First Principles Quarterly

Fall 2013

First Principles Capital Management, LLC

FPCM is a privately held investment management firm with expertise across the global fixed income securities and derivatives markets. Founded in 2003, FPCM is a Registered Investment Advisor.

FPCM is a fixed income investment manager with over $8bn in assets under management.

We provide customized investment portfolios for our institutional clients, which include endowments and foundations, commercial banks, insurance companies and corporations.

To our private clients - which include single- and multi-family offices, trusts, family-owned businesses and high net worth individuals and their advisors - we offer various investment management and wealth maximization strategies.

Contact:
140 Broadway, 21st Floor
New York, NY 10005
Tel: 212-380-2280
Fax: 212-380-2290
www.fpcmllc.com

In this Issue

2 **CIO Perspective**

6 **Rates, Inflation, Mortgages and Municipals**

9 **Corporate Credit**

12 **Emerging Markets Debt**

14 **Asset Backed Securities**

CIO Perspective

Doug Dachille
CEO & CIO
ddachille@fpcmllc.com
212-380-2281

"Doubt is not a pleasant condition, but certainty is absurd."
Voltaire

Shortly after 2:00 p.m. on September 18 (or allegedly several milliseconds earlier for a select group of traders) the universal thought traversing the minds of most global investors in response to the decision by the Federal Reserve to continue its asset purchases unabated was … **WHAT??!!** Or some variation unfit for publication. While investor certainty over the timing of tapering has now been replaced by a healthy dose of unpleasant doubt, there is one aspect of monetary policy that still remains a certainty – the inevitable end to asset purchases.

Surely, doubt over the timing of tapering can be psychologically unpleasant. But underestimating its timing could be even worse, inflicting both emotional and financial suffering. In many cases, determining *if* a particular event will occur in the financial markets is not the challenging part of investing. Money is made or lost in the miscalculation of *when* the event will occur. Therefore, it is only natural to expect investors would begin their exodus from fixed income and re-price market yields well in advance of actual tapering.

Given the asymmetric risk-reward profile faced by investors in determining the optimal time to break off their dating relationship with fixed income, it should come as no surprise that investors would err on the side of interpreting every subtle suggestion in the comments and testimony of the Federal Reserve Chairman as an indication asset purchases will end sooner rather than later. In addition, they attribute a much greater degree of certainty to the timing of the event than is justified by the commentary.

As a case in point, the market focused on the following comment made by Chairman Bernanke during his June 19 press conference to support its view that tapering would almost certainly begin in September:

"If the incoming data are broadly consistent with this forecast, the Committee currently anticipates that it would be appropriate to moderate the monthly purchases later this year. And if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear."

Unfortunately, the comfort of a high degree of certainty from the market's interpretation of this statement regarding the timing of tapering should have been offset by an equal and opposite unpleasantness of doubt gleaned from Chairman Bernanke's next comment:

*"I would like to **emphasize once more** **the point that our policy** **is in no way predetermined** and will depend on the incoming data and the evolution of the outlook as well as on the cumulative progress toward our objectives."*

As investors began to incorporate the increased likelihood of asset purchase tapering in September into pricing assumptions, market interest rates rose accordingly. In a virtuous circle, the rise in interest rates served as further evidence to other market participants that tapering was inevitable in September. Investors then turned the debate from one about the timing of tapering to one about its magnitude.

In a valiant attempt by the Federal Reserve to reduce market uncertainty associated with its use of unconventional policy tools, it has attempted to increase policy transparency and improve communication.

Unfortunately, enhanced transparency regarding a policy predicated on highly uncertain economic data does not necessarily increase predictability. Providing more frequent and open dialogue with investors regarding policy does not reduce the propensity for investor misinterpretation driven by inherent behavioral biases.

Despite these attempts, the Federal Reserve Chairman and other members of the FOMC were likely left scratching their heads after witnessing the subsequent market reaction to the Chairman's June press conference, and market participants were likely left similarly perplexed following the FOMC announcement in September. Both serve as healthy reminders that economics is a social science.

Taper Torture

Despite the now well-recognized doubt among FOMC members regarding the appropriate timing of tapering, should the FOMC have erred on the side of initiating tapering in September given that yields had already re-priced to reflect the market's expectation of timing? Chairman Bernanke has stated that the decision of the Committee to continue asset purchases would take appropriate account of the efficacy and the costs of the program. Yet, a careful analysis of the costs and the benefits could justify the case for tapering sooner rather than later.

One could argue that with markets anticipating a near term reduction or end to asset purchases, the program's efficacy would be greatly reduced, when efficacy is measured as the amount of Federal Reserve purchases needed to achieve a given reduction in yields. When investors do not anticipate a near term end to purchase activity, Federal Reserve purchases are met with follow-on purchases by a subset of investors attracted to the potential for short-term total return. Yet, once

this investor subset senses a reduction in program purchases on the horizon, the yield impact of Federal Reserve purchases is no longer augmented by speculative fixed income investors looking for a "fun date". Thus, prospectively, one would expect the yield impact of continuing purchases to be muted.

On the risk side of the equation, the Federal Reserve Bank's Combined Quarterly Financial Report for the period ending June 30, 2013 offers a glimpse of the potential costs associated with the asset purchase program. For the three months ending June 30, 2013, unrealized losses on the domestic securities portfolio totaled $149.7 billion, while unrealized losses for the first six months of the year totaled $179.5 billion.

To put in perspective the magnitude of these losses: the total capital base of the Federal Reserve is only $55.0 billion. Over a few short months, unrealized losses on the securities portfolio were in excess of three times the capital base of the Federal Reserve. Therefore, an interest rate move of only a fraction of that incurred during the second quarter could wipe out the total capital base of the Federal Reserve.

In medicine, the use of powerful and sometimes experimental medications may be necessary to combat a resistant bacterial strain. However, standard practice is for physicians to restrict their use to only the most serious cases for fear their overuse will reduce their prospective efficacy. A similar argument could be made with respect to the nonconventional asset purchase program of the Federal Reserve. Transitioning the treatment of the economic patient from nonconventional methods to more traditional monetary policy treatment offers the possibility of preserving the therapeutic benefit of such nonconventional remedies to battle the next bout of intractable economic disease. Powerful and experimental policies should not be used to treat economic sniffles.

There is one unfortunate additional consequence of the collateral damage associated with the decision of the Federal Reserve not to begin tapering in September: investors will continue to be subjected to the torture of the fruitless and ongoing taper timing debate.

Ben Bernanke and Mother Nature?

Bill Gross, in his recent investment outlook titled "Survival of the Fittest", makes an analogy between Mother Nature and Chairman Bernanke's decision to do nothing. While I generally agree with Bill in his description of the passive indifference of Mother Nature to allow Darwinian mechanisms to influence outcomes, I strongly disagree with his view that the inaction of Ben Bernanke is comparable to the hands-off approach taken by Mother Nature.

Unlike Mother Nature, Chairman Bernanke in September did not decide to sit back and do nothing and thus allow the forces of financial

markets to sort out the economic consequences.

Instead, Ben Bernanke decided not to stop trying to do everything. In contrast to passive indifference, Ben Bernanke has continued to meddle in markets with the belief that monetary policy can successfully mitigate all financial pain and suffering – and even serve to offset the chaos caused by a dysfunctional federal government.

Mother Nature's eons of experience have taught her that continuous tinkering to eliminate suffering is fraught with an endless array of unintended consequences. Ben Bernanke has yet to discover continuous tinkering with the financial markets is likely to have the same end result.

Rates, Inflation, Mortgages and Municipals

David Ho
MD, Asset Management
dho@fpcmllc.com
212-380-2292

Quick Read

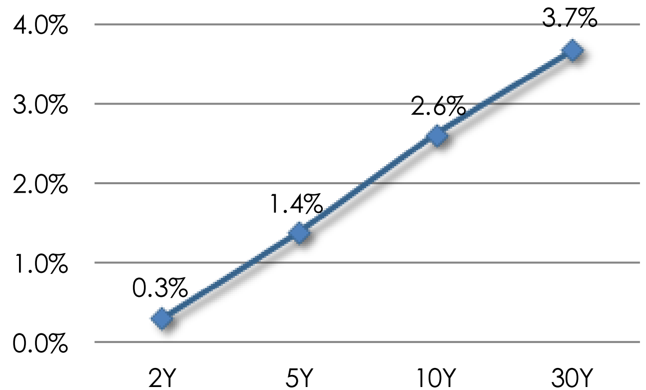
- **Lack of tapering post-FOMC meeting spurred a Treasury market rally**
- **How should we trade this market? Keep it simple**
- **Yields for municipals are fundamentally cheap**

Liquid rates

In the third quarter, Fed tapering speculation reached a fervor right before the FOMC met September 17-18 but was quickly doused by the Fed decision to hold off tapering. 10-year Treasuries traded briefly above 3.00% before that meeting but rallied back hard post-FOMC. For the quarter, Treasuries sold off 6 bps, LIBOR swap rates increased by 5 bps, and TIPS rallied 4 bps.

As mentioned last quarter, without the Fed's QE3, the 10-year Treasury yield would be in the vicinity of 3.25%. Before the FOMC meeting, expected 10-year Treasury yields for 2014 (when Fed was expected to finish tapering) had reached 3.50%, a good level to start initiating longs, or at least reducing shorts. The expected 10-year Treasury yield for 2014 came down to around 3.05% as of September end.

Treasury Yields 9/30/2013



	2Y	5Y	10Y	30Y
QoQ change (bps)	(4)	(1)	12	19

Post-FOMC, market focus shifted towards the federal budget and debt ceiling impasse. Post-government shutdown and debt ceiling showdown, it will be difficult to be constructive on rates if they stay at these levels. Some unwind of that rally should occur, and speculation on the timing and size of Fed's tapering will start afresh. We believe the Fed will continue to try to put a lid on rate rises, but each attempt will be less successful than the last.

How should we trade this market? Keep it simple: if the 10-year Treasury yield drops to 2.40%, we'd sell, but if that yield rises to 3.00% again, we'd buy. The Fed is convinced there is no need to raise short-term rates for at least

two years; economic data so far backs this up. If an investor can buy the 10-year Treasury today at 3.00% and fund close to 0% for two years, then this investor will lose money in two years only if the then 8-year Treasury yield is higher than 3.90%.

This seems a reasonable risk/reward.

Mortgage-Backed Securities

The MBS market recovered some of the losses experienced in second quarter relative to other liquid rates market, especially after the decision not to taper in September. For the quarter, the FNMA 30-year fixed-rate current-coupon mortgage rate was lower by 3 bps. In comparison, Treasuries sold off 6 bps and LIBOR swap rates increased by 5 bps.

It's difficult to be constructive about MBS at these levels. Relatively, the mortgage market is back to square one, before all the taper talks began. Some of the large REITs which restructured their portfolios in the second quarter will only generate 7% dividend yields going forward, according to our estimates. This is not a dividend level which attracts significant retail demand, especially with the pain still fresh from the Q2 REIT sell-off.

One sector of the MBS market which has not recovered is the loan-balance specified pool market. Loans with small balances refinance slower than most other conforming loans due to higher relative fixed costs, hence, they offer some protection from prepayments in lower rate environments. REITs were heavy buyers of this paper earlier this year when mortgage rates were low, believing it was worthwhile to pay up for the prepayment protection. For example, FNCL 4.0 low-loan-balance ("LLB" with loan size <= $85K) paper traded at a premium over TBA in late April.

When mortgage rates started rising towards the second half of the second quarter, extension as opposed to prepayment became the concern, and pay-ups on LLBs collapsed. Now LLBs look interesting

However, given the general richness of MBS, it only makes sense to buy these pools vs. TBAs. Additionally, patience may pay: the proper time may come if the TBA market continues to rally and if pay-ups on these pools do not change which would make the call options on these loan-balance papers increasingly valuable.

Overall, we still think the MBS market is very rich as pictured in the graph below:

Spread of current-coupon, secondary-market mortgage rate and 10-year Treasury Yield (bps)

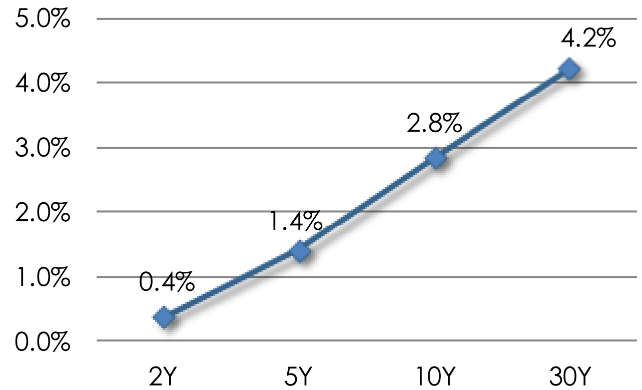
This spread is almost as tight as when the Fed announced the various quantitative easing programs, and Treasuries are not cheap given the tremendous amount of support provided by the Fed. We see little upside outright for fixed-rate MBS at current levels.

Municipal Bonds

In the third quarter, municipal bonds stabilized from the sharp sell-off in the second quarter. While yields continued to trend higher leading up to the FOMC meeting, the market traded with much less fear. After the non-taper announcement post-FOMC, the municipal market rallied and actually outperformed other liquid rates products.

In July, Detroit filed for bankruptcy. This came as little surprise and was already priced in. What was surprising was the rapid secondary market deterioration for Puerto Rico. The sell-off was technical in nature: the media disclosed some heavily invested funds, sometimes with high leverage. Tax-exempt long-maturity Puerto Rico bond yields traded north of 10% and some taxable Puerto Rico bonds traded north of 15%. These yields are hardly consistent with triple-BBB issuer ratings.

The municipal bond market seemed to take in stride the negative market action in Puerto Rico bonds. Bonds with sterling credit quality trade well and are difficult to find, especially given the low volume of primary supply.



	2Y	5Y	10Y	30Y
QoQ change (bps)	(2)	(1)	(6)	3

Even though we find current municipal bond yields fundamentally cheap, it may be hard for this market to rally. One reason: many hedge funds bought in June and July. If the market rallies, we will see selling to lock in profit. Another reason: supply should pick up, which - combined with continued mutual fund redemptions - may exert supply pressure. Investors should take advantage of any supply-driven sell-off to buy bonds with solid credit.

Corporate Credit

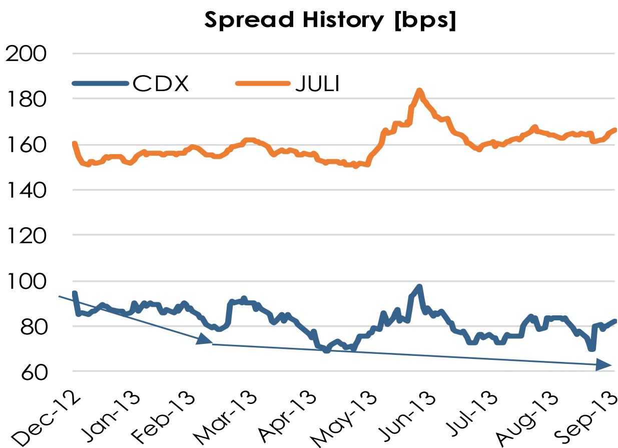
Mark G. Alexandridis
MD, Asset Management
malexandridis@fpcmllc.com
212-380-2293

Quick Read

- **Cash and derivatives markets exhibited long term divergent spread behavior**
- **Real money is making greater allocations via investment grade derivatives**
- **Allocations to credit should be positioned in short/intermediate maturities**

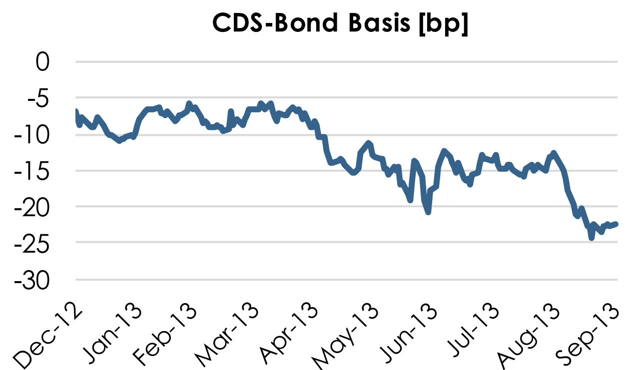
Mixed signals or paradigm shift?

The wide disparity between the year-to-date (YTD) performance of the investment grade cash market and the derivative market (CDX) is perplexing. Through September, the spread over Treasuries on the JPM JULI Corporate index has increased from 160 bps to 166 bps.



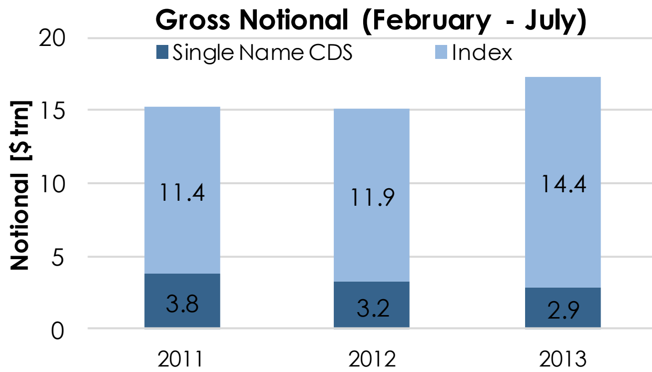
However, the chain-linked spreads on the derivative index CDX (CDX19 through the March end and CDX20 thereafter) have compressed by approximately 30 bps over the same time frame -- a meaningful rally given an initial spread level of 94.5 bps at year-end 2012.

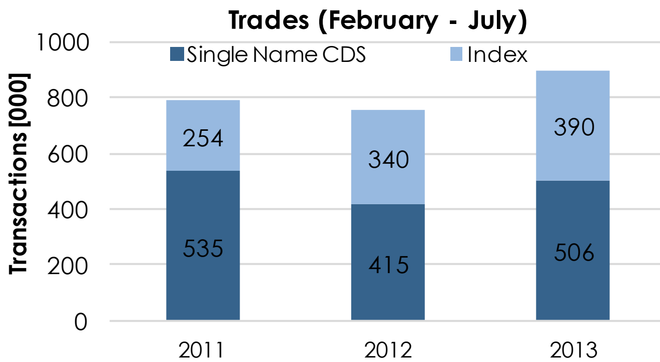
Comparing the two indices is non-trivial given that the JULI is a conventional broad market index and the derivative index represents a basket of five-year CDS markets on 125 investment grade entities that evolves every six months. However, this is the first instance the cash and derivative markets exhibited long-term divergent spread behavior post-crisis. And, moreover, the JPM CDS-Bond basis index (differential between the CDS spread and the implied spread on bonds) has experienced a 16 bps widening YTD – bonds underperforming derivatives on a single name basis.



In a recent study, ISDA examined the global trading activity in the CDS market between the months of February and July in 2011, 2012, and

2013. The study concludes that although the market activity (transactions and notional, as below) has expanded by roughly 13% over the last two years, all of the growth can be attributed to index trading (+53% in transactions and +26% in notional). Transactions (-5%) and notional (-24%) volume on single name CDS market continue to subside.

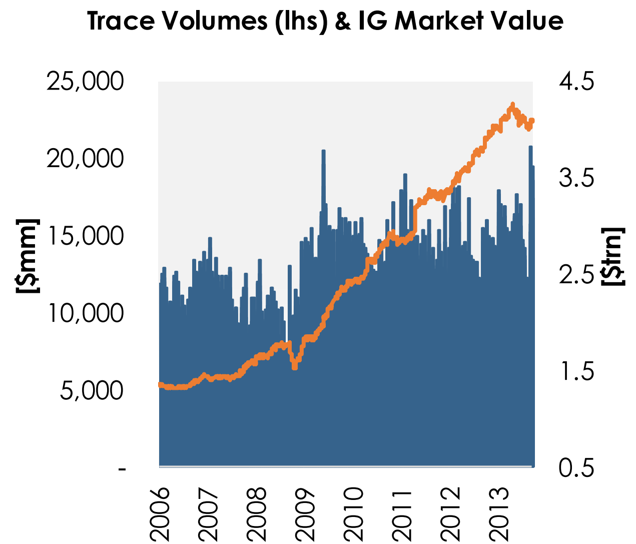




Traditionally, CDX activity has been dominated by macro-hedgers and speculators. The surge in activity in an environment of relatively temperate volatility – particularly in 2013 – suggests that other end-users (e.g., traditional fixed income managers) are having a greater influence on the market.

Although it is widely acknowledged that liquidity in the cash market has suffered perceptibly post-crisis, a cursory examination of the Trace investment grade volume data suggests otherwise.

The average daily volume in the period 2006-2008 was approximately $8.4 billion and the post-crisis average is nearly 40% higher at $11.6 billion. But when these volumes are adjusted for the fact the size of the investment grade universe has more than doubled (both market value and principal amount) since 2006, the results validate the claims regarding waning secondary cash market liquidity.



The confluence of the anomalous performance of the cash and derivative markets, trends in market activity, and historically small dealer inventories strengthen the proposition that real money is making greater allocations through the investment grade derivatives market. The rationale for the

rotation is some combination of: (1) increased liquidity (trade size and bid/offer) relative to cash market, (2) reduced counterparty and operation risk with centralized clearing, and (3) efficiently expressing views on spreads in a rising rate environment. Expect this behavior to persist if not expand in the future.

Roll me away

It is recommended that allocations to credit be positioned in the short/intermediate maturities given the:

1. Federal Reserve's commitment to low short rates for the next two years – although their adherence to forward guidance is less credible today than prior to the last FOMC meeting.
2. Uncertainty around fiscal and monetary policy.
3. Skewed risk/return profile in interest rates.
4. Historically attractive spreads and expectation for spread compression with rising rates.
5. Steepness of the Treasury and credit curves from 0-5 years.

Making more lemonade

The sector allocations recommendations from our Q2 2013 FPQ "Corporate Credit" section remain attractive. To reiterate: Off-the-run Financials offer unsecured investors attractive risk-adjusted returns. BBB/BBB- and Crossover Credits contain ample room for spread compression at current levels. For select Short-Dated High Yield issuers, the absolute level of yields and anchored short rates support an allocation to this sector. And certain High-coupon Yield-to-call/Make-whole Bonds provide sufficient carry to offset the risk of the call not being exercised.

Emerging Markets Debt

Prasad Kadiyala
MD, Asset Management
pkadiyala@fpcmllc.com
212-380-2297

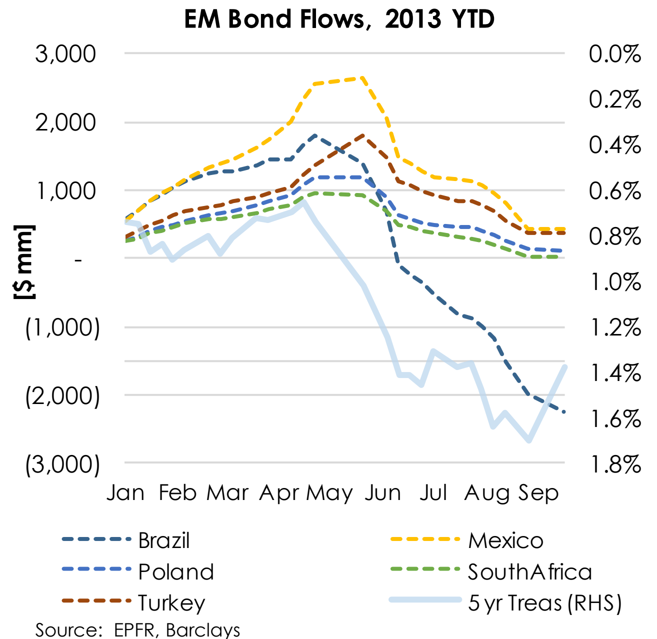
Quick Read

- **EM sell-off appears to be due to technical reasons rather than changes in fundamental views**
- **EM debt markets are now much deeper with improved liquidity**
- **Historically, EM has tended to lead in a broad market sell-off - overshooting other markets – and rebound vigorously**

Trend reversal towards middle of September

The first two months of the third quarter saw a continuation of the second quarter weakening trend with a widening of Emerging Market ("EM") credit spreads and further sell-off in currencies. The trend reversed toward the middle of September, due in large part to the Federal Reserve's decision to continue QE, and EM fixed income ended relatively unchanged for the quarter. The intra-quarter swing in returns of EM fixed income indices was approximately 5.0%.

The EM sell-off appears due to technical reasons rather than changes in fundamental views. A plausible explanation: increased rates, realized and expected, in the U.S. have made U.S. fixed income more attractive and are causing a reversal of investment flows into EM since the Fed began its QE programs. Recent funds flow data, below, corroborates this interpretation. A significant portion of investment is from retail investors, and such investors tend to be either tactical or unduly influenced by recent market developments.



Source: EPFR, Barclays

YTD cash flows into EM bond funds peaked in the first week of June at approximately $25 billion. However, outflows of $25 billion occurred in the last three months. The initial inflows and subsequent outflows followed the same pattern across all EM countries, although the magnitudes of the flows were dependent on the country. EM bond funds experienced 17 straight weeks of outflows before enjoying small inflows in the last week of September.

Rising rates

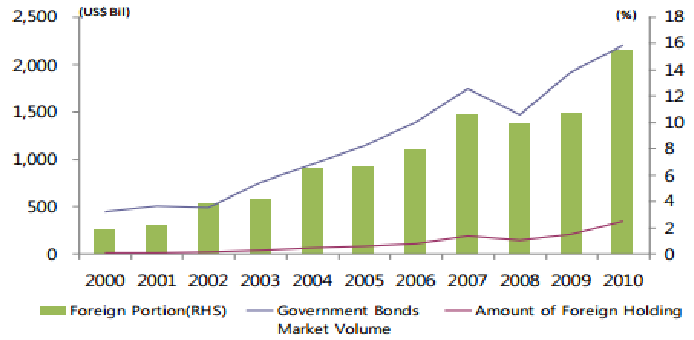
Rising rates in the U.S. will have some direct impact on EM through regular macro-economic and global trade mechanisms. Also, the redirection of foreign direct investment ("FDI") towards the U.S. could disproportionately affect the EM countries that are more reliant on FDI.

This was demonstrated in the recent sell-off as countries with high current account deficits, such as Turkey and South Africa, saw steep currency depreciation. However, a conclusion derived from fundamental analysis - that EM fixed income is an attractive option providing both relative value and diversification benefits - continues to hold.

This fundamental-based conclusion also benefits from a more attractive entry point today, provided by the market sell-off.

The size of the EM debt markets has grown substantially over the last decade, resulting in a much deeper market with improved liquidity. Data from a Federal Reserve study, Figure 2, show that for the ten countries included in the study, debt quadrupled to $2 trillion in the 10 years through 2010. For all EM countries, the EM debt markets now exceed $8 trillion, alleviating a long existing constraint to investing in EM debt.

Figure 2. Size of Government Bond Markets



Source: Federal Reserve New York 2013
Brazil, Hungary, Indonesia, Korea, Malaysia, Mexico, Peru, Poland, Thailand and Turkey

After the short run

Historically, EM has tended to lead in a broad market sell-off: often falling fastest, overshooting the drops in other markets, but then rebounding most vigorously. In the short run, it is possible that the EM sell-off experienced over the last few months will continue, and EM currencies could depreciate further.

While any investment in EM debt will experience losses in such a scenario, an investment in EM inflation-linked securities provides some defensive hedging benefits. Academic studies have found that over a period of time, currency depreciation is "passed-through" to local inflation. An investor in inflation-linked securities would accrue this pass-through and thus offset some losses due to currency depreciation. The magnitude of the pass-through benefits have ranged from 20% to 100% depending on the sovereign, tenor, and degree of currency depreciation.

Asset Backed Securities

Richard Dolan
CFO
rdolan@fpcmllc.com
212-380-2283

Rongfeng "Becky" Li, CFA
VP, Asset Management
bli@fpcmllc.com
212-380-2296

Quick Read

- **Consumer credit has reached another record high level led by auto and student loans**
- **Delinquencies and defaults have almost recovered to pre-2007 levels**
- **Spotlight on sub-prime auto: where opportunity still exists**

Steady ABS performance in 3Q 2013

Even as interest rates continued to rise in the 3rd quarter, the Barclays US Aggregate ABS index yield fell by 2bps to 1.26% on September 30. On a year-to-date basis, the ABS index yield increased 28bps, lower than the 85bps increase for the 10-year Treasury.

Asset backed securities (ABS) issuance in the first nine months of 2013 totaled $138 billion, according to Bank of America Merrill Lynch. This is 12% below the same period in 2012. All categories came down, including auto ABS despite strong auto sales this year with 15.21 million units on a seasonally adjusted annual rate ("SAAR") basis.

The slowdown in auto issuance is due in part to several auto finance companies increasing their access to the receptive unsecured corporate bond market. Still, auto ABS issuance remains the largest category of overall ABS issuance and accounted for 52% of total ABS new issuance year to date; while credit cards accounted for 20%; student loan 13%; equipment 7%; and others 9%.

Credit performance stays stable for now

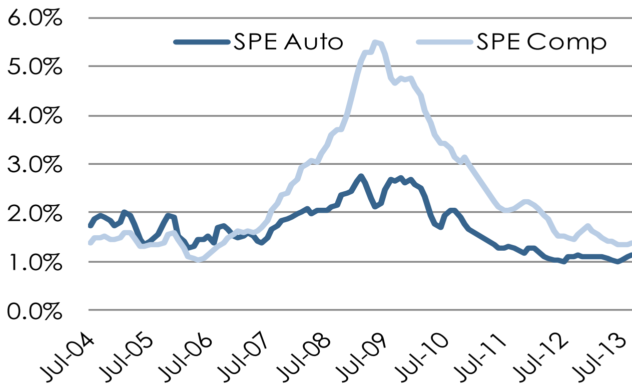
Continuing the trend of the past three years, consumer credit outstanding reached yet another record high level of $3.04 trillion in August 2013, according to the Federal Reserve. The majority of consumer credit expansion is in the non-revolving category (auto loans/leases and student loans). Non-revolving credit outstanding was $2.2 trillion, accounting for 72% of total consumer credit outstanding. Revolving credit outstanding - which is primarily higher-cost credit cards - fell to $849 billion, well below the peak of $1 trillion in July 2008.

Credit performance stays stable for now, but could deteriorate going forward. While

consumer credit has been expanding, overall consumer credit performance in the U.S. has continued to improve over the past three years.

Performance in terms of delinquency and default has almost recovered to levels prior to the credit crisis in 2007, as seen in Chart 1.
The default rate for all consumer credit loans in August 2013 was 1.34%, the lowest rate since reaching a peak of 5.51% in May 2009.

Chart 1: Consumer credit and auto credit default rates



Source: S&P/Experian/Bloomberg

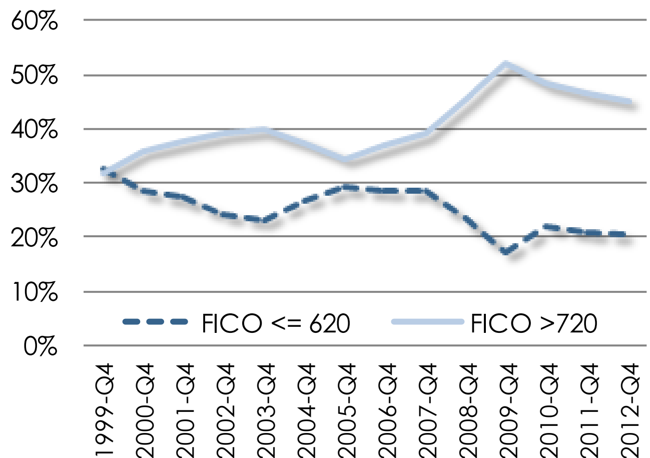
The default rate for auto credit was 1.11% in August 2013, down from a peak of 2.75% in February 2009. However, as we said before: we expect default rates to slowly change direction over the next few quarters and trend upward. In fact, auto default rates have been trending up slightly in the past two months driven by the subprime auto space.

Subprime auto: senior ABS still offer strong credit protection

As established auto lenders increase their subprime loan volume and new players enter the subprime space, subprime auto loan originations have bounced back sharply over the past four years (subprime loans have borrowers with FICO scores of less than 620). From a trough of $43.1 billion in 2009, subprime auto loan originations reached $73 billion in 2012 and could reach $80 billion in 2013.

For perspective, subprime auto loan volume is still substantially below the peak of $110 billion in 2005. As a proportion of total new auto loan originations since 1999, subprime auto loans account for a generally decreasing share from a high of 32.8% in 4Q 1999 to 20.5% in 4Q 2012, with 2009 as a low point of 17.5% (Chart 2).

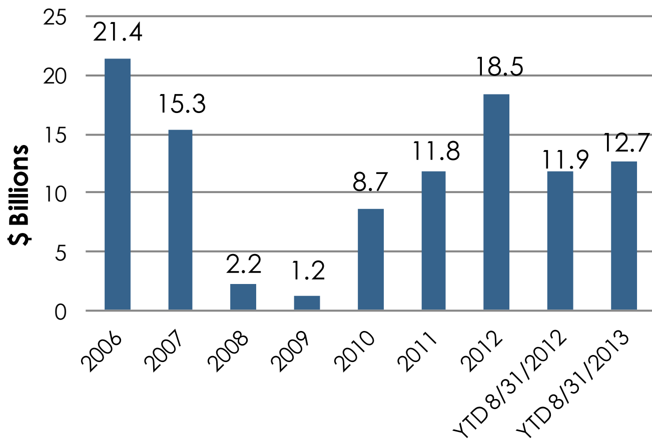
Chart 2: U.S. New Auto Loan Originations by Risk Scores



Source: Federal Reserve Bank of New York/Equifax

In line with rising subprime auto loans, subprime auto ABS issuance has also increased from a low $1.2 billion in 2009 to $18.5 billion in 2012. In the first eight months of 2013, subprime auto ABS totaled $12.7 billion, marginally higher than $11.9 billion in the year ago period.

Chart 3: subprime Auto Loan ABS Volume



Source: S&P

As subprime auto lenders increased their lending, many have also loosened underwriting lending standards. From 2006 to early 2008, the industry went through a lax lending phase; and subsequently, a draconian tightening phase from late 2008 to 2010. In the past three years, however, increased competition drove a pick-up in loan-to-value ratios, lengthening of borrower repayment periods, and reduction in annual percentage rates. The industry calls this "normalization" of lending standards back to 2005 levels.

The best predictor of subprime auto loan performance is underwriting standards. Not surprisingly, subprime auto delinquency and loss rates have risen in recent months, in contrast to the prime auto segment where performance has stayed stable. According to S&P, the net loss rate for prime auto ABS was 0.31% in July 2013, up only 2bps from its multi-year low of 0.29% in July 2012. On the other hand, the net loss rate for subprime auto ABS rose to almost 5% in July 2013, up 83bps from 4.13% in July 2012, although still much lower than a high of 8.68% in July 2009. Net loss rates for subprime auto loans could continue to trend upward.

Despite these trends, the senior tranches of subprime auto loan ABS should continue to offer ample credit protection for investors. Support comes from: a floor level of reserves and overcollateralization, high initial credit enhancement, and the gradual build-up of credit enhancement as the deal deleverages over time.

We often ponder the question of which is a riskier auto loan ABS deal: a AAA prime or a AAA subprime deal? In reality, it is hard to determine. Prime auto ABS deals performed well during the Great Recession with net losses around 1%, while the subprime deals experienced higher losses of around 16%. However, the AAA-rated prime deals have much lower initial enhancements (in the single digits) and it is not certain all prime borrowers will remain prime if they lose their jobs. For subprime deals rated AAA, the initial enhancement is much higher (over 30%), and the deals can sustain very high loss rates and still are able to fully repay principal and interest.

Data sources: Bloomberg, unless otherwise stated

Disclosure

The information contained herein has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security.

First Principles Capital Management, LLC ("FPCM"), or any of its affiliates, do not make any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein, and the information contained herein should not be relied upon as a promise or representation whether as to the past or future performance. The information contained herein includes estimates and projections that involve significant elements of subjective judgment and analysis. These statements are not purely historical in nature, but are "forward-looking statements". They may include, among other things, projections, forecasts, targets, sample or pro forma investment structures, portfolio composition and investment strategies. These forward-looking statements are based upon certain assumptions. Actual events may differ from those assumed. FPCM or any of its affiliates do not make any representations as to the accuracy of these forward looking statements or that all appropriate assumptions relating thereto have been considered or stated and none of them assumes any duty to update any forward-looking statement. Accordingly, there can be no assurance that estimated returns or projections can be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented.

The information contained herein does not constitute advice of any kind related to tax, accounting, legal or regulatory matters. Recipients of this information should seek expert professional advice with respect to such matters.

FPCM and its affiliates disclaim any and all liability as to the information contained herein or omissions here from, including, without limitation any express or implied representation or warranty with respect to the information contained herein.

Notwithstanding anything to the contrary contained herein, the recipient (and each employee, representative, or other agent of the recipient) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transactions described herein and all materials of any kind that are provided to the prospective investor relating to such tax treatment and tax structure (as such terms are defined in Treasury Regulation section 1.6011-4). This authorization of tax disclosure is retroactively effective to the commencement of discussions with prospective investors regarding the transactions contemplated herein.

By accepting this information, the recipient agrees to be bound by all of the limitations described herein.

Copyright FPCM 2013