

I wouldn't do that if I were you, Huck!

Just one
toe, Tom!

DANGEROUS
WATERS

NO TOES
ALLOWED

NO
FINGERS
EITHER

The Credit Pond

Qualitative Analysis

- Analyze industry trends
- Assess competitive environment
- Follow business cycle
- Monitor corporate governance
- Review analysts' recommendations
- Follow rating agency actions and news releases

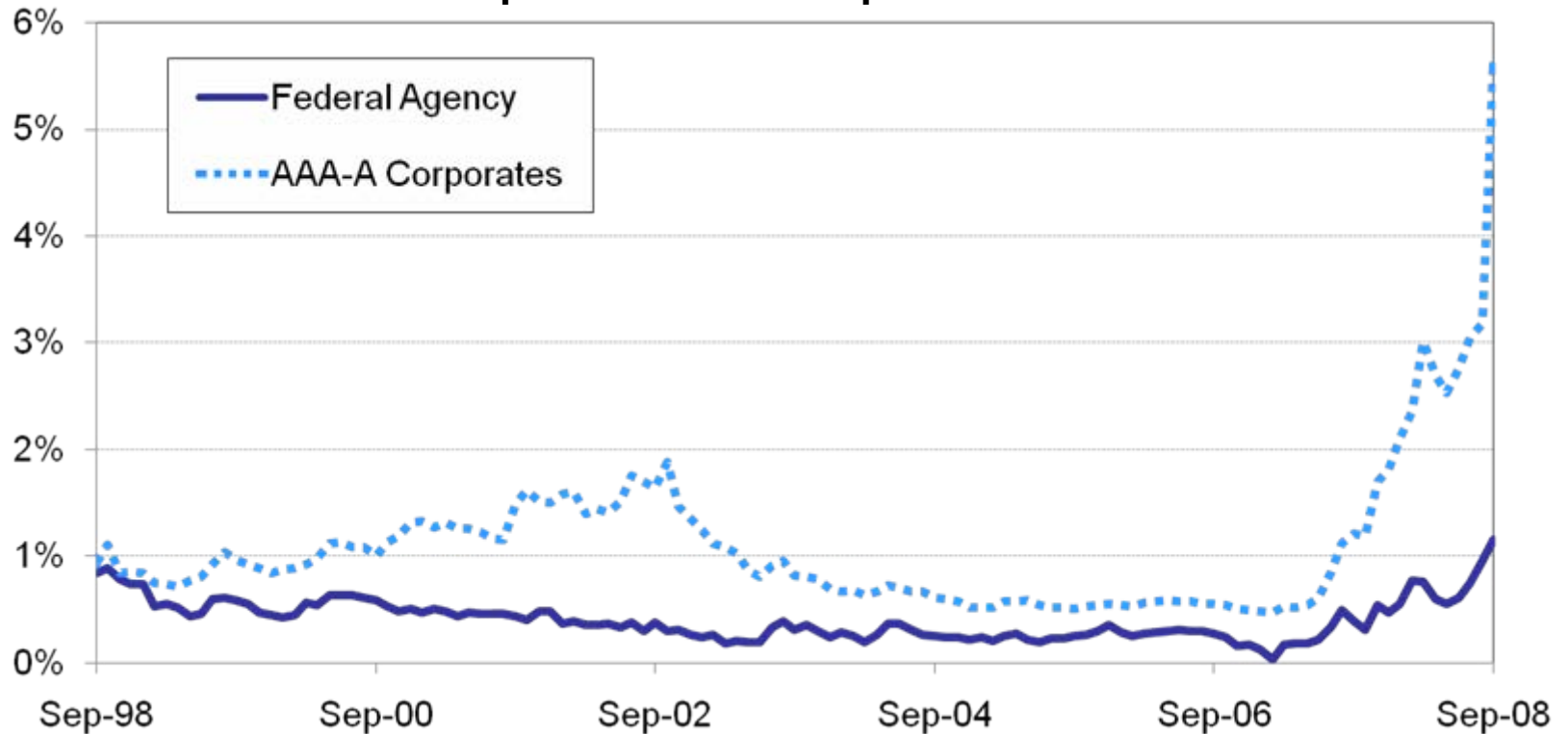
Quantitative Analysis

- Analyze balance sheet
- Review earnings projections
- Follow price movement of equities and fixed-income securities
- Monitor for sufficient trading volume
- Monitor credit default swap levels

Historical Credit Spreads



September 1998 – September 2008



*1-5 Year Benchmarks - Excess yield over U.S. Treasuries

Source: Bloomberg - Merrill Lynch Indices

Difference in Yields Between U.S. Treasury and Corporates



September 1998 – September 2008



Source: Merrill Lynch U.S. Treasury and AAA-A Corporate Master Indices

Leveraged Loans Take Center Stage
-The Wall Street Journal, December 22, 2006

Buyout Bonanza Compels Firms To Pile On Debt
-The Wall Street Journal, December 27, 2006

Bad Loans Inhibit Profit at Three Regional Banks
-THE NEW YORK TIMES, APRIL 18, 2007

Bear Stearns Staves Off Collapse of 2 Hedge Funds
-THE NEW YORK TIMES, JUNE 21, 2007

Bank Default Swaps at Highest on Record Amid Writedown Concern
-Bloomberg.com, November 21, 2007

Is AIG on Slippery Slope?
-The Wall Street Journal, February 13, 2008

At Lehman, Allaying Fears About Being the Next to Fall
-THE NEW YORK TIMES, MARCH 18, 2008

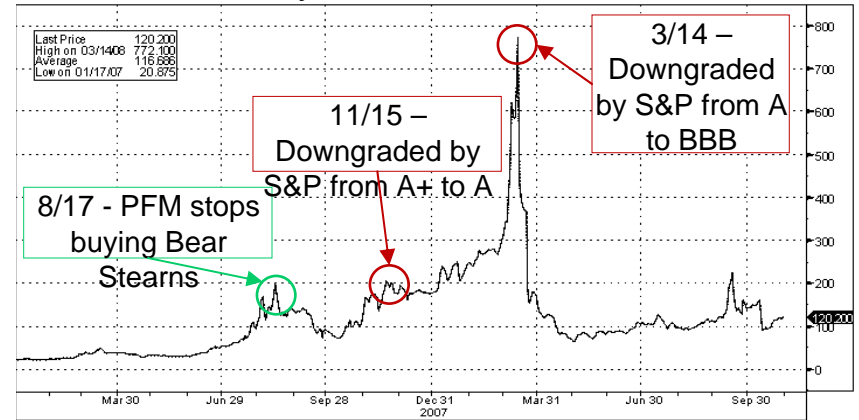
The Warning Signs – Bear Stearns



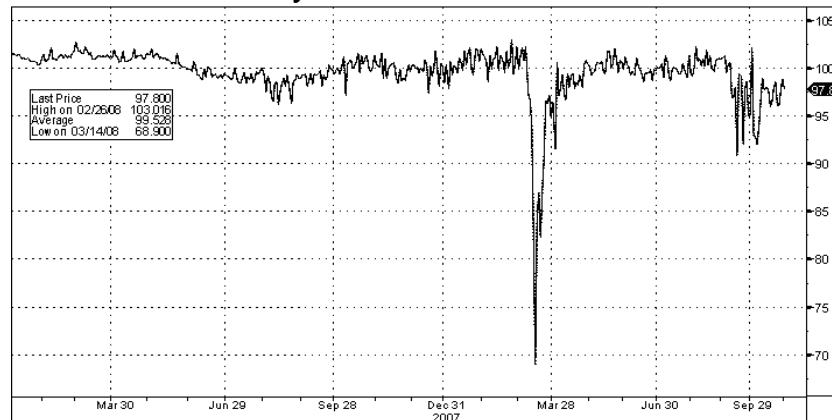
Stock Price
January 2007 – May 2008



Credit Default Spread
January 2007 – October 2008



Bond Price
January 2007 – October 2008



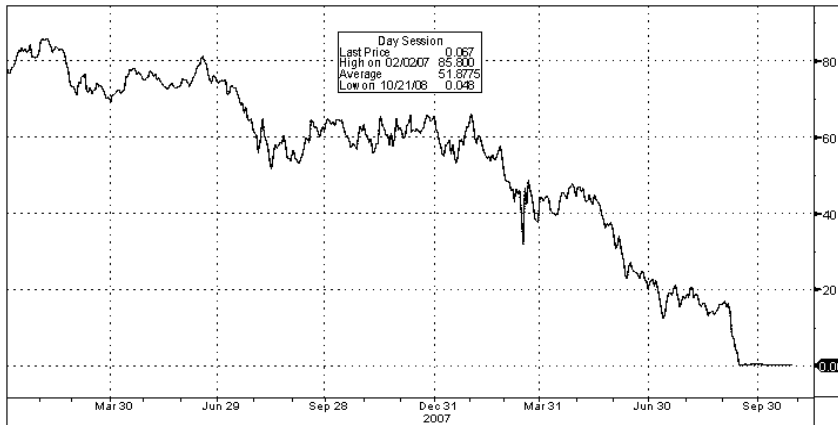
Source: Bloomberg

The Warning Signs – Lehman Brothers



Stock Price

January 2007 – October 2008



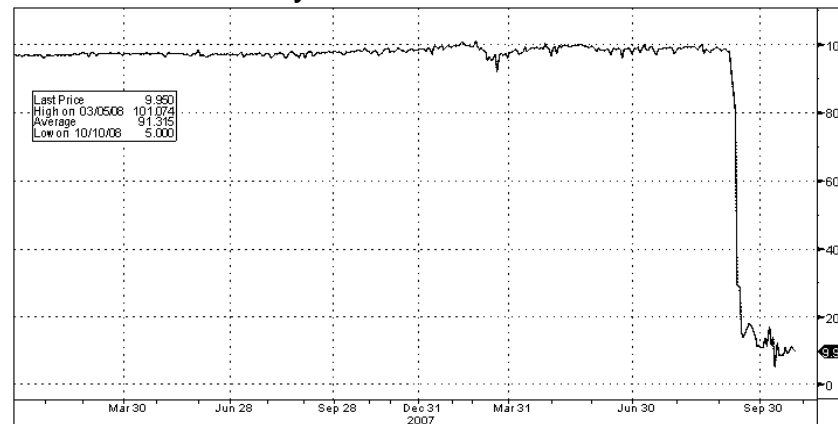
Credit Default Spread

January 2007 – October 2008



Bond Price

January 2007 – October 2008



1. Sep. 9 – Put on negative credit watch by S&P
2. Sep. 15 – Downgraded from A to CCC- by S&P
3. Sep. 16 – Downgraded from CCC- to D by S&P

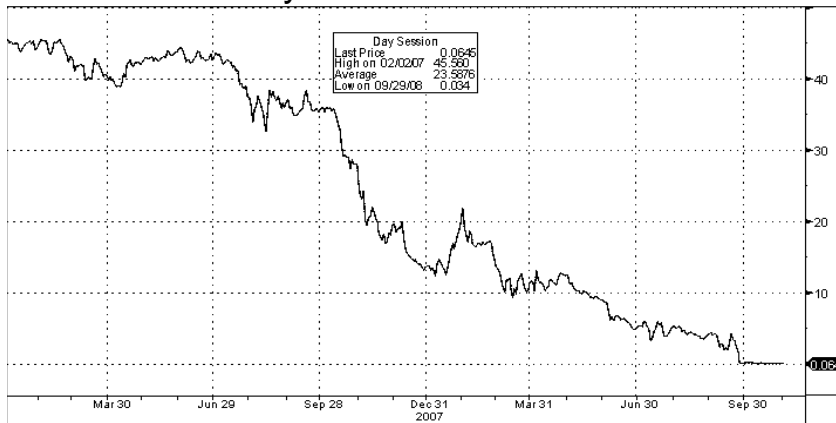
Source: Bloomberg

The Warning Signs – Washington Mutual



Stock Price

January 2007 – October 2008



Credit Default Spread

January 2007 – October 2008



Bond Price

January 2007 – October 2008



1. Jan. 18 – Downgraded from A- to BBB+ by S&P
2. Mar. 6 – Downgraded from BBB+ to BBB by S&P
3. Jul. 23 – Downgraded from BBB to BBB- by S&P
4. Sep. 15 – Downgraded from BBB- to BB- by S&P
5. Sep. 24 – Downgraded from BB- to CCC by S&P
6. Sep. 26 – Downgraded from CCC to D by S&P

Source: Bloomberg

Wal-Mart and Target – Are They Both Good Credits?



Current Credit Rating

AA/Aa2/AA



Current Credit Rating

A+/A2/A

Source: Standard & Poor's/Moody's/Fitch

Why Wal-Mart Is Not Like Target...



- Performance
 - Wal-Mart's sales are up 9% year-to-year, beating expectations.
 - Target's sales are only up 4.7%, less than projected.

- Sales mix
 - The majority of Wal-Mart's revenues are derived from groceries, pharmacy, and entertainment items.
 - Target's strengths are apparel, household goods, and electronics.

- Sensitivity to economic slowdown
 - Wal-Mart would theoretically benefit during an economic slowdown as more consumers switch down market.
 - Since a high percentage of Target's sales are derived from discretionary, non-essential items, it would likely suffer when consumers become financially strapped. Furthermore, Target also has an extensive consumer finance business, which is subject to elevated risk during an economic slowdown.

Importance of Credit – Lessons Learned



- Do your homework
- Cannot rely on brokers or rating agencies
- If you can't explain it to others, don't buy it
- Understand risks you are taking – what is worst case?
- If you are going to take risk, you need to manage it
- "Buy and hold" does not work in times of crisis
- Survive a small loss rather than sink with a catastrophic one
- Focus on the pragmatic
- Avoiding losses is not about "being lucky"





The California Debt and
Investment Advisory Commission

Presents

INVESTING PUBLIC FUNDS:
FUNDAMENTALS OF
MANAGING YOUR PORTFOLIO

November 20-21, 2008
Hilton Pasadena
Pasadena, California

How We Evaluate Credit

Presented by
Nancy Jones, Managing Director

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