ProfitScore® IQ

The Liquidity Crunch
Will This House of Cards Crumble?

July 27, 2007
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Dear Subscriber:

Is the housing market finally starting to slow down the equity market? The answer is yes, but the cause and effect is different than the media would have you believe.

The media's headlines this week highlighted gloomy comments from Countrywide's CEO stating that the housing market will not find a bottom until at least 2009. Many of the largest home builders reported terrible earnings and equally scary forecasts.

Is the real estate gloom the catalyst that sent the global equity market into a tail spin this week? In a word, "No." The market has an even greater and more ominous concern—illiquidity.

Money managers like me are paid to worry. We're paid to manage your risk and protect your precious capital, and the one thing that keeps every one of us up at night is the fear of illiquidity, of the global capital markets being unable to access and thrive on the one thing they need like we need oxygen—access to a free and steady flow of capital, preferably inexpensive capital.

Today's market, until recently, has been fueled by a nearly unprecedented flow of capital, one could almost say, "easy money." There has been money to buy homes and fuel the construction industry. There has been money to finance the boom in private equity deals and money for leveraged buyouts and stock buy backs and for major corporations to take themselves private.

And so the market has been happy. Until just recently. And now the talk on the Street is a drying up of capital, a constriction of liquidity, and that's why so many of my peers are showing up to work with dark circles under their eyes.

And this is because practically every major correction or bear market can be traced to illiquidity.

It was illiquidity that turned the crash of 1987 into a blood bath and prompted the Fed to step in on Tuesday morning after Black Monday with the plunge protection team and buy billions of dollars of S&P 500 futures contracts to pump liquidity back in the market.

When there is no one, or in our current situation, fewer buyers and even more sellers, the market can and will go haywire. So how can the real estate market be causing a liquidity crunch in the equity markets? It is because of the stinking cockroaches, the ever expanding sub-prime morass, that we discussed at length in our last letter. In case you missed it, here is the link http://www.profitscore.com/quarterly/ProfitscoreIQ_2007-Jul-9.pdf.

Let's take a closer look at the history of the last five years that brings us to where we find ourselves today.

The average yield on fixed income investments has been simply awful for several years. Since 2002, the average 5 year return on the Lehman Aggregate bond index has been a paltry 4.77%. In its never ending search for better yield and better ROI, Wall Street began loaning to more and more challenging credits. It finally reached the point where hedge funds and other large pools of liquidity were funding mortgage lenders directly and created what is currently called a sub-prime lender. I guess I should say was called a sub-prime lender because there are practically none left. The credits from these lenders were carefully packaged, disguised or hidden would be a better term, and sold to hungry investors looking for higher yields.

And now, to what should be no one's surprise, the fat lady has finally started to sing her last act and the lyrics are saying, "my friends, the "go-go" real estate ride is over."

<u>The high yield, bad credits aren't paying, houses can no longer be flipped, creditors are missing payments, buyers of these highly leveraged and mysterious credit default swaps are no longer happy campers, and flocks of attorneys are gathering like vultures to pick the bones of some really smart guys who live in the inner sanctums of some of the most venerable houses on Wall Street.</u>

Doesn't this sound like a tune we,ve heard before?

When junk bond investors start losing money, junk isn't as much fun as it used to be, and suddenly, the investors (speculators) want to be paid more interest to take on the additional risk of buying riskier credits. And therein my friends, lays the liquidity rub.

Higher rates lead to immediate and, one could say, harsh reactions.

On Monday this week, Expedia announced that it has slashed plans to buy back its own shares, blaming unattractive financing conditions in jittery credit markets. They had originally planned to finance a $3.5bn share buy-back of 25m shares – or 8% of its stock - with new debt but their grand plans ran aground because of fears that the US sub-prime mortgage crisis could spread to other asset classes.

There have been other such announcements from other companies because it has been common practice to float debt to buy back existing shares of a company's stock. When interest rates were low enough, it made perfect financial sense. But now, rates are much higher thanks in part to a jittery credit market caused by extreme leverage and the bad idea of loaning perfectly good money to people that have a bad habit of not paying their bills.

This credit crunch will also spread to the arena of multi-billion leverage buyouts which literally have been happening every single day. The credit crunch will cause these lucrative, high profile deals to wither, die and blow away like dead leaves in a desert wind because of limited financing options. In other words, cheap credit has indirectly been propping up an equity market by pumping artificially high amounts of credit/liquidity into a market that is priced for perfection.

With fewer buyers, the sheer weight of the market cannot be supported and the inevitable result that's just as sure as night following day is a market correction. With the exponential growth of leverage in the form of derivatives, the ride could range from somewhere between terrifying to at least very bumpy.

Derivatives revisited

In our last letter, link provided above, we took a brief excursion into the mysterious and complex world of derivatives and saw how quickly the Over-the-Counter (OTC) derivatives market has grown over the last decade.

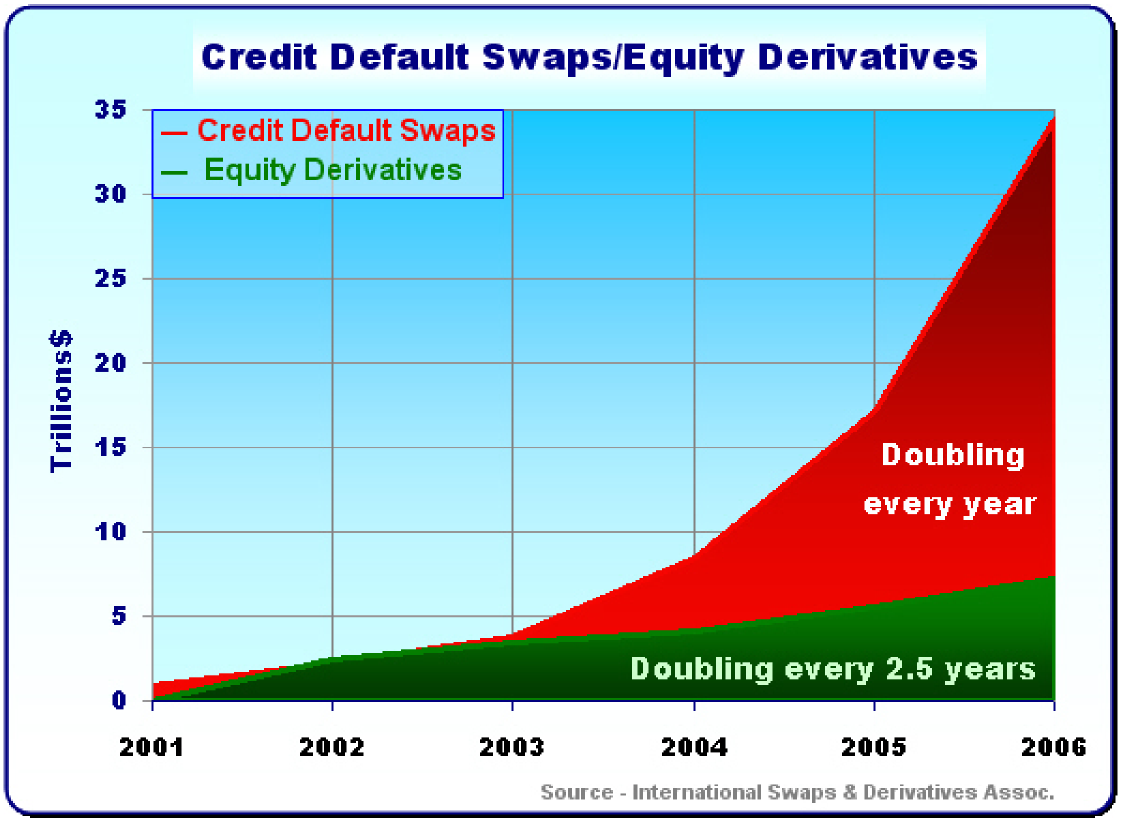

Figure 1 – Chart showing rapid growth in credit default swaps (CDSs) compared to equity derivatives. <u>Between 2005 and 2006 CDSs doubled from $17.1 trillion to $34.4 trillion which demonstrates how quickly they've become popular since their initiation in 2001.</u>

As we discovered, the rate of global growth for derivatives has continued at a breakneck pace. Total OTC derivative dollar volume is expected to surpass $500 trillion by the end of 2007. As we see from Figure 1, credit default swaps (CDSs) are the fastest growing derivative segment and at the current rate of growth they are set to total nearly $70 trillion by the end of the year.

Taking the pulse of the sub-prime market

If you're like me, you've been hearing increasing references to the ABX indexes used to track sub-prime mortgage bonds. The ABX-HE indexes are windows into the shrouded world of sub-prime mortgages and let us take the pulse of that segment as well as open a window to look into the strength of the overall housing market.

Before asset-backed-securities (ABS) existed, investors wanting to play the commercial mortgage game had few options. Shorting a position or obtaining insurance in the form of a credit-default swap (CDS) were out of the question. Enter the asset-backed credit default swap or ABCDS that allowed investors to do both.

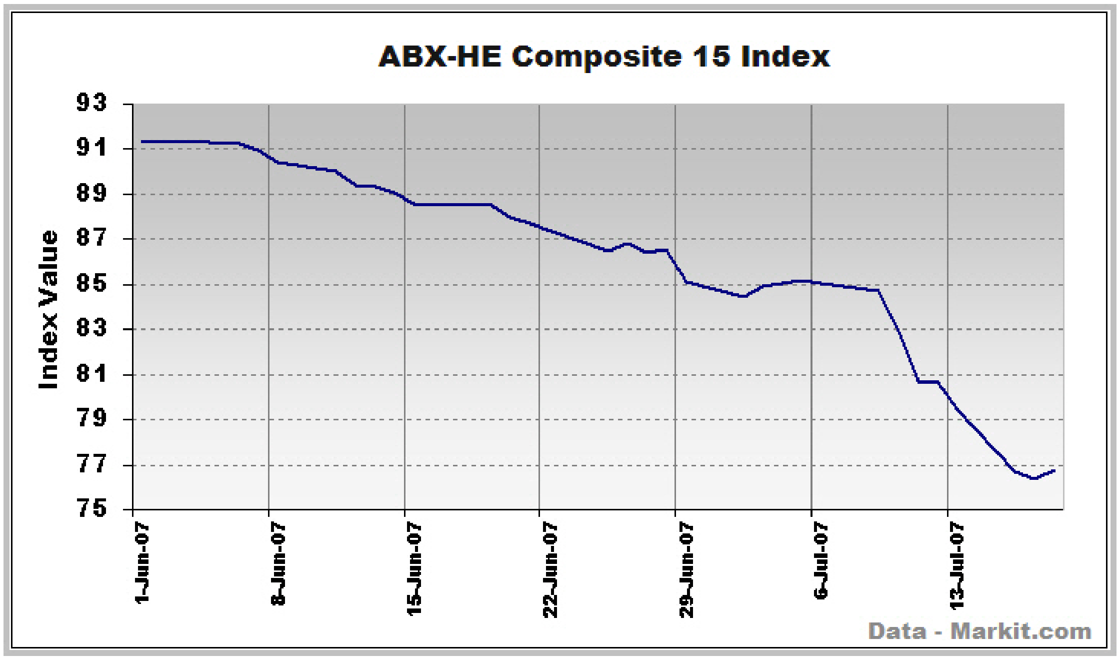

Figure 2 – Composite chart of the fifteen mortgage-backed securities sub-prime credit default swaps (CDSs) contract indexes available since January 2007 from AAA (Figure 3) to BBB (see Figure 4) tracked by Markit.com. As a group, they are down 23% since initiation on January 1 and 16% since June 1 with the greatest drop occurring in the last two weeks.

An index provides a new window into the storm

Markit.com then launched a family of credit default swaps based on the U.S. sub-prime asset-backed securities called the ABX.HE indexes which provided derivatives investors with a new trading tool. But perhaps more important to the broader markets, a way of gauging the ongoing health of the sub-prime market and those investment banks, brokers, hedge funds and institutional investors that participated in it. Each ABX index was set with a value of 100 at the beginning of January 2007 and tracks different series of sub-prime mortgage bonds from triple A (highest rated) to triple B minus (lowest grade or junk).

In effect, ABX indexes measure the value of insurance policies held by those who collect a premium to insure the various traunches of CDO bonds in case of default (kind of like the folks that put up their assets to back Lloyds of London insurance policies in return for a small annual premium). While the market was humming along and defaults remained small, the ‘insurers’ collected their premiums and banked the healthy cash flow.

Until the end of 2006, there were more insurers who saw it as a way to make easy money than there were investors wanting coverage. As we see in Figure 3, the highest rated of this group have held up reasonably well. Since some CDO traunches contain as many as a million separate mortgages, a few defaults here and there were no big deal.

But problems arose when defaults began to occur en masse. As we see in Figure 4, insurers backing the lowest grade triple B CDS have been getting hammered. Since January, (Friday's close was 42.10) these low grade CDS have dropped nearly 60% in value. But for those seeking to buy insurance on triple B minus CDOs, it also meant that insurance costs had more than doubled in just seven months.

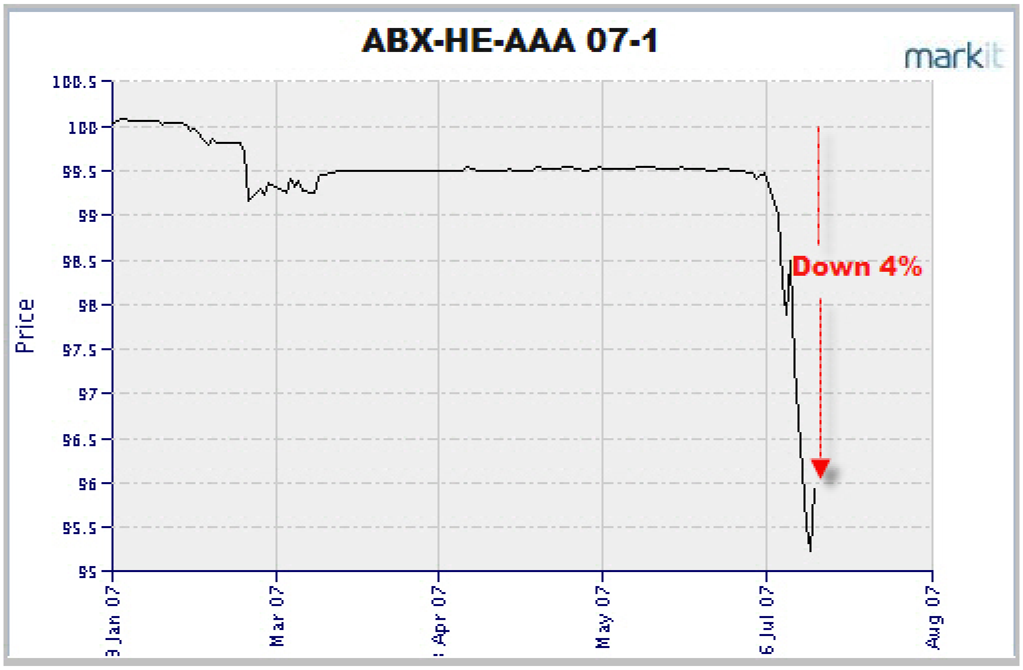

Figure 3 – ABX triple A index representing the value of the highest level of sub-prime mortgage-backed security CDSs showing the recent drop in light of the Bear Stearns hedge fund revelations.

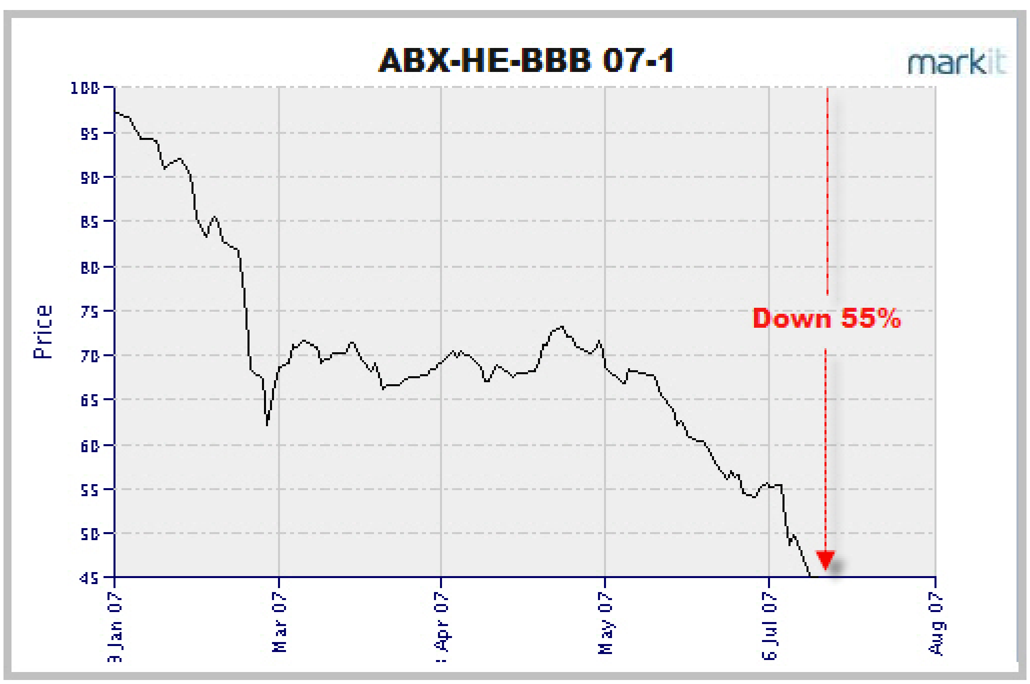

Figure 4 – Chart of the index of the triple BBB minus or riskiest subprime mortgage CDSs showing the gut-wrenching drop since the beginning of the year. Wonder how far above zero this index will level out?

Paying more than double for insurance on a triple B sub-prime investment than it cost at the beginning of the year may sound expensive but it is no doubt a bargain for sub-prime CDO traunch holders looking for salvation, especially after the news this week that investors in two failed Bear Stearns sub-prime hedge funds will get little if any money back.

Miami melt prompts calls for a 30% price drop

And growing mortgage risks were made even more poignant this week with news from Miami, the national foreclosure 'epicenter,' that there are now 20,000 new condo units being built, up from 12,000 units in April (see Miami Condo Glut below). Just to give you an idea of how many that is compared to historic demand, in the decade leading up to the year 2000, the Miami market absorbed an average 1,000 units per year.

This building surge has prompted industry experts to forecast price drops of 30%, but amazingly, new projects keep popping out of the ground at a frenetic pace. This situation promises to get more interesting by the week.

What the ABX-HE indexes provides is a way of taking an insider's look at the sub-prime market. These indexes greatly increase the transparency of those complex sub-prime derivatives and make it easier for investors who are considering participating in that market. Indexes also provide the additional benefit of making it more difficult to keep future failures out of the public eye.

We will be checking in on the fifteen ABX indexes in Figure 2 to track how they are doing in future issues along with another five indexes issued this week by Markit.com that provide an even more in-depth look at the sub-prime market.

The markets hate, and I mean hate, uncertainty. The recent volatility in the equity and fixed income markets is being caused by the market's nervousness over the uncertain fallout of this incredibly leveraged market.

A good friend of mine who runs a $250 million dollar fund of hedge funds suffered his worst monthly loss to date because of his exposure to the subprime market. I can tell you for sure that he isn't sleeping well and that he has lots of company in the wee hours of the night.

It all adds up to lots of very nervous fingers twitching on the triggers of some very large pools of capital.

ProfitScore Performance versus Our Benchmark Indexes

I am pleased to report that our performance for July is currently exceeding all previous months since our launch. If our portfolios continue to perform at their current pace, you and I will both be happy with your account(s) performance at month's end.

We update monthly performance numbers once per month in our month end issue that is published shortly after the 5th of each new month.

<u>What's most important to note is that we continue to experience about 1/3 of the downside volatility of the overall equity market while achieving equity-like returns. As we continually remind everyone we know, our job is to manage your risk and structure our portfolios with the goal of making money for you in both up and down markets.</u>

In case you didn't get a chance to review our performance through June here are PDF links to each portfolio's performance page.

http://www.profitscore.com/income_builder.pdf
http://www.profitscore.com/harmony_plus.pdf
http://www.profitscore.com/the_guardian.pdf
http://www.profitscore.com/the_expedition.pdf

<u>If You Are a Client, Don't Be Confused.</u>
Actual management and performance fees are incurred monthly but are deducted from client accounts in the first month of every quarter (January, April, July, and October). For performance reporting purposes, we deduct fees monthly as they incur and not quarterly as they are reflected in client statements. It all washes out in the end but this may cause your account performance to deviate from our published performance reports on a month-to-month basis. To be conservative, we also deduct the maximum fees we charge from our performance reports and your actual overall fees paid may be less than our maximum.

Tactical Trading Summaries

<u>Index Advantage:</u>

Our cumulative long/short index allocations have ranged from flat, net short to net long. <u>Volatility continues to increase and that is generally good for our portfolios. Volatility is the coal that feeds our fire. Month-to-date our team of specialized traders have been able to capitalize on this opportunistic trading environment.</u>

We were way ahead of our benchmarks going into this week. The Expedition was down this week but only a fraction compared to the overall market.

<u>Strategic Balance:</u>

Our rotational strategies have added positive gains to the portfolios this month. It has been a challenging month for these strategies but our traders have weathered the recent storm well.

Income Advantage:

Remember the story I told last month about one of our best traders having one of his worst months? Well, this month, he is having one of his best months. Our long/short government exposure is earning its keep and helping us wage war against the volatile storm. Overall, fixed income markets continue to be as nervous as a cat on a hot tin roof.

The important take away here is that the multi-manager concept is sound and rock solid, especially during periods of market stress. When one manager falters, the other 12 are there to carry the ball and help you reach your financial goal line.

Exposures Change Often.
Some of our traders trade daily, some weekly and some monthly, so when you aggregate all this activity into one account, some change almost always occurs on a daily basis. In other words, any portfolio's composition today can be completely different tomorrow. All of our portfolios are invested across one or more of the three pillars of strength highlighted above. Each pillar is comprised of several different strategies/managers that work together in a synergistic fashion. To enhance the consistency of performance, all strategically built and tactically managed ProfitScore portfolios leverage the uncorrelated talents of multiple investment managers to mitigate the manager specific risk found in all single manager portfolios.

14 Years, fishing and the hunt for cooler temperatures

Without question, the best sales job I have ever accomplished was convincing my wife to say "I do." I still can't believe that her father let me date her or that I actually convinced her to fall for me. My wife and I are high school sweethearts, and we recently celebrated our 14th wedding anniversary. We dating for eight years and didn't get married until we both graduate from college, so we have known each other for a long time. She will be the first to tell you that the trick is to get them while they are young so you can train them, and in my case, that was certainly true. Of course, I say the same thing when she is not around.

We both enjoy the outdoors and so to celebrate a wonderful 14 years of marriage and to avoid Boise's smoking hot weather, we are taking the kids and heading up into the mountains to one of my favorite get away places, Bear Valley Idaho, population 0.

Bear Valley is a high mountain valley that has the last all natural (un-stocked) Sockeye salmon run in Idaho. In case you haven't looked on the map, Idaho is a long way from the Pacific Coast and as a river runs, the distance must be at least a 1,000 mile swim. The river is also full of Brook Trout and seasonal Bull Trout that run up the Middle Fork of the Salmon River to spawn. In other words, there are lots of fish to see and many fish to catch.

After a tough day on the river, I know I can look forward to a great meal as my wife is a wonderful cook. My favorite dish is anything she cooks in a sheep herder's stove which can range from fried eggs to an upside down pineapple cake. I hope that one day soon you'll be on a multi-day white water river trip on one of Idaho's many rivers and feasting on whatever your guide has prepared with his trusty sheep herder's stove.

I'm not sure what I'm looking forward to more this weekend; fishing, hiking, my wife's famous outdoor cooking or acting like a bear and making my kids scream. I can't wait to get settled into camp.

Our sophisticated multi-manger portfolios are starting to gain notice with large institutional investors. Here is a recent article from www.finalternatives.com discussing our Unified Hedge Accounts™. Their web site requires you to be registered, so here is a PDF of the article uploaded to the ProfitScore web site http://www.profitscore.com/downloads/finalternatives_article.pdf. If you know anyone who may benefit from having their money managed like it was in a sophisticated hedge fund but in the safety and security of a separately managed account, we would welcome an opportunity to bend their ear.

Have a great weekend wherever your travels take you. Summer is short and sweet so try to soak up every second of it that you can.

Working to grow your wealth,

John M. McClure
President & CEO

ProfitScore's asset management programs generally involve above-average portfolio turnover, which could negatively impact upon the net after-tax gain experienced in taxable accounts.

Each client and prospective client agrees, as a condition precedent to his/her/its access to ProfitScore's web site, to release and hold harmless ProfitScore, its officers, directors, owners, employees and agents from any and all adverse consequences resulting from any of his/her/its actions and/or omissions which are independent of his/her/its receipt of personalized individual advice from ProfitScore.

We encourage readers to review our complete legal and privacy statements on our web site at http://www.profitscore.com/consumer_disclosures.html.
