

THE MONTH OF AUGUST saw North American equity markets give up most of their 2007 gain, due to the sub-prime meltdown effect. Investors must now ask themselves: How will the sub-prime effect play out over the coming months? To help you make sound investment decisions, Hillsdale offers you its views on the sub-prime effect.

START  
HERE →

## A Primer on Sub-Prime



### The Bond Market

10

Unexplained losses lead to rumors that create panic among investors. Concerns about credit quality and other ABS structures spread to short-term debt instruments as commercial paper markets begin to seize up. Equity markets tumble further until the central bank steps in and provides short-term liquidity to the system. Equity markets stabilize and recover most of their intra-month losses.

9

Contagion begins. Losses among hedge funds lead to margin calls, which in turn lead to greater selling. CDO markets begin to stall, liquidity dries up and markets go "no bid," yet margin calls continue. Forced selling begins as **multi-strategy hedge funds** and investment banks with credit exposure and outstanding margin calls seek to **deleverage**. Both parties turn to (very liquid) stock markets to raise cash. Forced selling causes atypical intra-day stock price movements.

8

The house of cards begins to collapse. As CDOs depreciate, high leverage among hedge funds exacerbates their losses. This process unravels slowly at first. A few hedge funds go bankrupt, while equity markets remain unaffected and continue to rise. CDOs continue to unravel and deterioration accelerates.

1

**Home buyer** borrows from mortgage lender; buys house with no money down.

2

Bank or mortgage lender pools mortgages into **Mortgage Backed Securities (MBSs)** and sells them to **investment bank**.

3

Investment bank combines MBSs with other **Asset-backed Securities (ABSs)** into **Collateralized Debt Obligations (CDOs)** and other leveraged products that receive investment-grade ratings from **credit agencies**.

4

CDOs can be illiquid and are **traded** over-the-counter (not exchange traded); their value is based on investment bank's theoretical pricing models.

5

While traditional institutional investors take on low-risk/high-quality CDOs, **hedge fund managers specializing in credit instruments** bet on riskier low-quality CDOs for higher returns.

6

Credit hedge funds use CDOs as collateral and approach other investment banks for additional borrowings, adding **leverage** as high as 5 to 10 times.

7

House prices start to fall and interest rates begin to rise. Borrowers struggle to refinance and/or cannot meet reset rates. As default rates rise, CDOs begin to fall in value.

Sub-Prime Effect Going Forward... →

#### HILLSDALE INVESTMENT MANAGEMENT

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#### INVESTMENT MANDATES

LONG ONLY EQUITY

LONG/SHORT EQUITY

MARKET NEUTRAL

130/30

## Q&A: Are Hedge Funds To Be Blamed for the Sub-Prime Crisis?

As illustrated in “A Primer on Sub-Prime,” certain types of hedge funds played a significant role in causing the sub-prime crisis through the build-up of leverage in the system. However, the respective involvement of mortgage lenders issuing the loans, credit-rating agencies rating the CDOs and investment banks creating and pricing the CDOs (and oftentimes seeded in these hedge funds) are just as guilty as the hedge funds – if not more so.

Not all hedge funds are the same. We must recognize that the types of funds causing and affected by the sub-prime crisis are large, multi-strategy and credit hedge funds. Other funds such as long/short equity hedge funds with a disciplined use of leverage and no exposure to credit markets are likely to be unaffected over the medium to long term.

### How will the Sub-Prime Effect Play Out Going Forward?

Over the longer term, the global fundamentals remain quite favourable and are well balanced across many regions. In the short term, the sub-prime effect will constitute a convenient scapegoat for all market ills. While some players in sectors such as investment banks, regional banking, real estate, private equity, hedge funds and consumer cyclicals have issues to deal with, other agents such as investors with good credit ratings, firms with no debt or high cash rates, opportunistic players, U.S. exporters and prudent risk aware investors will remain largely unaffected.

As we enter the fifth year of this cycle, and as earnings continue to slow, we see this environment playing out in a similar manner to previous late-cycle regimes. A focus on quality becomes more important as firms with deteriorating margins, higher leverage, weaker cash flows and more variable earnings will continue to experience greater business pressures. From a short sale perspective, the opportunities will now start to expand, unlike the 2005 and 2006 environments which distinctly favoured long bias and risk-seeking investors.

The main macro drivers going forward will be: (a) equity risk premiums that continue to favour stocks over both cash or bonds; (b) liquidity, which remains strong; (c) a central bank policy that is still neutral from a historic perspective; and (d) earnings that are slowing as per usual in a normal late-cycle regime. Sub-prime will be only a sub-component of these more important considerations for equity investors.

#### About Hillsdale

Hillsdale is an independent investment management firm with its head office in Toronto. The firm provides a full range of traditional and alternative equity solutions to pension funds, endowments, foundations, insurance companies and high net worth investors in Canada and abroad. Founded in 1996, Hillsdale has developed a sophisticated and disciplined investment methodology which includes real-time risk management of all its portfolios. Hillsdale currently manages client assets of approximately \$430 million.

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