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Ivy Market Update:
The Bailout of Bear Stearns

March 17th, 2008

On Friday, March 14th 2008, exactly nine months after Merrill Lynch seized the collateral of two hedge funds run by Bear Stearns Asset Management, the U.S. Federal Reserve (the Fed) stepped in to rescue Bear Stearns ("Bear") by providing emergency funding through J.P. Morgan Chase ("JPM"). During the week of March 10th Bear had experienced increasing difficulties running its business as banks and hedge funds, concerned about counterparty risk, began to refuse to do business with Bear. On March 16th, JPM announced the purchase of Bear Stearns for less than $2 per share. In this research note, we outline the recent timeline associated with the near-failure of Bear, and examine the near term implications for hedge fund managers. While this event has had thus far a negligible impact on Ivy's managers, it is nonetheless a significant market milestone: the near failure of a global counterparty.

A Recent Timeline

During the week of March 10th Bear Stearns experienced increasing difficulties in conducting its business. Following the failure of Peloton Partners, a highly leveraged mortgage ABS hedge fund, and the collapse of Carlyle Capital Corp., a levered closed end investment fund, rumors circulated that the recent sell-off in the mortgage ABS markets had impaired the balance sheet of Bear. Despite the lack of clear evidence that Bear was experiencing difficulties and statements early in the week from CEO Alan Schwartz that Bear was sufficiently capitalized, proprietary trading desks at major investment banks began charging extra fees when Bear was the counterparty for long-term over-the-counter ("OTC") derivative transactions or novations, and in some cases refused to enter into such transactions, according to financial media. Hedge funds, having shifted their business away from Bear Stearns over the past few weeks out of concerns about its health, accelerated this move away from Bear's prime brokerage service.

Observing the growing strain in the repo markets, on Tuesday March 11th the Fed made a surprise announcement to expand its securities lending program. Under this new Term Securities Lending Facility, the Fed would lend up to $200 billion of Treasury securities to primary dealers secured for a term of 28 days by a pledge of collateral that could include mortgage-backed securities. While this surprising move by the Fed resulted in the biggest one day gain in the equity markets in the past five years, it did little to reduce the perceived counter party risk of Bear. The spread of 5 year credit default swaps ("CDS") to protect against default of Bear's bonds jumped to 655 bps from around 300 bps two weeks earlier. On Thursday evening, the situation became desperate enough for Bear to seek outside help from JPM and the Fed. Negotiations continued overnight and a rescue package was put together for Bear,

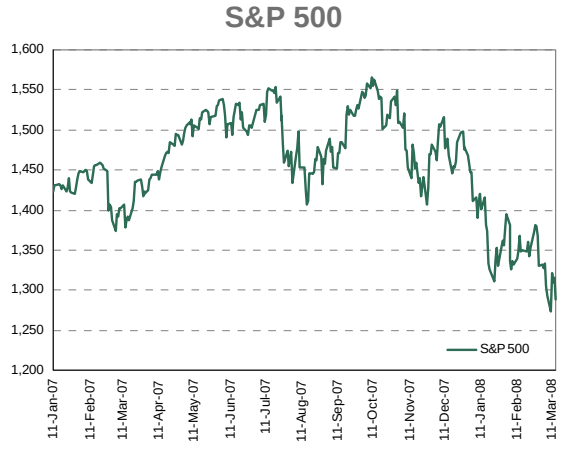
Bear Stearns Share Price

Source: Bloomberg

according to the Wall Street Journal.

On Friday morning, the Fed, JPM, and Bear made an announcement that JPM would provide secured funding to Bear for an initial period of up to 28 days, backed by non-recourse financing provided by the Fed through its discount window. In essence, the Fed provided liquidity to Bear by using JPM as a conduit, in an amount that is only limited by the amount of collateral Bear is able to provide. A 1932 provision of the Federal Reserve Act allows the Fed to lend to non-banks if at least five of its seven governors approve. This arcane provision was invoked to rescue Bear, according to financial media. The surprising announcement shook investor confidence and by the close of Friday, a sell-off of financial stocks pushed the major US equity indices down by over 2% while the price of Treasury securities shot up due to a flight to quality. Bear's stock price plummeted by 47% to $30 and rating agencies moved quickly to slash their credit ratings on Bear to a few notches above the high yield spectrum. The spread of 1 year CDS soared to 1250 bps, although no buyers stepped in according to the Financial Times.

On Sunday March 16th JP Morgan Chase agreed to buy Bear for $2 a share, valuing the former fifth largest American Investment bank at $236m. This compares to a market value of $3.54bn at Friday's close and $20bn prior to August of last year. In a move to restore confidence and avert further contagion of a banking crisis to other banks and institutions, JPM Chairman and Chief Executive Jamie Dimon announced that JPM would be guaranteeing all trading obligations and counterparty risk of Bear and its subsidiaries.



Source: Bloomberg

The US authorities and various counterparties had sought to reach an agreement on a deal prior to the opening of the Asian markets on Monday so as to avert broader financial contagion caused by a potential "run on the bank". The details of the transaction will see JPM exchange 0.05473 shares of its common stock in return for one share of Bear stock. In addition to the emergency loans provided on Friday, the Fed has also agreed to fund up to $30bn of Bear's less liquid assets in special financing arrangements.

In addition to the above, the Fed took the additional step of cutting the discount rate, or the cost at which banks borrow from the central bank, by 0.25% to 3.25%, and is expected to cut U.S. interest rates sharply on Tuesday in a move to restore faith in the banking system.

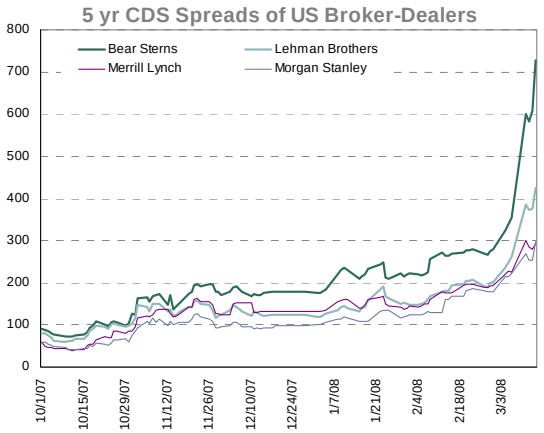
Impact on Ivy's Managers

This incident appears to have had little material impact on Ivy. While there are counterparty relationships with Bear across some of Ivy's managers, such exposure is limited in the context of Ivy's aggregate assets under management. Furthermore, managers that have used Bear's prime brokerage services have for the most part proactively been shifting their business, securities and cash balances to other prime brokers over the past few weeks. Their aggregate counterparty risk against Bear through OTC derivative transactions, already quite small, has generally decreased further over the past week. The exposure of Ivy's managers to Bear Stearns' repo desks is also de minimus because of the small exposure that they have to mortgage ABS. Having proactively contacted our managers over the past week, Ivy will continue to maintain an open line of communication with them and will carefully monitor the situation going forward.

Within the context of hedge fund investing, the ability to examine the financing arrangements entered into by hedge fund managers and to assess counter party risk that they face will become increasingly important. This is especially the case if one invests in managers who use a high degree of leverage. Over the past half year, Ivy has allocated much time and resources to evaluating the stability of underlying managers with leveraged capital structures. Specifically, our operational due diligence team has led our investigative efforts with respect to our managers' financing arrangements, such as cross margin requirements, terms of repo financing and the use of term financing, as we discussed above. Meanwhile, our research team carefully assesses the liquidity conditions of financial instruments used by these managers. Ivy will continue such efforts in the coming months.

Immediate Implications

The failure of a large counterparty like Bear would have been a significant negative event for the global markets in general, and the hedge fund industry in particular. The Fed-engineered purchase of Bear appears to have avoided this scenario, and therefore direct impact on the hedge fund industry has been limited. As noted above, many hedge fund managers that use Bear's primary brokerage service began shifting some or all of their business away from Bear weeks ago out of their concerns about its health. While last week's developments moved the funds to accelerate the withdrawal of securities and cash balances from their accounts, such a move should not materially impact their business, as the vast majority of hedge fund managers use multiple prime brokers and their efforts to pull securities and cash balances from Bear appear to have been successful. Further, it is important to note that Bear Stearns Security Corp., through which Bear provides its prime brokerage services, is a separately capitalized, guaranteed broker-dealer subsidiary whose clients are treated as senior to general creditors.



Source: Bloomberg

Conclusion

The turmoil in the global capital markets may have entered into a new phase with the bailout of Bear. While the Fed and JPM have provided a much-needed injection of certainty into the markets, the backdrop to this event has not changed. Credit conditions continue to remain tight, liquidity is a scarce commodity and increasing haircuts continue to be applied across a spectrum of securities. Leveraged investors in less liquid, more complex securities are also likely to continue to face difficulties—the bailout of Bear has not changed that situation.

What the Bear Stearns incident did reveal, however, is that the Fed is now more concerned about systemic risk than any "moral hazard" that could be interpreted by its own actions. The Fed's concern is understandable given the complex web of over-the-counter derivative transactions, but these actions will put the Fed on a slippery slope in the coming months. The Fed stepped in to bail out Long Term Capital Management ("LTCM") in the summer of 1998 for the same reason, but in 1998 there were very few entities like LTCM while now there are numerous other leveraged players that could face pressures similar to Bear.

The possibility of another failure is not totally out of the question given continued dislocations in the credit markets, resultant difficulties in estimating the values of complex securities that are used as collateral to secure short-term financing by leveraged entities, and the associated uncertainty that could greatly amplify perceived counter party risk.

All data sourced by Bloomberg unless otherwise stated.

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