SEI New ways. New answers.® December 2008

Update on CMBS: December 2008

By SEI Investment Management Unit

Overview and Market Update

Commercial mortgage backed securities (CMBS) have been and continue to be an integral part of some of SEI's fixed income strategies. Over the last several weeks, deteriorating credit fundamentals, confirmation of an economic recession, forced selling and a lack of buyers conspired to send CMBS prices plunging. Insurance companies and other traditional investors in this market are struggling themselves and have not only stopped buying, but have been forced to sell some of their existing CMBS holdings in order to raise cash. Given these extraordinary events, we hope a review of CMBS securities and an update on market conditions will provide some insight into why SEI remains confident in CMBS and the role they play in a diversified portfolio.

An Introduction to CMBS

CMBS are securities that are collateralized by pools of geographically diverse loans on various types of commercial real estate properties, including office buildings, retail, warehouses, multi-family housing, hotels and health care properties. These properties are income producing and operated for economic profit. A typical commercial real estate loan that is used as collateral for these deals is a ten–year, fixed-rate security. A typical loan would represent 80% of the value of the property (loan to value ratio) and incorporates features that require the borrower to maintain a minimum level of cash to cover interest payments. They also have very strong protection against prepayments for several years, preventing the borrower from refinancing due to lower interest rates.

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The structure of CMBS is very similar to the structure of a residential mortgage backed security (RMBS). The principal and interest payments from the underlying loans are passed through to the holders of each class or tranche of the CMBS, based upon a payment hierarchy determined upon issuance. Each tranche has varying levels of protection (know as credit enhancement) against potential delays or shortfalls in interest and principal payments. This credit enhancement is usually brought about through the allocation of any loan losses to the securities at the bottom of the capital structure before working up to the tranches with higher credit-quality ratings. This process is enabled by over-collateralisation, which means the underlying collateral backing the securities is greater than the principal amount. Combined with the priority of interest and principal payments, this over-collateralisation results in a top-level AAA rating for the most senior tranches from the credit rating agencies. As a result, the highest rated and better protected tranches trade at lower yield levels than the tranches with lower ratings.

The largest portion of a standard CMBS deal is the ten-year, AAA rated “super-senior” tranche, named as such because this AAA rated security has the most credit enhancement relative to other AAA rated tranches in the deal. These “super senior” securities are often used as the bellwether for the market, as they are typically the most liquid security in the deal. The CMBS allocations in the SEI Funds portfolios are predominantly comprised of these securities, which typically have 30% credit enhancement to protect against loan losses.

Recent Results: A Market in Turmoil

In November, the CMBS sector posted its worst month of performance on record, underperforming equivalent duration US Treasuries by nearly 23%. The spread between yields on higher quality (investment grade) CMBS and equivalent Treasuries widened over 7 percentage points to a record 15.41 percent, before retreating in the final week of the month to 10.85 percentage points. Even spreads on so called “super senior” CMBS likewise gapped wider, and these securities are now yielding close to 14.00%. Current pricing , for these high quality securities at approximately 67 cents per $1.00 of principal amount, is now reflecting wildly improbable assumptions regarding delinquency on payments, defaults and ultimate loss of principal (loss severity) even though the structural superiority of these bonds provides substantial protection against capital losses.

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The catalysts for this event include:

1) Widespread forced selling by hedge funds, banks and broker dealers.

2) A shift in the focus of the US government's Targeted Asset Relief Program (TARP) away from buying troubled mortgage-related securities, including CMBS

3) A buyers strike by traditional investors (insurance companies and money managers)

4) Three retailer bankruptcies (Mervyn's, Boscov's and Circuit City), and a warning from General Growth Properties, a real estate investment trust (REIT) that invests borrowed funds (is leveraged) and is a large owner of retail properties, that it may struggle to continue as a going concern.

5) A worsening US economic environment and outlook and the resulting negative impact on the outlook for the commercial real estate market.

6) Losses in line with overall widening in non-government (or "spread") sectors, including corporate bonds and other securitised sectors.

While this extremely adverse environment would not seem to encourage investment, we suggest that to objectively evaluate CMBS, consideration must be given to underlying credit fundamentals and current market pricing to determine whether there is value in the sector.

What is priced in?

The enormous dislocation between CMBS yields and the underlying intrinsic value of these securities is shown in the chart below comparing yields with the rate of delinquency on payments.

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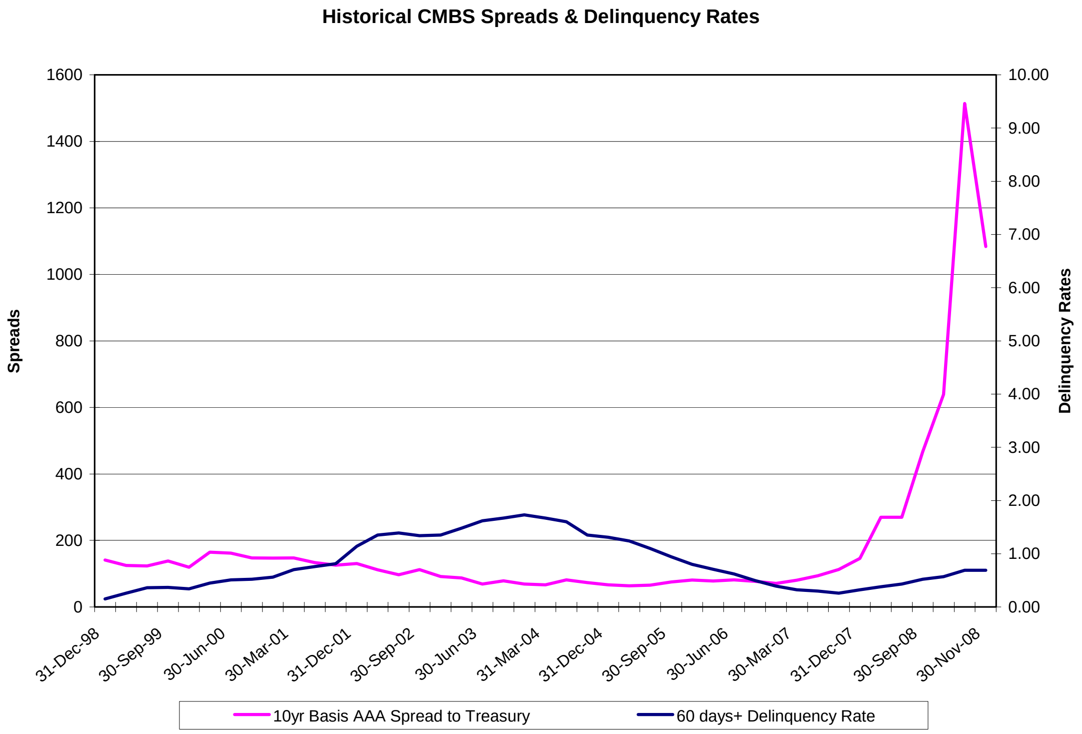

Source: JP Morgan

While an increase in delinquencies and ultimately defaults is a logical expectation given market conditions, to properly evaluate the sector, investors must look at what assumptions are priced in. In November, AAA-rated ten-year senior CMBS securities traded near 70 cents on the dollar. As mentioned above, before a senior tranche of a CMBS deal experiences any impairment, the 30% of the deal represented by subordinate tranches that provide protection for the AAA-rated class must experience a total loss (not just default but a zero rate of recovery from the underlying collateral, or 100% "loss severity."). This would suggest a default rate on 70% of the entire deal, and a loss severity rate of 43% (70% x43%=30%) on the value of the underlying collateral when the properties are liquidated. This compares with a historical ten year average cumulative default rate of 7.88%, according to a July 2007 report by credit ratings agency Fitch, and a historical average loss severity rate of 35%. [1] For a senior

[1] Bear Stearns US CMBS Primer – July, 2007

bond priced at today's current level of 70 cents on the dollar (a 30% discount on the principal amount), it would require a 100% default rate and a 49% loss severity rate before you have a loss on this discounted principal—an extraordinarily unlikely outcome. It should also be noted that these calculations simplify the actual default experience in this sector, where special servicers may extend the maturity of a loan or take other measures to maximize recovery.

A comprehensive study done by JP Morgan[2] comes to similar conclusions. Using their economic models and sophisticated database on commercial real estate prices, default rates and recovery rates, they conclude that a deep recession, with worst case assumptions about default and property prices, would result in a 15% cumulative loss to a CMBS structure. As described earlier this would not come close to triggering losses in the senior AAA-rated securities. Given the current pricing of such securities, not only should principal be protected, but a significant yield and total return opportunity is available.

How this affects SEI Funds?

Many of SEI's fixed income funds and the portable alpha strategies used in some of SEI's equity funds invest in CMBS. As such, the recent performance of these funds has been negatively impacted due to these allocations. It's important to note that the vast majority of the holdings in our funds consist of these AAA rated super senior tranches that have superior structural protection. Based on our managers' analysis of the underlying loans and the structure of these deals, the managers are confident that these securities represent tremendous fundamental and relative value based on today's prices.

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[2] JP Morgan CMBS Weekly Report – November 14, 2008

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Conclusion

As the credit crisis has evolved over the last year, the performance of many sectors of the fixed income market has shocked investors. At certain points it appeared that normalcy may be restored, only to have yield spreads hit new highs as markets remained dysfunctional. The recent spread widening in the CMBS sector has been driven more by forced selling and the drying up of liquidity than by deterioration of credit fundamentals. That is not to say that the fundamental credit outlook for the commercial real estate sector is positive. SEI and our managers anticipate that credit fundamentals will weaken and CMBS delinquencies, defaults and losses will trend higher. However, current pricing levels on CMBS super senior securities indicate that the loss assumptions priced into the market far exceed any plausible recovery scenario. Our managers view the dislocation between yield spreads and the underlying credit fundamentals as a unique investment opportunity. For investors who have a longer time horizon, and do not require near term liquidity, the spread sectors of the fixed income markets, including CMBS, offer a rare and attractive yield premium. While we can not predict an exact bottom in credit fundamentals, or the timing on a return to normalcy with regard to liquidity, we believe that patient investors should be rewarded in the long run by these unusually high yields and the potential for capital appreciation.

On a final positive note, after initially dismissing the government's participation in this market, US Treasury officials have stated that the Term Asset-Backed Securities Loan Facility (TALF), which was introduced to finance and support the consumer asset-backed securities market, may be expanded to include CMBS.

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Important Information:

Past performance is not a guarantee of future performance. Investment in the range of SEI's Funds is intended as a long-term investment. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested. Additionally, this investment may not be suitable for everyone. If you should have any doubt whether it is suitable for you, you should obtain expert advice.

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