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Securities and Fund Services

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Welcome

As part of Citi's commitment to developing new markets for Securities Finance and enhancing existing services, I am pleased to announce that we can now offer our clients collateral management services in 15 countries across Asia (Japan, Korea, Taiwan), Western Europe and the United States.

Through 2007–08, this service will be extended to key Eastern European and Asia-Pacific markets, commencing with Turkey and Hungary in the third quarter of 2007.

Unique to the market-place, Citi offers both a direct account structure that allows geographically separate holdings held in local Citi branches to be merged into a single collateral pool, without the need to transfer securities from your custodian, and a global custody platform via Citibank, N.A., London.

With dedicated collateral management operations now across three regional time zones, each accessing one global system Common Collateral Management Platform (CCMP), Citi can support your global collateral management requirements, including secured financing (both bilateral and tri-party), securities lending, and cash-equity and derivatives margining obligations.

With Basel II regulations coming more widely into force in 2008, the use of collateral to mitigate regulatory capital costs and manage counterparty risk will become even more widespread. Whether you are a collateral giver or taker, we believe we have the market solutions to enable you to maximise the business opportunities that accrue from this global trend.

For more information, please contact your Citi representative or David Allen at david.j.allen@citi.com.

US equities

Average balances were up 6.55 per cent for the month with average specials in demand down 5.73 per cent

News

The Dow fell over 1.00 per cent early in the month as fears about the sub-prime turmoil were revived and the dollar fell to a record low against the euro, with a 26-year low against the UK pound. The retreat was sparked in part when the ABX index, which tracks the sub-prime mortgage industry, hit a low and caused an allocation shift towards bonds. The retreat was short-lived as the market shook off any concerns and rallied to an all-time high, closing at 14,000 on 19 July, just three months after breaking through the 13,000 barrier. This continues the pattern of seemingly defiant bullishness by uneasy investors. The rally was amplified by investors, with short positions, reversing course to minimise losses.

The Dow's 14,000 celebration didn't last long as earnings misses from Google, Caterpillar and Ericsson weighed on the market. Worries about the sub-prime mortgage sector and debt-market risks added fuel to the decline, as the market slid about 800 points from the high over the course of the last eight trading sessions of the month. This was the second monthly decline in a row.[1]

Active stocks

• Luminent	LUM
• Medis Tech	MDTL
• Heartland Payment	HPY
• Midway Games	SXL
• Pool Corp	POOL

Sectors in demand included: autos, sub-prime lenders and exchange-traded funds (ETFs). Some drivers of this demand included: asset valuations, downgrades, commodity prices and supply issues.

[1] Sources: Bloomberg L.P. at www.bloomberg.com, accessed on 10, 13, 16, 17, 18, 19, 20, 26, 31 July 2007; Wall Street Journal (WSJ), 10, 13, 16, 17, 18, 19, 20, 26, 31 July 2007.

US issuance and credit

The US sub-prime mortgage market once again dominated the global credit headlines in July. Under pressure from the media, as well as from market experts, the big three rating agencies announced over 1500 ratings actions of structured finance transactions, most with some affiliation to the sub-prime residential mortgage-backed securities (RMBS) market.

The downgrades affected issues, primarily Collateralised Debt Obligations (CDOs) with a wide range of credit ratings, from non-investment grade all the way up to AAA. As a result of these rating actions, and heavy trading in the ABX indexes, market values of the affected structured finance transactions plummeted. Hedge funds, some of which borrowed heavily to invest in structured finance issues, faced huge margin calls, and some prominent funds were forced to either close or freeze redemptions.

US cash and money markets

Although no Federal Open Market Committee (FOMC) meeting was scheduled for July, the Federal Reserve Board did give the market some insight into their thinking when Chairman Bernanke gave his semi-annual testimony on the state of the US economy and monetary policy.

His remarks were consistent with the statement issued following the 28 June FOMC meeting, stating the economy is expected to continue to grow at a moderate pace with inflationary pressures receding, but there remains a risk that a high level of resource utilisation (employment) has the potential to sustain inflationary pressure.[2]

During the second half of the month, interest rates across the yield curve began to decline as concerns that the weakness in the housing sector could spill over to other sectors of the economy, creating a significant slowdown in overall growth. The slope of the money-market LIBOR curve changed from a positive ten basis points (bps) at the end of June to a negative seven bps at the end of July.

Pricing on the Federal Funds futures contracts and associated options contracts shifted to indicate a fully priced in easing of short-term rates by year-end. Several broker-dealer firms changed their outlook on interest rates to a more dovish position. Based on the shift in the money-market yield curve, the decision in mid-June to extend duration in the cash-collateral investment portfolios with relatively longer dated fixed-rate investments has resulted in additional spread for our clients

[2] Source: http://www.federalreserve.gov/boarddocs/press/monetary/2007/20070628 accessed July 2007.

US corporate bonds

Average balances were down 5.56 per cent for the month, while average special balances were down 0.98 per cent.

Current news

Investors, concerned about the debt some companies are taking on for a record amount of leveraged buyouts, are balking at risky toggle securities and covenants that do not protect bondholders. ServiceMaster Co. delayed its USD1.15 billion offering for a third time, even after it restructured the deal by halving the amount of toggle notes. According to Merrill Lynch & Co. index data, the spread on high-yield bonds to treasuries topped 300 bps for the first time this year. Yield premiums were at a record low of 241 bps just one month ago. More than a dozen companies have delayed or restructured offerings since 22 June.[3]

Moody's Investors Service may cut USD5 billion of Collateralised Debt Obligations (CDO) after lowering the ratings of the sub-prime mortgages that make up the securities. Moody's and Standard & Poor's, after coming under criticism for failing to downgrade sub-prime mortgages, recently began lowering ratings on over 1011 bonds, valued at about USD12 billion.[4]

The perceived risk on Home Depot bonds jumped to a six-month high as credit-default swaps on USD10 million of the retailer's debt rose USD3,500 to USD34,000, according to CMA Datavision in London. This came after Home Depot announced a profit warning that earnings per share (EPS) for the current fiscal year would fall between 15 and 18 per cent.[5]

Issues in demand

- Ply Gem Industries (CUSIP 729416AG2)
- Hawaiian Telecom (CUSIP 420029AD2)
- Beazer (CUSIP 07556QAQ8)
- Applied Extrusion (CUSIP 038196AE1)
- AMR Corp (CUSIP 001765AC0)

[3] Source: Bloomberg L.P. at www.bloomberg.com, accessed on 6 July 2007.

[4] Source: Bloomberg L.P. at www.bloomberg.com, accessed on 11 July 2007.

[5] Source: Bloomberg L.P. at www.bloomberg.com, accessed on 10 July 2007.

US Treasury and agency

On-loan balances of the US government and agency desk increased by eight per cent in July, primarily as a result of an influx of US Treasury collateral allocated to our programme as a reward for outstanding performance verses competing securities-lending agents with similar portfolios.

The entire curve in the US Treasury market continued to trade special throughout July, albeit somewhat tempered when compared to June's unprecedented 22 bps Treasury general collateral (GC) spreads. Despite July spreads slightly narrowing, the Treasury GC spread to funds still managed to average a robust 13 bps, which mirrored May's performance, and exceeded July 2006 by three bps. Agency GC traded flat to Fed Funds at 5.25 per cent. The term GC markets are indicating August's and perhaps September's Treasuries spreads will be similar to the 13 bps enjoyed in May and July.

The ten-year Treasury was the current issue that traded with the highest premium, averaging 115 bps. The five-year Treasury averaged 45 bps and the two-, 3- and 5-year all traded with approximately 25 bps of spread.

The Treasury term GC markets have begun to price in a slight possibility of a 25-bps ease at the 18 September Fed meeting, and has a 25 bps ease fully priced in to the 11 December meeting.

Asia-Pacific equities[6]

The Asia-Pacific markets generally have had a very volatile month as concerns over the sub-prime market in the US continued to plague the stock market. Most markets ended the month down. The only exceptions were Hong Kong and China, where markets reached another record high, despite continued measures by the government to soak up excess liquidity.

Australia

Balances with Australian record date fell 1.24 per cent for the month of July.

Tight stocks

- Geodynamics (SEDOL 6546218)
- Copperco Limited (SEDOL 6151441)
- Av Jennings Limited (SEDOL 6523556)
- Riversdale Mining (SEDOL 6932657)
- Aed Oil Limited (SEDOL B06YXJ5)

News

The Australian dollar continued to appreciate against the US dollar through the month of July. Against a basket of leading currencies, the Australia dollar has risen 9.00 per cent this year to a two-decade high. However, month-end saw a resulting depreciation as investors' unwound perceived risky trades, such as the carry trade against the Japanese Yen. Australia's retail sales unexpectedly declined and building approvals slumped to a six-year low, signalling the central bank would leave interest rates unchanged. Sales slipped for a second month, dropping 0.10 per cent. The number of approvals to build or renovate homes fell 5.60 per cent.

Mining giant Rio Tinto offered to buy Canadian aluminium company Alcan for USD38.1 billion in a friendly takeover that countered a hostile bid by United States' Alcoa. Business confidence remained at the highest level in more than two years last month as surging mainland demand for commodities buoyed sales for miners. A protracted bidding war for Australian retailer Coles Group closed with conglomerate Wesfarmers presenting a bid that could be worth up to AUD19.7 billion for the whole company. The deal would be the biggest takeover in Australian corporate history.

Australia's consumer confidence held close to record highs after the Central Bank left interest rates unchanged for an eighth month and fuel prices dropped. The confidence index fell 0.6 per cent from last month to a seasonally adjusted 120.8. A hiring boom has pushed Australia's unemployment rate to the lowest level since 1974, countering the effect on household expenditure of the central bank's three interest-rate increases.

Hong Kong

Hong Kong balances continued to sore, increasing 55.58 per cent in the month of July.

Tight stocks

- Geely Automobile (SEDOL 6531827)
- F E Consortm Intl (SEDOL 6331555)
- Sh Allied Cement (SEDOL 6562827)
- Mingyuan Medicare (SEDOL 6594046)
- Fu Ji Food & Cater (SEDOL B04W2V6)

News

The total value of mainland initial public offerings this year is forecast to double that of Hong Kong as red-chip companies return to domestic bourses, boosting investor interest in share sales. Hong Kong was the second-largest capital-raising market in the world last year after London, raising HKD341 billion. The mainland's first-half trade surplus may have widened by more than 60 per cent to USD110 billion. Last month's exports increased faster as exporters rushed shipments before the 1 July scrapping of export incentives. The mainland's foreign-exchange reserves surged to a record high of USD1.33 trillion at the end of last month, heightening pressure on the government to allow a faster rise in the yuan and raise interest rates to soak up excess cash.

Hong Kong Exchanges and Clearing Limited (HKEx) announced that its securities market's tick-rule would be suspended in the fourth quarter of this year, subject to the approval of the Securities and Futures Commission (SFC).

Japan

Japanese balances fell 13.98 per cent for the month of August.

Tight stocks

- Privee Investment (SEDOL 6673547)
- Tobishima Corp (SEDOL 6893000)
- Kimura Chem Plants (SEDOL 6492485)
- Tokyu Const Npv (SEDOL 6689351)
- Tokyo Kikai Seisak (SEDOL 6895039)

News

In July, the Bank of Japan voted eight to one in favour of keeping its benchmark interest rate at 0.50 per cent. On 5 July, the government upgraded its assessment of Japan's leading economic indicators for the second consecutive month, easing worries about a temporary slowdown in the economy. The low-yielding Japanese yen halted its slide against major currencies as investors pared back bets built up over recent weeks on expectations of divergent interest rates.

Japan's machinery orders, a key indicator of corporate spending plans, rose at triple the pace economists predicted. Orders climbed a seasonally adjusted 5.90 per cent. The median estimate of economists was a 1.90 per cent rise. Manufacturing equipment orders rose at the fastest pace in almost a year, signalling industrial production is likely to recover.

Korea

Balances in Korea increase by a margin of 21.62 per cent for the month of July.

Tight stocks

- Hyundai Autonet (SEDOL 6539036)
- Daiyang Metal (SEDOL 6167675)
- Han Jin Transport (SEDOL 6407780)
- Korean Air Termina (SEDOL 6496476)
- Korea Iron & Steel (SEDOL B00YY32)

News

South Korea's central bank raised interest rates to a six-year high on 12 July, and its upbeat comments on growth, combined with inflation warnings, convinced investors rates could rise again, prompting a sell-off of bonds. The widely anticipated 0.25 per cent increase initially had little market impact, but remarks by Governor Lee Seong later sent bond prices falling and the currency rising as investors began to factor in another interest-rate rise. Data showed foreign direct investment plans lodged with South Korea fell for the fourth successive quarter in the April to June period. The Ministry of Commerce said foreign direct investment commitments fell 35 per cent for the second quarter from a year earlier.

New Zealand

With record date finished, balances fell 23.99 per cent for the month of July.

Tight stocks

- Tower Ltd (SEDOL 6174299)
- Fisher & Paykel Ap (SEDOL 6421791)
- Guinness Peat Grp (SEDOL 6577371)
- Sky City Ent Gp (SEDOL 6823193)
- Auckland Intl (SEDOL 6123707)

News

Higher-than-expected inflation follows a report that retail sales rose more than forecast, adding to signs that domestic demand is not abating in response to three rate increases so far this year. Another increase may further fuel demand for the New Zealand dollar from investors who can borrow cheaply in Japan, helping extend the currency's 27 per cent gain the past year alone.

[6] Source: Bloomberg L.P. at www.bloomberg.com, accessed throughout July 2007.

Client-solutions update

On 1 August 2007, Citi completed its previously announced acquisition of The BISYS Group, Inc. for approximately USD1.44 billion in an all-cash transaction. In the transaction, BISYS shareholders will receive merger consideration of USD11.85 per share, and a special dividend of USD0.15 per share in cash. Immediately thereafter, Citi completed its sale of the Retirement and Insurance Services Divisions of BISYS to affiliates of J.C. Flowers & Co. LLC, making the net cost of the transaction to Citi approximately USD800 million.

With the acquisition of BISYS, we are now a leading provider of fund services to the global investment fund industry. As direct complements to our current fund administration offerings, the acquisition provides us with a private equity platform, enhanced mutual fund and fund-of-fund servicing capabilities and an expanded North American presence, significantly enhancing our market leading position in the investment services space.

European equities

Overall balances fell by three per cent over the month. This was due to term trades unwinding.

News[7]

European stocks post biggest weekly drop since March
European stocks had their biggest weekly decline in almost five months on mounting concerns that financing difficulties in the credit markets would stifle mergers and acquisitions.

Europe's Dow Jones 600 Index retreated 5.10 per cent in a week (ending 27 July) the biggest slide since a route in Chinese equities sparked a global sell-off in March.

Hedge Funds raise USD100 billion in first half of 2007[8]
Despite fears of sub-prime damage to the hedge-fund industry, hedge funds attracted USD58.7 billion in new investment in the second quarter of this year, for a record USD118.7 billion in the first half of 2007, almost as much as the whole of 2006.

According to Hedge Fund Research, a source of hedge-fund information and performance data, the USD58.7 billion attracted by hedge funds in the second quarter of 2007 was almost as high as the record USD60 billion in the first quarter, and brings overall assets under hedge-fund management to USD1.74 billion.

Top-performing emerging markets funds saw an inflow of USD3.6 billion in the period, up from USD978 million in Q1 2007, and just USD711 million in Q2 2006. Funds of funds (FOF) raised USD17.4 billion in new assets in Q2 2007, more than double the USD7.9 billion in Q1, bringing total FOF assets to a record USD745 billion.

Performance for the period remained strong, with the average hedge fund posting gains of 4.77 per cent, according to the HFRI Fund Weighted Composite Index. Emerging markets was again the top performer, up 8.85 per cent for the period, and 14.75 per cent year-to-date. Following emerging markets was equity non-hedge, up 7.35 per cent in Q2, and equity hedge and macro, both up 5.29 per cent.

Active stocks

Relative-value and merger-and-acquisition news

- Endesa (ELE SM)
- Fortis (FORA NA)
- Banco Popolare Di Verona (BPVN IM)
- Iberdrola (IBE SM)
- Mapfre (MAP SM)
- Sacyr Valleherm (SYV SM)

Directional and convertible-bond news

- Banca Italease (BIL IM)
- Altana (ALT GR)
- Qiagen (QIA GR)
- Tiscali (TIS IM)
- Conergy (CGY GR)
- Premier (PRE GR)
- Option (OPTI BB)
- Zardoya Otis (ZOT SM)
- Metrovacesa SA (MVC SM)

Sectors and markets in demand included: ETFs, REITs and emerging markets.

[7] Source: Bloomberg L.P. at www.bloomberg.com, accessed throughout July 2007.

[8] Source: ISF Magazine at www.isfmagazine.com, accessed throughout July 2007.

European money markets

Trichet and his colleagues opted to maintain the target European Central Bank (ECB) rate at 4.00 per cent during the first few days of August. A widely anticipated move, this news did little if anything to alter market behaviour.

Throughout July, European and indeed global attention was directed towards the sub-prime mortgage situation progressing in the USA. Whilst we here in London continue to monitor developments closely, we are confident with our investment strategies.

Recently elected French President Nicolas Sarkozy proved to be the most vocal adversary the ECB has seen to date. His outspoken views regarding the future of French fiscal policy were most certainly noted throughout the Eurozone although seemed insufficient to impact market behaviour. Market consensus remains for the ECB to hike once more in September and further to reach 4.50 per cent prior to the end of 2007.

Reverse-repo trades continue to generate modest revenues, whilst we continue to see commercial paper investments generating out most attractive returns.

European government bonds

European Government GC flows continued to slow throughout July as the European Equity dividend season drew to a close with just odd names in Spain and Netherlands paying dividends. The reduction in excess GC balances has seen tri-party levels come off resulting in a reduction in spreads for clients restricted to investing in Euro Govt paper. Conversely we have seen the spread widen between Euro Govt GC and ABCP, which has positively impacted the yield on our term book.

It was another volatile month in the Gilt Market with several issues trading special through the month. Again, the most noteworthy issue the UKT 5 03/07/12 (GB0030468747) traded at 200bps over GC, a general market short resulted in at least one market participant being forced to borrow around 400mm from the Bank of England at their emergency repo rate of 0.50 per cent (10 per cent of the current interest rate). Elsewhere UKT4 3/4 06/07/10 (GB00B0330274) traded up to 150bps, whilst UKT 4 09/07/16 (GB00B0V3WX43), UKT 5 03/07/08 and UKT 4 03/07/09 (GB0032785924) remained well bid trading above GC through the month.

As expected Monetary Policy Committee (MPC) members raised interest rates by 25 bps to 5.75 per cent as Consumer Price Index (CPI) inflation continued to fall back towards the Bank's 2.00 per cent target rate. However, in the committee's opinion the upside risks to the outlook for inflation in the medium term remain, indicating further hikes are still being considered. This is reflected in STG cash markets with LIBOR pointing to another rate hike in August or September.

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