MORGAN CREEK
CAPITAL MANAGEMENT, LLC

A Morgan Creek Capital Management White Paper

THE ROLE OF CREDIT IN THE NEW WORLD

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The Role Of Credit In The New World

Significant Opportunities in Credit Markets

Driven by the increase in leverage and volatility, the disintermediation of the financial system, and potentially the worst distressed cycle since the Great Depression, we believe that debt will become the "new equity" and that the opportunities for strong returns in the credit markets have rarely been better. Despite the return of credit spreads to pre-Bear Stearns bankruptcy levels over the past year, we believe there are opportunities across the whole risk spectrum of credit strategies and in all sectors, including investment grade, high yield, leveraged loans, RMBS, CMBS, ABS, converts, and preferreds.

This white paper reviews structural changes in the U.S. and global economies, the emergence of an extended deleveraging cycle, an increase in economic volatility, and the growth of securitization through the "shadow banking system." Based on these fundamental changes, we believe that the behavior of credit and its role in fixed-income portfolios has changed dramatically. As such, we contend that the traditional, long-only, fixed-income model will be sub-optimal and that managers who employ a long-short investment strategy will be better able to capitalize on the increase in economic volatility and the new behavior of debt.

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As spreads recover to less distressed levels, there may be a perception that the "credit opportunity is behind us." This perception is based upon the traditional view of credit market beta associated with the tightening of spreads. We disagree with this conclusion, and while we agree that the credit beta opportunity has diminished, we believe that the structural changes detailed in this paper support long-short investment strategies focused on deriving alpha from the extensive and prolonged distressed environment at hand.

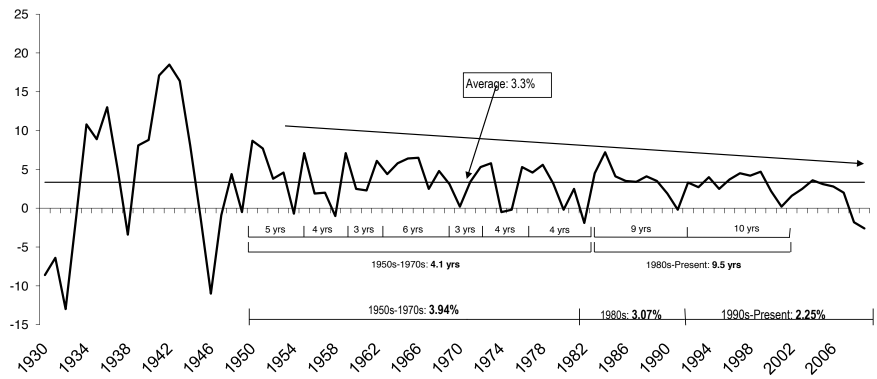
Deep Structural Changes in the U.S. and G-7 Economies

To better understand the current financial climate, it is essential to examine the deep structural changes that have taken place in the U.S. and G-7 economies since WWII.

In the years following WWII and leading up to the 1980s, the U.S. and G-7 economies were industrial-based and characterized by strong economic activity, robust GDP growth rates of around 4%, and short economic cycles. Driven by young demographics and highly cyclical industrial activity, these economic cycles consisted of deep recessions and ensuing strong recoveries. Consequently, economic volatility – as defined by the standard deviation of 16 quarters of gross domestic product – was in the range of 5% for most of this era.

By the 1980s, most G-7 economies had shifted from an industrial-based economy to a more service orientation. The impact of an increasingly interconnected globalized economy and maturing populations was to transform the once short and volatile cycles that characterized the industrial economies during the first few decades after WWII into milder and longer cycles of recessions and recoveries. During this period, economic cycles expanded from around three to four years to between seven and nine years, and GDP growth rates declined from approximately 4% to 2.6% as illustrated in Figure 1.

*Figure 1: Real U.S. GDP Growth**

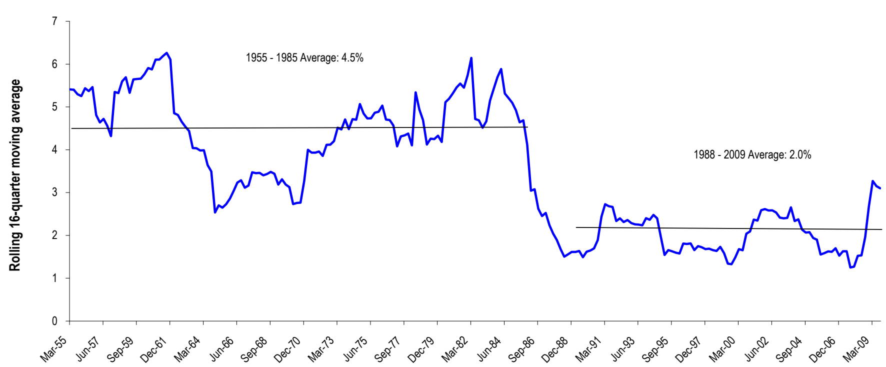


*Sources: Credit Suisse ("CS"), Federal Reserve Board ("FRB"), Bloomberg

A Return to Higher Levels of Volatility

Perhaps the most telling and significant statistic from the transformation of the industrial-based to the service-based economy was the reduction in economic volatility, as illustrated in Figure 2. In contrast to the 5% average during the decades following WWII, the post-1980 economy had an average of a 2% level of volatility.

*Figure 2: Real U.S. GDP Volatility (Quarterly)**



*Sources: CS, Bureau of Economic Analysis ("BEA")

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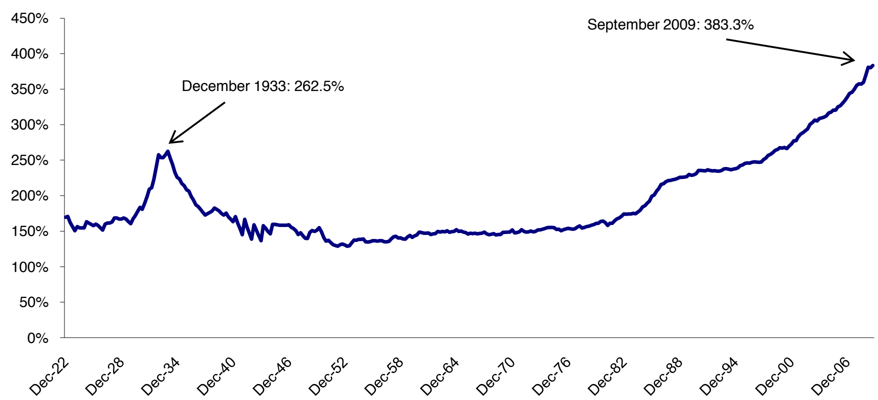
Importantly, over the last two years GDP volatility has escalated back toward the historical average of 5%. We believe that volatility will remain elevated due to an elongated distressed cycle, continued government intervention, and ongoing disruptions within the securitization market/shadow banking system. Based upon the historical link between GDP volatility and the length of economic cycles, the level of spreads and PE ratios, and the total amount of systemic financial leverage, we believe that the recent increase in volatility could have dramatic economic and financial implications. As economic volatility increases, we expect spreads to increase, leverage to decrease, PE ratios to come down, and economic cycles to shorten. We have begun to observe these changes in the markets and we expect these trends to continue.

Unprecedented Financial System Leverage

As GDP volatility decreased from 5% to 2%, economic activity slowed, the risk of default declined, and higher levels of financial system leverage could be accommodated. Consequently, companies increased debt in order to engineer relatively stable levels of earnings growth during a period of decreasing economic growth. Furthermore, the contraction of interest rates and spreads during this period, and the resulting low return/yield environment, encouraged investors with legacy liabilities to employ leverage in order to meet required hurdle rates. As illustrated in Figure 3, the amount of leverage employed since the early 1980s increased dramatically. As of September 2009, total debt as a percent of GDP was 383%, dwarfing even the 263% level reached during the Great Depression.

*Figure 3: Total U.S. Debt as a % of GDP**

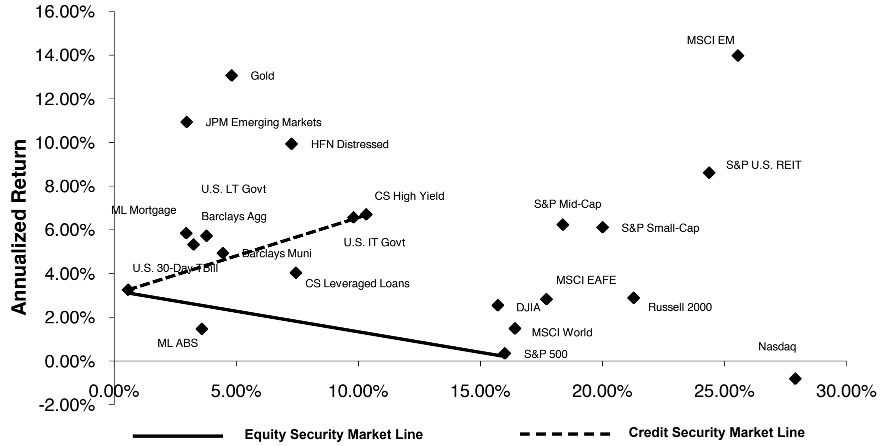


*Source: FRB

Given that leverage has increased dramatically over the last three decades, it is not surprising that all asset classes have experienced higher volatility and have taken on greater risk characteristics.

Given that leverage has increased dramatically over the last three decades, it is not surprising that all asset classes have experienced higher volatility and have taken on greater risk characteristics. Senior bank debt is now behaving more like subordinated debt; subordinated debt is behaving more like equity; and equity is behaving more like options. Essentially, there has been a "cram down" within the overall corporate capital structure. In the "New World", we would expect debt to have higher volatility, higher levels of downgrades and higher default rates. In fact, all of these trends have been recently observable in the marketplace. We believe that the returns over the last ten years, as evidenced in Figure 4, demonstrate how debt has replaced equity from a risk/return perspective, and we expect this trend to continue.

Figure 4: The New Capital Market Returns (Credit vs. Equity)
*Risk/Reward of Various Assets 1999-2009**



*Source: Bloomberg (for the period 1/1/99-10/1/09, or since inception).

Increased Securitization and the Role of the Shadow Banking System

In addition to the increase in leverage and the decline in interest rates since the early 1980s, the shift towards the securitization of previously unstructured, and often privately held, instruments had a significant impact on the capital markets.

While the underlying assets were not fundamentally liquid, their securitization "wrapping" allowed them to be standardized and, for the first time, priced by market systems rather than models.

Beginning in the 1980s, the growth of the securitization market transformed a broad array of previously unstructured assets, including bank debt, high yield debt, mortgages, credit cards, automobile loans, and emerging market corporate debt. As securitization rolled progressively from one fixed-income sector to the next, more and more illiquid assets came to the market. While the underlying assets were not fundamentally liquid, their securitization "wrapping" allowed them to be standardized and, for the first time, priced by market systems rather than models. During this period of heavy securitization, many debt instruments were no longer held on bank balance sheets and instead were owned by a multitude of non-financial investors and institutions. With the securitization market providing a substantial amount of the financing needs of corporations during this time period, it was often referred to as "the shadow banking system."

With banks controlling a smaller share of the overall financing market, there was a shift in influence and control from the traditional financial system to the shadow banking system. Historically, central banks were responsible for managing inflation and maintaining orderly capital markets by easing and tightening liquidity to moderate economic slowdowns and expansions. Consequently, available credit and money supply, like overall economic activity, were quite cyclical. But with the shadow banking system now providing a significant amount of capital, one of the central bank's most effective tools for controlling the market – liquidity – became less influential. The central bank had, in a sense, been disintermediated.

In addition to the increase in lag time between policy and economic effect, the rise of the shadow banking system forced a shift in the role of central banks and the Federal Reserve. As evidenced by the U.S. government's recent interventions, the central bank had to resort to much more aggressive tactics to impact the financial markets given the size and scope of the shadow banking system. In contrast to the stability of the traditional banking system, the shadow banking system was quite fragile and very sensitive to loss. The recent financial crisis and the unprecedented government response were not so much the result of the economic slowdown but were a reaction to the collapse of the shadow banking system. Given the sheer size of this system and its unstable nature, the recent uptick in economic volatility is not surprising. In U.S. financial history, only the economic crises of 1907 and 1929 were similar results of a disruption in the financial system rather than a slowdown in demand, a testament to the uniqueness of the current environment.

Record Defaults and Downgrades Expected

Within this cycle, we are likely to see an unprecedented volume of defaults, downgrades, M&A activity, restructurings, and equity issuance resulting from an extended period of deleveraging across a broad array of markets and geographic sectors.

The unique combination of elements, including the rise in economic volatility, the increase in leverage over the last thirty years, the shift towards securitization, and the disintermediation of the financial system have set the stage for a distressed economic cycle not witnessed since the Great Depression. Within this cycle, we are likely to see an unprecedented volume of defaults, downgrades, M&A activity, restructurings, and equity issuance resulting from an extended period of deleveraging across a broad array of markets and geographic sectors.

The scope of economic changes previously highlighted combined with three primary drivers of defaults – 1) the pace of innovation and natural increase in obsolescence; 2) the surge in the price of liquidity; and 3) the onset of the financial crisis – has created a "perfect storm" for downgrades and defaults. Yet despite the obvious negative externalities of job and financial loss, it is important to note that defaults are not inherently detrimental to economic growth. For example, vast improvements in our economy such as the highway system and airlines industry have come at the expense of defaults and bankruptcies in the train and passenger boat industries. Defaults, in a sense, encourage a form of economic Darwinism in which weaker companies and industries fall by the wayside, allowing stronger, more vibrant companies and industries to emerge and thrive. The presence of winners and losers provides significant opportunity for managers with the flexibility to go long and short.

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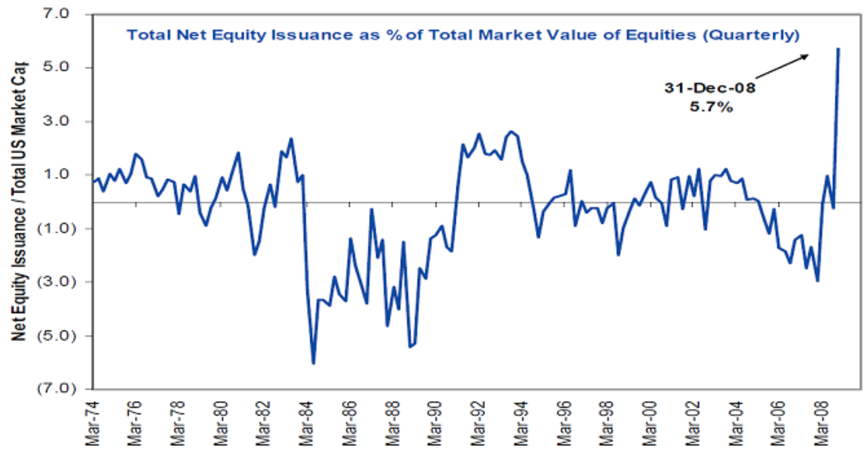
Given the buildup in leverage over the last thirty years, it would not be unreasonable to expect this deleveraging cycle to continue for a decade or more. For companies weighed down with debt and unable to outgrow their liabilities, defaults and equity issuance are two primary options for reducing leverage. While we have recently observed an uptick in both activities, and expect this trend to continue for quite some time, the particular forms of deleveraging (defaults and equity issuance versus M&A activity and restructurings) may not increase in a linear fashion. We expect the deleveraging to vary significantly across industries and companies as over-leveraged companies will have far fewer options. This process may be painful in the near term for many companies, as we expect approximately 60% of the high yield market to cumulatively restructure during this cycle.

As illustrated in Figure 5, during the decrease in GDP volatility in the early 1980s, there was an increase in corporate leverage through equity buybacks and dividend recapitalizations. This trend is reversing today, as the total net equity issuance has significantly increased for the first time in the last 30 years.

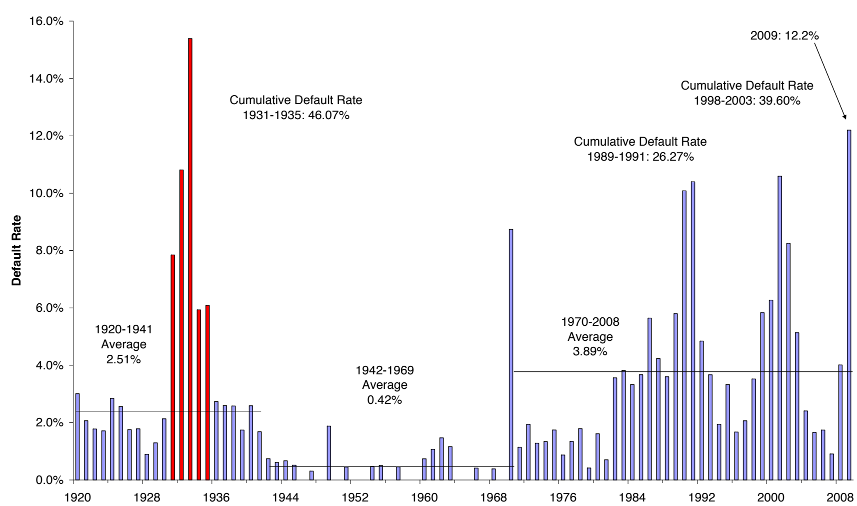
*Figure 5: Net Equity Issuance as a Percentage of Market Cap**



*Source: Goldman Sachs Research, Haver Analytics, FRB

Along with equity issuance, deleveraging cycles traditionally spark an increase in defaults. As shown in Figure 6, the average speculative default rate has increased dramatically from the era of low leverage during the decades after WWII. Following the secular decline in interest rates during the 1980s, corporations began to steadily and heavily increase their leverage, resulting in a natural increase in defaults. During recessions in particular, defaults rose dramatically and the cumulative default rate for non-investment grade credit during the 1989-91 and 1998-2003 periods reached 26% and 40% respectively.

*Figure 6: Annual Speculative-Grade Default Rates 1920-2009**



*Source: Moody's

By simply extrapolating the current increase in defaults relative to the continued increase in leverage (making no adjustments for the much more severe decline in

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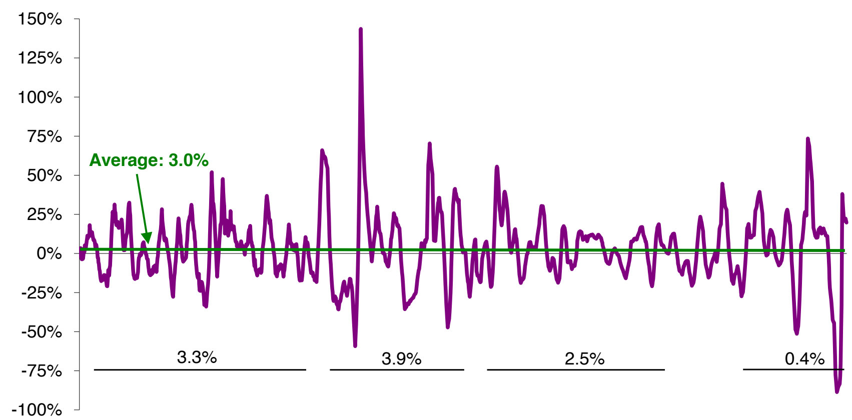
economic activity) we would expect the ultimate rate of speculative-grade defaults to reach nearly 50% in the current cycle. Considering the much larger than average drop in GDP during the current recession, we anticipate that the ultimate level of defaults could be upwards of 60%. Adding to this bleak outlook is the significant impact this recession has had on corporate earnings. As illustrated in Figure 7, the 89% decline in earnings during the current recession has outpaced the 59% drop during the Crash in 1929. To put this current correction and deleveraging cycle in context, (excluding financials) the current recession has resulted in an average decrease of 50% in corporate earnings. Despite the Great Depression's draconian 15% drop in GDP, the current economic contraction of 4%, when adjusted for leverage, has had a more significant impact on corporate earnings.

Figure 7: S&P 500 Real Earnings Growth 1872-2009[*]



Note: Inflation Adjusted. Goldman Sachs estimated 2009-2010 earnings.
[*]Source: Robert Shiller, S&P, Goldman Sachs

In the current cycle, downgrades and defaults should be higher than average and will not be limited to below-investment grade credit.

In the current cycle, downgrades and defaults should be higher than average and will not be limited to below-investment grade credit. Today, the size of the distressed and defaulted debt market is approximately four times larger than it was during the 2000-2002 recession, and it is substantially greater than one would expect given the 40% cumulative default rate experienced. Part of this increase comes from the expansion of defaults beyond sub-investment grade bonds to a substantial portion of the investment-grade bond market. Consequently, we are likely to see a dramatic increase in "fallen angels," a downgrade of approximately 20 to 25% of the investment grade corporate bond market, and a substantial loss of value in both US and global debt markets. In addition to corporate distress, we also see great stress in the commercial and residential real estate markets which will likely result in significant dislocations in those credit markets as well.

The View Forward

Increased leverage, rising volatility, disintermediation of the financial system, and possibly the worst distressed cycle since the Great Depression have created an unprecedented opportunity in global credit markets. We believe that debt will increasingly become the "new equity" and that the opportunities for strong returns for investors in the credit markets will exist for an extended period. The changes detailed in this paper will have a meaningful impact on how an investor should structure a credit portfolio going forward. Over the last thirty years, the environment of declining inflation, low volatility, and long economic cycles was conducive to managing traditional long-only credit portfolios. In contrast, today we believe that we are in an extended period of deleveraging which will result in increased economic volatility and high levels of uncertainty. In an increasingly volatile investment environment, we strongly believe that long/short strategies which are more "alpha" oriented, will produce more consistent returns than the traditional long-only approach.

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We have done extensive research on the performance of long-only managers versus long/short managers during periods of increasing volatility. For example, during the period from March 2005 to October 2009, long-only "best of breed" managers struggled to break even, averaging a -1.1% return rate with a 3.5% standard deviation. In contrast, a portfolio of the "best of breed" long/short managers over the same period significantly outperformed long-only managers, averaging an 11.2% return rate with a comparable 4% standard deviation. Long/short managers appear to protect capital more effectively during volatile periods and given the dramatic changes in the capital market, we expect higher than average volatility in the coming years. Additionally, with market experts calling for significant increases in future inflation, a long/short position within a diversified credit portfolio could help mitigate the risks loss related to the impact of rising interest rates on traditional fixed income portfolios.

In summary, given the market environment, we believe that an optimal investment strategy for a credit portfolio should have a number of characteristics including:

- Be evergreen in nature to capitalize on the extended distressed environment
- Utilize long/short strategies to hedge risk in volatile environment
- Invest across all credit sectors to capitalize on the breadth of the dislocation and enhance diversification within the portfolio
- Utilize specialist managers who have a significant expertise in a number of sectors or strategies with a flexible mandate to allow them to adapt to rapidly changing markets
- Be diversified globally to capture alpha across multiple geographies and enhance diversification

Morgan Creek is working with clients to design portfolios that incorporate these characteristics. We believe that an optimal portfolio strategy will be relatively concentrated across multiple managers employing complimentary strategies across all credit sectors. Through an extensive manager research process, we have evaluated over 600 managers and selected a group of "best of breed" managers that have the skill to both protect capital and add substantial value in what we expect to be a very uncertain and volatile investment environment in coming years.

We look forward to the opportunity to review our thoughts on the role of credit in the new world and how we might assist you in re-positioning fixed income portfolios to capitalize on the opportunities created in the current credit market environment.

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