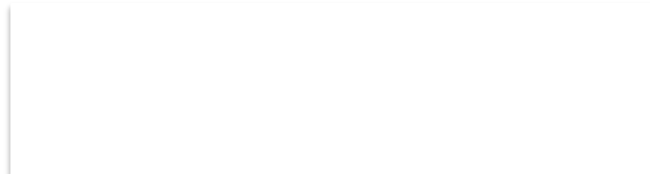


Financial Market Tectonics: Stability Precedes Liquidity

*A Structural View of Fixed Income
Finance*



R&R Consulting
Bringing science back to financial engineering



Conclusions

1. For fixed income asset management, stability is a better goal than liquidity. Stability means capital quality, so liquidity should follow stability.
2. To price fixed income assets fairly, start by estimating their value. Don't work backwards and justify valuations using prices. Dealers can corner the market.
3. Securitization throws off valuable information that facilitates very precise measurement. Don't waste what could be the key to preserving quality-of-life.

World As Balance Sheet Balance Sheet As World

“Assets” embodies how we view private property and production.

“Liabilities” reflects our understanding of ownership and shared responsibility.



“Assets” interpretation is very 19C

- Cash—AR—Inventory—Capital Assets—Land
 - Tangible
 - Static quantities
 - Arbitrarily recorded
- It only records one side of the “trade” with nature—we neglect our shared responsibility (more traditional societies see these assets as belonging to the earth, gods, ancestors....)
- It does not fully disclose the human contributions: know-how, skill, design.
- Which line item comes closest to this?

“Liabilities” Interpretation Favors Financing over Value-creation

- Suppliers of monetary capital fare better than providers of intellectual capital in the standard corporate finance model.
- Creators of the intangibles, who are not on the left side of the balance sheet, do not appear on the right side of the BS (only on the P&L, where their contribution is counted as a cost).
- Corporate financiers consist of two classes of investors, debt and equity.
- Debt is called “fixed” income: the risk is one-way, hence the value also is one-way. But if we refine our concept of debt to allow for higher- and lower-quality capital (“ratings”), debt investors may try to look-through and re-characterize the risk, thereby generating excess returns for themselves....
 - NB: at whose expense?

A Word about A/R

- The balance sheet presentation of A/R is “revolving.”
- Disaggregation into static pools is a better way to look at default risk—disallowed under GAAP.
- Benefit of decomposition in loss estimation is comparable to the analysis of “Incidence” vs. “Prevalence” in SARS.
 - For early 2003, the “prevalence” was estimated at 4%, until it shot up past 10%, then it was 15% and higher.
 - True “incidence” of SARS was ~11%.

Securitization Changes Everything

Disaggregating A/R into static pools reveals more about value and risk.

❖ Assets no longer = Liabilities + Equity

✗ But, this can mean $A \geq L+E$. **OR** it can mean $A \leq L+E$.

- If $A \geq L+E$ then A/R is bankable.
- If the assets can be isolated from company default, the A/R can be refinanced as “risk-negligible” and “residual” securities.
- Then, the ON- and OFF-balance sheet COC will be different. That difference is the value created by the firm.

❖ Early-stage businesses sacrifice most of this value to the banks.
Late-stage businesses eventually take it back from bond investors.

In shifting the focus from the company to the A/R, securitization reveals that...

Default risk on an amortizing security is measurable:

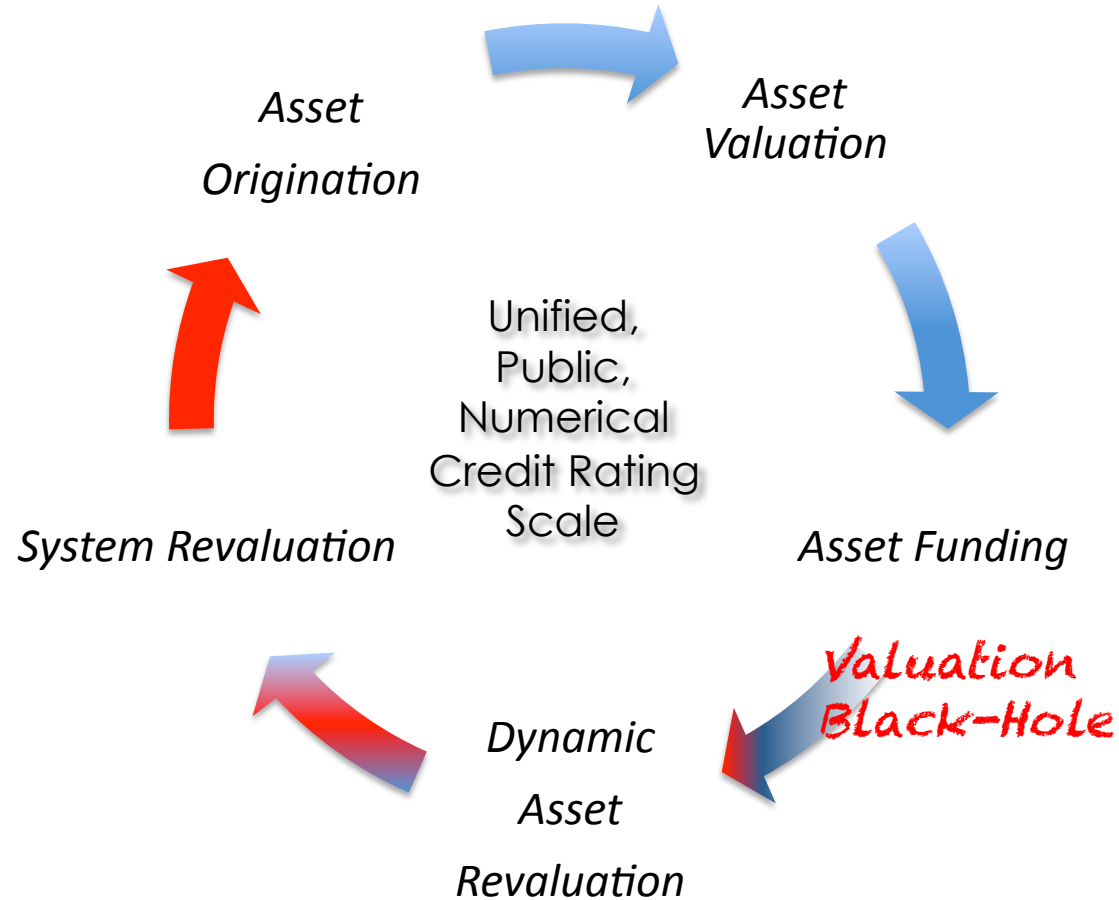
1. Origination (credit score)
2. Pooling & cumulative loss estimation (static loss)
3. Financial optimization through repackaging (rating)
4. Dynamic valuation through amortization (re-rating)
5. Applying lessons learned stages (1-4) to new originations (analysis)

Default risk on the security changes after stage (3).

If the risk is properly sized ex ante, it gets smaller.

If the risk is under-estimated ex ante, blow-ups may occur.

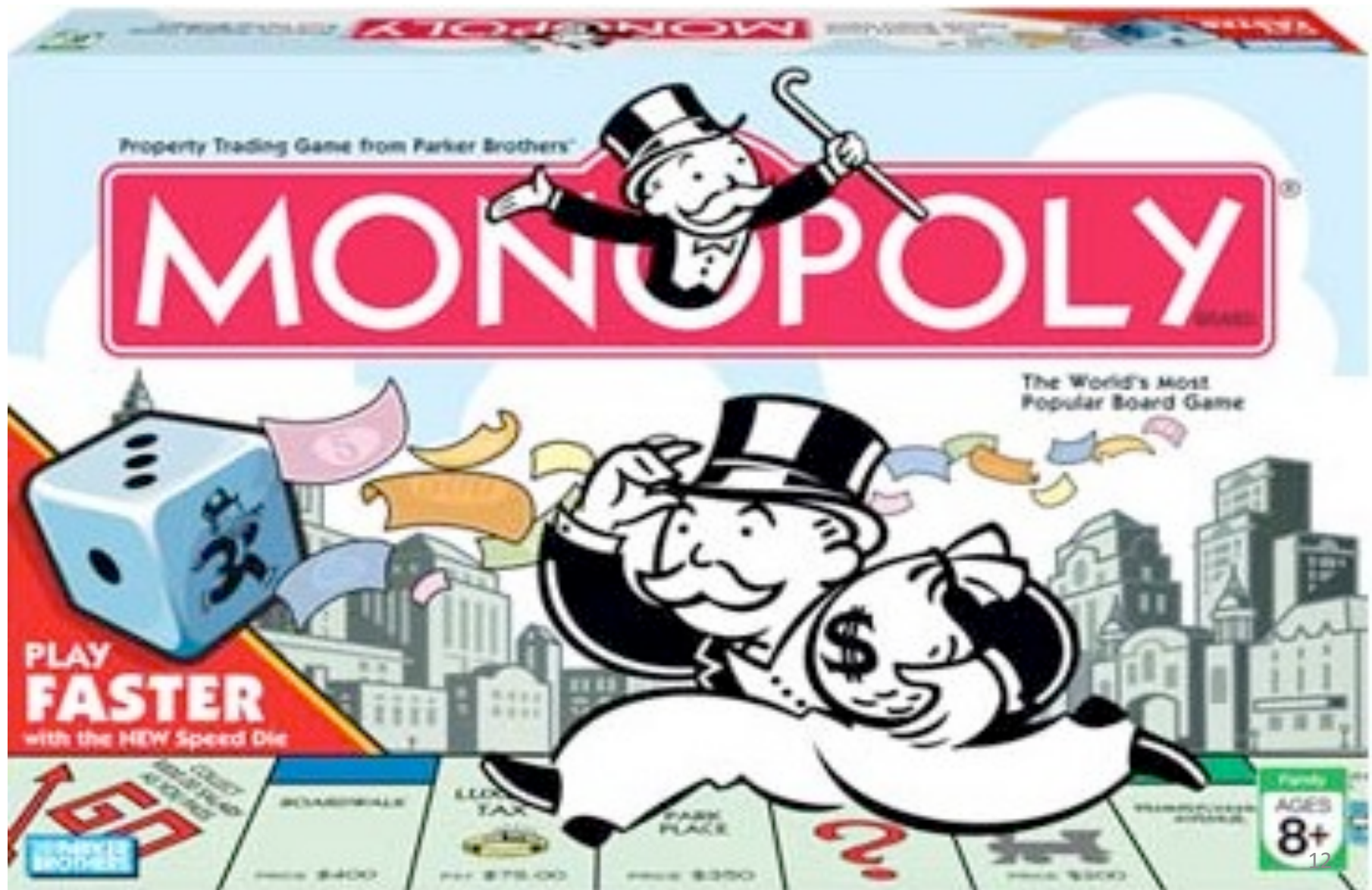
The Credit Supply Chain Dovetails The Economic Value Chain



Endgames

- (1) Maximize profits and destabilize the system.
- (2) Stabilize the system and maximize value creation.

Best economic model of price vs. value trade-offs experienced in the Credit Crisis—



Securitization: so, is it good or bad?

Where you stand may depend on where you sit.

1. **Without effective regulation, securitization can easily turn into institutionalized theft.**
2. **But, on the other hand, is solvency even possible under the corporate finance paradigm?**
3. **And assuming that it is, how well does it address the multi-faceted future challenges—**
 - a) Rising expectations for high quality-of-life globally
 - b) Latent, large-scale political unrest
 - c) Capital circulation blockages
 - d) Asymmetrical allocation of risk and reward
 - e) Environmental destruction
4. **If we have securitization, what philosophy of regulation should we adopt: restraint or disclosure?**
 - a) Regulatory restraint may prevent crimes but also block capital flows.
 - b) Disclosure permits continuous measurement. Given sufficiently wide education and disclosure, simultaneous value conservation and value creation is possible.
5. **What happens to much financial system architecture if we embrace securitization more fully?**
 - a) To banks and banking systems?
 - b) To traditional accounting and audit functions?
 - c) To traditional regulatory functions