

Securitized Products Outlook for 2007

Bracing for a Credit Downturn

December 2006

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212-526-8311

Please see analyst certifications and important disclosures beginning on slide 36

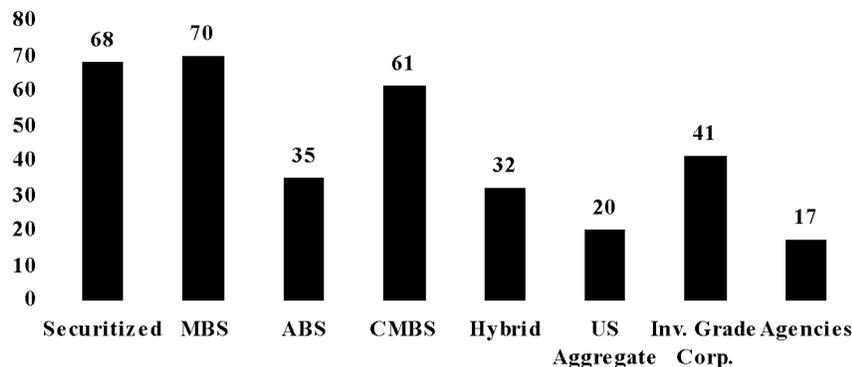
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A Brief History of Time

2006 was a strong year for securitized products; Leveraged portfolio up 8%

- ◆ Securitized products outperformed swaps by close to 70bp YTD.
- ◆ MBS (70bp) and CMBS (61bp) contributed well to the outperformance
- ◆ Excess returns were driven by decline in implied volatility (1H06) and spread tightening (2H06)
- ◆ At 8% ROE, leveraged portfolio enjoyed a decent year, though not a great one
- ◆ Best performing trades: MTA BBBs vs. subprime, '05 IOs vs. '03 IOs and long 5.5% IOs with a curve hedge
- ◆ Worst performing trades: Up-in-coupon, short MBS vs. hybrids/CMBS and long 15yr FN 5.0/4.5 swap

Excess Returns vs. Swaps of Major Indices, bp



Returns on Lehman Leverage Portfolio



The State of Affairs with the Housing Market

Baseline Forecast for 2007: Expect Housing to Stay Flat

- ◆ Dramatic softening in housing market over past few months
- ◆ HPA declined from 12.3% in 4Q05 to 3.5% in 3Q06 on an annualized basis
- ◆ Recent decline in HPA is sharp from a historical standpoint: few instances of 4% HPA drops in 2 consecutive quarters
- ◆ While national HPA is still positive, close to 25% of MSAs are currently reporting price declines
- ◆ While the hottest MSAs have seen the most dramatic slowdown in HPA, they are still above the national average
- ◆ We expect HPA to be flat to slightly up for 2007 and don't expect to turn the corner any time soon

Nearly a Quarter of MSAs with *Negative* HPA in 3Q06

HPA Buckets	4Q05	1Q06	2Q06	3Q06
<0%	4.22%	16.36%	21.37%	24.27%
1-10%	44.33%	49.87%	49.08%	52.51%
10-20%	32.19%	26.12%	24.54%	19.00%
>20%	19.26%	7.65%	5.01%	4.22%
National HPA	12.35%	9.22%	5.10%	3.45%

Hottest Markets Have Seen Largest Correction in HPA

MSAs	Cum HPA 2003-05	Avg HPA		Chg, 4Q05 to 3Q06
		3Q06	'06 YTD	
Bottom 10 th	6.5%	2.0%	1.6%	1.1%
10-25 th	7.8%	3.2%	3.3%	0.3%
25-50 th	13.4%	5.9%	5.6%	-2.2%
50-75 th	22.7%	8.0%	8.5%	-4.0%
75-90 th	40.7%	5.5%	9.7%	-12.7%
Top 10 th	59.8%	2.3%	8.1%	-20.3%

Supply Outlook '07: Lower Cashouts, Weak Underwriting

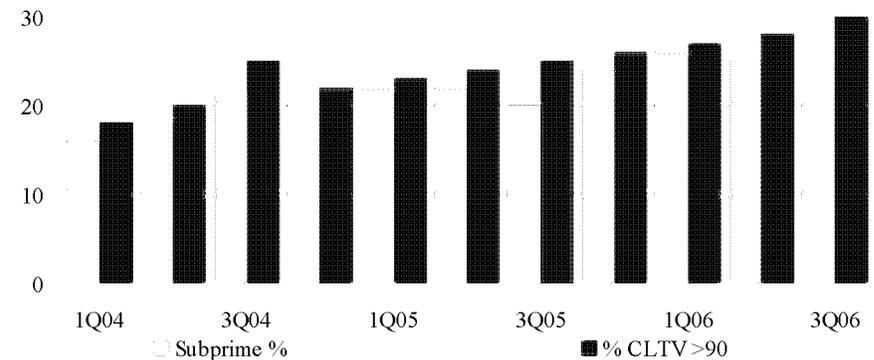
Equity Extraction declined to \$575B in '06, expect \$400B in '07 in a flat housing market

- ◆ Picture for '06: as expected decline in purchase volumes (25%) but cashout refis were surprisingly resilient
- ◆ Outlook for '07: volumes likely to decline an additional 10%-15% in a flat housing environment
- ◆ Equity extraction declined to \$575B in '06 vs. \$800B in '05. Expect \$400B for '07
- ◆ Proliferation of non traditional mortgages remained high in '06 and we expect more of the same in '07
- ◆ The significant supply dynamic in '06 was the rapid deterioration in underwriting fundamentals
- ◆ The impact of weaker underwriting is beginning to show in recent collateral performance

Originations and Cashout Refis Over Past 3 Years, \$bn

	Originations		Equity Extracted	
	Total	Cashout Refi	Total	Cashout Refi
2003	3,912	923	656	41
2004	2,772	721	733	64
2005	3,026	936	792	151
2006	2,579	897	575	220

Proliferation of Non-traditional Products



Demand Outlook '07: Same as '06, Risks to the Downside

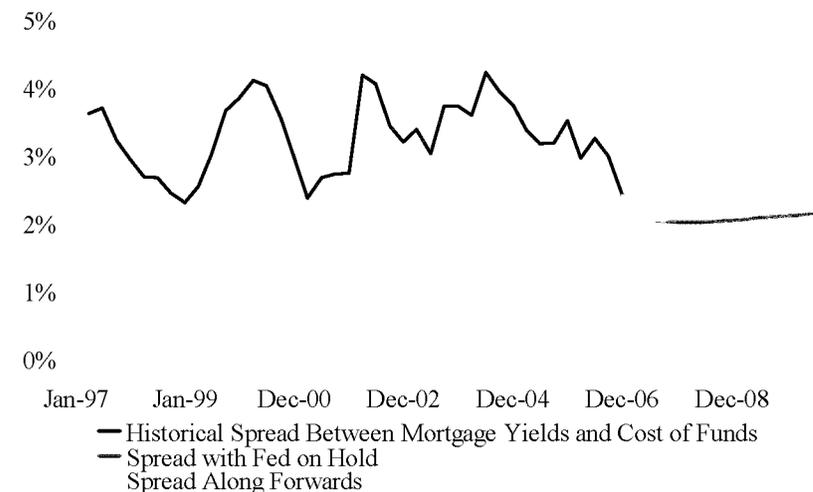
Bank and overseas demand surprised us to the upside in 06; we see risks to the downside in '07

- ◆ 2006 demand from banks and overseas exceeded our expectations
- ◆ Bank holdings of mortgages grew by \$200 bn, as slowdown in deposit growth did not materialize
- ◆ Overseas investors added \$125 bn of mortgages to holdings compared to our expectations of \$75B
- ◆ Despite continued asset growth and dovish bond markets, flat yield curve reduces appeal of adding duration for carry
- ◆ Overseas demand should be helped by continued deficits, substitution of reserve holdings into mortgages
- ◆ While we expect demand picture to remain the same in '07, we see risks to the downside

Net Additions of Mortgages (Loans + Securities), \$bn

	2003	2004	2005	2006*	2006 (Annld)
Commercial Banks	129	189	128	75	101
Savings Institutions	46	142	52	75	100
GSEs	184	15	-145	-10	-13
Overseas	22	59	100	93	124
<i>Total</i>	<i>381</i>	<i>405</i>	<i>134</i>	<i>234</i>	<i>312</i>
% of Net Issuance	50%	51%	14%	45%	45%

Expected Margin from Holding Mortgages for Banks

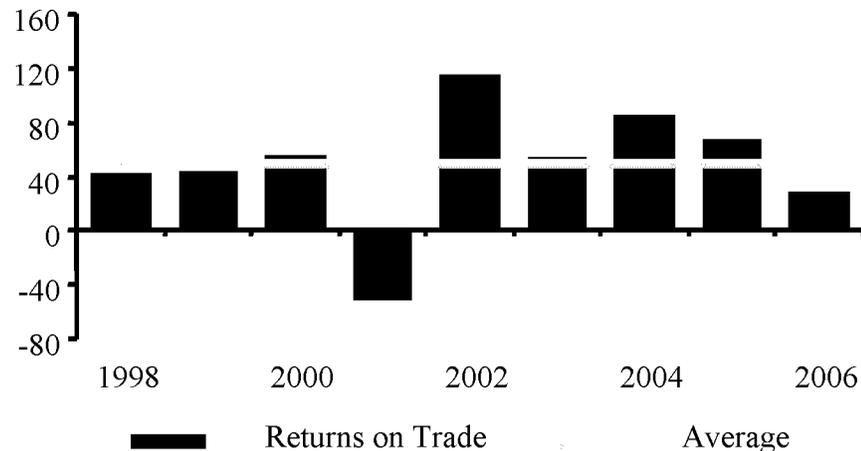


Volatility Outlook '07: Don't Bet the Ranch

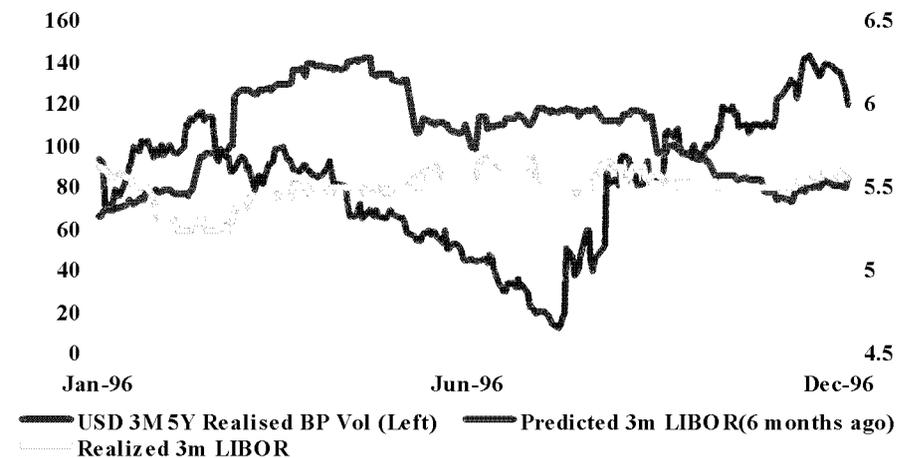
Will a short volatility position turn in a winner in an uncertain macro environment?

- ◆ Sellers of vol were plenty in 2006, as longer-dated vol declined close to 3 vega, realized vol also tame
- ◆ While realized volatility was also tame, the premium for being short gamma was also pretty low
- ◆ Returns from a short gamma trade in 2006 were between ½ to 1/3 of those enjoyed in 2004 and 2005
- ◆ For '07, technical picture looks good but the uncertainty around the Fed makes us nervous
- ◆ We are modestly short volatility but believe better risk/reward is in favor of selling liquidity
- ◆ Accordingly, we like selling liquidity through core longs in CMBS and hybrid asset classes

Returns from Short Gamma Strategy



The 1996 Experience



Prepayment Outlook '07: Value in Call Protection

Overview

Markets are pricing in prepayment expectations of a flat housing market but ignoring refi risk

- ◆ Impact of HPA on prepayments has been moderate to significant so far
- ◆ Speed declines have been more pronounced in *hot* MSAs, which have seen most dramatic HPA slowdown
- ◆ Adjusting for rising market rates, prepayments have remained sticky due to strong cashout refinancings
- ◆ In 2007, we expect prime discount prepayments to decline an additional 2% CPR in flat HPA environment
- ◆ As softer HPA catches up and cashout refis abate, we expect subprime speeds to slow by 10% CPR
- ◆ We think the most interesting opportunities on the prepayment front are in call protection stories

Prime MBS Turnover Slowed Significantly, CPR

Sector	Product	National			Hottest Markets		
		2004	2005	Diff.	2004	2005	Diff.
Agcy (FN)	30yr Fixed	10	8	-2	15	10	-5
Jumbo	30yr Fixed	8	8	0	13	10	-3
	5/1 Hybrids	16	14	-2	17	14	-4
Alt-A	30yr Fixed	13	10	-3	16	12	-5
	5/1 Hybrids	19	16	-3	23	18	-5
Sub-prime	30yr Fixed	26	23	-3	34	26	-8
	2/28 Hybrids	35	33	-2	48	44	-4

Call Protection from Weaker Credit, Penalty Pools

	Prepay diffs at 50bp ITM	Current Market Pay-up			Pay-up at even OAS		
		\$100	\$101	\$102	\$100	\$101	\$102
3yr penalty Agency Hybrids	13- 15CPR	2- 3/32 nd	8/32 nd	15/32 nd	0-06	0-15+	1-06+
Conforming Alt-A vs Jumbo	10CPR	3-4/32nds pay-up			0-08	0-09	0-17
Conf. Alt-A vs Jumbo Hybrids	8CPR	2-3bp tighter on N-spread			0-05	0-08	0-13
Premium Pools California: Fixed	5-7CPR	None			0-04+	0-07+	

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Credit Outlook '07: How Bad is Bad?

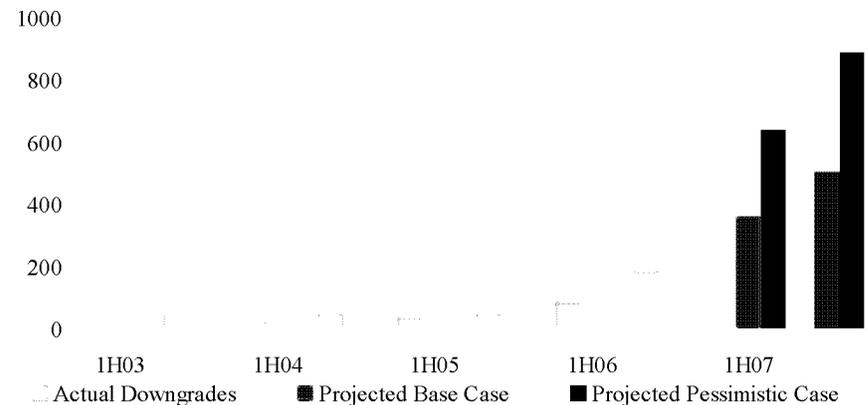
Bracing for a credit downturn

- ◆ 2006 originations look about 50% worse than 2003/04 counterparts from a loss standpoint
- ◆ Soft housing market may exacerbate losses further as borrowers are unlikely to be bailed out by rising home prices
- ◆ We expect cumulative defaults on '06 vintages to top 30% if housing stays flat for a year and grows at 5% thereafter
- ◆ Spreads down the capital structure do not reflect the magnitude by which losses can increase on newer vintages
- ◆ Short mortgage credit due to reality of losses, impending downgrades, effect of synthetics market on spreads

Subprime Cum Defs on 2/28s, Experienced and Expected

Vintage	Historical		Expected		
	1-12 mo	12-24 mo	1H07	2H07	Lifetime
2004	1.1%	2.6%	1.6%	1.4%	14.0%
2005	1.5%	4.0%*	2.4%	2.4%	20.0%
2006	2.5%*	-	1.8%	2.6%	31.0%

Hist Rating Downgrades, Proj Bonds at Risk of D/G



Summary Sector Views for 2007

- ◆ **The Mortgage Basis: Initiating a Modest Short Position vs hybrids/CMBS**
 - Historically tight spreads to swaps leave us bearish on mortgage basis

- ◆ **Prime Structured MBS: The Mortgage Sector of Choice**
 - Overweight hybrids and the non agency basis

- ◆ **Mortgage Credit: Favor Prime over Subprime**
 - Concerns around credit performance lead us to favor shorting subprime credit both outright as well as versus prime

- ◆ **High Quality ABS: Remains a Safe Haven**
 - Despite tight spreads in non-mortgage ABS, we stay with a core overweight

- ◆ **CMBS: Overweight AAAs, Underweight BBBs**
 - We like AAAs as a core liquidity play against swaps, agency debentures, and fixed rate MBS

Outlook for Flow Products and Prime MBS

Prime Supply: Option ARMs Hold Up, Hybrids Drop Significantly

- ◆ Option ARM Volumes (60% cashout) are mostly unchanged from last year
- ◆ Prime hybrid volumes (70% purchase) have dropped significantly
- ◆ Expect fixed-rate issuance to hold up due flat curve, greater availability of IOs
- ◆ Product for 2007: Negative-Amortization Hybrids?

Estimated Quarterly Volumes By Product \$bn

	Origination Volumes \$bn						By Product			Distribution by Sector \$bn			
	Agg Index	Loan size	Total	Purch	Rate Refi	Cash-out	Fixed-rates	ARMs	Agency	Prime Fixed	Prime Hybrid	Option ARMs	Sub prime
Mar-06	513	229	595	344	35	216	330	265	195	123	57	65	155
Jun-06	615	236	694	434	31	229	400	294	216	170	62	68	178
Sep-06	568	233	642	391	30	221	370	272	221	139	57	65	160
Dec-06	567	233	639	382	30	227	372	267	220	143	56	65	155
Quarterly Volumes \$bn													
Average 05	695	220	727	418	85	225	396	332	240	147	116	63	162
Current	567	233	639	382	30	227	372	267	220	143	56	65	155
Change	-18%	6%	-12%	-9%	-64%	1%	-6%	-19%	-8%	-3%	-51%	4%	-4%

Trade Recommendations: Prime MBS

Sector	Recommendation
Basis	Own Agency 5/1 hybrids and 10yr CMBS vs. Agency TBAs
Floaters/Short Duration	Favor AAA Mezz Option ARM floaters over HEL Non-agency 5/1 5.5 % vs. FN 6.5s
Intermediate/Long	Own DW 5.5s vs. FN 6.0s in a Gamma Neutral Fashion Own Non-agency 6.0s/6.5s vs. TBAs
Credit	<p><i>Theme: Down-in-Rating, Up-in-Borrower-Credit</i></p> <p>Own alt-A BBs vs. Subprime BBB-s hedged to be carry neutral (~1:2)</p> <p>Own Option ARM BBBs, Buy protection on subprime CDS</p> <p>Favor BBBs in XS/OC vs. shifting interest deals</p> <p>Based on Rating Agency Levels</p> <ul style="list-style-type: none"> ◆ Favor Cash-outs, Higher FICO Investor Properties ◆ Avoid 80/20s and Purchase Limited Doc loans (especially in lower FICOs)
Security Selection	<p>Call protection stories Are Under-priced: Penalties, Alt-A and California pools</p> <p>Seasoned hybrids with more than 15 months to reset still look attractive</p> <p>Favor Non-agency versus Agency hybrids</p> <p>Hybrids versus Short PACs/ Sequentials off Agency CMOs</p>

The Basis: Own Hybrids + CMBS vs. Fixed-rate TBAs

Modest Short on Mortgage Basis

- ◆ Hybrid ARMs stand to benefit from favorable technicals:
 - Lower supply due to drop in purchase volumes + Movement into fixed-rate IOs
 - Investor demand for hybrids should be strong in a flat yield curve environment
 - Increased demand from rebalancing flows following inclusion of hybrids in Lehman Brothers U.S. Agg Index
- ◆ LOAS difference between hybrids and par-priced fixed-rates is historically wide at almost 35 bp

5/1 Hybrids + CMBS vs. 30-yr TBAs

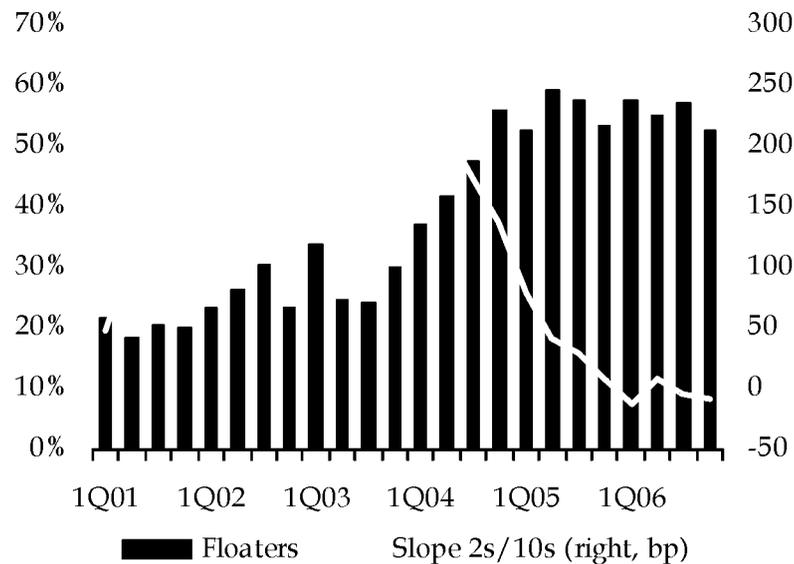
Security	Face	Carry (32 nd per year)	LOAS	OAD	Vega, 32 nd
FNCL 5.5	-100	9+/32 nd	-15	3.32	-6
Jumbo 5/1 5.5	63	11/32 nd	20	1.70	-2+
10yr CMBS	28	0/32 nd	25	7.95	0
Total		-2+/32 nd		-	3

Option ARM Floaters Stand Out as the Most Attractive Cash Instruments

Flat Yield Curve Stimulates Floater Demand

- ◆ The relatively flat curve environment in 2006 created a strong demand for floating rate assets
- ◆ We recommend owning option ARM floaters, which offer 4-5 bp pick in OAS versus subprime floaters
 - AAA Mezz. MTA floaters stand out as the most attractive cash instruments

Surge in Floater Supply \$bn



Comparison of Floater Valuations

Sector	Cap Type	Coll.	Strike %	WAL	Rating	DM	Option Cost	LOAS (bp)
Agency	Hard	FN 6s	7.0	3.0	AAA	32	36	-11
			7.5	3.0	AAA	26	27	-5
		FN 6.5s	7.5	3.0	AAA	25	24	-2
Non-Agency	Hard Cap Corridor	6.0s	7.0	3.0	AAA	43	35	1
			8.5	3.0	AAA	60	55	0
MTA	Avail Funds	MTA	9.0	3.0	AAA	18	1	17
			9.0	3.0	AAA Mezz	26	1	25
			9.0	5.0	AA	38	0	38
Sub-prime	Avail Funds	HEL	9.0	3.0	AAA	14	2	12
			9.0	5.0	AA	33	2	31

Don't Ignore Call Protection Stories

Market Discounting Call Risk

- ◆ The market is discounting call risk in mortgages given time since last refi wave in 2003-04
- ◆ Source call protection through:
 - Penalty pools in hybrids: historical speed differential of 15 CPR for 50 bp in-the-money pools
 - Weak credit conforming alt-A fixed pools: market does not price in any convexity benefit of weaker credit
 - Premium Cal pools: as hottest markets cool rapidly, we expect sharp decline in both turnover and refis

Call Protection Stories

	Prepay differences at 50bp ITM	Current Market Pay-up			Pay-up at even OAS		
		\$100	\$101	\$102	\$100	\$101	\$102
3yr penalty Agency Hybrids	13-15CPR	2-3/32 nd	7-8/32 nd	15/32 nd	0-06	0-16	1-06+
3yr penalty Non-agcy Hybrids	10CPR				0-03	0-06+	0-08
Penalty Non-agcy Fixed	5-8CPR	30% of Model Pay-ups			0-02	0-04+	0-05
Conforming Alt-A vs Jumbo	10CPR	3-4/32nds pay-up			0-08	0-09	0-17
Conf. Alt-A vs Jumbo Hybrids	8CPR	2-3bp tighter on N-spread			0-05	0-08	0-13
Premium Pools California: Fixed	5-7CPR	None				0-04+	0-07+
Premium Pools California: Hybrids	5CPR	None				0-03	0-05

Prime Credit: Move Up-in-Borrower-Quality, Down-in-Rating

Move Up-in-Credit, Down in Rating

- ◆ We expect alt-A, option ARM performance to hold up better than subprime in negative HPA scenarios
- ◆ Own alt-A BBs vs. subprime BBBs or BBB- CDS hedged to be carry neutral (~1:3 or 1:2)
- ◆ In the base case, alt-A BB suffers 14% loss, while subprime BBB- suffers 69% loss
- ◆ In the worst case scenario of -4% HPA, alt-A BB suffers 30% loss, while subprime BBB- takes 100% loss

Prime Losses Have Been More Resilient to HPA

Projected Tranche Losses Across Ratings, %

HPA	Alt-A Pools		Sub-prime Pools		Alt-A	-4	-2	0	2	4
	Cum. Defaults	Cum. Losses	Cum. Defaults	Cum. Losses						
0	417	133	2350	857	A	0.0	0.0	0.0	0.0	0.0
4	313	78	1930	547	BBB	20.0	12.0	4.0	2.0	0.0
8	182	33	1350	290	BB	30.0	20.0	14.0	9.0	6.0
12	95	13	1140	199	Subprime					
					A	2.0	0.0	0.0	0.0	0.0
					BBB	100.0	80.0	33.0	1.0	0.0
					BBB-	100.0	100.0	69.0	20.0	0.0

Prime Credit: Own Option ARM Credit vs. Subprime

Conservative Rating Agency Levels + Rather Low Delinquencies

- ◆ Rating agency levels are extremely conservative on Option ARMs vs. Other sectors
- ◆ Delinquencies on Option ARMs have been lower than fixed-rates/hybrids so far
- ◆ Pick 25bp DM versus subprime subordinates (cash)
- ◆ We favor BBBs in XS/OC structures over shifting-interest structures

Rating Agency Enhancements vs. Fair Levels

Factor	Rating Agency Assumption			'Fair Level' ⁽¹⁾		
	Freq	Sev	Loss	Freq	Sev	Loss
MTA vs. 5/1 IO	1.40	1.33	1.86	1.15	1.25	1.43
80 / 20 vs. 80	1.40	1.00	1.40	3.50	1.00	3.50
Purchase vs. Cashout	0.65	0.85	0.55	1.50	0.90	1.35
625 vs. 700 FICO	5.00	1.00	5.00	6.00	1.00	6.00

Projected Tranche Losses

	-4	-2	0	2	4
MTA					
A	0.0	0.0	0.0	0.0	0.0
BBB	21.0	0.0	0.0	0.0	0.0
Subprime					
A	2.0	0.0	0.0	0.0	0.0
BBB	100.0	80.0	33.0	1.0	0.0

1. Based on cum. defaults on the 2001/02 vintages by characteristics

Outlook for Subprime MBS

Subprime MBS: Expect Negative Headlines to Dominate

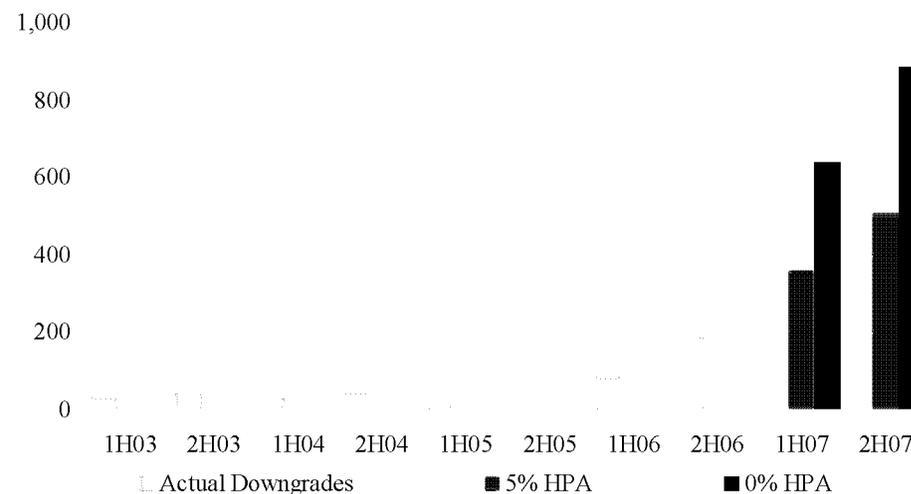
Risk Aversion Among CDO Liability Investors Might Increase Given Headline News

- ◆ Prepays expected to be slower than the 2003 vintage by 15-20% CPR in 1H07 assuming a 0% HPA scenario
- ◆ 60+ delinquencies on 2006 originations in 1H07 are expected to be about twice that of 2003-04 vintages
- ◆ Expect a sharp increase in the number of bonds at the risk of downgrade driven by weak early-stage credit performance and increased rating agency aggressiveness on the 2005/06 vintage

Projected CPR (0% HPA in '07, 5% thereafter)

Vintage	1Q 2007			2Q 2007		
	Projected	2003	Change	Projected	2003	Change
1H05	69%	73%	-4%	63%	67%	-4%
2H05	35%	46%	-11%	41%	55%	-14%
1H06	29%	51%	-22%	28%	48%	-20%
2H06	14%	28%	-14%	17%	41%	-24%

Historical and Projected Downgrades

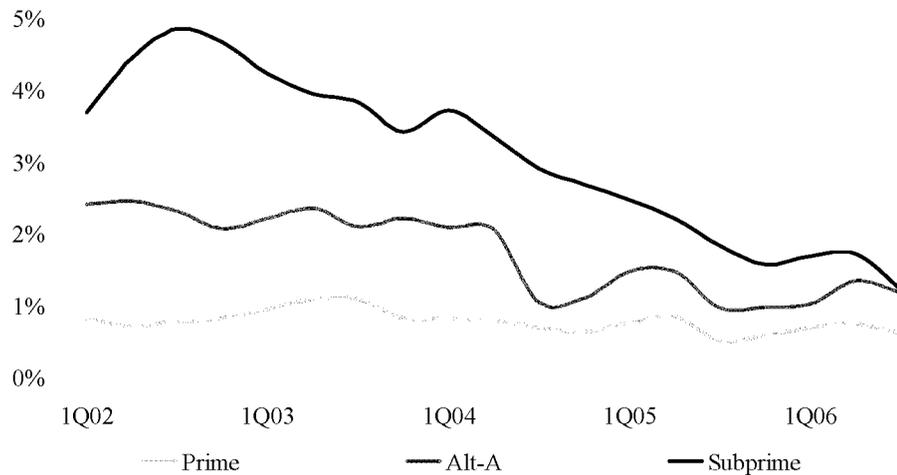


Originators and Servicers to Face Continued Pressure

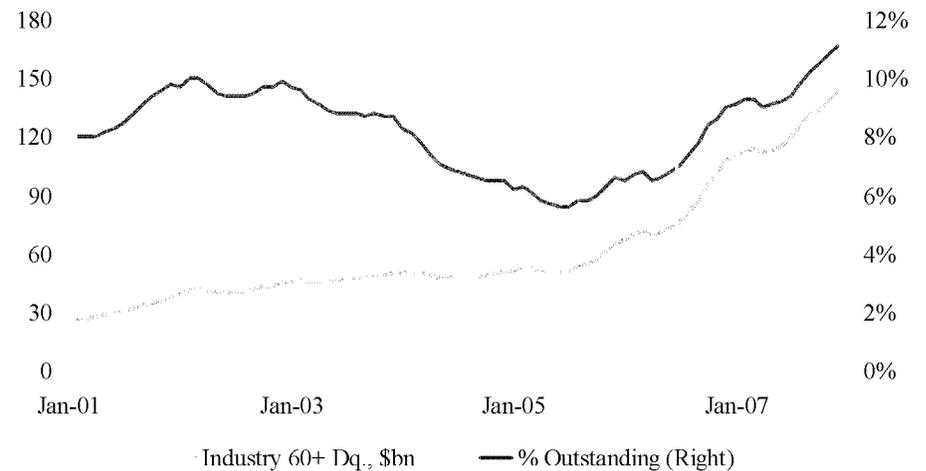
Declining Gain on Sale Margins, Higher Delinquencies to Pressure Originators/Servicers

- ◆ Originator profitability and viability to be under pressure due to lower supply and thin GoS margins
- ◆ Supply is expected to decline by 15%-20% in 2007 due to slow housing, higher WACs and tighter underwriting
- ◆ Originator margins to remain thin due to excess origination capacity and floored-out costs
- ◆ Large increase in delinquent loans to pressure servicing capacity and costs
- ◆ Additional dimension of originator/servicer tiering based on the financial strength of the sponsor

Gain on Sale Margin (GoS) by Quarter



Projected Subprime 60+ Delinquent Loans, by Date



2005/06 Vintage Underperformance to Continue in the Tail

A Large Part of the Recent Underperformance is Explained by High-CLTV Loans

- ◆ 2005/06 vintage underperformance is not merely an EPD issue and has continued later in the deal age
- ◆ Expect 2006 vintage cumulative defaults to be about 50% higher than 2003/04 purely based on underwriting
- ◆ High CLTV loans are a significant contributor to recent early stage underperformance of 2005/06 vintages ...
- ◆ ... but the risk layering story on the purpose and documentation dimension is overstated
- ◆ Within the high CLTV universe, low SATO borrowers have underperformed relatively more versus 2003

Roll Rates from Current to 30-59 Dq, by WALA

Vintage	WALA					
	6 Mo	9 Mo	12 Mo	15 Mo	18 Mo	21 Mo
2001	1.0%	1.4%	1.8%	1.9%	1.9%	2.2%
2002	0.9%	1.2%	1.6%	1.8%	2.1%	2.3%
2003	0.6%	1.1%	1.4%	1.5%	1.8%	1.9%
2004	0.8%	1.3%	1.7%	2.1%	2.4%	2.4%
2005	1.2%	1.7%	2.1%	2.4%	2.6%	2.7%
2006	1.7%	2.3%	2.6%			

60+ Dq for >90 CLTV Loans across SATO

>90 CLTV Universe	60+ Delinquencies, 15 WALA		
	2003	2005	% Worsening
Overall	4.6%	6.7%	44%
-100bp SATO	2.0%	3.7%	84%
100bp SATO	7.3%	10.6%	45%

2007 Portfolio Positioning: Advocate a Defensive Posture

Subprime MBS

Move Up in Credit, Short the BBB/BBB- ABX Basis Using a Box Trade

- ◆ **Basis Call:** Overweight 1-3 year AAA floaters versus consumer ABS
- ◆ **Cross Capital Structure:** Move to AAA/AAs from A/BBBs, Outright short BBB- looks attractive
- ◆ **Cross Vintage:** Overweight 2005 vintage versus 2004 and 2006
- ◆ **Synthetics:** Box Trade – Short 06-2 BBB-/06-1 BBB paired with long 06-2 BBB/ 06-1 BBB-

Loss Coverage Multiples across Vintages, 2% HPA

Loss Coverage Multiples, 2% HPA								
Rating	1H03	2H03	1H04	2H04	1H05	2H05	1H06	2H06
A2	2.12	2.46	1.88	3.08	6.06	4.34	2.79	2.54
A3	1.59	1.93	1.41	1.65	3.94	3.15	2.16	1.93
Baa1	1.36	1.40	1.12	1.31	2.54	2.18	1.67	1.53
Baa2	1.19	1.03	0.88	1.10	1.30	1.55	1.26	1.21
Baa3	1.03	0.83	0.75	0.96	1.18	1.23	1.00	0.98

Market Implied HPA at Current Spread Levels

ABX Series	Rating	Current Spread	Market Implied Mean HPA	Market Implied Prob(<0 HPA)
ABX 06-1	BBB	145 bp	1.52%	30.7%
ABX 06-1	BBB-	270	1.74	28.1
ABX 06-2	BBB	235	2.42	21.0
ABX 06-2	BBB-	370	3.15	14.7

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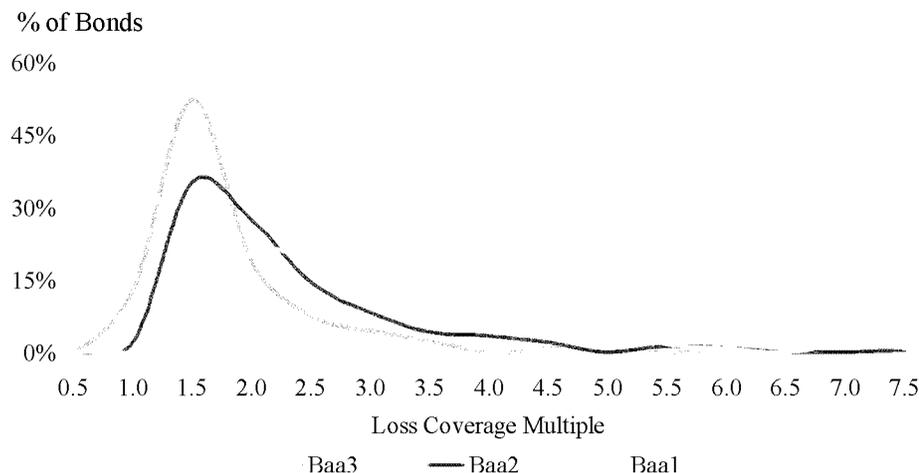
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Security Selection the Key to Generate Alpha

Top Tiering Stories

- ◆ Originator effects not fully reflected in subordination, will need to be re-estimated in 2007
- ◆ Purchase loans and low documentation loans have underperformed versus rating assumptions
- ◆ Rating agencies have caught up to 2000-04 High-CLTV underperformance, recent performance looks worse
- ◆ Own IO Loan Exposure in the 2005 Vintage – rating agencies understate post-reset prepayment speeds

Loss Cov. Mult. Distribution, 2005 Vintage, 2% HPA



Historical Performance versus Subordination

Characteristics	Rating Agency Foreclosure Frequency	Historical Cum Defaults, 24 WALA	
		Multiple	Cum Defaults
Purchase	100*	100*	3.6%
Cashout	137	78	2.8%
Full Doc	100	100	3.6%
Lim Doc	117	136	4.9%
80 LTV	100	100	3.6%
80 LTV/100 CLTV	154	153	5.5%

* Foreclosure frequency for a purchase 80 LTV, 80 CLTV, full doc loan is benchmarked to 100

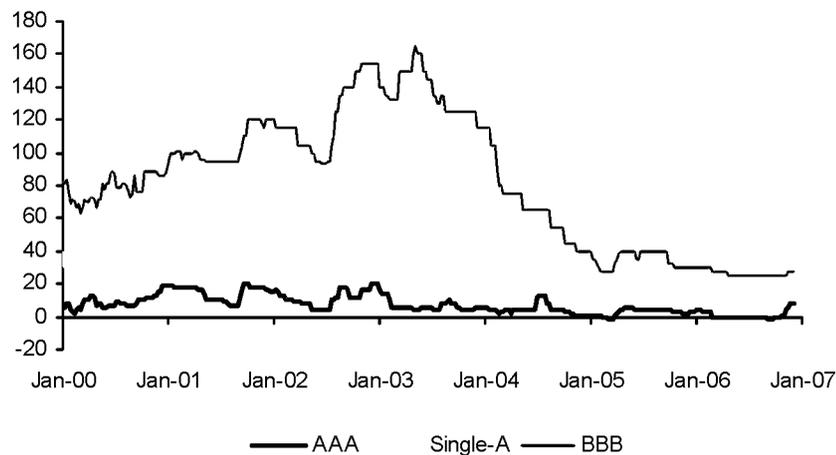
Outlook for Non-Mortgage ABS

Non-Mortgage ABS: A Safe Haven

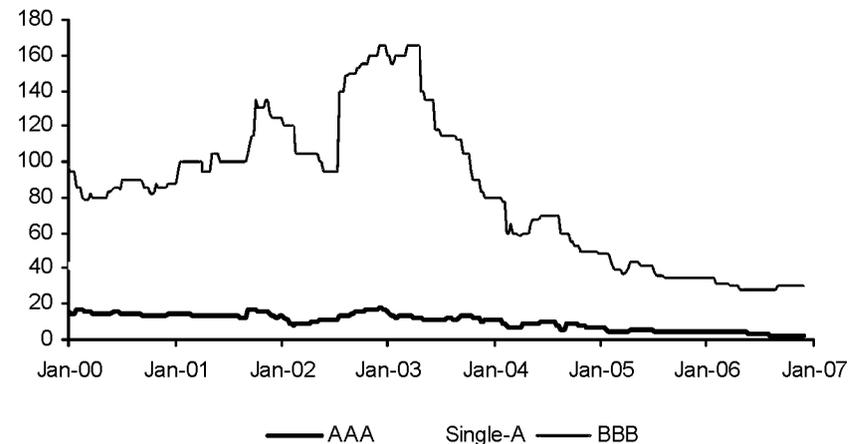
Top Themes for 2007

- ◆ Overall, look for collateral performance to weaken
- ◆ However, since 2006 performance was very strong by historical standards there is plenty of cushion
- ◆ Credit spreads are at historic tightness so outperformance will be difficult
- ◆ Student loans and autos have more total return upside due to prepayments
- ◆ Diversify with esoterics. Whole business and insurance ABS offer additional spread versus traditional consumer ABS sectors with orthogonal risk.

Prime Auto ABS Spreads, bp



Prime Credit Card ABS Spreads, bp

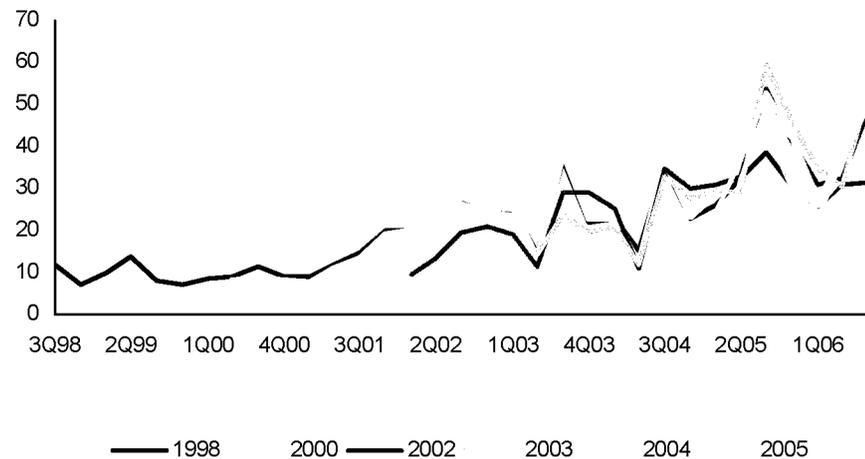


Student Loan Outlook '07: Prepayments & Washington

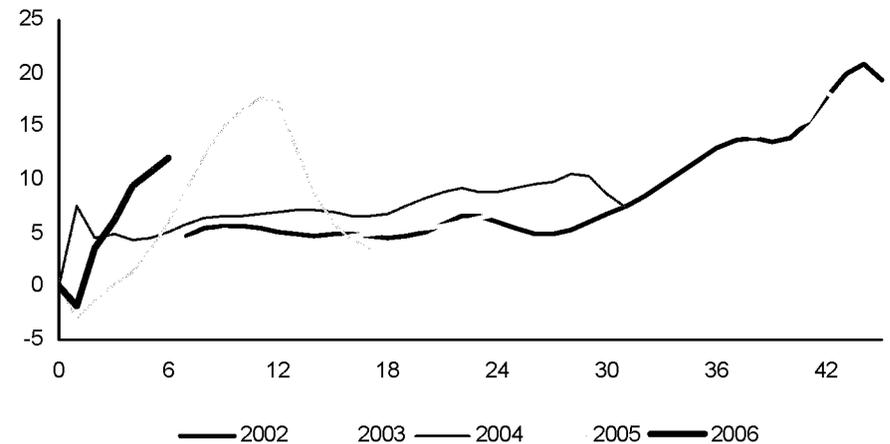
The End of One Consolidation Wave and the Start of Another

- ◆ FFELP Non-consolidation prepayment speeds will slow markedly, favor vintage premium-priced bonds
- ◆ FFELP Consolidation prepayment speeds depend on vintage – older vintage will slow, recent vintage will be faster
- ◆ Private student loan prepayments could increase as lenders push private consolidation loans
- ◆ Student loan reform is a priority. Among the proposals:
 - Cutting borrower rates in half
 - Favoring the Federal Direct Lending Program (FDLP)

SLM Non-Consolidation Prepayments, CPR



SLM Consolidation Loan Prepayments, CPR

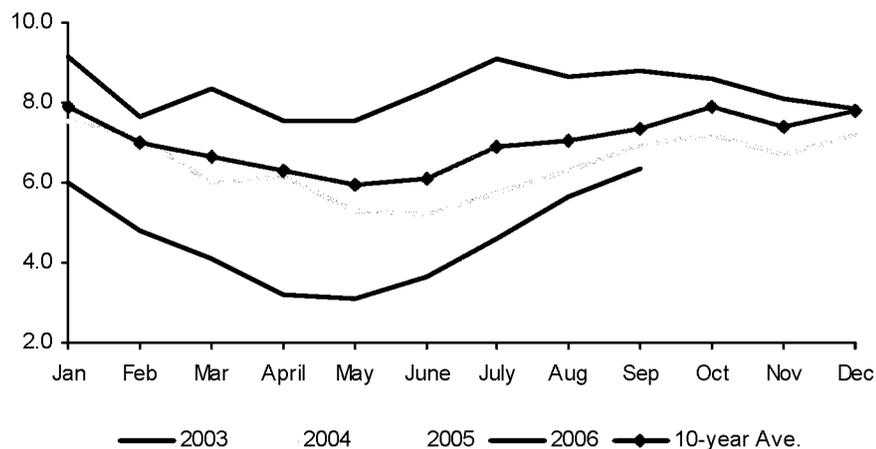


Auto Outlook '07: Play the Speed Game

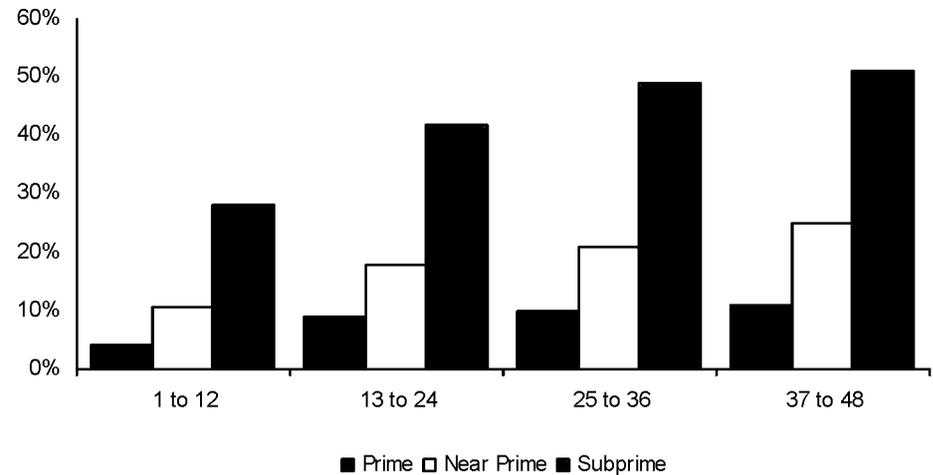
Credit Should Not be an Issue, but Changing Prepayments Will

- ◆ Ford and GM will dominate the headlines, but outperformance will be based on getting prepayments correct
- ◆ Although collateral performance in subprime is already starting to soften, the impact on bond valuation will be through prepayments, not credit
- ◆ Impact of weaker collateral performance will depend on borrower credit
 - Prime prepayments should slow
 - Subprime prepayments should increase

Moody's Subprime Auto Losses, Y-o-Y



Defaults as a % of Total Prepayments, WALA

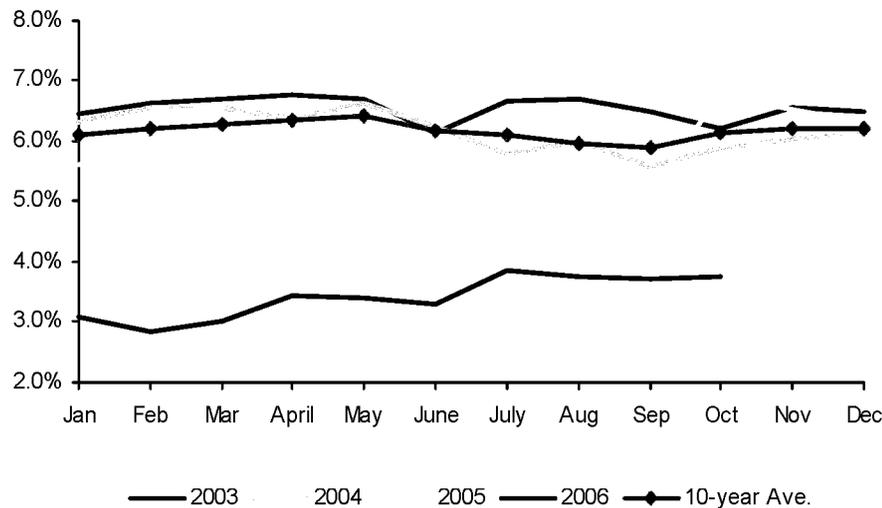


Credit Cards Outlook '07: Up in Borrower Credit

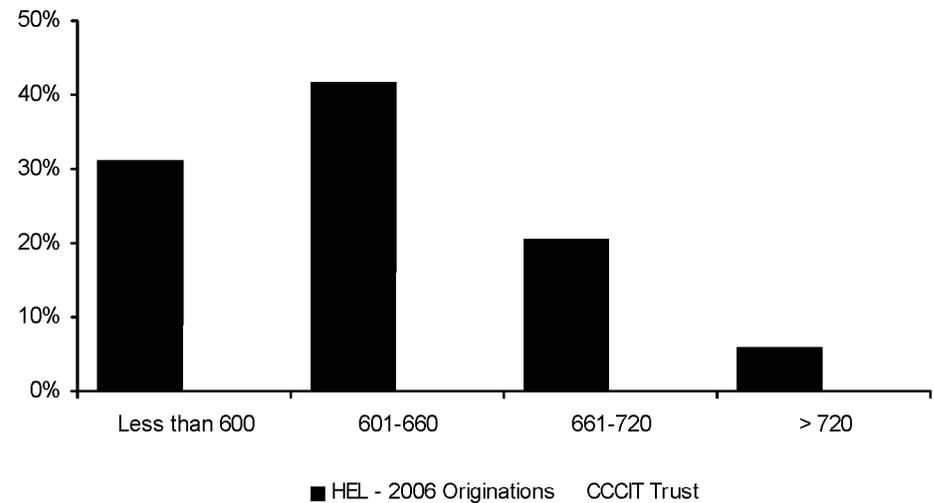
Attractive Versus Agencies and Treasuries

- ◆ Collateral performance will soften, but charge-offs will remain below historic levels
- ◆ Watch pay rates for early signs of deteriorating credit
- ◆ Credit card trusts will weather a downturn in the housing market.
- ◆ Investors are not being adequately compensated for moving down in borrower credit
- ◆ Subordinates are fairly valued versus corporates
- ◆ Top tier AAA cards are attractive relative to agencies with additional upside if swap spreads tighten

Industry Average Credit Card Charge-Offs, Y-o-Y



Trust Receivables Balance, by FICO



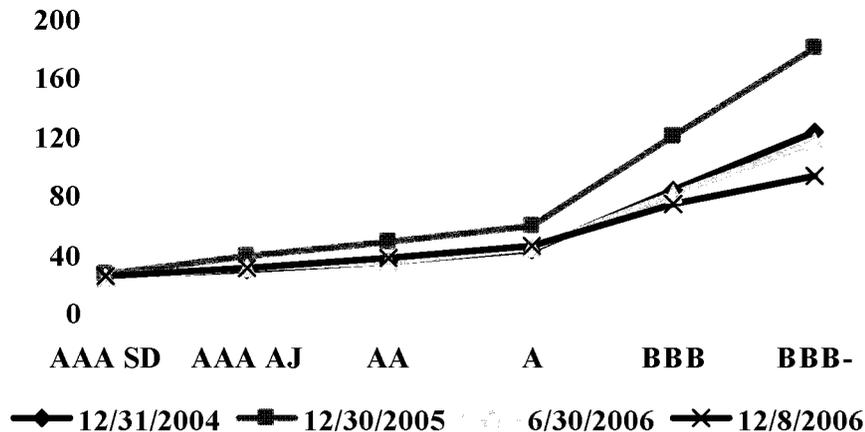
Outlook for CMBS

Highlights of 2006

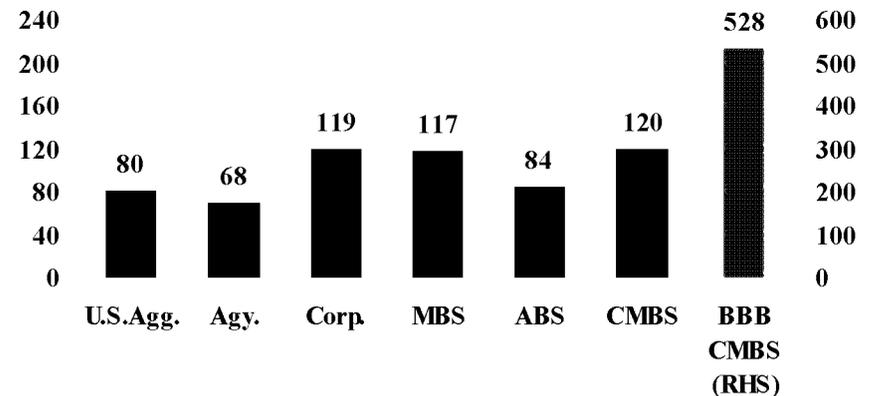
Strong Year for Subordinate CMBS

- ◆ Commercial real estate fundamentals continued to improve
 - Credit indicator for CMBS fell 40 bp from +0.23% to -0.17%
- ◆ Property acquisitions, REIT privatizations were common as capital gushed into CRE
 - Result: blockbuster issuance year for CMBS; domestic issuance likely to top \$200 billion
- ◆ Significant credit curve flattening: BBBs tighter by 47 bp and BBB-s by 88 bp
 - Despite weaker underwriting and lower credit support
- ◆ CMBS tops the fixed income charts in terms of excess returns over Treasuries
 - Most spread sectors do well

The Credit Curve Flattens in 2006



Excess Returns over Treasuries, YTD Dec. 8, 2006

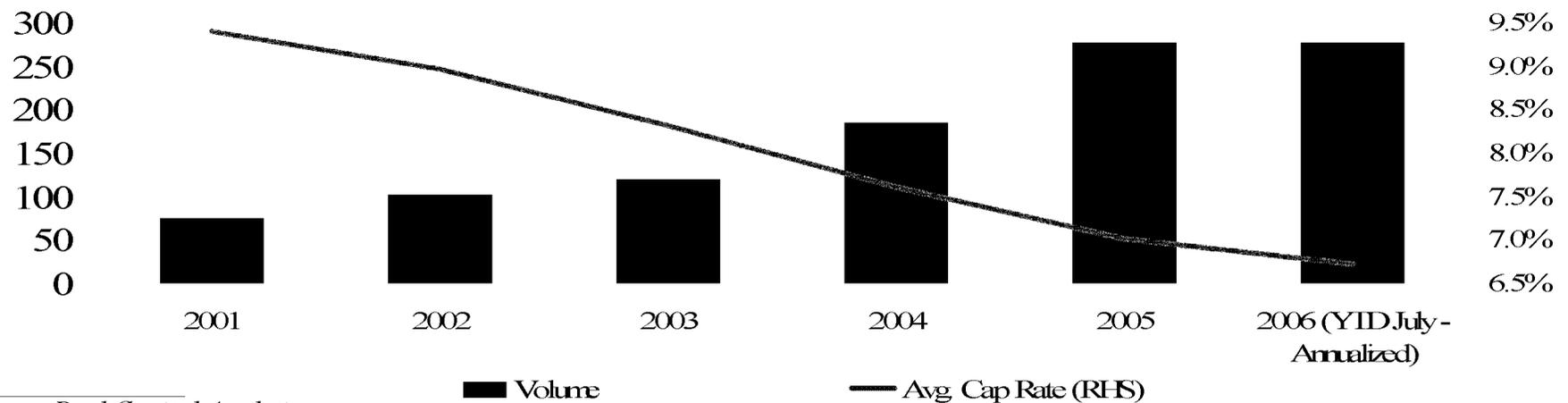


Key Themes for 2007

Another Strong Issuance Year Expected

- ◆ Current momentum of capital inflows should continue, fueling CMBS issuance
 - But don't expect too much improvement in underwriting
- ◆ Less potential for significant appreciation in CRE values
 - Some rent upside already priced in, given compression in cap rate – UST spread
 - Income growth will be the key; slowdown could put pressure on valuations
 - CRE fundamentals look good, but downside is large in the event of any hiccups

Acquisition Volume and Average Cap Rates



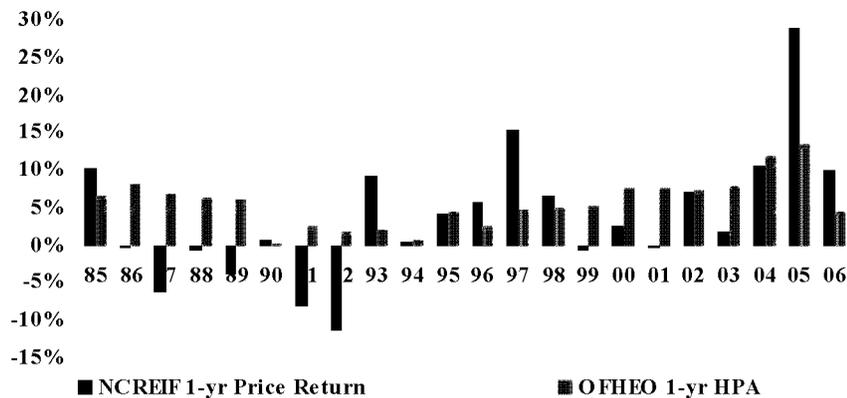
Source: Real Capital Analytics

Link Between Commercial and Residential Markets

CRE Should Withstand Residential Slowdown, but Some Risk to Downside

- ◆ Base case forecast: residential slowdown will be contained
 - Commercial markets should be relatively unaffected
- ◆ However, downside for CRE exists in unfavorable HPA scenario
- ◆ Most vulnerable property type will be retail as consumer spending likely to be affected
 - Retail property returns have shown strongest historical correlation with home prices

NCREIF All Property Index versus OFHEO HPA



Source: NCREIF, OFHEO

Correlation: Residential versus Commercial R.E.

	Correlation of Returns w/ OFHEO HPA
NCREIF All Property Index	0.65
NCREIF Apt	0.53
NCREIF Retail	0.81
NCREIF Office	0.50
NCREIF Industrial	0.58

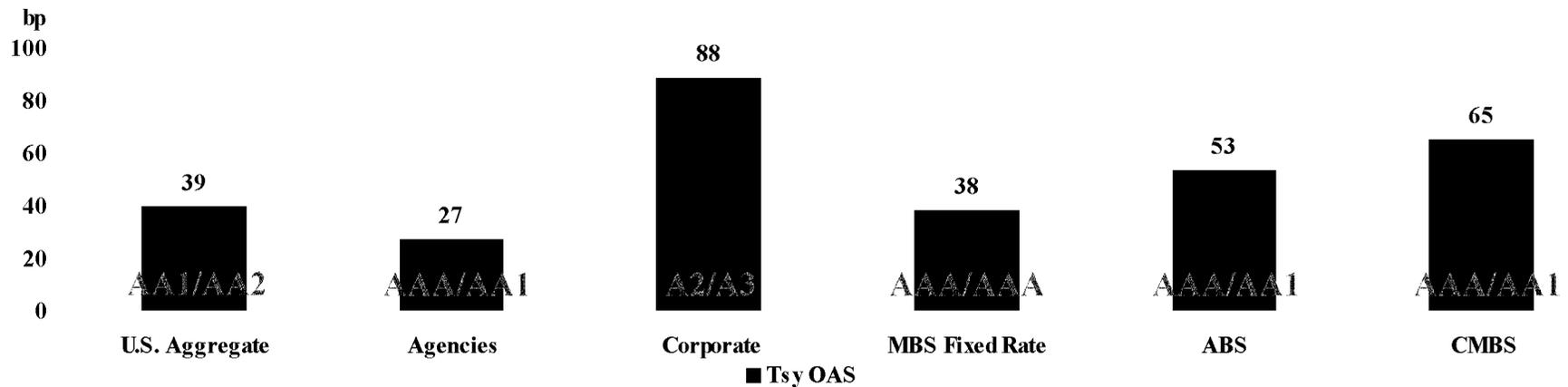
Based on calendar-year annual returns from 1985-2006. 2006 returns are YTD through 9/30/2006. Source: NCREIF, OFHEO

Relative Value: AAAs At One End ...

AAAs Offer Value Versus Benchmark Sectors

- ◆ Sizeable spread advantage over similar quality asset classes
- ◆ Strong convexity characteristics in 10-year AAAs
- ◆ Expect 2007 supply to be met with strong demand
- ◆ 10-year 30% C.S. AAA spreads should once again test the 20 bp mark in 1H07
 - Treat any technical widening as a buying opportunity

Treasury OAS and Average Quality of Major Sectors of U.S. Aggregate Index, Dec. 8, 2006

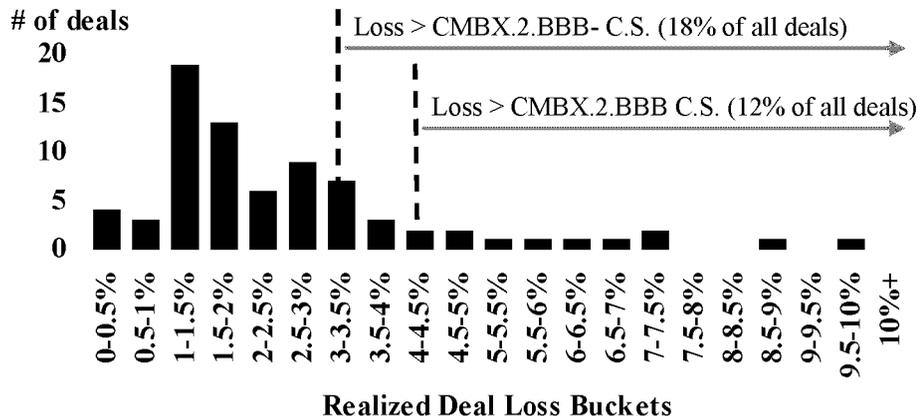


... And BBBs at the Other

We Recommend an Underweight to BBB/BBB-

- ◆ Significant spread tightening despite weaker underwriting and falling credit support
- ◆ Average deal losses need to be only 1.5-2.0% for sufficient outlier BBB/BBB- classes to suffer losses
 - Based on historical loss dispersion across transactions
- ◆ A number of 95-98 vintage transactions had losses > today's BBB/BBB- credit support
 - Despite relatively benign credit environment for core property types in past decade
- ◆ Look to buy protection on BBB/BBB- classes
 - Offset some negative carry by going long senior risk

Distribution of Historical Deal Losses (95-98 Vintage)



Deteriorating Underwriting Trends

	% IO (full/partial)	% shadow-rated IG	% Lodging	Avg DSCR	Avg BBB-C.S.
1Q04	39.04	24.95	1.98	1.89	3.89
3Q04	40.12	21.52	4.03	1.93	3.54
1Q05	56.76	13.57	6.08	1.84	3.30
3Q05	68.47	11.52	8.18	1.60	3.39
1Q06	66.37	13.90	12.33	1.56	3.22
3Q06	74.95	8.29	10.12	1.41	3.07

Summary of our Trade Recommendations

CMBS

Basis

Overweight CMBS; attractive versus swaps, agencies and corporates; look to any technical-driven spread widening as a buying opportunity

Credit Curve

Underweight BBBs; overweight AAAs through A; underwriting trends are not favorable for newer vintage BBB/BBB- securities given credit support, CDO technicals remain strong, but there is limited scope for further spread tightening.

Trade Ideas

Cash Only

- 1) Buy 5-year AAA versus 3-year and 10-year SD AAA
- 2) Buy AM classes versus super duper-AJ combo:
AM should price closer to super-dupers than to AJ
- 3) Buy newer vintage CL IOs: extension upside
- 4) Buy 2002-2003 vintage CP IOs versus front-payers:
spread pickup; steady cash flows; high CDR break points

Cash/Synthetic

- 5) Buy protection on CMBX.2.BBB; offset negative carry with leveraged 10-year AAA SD
- 6) Sell protection on CMBX.1.BBB-, buy protection on CMBX.2.BBB; positive carry, comparable quality

Cross-Sector

- 7) Buy AAA 5-year CMBS, buy protection on CDX.NA.IG.7, pay on interest rate swap
- 8) Buy AAA CMBS versus agency debentures

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◆ The Lehman Brothers Mortgage Valuation Model allows investors to analyze mortgage-backed (MBS), asset-backed (ABS) and commercial mortgage-backed securities (CMBS). The model collects pertinent and material information needed to evaluate and calculate the risk measures of the security. The model provides option-adjusted spreads and durations along with other risk measures using Lehman Brothers' Prepayment, Default, and Term Structure Models.

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