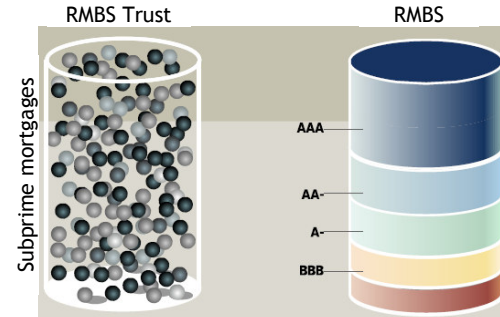


## THE ABC OF CDO'S

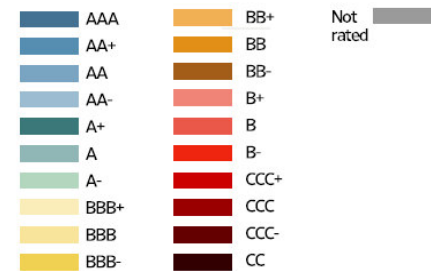
Investors are being forced to learn new terminology as difficulties related to structured credit investments such as Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO) generate significant losses for financial institutions around the world.

### HOW CDO'S ARE BUILT

The techniques behind CDO's were first developed by Lew Ranieri in the 1980's, and initially applied to basic mortgage products. The targeted benefit was greater diversification and better dispersion of risk related to mortgage lending. The governing principle is quite simple: by pooling thousands of loans made in different geographical areas by different lenders, investors as a whole are less exposed to the problems on any single borrower. In essence, we are spreading eggs among multiple baskets. Let us note that these techniques can be applied to any type of mortgage loan as well as to a broad array of other lending products such as commercial loans, credit cards receivables, and auto loans. In this edition of the Marker, we focus exclusively on residential mortgage-backed securities (RMBS).



As demonstrated by the chart, RMBS package thousands of loans from a broad range of areas and borrowers. These vehicles then redistribute cash payments and income across various bond categories issued by the pool. Each bond class has a specific risk profile as evidenced by its rating. The highest-rated bonds have first access to incoming cash, and are deemed to be safer. Their yields will however be lower. The lowest-rated classes - often referred to as mezzanine or equity - present the greatest risk should borrower defaults exceed expectations, but their returns are expected to be significantly higher. The critical point to remember about CDO's is they may apply these techniques with very different results. In their purest form, they are assembled exactly as outlined in the accompanying chart. However, a large number has been assembled by repackaging existing RMBS bonds, while some even consist of CDO's of CDO's whereby one CDO purchases securities issued by another, thereby further removing the investor from the original underlying loans.



Source: WSJ

### FAULTY UNDERLYING ASSUMPTIONS AND AGENCY CONFLICTS LEAD TO NEED FOR EARLY SPRING CLEANING

The most critical assumption underlying RMBS and related CDO securities is the fact U.S. home prices had never before declined on a national basis. As such, a geographically diversified portfolio was deemed to be immune to broad defaults. Holders of these securities are now learning a very painful lesson about poor loan underwriting and the disastrous consequences of a pyramid effect on risk. Recent difficulties in this area are also triggering fears that similar trends could occur in other areas where these techniques are used, including corporate loans such as those destined to finance private equity leveraged buyouts.

### NATCAN WEEKLY MARKER

The end of a record bull market for the U.S. residential housing sector confirmed that faulty lending practices and poorly engineered financial instruments can be a recipe for disaster. Financial institutions around the globe are now acting as mediums for asset markdowns. This is a painful but healthy development. Opportunities could emerge in financial services in 2008. Yet, much hard work will be required to distinguish the good from the bad; investors should proceed with caution in this area.

Michael Quigley, CFA  
Senior vice president, Distribution

## FINANCIAL MARKETS

RETURNS AS AT JANUARY 11, 2008 (%)	MTD	QTD	YTD	RATES AS AT JANUARY 11, 2008	
S&P/TSX	-1.41	-1.41	-1.41	CAD/USD	1.02
S&P 500	-2.04	-2.04	-2.04	CAD/Euro	1.51
S&P/TSX Small Cap	-2.82	-2.82	-2.82	US Treasuries yield 10-yr/30-yr	3.81/4.39
Russell 2000	-5.60	-5.60	-5.60	GOC bond yield 10-yr/30-yr	3.80/4.06
MSCI EAFE	-1.18	-1.18	-1.18	Fed Fund Rate (target)	4.25
MSCI World	-1.32	-1.32	-1.32		
DEX Universe Bond	1.03	1.03	1.03		

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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