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Bear Stearns Asset Management Transcript of Conference Call

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MS. MALLOY: Uh, thank you for joining us. This call is for Bear Stearns High Grade Structured Credit Strategies to discuss the recent volatility in the CDO mark-market and our current leverage levels. Um, the following conference call is strictly for current investors in the fund. If you are not a current investor who was specifically invited to attend this conference call by a Bear Stearns sales representative, please disconnect now and call Heather Malloy or Ken Mak at 800-436-4148 for additional information on the fund. Ralph Cioffi, Senior Portfolio Manager, will be moderating the call.

MR. CIOFFI: And-and the call's actually for the High Grade Structured Credit Strategies and the leveraged version of the High Grade Structured Credit Strategies. We have, uh, quite a bit to go over so I want to initially just hit on some of the high points and leave a lot of um, time for Q & A, um… which we anticipate there'll be plenty of.

The return estimates for February are uh, +1.56 for High Grade and -1.56 for Enhanced. Um, the differential in return between the two funds is-is obvious, the Enhanced Fund is leveraged, uh where the HGS only uses our repo leverage, and as-uh most of you probably know from reading the papers and listening to the talking heads on TV, there was a significant widening of spread, uh, the last week or so of the month of, uh, February. The bulk of the negative return for the Enhanced Fund was a result of us, uh, ramping assets for a CDO that we are pricing in March. Um, and as a result, most of that negative number should be reversed in March once we sell the assets into the CDO. Um, that should bring, um, uh, the uh-- well, not taking into account what mark to markets may occur in March - uh that's about $11 million in mark to market in the Enhanced Fund that we should be getting back in, in March. Um, in terms of our hedges, we-we-we currently primarily hedge with the ABX, which is the major market index that most dealers and hedge funds use to hedge their subprime exposure. We have, uh, between the ABX and single-name shorts that we have entered into, we have about $2.5 billion in total short positions, and I-I anticipate holding those hedges indefinitely. Our, ahm, our subprime credit model that-that we've been using, uh, still shows that there's significant loss and-and/or price decline in those major market indices, so we want to hold on to those hedges. Uh, they are-they are costly, uh they certainly eat into the carry, but I think right now, given, uh, the uncertainty and the volatility, we want to-we want to stay, uh, as hedged as possible. Um, we think it's um, uh, prudent to do so, and-and-um we may even take them up to some extent, uh, more so in the single-name space than in the ABX space because, as you know, with our surveillance system we've been pretty uh-efficient and effective at-at monitoring the single-name exposures and we've been-we've been very-very good at hedging those single-name exposures out. Um, on the um funding side, we've accomplished quite a bit in, uh, in the last two weeks. On Friday, we executed a-a $4 billion, uh, CP funding facility with BofA, and we have the option to take that up-up to 5 billion, assuming, uh, we have assets that we want to put into that facility. And that's a very attractive funding facility; the-the CP, uh, liquidity cost is 20 basis points, and with spreads widening as significantly as they have in the-in the marketplace, we've got a very efficient funding vehicle that, uh, will-will-will allow us to generate a-a very high return on-on capital. And away from the return on capital, the added benefit is we're able to move almost $4 billion worth of assets that we have in the hedge fund off of repo and move them into the BofA CP facility. That also raises about 110 million of additional cash capital in both the High Grade and the Enhanced Fund, so we, um, we-we-that's-that's a very valuable transaction for us. And if we do, um, take the option of raising that funding from 4 to 5 billion, we have the ability to add another billion dollars of assets into that facility at today's levels. Uh, so the added liquidity, the-the increase in the repo capacity, is a great, great position to have the two hedge funds in at this point. Additionally, we are working to restructure a facility that we talked about in the past that's called CIRC, which is a $4 billion facility we have with, uh, Dresdner Bank. That is also being, uh, converted into a, uh, um, uh, -- we call it a "super-senior funding" at the top, but it's effectively like commercial paper. Um, that's going to have the benefit is-of-of, comparable to the BofA facility, of adding, uh, getting back cash because the, uh, um, the subordination amount in that vehicle will be coming down. So we'll be adding back, uh, some cash there--

MR. MCGARRIGAL: A little over $100 million.

MR. CIOFFI: About 100 million from that facility. So between that and the BofA, we're going to add over $200 million worth of additional cash to the-to the hedge fund. That cash plus what we currently have between High Grade and Enhanced, uh, will bring our c- our cash positions, um, to over $400 million. So we'll have plenty of liquidity and we'll have plenty of repo capacity as well.

Um, all right, what's my bottom line takeaway here? Well, we've talked about the hundred year storm and the 4 and 5 standard deviation moves, and how we felt we were effectively able to hedge that mark-to-market volatility, and certainly in High Grade we've done that. Um, in Enhanced, we've effectively done that, save for that CDO warehouse, which I said we'll-we'll be getting most of that mark-to-market back in March. We put ourselves in a position to have added liquidity because of the CP facility, added f-funding capacity because of our ability to pay down repo, and we're-we're now at a point where spreads are equal to if not wider than where they were when we started the fund in '03. So there's tremendous opportunity.

Uh-that being said, we still see a-a-a challenging environment over the next month or two or three. The market is searching for a trading floor, if you will. Uh-the market has been pretty stable the last week or so. The ABX index has actually rallied significantly, um, and the CDO market is somewhat stabilized as well.

Dealers have liquidated quite a bit of inventory and, uh, spreads have somewhat stabilized, but, um, we anticipate some more volatility, and we're well positioned to-to-to take advantage of that.

The other thing we've talked quite a bit about in the past is our Rampart facility which is a permanent capital vehicle for our CDO equity.

The, um, the SEC filing is April 6th. Our IPO is still on schedule for, um, let's call it July or August of, uh, this year. Market, equity market conditions, um-um, are -- you know, the success of that will be dependent upon the equity market.

Um, Rampart is primarily, uh, a CLO vehicle. We do have some CDO equity in there that has subprime exposure, but we've hedged quite a bit of that. Um, and the m-majority of the assets there are-are-are CLO equity pieces, which, so far CLOs -- bank loans -- have not been impacted. High grade credit and high-yield credit spreads widened initially last week, but they're back, they're back -- they've tightened up quite a bit. So the IPO is still in, uh, in place and we're, uh, you know, we're optimistic about the prospects for that.
So that's uh, again, I said I'd kind of hit-hit on the high points and leave-leave plenty of time for Q & A, and that's-that's what I'd like to do now, open it up to Q & A.
OPERATOR: Okay, thank you, if you have a question at this time please press the 1 key on your touchtone telephone. Once again, if you have a question at this time please press the 1 key on your touchtone telephone. One moment, please. Our first question comes from Brad Alford from Alpha Capital. Your line is open.
MR. ALFORD: Um, yes, do you have an estimated return for, uh, March, year to date?

MR. CIOFFI: Um, we don't because, as is normally the case, we-we mark our hedges daily, um, but we mark our assets towards month end. And quite frankly, we've been spending all of our time making certain we have our February marks in order, um, and we still have, I would say, about 10 marks that are missing. We've marked them ourselves for-for February. Um, but, um, you know, we-the reason we deem this still an estimate is we're waiting for those last marks. We think we've marked, marked conservatively; um, and then of course we have to send everything to the fund administrator. But I-I don't want to give you an estimate for-for March just yet.

OPERATOR: Okay, thank you. Our next question comes from Joel Dryer, from LL Partners. Your line is open.

MR. DRYER: Every time I-uh call in the name of my company changes, does that make you nervous?

MR. CIOFFI: [Laughs] Ha-ha-No.

MR. TANNIN: The only thing that makes us nervous, Joel, is you're not the first caller this time to get your question in.

MR. DRYER: Um, I-I-I got on the call at 10:02, so I missed two minutes of your quick presentation.

Um, February, uh, because of the volatility in the, uh, leveraged high-grade, uh, markets -- if I understood the tail end of what you said -- was that, uh, um, there was a timing issue and that, uh, the mark to market, uh, got-got hit.

MR. CIOFFI: Yeah, let me, I'll give you the exact, let me give you the exact numbers. Um, we had ramped about 250 to 260 million of assets for a CDO that we were, that we are doing with JP Morgan Chase.

MR. DRYER: Alright.

MR. CIOFFI: And we have a-a committed facility from them and an engagement letter. Um, between, call it February 20th and the end of the month, CDO spreads massively widened.

MR DRYER: Right.

MR. CIOFFI: Um, we hadn't hedged that position because we had anticipated selling it into the warehouse. We're not going to-we're not going to do that until either this week or next week. So those positions net-net were marked down about, um, $11-plus million for-for February.

MR. DRYER: Right.

MR. CIOFFI: We'll get that back in March when we-when we sell them to the-to the warehouse at our cost. And we have the super-senior funding, which is

the most important part of that capital structure, locked in from two-month-ago spreads.
MR. DRYER: Right.
MR. CIOFFI: So, the arbitrage--
MR. DRYER: Which were narrower at the time.
MR. CIOFFI: Right. So the arbitrage to the equity piece we'll be taking back, even though we're selling the assets at last month's prices in March because the super senior is priced at, you know, those old levels, the equity IRR is still north of 40%, which is where it would be today if we were to price a new CDO today.
MR. DRYER: Right, with the wider spreads.
MR. CIOFFI: Right.
MR. DRYER: So the-the net results for February in terms of performance -- did you say what that was going to be?
MR. CIOFFI: Uh, down 1.56.
MR. TANNIN: For-for the Enhanced fund. Up 1.56 for the High Grade fund.
MR. DRYER: The Enhanced would be down 1.56 but you're going to pick up all of that, uh, the next month?
MR. CIOFFI: In-in, uh, in March. I mean, we debated -- look, we debated whether or not we even would

mark it in February but--

MR. DRYER: Right -- no that's all right, you got to mark it to market.

MR. CIOFFI: We debated--

MR. DRYER: No, I understand that--

MR. CIOFFI: Yeah.

MR. DRYER: And I don't want to make you go over your logic here. But, uh, so, you're going to pick up all that, all that -- you're going to pick up a 156 basis points in March. Does that mean that when you pick up the 156 basis points in March that February will, in fact, have been just a-a-a push? A zero month?

MR. CIOFFI: Yeah. February would have been about a-a push to maybe down 25 bps.

MR. DRYER: Ah, okay. So, that's what I was looking for, is what our kind of adjusted bps were, and maybe you said that earlier.

MR. CIOFFI: Actually -- I didn't say that, but--

MR. DRYER: Oh, okay. That's to me a more relevant number. So, the adjusted bps are 0 to 25 bps down. Okay, that-that makes a lot more sense. And then, you're going to pick up all -- so-so you're starting out March net zero. Spreads have substantially widened. You're now in a position to take advantage of some of that widening?

MR. CIOFFI: Yeah, we-we are. And-and, for a number of reasons. We mentioned the CP facility we have with BofA, uh, which gives us 4 billion of--

MR. DRYER: Right.

MR. CIOFFI: Yeah, you heard all that, Joel.

MR. DRYER: Right, yeah.

MR. CIOFFI: Yeah.

MR. DRYER: So-so you're-you're going to put that into play you think in March--

MR. CIOFFI: Well, you know what, we're actually talking about putting that into play over a three- or four-month period.

MR. DRYER [simultaneous]: You think spreads are going to widen some more?

MR. CIOFFI: One of the good things -- excuse me?

MR. DRYER: Because you think spreads are going to widen more?

MR. CIOFFI: It's not actually because I think they're going to widen more, I just don't think they're going to compress--

MR. DRYER: Oh, okay.

MR. CIOFFI: --in the next six months. We may be wrong, and in fact, I mention the ABX index has been tightening here, which-which is surprising given all the negative news. Um…

MR. TANNIN: Although not-not surprising given the number of short positions.

MR. CIOFFI: Right, right, the technical is-is pretty short. I mean, the fundamental on that AB—on that subprime space we see as continuing to deteriorate, and that's why we have so much in the way of hedges, both-both on single-names that we're short -- specific deals we don't like -- as well as the-t-the market index.

MR. DRYER: So your shorts are starting to come home too?

MR. CIOFFI: Oh yeah-yeah. I mean, the shorts, I mean we made -- the shorts, I don't know the exact numbers but, uh, I mean, I-I've got them generally speaking - but, um, we, um, we had, you know, well over $140 or 50 million of mark-to-market gains in our-in our hedges--

MR. DRYER: Right.

MR. CIOFFI: --both single name and index. We marked that -- even with a 1.5% gain in High Grade -- we marked assets down a lot. We marked assets down a lot. So we're not - the hedg- it's not that the hedges went up but we didn't mark the assets down. We marked-we marked CDOs down quite a bit. I mean, to give you an example, AAA CDO spreads now are-are anywhere from 75 to 100 basis points, I mean, 60 to 100 depending upon the deal. I mean, there's variations on-on the CDO AAA that-that are, you know, there's 100 shades of gray, if you will, but they do vary. Those are the spreads we were buying in '03.

MR. DRYER: Right, yeah.

MR. CIOFFI: And-and, you know, double yeah, AAs are 120, well call it AAs can be anywhere from 100 to 200.

MR. DRYER: Right. So when you leverage that 8, 9 to 1, that's gonna -- you're gonna start hitting your stride again.

MR. CIOFFI: Well, that's -- you got it, you got it. And with the CP facility and, um, restructuring the CIRC, we've got, uh, we've got a lot of capacity. I-I don't, I'm sure there's-there's other funds out there that have capacity, but we certainly are in-in a pr- I think a pretty enviable position from that perspective.

MR. DRYER: Did you, uh, -- other than what you consider to be hedges off of your long positions -- did you just take-did you take-a fair amount of just outright short positions because of your feeling on the marketplace? That you would not consider, I mean-I mean, you could call them technical hedges, but you really didn't put them on as hedges, you just put them on as a-as a gauge in the market?

MR. CIOFFI: Well-we-we-we-We did; we did. We've done that recently, where we're, let's call it, we're-we're more net short. So, um, we probably are g-- we're going to experience a little more mark-to-market volatility. But again, you know, it's marked to market. And what typically has happened in the past -- as all of you've heard me say and talk about -- our hedges are going to be marked day to day and they move intraday. The assets just don't move that much. In fact, in February, they didn't start moving out really until around, be-between the 20th and the 28th. The bulk of that move was probably in the last three or four days of the month, actually. Um, now, we were marking our assets. We-we knew they were going to be wider. Um, I think we underestimated a little bit [laughs] how much they would widen out, but, um, they did, and-and um--

MR. TANNIN: Although again, uh, uh, the context here is critical. First and foremost, um, the dialogue with our repo counterparties -- which at the end of the day is the most important dialogue and the only real meaningful dialogue, you know, that occurs at this period of time -- was one of real transparency and calmness. We didn't have, um, a single repo counterparty, um, call us up with, you know, some sort of crazy mark on any of the positions.

So the--again, the--80% of our return from day one is carry, so our ability to do, um, capital markets arbitrages come and go, right? And it was, there was lots of stuff to do in 2003 and 2004, and very little to do in 2005 and 2006.

In 2007, we see, you know, I would guess, that we would see more opportunities to do some of our capital markets arbitrage, but the return for the fund is the cash flow return.

And what you've seen in the last two weeks of February, right, is a very volatile ABX market that's volatile for lots of reasons that are, um, not independent, but only secondarily related to fundamental underlying credit deterioration in AA and AAA assets. So, first of all, February was a month end for broker-dealers.

So you had pressure on the broker-dealers to rationalize marks with an index that is really not completely appropriate to match off against those very high quality assets. And as the market moves forward -- and again we've seen relative calmness and-and stability begin to reassert itself in the CDO market -- there's every reason to think that the-the spreads that were basically thrown out, you know, by the dealers, the marks were really, you know, um, not willy-nilly, but conservatively given to us by the dealers at the end of February, there's every reason to think that-that there's going to be some stability coming into the market at the high grade end of the spectrum. So um--

MR. CIOFFI: Well, we, yeah, there should be, not only will we get this CDO mark back, but a lot of these assets we marked down significantly should come back as well. The rationale being that the ABX index is what everyone was using as the rationale for marking down CDOs has rallied significantly from the Feb. 28 level. But again, I do want to reiterate, the assets are slow to get marked down, they may be slow to get marked up. But I don't want to take those hedges down until I feel there's a-a-a-a normalcy to the market, meaning there's-there's several weeks if not-if not a couple of months of-of trading at-at current levels. Um, so I think-I think it's important to keep that in mind, from a risk-management perspective. We certainly-we certainly could've taken the hedges off at the lows, but we chose not to. We did reduce, we did realize some significant gains, and then we started adding to the hedges as the ABX started moving up again because we-we-we thought it prudent against our exposures. Same with the single-name exposures, we're monitoring all these portfolios, and we-we-we see deteror-deterioration early, and we've been, we made a lot of money in, uh, in January and February on our single-name credit protection. Those single names both hedged positions we owned, as well as they were net shorts, just-just deals we didn't like.

MR. DRYER: So -- and I'm sorry to-sorry to keep asking questions here Ralph... You're supposed to-- that's when you say, 'It's okay, Joel.'

MR. CIOFFI: Okay; maybe you're asking questions that others would want to ask as well.

MR. DRYER: Um, we keep talking about the mark down on the CDOs, but what-what was the-what was the primary category of the assets, uh, within the CDO structures?

MR. CIOFFI: Well, it’s-it’s-it's mortgage -- it's subprime and it's midprime mortgages. There's some credits and CLOs, some loan credit and high grade credit, but it-it's mostly subprime.

MR. DRYER: Yeah but that's, that's what I was hitting at, is what-what was the breakdown of most the CDOs? You know, was it 75% subprime mortgages? Was there some corporate debt in the CDOs? I mean…

MR. CIOFFI: Well, it's all over the place. But if you remember from our, um, from our December -- I guess just -- I can't remember if we did it December or January, but, um, we-we went through what our additions to the CDO book were in '06. And again, the most of the mark downs that occurred were-were '06 originations; and although in '06 we didn't buy a subprime bond, uh, directly, we did buy $7.7 billion of CDOs that were issued. The majority, 85%, were AA rated or higher, and of that, only -- the underlying collateral that was represented by-by those CDOs -- only 28% was this late-'05, '06 originations, which everyone is most concerned about because of the, you know, the underwriting standards and the concern about, um, you know, the lax underwriting standards, which we-which we discussed. So, I'm not saying it's not appropriate that CDO spreads widened, they-they definitely should have. What I'm saying is, the ABX has rallied probably 10, at least 10 maybe 15% at the lower end of the -- you know at the BBB- category -- from Feb. 28. My point is that the CDOs may not get marked up that quickly. They were slow to get marked down. They're probably going to be slow to get marked back up. So we're going to have - you-you-whenever-whenever the market goes through a period of volatility, that we-that we experienced literally in 5 days, 6 days, it's not going to come back and have a normal trading period, um, trading pattern. The relationship between the hedges has changed. And it-it'll-it'll be, whether it's several weeks or two months or another week, we don't know, but there'll be some normalcy and, there'll be some, um, there-there'll be some normalcy in trading and the hedges and assets should-should start moving more in sync again. So yeah, they should've been marked down. The point is it took a while for them to be marked. It's probably going to take a while for them to be marked back up.

MR. TANNIN: And-and what's going to happen over the next, you know, number of months is - and-and this we saw happening already in January -- that the-the market, which in 2005 and 2006 tightened uniformly across every single asset class and across every single kind of manager -- what we saw happen in January, which, um, will only, um, intensify over the next few months, is that particular tranches and particular kinds of collateral deals will begin to trade with spreads that are, um, relevant for that particular deal. So, um, as in any sort of, at-at any time where there's a readjustment, right, the-the ability, our ability to identify assets that are wide and should be wide, and assets that are wide and should not be wide, gives us additional opportunity. So, um, there's tremendous opportunity now from a credit point of view to differentiate between, um, diverging credit behavior in the underlying assets. And, in-and-in addition to that, when-when-when Ralph says that we own -- and it's true, most of the CDOs that we purchased are backed in some form by subprime, the way in which they're backed by subprime differs substantially from deal to deal. So, we have some deals where we, now we own AA and AAAs off of all of them, but some of the deals are securitizations of AA and AAA subprime, some of them are securitizations of A subprime, and some of them are securitizations of BBB subprime, and the subordination in each of those deals is different depending upon the collateral. So all of these things which are, we took, you know, tremendous time and effort evaluating before we bought them. You know, at the end of March, or at the end of-of February, things kind of widened out all in one clump, right? And now what we'll see going forward is things tighten back that should tighten back, and things that shouldn't tighten back won't tighten back.

MR. CIOFFI: Yeah, there's just going to-there's going to be a-a tremendous bifurcation of the market.

MR. DRYER: So yeah, I mean, that leads me-that leads me into what my last and final question was, before I let somebody else punch their one key, which was, how are you going to knock the cover off the ball given the-given the market situation?

I think the answer is there's a bifurcation in the, of-of the quality of the credits, and you're going to be able to-to really slam it on the ones where you-where you see the credits haven't widened. The credits-credits haven't narrowed enough to what you think they should narrow to, so they're still wide, so you can take advantage of the widened credits because everything-everything got slammed.
MR. CIOFFI: Well--
MR. DRYER: Select-selective things are going to come back and narrow, and those are the things you're going to make money on.
MR. CIOFFI: Right. And-and also, we've got-we've got, because of, you know, good planning and the ability to structure these financing vehicles, we're g-we're going to have oodles of liquidity, both in cash and in repo and in CP. So, we're going to be able to demand very, you know, very good terms from our, from the street both in structure as well as spread. So that is-that is exactly right, that is exactly right. Okay, question - uh next, someone else, please.
OPERATOR: Thank you.
MR. CIOFFI: Thank you, Joel.
MR. DRYER: You're welcome, thanks.

OPERATOR: Our next question comes from Steve Kris, with Legend Investment. Your line is open.

MR. KRIS: Yeah, hi, I, uh, missed the first couple minutes also, so I apologize if I missed the explanation, but-uh understanding the transaction that caused the-uh drawdown for February in the Enhanced, there's still quite a differential with the-uh regular, uh, unleveraged fund--

MR. CIOFFI: Right, and-and-and the-and the answer is leverage. We've been ramping up assets, although-although not significantly so. We only drew down about 200, up until -- let's say we drew down 275 million of the-of the Barclays facility, and as you know we have the ability to go up to 2 to 1 leverage.

MR. KRIS: Uh-huh.

MR. CIOFFI: We're at 0.4 to 1. So we've been buying assets, um, and, um, uh, absent the CDO, uh, we still would have underper—yeah you're exactly right, we still would have underperformed HGS because Enhanced is-is-is just more levered.

MR. KRIS: Is that the, uh, well aside from that -- obviously, more levered, you-you would assume better performance on the same assets. But the difference is you've been levering and buying assets at a time when they didn't produce the returns--

MR. CIOFFI: Well, spreads-spreads widened on those assets, exactly.

MR. KRIS: Okay, I got it.

MR. CIOFFI: Yeah.

MR. KRIS: Thank you very much.

MR. CIOFFI: Yeah.

OPERATOR: Thank you, if you have a question at this time, please press the one key on your touchtone telephone. One moment, please.

MR. CIOFFI: And-and-and one thing to just mention today, I mean, when the spreads do come back on a lot of these CDOs we marked down, then obviously Enhanced has got, you know, got the additional leverage going back the other way.

OPERATOR: I'm not showing any questions at this time.

MR. TANNIN: Okay, well, again, y-you guys can always feel free to call me. I mean, there's-there's lots to talk about in the subprime market, um, and, you know, we have lots to say, so please, you know, feel free to give me a call about anything.

MR. CIOFFI: Okay.

MS. MALLOY: Thank you very much.

MR. CIOFFI: Thank you very much.

0026 - 31:10

OPERATOR: Ladies and gentlemen, thank you for participating in today's conference. This concludes the program for today. You may now all disconnect and have a wonderful day.

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