

July 31st 2013

The correction in the U.S. equity markets that many, including us thought would materialize in the second quarter failed to occur. Aside from a handful of nerve racking days in late June, including multiple triple digit swings, all the leading indices were in the black for the quarter. The technology laden NASDAQ was the best performer advancing by 4.15%, while the S&P 500 trailed the pack gaining a respectable 2.91%. The gains established in the second quarter coupled with the stellar results posted by all the leading indices in Q1 were among the best six month totals recorded in many years. For example, the S&P 500 stock index posted a first half gain of 13.82%, the best since 1998.

However there was considerable bloodletting in other asset classes. The Barclay's Investment-Grade Corporate Bond Index plummeted by 3.3%. The Barclays Municipal Long Bond index fared even worse dropping 4.4% in June alone, its worst monthly decline since September 2008. Those of you that have been reading our quarterly missives know we have been warning about a bond bubble for quite some time. **Unfortunately, a great many investors still do not understand the enormous underlying risk that remains in investing in debt instruments of medium to long duration.**

PRICE OF GOLD



Gold prices plummeted 23% in the second quarter, the biggest quarterly decline since trading of U.S. gold futures began in 1974. Emerging Markets also took it on the chin, as investor concerns focused not only on rising interest rates, but also on a less than robust Chinese economy, as well as political unrest in Turkey and Brazil. The MSCI, EM stock index, which is widely used to measure stock performance in emerging markets, dropped 9.1%. Even the gains captured in the U.S. equity market during the June quarter did not lift all sectors. Money was lost in telecommunications, consumer staples and utilities. The S&P Utilities Index, for example lost 3.7%.

We were quite pleased with our performance both for the quarter as well as year to date especially given our already high cash position. During the quarter we tendered the shares of Heinz we owned in client accounts to the acquiring partnership, realizing a healthy profit. Heinz shares in many accounts were a substantial position and added even more to our cash reserves. Two other material events transpired during the quarter which positively impacted our portfolios. David Murdock, Dole's octogenarian Chairman announced that he wants to take the company private at \$12 per share. In addition, it has been rumored that Saks Fifth Avenue has put itself up for sale and has hired Goldman Sachs as its investment banker. Stay tuned...



A look ahead

History has taught us that as interest rates rise stocks become a less compelling investment. We saw what happened in June when the Federal Reserve Chairman indicated that the \$85 billion a month asset purchase program might be lessened in the not too distant future. He went out of his way to say lessen, not eliminate, and this would be done only if economic conditions warrant such action. He continued by indicating that if the medicine was too strong, and hindered economic growth, the Fed would reverse course and reaccelerate the asset purchase program. And yet, the market swooned shortly thereafter, sliding by more than 7%, before recovering.

We have never seen a major central bank exit a quantitative easing of this size. So, we frankly do not know how markets will react. How the Federal Reserve telegraphs a change in its accommodative stance is crucial to the future direction of the market. In 1994 a sharp unexpected rise in interest rates wrecked the value of bond portfolios. Hedge funds blew up, banks plunged into the red and the resulting shock waves even hurt the equity markets. So, our best guess is since we are in uncharted waters, expect a spike in volatility in the coming quarters.



One last thought, even with the recent spike in interest rates, they are still at historically low levels. They would have to rise materially from here to stifle economic growth. For example, even with the recent pick up in housing and home prices, single family homes in a great many parts of the country are quite affordable. The rate on a 30 year fixed mortgage jumping from 3.5% to 5% should not impede a buyer from purchasing a home. Stocks are clearly not nearly as cheap as they were in 2009, but they are not blatantly overvalued either. They still remain, on a relative basis the cheapest asset class that we can think of.

*Some of the riskiest investments we observe at this time are companies that rely heavily on China for their profits. While the Chinese economy is still growing rapidly, this growth has slowed considerably since 2007. While China could be a profitable place to invest for people with a long-term horizon, we believe there will be significant bumps along the way. That is why very few companies that Boyar Asset Management invests in rely heavily on China for a large percentage of their profits. One of the biggest risks of investing in China is that we believe there is a property bubble unfolding there that could be of a greater magnitude than the one the U.S. recently experienced. This could have tremendous negative repercussions for the Chinese banking system, which would then affect their overall economy. One of the biggest dangers in our opinion is the "wealth management" products that are being sold by Chinese banks to wealthy individual investors as part of the Chinese "shadow banking system." **By the end of last year, China's shadow banking activity was valued at \$6 trillion twice what it was in 2010 and currently equal to 69% of China's gross domestic product.** Below is an excerpt from a recent New York Times article that discusses the questionable loan practices that Chinese banks are currently undertaking and the potential consequences of this practice.*

Loan Practices of China's Banks Raising Concern

Shanghai— Text message solicitations began arriving on the mobile phones of many of China's wealthy last month, promising access to lucrative wealth management products with yields far above the government's benchmark savings rate. One message read: "China Merchants Bank will issue a high interest financing product starting from June 28th to 30th. The product will be 90 days with a 5.5% interest rate. Please call us now." A day later came another. "Warm reminder: The interest rate of yesterday's product has been raised to 6%. (Product duration is 90 days). There is limited access to this product. First come first served." The offers are not coming from fly-by-night operators but some of China's biggest banks. They are raising huge pools of cash to finance a relatively new and highly profitable sideline business: lending outside the scrutiny of bank regulators.

The complex way they go about making off-the-balance-sheet loans is at the heart of China's \$6 trillion shadow banking industry, which the government is now trying to tame. Efforts to rein in the dodgy lending practices rattled stock markets worldwide in late June. China's regulators — and a fair number of economists, policy makers and investors — worry that legitimate banks are using lightly regulated wealth management products to repackage old loans and prop up risky companies and projects that might not otherwise be able to borrow money.

Analysts warn that shadow banking is helping drive the rapid growth of credit in a weakening economy, which could lead to — in the worst situation — a series of bank failures. "This is the biggest uncertainty I've seen in my 18 years following the China market," Dong Tao, an economist at Credit Suisse, said of shadow banking. "You don't know how banks are deploying capital. And you don't know the credit risks."

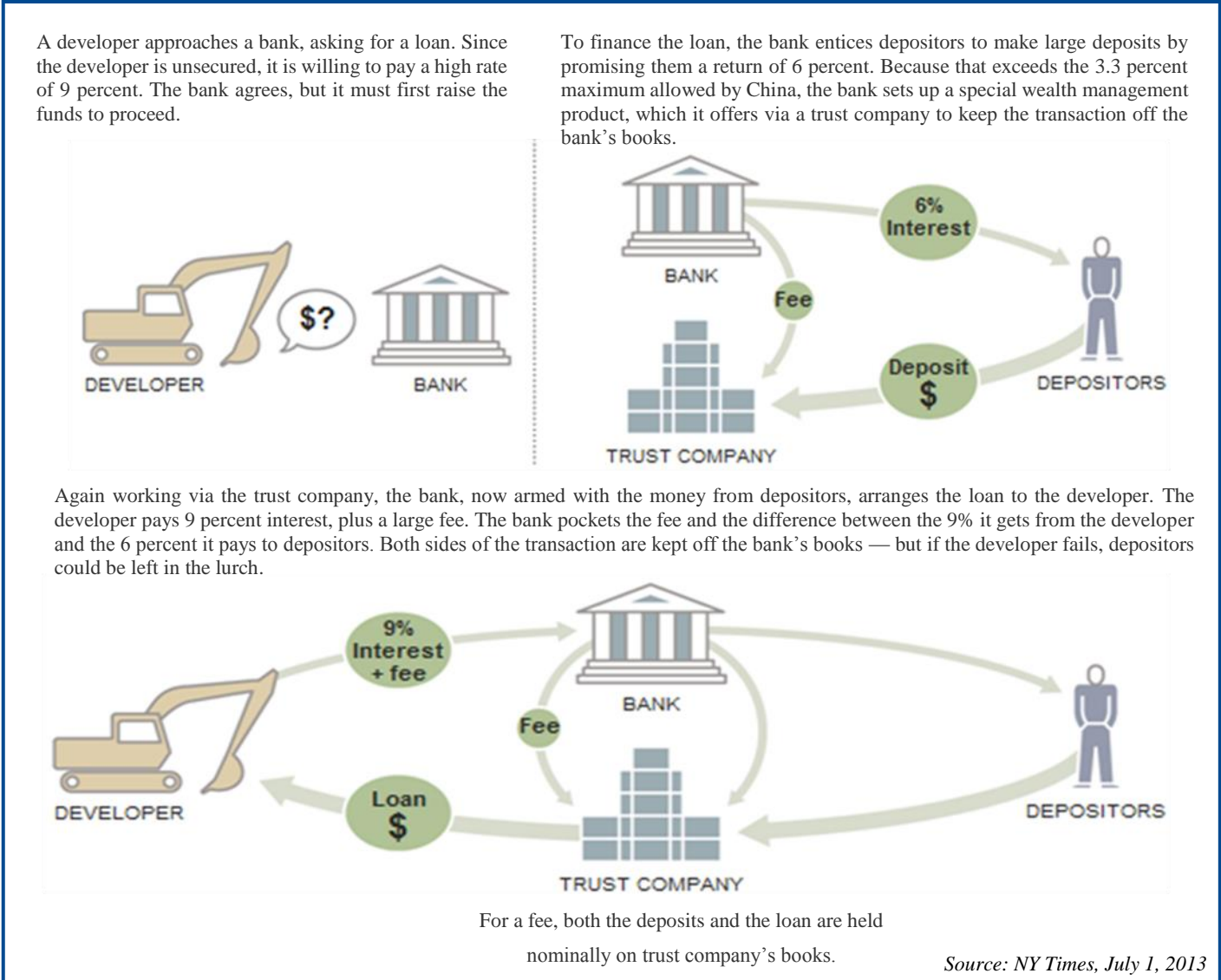


What banks are doing, analysts say, is pressing customers to shift money from the old, regulated part of their operations — savings deposits — into the new, less regulated part consisting of high-yielding wealth management products that can circumvent government interest rate controls and be used to finance high-interest loans to desperate customers. China's leaders are so worried about credit risk that last month the country's central bank tightened credit in the interbank market, where banks typically go to borrow money from other banks.

The move sent short-term interest rates soaring, and for a day at least, created a debilitating credit squeeze. The stock markets in China calmed down last week. But financial institutions are hinting that cash is still hard to come by. Some banks temporarily suspended lending in order to preserve cash, according to Caixin, the Chinese business magazine...

Many of the investments pay 6 percent annual interest, which is far above the highest savings deposit rate set by bank regulators: 3.3 percent.... Though the products are popular, their disclosure is often poor. Bank employees insist the principal is guaranteed, but contracts for wealth management products are usually vague, simply noting there could be risk. Most offer little detail about where the money will be invested. Much of the money, analysts say, is lent to property developers and local government financing vehicles, areas that have government officials worried because of an explosion in property development and soaring housing prices. Regulated banks will not make the loans because the borrowers are too risky.

So the loans are often made off the balance sheet, and therefore outside the purview of bank regulators, which is why experts call it shadow banking. They are made at higher interest rates, so everyone wins — the borrower, the banks and the investor of the wealth management product — as long as the borrower repays. “The banks now have these dark pools of money,” said Joe Zhang, a former investment banker and the author of “Inside China’s Shadow Banking: The Next Subprime Crisis?” He said, “to finance deals they usually have a trust company stand in the middle and simply put their stamp on it. The trust companies get a fee for that but often they do next to nothing. The bank does all the work...”



By the end of last year, China’s shadow banking activity was valued at \$6 trillion, twice the level in 2010, and now equal to 69 percent of China’s gross domestic product, according to a report released in May by JPMorgan Chase. Now, even state-run banks are doing shadow lending, extending financing to companies in high-risk sectors.

Who is responsible for the loans is not always clear, and that’s where everyone starts getting nervous. “If a wealth management product defaults, who is on the hook?” asked Michael Pettis, a finance professor at Peking University in Beijing and senior associate at the Carnegie Endowment for International Peace. “It’s all very murky. In these things, the banks are technically acting as intermediaries.” Financial experts worry about the lack of transparency in the market when China’s economy is weakening. They also fret about whether some borrowers have the cash flow to repay their loans.

Fitch Ratings, the credit ratings agency, began warning two years ago that “wealth management activity carries unique liquidity and credit risks.” But the lending continued and increased. In a newspaper opinion piece last year, Xiao Gang, then head of the Bank of China, a leading commercial bank, and now the nation’s top securities regulator, referred to shadow banking as “fundamentally a Ponzi scheme.” The government has so far tolerated shadow banking because getting rid of it is all but impossible, analysts say. Wealthy customers are accustomed to getting better returns, and a large segment of the economy is desperate for capital and cannot easily gain access to regular bank loans, largely because of government restrictions. But they are willing to pay the shadow banks 9, 10, even 15 percent interest.

And to make that possible, China’s banks are raising pools of capital and creating increasingly complex financial instruments with outside institutions to make off-the-books loans to those willing to pay a premium. Perhaps the biggest worry, though, is that this booming practice could be undone by a major business failure that forces bank customers to suffer losses. “This is a major problem,” said Ding Shuang, a Citigroup analyst based in Hong Kong. “Many of these are just three months, and they need to be rolled over. So if there’s a default that could change things. This is a problem regulators are very aware of.”

Excerpt from The New York Times 7-2-13

*We have been warning of the dangers of fixed income investing (particularly bonds with long maturities) for quite some time. We have argued that investors do not understand the risk they are taking by stretching for yield. Our thesis was and continues to be quite simple. Interest rates are historically low, and this low level of yield is unsustainable in our view. Especially when you take into consideration the amount of money the government is currently printing. In May after many years of constantly being proven wrong, the fixed income market finally took a beating, wiping out years of interest payments from investor’s bond portfolios. While we understand that investors want income, it is infinitely more important to protect your principal. Now that investors have seen that the fixed income market is not immune from losses, we think individuals may start to withdraw from their “safe” bond funds which could cause more selling pressure for that asset class. **We believe high quality dividend paying stocks with the ability to raise their dividend higher than the rate of inflation could be a beneficiary of this trend.***

A Bond Market Plunge That Baffles the Experts

As if it wasn’t bad enough for the millions of Americans scraping by on paltry interest payments, now they face another threat: the loss of principal on their bonds and other fixed-income assets. The month of May, and this first week of June, were terrible for many fixed-income investors who have spent the last few years reaching for higher yields. If there was an index for fixed income with the status of the Dow Jones industrial average or Standard & Poor’s 500 index for stocks, the carnage in fixed-income markets would have been a big story and we’d all be talking about a bear market in bonds.

Consider the damage: mutual funds that invest in long-term United States Treasury bonds lost an average of 6.8 percent in May, according to Morningstar, with the loss in principal wiping out years of interest payments {emphasis added}. But that’s not the worst-hit sector. Higher-yielding bonds and fixed-income securities, to which investors have turned to in droves in recent years, have suffered even more, especially mortgage-backed securities and emerging market debt, as well as just about anything that uses borrowing to increase returns.

Many individual securities and funds were hit much harder than the averages. Vanguard's Extended Duration Treasury Index fund was down more than 6 percent in the last month. In the mortgage area, Annaly Capital Management, a popular real estate investment trust that invests in mortgages, fell 8.7 percent, and an iShares mortgage exchange-traded fund lost 10.4 percent. Pimco's Corporate Opportunity Fund, which is managed by the star analyst Bill Gross and which invests in a mix of corporate bonds and mortgage-backed securities and uses some borrowing, lost nearly 13.4 percent. Annualized, such declines are off the charts...

The severity of the market reaction shows how skittish investors have become about ultralow interest rates. Bond prices fall when interest rates rise, with longer-maturity, higher-yielding and riskier bonds the hardest hit — the very assets that the Federal Reserve's ultralow interest rate policy has encouraged income-seeking investors to embrace.

Fixed-income funds are where investors have traditionally looked for safety and low volatility, unlike stocks, and such precipitous moves are rare. To put this in perspective, the recent plunge in prices of fixed-income securities had analysts reaching back to 1994, when the Fed began raising rates and 10-year Treasury rates rose two and a half percentage points. That year, Orange County, Calif., had to declare bankruptcy after its bond portfolio plunged in value.

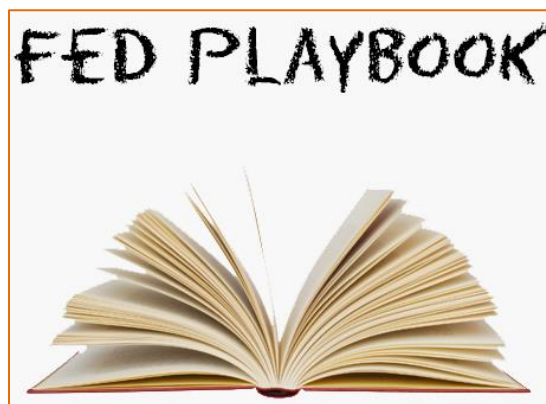
The sudden recent moves in the markets have left many experts scratching their heads, because, on the face of things, not much has changed in the overall economic outlook. This week's employment number — American employers added 175,000 new jobs in May — was the average rate for the last year, suggesting slow but steady growth in the economy. Other measures released in May, like consumer confidence, consumer spending, and personal income, were generally positive, but nothing to suggest any imminent surge in economic growth.

"Last week's sell-off was very indiscriminate," said Jonathan A. Beinler, chief investment officer for global fixed income and liquidity at Goldman Sachs Asset Management. Added Mr. Baruffi, "I was surprised at how severe the market reaction was." After all, the Fed hasn't actually raised rates, as it did without any advance warning in 1994. But all it took this time was the merest hint from the Fed's chairman, Ben S. Bernanke, that the Fed's quantitative easing policy might be tapering off sooner than expected....

The sell-off in fixed income began slowly on May 10, an otherwise uneventful day with no obvious catalyst for any change in sentiment. It picked up steam when Fed sources didn't step forward to calm markets. Then, in comments to Congress on May 22, Mr. Bernanke said, "We could in the next few meetings take a step down in our pace of purchases."

That set off alarm bells, in contrast with his prepared text, which gave no suggestion that the Fed's policy would change so soon. And then, the minutes of the Fed's May meeting suggested that some Fed governors were prepared to start tapering off bond purchases as soon as the Fed's next meeting, which will be June 18 and 19. Near-panic selling in some markets ensued.

"When you get a fundamental shift in interest rates, which doesn't happen very often, the initial move is always pretty dramatic," Mr. Cohn said. "It's a move from a lower rate world to a higher rate world, and people try to get ahead of it." Mr. Beinler added: "The concern is that the Fed is taking away the punch bowl and taking liquidity out of the market. The increase in liquidity has been a big driver of these markets, and as the market gets its head around these things, it follows that those markets will weaken..."



Whether or not the current sell-off continues, the plunge has startled investors who may not have realized how much risk was embedded in their portfolios. “The only thing I guarantee for sure is that someday we will have high interest rates again,” Mr. Cohn said. “It may take 50 years, but rates are going to go higher. We have an entire generation of investors who have never experienced a rising rate environment.”

Mr. Beinner said investors need to reconsider their traditional fixed-income allocations, nearly all of which carry interest rate risk. “It’s an asset class with a negative expected return without any other positive offsetting properties. So why have it as a part of your portfolio?”

He said the simplest and safest approach is simply to park funds in a low-volatility money market fund and accept near-zero returns. There are also floating-rate funds, which invest in floating-rate bank and corporate loans as a way to protect against rising interest rates, at least in theory. But there has been a recent rush into these funds, and the risks may not be clear to investors. Their track records are relatively brief, and it’s not clear how they’d react in another financial crisis...

There are also so-called unconstrained bond funds, like Goldman’s Strategic Income Fund, of which Mr. Beinner is a manager. His fund uses hedging strategies to minimize interest rate risk and can seek opportunities around the globe. (He says he thinks emerging market debt is undervalued.) But returns on such funds depend on the skills of their managers. “I’ve been hearing from a lot of worried baby boomers,” Mr. Baruffi said. He recommends a cautious approach, which means accepting low returns for now in return for safety. “People need to be patient,” he said. “This is no time to reach for yield. What people need is a bomb shelter. There’s no return on those, but if the market continues to drop, you’ll be happy and you can reinvest at lower prices.”

The next two excerpts discuss the always frenetic Manhattan real estate market. The first article highlights the dramatic contrasts in value within New York City in terms of commercial real estate. Recently the rapid growth of New York’s tech sector has dramatically increased the rental rates in the “Midtown South” area. Areas that used to command \$20-\$30 per square foot are now fetching in some places over \$60 per foot. This is an interesting contrast with 6th Avenue which used to be one of the most expensive places in Manhattan to rent office space. For a variety of reasons, tenants have abandoned this area sending the vacancy rates higher and the rents lower. The next article discusses the boom in the residential condominium market in Manhattan. Historically valuable areas like uptown and midtown are currently seeing certain apartments sell for over \$90 million and some downtown areas which up until the last twenty years were not considered to be desirable places to live have apartments that are commanding prices of over \$40 million. In our opinion, the takeaway from these two articles is if you are a purchaser of real estate you must remember nothing is forever, and like purchasing a stock the most important factor in whether you make a successful real estate investment is the purchase price. The people who are presently buying \$40 million condos in downtown Manhattan should take note of what happened to developers who bought real estate on 6th Avenue at the top of the market in 2007.

A Slump on Sixth Avenue



Manhattan's Sixth Avenue used to command some of the highest office rents in the city thanks to the appeal of its hulking towers to big-name companies like Exxon MobilCorp., J.C. Penney Inc. and Time Warner Inc. But these days Sixth Avenue is getting hit by a double-whammy. On one hand, expanding technology companies are the biggest source of growth in the office market and these companies favor older buildings and hip neighborhoods.

On the other hand, Sixth Avenue has seen about a half-dozen big blocks of space come on the market from tenants moving, contracting or failing. More than 780,000 square feet of office space is available for sublease along Sixth Avenue, according to real-estate information firm CoStar Group Inc. The result: Rents on Sixth Avenue are anemic and vacancy is on the rise... "Large contingencies of sublease availability will, in general, drag down rents nearby," says Noam Shahar, research director at CompStak, a New York firm that tracks office leases.

The strongest evidence of weak rents came recently with the efforts by AXA Equitable to sublease roughly 300,000 square feet in the 2-million-square-foot office tower at 1290 Sixth Ave. The financial-services giant, which was represented by Jones Lang LaSalle, filled all the space by doing deals with tenants including Morgan Stanley, Sirius XM Radio and Remy Cointreau. But the rents those tenants are paying are in the mid-\$40-a-square-foot range, according to CompStak. That's well below what AXA is paying in rent, \$88 a square foot, according to statements made by the building's owner, Vornado Realty Trust, earlier this year...

But broader market statistics also don't bode well for Sixth Avenue. Overall the "availability" rate in the Sixth Avenue-Rockefeller Center market increased to over 14% in the first quarter of 2013, up from just over 10% in the first quarter of 2012, according to CBRE Group Inc. That rate includes vacancy and space coming on the market in the next 12 months. Tenants that are benefiting from this trend include law firm Zeichner Ellman & Krause, which subleased 42,000 square feet at 1211 Sixth Ave. from Ropes & Gray. Zeichner Ellman is paying rent in the low-\$50-a-square-foot range, well below the rent in the high-\$60-a-square-foot range that Ropes & Gray is paying, according to CompStak. Three blocks to the north, at 1271 Sixth Ave., Sandow Media is subleasing 40,000 square feet of space for 35% below market price, according to Newmark Grubb Knight Frank, which brokered the deal.

Meanwhile, in Midtown South, the neighborhood of choice for many technology companies, the picture is a lot different. In the first quarter, average rents increased 9%, passing the \$60 threshold for the first time, according to CBRE... Many of the towers along Sixth Avenue between 42nd and 57th streets were developed in the 1960s and 1970s during an era in which New York architects favored towers set back on spacious public plazas....



Many of the original tenants along Sixth Avenue, including Exxon and J.C. Penney, moved out. While they were replaced by others, the architecture along Sixth fell into disfavor, with the towers seen as sterile and inimical to street life. Today city zoning rules discourage such towers from being built. To be sure, the value of office towers on Sixth Avenue today remains strong along with other trophy Manhattan properties. For example, Montreal-based Ivanhoe Cambridge Inc. and a partner recently agreed to purchase a 49% stake in 1211 Sixth Ave. in a deal that values the Manhattan office

tower at about \$1.75 billion, according to multiple real-estate executives with knowledge of the deal. But these high values are being driven primarily by investors seeking yields in a low-interest rate environment. Rents and occupancy rates in Manhattan are still far from pre-bust levels...

Large space availability on Sixth Avenue could spell trouble for developers like New York-based RXR Realty, which took a gamble when the company signed a 99-year lease for 75 Rockefeller Plaza. The 33-story tower will be completely empty in 2014. But the company's executive vice president, William Elder, is bullish about the market on Sixth Avenue, which he predicts will get tighter in the coming year. He points to the AXA Equitable subleases as a sign of strength because the company succeeded in finding tenants for all of its sublease space in a short of amount of time. "People jumped on the opportunity and that space is all gone," says Mr. Elder. "That's a good sign." A lot of the available space in the area "is not a bad thing," he adds. "It gives larger tenants choices to locate on a great avenue."

Excerpt from the Wall Street Journal 6-17-13

Condo's Price is Straight Up

A penthouse atop a new condominium skyscraper that resembles a pile of haphazardly stacked boxes has gone into contract for \$47 million, a record for a condo sale below Midtown Manhattan. If the deal is completed, the purchase at a 820-foot glass tower under construction at 56 Leonard St. in TriBeCa would be the high-water mark in a strong surge of condo deals this year in marquee developments coming to market downtown.

Wealthy buyers, including many from nearby neighborhoods, have been snapping up many units in new developments, often based on floor plans and model show rooms, even for buildings that won't open for many months or sometimes years.... The building is essentially the same modernist tower designed by Pritzker Prize-winning architects at Herzog & de Meuron that went on the market just before the financial crash in 2008. Sales were soon halted then and the off-site sales center was mothballed.



But in February, the 145 apartments in the same 60-story building went back on the market in the same showroom that was closed in 2008. Since then 80% of the building has been sold, with sales totaling \$900 million to date, according to the developers. Asking prices are now 19% higher than they were in 2008, condominium plan filings show. At 150 Charles St., another new development that went on the market in February, all but one of the 91 condos is now in contract, according to Leonard Steinberg, a broker at Douglas Elliman, who is marketing apartments there. That building in the West Village has a more traditional design...

At Walker Tower, a condominium built in a 1929 telephone company tower on West 18th Street in Chelsea, about 80% of the 46 apartments have gone into contract, and the developers, JDS Development and Property Markets Group are preparing to list a 6,000-square-foot penthouse for \$55 million.

Mr. Steinberg said that the surging sales in new condominium towers shows that buyers in Manhattan are now more interested in light and air and views than the features in a particular neighborhood. "There is a huge premium people will pay for a view," he said. "Manhattan has become a lot less neighborhood specific." Still the highest prices in contract downtown lag behind those in the latest glass towers in Midtown, like One57

on West 57th Street, where two apartments are in contract for \$90 million or more and at 432 Park Ave., a slender tower on the corner of 56th Street where a high-floor penthouse was under contract for \$95 million, the developers say.

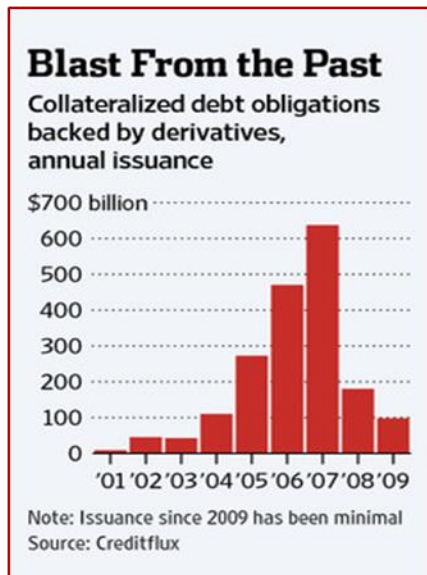
Kelly Mack, the president of Corcoran Sunshine Marketing Group, which is marketing the condos at 56 Leonard, said the duplex penthouse totals about 7,800 square feet plus more than 1,200 square feet of terraces. The space works out to about \$6,000 a square foot, far below sales at top buildings near Central Park. Still, she said that the pending sale highlighted a fundamental shift of buyer sentiment in favor of downtown buildings, where average prices have been rising. "The downtown market is one of the most talked about in the city," she said. "For the first time there are super prime luxury developments that are powering the downtown market."

Excerpt from the WSJ 6-26-13

It never ceases to amaze us how short investor's memories are. Two of the major causes of the financial crisis were due to poor lending standards on behalf of banks as well as what Warren Buffet famously called, "financial weapons of mass destruction." One of those "weapons" was a CDO or a collateralized debt obligation. It appears as if this type of security is making a comeback. The excerpt from the article below discusses the return of the CDO. The next article discusses how debt recently issued by corporations lack certain covenants traditionally designed to protect investors in these securities. Both of these are really disturbing trends in our view and must be monitored closely.

One of Wall Street's Riskiest Bets Returns

Investors are once again clamoring for a risky investment blamed for helping unleash the financial crisis: the synthetic CDO. In a sign of how hard Wall Street is trying to satisfy voracious demand for higher returns



amid rock-bottom interest rates, J.P. Morgan Chase & Co. and Morgan Stanley bankers in London are moving to assemble so-called synthetic collateralized debt obligations. CDOs give investors a chance to bet on the creditworthiness of a basket of companies. Basic CDOs pool bonds and offer investors a slice of the pool. Synthetic CDOs pool, instead of the bonds themselves, insurance-like derivative contracts on the bonds.

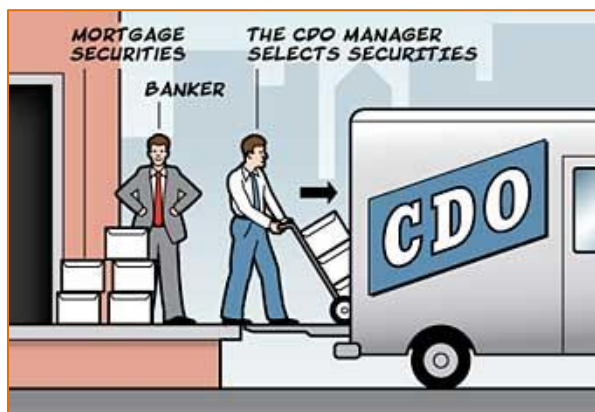
Like their crisis-era predecessors, the new CDOs would be sliced up into different levels of risk and returns. Investors who want a chance at the highest returns would have to buy the riskiest slice. While spreading risk in some ways, synthetic CDOs also can multiply the financial damage if companies fall behind on their debt payments.

During the financial crisis, CDOs pegged to soured mortgage loans caused losses to careen around the world.

Their catastrophic impact was denounced by many lawmakers and investors, and the market for all kinds of highly engineered financial instruments evaporated... A small number of institutional investors recently approached the two banks and asked them if they would put together the synthetic CDOs, according to people familiar with the discussions. The requests were made in London, a global center of derivatives trading. J.P. Morgan and Morgan Stanley now are trying to line up more investors as buyers for the instruments, said a person familiar with the talks. An investor usually buys just one slice of a CDO,

which usually is chopped into about six pieces. The banks likely won't proceed with the CDOs unless they can sign up enough investors.

J.P. Morgan and Morgan Stanley aren't expected to invest in their own deals because of post crisis rules that require banks to set aside large amounts of capital against possible losses on these types of investments. The interest by potential investors in new synthetic CDOs shows that demand for higher returns is intense, said Brian Reynolds, chief market strategist at brokerage firm Rosenblatt Securities Inc. "Wall Street will create new, more complex, more risky structures to satisfy that demand," he said.



In the peak year of 2007, financial firms issued \$634 billion of synthetic CDOs, according to data provider Creditflux. Sales fell to \$98 billion in 2009. Since then, some hedge funds and banks have worked together to bundle derivatives into custom-made trades, but those private deals were often small and weren't evaluated by credit-rating firms...

It isn't clear how much investors would stand to earn on the synthetic CDOs being assembled by J.P. Morgan and Morgan Stanley. Investment-grade corporate bonds now yield less than 5%. Efforts to pull off the deals show that banks and investors battered by CDOs during the financial crisis are increasingly willing to ignore bad memories in order to reach for higher returns. In markets ranging from commercial mortgage-backed securities to junk bonds, investors are eager to buy even the very riskiest investments, some of which now deliver yields of more 20% per year...

Investors are barreling into a related type of security tied to corporate debt, called collateralized loan obligations, or CLOs. So far this year, more than \$35 billion of CLOs have been sold in the U.S., while European issuance is equal to more than \$2 billion, according to Royal Bank of Scotland Group PLC. The synthetic CDOs being built by J.P. Morgan and Morgan Stanley differ from their predecessors in some ways. For example, one middle slice has been harder to sell than other pieces because it doesn't yield enough, some investors complain. Since the crisis, credit-rating firms have made it tougher for deals to get top-notch letter grades.

In another difference, buyers of the least-risky slices would get more protection against potential losses than buyers of similar slices did before and during the crisis, said people familiar with the discussions. Hedge funds are considered the likeliest buyers for riskier parts of the deals, which are the first slices to absorb losses.

Excerpt from the WSJ 6-4-13

Cov-Lite Loan Surge Fuels Fears

Investors are giving up many of the protections that have traditionally accompanied lending to risky companies, with the hunt for high-yielding assets shifting the balance of power towards borrowers. Many of the world's most highly indebted companies have been able to issue new loans without covenants, which limit the amount of debt they can take on or which give lenders a major say in the business if its results start to lag.

The proportion of so-called "cov-lite" loans has soared to more than 50 percent of all leveraged loan issuance so far this year, twice the level seen during the credit boom in 2007... Some strategists argue that cov-lite lending could be a "new normal", the wisdom of which will be tested in the next economic downturn.

Moody's, the credit rating agency, last week said it saw signs of a "covenant bubble" that poses dangers for loan investors when the US Federal Reserve begins to tighten monetary policy. Covenants typically set parameters that force a company to stay within a particular debt-to-earnings ratio, or keep earnings above a certain multiple of interest payments. If covenants are breached, creditors can insist on a financial restructuring, even if the company is not close to bankruptcy.

Record inflows this year into funds which buy loans, plus demand from leveraged investment vehicles called collateralized loan obligations, have sent loan prices sharply higher and shifted negotiating power to the issuers of loans... Moody's said cov-lite loans had typically been given to better-rated companies, but that the traditional relationship had broken down since February... So far this year, \$129bn of leveraged loans have been sold with cov-lite features, up from \$22bn in the same period last year, according to S&P Capital IQ data. Issuance was \$96bn for the whole of 2007...

Mike Kessler, credit strategist at Barclays, said the rise in cov-lite loans had raised a debate about whether covenants were actually a positive for lenders at all, since they reduce the amount of flexibility companies have to weather an economic downturn. Cov-lite loans from the pre-crisis era had not performed worse than those with covenants, he said, though this may be because previously only stronger companies were able to borrow without covenants. "Just because something worked on a small scale, does not necessarily mean that it will work on a large scale," Mr. Kessler said.

Excerpt from the Financial Times May 28, 2013

Email Trove is Big Job for Bush Library

Dallas—Along with the obligatory replica of the Oval Office, the George W. Bush Presidential Center will house a less conventional collection of presidential artifacts when it is dedicated here Thursday: Millions of emails. The one billion pages or so in electronic White House correspondence during George W. Bush's eight years in office are unprecedented in the history of presidential libraries, scholars said. They promise to offer an unvarnished look at the inner workings of the Bush administration that hasn't been possible for other presidencies. But first, the roughly 200 million emails have to be reviewed by the center's archivists, a process that could take a long time. With current technology, archivists can only review about 800,000 pages a year. "It's a fantastic resource," said Alan Lowe, director of the Bush library, located on the campus of Southern Methodist University. "Our challenge is, how do you preserve it? And how do you process it to make it available?"



The Bush library is at the forefront of a growing problem for the U.S. National Archives and Records Administration, the federal agency that keeps the nation's trove of historic documents. The digital stacks of information it has to process are rapidly expanding as more of the government's business is conducted via email. Presidential electronic records went from none during the Carter presidency, to less than one terabyte—one trillion bytes—during each of the Reagan and George H.W. Bush administrations, according to Sam McClure, deputy director of the National Archives' Office of Presidential Libraries. Electronic records then grew to 4 terabytes during the Clinton years, he said. The size of the electronic library at the Bush Center: 80 terabytes. "It really is the new frontier of archival practice," said Mr. McClure, of the task for the center's staff. "They're setting the stage for every other administration..."

In planning the library, Mr. Bush's instructions were: "Put out the facts. Show what happened, and let people decide," said Karen Hughes, who was a top adviser to Mr. Bush. Visitors have a chance to do just that in the Decision Points Theater. There, guests stand in front of screens and make their own decisions when presented with scenarios related to the war in Iraq, Hurricane Katrina and the financial crisis, as interactive displays allow them to heed or reject advisers' guidance....

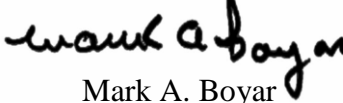
The emails, however, will only be accessible to the archivists working on them, at least initially. Starting next year, the public can request specific items under the Freedom of Information Act. While the National Archives has developed a massive storage system for electronic files, the agency is still looking for technology to sift through the documents more quickly, officials said. Each page has to be inspected—and redacted or withheld, if necessary for security reasons. In addition to the bulging electronic archive, workers also have to handle the more traditional papers that presidential libraries have dealt in since 1939, when Franklin D. Roosevelt created the first by donating his documents to the government.

The Bush Center alone has some 70 million pages in such memos, letters and reports. So far, the National Archive has gone through 45%, or some 315 million pages, of all the papers housed in presidential libraries, with about 385 million remaining. "Obviously, to be able to learn from our history, to avoid the mistakes of the past, they need to process those things more quickly," said Benjamin Hufbauer, an associate professor at the University of Louisville in Kentucky who wrote a book about presidential libraries.

A 2012 study by a congressional panel, the Public Interest Declassification Board, urged President Barack Obama to modernize the way the government analyzes documents and releases them to the public. In a previous report in 2007, it recommended that the National Archives hire more specialists to process presidential files. The Bush Center will have more archivists than some of its peers—16 compared to 10 at the Eisenhower library, for example.

Dan Mahaffee, who coordinates research at the Center on the Study of the Presidency and Congress, a Washington-based nonprofit group, said the emails will allow researchers to get into the minds of top officials as they developed policy, instead of relying on memos written at the end of the decision-making process. Still, he added, there are limits to the kind of information they may offer. "The president rarely emails," Mr. Mahaffee said.

If you have any questions or comments, please do not hesitate to call.

Best regards,

Mark A. Boyar