



Hedged Convertibles: Navigating the Current Credit Crisis

Excerpts from SSI/UBS Conference Call

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UBS: Can you tell me about SSI and your Hedged Convertible products?

George Douglas: SSI manages \$900 million in AUM and we manage about \$300 million in convertible arbitrage. Our historical client base is pension funds and managed accounts.

In convertibles we have two track records. We have a 14-year record in unlevered convertible arbitrage – looking for essentially a rate of return of 300-400 over LIBOR with very low volatility in the 2-1/2 percent range which we've achieved since 1995. And we have a 7-year leveraged record in which we utilize maximum 3x leverage.

In March of this year we launched a new offshore fund we call the **Hedged Convertible Opportunity Fund**. The Fund started with \$75 million of seed capital from our seed investor – an existing corporate client. We're at about \$86-87 million right now and actively marketing that.

UBS: What are your Target Markets?

GD: Our strategy is to target large institutional hedge fund investors. By large we generally mean \$2 billion and greater in assets which have existing allocations to convertibles. Maybe they've got several hundred million in the convertible space spread across 3 or 4 or 5-10 funds and we really seek to compete in that arena. And in that arena – these tend to be investors that only look at funds in firms with a certain amount of critical mass in terms of depth of investment team, longevity of investment team, stability, back office capability, compliance capability, registered investment advisor, etc... SSI fits those criteria.

In addition we have targeted the large managed account platforms. That tends to be our strongest suit, since we've managed pension funds primarily in a managed accounts structure. Managed account platforms are a great fit with us.

UBS: Can you give us a little bit of history and how the Opportunity Fund is positioned right now?

GD: In terms of our approach, and this comes from the legacy of the nature of our clients, we are relatively style pure. The convertible arbitrage fund is convertible arbitrage – it is not eclectic with debt instruments or long equity or directional positions within it. We utilize up to 3x maximum leverage. We will use additional tactical tools for risk management such as Treasury bond futures, CDS' and other potential instruments for tactical hedging.

The differentiating points, longer term, have been (in terms of our competitive edge) our individual company analysis and our ability to analyze individual credits. We have a 3-person convertible team: myself, [Alex Volz](#) who is co-portfolio manager, and [Dagney Maseda](#), and we have a 7-person equity team that also reports to me as CIO and over that timeframe the entire team has contributed to the convertible process.

UBS: How are you managing the current credit crisis?

GD: We believe unsettling credit markets require superior individual company analysis. The 2001, 2002, 2003 period in which we had a lot of disruption and uncertainty in the credit side of things, played to our strength. The unsettled market condition today also plays to our strength, particularly in the financial and the energy sectors, because we have dedicated research capability and we do proprietary work. The financial sector, for example, is an arena that is going to present enormous opportunity over the next couple of years based on the turmoil in the sector and we're very strong analytically in this sector. We do our own proprietary modeling of things like Case-Shiller House Price Index. We look at downside via the mortgage cycle from the standpoint of our own proprietary view of home prices, mortgage losses, etc. And we do a lot of in depth work there, and that's been our strength in this space over the last 14 years.

Periods like this in which there's a great need to look at controversial issuers whether its Fannie Mae, Freddie Mac, Washington Mutual, Lehman, etc., and differentiate the survivors from the non-survivors and the opportunities from the traps is also a real strength of ours.

The second element, and this is something we've placed increasing focus on over the last couple of years, is managing convertibles through the cycle. Convertible Arbitrage is a cyclical strategy. We saw that in 2005, and we've seen it over the last 12 months. It's really incumbent to not only look at individual positions and look at valuations in the convertible market, but bring in what's going on in the broader markets – the broader economy and manage exposures along those lines.

Case in point, post-2005 which was actually a tough year for us, we've been substantially more aggressive in terms of modifying our leverage positions. We've been as high as 3x leverage. We've taken that down to about 1.5x. Right now, for example, we're at about 1.7x leverage which is pretty defensive – we got more defensive in June based on what we saw via the broader credit markets and broader economy. We think over this more recent cycle we've managed that risk pretty well in terms of avoiding

major drawdowns and losses over the last 12 months. In general, our leverage tends to be lower than the peer group. While the peer group tends to be a little tough to get a handle on, we believe that we operate at about 1/3 less leverage than the broader average convertible fund. And our performance (longer term) against HFRX and CSFB Tremont and Dow Jones Index has been, basically, higher returns with lower leverage. So it's the individual company analysis and ability to manage the cycle that are SSI's differentiating factors, particularly in the current environment.

UBS: How do you compare to some of the better performing funds?

GD: We do some screening against larger funds that would tend to be on the radar screen of your larger institutional investors – meaning the firm runs more than \$100 million or the strategy has more than 100 million in it. They have reasonable style allocations and when we look at things that way, particularly over the last year (which has been a pretty tough); we find very few funds that are up substantially.

According to our own screen, we only know of one convert manager here in the U.S. of decent size that's up about 10% over the last 12 months, and that's a manager with a very significant directional component. Investors obviously will look at that, but at the same time, directional components have downside risk if they're wrong in their directional exposure. So on balance, what we've seen over the last year among convertible funds are those that have basically held up – maybe they're flat or they're up a percent or two. Those that have been too highly leveraged, and they've had too much exposure, are down 8-10% over the last year.

UBS: We know institutions pay attention to quartile analysis. Where do you stand over the last 1- and 3-year time frames?

GD: The HFRX Index is down about 9% YTD, so there have been some funds that have been overleveraged. In the peer group of investors we talk to, SSI tends to be at about the 25th percentile. We are not trying to be the first percentile manager. There are obviously benefits and disadvantages to that. We're trying to be about a 25th percentile manager that manages risk well through the cycle; can outperform a broader peer group with reasonably good consistency; and has institutional stature in terms of depth of staff, AUM, consistency of staff, longevity, etc. That's really our differentiating factor.

UBS: You mentioned you have a dedicated research staff in financials and energy, and that there'd be significant exposure there. Do you have a sense of what your breakdown is, typically, or what you expect it to be between the different sectors?

GD: To be successful in the convertible market going forward, is that we want to be (probably) lower leveraged than the peer group, with greater concentration in the sectors of maximum opportunity. Near-term, we obviously like energy. We like the healthcare sector where we have fairly substantial exposure. We think the financial sector offers tremendous opportunity; although, we're somewhat underweighted there in the very short term. And we're just kind of watching the broader credit picture play out

for an opportunity to get much larger there. So I would envision a situation where potentially over the next quarter or two, we would move up our allocation to the financials fairly dramatically and instead of a broadly diversified portfolio leveraged 3x, we would rather have a more focused portfolio in the best individual situations. Leverage may be 1-1/2 to 2x or 2-1/2 times at max. We are pretty active in terms of shifting sector exposure.

UBS: I guess you touched on it a little bit, but is the portfolio always dubbed neutral, and if not, will you ever take directionality or is it always hedged completely?

GD: We would reserve some ability to have small directional exposure, but our beta, relative to the S&P 500 for 14 years has been zero, so we've had no correlation to the S&P in the returns, and our returns stream is uncorrelated. We have the 14 years on the unleveraged record. The unleveraged record is at 2.5% annual standard deviation with zero R^2 to the S&P; about 1-2% R^2 to movements in treasury rates which is almost nothing, and about a 5% R^2 to movement in credit.

UBS: As far as credit hedging goes, what do you do to supplement short stock? Is there any credit default swaps, or put options, or other vehicles?

We will tactically use those tools, but we won't just keep a large position on something like credit default swaps. Particularly now because it is basically cost prohibitive relative to the cash flow in the convertible market (with the high yield market at 800 or over, there's no real way to do that). We will modify the portfolio in terms of shifts towards higher delta lower credit sensitivity and larger cap kind of issuers. That's something we've been doing more recently. And we'll change the portfolio structure to manage the risk along those lines. But on balance, we've actually tended to do pretty well in widening credit spread environments and 2002 is a case in point.

UBS: How have you *tactically* adjusted to the recent market in terms of individual securities or sectors?

More recently, in June, we took some actions to move to a somewhat more defensive positioning, and we lowered investment levels from about 2.3x leverage, to about 1.7x leverage. That was based on the building spike in energy prices, the widening of credit spreads (which was overwhelming the volatility benefit which you get in convertibles), and a feel that we could see market conditions deteriorate coming into July and August.

Commensurate with the reduction in exposure, we eliminated all exposure to the auto and auto-related convertible areas as being the area hardest hit by the energy crisis. We reduced exposure to financials which had actually been very good to us YTD up until this last month or so.

July obviously was a very, very tough month in the convertible market. We saw the crisis in the first half of July in Fannie and Freddie Mac which we are seeing again here this morning [08/20/2008]. And we saw liquidity contraction and disruption in the

convertible market. In addition to the broader view, you've got to look at the convertible market individually. Is capital coming in or out? Are funds de-leveraging? We've seen both. We get reports from some of the prime brokers that have data showing capital coming out of the strategy and some de-leveraging occurring. In the first half of July, we did see some panic sales in the large financials – very, very large trades. From mid-July on, things have been fairly stable and I think the key catalyst has been the major break in energy and commodity prices that longer-term will be very positive for all of the markets, help stabilize the credit market and bring the US economy around. So near-term we're a bit defensive – we're kind of at the low end of leverage and exposure versus (as best we can tell) most of our peer group.

UBS: In view of the recent sell-off, is the convertible market a “good buy”?

GD: The convertible market is very cheap. The valuations are the best we've seen in probably six years. Our average position, using very conservative inputs, is running 6-7% below theoretical value. The structure of convertibles has been increasingly attractive in terms of issuers coming with convertibles. That gives you greater equity participation due to lower premium – more call protection. Premiums are lower; call protection average is 5-7 years; maturities are somewhat shorter on the bond side, and we're seeing good structural changes in terms of the convertible market being more statistically attractive. Since there have been some difficulties in the space, the space is much less crowded than it was in 2004-2005, and it's even much less crowded than it was 12 months ago. So we're getting bigger allocations in terms of cheaper deals that are coming down the pike.

Historically, when we've seen conditions like this in the convertible market, they've been followed by periods of very, very good excess returns. So after that 2005 market, 2006, with low leverage of about 2:1 was very positive, gaining over 14%. We see the same thing developing now, but it's going to require some stabilization in the broader credit markets which may take essentially a couple of months. We think once we hit that broader inflection point in the credit cycle, we'll be in position to have probably 18 months to 2-years of very strong returns in the convertible space.

UBS: To what extent does the Federal-governmental intervention in the financial sector affect a Convertible Hedge Strategy like SSI's?

GD: It's been a ripple effect and we, for example, saw it even this week [8/18-8/20/2008] with the turmoil in the marketplace. Barron's put out an article about Fannie and Freddie on Sunday which exacerbated some of the market panic around the two companies. That creates a ripple effect in terms of spreads widening – CDS spreads widening among the rest of the financials. And we saw some cheapening of financials and a little bit of what I would say was almost distress selling in some of the bigger financial convert names this week. I define distress selling by things like Bank of America where they are not really going out of business tomorrow – cheapening 4 points earlier in the week off of the turmoil around Fannie and Freddie. What's happened there is you've got to respect market sentiment. The reality of Fannie and

Freddie with respect to their regulatory capital is that even under the worse case scenarios, they don't get into a tight regulatory capital situation for 18-months to two years.

What I think the regulators are dealing with is market panic. Prices of market securities are embedding another 1-1/2-2 years of downward pressure on home prices. So far, neither Fannie Mae nor Freddie has actually even borrowed a penny from the government, and the government is reluctant to participate in the auctions because that will be an intervention. So, what they're going to try to do is talk up confidence that they don't "have to" participate in the bond auctions over the next six weeks. However, if the government does end up participating in the auctions they might as well buy some preferred stock as a last ditch effort.

UBS: Thank you George for spending this time with us to discuss your thoughts around the Convertible Market.

The above Q&A took place on August 20, 2008 between UBS Prime Brokerage Department and SSI's Chief Investment Officer, George Douglas.