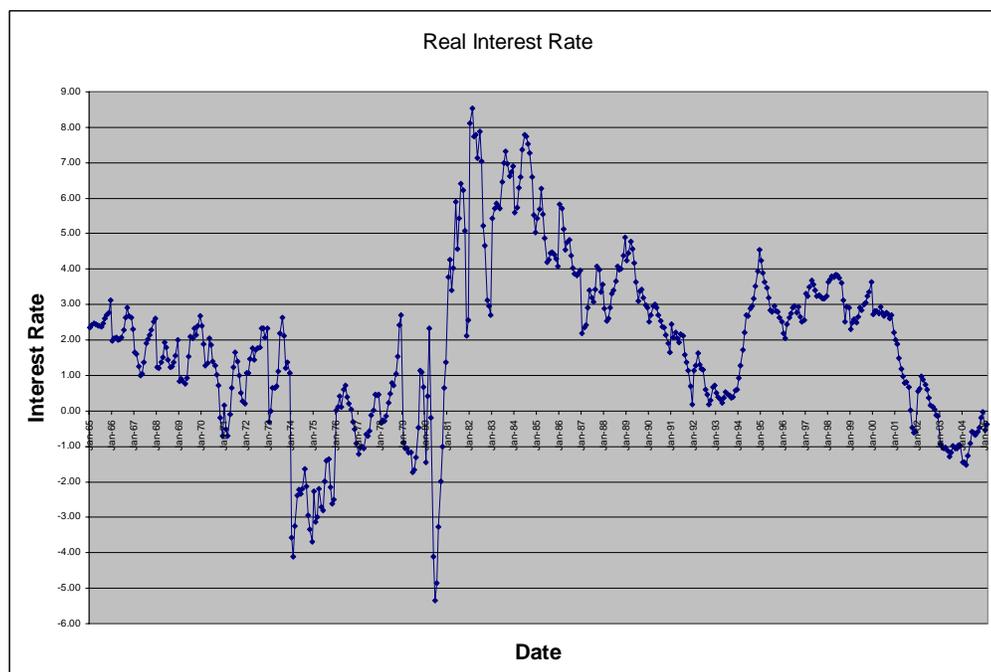


**Quarterly Commentary:** After 8 straight issues of Sopa Piranha that focus on optimistic scenarios, it is time to shift toward the risk of a meltdown in the next 18 months. Many of our core fundamental indicators are turning negative. I do not have enough space to write about why the meltdown will come and so I will simply state that now it is time to think about who is out over their ski tips and to insure that it is not us.

Selecting a topic for meltdown is not random. The meltdown is always a function of the excesses of the prior period. It always includes similar factors and only the emphasis changes. **These include excessively high asset prices, leverage with little price margin, reliance on uncertain liquidity, misinformation, failure to mark to market, and implied negative gamma.** Some people are pointing to real estate as a potential culprit. It fits most of the criteria but I argue it is not yet excessively priced globally. Others point to commodities. Again I argue that prices are not yet far enough ahead of fundamentals. The clear winner seems to be yield as it relates to an inflation bottom. Real interest rates have gone negative on the 40 year chart below.



We know that negative real interest rates start from a period of falling interest rates and generally loose monetary policy. In this environment money chases ever falling yields and brings with it low bond and equity volatility. In this type of environment, correlation among assets is assumed to be constant and stable. This brings us to CDO's and synthetic credit securities in particular. They are **long real yields at excessively high prices**, they are **leveraged with little margin** for error, they rely on **uncertain liquidity** as new complex instruments, there is some **misinformation**, many of the buyers **do not mark these securities**. Market players that do change their pricing are marking their securities to model - different models. Last and most important, credit derivatives have **implied negative gamma** with their extreme reliance on correlation assumptions and a structure that implodes as credits move out of the mix. Further if you think about how the hedge fund industry creates profits, two of its most important variables are correlation across markets and volatility. Credit derivatives are impacted by both and are impacting both. Credit derivatives are far more important to the hedge fund industry than interest rate swaps or mortgage securities. **Yield from credit based securities is our dangerous instrument of choice**. It directly affects both fixed income and equity prices. It directly affects you.

**My premise is that corporate interest rates will rise far beyond anything intended by central banks due to the temporary meltdown of the synthetic CDO marketplace. It is hard to imagine this will be as devastating as the 1998 meltdown but when things start to turn bad these days, they seem to get really bad quickly. We only need to know the trend is toward defensive strategies.** This premise is a corollary argument to the September 2002 commentary that indicated the rates companies pay for debt was about to collapse. At the time market participants thought the stock market was expensive. Those same participants now think it is cheap. The market is paying too much attention to the central banks and not enough attention to the actual rates companies are paying for credit. As always, I start my case from the simple and move to the complex.

**Section One: What is the CDO/CDS and Credit Derivative Market?** This group of repackaged debt securities is now one of the world's largest complex debt markets. There are many types of securities. Hedge funds are involved at the risky end of the spectrum primarily in the equity and mezzanine tranches.

- I. **The basics for beginners.** In the mid 90's banks began to remove debt and loans from their balance sheets by creating repackaged securities. These securities were portfolios of loans that were normally split into different types of assets giving buyers the chance to hold senior obligations, mezzanine obligations, or very junior obligations such as equity. The securitization removed these assets from balance sheets and reduced capital requirements.

**A basic CDO of the type mentioned above is often split into three or four pieces; 1) a triple A senior piece, 2) a single A mezzanine piece, 3) a BB lower rated piece, and 4) an equity piece that is not rated.** The securities are structured in a payment “waterfall”. This means the senior piece is paid first. The equity piece is paid last. CDO’s can be thought of as portfolios of unrelated credits that are put into a standard capital structure from senior to junior.

The senior note holder in the CDO is getting a rated security that is less risky than the portfolio of credits as a whole. So if the credit pool is single A and the senior tranche that has 85% of the collateral is rated AAA, then something else has to be taking credit risk. The credit upgrade is called credit enhancement and this enhancement is given from the lower rated securities such as the equity tranche. Like any AAA asset, the risk of default is low. In this type of security, the holder is at risk if there are many defaults. Thus the holder is worried about a high correlation of defaults. The holder is said to be short correlation or short a bet on low correlation of defaults.

This is somewhat like being short a lot of out of the money puts. It is essentially systemic risk and not idiosyncratic risk. These buyers are getting a higher interest rate or spread for the rating on these assets. This is only possible because they are taking on some risk. That risk is correlation risk. The senior piece is also sensitive to the recovery rate of defaults. If there are many defaults, the recovery rate of those becomes critical to the overall cash available for repayments. If the equity holder is getting a lot of cash due to high recovery rates, the senior holder is losing. He is short recovery rates.

At the other extreme, the equity or first loss piece is highly exposed to a single default. If a structure contains 200 credits and only 5 defaults on payments without significant recovery, the equity holder can be wiped out. Correlation risk is not a factor for an equity holder since only one default is already a problem. He is more exposed to a single default than correlation. This is idiosyncratic risk. The equity holder is also sensitive to recovery rates and is long hoping that any default also recovers.

The mezzanine and other tranches fall in the middle and are not very short correlation nor very long default risk. They can be thought of as leveraged credit portfolios. They are highly exposed to business cycle risk when credits in general decline. While only 20% of the market is in junior tranche securities such as mezzanine and equity, these securities account for 50% of the volume of trade. Their impact is much greater than their pure size would indicate. Overall these tranches can

be considered like options on default. This poses the question, what is a default?

**As we move toward our concerns about these securities for the uninformed buyer or seller, the first thing we want to notice is that there is little to no data as it relates to defaults of debt on most companies because most companies have never defaulted. Pricing is model dependent.** We also notice that default rates are highly cyclical and unpredictable. We will use a physical example for our beginner readers. Let us assume that we are in a portfolio of only two credits in our CDO. One is GM and the other is Ford. How do you determine the probability of default and the codependence of default on two companies that have no default history? The industry analyzes the probability of default defined as the distance to default. If we define default as a cliff, then we can define distance to default as the distance to the cliff for each of the drivers of SUV's that represent Ford and GM. The market measures this in time to default. Think of it as how long it will take to make enough SUV's with oil at 50 dollars to destroy these companies and send them each over the cliff.

It is easy enough to imagine that the main variables will be the amount of earnings and assets plus the total amount of debt or firm leverage. Lots of bonds to pay off against little asset value should push us closer to the cliff. It is less obvious to realize that volatility is a critical factor. This is essentially the price investors want to be paid for any given level of risk. So with all else constant, low volatility pushes the SUV back from the cliff. When measuring default, no one is measuring actual defaults; the industry is measuring chances of defaults and chances of recovery. This is measured as probability.

In a portfolio of credits, we have said that correlation of the defaults is critical to value for the senior holder. Our GM and Ford assets can be thought of as have a strong or weak link. Their correlation measures whether they are moving together toward or away from the cliff at the same pace. One hundred percent correlation means that if one defaults and goes over the cliff, the other must default and will automatically go over the cliff. Their defaults are entirely dependent. The correlation is the tendency of the GM SUV to move when the Ford SUV does. Notice both are in motion and this is a two way measure. Intuitively we can think that these defaults are pretty co-dependent on Ford and GM but in a portfolio of 1000 independent companies or loans, determining all the dependencies so we can price the security must be risky business and it is.

These securities are quoted in the marketplace as correlation. Their implied correlation is the correlation that would be needed to get to the

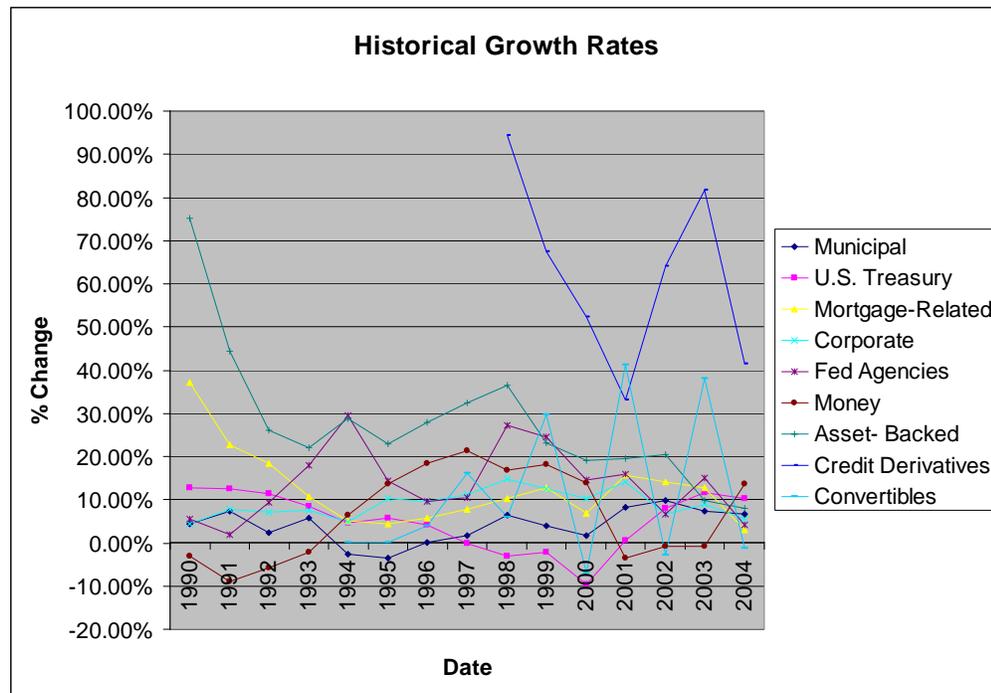
price of the security. This is often compared to quoting implied volatility. **This is a terrible analogy. Implied volatility in options is based on real price data.** It is a universally accepted concept with one method for pricing it. Implied correlation is a model dependent concept defined differently by different people. This opens up the possibility to make money trading it, but also opens up the possibility for chaos if liquidity dries up. Implied correlation should be thought of as only a value relative to actual correlation of defaults. It is not an absolute measure. Therefore in structures that require hedging, no one can really say how to exactly construct a perfect hedge. Further if credits can move into or out of that same portfolio, the hedging is more art than science. In our example if GM is replaced by AIG, our assumptions about correlation are obviously different. If GM trades down in price and Ford does not, then GM's weighting is reduced in the correlation calculation. Volatility is science and should not be compared to correlation.

Another difficulty with pricing comes from the underlying credits themselves. CDO's are term securities and therefore each credit has a term structure of spreads. The credit spread is not a single number but a series of numbers that are in motion. This has caused participants to need to develop more sophisticated models to allow for this. We can assume that the markets best and brightest know what they are doing but we cannot assume that everyone does.

If we think of what might really cause pandemonium it is not a few defaults that cause some high yield CDO's to take a nose dive. It is the general perception of rising defaults and the possibility that this could spread to highly rated credits such as insurance companies, banks, and FNMA. These entities do not need to actually go over a cliff: we only need to think they are moving toward the cliff with ever increasing dependence. This means the major risk is "jump risk" or the perception that everything is suddenly more correlated. An example would be a lending chain or a Long Term Capital type event that created a perception of risk to the system. **If a lending chain is our primary risk, then we only need to notice that the credit derivative market is a lending chain. It potentially creates its own demise. Read that sentence again.** Obviously, the street has spent considerable effort to analyze and build models for "jump risk". However, analyzing any stress related risk is an art form. Risk managers always have a plan as it relates to stress testing. But, to quote Mike Tyson, "everybody's got a plan until they get punched in the face".

CDO's are often described as leveraged assets. In fact it is the lower rated pieces that have effective leverage. We can think of the senior tranche as being deleveraged and therefore safer. The other assets

must contain effective leverage. So we can say that about 20% of all assets in this market contain significant leverage averaging around 5-7 times. In some cases those assets are debt of companies that are already leveraged. This means we may have double leverage of about 10 times. **If those same assets are put into hedge funds (hedged or not) and then leveraged again, we have reason for concern that there is triple leverage of about 30 times.** If that hedge fund is put into a leveraged fund of funds, we are now at quad leverage, maybe 90x. At this level hedging must be perfect and it is not. Fortunately this is only a tiny fraction of the market. Historically we have seen it only takes a fraction to create a scare in a poorly understood market that is large in its impact. Below, the blue line shows how fast this market is growing.



**II. The arrival of synthetics and more effective leverage:** By the early 00's demand for CDO type instruments outstripped supply and the marketplace began to create the assets for the buyer. The portfolios began to contain only credit default swaps and these were labeled synthetic CDO's. Because the buyer is essentially using leverage to buy expensive credit, the seller owns cheap credit in the form of a swap. This cheap credit is sold back to other banks and to hedge funds. The buyers of the cheap credit protection are then in a position to purchase other credit based securities, such as convertibles. The

swaps they own are used as a hedge. This snowball effect creates very high demand for credit and has been instrumental in crushing all credit spreads at a higher speed than ever before. It also took a new market that was relatively contained and caused it to spread through the financial industry. This has been viewed as a good thing given that credit risk is spread throughout the system. This will be a good thing as long as the contracts hold and there is no default dependence among the participants.

The main risk that synthetics add is that they are not really a sale of assets. They create exposures to the sponsoring bank: counterparty risk. It does not seem like long ago when this was a big risk. All market participants are using lawyers to protect themselves but the interpretation of many of the legal clauses is untested.

These synthetic structures have advantages as well. When you are dealing with paper assets such as swaps, you can be flexible about the collateral. The portfolio can evolve. Of course it can devolve as well. Another advantage is that since there are no assets to buy, the structure can be unfunded. This means the buyer gets the asset like a swap with little or no money put up except for margin. More than a few people have noticed this is yet another way to create leverage under the radar. In fact it makes it possible to lever up 90% of the deal. **Some participants will point out that, because these things can be done does not mean that they are being done. I say, yes it does mean exactly that. If you give the financial industry a new toy, it will play with it.**

- III. **The Arrival of Single Tranche CDO's:** More recently buyers for every tranche of a CDO have been scarce. This has resulted in the emergence of a CDO where only one tranche is publicly available and the others are hedged by the structuring entity. This creates a hedging challenge (mentioned above) in addition to a structuring challenge. The issuing entity sells expensive leveraged credit, often in the mezzanine tranche and then is left with the most challenging task of hedging the default and correlation risk. This has caused more new models to appear and these are better models.

The market for single tranche CDO's is creating negative supply in credit due to the higher leverage implied. For the first time debt is not created by one party and then consumed by another. In the history of debt we know that spreads move as a function of this net supply/demand. Now we have the possibility of huge volumes of

negative supply. As spreads narrow the yield hogs have no where to turn and demand more CDO's, the only instruments offering enough yield. Further, as spreads narrow, the cost of debt to those companies declines. This means earnings rise and companies can even pay down debt. **Credit quality improves in a virtuous cycle and under prices risk.** The corollary to negative supply is an environment of negative demand for leveraged credit. There will come a vicious cycle even if it is temporary. The little prequel we are in now is nothing. It is even possible that spreads have not seen their lows as we move back into the virtuous cycle. When the main feature length movie hits us, it will be the sorrow and the pity for some participants.

- IV. The arrival of options on CDS, constant maturity default swaps, credit curve trading, forward starting credit default swaps, 10 year maturity swaps, CDO squared, real estate CDO's, reduced tranche width, recovery swaps, revolving variable funded CDO's, tradable credit baskets, first to default basket swaps, CDS swaptions, credit vs. equity correlation trading, and that ain't all folks:** The last time the market created this many ways to confuse investors, it ended in a congressional investigation. I speak from experience here regarding the early days of the mortgage market. For a while between 1991 and 1993 it seemed like every week brought another new confusing instrument. Eventually the profits went away and so did the desire to create instruments to trade. The market was then simplified.

As we look at why the CDO market is vulnerable now when it held up during the stock market crash from 2000-2002, we might be well advised to remember that most of the securities above did not exist in 2000. Even by 2002, the market was relatively small and a buyer of credit product had plenty of places to go to find yield. The arrival of extreme leverage and complexity is relatively recent. The 2002 default experience was extreme. However it was a small cap and dot com bust more than a bust in credits generally. We cannot say that 2006 or 2007 will have the same default experience.

- V. Size of the Credit Derivative Market:** The credit derivative market as a whole is now about \$6 trillion excluding swaps and is projected to grow quickly to 10 trillion dollars. With swaps (CDS) included, the total is more like \$16 trillion. Growth to \$25 trillion is likely. Some of you will point out that this pales in comparison the interest rate and currency swap market, and it does. I only point out that rate and currency swaps are simple instruments by comparison and are easy to mark. **Another**

**difference is that the size of credit derivatives relative to outstanding debt obligations is already enormous early in the development of these securities.** At \$25 trillion for the whole pie, it will dwarf the corporate debt outstanding. I further will repeatedly point out that this is happening at a time when we are shifting from 22 years of disinflation to some inflation. These shifts are unstable. It is a bad choice of environment to be creating complex corporate securities based on yesterday's assumptions.

- VI. Structure of the CDO Market:** If we want to understand how correlation dependence could impact markets generally, we need to understand the players and their behaviors. The chart below shows the basic market structure excluding swaps. We should note that heavy amounts of buying come from Continental Europe. Insurance companies are important sellers of protection. Index product is growing rapidly. Perhaps the most important factoid is not on the chart. I took a poll and am told the average age of the players is 33. It is a new market and it is fair to say that very few of the players are real experts.

**One of the most important aspects of any market containing leverage is the ability to accurately mark to market.** We know that many of the yield buyers do not mark. This is especially true in non US Banks and some insurance portfolios. For assets that are unfunded, it is easy to keep these at purchase price. For OTC assets with only limited sources of data, it is also easy to mis-mark them. While these practices may be limited, they are important. Perhaps more stunning is the fact that there is not one absolute agreed upon method of software used to mark. In fact participants marking to model have the choice of at least three different models that depend upon three different theories. One might ask why mark to model at all. Recall that many of these securities are one off deals that don't trade much or are hedging books. You can't mark a one off hedge to someone else's bid. You must mark it to your preferred model.

Of the three models widely known, the Merton based models are the most used. These are the basis of the Credit Metrics and KMV models. These are highly sensitive to asset correlation and industry variables. A second model based on econometrics is dependent more on macroeconomic variables. This is the basis of Credit Portfolio View and many proprietary models. A third set of models are actuarial. They have higher sensitivity to volatility of defaults. This is the basis of Credit Risk +. One only has to notice that these models are quite different.

Their outcomes may not create extreme differences now, but in a state of higher defaults and a possible unwind, losses could be severe just from using a model no one else likes. Further we can say that for the structures that require hedging and constant rebalancing, there is considerable room for self dealing and front running of clients. Perhaps investors will only be faced with a lack of liquidity in what they own.

Summary of the key survey statistics 2003/2004						
	2003		2004		2006	
	\$bns	% share	\$bns	% share	\$bns	% share
Global market size (excl. asset swaps)	3,548	100%	5,021	100%	8,206	100%
London market size	1,586	45%	2,230	44%	3,563	43%
Americas market size	1,459	41%	2,000	40%	3,173	39%
Asia/Australia market size	287	8%	446	9%	858	10%
Other Europe/RoW market size	216	6%	345	7%	612	8%

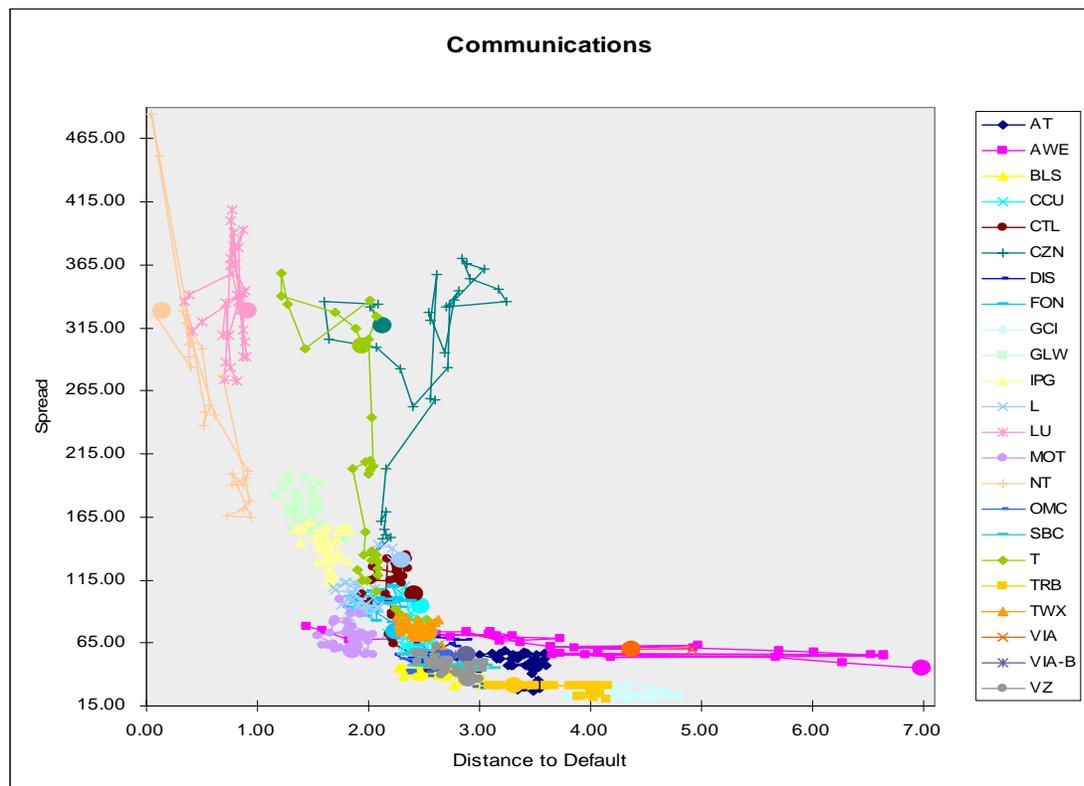
	2003	2006
Banks' % of protection buyers market	51%	43%
Securities houses' % of protection buyers market	16%	15%
Hedge funds' % of protection buyers market	16%	17%
Banks' % of protection sellers market	38%	34%
Insurance co's' % of protection sellers market	20%	21%
Securities houses' % of protection sellers market	16%	14%
Hedge funds' % of protection sellers market	15%	15%
Market share of credit default swaps	51%	42%
Market share of synthetic CDOs	16%	16%
Market share of indices	11%	17%
Market share of corporate assets	64%	64%
Market share of financials assets	22%	22%
Source: 2003/2004 BBA Credit Derivatives Survey		

Summarizing section one we now have the world's largest non sovereign debt market by volume impacting nearly everything investors do. The economics of the new production are causing securities to be created for the sake of leverage to buyers who cannot otherwise easily leverage. Not all of these securities are marked and if they are, many are marked to different models.

**Section Two: How does the CDO market impact other markets?** I have said that CDO's are leveraged bets that create negative supply of debt. This has

compressed spreads. Next I take on the connectivity and show why this matters to everyone.

**I. The basics of security connectivity.** I described Distance to Default above in physical terms noting it is a way to express when a company will default by using the firm's components of value. D2D is also useful as a way to compare the value of companies. Relative value trading can be done using this method because it can be used to imply where a company's credit spread should trade. I also said that the firm's value is a function of the value of its components, its equity, its debt, and any other security it might have. Given that the firm's assets can be priced as call options on the Company (after Merton), the other main variable is volatility. I already indicated that extremely high volatility for all assets implies that investors want to be paid more for the same risk. This volatility is expressed though the credit spread. So all else held equal, the credit spread and volatility of both the company and the market generally are directly mathematically linked. The chart below shows how empirically the D2D accurately prices spreads. The chart is courtesy of the Provenia Capital Structure Fund.



If CDO's are artificially driving down credit spreads, they are also driving down volatility or artificially raising equity values or both. The

CDO market is easily large enough to be doing both. The volume of leverage in the CDO market is also probably large enough to be keeping absolute rates low in the middle part of the treasury curve. Remember that the mezzanine tranche is essentially a leveraged bet on credit spreads and the business cycle. These tranches are purchased largely unhedged and are long fixed income securities. One wonders if the conundrum of the strong 10 year in the face of Fed tightening and inflation is not really just a reflection of massive effective money supply from leveraged credit bets.

- II. Are CDO's impacting correlation or covariance of companies?** If I am correct that CDO's are large enough to impact just about everything then I should ask, can they also be impacting correlations. If they are impacting correlations of companies, then they are impacting the very thing they are dependent upon. This is a subject that needs to be researched by the experts. We can say that the CDS market is already showing signs of unusual correlation. The basis between these swaps and their underlying bonds is unusually volatile. A correlation problem is already evident and will spread to the underlying bonds. Perhaps in the extreme, it will spread to the equities and their volatility.

In section two I have shown how securities are all linked and why those of you investing elsewhere might want to pay attention to the CDO market even if you are not involved.

**Section Three: How would a reversal of the current cycle ripple through the hedge fund industry?** We can say that any bubble gets reversed when the last buyer has bought. In this case it happens when the negative supply shifts to negative demand. This should be revealed in a credit spread bottom. It may also be when the yield curve is flat and buyers no longer are riding the yield curve with leverage. This seems some distance off at the moment. Recent downgrades of GM do not seem to be enough to set the unwind in full motion. The buyers have to turn to sellers. I am watching the spread market for news. My best guess is that an unwind begins this fall but that the big selling is over a year away.

- I. What are hedge funds actually doing in these credit securities?** Hedge funds are largely trading and doing "arbitrage". In general the argument goes that they are able to extract free money from rehedging their books just like convertible funds extract Vega through gamma trading when volatility is very high. In fact eventually this market makes a good counter balance to a convertible manager's portfolio. In many ways it behaves the opposite of convertible arbitrage. While I agree

there is money to be made, I do not think this is happening without substantial systematic risk. There is no free lunch.

Many hedge funds are also long correlation by buying equity and hedging it with mezzanine. Recall that the senior holder is short correlation so the equity is long correlation. The mezzanine piece is neither long nor short in a big way creating the mismatch in correlation. This may be fine until the market is exposed to idiosyncratic default shocks. These can come from hostile takeovers for example. It only takes one problem to cause the uninformed investors in these hedge funds to run for the door.

Given how much uncertainty there is around hedging, model mismatch, mis-hedging, structures that get mismanaged, and liquidity, I am operating under the assumption that at least one of the hedge funds operating in this space is doing so with a naïve perspective. It is this fund and the uninformed buyers that cause me to want to stay clear of direct exposure to CDO's. However it is abundantly clear that any market exposure at all is in some way an exposure to CDO's. We must all be informed.

**I have made the claim that CDO's are our instrument of choice for a meltdown. Let's reexamine the list of criteria. 1. CDO's are long real yields at high prices. Spreads are at historic lows and baffling most people. 2. CDO's provide leverage on small margin for many investors. The hedge fund industry is highly involved and is leveraged on top. 3. The securities have uncertain liquidity given their model risk and lack of agreement about value. 4. Some investors are misinformed. Evidence of this comes in repeated warnings from the rating agencies and even the Fed. 5. Some investors are not marked to market and no one is marked to the same market. 6. The securities have implied negative gamma. This is only true of the equity which has negative cross gamma. One does not need to be an expert in lower tail dependent copulas to get the joke here.** The key is to determine who will be forced to sell and in what order. Liquid hedge funds will be among the first that are forced to sell.

- II. Redemptions of credit based funds.** The hedge fund industry is a key factor in a lending game given that it has no lender of last resort behind it. As a critical player in this chain, the hedge funds need to remain involved. If they are forced out due to client redemptions, a reversal of the process can come quickly. At the moment this seems

unlikely but at the moment these hedge funds are all profitable. Certainly on the back end of any chaos, the opportunities for free money will be extraordinary.

As the market starts to unravel, the fundamentals of companies may become temporarily irrelevant. Funds that are long and short or hedged in their books may find that their great opportunities for arbitrage just got greater. With leverage, the risk of a mark to market problem grows. If funds mark to model and their prime brokers change their mind about the margin, a fund could go completely under. Uninformed investors would cause a run on all such activity. In fact many bubbles unwind when someone changes the rules. This seems a likely scenario.

Trading through swaps is pervasive in the convertible space. The swaps are used to hedge underlying credit risk. Converts are then purchased and the manager is long volatility. This allows him to then step into the market and sell volatility with more leverage and confidence. This directly compresses volatility and decompresses it when these swaps are unwound. We expect this unwind to accelerate into 2006 and that sometime in the middle of the year, volatility will move higher and remain high.

- III. Collateral Damage:** We know that when things start to unravel in one area, it affects everything else. We can follow our standard rule of thumb. The most liquid markets are the first hit and the least understood are the last and hardest hit. In the unwind described above, collateral damage would be heaviest first to the most liquid credit based markets. This would be emerging markets, high yield, higher grade securities, and the most liquid CDO's. The securities that are not marked would likely get hit last. These securities may be the most expensive creating large disparities in how things should be priced. One thing is for sure, anyone trading credit needs a staff large enough to be informed about CDO's.

Corporations are also faced with needing to understand what is happening to their credits. In the extreme, they may begin to trade their own swaps if a pure arbitrage develops. In a marketplace that can actually cause a company to have financial problems, treasurers may find their best course of action is to step in and stabilize their own debt.

**IV. The risks of tracking error and counterparty failure on hedges.** If we turn to focus on how to make baskets full of money from this, we can ask the question: why not just get short constant maturity default swaps in size and wait it out. Perhaps this is initially the right thing to do but in the late stages of any unraveling, people will be questioning whether the contracts are valid. People will be reading the fine print of their contracts and discovering they can at least **try** to get out of them. Investors will be suing and claiming misinformation. The tracking error on hedges may be severe. All in all the risks of playing this from the short side are many.

In section three I have focused on the risk of market chaos. Any market chaos creates extraordinary opportunities for profit both the short and long side. We see many more opportunities coming than we see in today's relatively dull environment. The key is to be properly positioned at exactly the right time. In order to take advantage of this we are doing four things; 1.) We are discussing this market risk with everyone of our managers. Any managers who feel that this risk is insignificant are being redeemed or reduced. 2.) We are actively seeking managers who will profit from the difficulties we describe. 3.) We are lowering risk every month to improve our flexibility in the coming environment. 4.) We are increasing liquidity by avoiding funds with lock-ups. We feel that we are in a strong position to generate performance through the coming environment.

**Conclusions:** The world as we know it is not about to come to an end. In the long run I remain extremely bullish on the World's growth prospects. The United States will survive its debt bubble and China will float its currency. Oil prices will rise but we will find oil and those prices will fall again. For now, we have an environment where there are some excesses that need to be wrenched from the system. These are likely to be on us by autumn given the likely hood of short term inflation combined with declining growth and liquidity. The Federal Reserve has already warned dealers. They have issued public warnings to buyers. Rating agencies are issuing warnings. We should all pay attention.

Good luck in your investing and we hope you enjoyed your piranha soup...

Mari Kooi

Wolf International

April 30, 2005