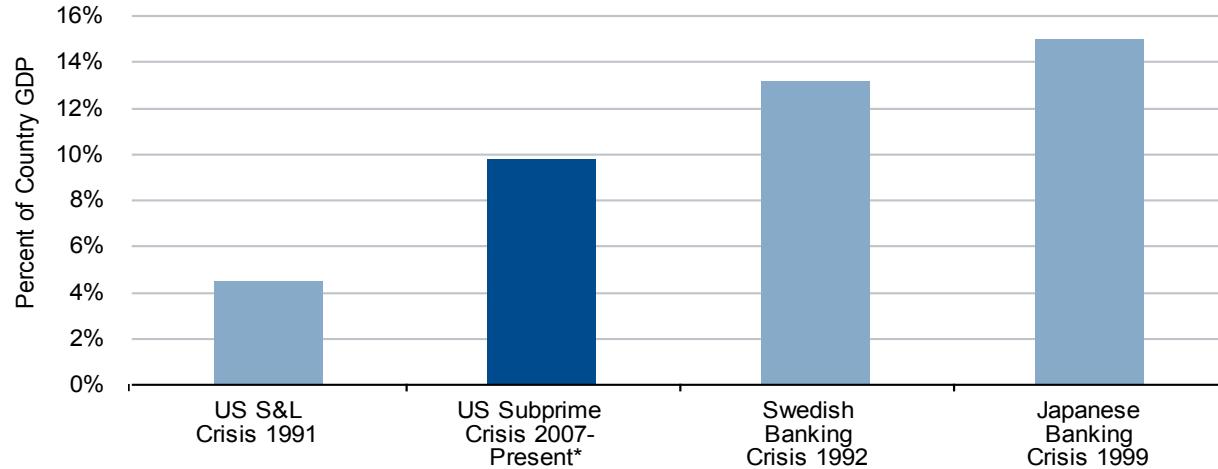
system and concerns about counterparty risk internationally required collective action. Even with such action, it will take a long period of time to unwind the massive amount of leverage in the financial system and to restore investor confidence. Below, we will attempt to put the global credit crisis of 2008 into perspective and discuss some of the macroeconomic consequences for the global economy and financial markets.

Putting the Global Credit Crisis into Perspective

The International Monetary Fund estimates that total losses associated with write-downs of US originated and securitized mortgage, consumer, and corporate debt will amount to \$1.4 trillion worldwide, or roughly 9.8% of US gross domestic product. While this is roughly three times larger than the US Saving & Loan Crisis of the early 1990s, it is much smaller than past banking crises in Scandinavia or Japan. In addition, the losses are more broadly spread across different countries and financial institutions.

For example, although most of the bad debt is concentrated in the United States, roughly 35% is in Europe and the remaining 5% is in Asia. In terms of financial institutions, the global banking industry has suffered the most, with between \$700

Total Losses From Past Banking Crises

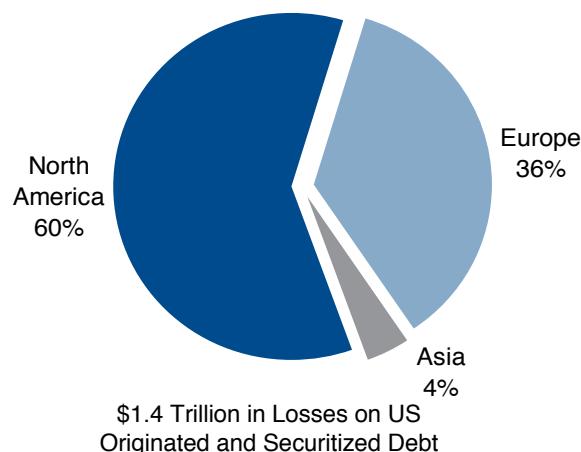


Sources: International Monetary Fund and the Bank of International Settlements

* Estimated losses on US originated and securitized mortgage, consumer and corporate debt.

billion and \$800 billion in losses. However, approximately 80% of these losses have already been written down suggesting that the drag on bank earnings should lessen over time.

Share of Total Credit Losses by Region



Sources: Bloomberg and Payden & Rygel Estimates

The progress on each of these fronts has varied by country, but there are some encouraging signs. Financial institutions in the United States have been the most aggressive in recognizing losses, writing down more than \$400 billion in bad debt over the past year. Moreover, the US policy response from both the Federal Reserve and the US Treasury has been swift. The Fed has slashed the fed funds rate and sought to provide liquidity through several new credit facilities.

More recently, the Fed began paying interest on reserves which effectively sets a floor on the federal funds rate and thereby eliminates constraints on the central bank's balance sheet. Previously, the Fed needed to immunize the money it was pumping into the financial system through its credit facilities with offsetting sales of US Treasuries to keep its balance sheet from growing. Otherwise the money supply would expand and the federal funds rate would fall. As a result of immunization, the Fed's balance sheet was essentially unchanged at \$900 billion between January and September of this year. Then suddenly, the Fed's balance sheet doubled in the span of one month to \$1.8 trillion by the end of October.

At the same time, the US government is working to remove bad assets from bank balance sheets and recapitalize the US banking system. To this end, the US Treasury has launched a \$700 billion Troubled Asset Relief Program (TARP). Initially, the government had proposed using the entire amount to purchase illiquid mortgage-related assets from financial institutions. However, the Treasury shifted gears in October and has now said it will allocate \$250 billion of the TARP money toward recapitalizing the banking system through purchases of preferred stock. The government also said it would guarantee new bank debt issuance through the Federal Deposit Insurance Corporation.

These ideas for injecting capital directly into the banking system and guaranteeing bank debt originated in the United Kingdom. In mid-October, the UK government announced a guarantee on new bank debt issuance and an injection of up to £250 billion in new capital to seven leading banks and the Nationwide Building Society. Under the

The question is whether the estimates of losses are high enough given the negative feedback loop that appears to be developing between financial markets and the real economy. There is also concern about whether other market players outside the banking sector – including insurance companies, pension funds, and hedge funds – have been aggressive enough in marking their own portfolios to market. This uncertainty is one of the factors responsible for the ongoing volatility in the financial markets.

Getting Everyone on the Same Page

There are no silver bullets to resolving a banking crisis, but past experience in Scandinavia, Japan and United States indicates successful plans have several elements in common. First, policy responses must be rapid and involve the early recognition of losses by financial institutions. Second, bad assets must be removed from bank balance sheets and banks must be recapitalized. Third, the adverse impact of the credit contraction on the real economy must be addressed through fiscal and monetary stimulus. And fourth, the regulatory infrastructure must be updated to avoid a repeat of past mistakes and limit the risk of moral hazard.

British plan, banks will initially apply for £25 billion in permanent capital with a further £25 billion available as a stand-by and for other eligible institutions. The hope is that the government backstop will make it easier for the banks to go out and raise capital in the market. The government has insisted that the banks conclude their recapitalization by the end of the year.

Leaders in continental Europe initially resisted calls for a pan-European rescue package, but sentiment changed quickly as it became apparent that the country-by-country approach was failing to soothe panicked investors. European financial institutions have accelerated the recognition of losses in recent months, writing down an estimated \$200 billion in bad debt. At the same time, euro-zone governments are taking a more unified approach to the crisis based on the British model of bank debt guarantees and recapitalization.

Fears that global policymakers will run out of ammunition are grossly exaggerated at this stage. Both the Bank of England and the European Central Bank have ample room to lower interest rates and have finally showed a willingness to do so. Furthermore, as Fed Chairmen Ben Bernanke outlined in a 2002 speech entitled, "Deflation: Making Sure 'It' Doesn't Happen Here," the Fed still has plenty of other tools at its disposal even if it were to reach the zero bound on interest rates.

In fact, the Primary Dealer Credit Facility, which

opened the discount window to non-bank broker dealers last March, was straight out of this playbook. Given the severity of the crisis in the US, the Fed may even choose to pursue a quantitative easing in the coming months as a means of getting cheap money to where it is most needed. Under such a strategy, the central bank could purchase long-dated Treasuries or perhaps even agency mortgages to bring down market interest rates. Most importantly, the willingness of global policymakers to work together



er toward a solution to the global credit crisis represents a sea change in attitude.

Action Comes Too Late To Avoid Global Recession

Even with coordinated global action, it will take a long time to unwind the massive amount of leverage in the financial system and to restore investor confidence. Past banking crises indicate that the deleveraging process acts as a restraint on economic growth and puts downward pressure on inflation. The Japanese experience is perhaps the most telling. The government's refusal to take decisive action early on resulted in a decade between 1992 and 2002 in which the economy was in recession two-thirds of the time and the aggregate price level actually fell. The macroeconomic con-

Macroeconomic Consequences of Past Banking Crises

	Japanese Banking Crisis 1999	Swedish Banking Crisis 1992	US S&L Crisis 1991
Peak to Trough Decline in GDP	-6.0%	-3.1%	-1.3%
Average Change in Inflation Rate (percentage points)	-3.8	-1.1	-1.9

Source: Payden & Rygel Estimates

sequences of the Swedish banking crisis and the US S&L crisis, though not as severe, were similar.

Given that the magnitude of the losses resulting from the US subprime crisis fall somewhere between the US S&L crisis and the Swedish banking

crisis, it seems reasonable to assume that the macroeconomic fallout will be on the same order.

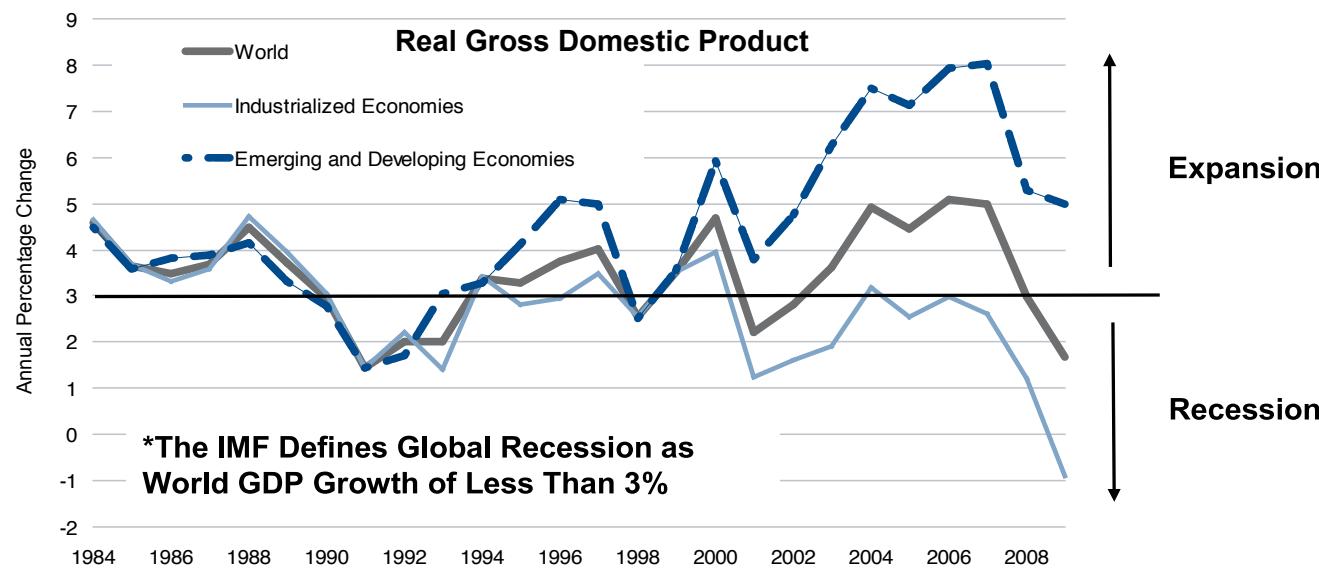
Global economic growth averaged nearly 5% between 2004 and 2007—its highest level in three decades. This year, we are anticipating that real world GDP will grow at less than half that pace and that inflationary pressures will recede. The International Monetary Fund defines a global recession as a period in which world output expands at 3% or less. By this measure, the world economy likely slipped into recession in late 2008. The brunt of the slowdown will be borne by the industrialized economies, but economic growth in emerging markets will also be affected through declining imports and adverse global credit conditions.

The rapid policy response in the US and Europe suggests the risk of a Japan-style decade of stagnation is small. That said, when a global recovery does

banks during the latter stages of the boom. The reduced amount of leverage in the financial system suggests global economic growth rates could be more subdued for the next several years.

Global financial markets have already discounted a global recession, but its depth and duration remain uncertain. Volatility is likely to remain high until there is greater clarity on this front. The willingness of global policymakers to work together toward a solution to what has become a global credit crisis represents an important change in attitude. The extraordinary measures they have adopted will take time to work, but the amount of liquidity flooding the system should gradually help to thaw the credit freeze. Thus, for investors who have a long enough time horizon and a strong stomach, the current market environment may present an opportunity. ■

Global Recession Likely



occur hopefully sometime in late 2009, the trajectory of economic growth is likely to be significantly lower than what it was heading into the crisis. At the heart of the problem is the fact that the global market for securitized lending is frozen and the traditional banking system does not have the capacity to reintermediate all the debt that was previously borrowed through the credit markets. Regulations prevent traditional banks from leveraging up by more than 10:1 on their capital, which compares with leverage ratios of 30:1 among the investment

Notes:

1. The International Monetary Fund Global Financial Stability Report. October 2008.
2. Ben S. Bernanke. "Deflation: Making Sure 'It' Doesn't Happen Here." Federal Reserve. November 2002.

Swimming the English Channel and the Art of Investment Management

Our colleague Jeffrey Cleveland recalls his recent English Channel swim:

It's September 13, 2008. The sun is out and the air is a crisp 50 degrees. I'm standing near the railing on a 30-foot boat, just 100 yards off the beach at Dover, in southeast England. I nod to my team manager, my brother, and quickly jump over the side of the boat, landing feet first in the calm, 62-degree water. Shivering, I slowly make my way to the beach and wade up the shore. I turn and face the boat, waiting for the signal. I stretch my goggles over my eyes and pull my swim cap over my ears. I take a deep breath.

From out on the boat, a horn sounds. I spring forward, diving into the shallow surf. Only 21 miles to go. This is the start of the English Channel Swim.

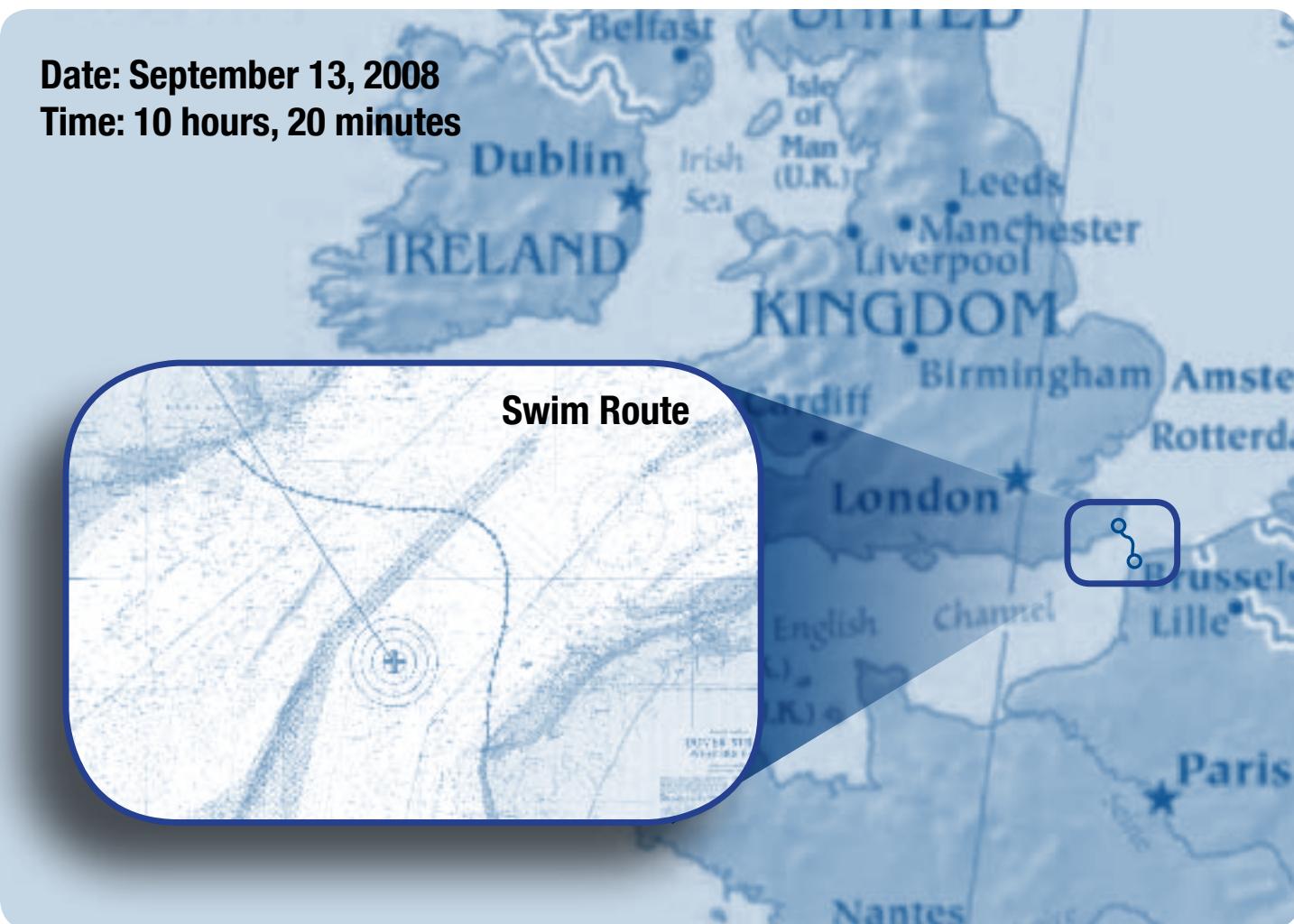
The Mount Everest of Ocean Swims

The idea of swimming the English Channel got its start in 1875, when Captain Matthew Webb jumped off the pier in Dover Harbor and set off for France. He emerged from the Channel about 21 hours later at Cap Gris Nez, France. Today, the swim is considered the Mount Everest of ocean swims. The challenge of swimming across open water between two countries beckons a cast of ocean swimmers from around the world to Dover each year between July and September to attempt the 21-mile Strait of Dover.

Part of the fascination and attraction to the mammoth swimming challenge of the English Channel is that there is simply no guarantee of success in Channel swimming. In fact, most swim attempts

Date: September 13, 2008
Time: 10 hours, 20 minutes

Swim Route



fall short as noted by the Channel Swimming & Piloting Federation (an organization that ratifies eligible swims), which reports that the success rate on solo attempts is less than 50%. As illustrated below, the journey across the English Channel parallels the obstacles faced by investment managers guiding clients to investment goals. Financial markets are fraught with uncertainty and risk, but they can also provide great rewards. The odds of success on this journey can be increased by enlisting the guidance of an investment manager with experience who can help navigate you to your final destination, facing challenges one day – or one arm stroke—at a time.

The Obstacles: Risk and Uncertainty

There is no such thing as a risk-free world. That is the first thing that struck me as I left England behind and swam out into the open water of the English Channel. You are alone in the water—except for your escort boat 30 yards to your right. While you can stop to eat or rest, you cannot touch the boat or anything else or you face disqualification, monitored by the “Channel swimming official” stationed on each boat. Suddenly, the risks and challenges become a reality.

In recent years, investors may have lost sight of this reality, believing that risk could be eliminated through sophisticated financial modeling. Investors were lulled into a false sense of security as stock market volatility, as measured by Standard & Poor’s VIX, hovered at historically low levels between 2004 and 2007. Then, suddenly, the level of the VIX quadrupled in a one month span between September and October 2008, jarring investors out of their complacency.

Whether our usual indicators point to it or not, risks always loom. The Channel is a testament to this fact. First, there is the cold. It might seem bright and sunny out, but the water was 62 degrees and the air was colder. Channel swimming rules prohibit the use of wetsuits so under these conditions many swimmers face hypothermia. At its narrowest point, the Channel is 21 miles or 35 kilometers across and the average swimmer faces 14 hours in cold water to make the crossing. Second, the weather is unpredictable and conditions

change rapidly. Our swim began under sunny skies but storm clouds soon rolled in and we swam through the rain at one point. In fact, we were stationed in Dover for 10 days through rain and wind before a window of opportunity presented itself for the swim. Some swimmers did not get the chance to go at all. Third, there is the marine life. Fortunately, it is often said that no self-respecting shark would spend time in the English Channel—it is too cold and there are too many ships. But we did encounter a few fish floating by as we entered French water. Fourth, approximately 600 ships move through the Channel each day, making it one of the busiest waterways in the world. Finally, the swimmer faces dehydration, fatigue and exhaustion. For food, swimmers stop every 20 minutes for 10 to 20 seconds to consume a mix of carbohydrates and water out of a water bottle tossed out into the ocean. The infamous “Channel chop” water makes it difficult to consume solid foods quickly.

At first glance, the risks and obstacles may seem overwhelming. Jellyfish, hypothermia and 20+ miles of swimming? Over a lifetime of investing, managers face their own daunting list of obstacles. Recessions, bouts of inflation, company defaults, interest rate volatility, and financial crises—all stand in the way of a successful journey. Understanding the nature of the risks is important, but possibly more important is realizing they can never be eliminated. In fact, somewhere on the journey the investor—like the swimmer—will be forced to face the unexpected and improbable.

A Combination of Talent and Commitment

So what makes a swim successful? Talent is often thought to be the key ingredient for athletic success, but in the Channel talent only takes you so far. During our stay in Dover, we met a speedy, talented swimmer—a national record-holder from the United States. He was on a relay-team training to swim a “Channel two-way” (England to France and then back to England). The team had to abandon the attempt after reaching France because, while they had one of the fastest swimmers to ever swim in the Channel, he was seasick and suffering from symptoms of hypothermia.

Indeed, the Channel swim is far less about talent or speed, and more about experience, preparation and desire. These characteristics are a lifetime in the making. From the YMCA pool where my mother first tossed me in at six months old to watching the "Escape from Alcatraz" triathlon on television with my brother to my first ocean race four years ago, my desire to face this challenge head on did not diminish. Over the last three years, I completed dozens of ocean races and ocean training swims up and down the California coast and in Maui. At the peak of my preparation for the English Channel I trained 20-30 hours per week, covering 100,000 yards or approximately 50 miles in combined pool and ocean time.

Even if you are a skilled, experienced ocean swimmer, it is virtually impossible to navigate the Channel alone. In fact, the one known swimmer to set off across the Channel without the assistance of a navigator ended up as a fatality statistic. The lesson is simple: no matter how talented you are, your odds of success are greatly improved by an expert navigator. The navigator I chose for my swim had a 25-year track record during which he guided 76% of his swimmers successfully cross the Channel. Likewise, an experienced investment manager can be critical for an investor who is seeking to meet their long term goals. A 25-year history for an investment manager means many storms have been weathered.

Good, Old-Fashioned Swimming (And Investing)

As with investment management, Channel swimming has become increasingly sophisticated. Expensive carbohydrate mixes have replaced simple oatmeal and honey feedings. Computer models allow navigators to estimate the swim route given a host of meteorological data (winds, currents, etc.) inputs. In the end, it all comes back to simple swimming.

After diving off Shakespeare Beach, I remember the first four hours of the swim well. I remember thinking that the water was calm and flat at the start. For me, this set off alarm bells. My experience in open water swimming (and, strangely

enough, my thoughts of the 2007-2008 financial crisis) told me to expect the unexpected; that calm water ahead could be interrupted at any moment. Ten miles off the coast of England and in the middle of international shipping lanes, approximately four hours into my swim a wave of nausea swept over me.

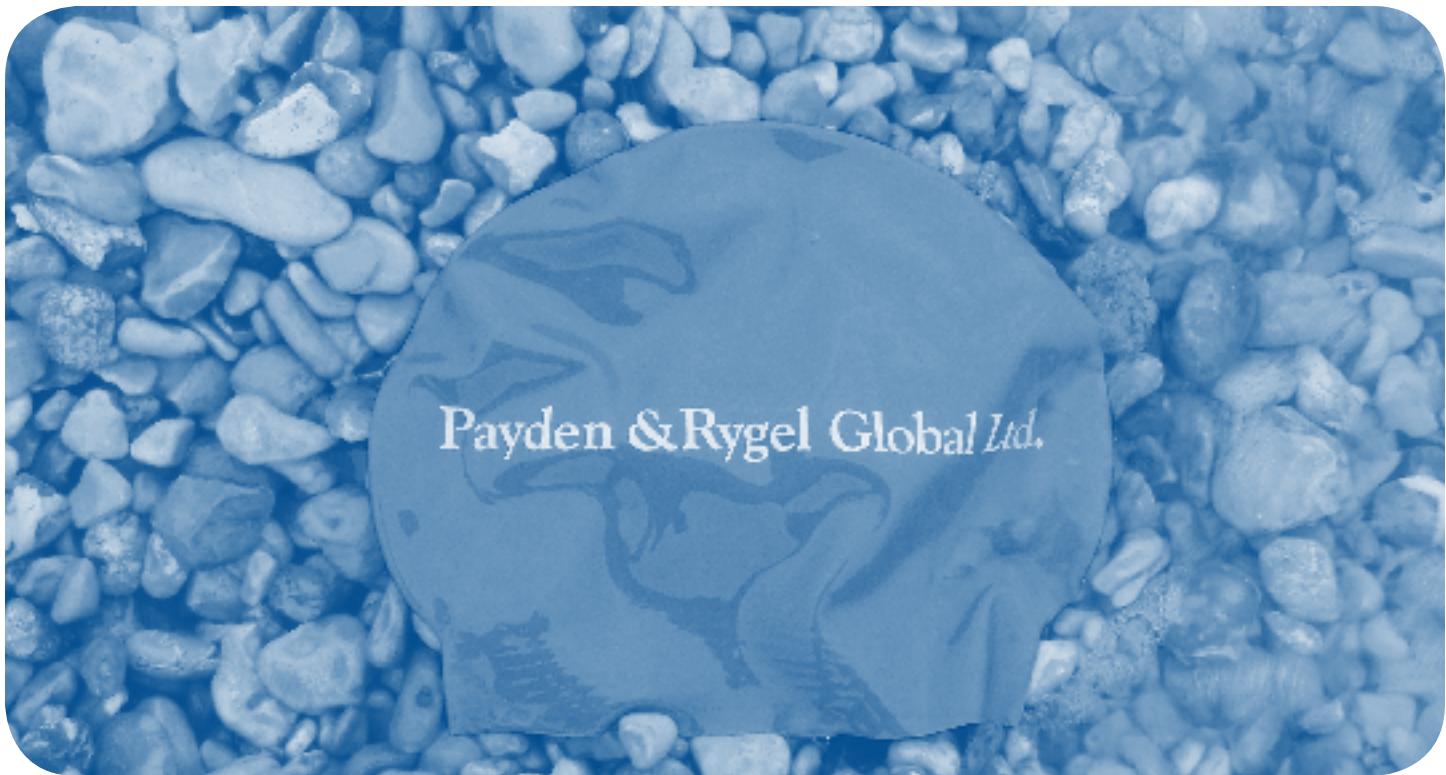
I hoped it was a momentary feeling brought on by the wake of the last container ship. However, a short time later I stopped swimming, started treading water, and vomited. My English breakfast and the carb drink I had been consuming found its way into the English Channel. I glanced up at my brother. He shrugged as if to say, "Oh well, just keep swimming. We didn't come here to stop after four hours." I kept swimming. But with each subsequent feeding stop, my stomach refused to keep the feedings down. I yelled to my brother, "Forget the feed – just give me water. Just water."

Many swimmers get sick during the swim. We had hoped it would not be one of the problems we faced. We had discussed the problem – viewing it as a low-probability event given our extensive ocean training. I consumed only water for the next two hours worth of feedings. It was at this point that I realized the full weight of the challenge was upon me. Facing fatigue, cold, nausea and sickness, the Channel swim suddenly appears impossible. Yet, allowing doubt to creep in and momentarily questioning whether you can make it could doom the entire effort.

Swimmers are told not to look back during the swim because the White Cliffs of Dover are visible for miles, making the crossing seem endless. Of course, I glanced back. I could not help it. I saw those gleaming White Cliffs, almost as if they were taunting me. It is virtually the same idea investors face today. Faced with a financial crisis, they stare back at past economic crises and market catastrophes and wonder, "Will this ever end? How can we possibly get through this?"

Perseverance through Adversity

Teeth chattering, I pressed on for what seemed like hours, stopping just briefly to consume my



brother's newest concoction. I could see the sun setting and feel the air temperature dropping. Then, all of a sudden, I sensed I was near France. I could see a lighthouse on the edge of the cliff; I could see houses lining the cliff. I realized I wasn't much further off the coast of France than I would be during training swims out beyond the piers in Newport Beach, California.

The boat captain yelled for me to stop. He issued a final set of instructions: "Go find a safe place to finish on those rocks. No heroics. No mountain-eering." In the darkness, I sprinted toward shore. As I approached, I could see the faint beam from the boat's floodlight illuminating a portion of the rocks. The waves were pushing me forward. All of a sudden my knees smacked against the slimy, slippery surface of a rock lurking underwater. I could not see the rocks but as the next wave crashed in, I felt them.

Scrambling to stand on a rock as the last wave washed out, I thrust two arms in the air and looked back toward the boat bobbing in the waves and the outline of England in the background. A faint ray of light was all that remained, crowded out by darkness. After 10 hours and 20 minutes of swimming, I had conquered the English Chan-

nel. I think that is what the Channel is all about: refusing—under any circumstance—to quit. Later that evening, after a three-hour boat ride back to Dover, I took part in the ultimate Channel swimming ritual: I etched my name into the ceiling of the White Horse Pub and included the quote that became a theme for our journey: "Pain is temporary, quitting lasts forever."

The Channel, like investing, is far less of a science and far more about discipline and preparation. Of trust between yourself, the navigator and the team assembled to help guide you across through the volatility and the relentless focus on your ultimate destination. The Channel is about the moment where you face what seems altogether impossible and improbable, chaotic and overwhelming, but remain calm and swim on.

One stroke at a time. ■

A Contrarian View: The Credit Crisis as an Opportunity

The global credit crisis has left investors unsure of what the future holds. When the crisis began more than a year ago, few would have imagined that American Insurance Group (AIG), Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, Merrill Lynch and others would be out of business, seized or bought. Fear and panic have gripped investors as they shun all but the safest and most liquid investments.

But, history suggests an opportunity is at hand. The US government and private sector are working together to resolve the crisis, and investors should look to position themselves to take advantage of the changing environment. During prior periods of financial upheaval, corporate credit spreads have typically widened out at the height of the crisis, before eventually tightening back as the government intervenes and the economy improves. This pattern was evident during the Oil Crisis of the 1970s, the Savings and Loan Crisis of the 1990s, and the Enron Collapse in 2001. In the text that follows, we will examine these past crises and discuss the implications for the corporate bond market going forward.

The Oil Crises of the 1970s

The 1970s saw two separate periods of economic stress in which corporate bonds suffered. The first oil crisis began in October 1973, as members of the Organization of Petroleum Exporting Countries (OPEC) announced that they would no longer

ship oil to the United States because of American support for Israel in the Yom Kippur War. This embargo was reinforced by the producers' decision in November 1973 to reduce output by a quarter. The embargo, which extended through March 1974, resulted in the net loss of four million barrels per day and represented a decline of 7% of world production.

Oil prices quadrupled in a matter of months and the global economy slipped into a deep recession. As the impact of the crisis rippled through the US economy, corporate spreads widened to a peak of 207 basis points over US Treasuries in December 1974. At that point, interest rate cuts by the Federal Reserve began to revive economic activity and corporate spreads started to tighten in. Although the oil crisis of the late 1970s had different roots, corporate spreads followed a similar pattern once the Fed began cutting interest rates and the US economy began to recover.

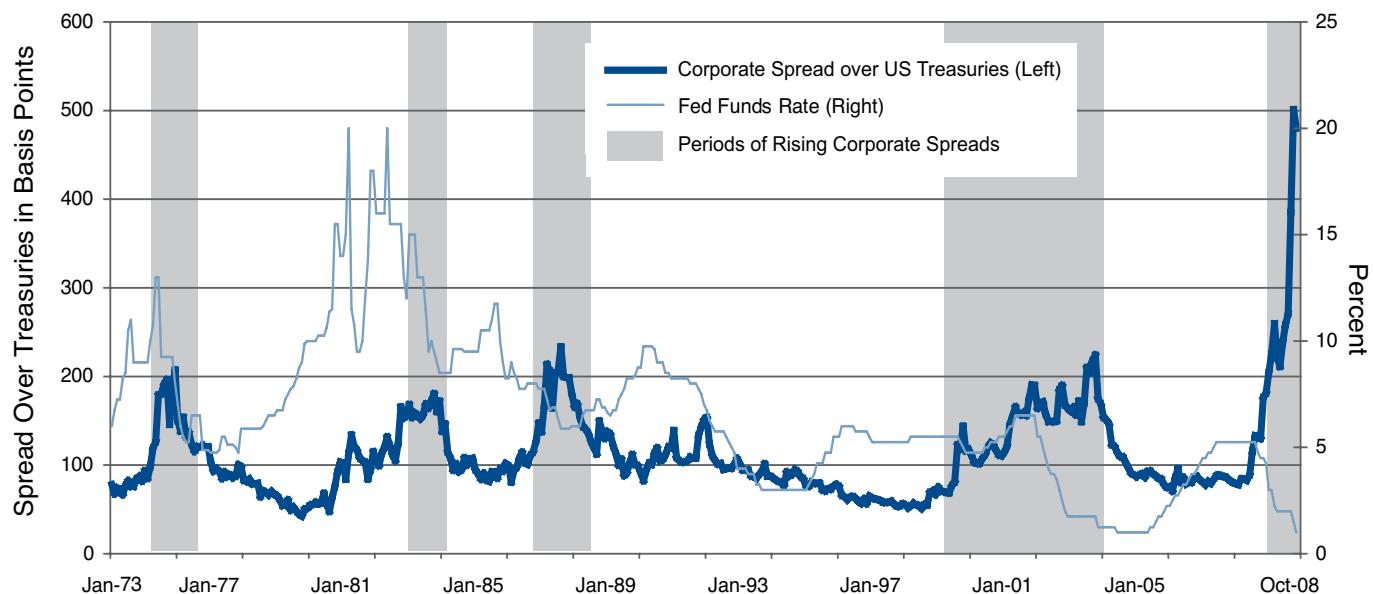
The Enron Collapse

Enron's debacle began with the disclosure of a quarterly loss of \$638 million and the ousting of its CFO Andrew Fastow in October 2001. The world would soon learn of the offshore special purpose entities (SPEs) Enron created to keep significant losses off its balance sheet. Enron's senior executives and insiders knew of the offshore accounts and were trading on insider information. Moreover, the company began to adopt aggressive

The **corporate credit spread** is the yield differential between a corporate bond and a risk-free US Treasury security of the same maturity. Spread tightening occurs when default risk of a corporate bond decreases, while spread widening occurs when default risk of a corporate bond increases.

A **basis point** represents one hundredth of a percentage point and is used to measure changes between yields on fixed income securities.

Credit Spreads vs. Fed Fund Rates Since 1973



Sources: Lehman Brothers and Bloomberg

accounting practices, which led to premature recognition of future profits in its Internet-based energy trading business.

By the time Standard & Poor's (S&P) downgraded Enron's debt to junk status, the company had amassed significant liabilities that totaled \$23 billion. Enron was forced to file for bankruptcy protection in the United States and Europe. Corporate spreads widened out to a peak of 224 basis points over US Treasuries by October 2002. During this period, significant off-balance sheet debt and poor corporate governance undermined investor confidence.

MCIWorldCom was another high profile case of corporate malfeasance which occurred around the same time as Enron. From 1999 to 2002, WorldCom managed to hide declining earnings to help buoy its stock price. The fraud was accomplished through capitalizing certain expenses rather than expensing them and inflating revenues through "corporate unallocated revenue accounts." Investigators found that the company had inflated its assets by \$11 billion. CEO Bernard Ebbers also used his MCIWorldCom stock to finance his other businesses and persuaded the board to provide over \$400 million in corporate

loans and guarantees to cover his margin calls in the wake of these realizations.

In July 2002, WorldCom filed what was the largest bankruptcy in US history at the time. In that same month the Sarbanes-Oxley Act was passed, establishing new standards for auditor independence, requirements for off-balance sheet reporting, analyst conflicts of interest and corporate fraud accountability. As confidence in corporate accounting slowly returned, corporate bonds rallied and tightened 125 basis points over the next twelve months.

The Savings and Loan Crisis

The Savings and Loan Crisis of the late 1980s provides the most direct parallel to the problems facing investors today. The S&L Crisis involved a prolonged period of structural weakness in the financial sector brought on by a collapse of the commercial real estate market. Corporate credit spreads peaked above 200 basis points over US Treasuries during the summer of 1986 when it became apparent that the Federal Savings and Loan Insurance Corporation (FSLIC) was facing insolvency. Bank failures were becoming more widespread, and the thrift sector, which was



responsible for about 40% of mortgage originations at the time, was experiencing unprecedented financial hardship. Investor concerns culminated on October 19th, 1987, Black Monday, when the Dow Jones Industrial Average plummeted by more than 22%.

It took an act of Congress, the dissolution of the FSLIC, and the creation of the Resolution Trust Corporation (RTC) in 1989 to clean up the S&L Crisis. The FDIC estimates that that ultimate taxpayer cost of the RTC bailout was approximately \$124 billion, representing the clean-up costs of 1,043 individual bank failures with total assets of \$500 billion. Corporate spreads tightened in sharply during the late 1980s, but this process reversed briefly during the 1990 recession as default rates began to rise. Subsequently, corporate spreads tightened back in when the US economy began to recover in 1991.

The Subprime and Global Credit Crisis

The similarities between the S&L crisis and today's global credit crisis are readily apparent. In both

cases, a slowdown in the real estate market – then commercial, now residential – resulted in the freezing of the credit markets. Corporate spreads widened as investors digested the failure of a lynchpin of the US mortgage market – then the FSLIC, now Freddie Mac and Fannie Mae. The use of leverage has aggravated the widening of corporate spreads in the current crisis, pushing them to unprecedented levels at 550 basis points over comparable Treasuries.

Even so, both the S&L crisis and the global credit crisis had their roots in poor risk management practices within the banking sector compounded by the negative impact of an overly lax credit environment. In both instances, a massive government intervention was necessary to clean up the mess. In the late 1980s, the government bailout came in the form of the RTC. Today, it is the Treasury's \$700 billion Troubled Asset Relief Program (TARP), which is designed to recapitalize the banking system.

Perhaps the most important lesson from the S&L crisis is that most of the widening of credit spreads occurred well in advance of the deterioration of the real economy. Spreads were far wider when investors first realized that the FSLIC insurance fund was facing insolvency than they were when bank failures actually hit their peak five years later. No one knew how big the S&L crisis would ultimately become or whether the government was willing and able to address the root causes of the problem. The credit markets started to improve well before economic conditions actually began to improve.

Take Advantage of the Opportunity

Putting aside the lessons learned from past financial crises, there are other reasons to be optimistic about the current situation. One notable and little discussed positive in the current crisis is the lack of excessive leverage among many non-financial companies. In 1998, the Standard & Poor's (S&P) 500 companies had an average debt-to-equity ratio of 0.62x. Today, these companies have lowered their debt-to-equity ratio by almost

one-third from a decade ago to 0.40x. One of the most dramatic examples of deleveraging is the consumer discretionary sector. The S&P 500 consumer discretionary sector reduced its debt to equity ratio from 1.26x in 1998 to 0.19x in 2008.

Another positive is the dramatic decline in oil prices from peak levels of \$145 per barrel in July to less than half that level today. Lower oil prices will help lower operating costs for many companies in the food and beverage, restaurant, transportation, chemicals, and packaging sectors. Airline companies, such as Continental and Southwest, should see direct benefits from lower oil prices. Other commodities, such as corn and soybean, have also fallen with the price of oil. These agricultural commodities represent a large input cost for many food and beverage producers, and declining prices should result in an incremental margin improvement for companies in these sectors.

If history serves as a guide for what could happen, today may be an opportune time to selectively increase exposure to corporate debt, across the ratings spectrum from investment grade to high yield. A low federal funds rate, strong balance sheets ex-financials, and attractive yields should set the foundation for another period of spread tightening. ■



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