

## Subprime Breaks Up Another Relationship

Our July and August market commentaries highlighted several market disruptions caused by the subprime mortgage collapse, and the resulting impact on hedge funds, including credit, quant and merger arbitrage funds. We now address another of these disruptions – the dramatic jump in the yield spread between short-term Libor<sup>1</sup> and US Treasury bills. But first some background.

The short-term institutional lending market can be roughly divided along two dimensions: government versus private sector issued, and secured versus unsecured. Treasury bills are government issued short term debt instruments secured by the “full faith and credit” of the U.S. Treasury and thus are considered “risk free” and offer the lowest yields. For short-term secured debt issued by the private sector, yields will reflect the quality of the collateral. Repurchase agreements, or repos, for example, are short-term loans secured by low risk government securities and therefore trade at low yields. Unsecured private-sector loans, such as commercial paper (borrowing by banks, non-financial corporations or, more recently, SIVs<sup>2</sup>) trade at yields which vary to reflect the perceived credit quality of the borrower. Libor has come to be recognized as the benchmark yield for unsecured private loans. Its importance is demonstrated by its use as a reference index in many swap and loan agreements.

In the current environment, trust in the credit-worthiness of long-standing financial institutions has been hurt by uncertain losses in (1) subprime securities, (2) “hung loans”, and (3) commercial paper issued by SIVs. Potential losses are causing banks and other financial institutions to cut lending, even to each other (Libor), both to ensure they can satisfy federally mandated capital reserve requirements and also to build liquidity. Libor yields have increased as a result while at the same time Treasury bill yields have fallen dramatically in a “flight to quality.” The result has been an increase of startling magnitude in the spread between T-bill and Libor yields.

Exhibit 1 displays daily 3-month Libor and 90-day T-bill yields and yield spreads from January 1 through September 11.<sup>3 4</sup> The yield spread for the first seven months of the year averaged 0.4% but began climbing in early August and peaked at 2.4% on Monday, August 20<sup>th</sup>, following the Federal Reserve’s action on the previous Friday to lower the discount rate it charges banks. It has since bounced around and is now 1.7%. How severe is this spike in yield spread and what does it mean?

Exhibit 2 shows the same yield data as Exhibit 1 back to December 1984. The average difference between Libor and T-bill yields over this time period is 0.5%, though there have been significant deviations from this average, most notably during the 1987 stock market crash and the 1998 LTCM hedge fund collapse. In comparison to those two events, the recent spike appears very significant, highlighting the seriousness of the credit and liquidity crunch we are experiencing.

Beyond reflecting general unease in the private lending environment, this spread widening has other implications. First, further increases in Libor could exacerbate the problems in the residential

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<sup>1</sup> The London Interbank Offer Rate, better known as Libor, is the rate at which member banks of the British Bankers’ Association (BBA) make loans to each other.

<sup>2</sup> Commercial paper SIVs (Structured Investment Vehicles) are like other structured finance vehicles but issue short term debt – commercial paper – and invest the proceeds in higher yielding assets. SIVs represented over one-third of the commercial paper market, though recently new issuance from these vehicles has dried up.

<sup>3</sup> The BBA publishes Libor rates for multiple currencies and multiple periods ranging from overnight to one year, but the most commonly used rate is the 3-month Libor rate.

<sup>4</sup> Historically, this spread has tended to trend with absolute rate levels, a relationship clearly visible in Exhibit 2. This causes many to argue that the more relevant metric is the relative, not absolute spread. However, we are more interested in the absolute spread, as it can be more easily interpreted in the context of recent events.

mortgage market as rates on Libor based adjustable rate mortgages reset even higher, forcing more foreclosures, and higher losses to subprime and prime mortgage investors. Second, continuing reluctance by financial institutions to lend could hamper economic growth, limiting a major source of funds for capital expenditures. The alternatives for corporations of issuing public equity or debt in a marketplace of declining stock prices and widening credit spreads would prove very expensive. Finally, the deviation of Libor yields from T-bill yields reinforces the appropriateness of using Libor as a benchmark for evaluating hedge fund performance. While Libor is often viewed as a risk-free rate, the current environment demonstrates that Libor yields do incorporate some systematic risks, like credit and liquidity. Consequently, if what hedge fund investors really want to capture is “alpha” and not “beta”, the use of a Libor benchmark to evaluate hedge funds seems more appropriate than the use of a T-bill benchmark.

Many expect Libor yields to ease as trust increases and uncertainty decreases among lending institutions. In the meantime, many hedge funds, particularly distressed funds, will look to capitalize on the fear in the marketplace and act as buyers in an otherwise less liquid environment.

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Exhibit 1: 3-month Libor Rates versus 90-day Treasury Bill Rates, 1/2/2007 to 9/11/2007

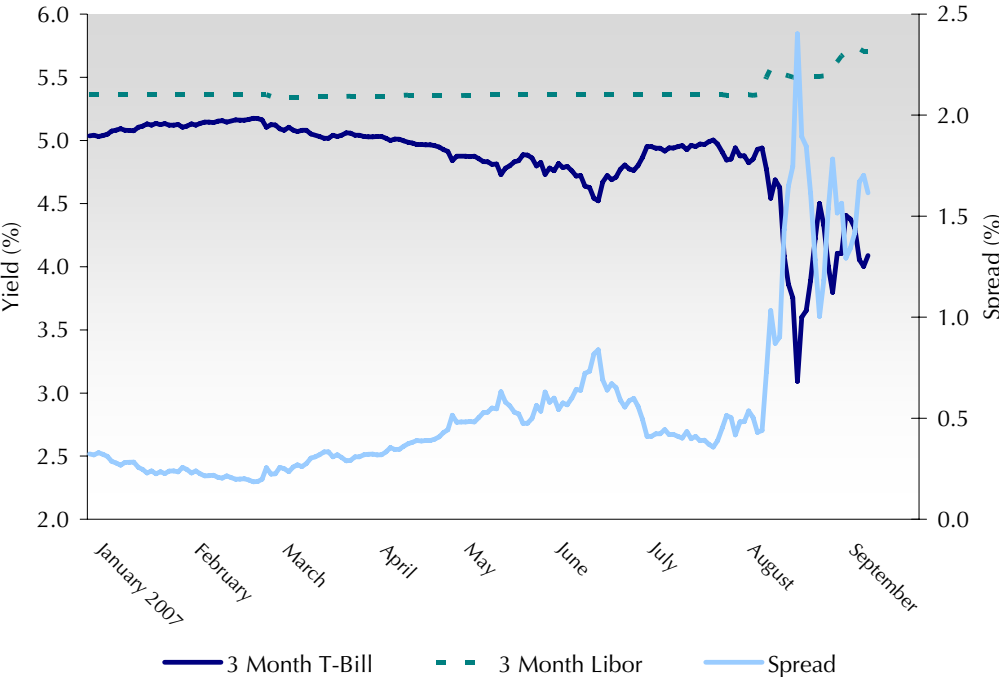


Exhibit 2: 3-month Libor Rates versus 90-day Treasury Bill Rates, 12/14/1984 to 9/11/2007

