A Treasure Chest Beneath A House Of Cards?

Michael Kao
Akanthos Capital Management LLC

Disclosure Statement

THIS PRESENTATION IS FOR INFORMATIONAL AND EDUCATIONAL PURPOSES ONLY AND SHALL NOT BE CONSTRUED TO CONSTITUTE INVESTMENT ADVICE. NOTHING CONTAINED HEREIN SHALL CONSTITUTE A SOLICITATION, RECOMMENDATION OR ENDORSEMENT TO BUY OR SELL ANY SECURITY OR PRIVATE FUND MANAGED BY AKANTHOS CAPITAL MANAGEMENT, LLC. SUCH AN OFFER WILL BE MADE ONLY BY AN OFFERING MEMORANDUM, A COPY OF WHICH IS AVAILABLE TO QUALIFYING POTENTIAL INVESTORS UPON REQUEST. THE INFORMATION HEREIN MAY NOT BE USED IN ANY DECISION WHETHER TO INVEST IN ANY SECURITY OR PRIVATE FUND MANAGED BY AKANTHOS. AN INVESTMENT IN A PRIVATE FUND IS NOT APPROPRIATE OR SUITABLE FOR ALL INVESTORS AND INVOLVES THE RISK OF LOSS.

INVESTMENT ENTITIES MANAGED BY AKANTHOS TAKE LONG OR SHORT POSITIONS IN STOCKS, BONDS OR OTHER SECURITIES OR DERIVATIVES OF MANY OF THE COMPANIES DISCUSSED HEREIN. WE HAVE NO OBLIGATION TO UPDATE THE INFORMATION CONTAINED HEREIN AND MAY MAKE INVESTMENT DECISIONS THAT ARE INCONSISTENT WITH THE VIEWS EXPRESSED IN THIS PRESENTATION.

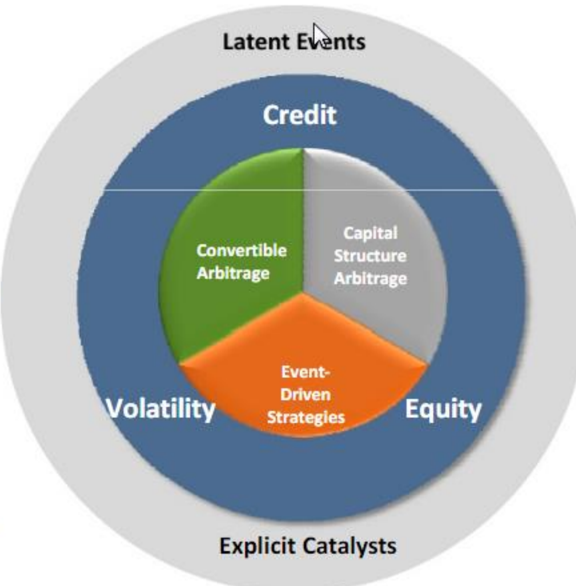
WE MAKE NO REPRESENTATION OR WARRANTIES AS TO THE ACCURACY, COMPLETENESS OR TIMELINESS OF THE INFORMATION, TEXT, GRAPHICS OR OTHER ITEMS CONTAINED IN THIS PRESENTATION. WE EXPRESSLY DISCLAIM ALL LIABILITY FOR ERRORS OR OMISSIONS IN, OR THE MISUSE OR MISINTERPRETATION OF, ANY INFORMATION CONTAINED IN THIS PRESENTATION.

CERTAIN INFORMATION CONTAINED HEREIN CONSTITUTES “FORWARD LOOKING STATEMENTS”, WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS “MAY”, “WILL”, “EXPECT”, “ANTICIPATE”, “TARGET”, “PROJECT”, “ESTIMATE”, “INTEND”, “CONTINUE” OR “BELIEVE” OR THE NEGATIVES THEREOF OR OTHER VARIATIONS THEREON OR COMPARABLE TERMINOLOGY. DUE TO VARIOUS RISKS AND UNCERTAINTIES, ACTUAL EVENTS OR RESULTS OR ACTUAL PERFORMANCE MAY DIFFER MATERIALLY FROM THOSE REFLECTED OR CONTEMPLATED IN SUCH FORWARD-LOOKING STATEMENTS. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS AND FUTURE RETURNS ARE NOT GUARANTEED.

2

A Different Style Of Value Investing

- **Capital-structure long/short** approach with a convertible centricity…
- …that seeks “margin of safety” across multiple dimensions:
  - **Credit**
  - **Equity**
  - **Volatility**
- …that is implemented through a variety of disciplines:
  - **Convertible arbitrage**
  - **Capital-structure arbitrage**
  - **Event-driven strategies**
- …that looks for latent and explicit **catalysts** to unlock value
- …that maximizes **asymmetry** through credit/equity derivative hedging overlays



How To Outperform In A Risk Mitigated Way

- High conviction bets should be overweight but with stop loss limits
- Position/geographic diversification means nothing if bets are thematically correlated
- Thematic diversification should be the cornerstone of risk management discipline
  - Convertible arbitrage
  - Synthetic puts
  - "Perpetuity options"
  - Special situations
  - Bond activism / company buybacks
  - Capital structure relative value
  - Refinancing arbitrage
  - Distressed bank loans
  - Bankruptcy reorganizations
  - Risk/event arbitrage
- Explicit hedges through CDS' and ETF's can be used to maximize asymmetry both at the individual trade level and at portfolio level

So What "Theme" Is This?

- **Investment:** the commitment of money or capital to the purchase of financial instruments or other assets, often based upon an estimate of future cash flows, with the aim of profitable returns in the form of interest, dividends, or appreciation of the value of the instrument (capital gains).[1]

- **Speculation:** the taking of above-average risks to achieve above-average returns, generally during a relatively short period of time. Speculation involves buying something on the basis of its potential selling price rather than on the basis of its actual value.[2]

- **Perpetuity Option:** an opportunity with the asymmetric payoff of a speculation that can be analyzed like an investment. An option with no imminent expiration date. See also: "Railroad Bond".[3]

---

1. *Economics: Principles in Action* by Arthur O'Sullivan, Steven M. Sheffrin (2003). Pearson Prentice Hall.
2. *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor* by David L. Scott. (2003). Houghton Mifflin Company.
3. Akanthos Capital Management, LLC

A Depression Era Parallel: Railroad Bonds

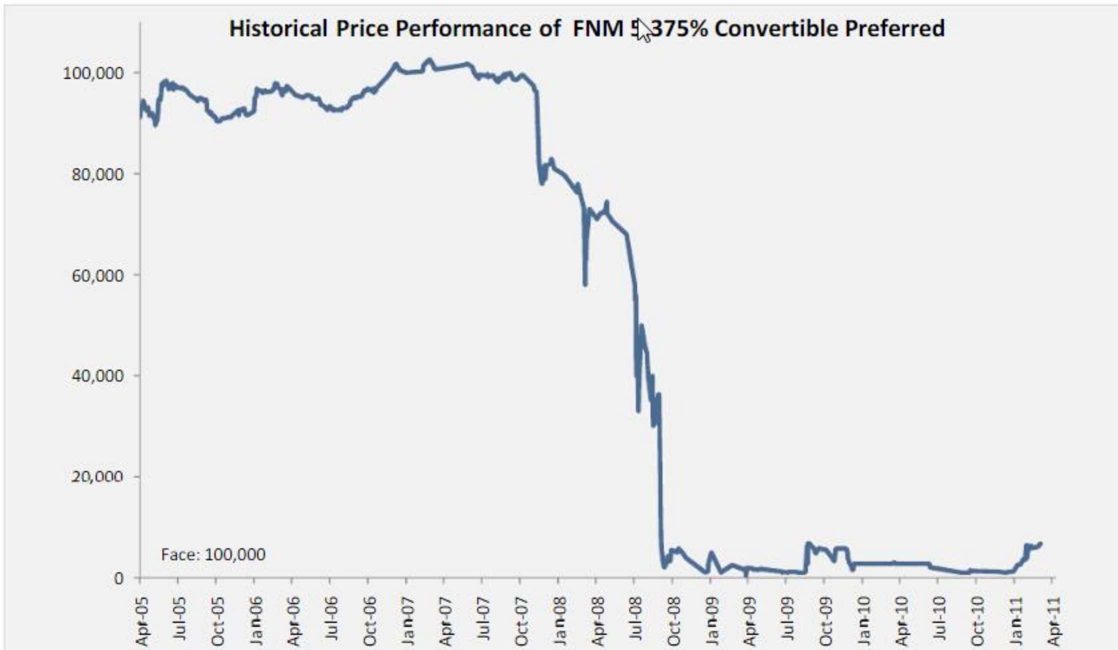
- Cy Lewis started on Wall Street at the bottom, parking Herbert Salomon's car at Salomon Brothers which led to him landing a job as a bond runner. In 1933, he got the chance to trade bonds at Bear Stearns, one of the smallest firms on the Street
- Roosevelt commandeered the railroads at the start of WWII, and railroad bonds that were trading at par plummeted to pennies on the dollar and traded "flat" – as interest was no longer being paid
- Lewis figured that the downside was minimal, and the bonds would be worth a fortune if the Allies won the war
- After the U.S. won the war, the bonds quickly returned to par and holders also received past accrued interest
- By 1946, the bonds were trading well over par with yields only slightly higher than treasuries; Bear's capital had grown from $800,000 to $17mm!

Nationalization fears and government intervention produced a generational opportunity in railroad bonds

2008 produced multiple "Railroad Bond" opportunities in convertibles

6

GSE Preferreds = Modern Day Railroad Bonds

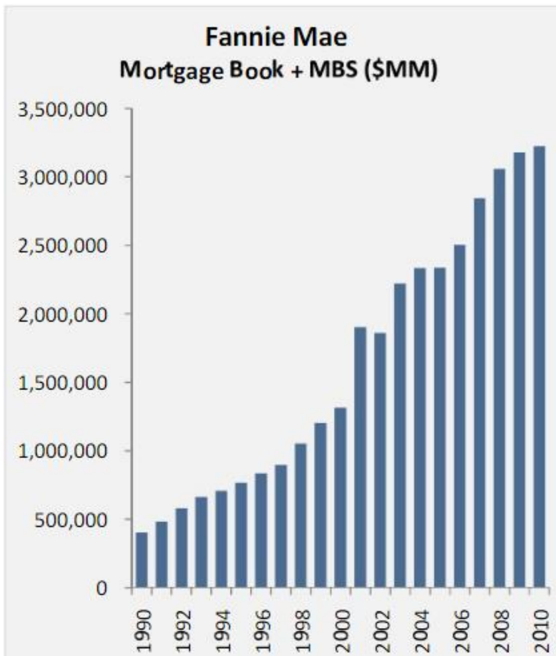


7

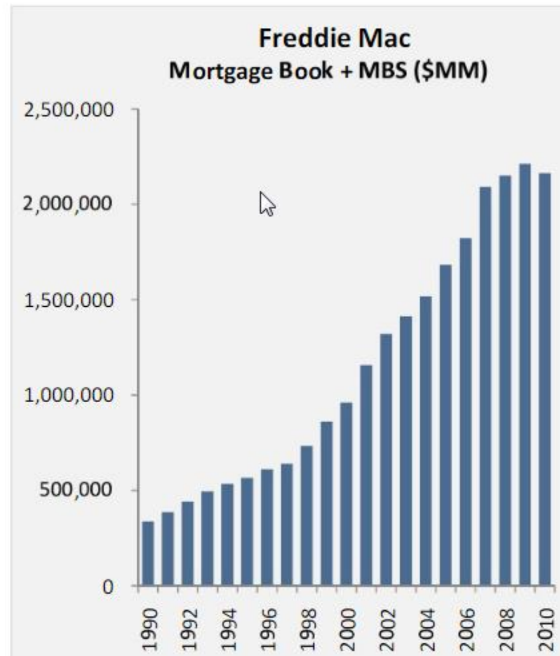
"Well, How Did [We] Get Here?"
-- Talking Heads

- Fannie Mae was established in 1938 and became public in 1968
- Freddie Mac was established in 1970 and became public in 1989
- Original public/private mandate was:
  - To provide liquidity, stability and affordability to the U.S. housing and mortgage markets
  - To expand opportunities for homeownership and affordable rental housing
- Unchecked abuse of quasi-government guarantee led to overwhelming market dominance; that, coupled with a departure from the original mandate, led us to the present state

Too Big To Fail



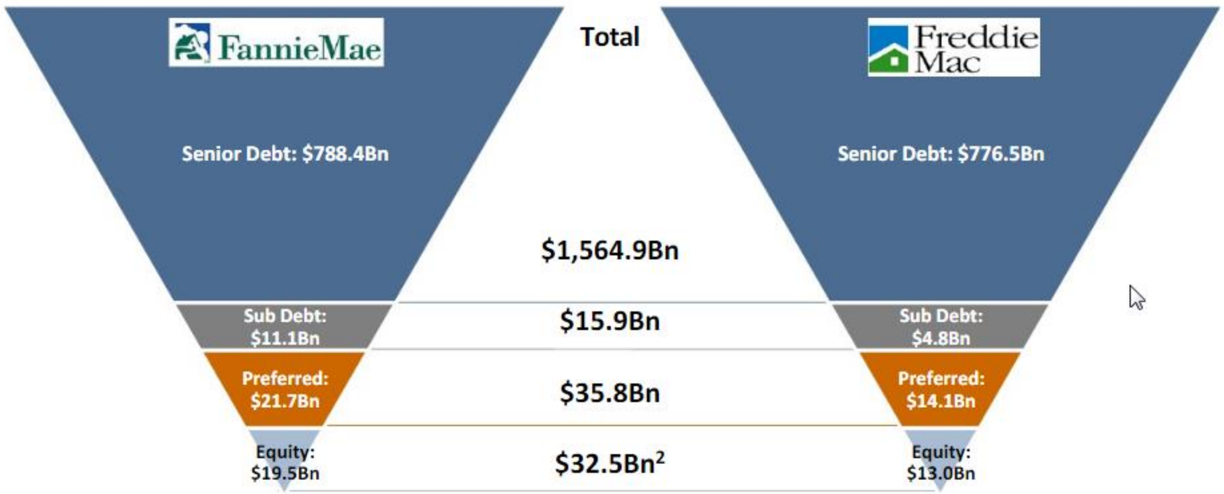
Source: FHFA 2009 report to Congress, 5/25/2010, company filings with the SEC and Akanthos estimates



Source: FHFA 2009 report to Congress, 5/25/2010, company filings with the SEC and Akanthos estimates

"A House Of Cards"

Pre-Conservatorship Capital Structures[1]



1. As of June 31, 2008
2. Over $120Bn in combined equity market capitalization at the peak

Source: Company filings, Akanthos estimates

Who Is To Blame For The Housing Crisis?

- Low interest rate environment
- Record capital availability
- Growing securitization markets
- Ability to offload risk via CDS
- Appetite for yield due to low interest rate environment
- Political mandate to accommodate instead of maintaining lending standards
- Strong historical housing market
- Overreliance on rating agencies
- Poor incentive alignment
- Poor judgment
- Massive fraud at the ground level
- Weak regulators
- Pressure to maximize profits

Many enabling factors were to blame, not just the GSEs

Conservatorship

- On September 6, 2008 the GSEs were placed under conservatorship, due to deteriorating statutory capital and fears of inability to roll debt
- U.S. Treasury arbitrarily guaranteed senior and subordinated debt at par, while eviscerating dividends on $35.8Bn face amount of AA- preferreds
- The GSEs voluntarily delisted on July 8, 2010, directed by FHFA
- U.S. Treasury injected $155.9Bn of capital to date via a senior preferred with a <u>10% dividend rate</u>

12

The Opposite Of Moral Hazard

- $17.8Bn of preferreds out of $35.8Bn outstanding were raised in late 2007 and as late as May 2008 at Treasury's behest to bolster capital ratios
- Paper was rated AA- given the implied government guarantee
- An estimated $15-20Bn of FNM and FRE preferreds was held by the banking sector including many Main Street community banks (according to the Independent Community Bankers of America)
- Four to nine months after issuance, <u>98%</u> of principal was wiped out. The $2.6Bn mandatory convertible preferred issued in May 2008 <u>never paid its first dividend</u>!
- Treasury's arbitrary decision to backstop both senior and subordinated bond holders while eviscerating the preferreds was the first of many arbitrary decisions by the government that exacerbated the crisis of confidence in 2008

13

The Opposite Of Moral Hazard (Cont'd)

"There is no moral hazard existing with shareholders of Citigroup (NYSE: C), with Freddie Mac, with Fannie Mae, with WaMu, with Wachovia. Those people lost anywhere from 90% to 100% of their money. The idea that they will walk away and think, "Ah, I've been saved by the federal government!" [is wrong]. There's at least half a trillion dollars of loss to common shareholders. Now, there's another question of management. But in terms of moral hazard, I don't even understand why people talk about that in terms of equity holders."

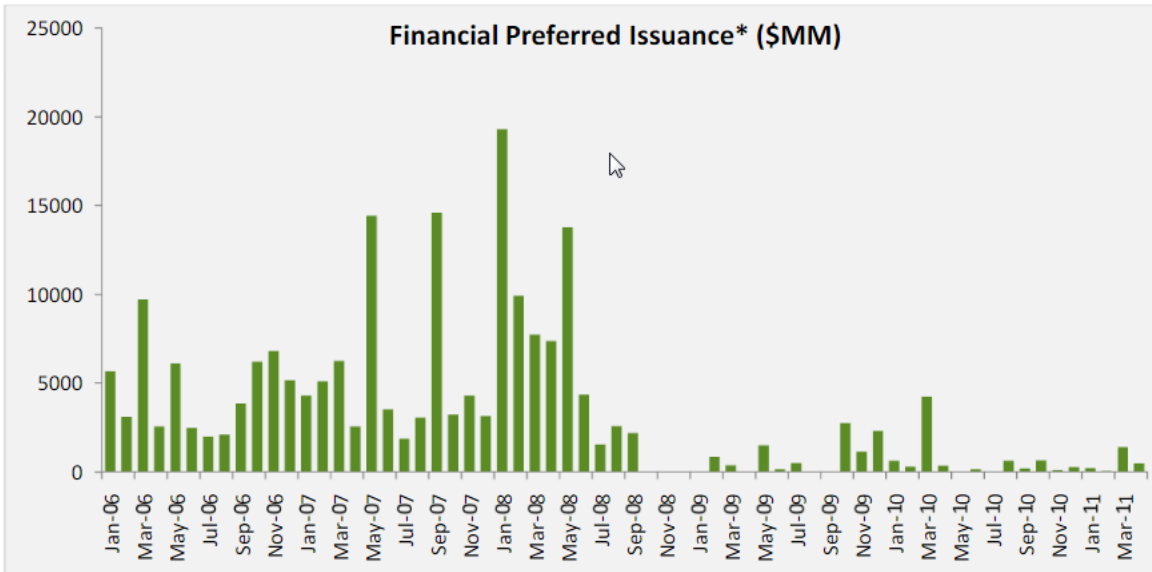
--Warren Buffett

Community Banks: Like Sheep To Slaughter

- Federal regulators encouraged banks to invest in Fannie Mae and Freddie Mac preferred stock as part of their core capital, which they used to guard <u>against</u> losses
- Henry Paulson on banks holding GSE preferreds: *"The banking agencies are prepared to work with the affected institutions to develop capital restoration plans"*
- Yet the Financial Crisis Inquiry Commission found that: *"The decline in value of the preferred stock caused losses at many banks … <u>contributing</u> to the failure of 10 institutions and to the downgrading of 35 to less than 'well capitalized' by their regulator"*

15

Financial Preferred Market: Knocked Out



*Excludes mandatory preferreds and GSE preferreds

"Preferred stock investors should recognize that … GSE preferred stocks are not a good proxy for financial institution preferred stock more broadly"

-- Henry Paulson

Common Misconceptions About The GSEs

- GSEs were the leading cause of the crisis
- GSEs are “black holes” for taxpayer funds
- GSEs’ moral hazard issues are not fixable due to inherent problems with a public/private model
- GSEs must be abolished to avoid a repeat of the crisis
- GSEs’ abolition must be absolute, with either full nationalization or full privatization

“Caught Between The Scylla And Charybdis…”

-- The Police

Fully Privatized System

- No backstop in hard times, increasing economic volatility
- Increased reliance on too-big-to-fail banks
- Full wind-down is not politically or economically feasible, as 9 out of 10 new mortgages are currently originated with GSE guarantees

Fully Nationalized System

- $6 Trillion gets added to the $14.5 Trillion National debt
- S&P already has Treasury bonds on negative watch
- No private capital to absorb initial losses
- No market controls, reduced scrutiny

Where Do We Go From Here?

Our Thesis

- Public/private compromise of some sort is necessary
  - Shock absorbing function in downturn worked well for decades
  - Lower financing costs without taking the liabilities onto the Treasury's balance sheet
  - Better regulated status quo is the "least of all evils"
- Consensus view that GSEs are worthless and a black hole for the taxpayer is incorrect
  - At the peak the GSEs had combined equity market capitalization of over $120Bn
  - GSEs are generating record NIMs: ~$16Bn / year each prior to provisions
- 10% dividend on government preferred is unduly punitive, especially in relation to 5% paid by TARP banks

Given the opportunity the GSEs can recapitalize themselves

Treasury's Options

1. Privatized system with government guarantee limited to loans issued by FHA, USDA and Veterans' Affairs

2. Option 1 + additional government backstop financed by a guarantee fee; backstop would maintain "minimal presence" and "scale up" when needed

3. Option 1 + reinsurance program structured behind private capital
   - Appears to be the Treasury's preferred path
   - Is this really different from the status quo guarantee business?

Treasury is steering away from extreme outcomes and toward a "modified status quo"

What Is Treasury Doing Now?

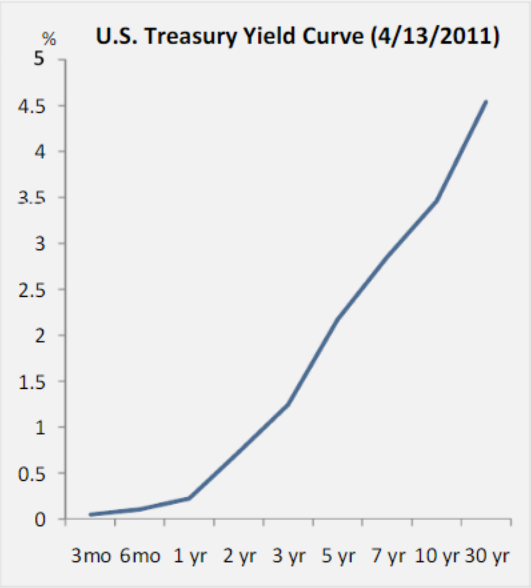
- For now Treasury is proceeding with the following:
  - Reducing FNM/FRE market share to under 40% within 5-7 years
  - Raising price on GSE guarantees (cost of FHA loans to go up by 25 bp)
  - Reducing conforming loan limit by letting a temporary increase expire
  - Phasing in 10% minimum down payment
  - Reducing GSE Portfolios at least 10% a year

- In an interview with CNBC Tim Geithner said:
  - "We are going to work very hard to recoup for the taxpayers as much as we can"
  - "We need to create conditions for private capital to return to the housing market"

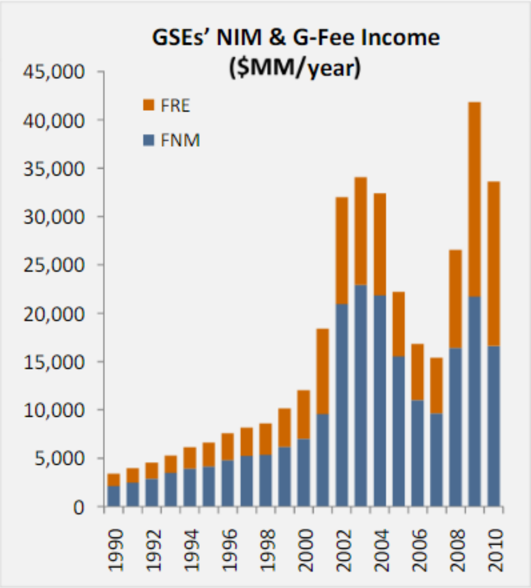
No extreme remedies → <u>Preferred optionality extended into perpetuity</u>

"Time is On The [GSEs'] Side"

-- Rolling Stones



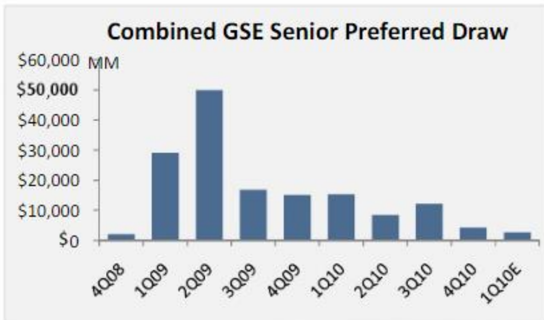
Source: Bloomberg

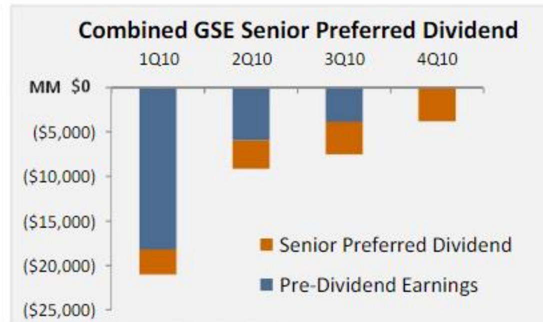


Source: FHFA 2009 Report to Congress, SEC filings, Akanthos estimates

GSEs are currently "minting" money in terms of net interest margin

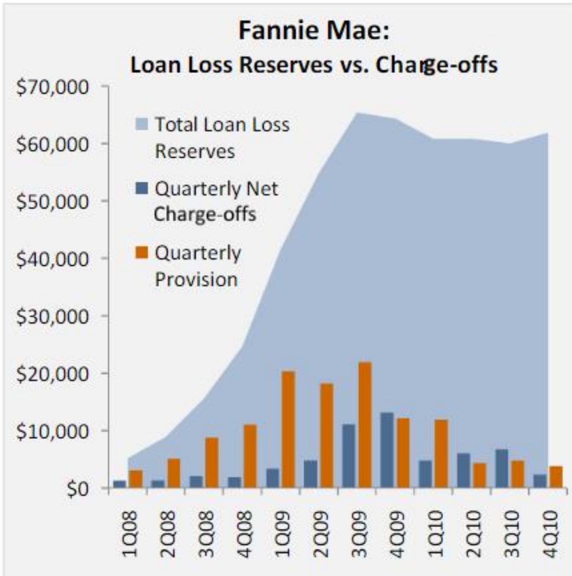
"Get The Monkey Off Your Back"
-- Aldo Nova

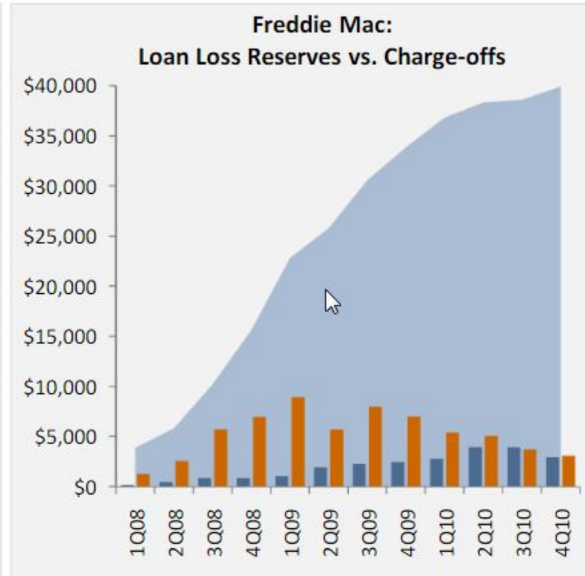




Punitive 10% government preferred dividend prevents recapitalization

Are GSEs Adequately Reserved?



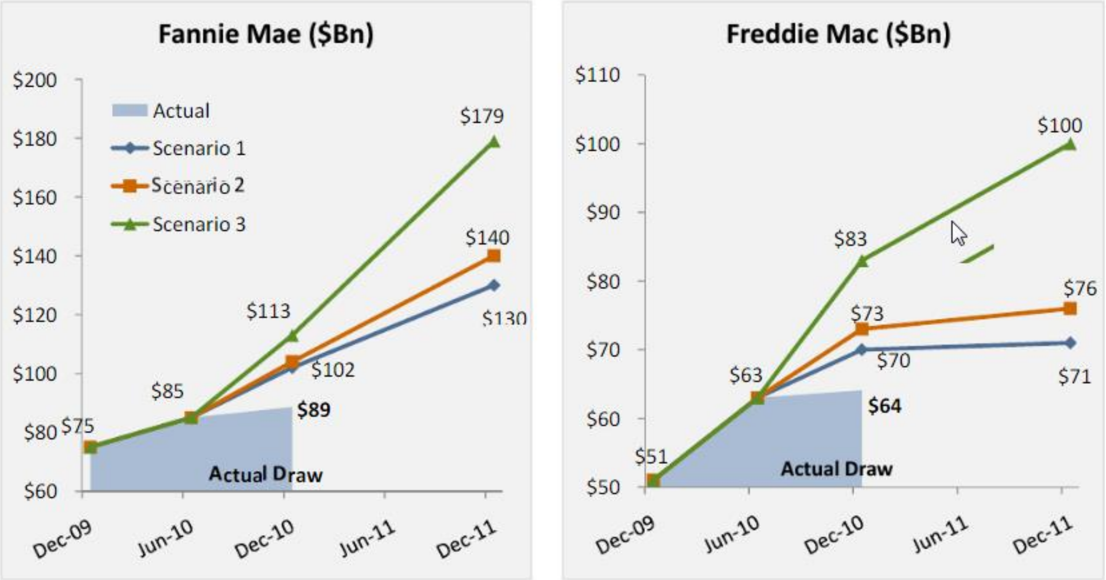


Loss reserves greatly exceed actual charge-offs (so far)

Total realized mortgage losses since 1Q08: FNM - $59.1Bn and FRE - $23.4Bn

So Far, So Good...

FHFA Estimates On Senior Preferred Draw



Actual draws are lower than FHFA's most optimistic scenario!

Source: Federal Housing Financial Authority (FHFA) Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac, October 21, 2010

What Do We Suggest?

Recapitalization Plan #1

Plan:

- Cut senior preferred dividend to 5%
- Restore publicly-traded preferred dividend
- Reassure the markets of the future role of the GSEs

Benefits:

- Allows organic recapitalization
- Reopens doors to publicly-traded preferred to replace government preferred
- Prevents transfer of value to the big banks
- Enables FNM / FRE to earn back what they owe to the taxpayers
- Avoids making the big banks even more systematically important
- Restores capital at regional banks and the FDIC, producing a multiplier effect

Where Can Preferreds Trade Under Dividend Reinstatement?

- Under conservative assumption that required return on the restored preferreds is in 10% range, these preferreds should trade up to 80-90 cents on the dollar should the dividends be restored
- Market implied probability of preferred restoration in then 8-9%
- For the reasons presented before, we believe that the possibility is significantly higher

Recapitalization Plan #2

Plan:

- Equitization
  - Equitize senior preferred and publicly-traded preferred as pari passu obligations
  - GSE Newco equity to split amongst government and publicly-traded preferreds
  - The GM "template"
- Reassure the markets of the future role of the GSEs

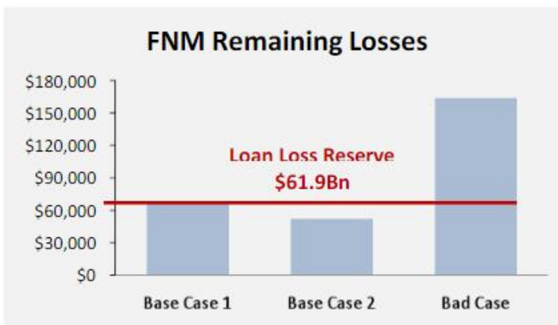
Benefits:

- Allows organic recapitalization
- Re-opens doors for all private funds (equity or preferred)
- Creates a much less leveraged entity
- Allows tax payers to benefit from housing recovery and faster return of capital
- Prevents transfer of value to the big banks
- Avoids making the big banks even more systematically important
- Restores capital at regional banks and the FDIC, producing a multiplier effect

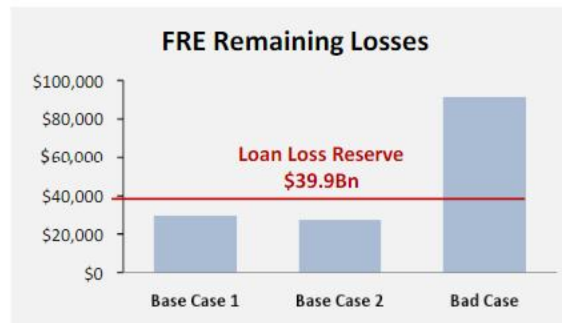
How Much More Can They Lose?

Methodologies:

- **Base Case 1:** all serious delinquencies default[1]
- **Base Case 2:** based on estimated cumulative default curves[1,2]
- **Bad Case:** bulk of high current LTV (CLTV) loans default[1,3]



Source: Company released data and Akanthos estimates



Source: Company released data and Akanthos estimates

---

1. Loss experience assumption for all cases: 20% for 2010/2009/2004-, 40% for 2008/2005, 50% for 2007/2006. This is on top of ~20% subordination
2. Base Case 2: Based on company released cumulative default curves to date and our estimates.
   - For FNM, 2010/2009: 1.5% cumulative defaults, 2008/2006: 8.5%, 2007: 9.5%, 2005: 5.5%, 2004 -: 2%
   - For FRE, 2010/2009/2004-: 1.5% cumulative defaults, 2008/2006: 8.0%, 2007: 9.0%, 2005, 4.0%
3. Bad Case:
   - For FNM all loans with CLTV >125% and 50% of loans with 100% < CLTV < 125% are assumed to default
   - For FRE, 75% of loans with CLTV > 110% and 50% of loans with 100% < CLTV < 110% are assumed to default

What Can They Make?

	FNM	FRE
2010 NIM + G-fees	**$16,409**	**$16,856**
NIM Reduction (market share, curve changes)[1]	**(5,743)**	**(7,080)**
NIM Increase (due to additional spread)[1,2]	**9,500**	**7,300**
Pre-provision NIM	**20,166**	**17,076**
Normalized Provision	**(2,500)**	**(1,800)**
NIM (net)	**17,666**	**15,276**
OpEx	**(2,500)**	**(1,500)**
Pretax Income	**15,166**	**13,776**
Income Taxes[3]	**0**	**0**
Net Income	**$15,166**	**$13,776**

1. Corresponds to a total of 40-50% market share
2. Assumes max spread increase of 75 bps, year 5 phase-in scenario (60% of portfolio phased in with some spread increase, 25% with max spread increase)
3. Over time, tax shields will erode but more spread increase will phase-in to offset taxes

Where Can Preferreds Trade Under Equitization Scenario?

Fannie Mae				
Senior Government Preferred	$110,000	(assumed amount at equitization)		
Publicly-Traded Preferred	$20,204			
Earnings		$15,166	$15,166	$15,166
Multiple[1]		8.0x	9.0x	10.0x
Company Value		$121,328	$136,494	$151,660
Total Government Value[2]		**105%**	**116%**	**128%**
Publicly-Traded Preferred Value		**93%**	**105%**	**116%**

Freddie Mac				
Senior Government Preferred	$70,000	(assumed amount at equitization)		
Publicly-Traded Preferred	$14,100			
Earnings		$13,776	$13,776	$13,776
Multiple[1]		8.0x	9.0x	10.0x
Company Value		$110,208	$123,984	$137,760
Total Government Value[2]		**147%**	**164%**	**180%**
Publicly-Traded Preferred Value		**131%**	**147%**	**164%**

1. Financials trade at 8x-10x earnings (JPM is at ~8x). As GSEs should have more recurring earnings, they should trade at a premium. In addition, in a world with stable GSEs, all financials should be trading at higher multiples
2. Includes assumed dividend paid to the date of equitization

Risks To The Thesis

- **Political Risks**
  - Adverse government action like nationalization
  - Aggressive forced wind-down
  - More aggressive principal reduction programs
  - Commitment fee (that has been waived thus far)
  - Uncertain regulatory environment
- **Market Risks**
  - Significant further decline in housing prices
  - Interest rate shock
  - Credit shock
  - Increase in competition
- **Idiosyncratic Risks**
  - Accounting issues
  - Derivative mis-hedging

Summary

- Extreme solutions of nationalization and full privatization are not feasible in foreseeable future
- A better regulated public/private model is still the best solution
- Reformed, recapitalized, tightly run Fannie and Freddie have the infrastructure and decades of experience in this business => the best candidates for the job
- If allowed, GSEs can recapitalize themselves under most scenarios
- Prerequisite to attracting new public funds is to restore value to public preferreds

At 6-7 cents on the dollar, GSE preferreds might just be a
Treasure Chest Beneath a House of Cards

Q & A