Smith's High Yield Conference

The Beginning of the End

Smith's Research & Gradings

Smith's High Yield Conference

- Credit is a foundational property for modeling and understanding what drives your business. It is a ubiquitous information ingredient in achieving your long-term mission. Credit can be exploited as a unifying information theme to better understand the most real and abstract phenomena associated with investment management. Credit, in its simplest form, is an expression of an ability and willingness to enter into a transaction. It is contextually simple and intuitive to most people. Credit is the way that most people commonly understand and relate to one another in the marketplace.

Smith's High Yield Conference

- Past is Prologue
  - Beginning 2007-2008 (18 Months Duration)
    - Speculative Bubble in Real Estate Collapses
    - Capital Crunch for World's Banks
      - Triple-A Insured CDS Squared
      - Triple-A Tranched RMBS/CMBS/Autos/RVs/Boats
    - Record Number of Corporate Bond Defaults
      - Bear Stearns
      - Lehman Brothers

Middle

- Middle 2008-2011 (36 Months Duration)
  - Political Solutions to Economic Problems
    - Federal Bailout Programs To Extend Credit (TARP, SECRET, ETC)
    - Monetary Stimuli (QE I, QE II)
    - State Sponsored Capitalism (GM, AIG, FNMA, Freddie Mac).
- State-Sponsored Capitalism
  - Housing Finance Agencies "Sell" $17 Bln. (par) to Fannie/Freddie
  - Fannie/Freddie will "securitize" and "sell" to the US Treasury
  - Wall Street Paid to Structure and Sell these bond deals.

Smith's High Yield Conference

- Beginning of the End (18 Months Duration)
  - Persistent Economic Problems
    - Low/No Growth
    - High Unemployment
    - Large Deficit Spending Programs

Smith's Research & Gradings

- Principles-Based
  - Independent
    Conflict-Free (Paid By Investor/Stakeholder)
  - Universal
    - Consistently Applied Across All Investment Sectors
  - Equality
    - No Investor Group Favored Over Another

Smith’s Gradings

- Each Grade has Three Components:
  - Probability of Repayment (0-135 Best)
  - Recovery (1-10 Full)
    - in event of Default Higher of Ongoing Concern or Liquidation
  - Event Risk (+1, O, -1)

Smith's Sovereign Gradings

- Smith's Sovereign Risk Grading Alerts
  - Iran Has/Had Atomic "Dirty" Bomb
  - Palestine Seeking Statehood from U.N.
  - Heightened Alerts For Iran, Iraq, Saudi Arabia, Israel, Syria, Russia.
  - European Union Increasingly Unsustainable.

Smith's Bank Gradings

- FDIC Is Insolvent
  - Smith's Research Reported FDIC Was Under Congressional Mandated Minimum Capital Reserve of $55 Bln. In January.
  - Smith's Bank Recovery Gradings Placed Under Review for 4,500 Institutions in January.
  - FDIC Asked Banks to Pre-Pay Three Years of Premiums (100% would produce $42 Bln.)
  - Smith's Research Reports FDIC Still Not In Compliance with Congressional Mandate

Smith's Political Event Risk

What is Political Event Risk?

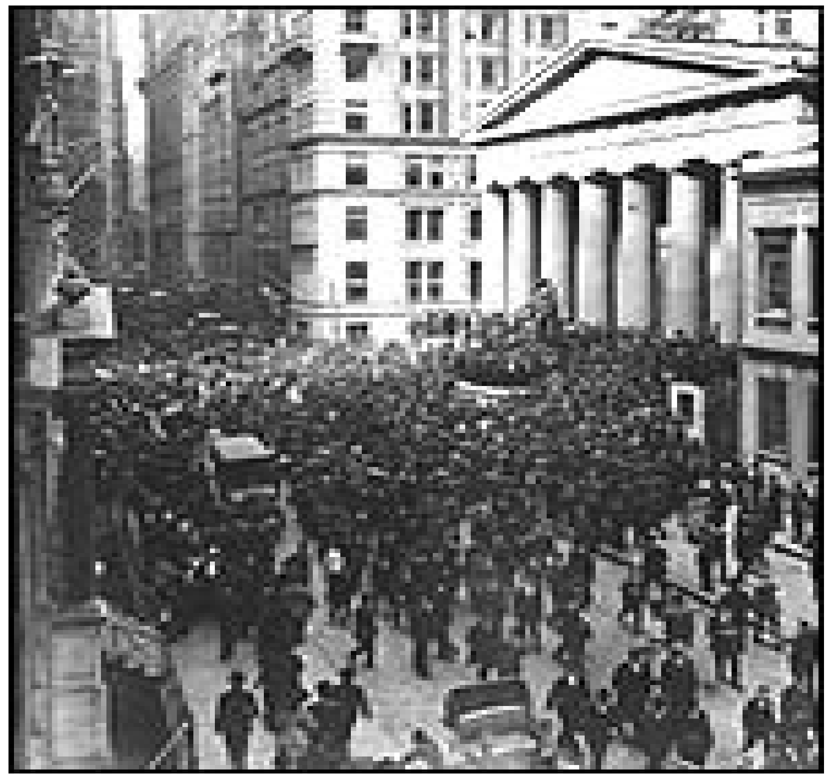
This is Political Event Risk…

Smith's Political Event Risk Model

- Could it happen here?

Smith's Political Event Risk Model

- Black Monday Was The Result of a series of Speculative Bubbles…



Smith's Political Event Risk Model

- Smith's Political Event Risk Covers (classes):
  - 1) Currency inconvertibility (CI) and exchange transfer (FX);
  - 2) confiscation, expropriation and nationalization (CEN);
  - 3) Political Violence (PV) or War (including revolution, insurrection, politically motivated civil strife, terrorism);
  - 4) Breach of Contract, Contract Frustration (CF), Contract Repudiation.
  - 5) Wrongful Call of a Guarantee (WCG).

Smith's Political Event Risk Model

- Use of Smith's Default Probability Grades (probability of claim or default rates)
- Use of Smith's Recovery Grades (percentage of loss within a policy limit or recovery rate based on the greater of ongoing concern or liquidation).
- Use of Smith's Political Event Risk Grade (percentage of defaults within a sovereign nation given that the county is in default.)
- Smith's Correlation Matrix.

Smith's Political Event Risk Model

- Provides a consistent and objective framework to conduct analysis of political risk across a portfolio of international bonds or book of business.
- Smith's model was developed based on a distribution of political risk losses that would support a determination of value at risk (VAR) to determine the capital requirements to conduct the business that is being analyzed.

Smith’s Political Event Risk Model

- Methodology
  - Facilitates analysis of underwriting profitability, Return on Capital and Reinsurance Pricing.
  - The development of loss distributions at the portfolio and transaction level is based on the entity’s political risk exposure within a county, political risk default rates, Smith’s Recovery Gradings, and Smith’s Research for regional/trade correlation assumptions.

Smith’s Political Event Risk Model

- We enhance decision making environments…

Smith's Research & Gradings

- Smith's Reported a Political Event Risk Alert For United States in March of 2011*
  - "Probability of Sovereign Debt Crisis Now Escalating to Over 40%"
    - Weak US$ Policy Vs Weak Chinese Yuan
    - Depression Looms As Central Governments Attempt to Eliminate Speculative Asset Bubble

*Smith's Affordable Housing Conference 3/11

Smith's Political Event Risk Model

- What's Next?

Smith's Political Event Risk

Smith's Political Event Risk Model

- Food price volatility. After staying at historic lows for decades, food prices have become significantly higher and more volatile since 2007. A first price spike occurred across almost all commodities in 2007/2008. After a drop in 2009/10, prices are now climbing again and volatility remains high.

Smith's Political Event Risk Model

- The truth is we cannot feed all of the world's 9 billion people – yet.
- Food Security will play an increasingly important role in public policy decisions that ensure the most vulnerable members of the world's community can find food.

Smith's Political Event Risk Model

- United States is a bread basket nation. And, the development of high-yield, disease resistant crops can help advance the green revolution to feed the growing population.
- There is some cause for optimism because the U.S. can provide thought leadership and technology transfer to ensure food security.

Smith's Political Event Risk Grading

- Corn and Soybean States (+1) Positive
- Wheat, Barley, Cereals (+1) Positive
- Food and Kindred Products (+1) Positive
- Bulk Carriers (+1)
- Grain Ports (0) Neutral
- Alternative "Grain" Energy Plants (-1)

Smith's Research & Gradings

Smith’s High Yield Gradings

Financing Prisons and Jails

- Crime and Punishment
  - 3.3% Error In Conviction Rate
    - Rising Restitution Costs
  - Recidivism Rate 67.5%
    - The recidivism rate for prisoners released from prison within one year is 44.1%; this number rises to 67.5% within three years of being released from prison. Sixty-seven percent of the people who were rearrested were charged with 750,000 new crimes, which include property offenses, drug offenses, public-order offenses, other offences, unknown, and over 100,000 of these crimes were violent crimes. Of the new violent crimes committed, 2,871 were murder and 2,444 were rape.
  - Costs Are Rising -- $45,000 a year per prisoner in California
  - Implications of Pandemic on Prisons

Smith's High Yield Gradings

Tobacco (FX Model) Smith's Tobacco Gradings build on the role of relative prices in a portfolio balance model. The relationship between black markets for cigarettes and smuggling is first analyzed from the perspective of an individual importer. According to the portfolio view, the black market rate behaves like the financial rate in a dual market. The premium of the black market rate over the official rate is thus related to the probability of success in smuggling and the tariff. Then the black market is analyzed using a simple three-good,two-asset general equilibrium model. Under the assumption of regressive exchange rate expectations, the portfolio view is contrasted with a monetary approach to the black market. The short-run and long-run effects of monetary and exchange rate policies on relative prices are assessed. Different assumptions about expected returns are contrasted, but emphasis is placed on the perfect foresight case. Unless expectations are static, official exchange rate policy has to adjust to the private valuation of cigarettes, as stressed in the conclusion.