DRIEHAUS CAPITAL MANAGEMENT LLC

July 15, 2009 Credit Market Observations

Correlation Does Not Imply Causation — Our Take on Liquidity in the Credit Markets Over the Past Year

Since the peak of the credit crisis in the fall of last year, I have read countless stories of extraordinary "illiquid" conditions in the credit markets from market participants and the financial press. In fact, one of the most frequently asked questions I have received from our clients and prospective clients is: "How do you manage your strategy in a daily liquidity fund?" Although last year was a historic one for global financial markets, and pockets of illiquidity in selected credit instruments crippled some investors, I believe most investors' perception of liquidity conditions in the credit markets over the past year are far different than what actually occurred — liquidity was available, for buyers and sellers willing to execute at market price.

My comments apply to the securities we primarily trade, namely corporate bonds (both straight and convertible debt), credit default swaps (CDS), agency securities, preferred stock, and hybrids. These security types have been often labeled as prime contributors to last year's widespread financial destruction. In addition to outright long and short positions, we use these securities to employ relative value strategies such as capital structure arbitrage, convertible arbitrage, and fixed income pairs trading in both a hedge fund and a mutual fund vehicle.

Following the collapse of Lehman Brothers in September of 2008, liquidity became somewhat stressed for many of these credit instruments, but it was certainly not what I would describe as an illiquid environment. Securities that traditionally traded with a quarter to half point bid-ask spread traded with a spread two, three and sometimes five points wide. For example, a bond with a bid-ask spread of 90 – 90.5 may be quoted 88 – 91 during market stress. These wider spreads increase transaction costs and can make price discovery more difficult, but do not impede a manager from trading. In fact, we had little problem executing our strategy in such conditions and entirely repositioned our portfolio during the fourth quarter of 2008. The market crisis brought some of the best relative value opportunities I have ever seen and we identified superior opportunities and implemented these trades into the portfolio.

To illustrate a corporate bond's liquidity, I pulled the last twelve months' trading activity of KB Home's 5.75 senior unsecured note of 2014. This bond issue is fairly small ($250 million), rated by Standard and Poor's at BB, and would have been a part of many basis trades given its near five year maturity. We have not held this security or the CDS over the past year. The data below shows all trades of over $250,000 notional value from July 1, 2008 to June 30, 2009.

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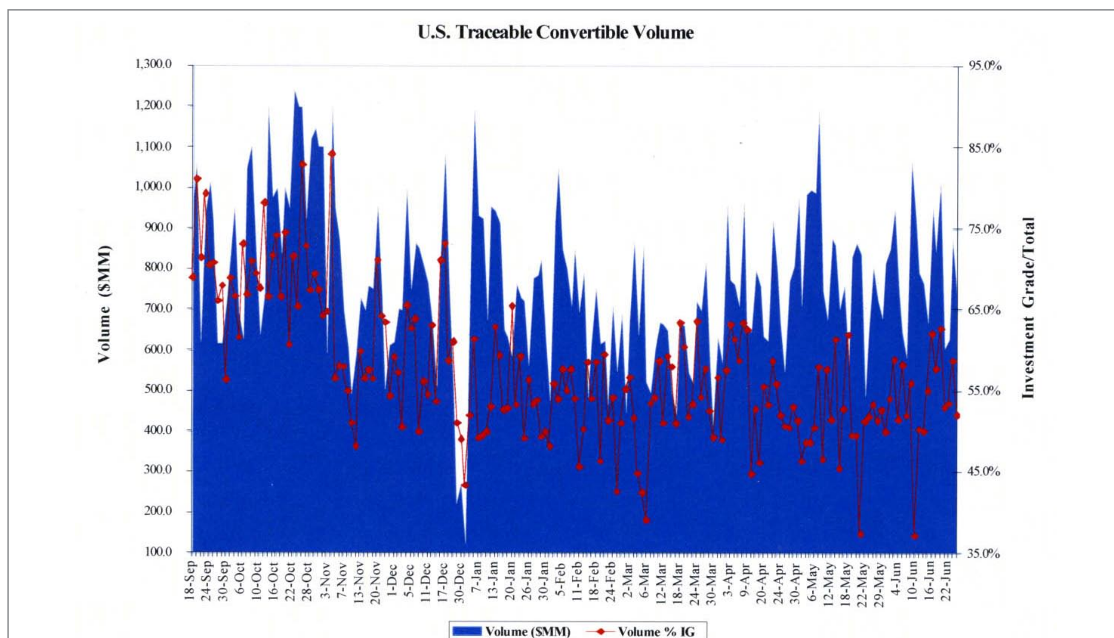
Jul 08		Aug 08		Sep 08		Oct 08		Nov 08		Dec 08	
Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity
82.5	1075	84	540	84	1000	78.5	1000	65	1000	59.5	1000
83.25	7000	84	1000	83.938	4000	72	1000	60.438	6730		
84.5	670	84	1000	85.5	2000	69	1000				
83.25	5010	83.313	2000			63.333	3000				
83.5	550	83.75	1000								
84.188	2160										

Jan 09		Feb 09		Mar 09		Apr 09		May 09		Jun 09	
Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity	Price	Quantity
73	1000	81	1000	74.5	2000	78.5	1596	87.75	2192	89.25	4909
73	6015			74.75	1000	85	1000	89	1000	88	250
				75	2000			89	1000	87.625	1000
				80	4000			87	1565		
				79.75	2000			87.75	1400		

As you can see, trading did slow during the fourth quarter. However, it is not difficult to estimate what a fair price for the security was during each month. I would suggest that if an investor wanted to sell a large block of this bond during the fall of 2008 at the peak of the crisis, then 58 to 65 would have been the price. If one wanted to sell the bonds at 70 in November, then you would have a "liquidity" problem finding a buyer. Come January though, there were no such issues. This illustrates another misperception by the investor community – that liquidity was challenged for many months in these securities. On the contrary, the only liquidity that was scarce by January in most credit securities was finding someone who would sell. For example, this bond, which was quite typical of most corporate credit bonds, was generally "bid only" in the first quarter of 2009 (i.e., there were only buyers with no one willing to sell). From trading at a low of 59.5 in December, this bond was two trades separated from trading at 81 in February. If one needed liquidity, I believe a 70 or 75 offer in January would have done the trick.

Likewise, I am often asked about the "horrendous" liquidity in convertible debt during the fourth quarter. I typically reply that converts' performance was terrible, but liquidity was acceptable. Many are skeptical at my response, so I searched for some data and found the chart below from Miller Tabak Roberts.



Source: Miller Tabak Roberts

As shown above, there was no massive drop in liquidity during the dark days of last year. In fact, the 30 day moving average of daily volume was $773 million on June 24th, 2009 compared to $896 million on November 24th, 2008. Not only was liquidity fine, daily volumes were actually higher on average in the 4th quarter of last year. Another notable trend is the decline in the share of investment grade credit instruments as a percentage of total volume. Following the Lehman failure, investors sold the largest, most liquid securities they could – investment grade converts fit the bill. Since the beginning of 2009, investors have clamored for higher yielding bonds, bringing the investment grade to high yield split back to roughly 50/50.

While I will not express my opinion as to why so many credit hedge funds instituted gate provisions last year, I will tell you what helped us stay liquid. First, we traded liquid securities with little to no leverage going into the crisis. These securities remained relatively liquid during the crisis. Second, our relative value approach made losses on our longs less shocking given the gains on our shorts. If we simply ran a levered long fund, the extent of the losses may have been overwhelming. Third, we remained active on a daily basis which kept us in front of the sell side trading flow. As opposed to retrenching and just holding a stagnant portfolio, we were constantly looking to see if our "cheap" positions were cheap enough compared to other opportunities that were arising. And last, our use of a daily independent pricing service helped our team gauge the extent of each day's market move. Given the chaotic environment, "taking our medicine" in daily doses from an outside party was more palatable than making internal price judgments on a monthly basis.

Instead of classifying security types as illiquid, I would argue the past year has enabled investors to classify their investment managers as more or less "liquid." The liquidity issues that arose over the past year were not the result of a security or a strategy, but rather common inputs/factors such as leverage, diversification, risk tolerance and manager execution. I believe that those factors, as opposed to the credit securities themselves, were the root of the hardships that besieged many credit funds. As a low volatility, absolute return manager, we are trying to avoid subtle pitfalls in these factors, and welcome the opportunity to find value in any class of securities.

Please do not hesitate to contact us to speak at greater depth.

Sincerely,

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