



Choice Research Quarterly

Second Quarter 2008

Federal Reserve's intervention, not really so unprecedented?

Each quarter we issue research describing current intermediate term market trends, followed by a discussion of various fund management including risk control techniques we employ and the manner in which they may come into play during those trends. This research is intended to complement our regular Monthly Commentary.

A summary table of contents is shown below. **If your interest is more towards the techniques CAI has adopted and/or emphasized in adapting to the current environment, go directly to Page 8. Otherwise, we hope you find this commentary of interest, and if you have any comments please feel free to email us at info@choicealternative.com or telephone +1 (212) 248-2733 x701.**

Table of Contents

Part I — Current Market Analysis	1
Part II — Historical Antecedents	4
Part III — Historical Relevance	8
Conclusion	8

Disclaimer and Notices

The material presented and calculated here is based on information considered reliable. Choice Alternative Investments, Ltd. ("CAI") does not represent that it is accurate or complete. Investing in hedge funds and structured products carry substantial risk. Investors could lose their entire investment. Past performance is not a guarantee of future performance. CAI has limited operating history since March 2005, and Fund Managers utilized by CAI may have track records in other vehicles implementing those strategies now planned by CAI. Not all strategies found herein necessarily are currently being implemented at CAI at this time. This informational content is not an offer to buy or sell securities. Offer of securities is by prospectus only. Please read all offering materials carefully before investing.

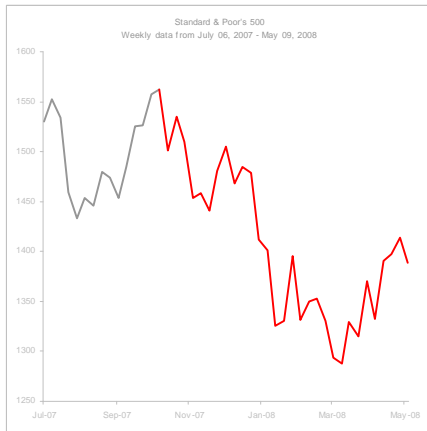
The above disclaimers apply to every page of this document.



Part I — Current Market Analysis

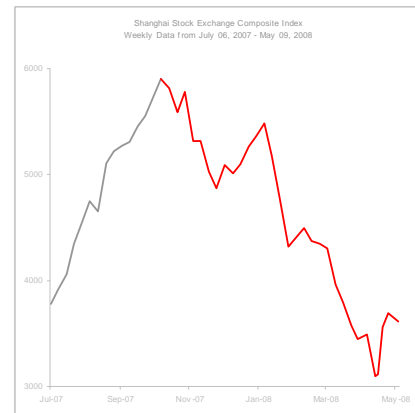
Current Market Events and Central Bank Involvement

“The more things change the more they stay the same.” – Rousseau



In our opinion, the past few months have seen the full flowering of the international credit and liquidity contraction. For decades, and particularly since the beginning of the millennium, low interest rates have fueled enormous gains in real estate, globally, with equity market indices also benefitting. Much of these gains were built on the risk prone and unstable base of massive leverage, as evidenced by the growth of the credit default swap market to a total value of US\$45 trillion. This is more than five times the total of the US government bond market.

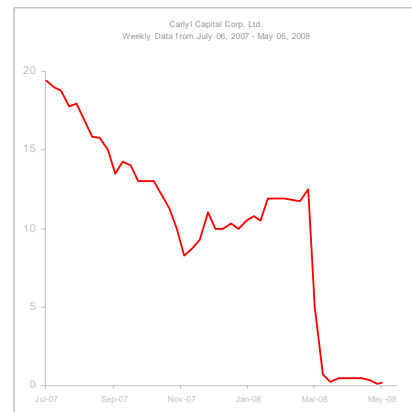
Although leverage, *per se* is not a bad thing given that “risk” is the name of the investment game, it is now clear that too much leverage was being employed with poor risk control and buried inside overly opaque investment vehicles associated with an inability to mark risk to market. On top of this, credit was being extended to borrowers of dubious creditworthiness.



The worst U.S. housing slump in decades, combined with tightening credit as mortgage-backed securities plunged in value, has had a domino effect on the financial system, and, a negative effect on global equity markets. For example, from their intra-day highs in 2007 to recent intra-day lows, the S&P 500 fell **20.29%** (see index price line chart in the top left), the Russell 3000 fell **19.13%**, the FTSE 100 fell **20.93%**, the Nikkei 225 fell **36.16%**, the Hang Seng fell **35.63%**, and the Shanghai SE fell **51.27%** (index price line chart in right above).

As a result, some of the most venerable names in American finance, such as Citibank and Merrill Lynch, have been forced to wander the Earth hat-in-hand seeking additional capital.

Also eviscerated by capital calls have been other major market participants such as Carlyle Capital Corporation (“CCC”) which was forced into compulsory liquidation on March 18, 2008. At the time of its demise CCC’s bond fund was holding an astonishing US\$31 of debt for each dollar of equity (see stock price chart of CCC to the immediate right).



Data Source: Bloomberg LP

Of course, the highest profile event (so far) of the current crisis has been the spiraling liquidity run on Bear Stearns Companies Inc. (“Bear Stearns”) causing the U.S. Federal Reserve Bank (the “Fed”) to invoke a law added in the 1930’s and last used in the 1960’s to facilitate a non-recourse loan of US\$30 billion to JPMorgan Chase & Co. as an inducement for it to make a merger offer for the beleaguered Bear Stearns.



To secure the financing, Chairman Ben S. Bernanke invoked an affirmative board vote under a section of law which states that due to “unusual and exigent circumstances” the Fed could provide emergency financing measures such as those employed with JPMorgan.

Additionally, the Fed opened a new facility known as the Primary Dealer Credit Facility offering direct lending to primary government bond dealers (e.g. investment banks) giving other Wall Street investment banks access to a direct lending window normally only available to commercial banks.

Of lower profile, but arguably even more significant, have been several other moves by the Fed to mitigate the effects of the ongoing worldwide deleveraging:

- It has lowered interest rates 3.25% points since September 2007, the fastest drop in borrowing costs in two decades.
- It announced that it would expand its auctions of funds to commercial banks to US\$100 billion a month, from US\$60 billion. It also announced up to US\$100 billion in term repurchase agreements, recently increased to US\$150 billion.
- It decided to swap up to US\$200 billion of Treasuries out of its portfolio (e.g. nearly half their Treasury portfolio) in exchange for primary dealers' (e.g. investment banks) holdings of mortgage securities, at the same time dramatically expanding its list of eligible collateral.
- It reduced the premium on direct loans to banks over the benchmark overnight rate, to .25% from .5%.
- It decided to increase swap lines with the Swiss National Bank and the European Central Bank and establish a securities lending facility for government bond dealers.

It should be noted that the Fed is not the only central bank engaged in such activities. In the past few months:

- The Bank of England morphed the Collateralised Mortgage Backed Securities Market into the Collateralised UK Government Bond Backed Mortgage Market, effectively swapping 100% guaranteed Government Bonds for illiquid, unpriceable mortgage-backed securities, thus allowing banks to offer Government Bonds as security on the Interbank Market.
- World central banks are currently devising a plan whereby commercial banks' overseas branches would be allowed to borrow funds from the central banks of the countries where the branches are located. The branches can obtain the funds on condition that government bonds deposited at the central banks of the commercial banks' home countries be put up as collateral. For instance, a Tokyo branch of a U.S. bank would be allowed to borrow yen funds from the Bank of Japan, using as collateral U.S. Treasury bonds the bank has on deposit with the Fed.
- The European Central Bank (ECB) and the Swiss National Bank (SNB) decided to expand their efforts with the Fed to open up credit in view of the persistent liquidity pressures. The Fed boosted its swap agreement with the ECB by US\$20 billion to US\$50 billion, and doubled that with the SNB to US\$12 billion.

Conventional wisdom states that such Central Bank activities are “unprecedented.” In fact, this opinion has seemed virtually unanimous, i.e.:

- “Much of our focus today will center on a period of 96 hours—mostly over the weekend of March 15th and 16th. During this momentous 4-day period (in March 2008), the



Federal Reserve, the Federal Reserve Bank of New York and the Treasury Department took dramatic and unprecedented action to stabilize our markets, to infuse them with liquidity and to prevent additional financial firms from being swept under the riptide of panic that threatened to have taken hold of our markets.” – Christopher Dodd, U.S. Senator (Connecticut) in prepared remarks before that Body’s Finance Committee.

- “The Federal Reserve's unprecedented intervention on behalf of Bear Stearns was intended to ease fallout from the credit crunch” – Associated Press
- “The European Central Bank today lent €61 billion (£41.3 billion) to the Eurozone banking system, in addition to the €95 billion it provided yesterday to 49 banks in unprecedented emergency action by the Frankfurt-based institution.” – London Times
- “The Fed's March actions are ``definitely a major turning point in our understanding of the role of the lender-of-last-resort in modern markets,"– Lou Crandall, chief economist, Wrightson ICAP LLC.

However, are these activities truly “unprecedented?”

Repeatedly during the past two centuries, central authorities have been on hand to bail out the markets. So often, in fact, that one could surmise that post-agrarian *lasses-faire* capitalism can more often be found in classrooms, and less often in the real world of global market interaction, especially during periods of crisis. Since 1980, here are some memorable crises where central banks intervened:

1. Latin America defaults causing an international banking crisis in 1982;
2. the Collapse of Penn Square Bank and subsequent demise of the then 6th largest bank in the US, Continental Illinois National Bank and Trust Company in 1984;
3. the Savings & Loan industry implode in the late 1980s and early 1990s; and
4. the Russian Ruble collapses causing a ripple effect on global currencies in Asia, and the subsequent failure of Long-Term Capital Management in 1998.

What do these modern events have in common? First, the markets were globally coupled and there were efforts lead by several central authorities to aid in subduing the crisis.

Also, we believe that part of the reason people nevertheless now accept that we live in “unprecedented” times, is 1). the common misperception, promoted by most business schools and repeated *ad nauseum* by media pundits, that claims markets are self-correcting, and behave almost as a law of physics or an enclosed self-healing bio-system. In short, that markets left undisturbed, tend toward **equilibrium**. However, in each of the four events above, and the current credit crisis, the markets seemed right, until they went totally wrong, and as with any large scale system that is as global and interconnected as the capital markets, they eventually trended towards **disequilibrium**.

As the “big fellow” investor of our time, George Soros, notes in his book *The Alchemy of Finance* which was published in 1987, “Market participants base their decisions not on objective conditions but on their interpretation of those conditions. When this process called “reflexivity” takes place, the human bias becomes one of the fundamentals which shape the evolution of price.”

So, when large scale crises occur it is the job, of governments, past and present, to save the system, i.e. authorities must intervene. As this research will indicate, central banking and regulatory authorities have not only been created in response to market crises, but invariably they take on additional powers during each successive crisis.

Part II — Historical Antecedents

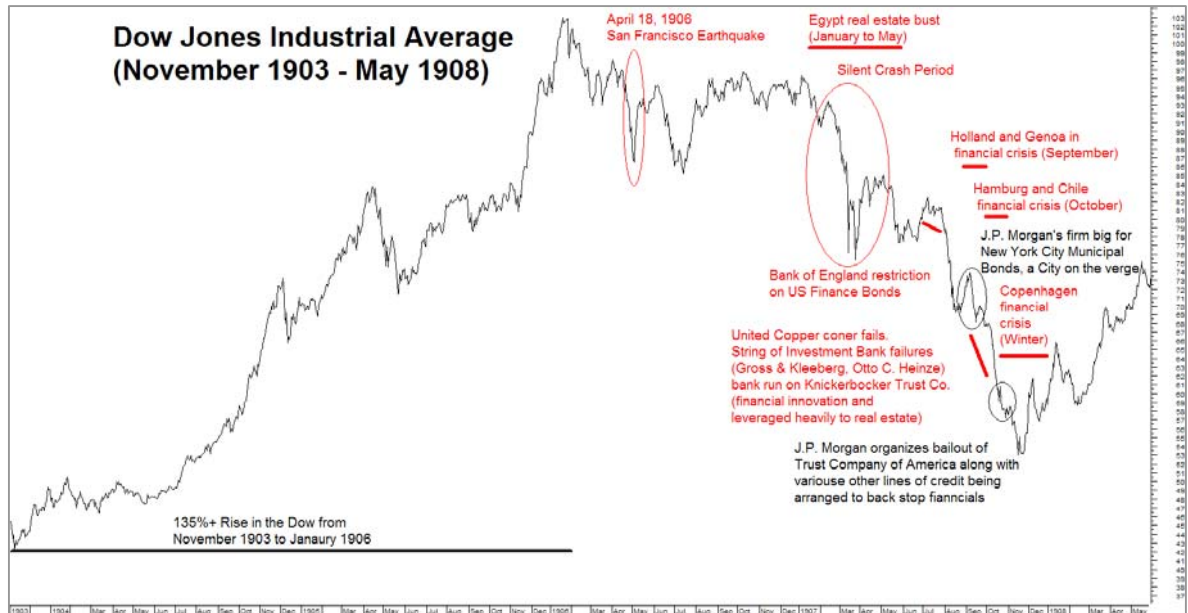
The Panic of 1907 and the Resultant Creation of the U.S. Federal Reserve System

The Seeds of Panic

The Panic of 1907 is little written of today but was at the time the most severe financial panic in the U.S.'s history. The thirteenth banking panic in the nation's first 120 years, it was directly responsible for the creation of the Federal Reserve System.

Between November 1903 and January 1906 the Dow Jones Industrial Average went up over 135%, and celebrations erupted all over Wall Street as the Dow hit 100 for the first time. Hidden behind the hoopla, however, were weak and decentralized bank regulations, brazen financial manipulations by bank managers and directors, rampant speculation, a patch work of interdependence among banks and nations, and a growing scarcity of capital. These all were all impacting on the New York markets, but went largely unnoticed. Until suddenly, a natural disaster some 3,000 miles away from the New York markets began a reaction that would take eighteen months to fully unfold.

At 5:12 A.M. on April 18, 1906, the Great San Francisco Earthquake began. After four days and nights of raging fires, 80% of the city was destroyed. Damages were estimated at nearly US\$500 million.



Relief funds were drawn into the city from around the country and the world: England supplied US\$30 million; Germany, France, and the Netherlands collectively provided another US\$20 million. Such international effects of the earthquake were further amplified because many foreign insurers had provided San Francisco's underwriting protection. British insurance firms, for instance, faced losses of close to US\$50 million. In fact, several insurers were overwhelmed by the claims and could not meet their insured obligations.

Source: Dow Jones & Company and Choice Alternative Investments, Ltd.

British insurers mostly met their obligations by liquidating their holdings, which resulted in a 14% decline in Britain's gold holdings. Eventually, these outflows of gold created liquidity fears for the Bank of England. In an attempt to stop the depletion of the country's gold supply, the Bank



of England nearly doubled its interest rate in the following months, from 3.5% to 6.0%. Other European central banks sharply raised their rates as well.

In New York City, capital was becoming scarce, too, as gold reserves also went to San Francisco. Interest rates rose in New York and by the end of 1906 a severe credit shortage had set in. The U.S. at the time had no Central Bank, and in a speech to the New York Chamber of Commerce, Jacob Schiff of Kuhn, Loeb & Co. warned that, "Unless we (the U.S.) have a central bank with adequate control of credit resources, this country is going to undergo the most severe and far reaching money panic in its history."

In Egypt at the beginning of 1907 — in an environment that sounds eerily familiar — **a real estate boom financed by low interest rates and rampant real estate speculation suddenly imploded.** As Great Britain transferred gold supplies to Egypt to ameliorate the situation, available credit tightened further. In response, the equity markets began to crash.

In the U.S., during February and March of 1907, the Dow Jones Industrials lost -19%, a period that was known as a "silent crash" (e.g. fundamentals seemed fine, but stock market prices precipitously dropped). A temporary respite followed, but in July Egypt's Alexandria Stock Exchange collapsed, overextended Egyptian banks began folding, and when the Bank of England sent gold to Egypt a run on the pound followed, and a multinational rout was on. A wave of bank failures swept Japan, then Germany, then Chile demonstrating that the system of money and markets were as **coupled** then as they are today (i.e. see recent "de-coupling" myth espoused by media pundits during the lead up to the recent global bear market in equities).

The Panic

By October, the chain of events which began a year earlier in the ruins of San Francisco and then accelerated as the Egyptian property market went bust; the world indeed witnessed aftershocks rippling from Holland to Genoa, then Hamburg, Chile to Copenhagen. In the United States, credit anorexia set in.

As a backdrop, the period saw the rise of the "trust company", which took on both the function of a commercial and private bank and was in the *avant-garde* of **financial innovation** in industrial and **real estate financing**. However, by October 17, 1907 after a string of investment banks failed, the outwardly — and according to its balance sheet — flourishing Knickerbocker Trust, a leading trust company at that time, fell victim to a run on deposits, and an accelerated collapse. Panic took wing and by the end of October 22, 1907 the National Bank of North America had failed, and runs were sparked on nearly every bank and trust in New York as well as many distant correspondent banks in the nation's interior. During the next six weeks, the Dow would shed another -23%; its loss from the 1906 highs eventually reaching -50%.

In an attempt to quell the panic, U.S. Secretary of the Treasury George Cortelyou pumped US\$35 million of Federal money into the banking system. This effort was unsuccessful. Finally, complete ruin of the banking system was averted as J.P. Morgan organized a team of bankers and trust executives, who, with the help of the backing from the Government, redirected assets between banks, secured further international lines of credit, and purchased the plummeting stocks of healthy corporations. Within a few weeks the Panic of 1907 was ended, but the long-term aftereffects are felt to this day.



The Aftermath of the Panic of 1907

Following the Panic, banking reform became a major issue in the United States. In May 1908, Congress established the National Monetary Commission, chaired by Senator Nelson Aldrich, to investigate the panic and to propose new banking regulations.

In 1910, after two years of studying the more developed banking systems of Europe, Aldrich convened a meeting of the U.S.'s leading financiers in Jekyll Island, Georgia to discuss his findings and recommendations, among which were the creation of a U.S. central banking system which could provide a ready reserve of liquid assets in case of financial panics and would also provide for a currency that could expand and contract as the seasonal U.S. economy dictated. On December 23, 1913, Congress and President Woodrow Wilson created the U.S. Federal Reserve System. Its formal stated purpose was "To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." Over the years, its role has evolved.

The Worldwide Depression of 1929-1939

Much has been written about the Stock Market Crash of 1929 and the Great Depression. While economists debate the exact beginning and end of the Great Depression, there is general agreement on the root cause: a boom in easy credit, which inflated asset prices and leverage, followed by debt deflation. This cycle, as always, played out in familiar fashion: consumers and businesses relied on cheap credit, the former to purchase consumer goods such as automobiles and furniture and the latter for capital investment to increase production. This fueled strong short-term growth but created enormous consumer and commercial debt.

People and businesses who were deeply in debt when price deflation began, or demand for their product decreased, cut current spending to remain solvent, thus lowering demand for new products. Businesses began also to fail, large scale layoffs commenced, and unemployment rose dramatically. Banks which had financed this debt began to fail as debtors defaulted on debt and depositors became worried about their deposits and started withdrawals and runs.

Ultimately, the federal government propped up the economy, directly and indirectly. Without getting into all the relevant activities during the 1930's, one simply need point out that federal expenditures rose from 3% of GDP in 1929 to nearly 10% between 1933 and 1939, funded primarily by growth in the national debt. The debt as proportion of GNP rose from 20% to 40%. In a very real sense, the suffering Americans of the 1930's were bailed out by the taxpayers of the 1940's.

The reforms, new government powers, and regulatory bodies resulting from the Great Depression were many and varied. One was a seemingly small change to the Federal Reserve Act:

Section 13-3. Discounts for Individuals, Partnerships, and Corporations (added July 21, 1932): In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

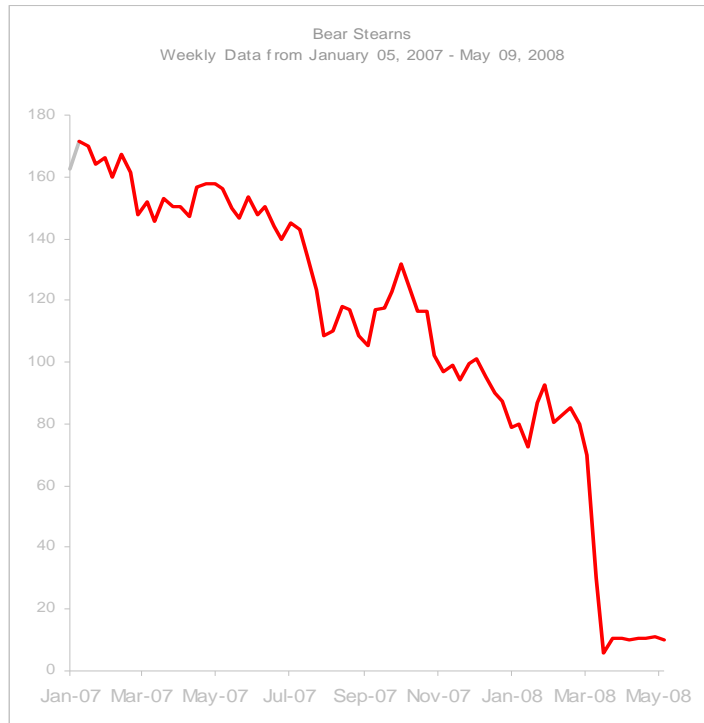
Fast-forward, March 16, 2008.....



.....March 16, 2008 (Bloomberg) JPMorgan guarantees business of Bear Stearns until Deal Closes

It was the powers granted in Section 13-3 added in 1932 that the Fed invoked in March 2008, 100+ years since the Panic of 1907 to assume and solidify JPMorgan's modern day buy-out offer for Bear Stearns.

At the outset of this commentary we described the illiquid environment of 2007 and 2008 – once again, a story of easy credit, a bursting asset bubble, and a resulting credit freeze. Subsequently, there have been several steps taken by various central banks to ameliorate the crisis. It's a complex story, with many causes, culprits and victims, but to date certainly the greatest victim (or culprit, depending on your point of view) has been Bear Stearns.



Although part and parcel of the larger credit crunch, the primary story line is the collapse of the subprime lending market. Ironically, “subprime lending” refers to the practice of making loans of poor quality. Starting around 2005 a securitization mania began and loans such as “Alt-A” (or “liar loans”) with low or no documentation, or at the extreme, the absurd “ninja” loans (no-job, no income, no assets) were made to weak borrowers, aggregated, repackaged, and then sold off by Wall Street with active convenience. However, this securitization mania is not confined to the mortgage market as by far the largest synthetic market today is credit default swaps (“CDS”s), with a nominal value of approximately \$42.6 trillion. To put the size in to perspective, the capitalization of the U.S. stock market is \$18.5 trillion and the treasury market is only \$4.5 trillion. Hence, as in other large scale crises, government involvement and tax payers have been summons for help.

The roots of the 2008 crisis were weak fragmented supervision and poor credit analysis. Similar to the Panic of 1907, financial innovation and less than optimally capitalized balance sheets plus, exotic securitization methods developed a bubble enabling lenders to much more widely access low quality borrowers.

These events seem little different, in principle, to other historical crises, and ultimately, on March 16, 2008, under the supervision of the Fed, Bear Stearns, the 5th largest investment bank and major player in mortgage securitization in America, was effectively absorbed by JPMorgan.

Many viewed the Fed's actions as an “unprecedented” government bailout of an investment bank, with a US\$30 billion bill handed to taxpayers. However, while the particulars may have been unique, the government's willingness for large-scale involvement was essentially a repeat of past history with laws invoked from the 1930s, and with the 1907 crash as a precedent.



Part III — Historical Relevance

Historical perspective is interesting, but the question for our purposes here, as always, is, “How does this knowledge impact on CAI’s investment strategy, trading tactics, and market positioning?”

To an extent, it can be expected that a repeating virtual cycle of creation and destruction exists in both economies and stock markets. Therefore, market disruptive events are a natural part of the evolution of price, and happen with regularity over time. Bear markets exist, and vary in length and time relative to the depth of the disequilibrium being corrected. Government officials have proven ready to take corrective actions to avert worsening of large scale crises.

So, what does this suggest now that markets seem to have stabilized, somewhat? Although the situation is more known, and likely better than it was a few months ago, a bear market is still a bear market until it proves otherwise, and the intermediate trend is still down. Therefore, that being so, our positioning for the time being remains bearish. Tactically, we:

- 1) **Preserve Capital**, first and foremost, as always.
- 2) **Practice diligent counter party risk management**: As the Bear Stearns collapse illustrates, casual assumptions about the health of seemingly invulnerable counterparties are, in the current environment, extremely dangerous. Therefore, we continue to monitor and take decisive action that helps support **return of capital**.
- 3) **Employ Leverage Prudently**: As the strategy normally employs very little leverage in bull markets, we continue to do the same in bear market.
- 4) **Realistic expectations**: A bear market demands lessened expectations, both qualitatively and quantitatively. For instance, any short-side unleveraged trading can only by definition yield a maximum 100% gain. Whereas in a bull market stocks regularly move 100%, 500%, or more than 1,000%. As you will recall from our First Quarter 2008 research, Cisco Systems appreciated 75,000% in the 1990s, before imploding by 90%.
- 5) **Scaling In for Outsized Returns**: By scaling cautiously and following a trend to build a position (but without excess leverage, see #3 above), the Fund captures portions of moves that lead to outsized returns. We test first and scale in to larger positions as warranted, lessening downside risk if a position does not work out.
- 6) **Risk Control**: We always employ our proprietary risk-based algorithms and are cognizant of the varying temporal nature of down-trending markets – in bull markets profitable moves are large and continue to run over long periods, and in bear markets profitable moves are smaller and develop (and end) much more rapidly.

Conclusion

CAI AG implements these adaptive risk management and trend following processes to navigate the current market environment, critical tools since September 2007 when the bear market first seemed to emerge. So far, analysis indicates that the primary bear market remains intact. Structural market problems we track add confirmation. Overly bullish sentiment and divergent internal breadth measurements show uncanny resemblance to previous bear market rallies in 2001 and 2002. We believe risk remains very high and is growing.

If you would like to see the impacts of all this, examine CAI AG’s monthly results since September 2007 in the attached Fact Sheet. If the Fact Sheet is not attached, please feel free to email us at info@choicealternative.com or call +1 212 248 2733 x701 and request it.