Market Update

Overview

The credit markets have deteriorated significantly since our previous update at the start of August as the market has come to realise that we face significant balance sheet pressures across the financial system and not just a crisis in the sub-prime market. After staging a short recovery in September and early October spreads have moved substantially wider and a broad market consensus has now emerged that these market conditions are likely to continue for several months. A number of negative themes currently dominate the ABS market:

(i) Industry-wide sub prime losses are now conservatively estimated to top $200bn. With less than $60bn disclosed to date, most notably by UBS, Citigroup and Merrill Lynch, the shortfall between aggregate industry exposure and disclosed losses has led to a crisis of confidence between banks, elevating credit risk premiums and sharply reducing liquidity in asset classes across the credit spectrum including inter bank lending and covered bonds. Sub prime and related fixed income trading losses reduce bank tier 1 capital, curtailing lending and further damaging liquidity in the system.

(ii) The weak outlook for the US consumer in part driven by falling US house prices and rising concerns about the probability of a US recession in 2008 - reflected in bank equity valuations and credit spreads. We are also concerned about the impact of higher consumer refinancing costs on ABS over the longer term as the financial industry adapts to its reduced balance sheet capacity.

(iii) Leverage is being rapidly forced out of the system as several liquidity arbitrage strategies, some employed successfully for several years, are being forced to unwind. SIV's, conduits, market value CDO's etc. drove demand at the upper end of the capital structure and their absence reduces appetite for higher quality ABS paper which we believe will in turn lead to a fundamental re-pricing of credit risk over the longer term. In the shorter term their forced sales may depress asset prices further.

The US Treasury's M-LEC initiative appears to be gaining some support after initial skepticism but we do not expect it to materially raise prices for the high credit quality assets that are caught in the liquidity crunch.

(iv) The scale and pace of rating downgrades has taken most market participants by surprise. Reflecting underlying credit deterioration and in some cases a change in methodology, CDO of ABS transactions have been particularly badly hit since the start of October, over 1,300 tranches with a notional value of $110bn have either been downgraded or put on negative watch by at least one agency. The knock-on effect of these actions is that at least 25 CDO's have triggered an Event of Default (as their over-collateralisation tests fail), with at least 20 more thought to be close to their triggers. In many cases this gives the most senior ranking investor the right to liquidate the portfolio and creates another source of distressed seller that further undermines market pricing and liquidity.

(v) Monoline insurers are also a cause for concern as Moody's and Fitch recently announced they were reviewing their capital adequacy in light of revised stress testing. Concerns have abated somewhat following capital commitments or comments to that effect from the owners of some of the larger players, though concerns persist about some insurers, all of which adds to nervousness in the market.

A couple of examples demonstrate the impact of these themes on the pricing of our managed portfolios (a) UK prime RMBS 5yr AAA levels traded around 10bps from the start of year to July, widened to over 50bps at the first peak in August, tightened to 30bps during the September and now trade over 60bps (b) European 5yr AAA CMBS (granular) traded out from 20bps earlier in the year to 35bps in August and now trade over 60bps (c) US super senior Alt A began the year at 20bps, widened to 125bps in August, tightened to ca. 80bps during September before widening to current levels of ca. 150bps, though liquidity has almost completely dried-up.

There have been light deal flows in the new issue pipeline with an absence of pricing transparency, we understand deals are being offered at a discount to their printed coupons. In the secondary market flows are extremely light and the number of bid lists has fallen away as a number of lists failed to clear. Recent reports that a number of SIV's have de-levered by way of assets sales to investors (so called vertical slice asset switches) or to the affiliated financial institutions removes a significant overhang from the market as the threat of large scale asset sales into an already distressed market recedes.

Impact on AC Capital Partners Managed Funds

LAAM funds have been successfully restructured following a long period of evaluation of proposals and consultation with our investors and financing counterparties. A variety of restructuring measures were selected by investors and financing counterparties to suit their individual circumstances.

Restructuring measures taken included inter alia (i) Term funded solutions where market price triggers were removed from financing arrangements in exchange for additional collateral or other form of credit support; and (ii) Longer financing commitments where substantial cash injections were made in exchange for the removal or amendment of market price triggers and/or in exchange for longer term funding commitments. While these measures have had a negative impact on investor returns as funding costs have inevitably risen, based on the high credit quality of these assets we expect that investors will have their principal repaid if the assets are carried to term.

Considerable efforts were required to restructure these funds and we are grateful to our investors who supported their investments and our financing counterparties who have played a key role in the LAAM funds.

The underlying credit quality of our AAA LAAM portfolios continues to be of the highest quality - no exposure has been downgraded or put on watch.

We have avoided selling assets at distressed prices, though we felt it prudent to selectively de-lever when prices increased during September. In addition to open market sales, some investors have also purchased assets directly from their funds to assist with deleveraging.

One of our funds closed during the period, at the request of the underlying investor who elected to redeem their units and took the underlying assets onto their balance sheet.

Our funds continue to be priced daily on Bloomberg and NAV's have deteriorated in line with general market conditions. As the restructuring measures undertaken include certain support measures to mitigate market price volatility, NAV fluctuations should not necessarily be expected to trigger any required action.

Market Outlook

We expect spreads to continue to soften into year end as funding issues over the year end constrain investor demand and the issues highlighted above persist. We recognise that the large US brokers start their new financial year in December which may provide some stimulus to activity in the primary market but see little overall stimulus for spread tightening and would expect there to be substantial sellers into any signs of market strength.

As market conditions remain fluid - the risk to our outlook is skewed to the downside, our focus remains on retaining flexible structures for our funds, avoiding any forced actions and prudently deleveraging where appropriate.

The current distressed condition of the ABS market provides several opportunities to invest in high quality assets at attractive valuations, we are evaluating new products with high risk-adjusted returns to market to our clients.