Preferred Securities Market Update – 3rd Quarter of 2010:

The preferred securities had its strongest showing of the year this quarter, after last quarter's correction. The Merrill Lynch US Preferred Stock, Fixed Rate $25 Par Index (p0p1) rallied 8.78% and the Barclays Capital Securities US Dollar Tier1 Index rallied 10.33%.

Review of July Investment Environment (p0p1 +4.15%; Tier1 +5.03%):

July was the best month for hybrid securities since September 2009. The strong performance was driven by several positive catalysts including:

- Goldman Sachs reaching a settlement with the SEC which helped to add light to a regulatory shadow in the broker-dealer community,
- US bank trust preferred securities receiving an unintended technical boost from the Collins Amendment to the financial reform bill (i.e., Dodd-Frank Bill),
- continued momentum in the insurance sector where equity credit is knocked-down by Moody's reversing earlier views,
- the European bank stress test results being supportive and showing no surprises, and
- Basel-3 recommendations taking a much easier stance on capital reform and allowing banks extended time to make the transition to new standards.

Our early read that US bank trust preferred securities should perform well within the context of them becoming expensive funding rather than cheap equity gained market affirmation as this sector rallied steadily throughout July. Discounted US bank trust preferred issues rallied toward par and premium issues began to trade to a defacto term of 2013 (when the phase-out of Tier-1 capital begins). Lower coupon trust preferreds from banks that have heavily weighted the structure in their Tier-1 performed extraordinarily well on the heels of the Dodd-Frank Act. In the Yankee space, foreign bank names were the standout performers due to the more relaxed stance from the Basel-III Commission which affirmed Tier-1 capital as a key measure of solvency strength. It also allowed a broader capital definition which fostered improved views on risk premiums and drove prices higher. Credit Agricole and SocGen did well because the easier capital rules had specific relevance to French banks. Discounted step-up structures traded up at the end of the month after UBS announced intentions to call its 8.622% issue rather than extend it at a much lower floating rate coupon.

The insurance sector had a strong rebound during the period, as well. There was increased focus on possible liability management trades by enhanced trust preferred issuers due to reductions of equity credit by Moody's. Progressive's tender for its 6.70% hybrid provided a clue to what could become a broader move toward calling insurance hybrids due to the lower equity credits. Overall, hybrids did well during July due to bullish technicals such as no new supply, the possibility of liability management exercises and the broad reach for yield. Lack of alternatives in the money markets and fickle equity performance added a supportive investment theme to hybrids during the month.

- There were no new issues in July

Review of August Investment Environment (p0p1 +2.66%; Tier1 +2.23%):

Performance for the month was among the best of the year as the strength from July's gains continued its momentum into August. The main drivers this month were rates. August provided the greatest decline in long US Treasury yields since November 2008 when the financial markets were reeling after the Lehman Brothers bankruptcy. The 10yr US Treasury yield declined 44 bps and the 30yr US Treasury yield declined 47 bps due to significant concerns that the US recovery was losing momentum. A broadened backdrop of falling equity indices worldwide also encouraged investors to buy yield. As was the case in June, preferred securities prices went up along with US Treasury prices affirming our statements then that preferreds should be returning to trade in a more traditional fixed income fashion. Amidst the strong rally in the yield curve structure, there was other news even more profound for hybrid preferred securities.

The Basel Committee proposed new and specific regulations on the design of future hybrid capital instruments for banks. Although the Committee has no regulatory or enforcement powers itself, its proposals carry significant weight among national regulators and tend to set overall design targets. This proposal is about the specific design of bank capital instruments other than common equity. The Basel Committee's goal is to ensure that all regulatory capital instruments (including preferred stock and other hybrids) bear a loss should the bank become effectively insolvent and need public funding. This loss would come in either a principal write down or equity exchange in the event a bank is unable to support itself in the private market. The Committee's rationale is that many bank capital securities experienced little, if any, interruption in payments during the crisis – this is one of those "half-truths", as many bank capital securities did absorb losses. Nonetheless, the Committee is concerned that various forms of governmental support provided during the financial crisis "lifted all boats" – including hybrids. It believes that market disciplines would be improved should hybrids be forced to absorb losses in the event a bank becomes effectively insolvent. The trigger events for such hybrid losses would be the earlier of: a) a decision by a bank's regulator that a write-off would be necessary to prevent a bank's non-viability; or b) an injection of capital by a government to prevent a bank from becoming non-viable. The nature of the write-off of the hybrid instruments could be either: a) a complete write-off of the obligation (temporary write-downs would be prohibited), or b) a forced conversion of the hybrid into common stock of the bank – the amount of such stock to be determined by the bank and its regulator. We expect there to be a lot of comments about this come October when the comment period ends.

- Farm Credit Bank of Texas (A3/nr/A) did a $300mm new issue perpetual, non-call 10yr, non-cumulative preferred security to yield 10%.

Review of September Investment Environment (p0p1 +1.74%; Tier1 +2.75%):

The hybrid market continued its uptrend in September to close out it best quarter of the year. The rally was aided by two factors within the themes of our Technical Trifecta relating first to Dodd-Frank and then to Basel III. The first factor was triggered on September 1st when Comerica announced that it will call its only trust preferred, CMA6.576%, by stating, *"The recently signed Dodd-Frank Act changes the treatment of this type of security, so it is no longer an effective form of equity capital for us,…"* The issue was trading at a 6 point discount at the time and the call surprised the market because the phase-in period from Dodd-Frank was still over 2 years away. The US bank trust preferred market rallied on this news, but at the same time it raised significant confusion over the company's actual ability to exercise its call option. We found the company's rationale to be peculiar for two reasons: 1) the Act does not currently change the capital treatment and 2) the current treatment (i.e., 100% treatment) is still effective and will be so until 2013. Comerica appears to have supported its call rationale by remarking that the issue is no longer effective equity capital even though this type of issue was ruled (and desired) to be effective by the Dodd-Frank Act until 2013. Spectrum, despite no position of interest in this Comerica issue, endeavored to provide its perspective on the Capital Treatment Event by writing an interpretive opinion and posting it on our website. Our objective was to present the business spirit of the covenant to the court of investor opinion and to provide bank managements with a reasoned point of view on why this call option is not available now. We also encouraged the Fed to provide an interpretive letter on the call provision. Eventually, two of the bigger banks (BB&T and Keybank) appeared to understand the magnitude of the concern by announcing that they would not consider calling their trust preferred until the phase-in period begins. Another small bank, City National, nonetheless decided it too would call its only trust preferred issue. Clearly, US bank trust preferred will become increasingly expensive capital for banks to leave outstanding as we get to the phase-in period where its Tier-1 status is taken away. Calling trust preferred securities will still be an economic issue nonetheless, that may or may not look as attractive years from now as it does today – this will depend mostly on funding rates at the time. As a result, it is difficult to precisely gage at what phase-in point US banks will retire their trust preferred, but in any event, prices should be far less volatile in this sector over the next 5 years due to the phase-in "legislated maturity".

The second factor which positively influenced the preferred market this month came on September 12th when the Basel Committee on Banking Supervision announced higher minimum capital standards and fully endorsed agreements it had reached on July 26, 2010. The Group of Governors and Heads of Supervision (the oversight body of the Committee) stated that the new capital "transition arrangements will enable banks to meet the new standards while supporting the economic recovery." The Committee's Basel-3 capital reform package includes increasing the minimum common equity to 4.5%, Tier-1 capital to 6%, and total capital ratio to 8%, as a percentage of risk-weighted assets. Banks will also be required to hold a 2.5% capital conservation buffer to absorb losses during periods of economic or financial stress. In the event regulatory capital declines toward minimum levels, restrictions could be placed on a bank's ability to pay dividends and discretionary bonuses. These capital reforms, as well as the introduction of a global liquidity standard, will be presented to G20 leaders at the Seoul summit in November. Member countries must translate the September 12th agreements into their national regulations on or before January 1, 2013. The issue of what will set the entry criteria for Tier-1 and Tier-2 capital is still undecided (Spectrum provided two views on this to the Basel Committee). Nonetheless, the new announcement proclaimed that "capital instruments that no longer qualify as non-common equity Tier1 capital or Tier2 capital will be phased out over a ten year horizon beginning January 1st 2013." We are pleased with the long grandfathering period, but were surprised by a waterfall phase-out of the step-up structure once they reach their first call date. Here, the Committee decided to accelerate the disqualification at the call date to appease some investors who were steadfastly positioned on the banks "moral obligation" to call the paper on the step-up date. It seems conflictive to us, that on the one hand, the Committee was disappointed that some hybrids weren't behaving properly by not absorbing sufficient losses, yet when the step-up structure does behave properly and extends to a perpetual when funding rates rise the Committee concedes to investor complaints – even though these institutional investors knew that this risk was there to begin with and accepted it. As a result of this "moral kiss" from the Committee, discount Yankee step-up hybrids rallied 4-5 points over the course of the month. We note that even to the extent that a step-up is fully-phased out with the accelerated rule, extension risk still exists because some issuers have very inexpensive funding rates by today's standards – the floating coupons could be cheap especially if the swaps curve remains as compressed as it is now.

The quarter came to a close with another boon for hybrid investors, this time from Citigroup. The bank came to market with a surprise trust preferred refinancing of the US Treasury's TARP funding. Citigroup did this by exchanging the $2.2billion 8% TARP trust preferred sold to the US

Treasury for Citigroup Capital XIII 7.785%. This issue pays a fixed coupon until 10/30/15 and then floats at 3mL+6.37% until maturity on 10/30/40. Because this was a restructuring of existing TARP funds the exchange issue is not subject to the phase out requirements of the Dodd-Frank Act. These trust preferred securities should count towards Citigroup's Tier-1 regulatory capital until 1/1/18 and are not callable before 10/30/15 even in the event of changes in bank regulatory law or interpretation. The deal was split 50/50 between retail investors and institutions and was heavily oversubscribed due to the yield and 5yr fixed term feature.

- Citigroup (Ba1/BB-); $2.246mm new issue cumulative trust preferred, non-call 5yr, to yield 7.875%. No capital treatment event call risk prior to ordinary call provision.

The Market Outlook for Preferred Securities:

- We have a constructive fundamental outlook on credit and regulatory reform in financial services and a slow growth outlook for the US economy.

- Regulatory reform by year end should foster counter-cyclical capital requirements that call for more reserves during good times and thicker core capital. The Basel-3 standards will be presented to G20 leaders at the Seoul summit in November.

- We expect realignment of bank capital come by 2013 that should lead to new hybrid products like contingent capital and more foreign issuance of (tax efficient) exchangeable capital securities (like HSBC) and perhaps a rebirth of the trust preferred from US banks, but in the form of junior subordinated debt (i.e., Tier-2).

- Trust preferred securities of US banks are to be grandfathered until 2013 and then a 3 year phase out by 2016. Foreign issuers have a grandfathering period through 2013, then a 10 year phase out by 2023. Both serve to make a "legislated maturity" and potential attractive horizon yields with reduced volatility. We expect either outright calls to ensue or various forms of liability management opportunities that support price behavior.

- Reductions in equity credit allowed by rating agencies should augment call option likelihood on certain discounted capital securities in the insurance sector, as well.

- Sovereign risks will likely continue to cause some macro uncertainty, thus fostering real rates of return on preferred securities that should persist at attractive differentials to senior financial debt – this spread today is about 165 basis points on average.

- The steepness of the yield curve should continue to make preferred securities a compelling asset class as declining return expectations in equities could foster a rotation into more defensive dividend sectors like the preferred asset class.

- We experienced positive ratings actions this quarter and we expect this trend to continue given the capital changes underway on a global perspective – this should foster a benign investment environment for hybrids.

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