Basis

Market Summary

Issued April 2008

January — March 2008

Dear Investor

Below is a market commentary and update on the Basis Pac-Rim and Basis Yield Alpha Funds for the March Quarter of 2008. The commentary also includes an overview of the structured credit securitisation process and highlights how the Basis Funds attached to CDO investments.

Contents

→ General market commentary and themes

→ Basis Pac-Rim Fund

→ Basis Yield Alpha Fund

→ A Few Words on Investing in CDO's

→ Structured Credit Commentary

Credit market meltdown hits real economy.

General market commentary and themes

Systemic issues within credit markets spread from the financial sector to the real economy as markets continued to increase risk aversion and shun any corporation that showed signs of capital inadequacy or an inability to service debt.

- The ongoing credit crunch escalated into what many commentators describe as a systemic meltdown, where at times the large US banks struggled for liquidity and ultimately for corporate survival.
- The first quarter of 2008 was one of the worst in the last decade for the performance of equities, credit markets and hedge funds globally; amidst what amounted to the nearest thing to a full blown collapse of the banking system. Banks stopped trusting each other and normal market inter-bank functions ceased to exist, forcing unprecedented intervention and support from the US Federal Reserve.
- Widespread fears that the US economy is already in recession dominated investor concerns – and a "flight to quality"

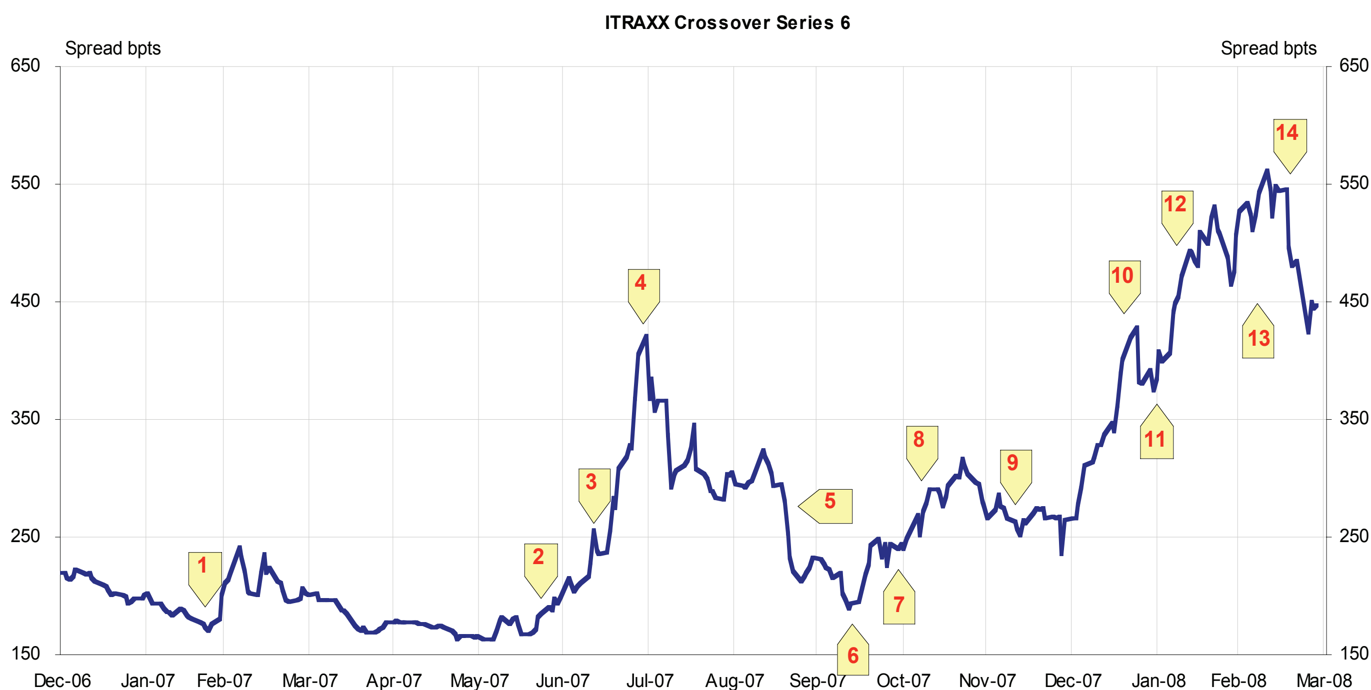
mentality dominated. The big winners from this psyche were commodities, commodity based currencies and US Treasuries.

- International banks continued to report record losses with total write-downs including reserves set aside for bad loans estimated to total in excess of $US230 bln. since the beginning of 2007;
- JP Morgan Chase bailed out Bear Stearns in an historic deal supported by the Federal Reserve, in which US taxpayers have effectively underwritten approximately $US30 bln. of Bear Stearns' difficult-to-value assets;
- Monoline insurers, which provide credit support for lesser-rated structured credit instruments, suffered additional losses and ratings downgrades — affecting their ability to write new business and their ability to support insurance business already written.
- The US Federal Reserve continued to aggressively cut official interest rates with three cuts totalling 200 bpts;
- The Fed cut the official Discount Rate — at which banks borrow from the Federal Reserve — by 25 bpts to 3.25%;

The Fed steps in to provide liquidity.

The Federal Reserve and the Bank of New York created a lending facility for primary dealers accepting in return a broad range of investment-grade debt securities as collateral. The facility was effectively established by providing primary dealers with access to the discount rate – a domain up until then exclusive to mainstream deposit banks.

The chart below highlights the cost of funds for a typical benchmark index of sub-investment grade corporate borrowers, as measured by the spread over and above prime bank cost of funds. For illustrative purposes, we have used an index of Europe's liquid benchmark high yield borrowers (approx 4 years' duration), the ITRAXX crossover series 6. Please note, the current series of ITRAXX series 9 trades some 100 basis points wider than series 6.

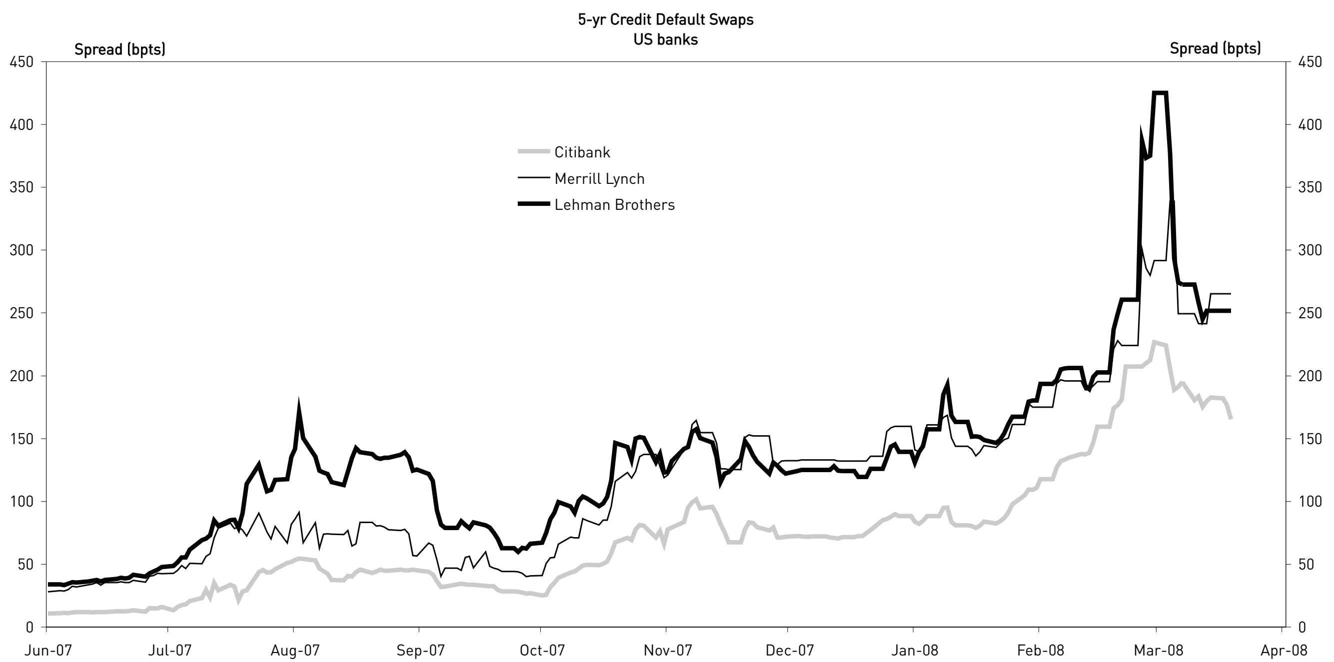


Source: Bloomberg

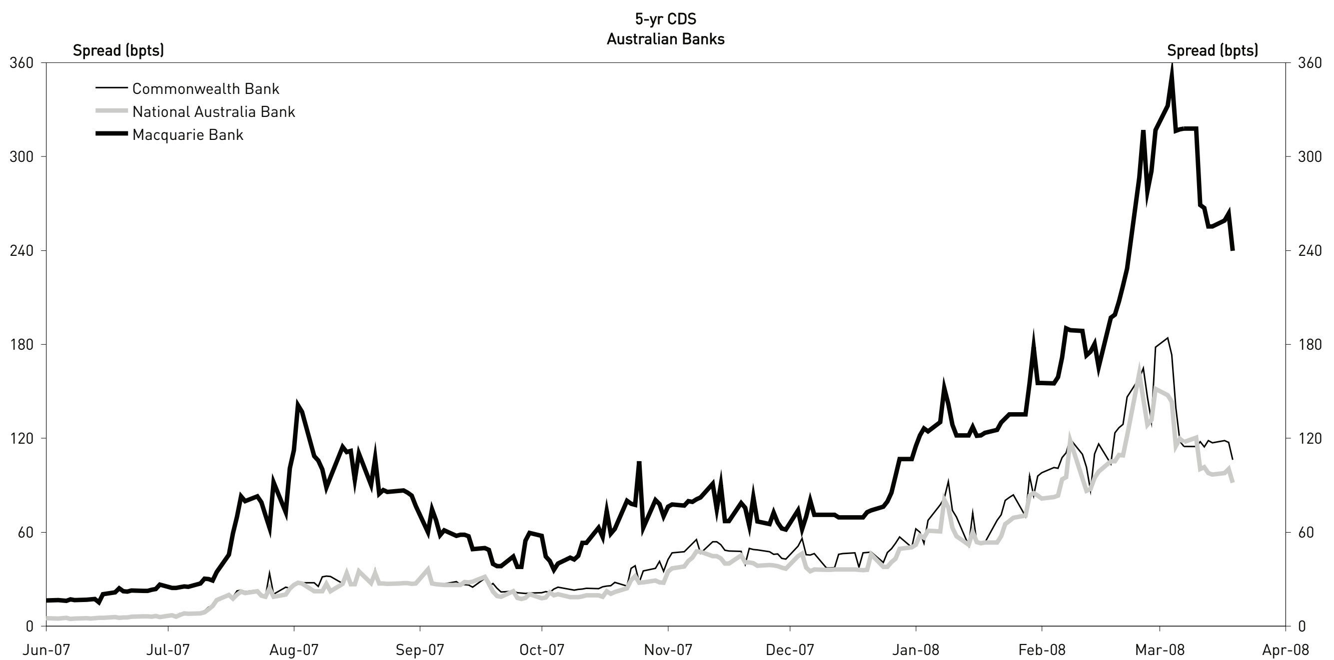
1. 22 Feb — Reports show an increase in January ABS Mortgage delinquencies.
2. 22 Jun — Bear Stearns Liquidation.
3. 12 Jul — Moody's and S&P downgrade ABS.
4. 30 Jul — Liquidity injection by the World's Central Banks.
5. 18 Sep — US Fed cuts rates by 50bps
6. 11 Oct — Moody's downgrade ABS.
7. 31 Oct — US Fed cuts rates by 25 bps.
8. 8 Nov — Further ABS + CDO downgrades.
9. 11 Dec — US Fed cuts rates by 25 bps.
10. 22 Jan — Fed funds emergency rate cut of 75bps pre-FMOC meeting on 30 Jan.
11. 30 Jan — Further cut at FMOC meeting — 50bps.
12. 10 Feb — Economic stimulus package; FOHC increases Freddie Mac and Fannie Mae mortgage limits.
13. Early March — Rumours of Bear Sterns and other banks collapsing.
14. 17/18 Mar — Fed cuts discount rate and opens auction window to accept mortgages as collateral ; Bear Stearns bailout; Fed cuts discount rate by 75 bps.

Corporates feel the pinch.

It is evident from the chart that weakness in the credit markets was driven by a renewed sense of fear – as the cost of funds above cash for HY corporate borrowers doubled from the end of last calendar year (see Charts below). The markets finally found some support around mid March, after the US Fed came to the rescue with an "open" cheque book.



Source: Bloomberg



Source: Bloomberg

Strategy continues to take risk off the table.

Basis Pac-Rim Fund

Throughout the quarter, the strategy continued to focus on reducing portfolio risk and increasing liquidity amidst trading conditions that remain difficult. Consequently, the multi strategy Fund has:

- Sold from the portfolio in excess of $100 million of Asian and global securities;
- Reduced net leverage on the portfolio to less than 1 times NAV;
- Maintained a policy of marking to market CDO assets on a monthly basis, despite major disruptions in credit markets.

From a performance attribution perspective and despite dislocated trading conditions and ongoing portfolio risk reduction, the Fund's more liquid and Asian high yield strategies continued to maintain capital. Conversely and amidst the market's ongoing repricing of risk-based assets, the Fund's CDO investments continued to drag down overall portfolio performance.

Suspension remains in place.

As a result of the unprecedented and escalating dislocation in the Structured Credit space, which makes up a material part of the Fund's investments, the Fund's existing freeze on Applications and Redemptions remains in place.

Basis Yield Alpha Fund

Basis Yield Alpha Fund now in Joint Official Liquidation: no NAV calculated.

The Basis Yield Alpha Fund (BYAF) invests predominately all of its cash into the Basis Yield Alpha Master Fund (Master Fund) which is currently in the hands of Joint Official Liquidators, being certain representatives of Grant Thornton. Consequently, no NAV is being calculated for the Master Fund and in turn the BYAF and Basis Yield Fund. Official liquidation proceedings began with a hearing on December 19th 2007. For further information on BYAF and the Basis Yield Fund please refer to www.basiscap.com.au.

A Few Words on Investing in CDOs

Basis Funds do not invest directly in sub prime mortgages.

The Basis Funds held a range of structured credit assets across various asset classes including the corporate, bank, consumer and mortgage sectors whose performance historically had low correlation and whose premise was to achieve a Fund of Funds type of portfolio (please see below regarding the asset manager of a CDO). Importantly, Basis Funds did not invest directly in US sub prime mortgages or mortgage bonds. Any exposure to the mortgage market was via CDOs.

CDOs buy pools of securities with broad exposure to different asset classes.

Regarding mortgages, the CDOs, where relevant, typically bought pools of bonds rated investment grade that in turn may have exposure to prime, mid-prime and sub-prime mortgage pools.

Securitisation involves many steps and is driven largely by the credit models and assumptions of Rating Agencies.

The typical asset production, Rating Agency and Fund Management process involves the following steps:

- Mortgages are pooled into a bond trust which issues bonds and an equity — or 'residual' — piece;
- These bonds are assigned ratings by the Rating Agencies using their credit models and default assumptions;
- Investment Grade bonds are chosen by an Investment Manager and pooled into a CDO;
- A CDO issues bonds and an equity piece;
- Again the Ratings Agencies assign ratings to these bonds;
- Basis Funds and other investors seek to take advantage of the diversification, asset selection of the Investment Manager of the CDO and the non-recourse capital markets financing of the CDO;

CDOs are described in many ways.

The CDO is variously described as like:

- a managed account with strict investment guidelines;
- a Fund;
- a Special Purpose Company;
- a "Virtual Finance Company" as it owns loans and mortgages and can finance itself by issuing rated bonds and an equity piece in the capital markets. The equity size is driven by the ratings of the assets held, much like various types of financial institutions.

CDOs are managed by well respected and focused collateral managers.

Additionally, a CDO has a Collateral Manager/ Investment Manager, which, on behalf of the CDO's debt and equity holders, is a fund manager choosing the assets and ensuring compliance with the CDO's Trust Deed.

CDO securities of choice were created and managed by asset class experts. The Fund's CDO Investment Managers include groups such as Pimco, Credit Suisse Alternatives and AXA . These entities are highly competent in the task of ensuring exposure to a diversified pool of assets and in the monitoring and managing of those underlying assets.

Example of the collateralisation process.

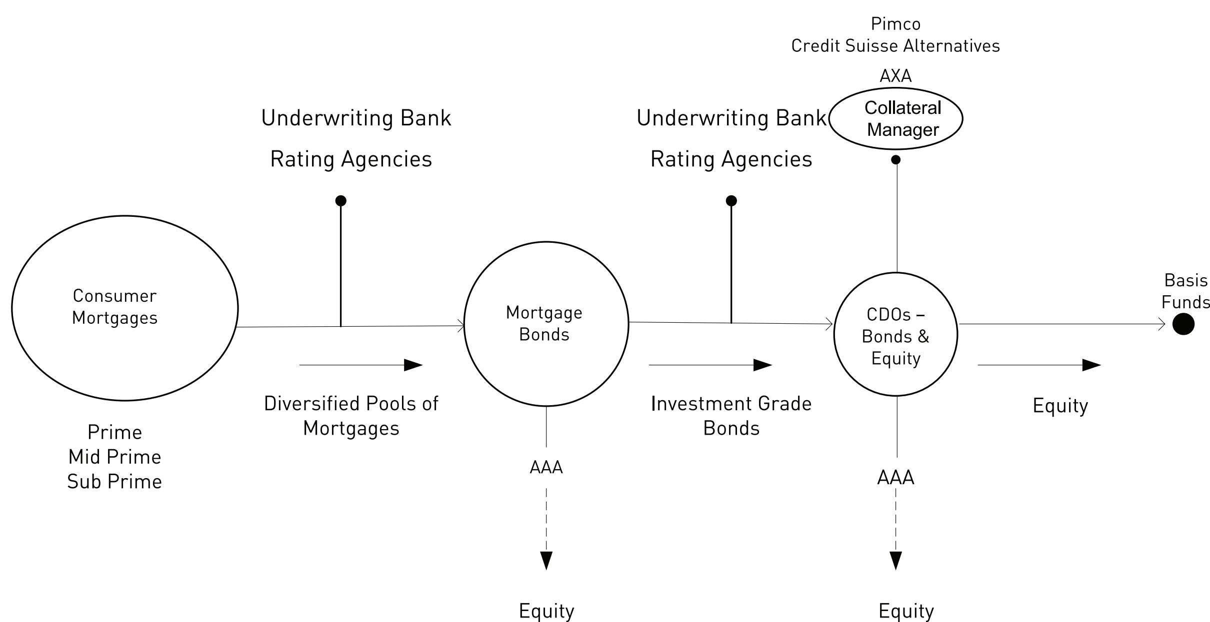
The diagram on the next page is designed to help you understand the sequence of steps involved in the securitisation process (please note again: the example is purely of CDOs of Asset Backed Securities and not CLOs which are corporate backed securities that Basis Funds also invested in.) It is to be read conventionally from left to right with each circle representing a different step in that process. What's more, each step is a market unto itself, and the relative size of the circles represent the relative value of each of those markets. There are a few important points to note in this diagram:

- Basis Funds are not investing directly in consumer mortgages or mortgage bonds but are involved via the re-securitisation processes;
- The repeated participation of Rating Agencies in the investment assessment process well before Basis Funds attached to any exposure to structured credit;
- Basis Funds' use of a collateral manager to attach to

structured credit assets that is recognized as an expert in a particular type of CDO credit exposure;

→ **The ABS CDO equity pieces into which Basis Funds invested were themselves backed primarily by the Investment Grade Bonds of Asset Backed Securities.**

Additionally it must be stated that whilst this diagram references mortgage pools by way of providing an example , CDOs invest in pools of assets across the entire spectrum of economic activity: from mortgages and other forms of consumer debt to corporate and bank obligations. Contrary to claims in the popular press, CDOs are NOT vehicles that invest solely in sub-prime mortgage backed assets.



Structured Credit Comment.

Economic slowdown a portent of weakening credit fundamentals.

A US economic slowdown is now the consensus view in the market but the question remains regarding its length and depth. Systemic issues that emerged throughout the last quarter of 2007 became manifest in the first quarter of 2008.

Fundamentally, despite some support from lower Libor base rates, credit fundamentals have weakened due to slowing economic conditions. There have been 10 defaults to the end of February compared to a total of 7 throughout 2006 and 2007.

The current market default rate is 1.8% up sharply from December 2007's all-time low of 0.26% but still only 60% of the historical average of 3.0%.

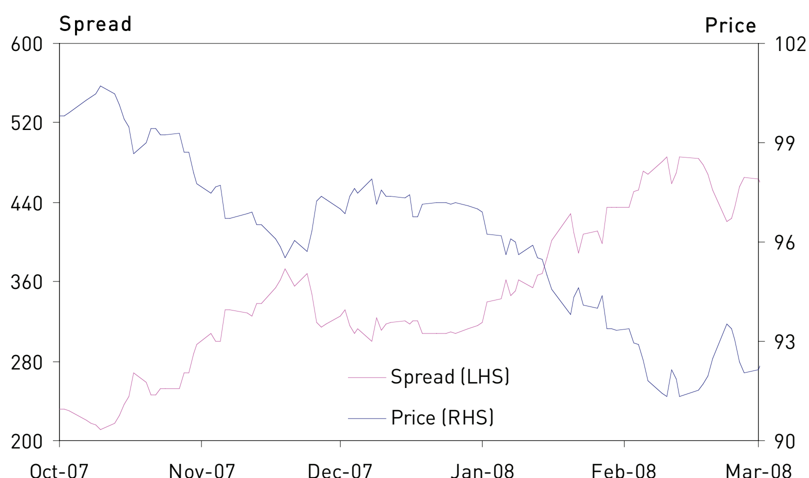
Market pricing remains difficult.

Transparency and market pricing is proving difficult due to very limited secondary trading in the market and where CLOs are concerned the primary market is stalled.

Corporate risk trading wider throughout the quarter as...

Despite the continuing low level of actual defaults (as a percentage of outstanding loans), corporate risk is now trading wider than levels seen during 2000—2002 when defaults touched 6%.

The traded US loan index (LCDX) reflected this structural deterioration trading lower on 29 out of the first 30 business days of 2008 eventually touching lows around 91 in late February before recovering slightly by the end of March.



Source: Morganmarkets

sentiment dominates the actions of market participants.

Whilst the forecast is for defaults to increase and recovery rates to fall towards year-end, at this point it is a combination of technical factors outlined below which is leading fundamentals.

Actions like Citibank's potential sale of $12 billion of hung loans and bonds and Deutsche Bank's potential sale of $20 billion whilst helping to clear an excess supply of inventory, places widening pressure on credit spreads.

In response, traders position themselves for potential forced selling from market value funds whose exposure is predominantly in the loan space.

These investment vehicles are subject to market value triggers or there are Funds that have financing with banks subject to margining, meaning assets are sold into an already weak market. Furthermore, mutual funds that invest in loans have seen continuous outflows of capital reducing support for the loan market.

Additionally, as the US Federal Reserve lowers its rate and in turn USD Libor drops, the total return (Libor plus the credit spread) falls and investors are less inclined to invest into these products.

Cash loan prices fell to a record low of 86 and the index to levels in the low 90s. These falls were caused by the deleveraging of market value structures and subsequently fed into CLO values despite the CLOs not being market value structures per se given that their prices tend not to be struck and realised for as much as 3—9 years in the future. This usually occurs either when the CLO is called (not likely with low loan prices) or when it reaches its maturity date. A forced seller of CLOs did not help the market with an auction that shook confidence further, as it underscored the prevailing absence of liquidity and risk appetite in the market.

Post-meltdown issues priced to attract demand from investors seeking value.

More positively, those who have reduced their hung deal exposure to manageable levels are now beginning to underwrite new deals. These "post meltdown" new issues are coming with improved pricing (including LIBOR floors), less leverage, and stronger covenant protections, resulting in better credit quality and risk/reward.

Disclaimer: The information contained in this Market Summary is for information purposes only and is not to be relied on as a recommendation or forecast by Basis Capital Funds Management Ltd (Basis Capital) or any related party. Basis Capital and its affiliates assume no liability for any inaccurate, delayed or incomplete information, nor for any actions taken in reliance thereon. Under no circumstances will Basis Capital and its affiliates be liable for any loss including, but not limited to direct, indirect, incidental, special or consequential damages caused by using the information. Nothing in this Market Summary should be construed as either an offer to sell or a solicitation of an offer to buy or sell any investments in any jurisdiction. Fund risks are outlined in the current Confidential Information Memoranda.