

Vodia Group Note

Institutional Investors, the Credit Crisis and Exchange Liquidity: Keeping the System Intact

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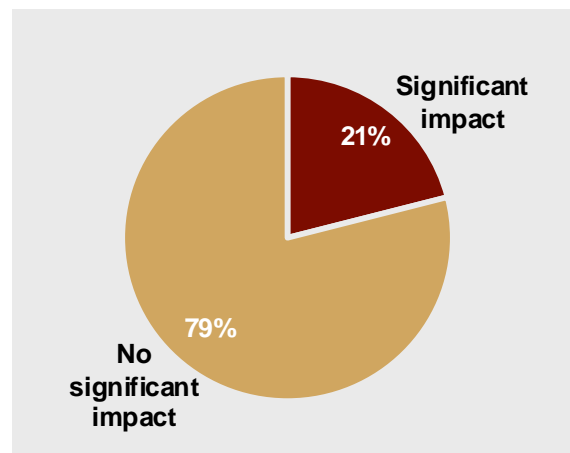
New research from Vodia Group shows that most institutional investors, including public retirement systems, company pension plans and endowments, were not affected by 2007's subprime credit defaults. This is great news for the markets, which narrowly avoided a major impact to liquidity and the cost of trading. If institutions had been hurt badly enough and chose to withdraw from the cash and collateral management activities where most subprime credit is held, the ripple effects would have been felt far and wide. The cautionary tale is that we are not out of the woods yet.

Cash and collateral management accounts are the results of two types of investing. The first is plain old cash management, where balances can be swept overnight or left for months at a time. Cash management accounts try to earn returns better than the federal funds rate. The second type is from investing the cash collateral left in exchange for a securities loan. Today, collateral management generates much of the return of an institution's securities lending activities. Too much risk or not enough return in collateral accounts means more institutions won't lend securities.

A substantial portion of liquidity of major equities, and hence derivatives markets hinges on the ability of short sellers to execute their trades. Short selling lets the market know that sellers consider a stock price overvalued and are betting accordingly. Without short selling, a major component of market information is lost. Market makers in particular lose much of their ability to efficiently manage up and down markets.

Short selling is driven by securities lending, and securities can only be lent with the agreement of the

Institutions reporting significant negative impacts to their cash and collateral management programs in 2007



Source: Vodia Group

actual asset holder. In US equities, pension plans and endowments contribute 73% of securities lent. Mutual funds make up another 25%, with the difference held by hedge funds and retail broker-dealers. If 73% of securities loans were no longer available in US equities, that would make a stunning difference to liquidity.

The majority of institutions we surveyed have managed to dodge the credit crises bullet thus far: in a recent survey of institutional investors, Vodia Group found that 79% of asset holders report no financial damage in their collateral pool due to the 2007 credit crisis. The remaining 21% believe they had no material or long-term impact. With investment failures such as the highly publicized run on the Florida Local Government Investment Pool to Harvard University's loss with their former high-flyer Jeffrey Larson's Sowood Capital, we got the impression that institutions were likely suffering. This has generally not been the case.

Institutional investors are not standing still: they have strapped down already tight collateral requirements and are evaluating their collateral managers closely; some securities lending agents reported to us very strained conversations with their clients this past fall. The most important question, stated nearly verbatim by many institutions we spoke with, is how the manager of their collateral pool is marking derivative assets to market. The ability to answer that question will play an increasingly significant role in the comfort that institutional investors have in their securities lending programs.

Institutions are not yet thinking about the next credit crisis, whether it is in credit cards or auto loans. Their cash managers are, however, and hope to avoid damages to both their cash positions and reputations. This is a space to watch closely; where go institutional investors, so go the markets.

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