

Financial Market Assessment



SEPTEMBER 18, 2008

U.S. Government Bails Out American International Group, Inc.

Why Did This Occur

The current financial crisis is the worst in nearly 80 years. Like most financial crises, it is characterized by a vicious cycle of rapidly declining asset prices and forced deleveraging. What distinguishes this crisis from others is the broad application of leverage to a sharply declining housing market as well as leverage applied through new financial derivatives. The results of this lethal combination have been felt in all facets of finance and the ripple effects have permeated through to the broader economy.

American International Group (AIG), proved to be among those most vulnerable to asset price declines and the deterioration of capital cushions. The rapid collapse and subsequent bailout of AIG, one of the world's largest insurance companies, underscores the severity of the current crisis. The causes for AIG's decline are numerous. Higher than expected claims on mortgage insurance and capital losses and impairments in its investment portfolios caused strain on AIG's financial position. However,

the primary reason for AIG's downward spiral was its excessive exposure to credit default swaps (CDS). These contracts insured against the default of a pool of underlying corporate and structured assets. As the market began pricing greater risk of defaults across these assets, the value of these contracts declined. In combination with deterioration in more traditional investments, losses led to a need to recapitalize. Amid a marketplace still shell-shocked by the failure of Lehman Brothers and the government conservatorship of Fannie Mae and Freddie Mac, AIG appeared to be in trouble. AIG's subsequent declining stock price rapidly became a self-fulfilling prophecy as the required capital began to exceed the company's total market capitalization. Given this reduced financial flexibility, on Monday, September 15th, each of the major rating agencies downgraded AIG, which could have triggered significant additional collateral calls. The firm requested the U.S. Government to extend its funding in order to meet its liquidity needs and stay out of bankruptcy. On Tuesday, September 16th, the Fed Chief Bernanke, Treasury Secretary Paulson and other public officials worked with several Wall Street firms to arrange private sector financing to aid AIG. However, after failing to arrive at a solution the Fed began to weigh the options of either providing funds to AIG itself or allowing the company to go bankrupt and face the impacts that it would have on the global financial system. It was determined that AIG was too interconnected in the global financial system and that the repercussions of an AIG failure would be too severe.

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| Market Pricing For Various Securities of Lehman Brothers & AIG | | | |
|----------------------------------------------------------------|--------------------|--------------------|--------------------|
| | As of 9/12/2008 | As of 9/15/2008 | As of 9/17/2008 |
| American International Group, Inc. (AIG) | | | |
| Senior Debt | \$80.00 | \$68.00 | \$46.00 |
| Subordinated Debt | \$45.00 | \$15.00 | \$10.00 |
| Common Stock | \$12.14 | \$4.76 | \$2.32 |
| Lehman Brothers Holdings Inc. (LEHMQ) | | | |
| Senior Debt | \$84.00 | \$34.00 | \$16.50 |
| Subordinated Debt | \$72.00 | \$2.50 | \$0.75 |
| Common Stock | \$3.65 | \$0.21 | \$0.14 |

What Happened

As a result, on Tuesday night, September 16th, the U.S. Government provided emergency assistance to American International Group in the form of an \$85 billion secured liquidity facility from the Federal Reserve.

Terms of the Deal

In exchange for this \$85 billion lending facility, the U.S. Government will get a 79.9% equity stake in the company in the form of warrants, called equity participation notes. The term of the deal will be 24 months and will carry an interest rate of LIBOR (London Interbank Offered Rate) plus 8.5% for any funds drawn. The loan will be secured by all of AIG's assets providing some protection to the government, and is expected to be paid down from the proceeds of asset sales. AIG has 24 months to implement an orderly restructuring plan and to monetize various business units to raise capital and repay the facility. The structure of the deal creates upside potential for the U.S.

Government in the form of equity appreciation should the company be successful in its restructuring. The deal will result in the replacement of current AIG CEO Robert Willumstad by Edward Libby, the former CEO of Allstate, who has experience in dismantling large corporate conglomerates (Sears, Roebuck & Co.) with multiple business lines like AIG.

Potential for Global Contagion in the Financial Sector

The U.S. housing market woes have worsened significantly over the last 18 months and the effects have been felt in foreign markets as well. This is illustrated by the news of U.K. based Lloyds TSB Group's \$22.2 billion takeover, supported by regulators, of lending mortgage giant HBOS, which is bringing the international housing market crisis to the forefront. Additionally, Russia is experiencing a potential financial crisis, stemming from its own banking sector. In an effort to boost investor confidence the Russian Government plans to inject \$44 billion of liquidity into the nation's most influential banks. The three targeted banks include VTB, Sberbank and Gazprombank.

In a coordinated effort to ease the credit crunch, central banks around the world, including the U.S. Federal Reserve, European Central Bank, Bank of England, Swiss National Bank and the Bank of Japan, developed a plan to boost short-term liquidity. This plan will allow the Fed to expand its dollar swap arrangements with other central banks by \$180 billion. Early indications are that this has stabilized foreign markets; however, we have believed for some time that global markets lag the U.S. Therefore the positive effect of this coordinated effort has yet to be felt globally.

Developments Regarding Lehman Brothers

On Wednesday September 17th, 2008, the U.K. bank, Barclays PLC bought Lehman Brothers' (Lehman) North American capital markets and investment banking divisions for \$1.75 billion. The deal salvages Lehman's fixed income/equity sales, trading, research, and investment banking operations. As a result, Barclays will gain a much stronger foothold in the U.S. investment banking business, something they have been trying to do for some time. While the \$1.75 billion price tag was much lower than what Lehman was hoping for, the deal will allow approximately 8,000 employees to keep their jobs. Lehman's office in New York was included in the purchase, as were data centers in New Jersey. The transaction is not finalized as U.S. regulators and the New York court in charge of Lehman's bankruptcy case have yet to officially sign off on the deal. However, we believe it is likely that they will do so.

The effects of Lehman's collapse are being felt across all areas of the market even those that are generally considered to be safe havens for investors. The Reserve Management Corporation's Primary Fund, the first money market fund ever established, witnessed losses and fell below the \$1 per share mark as a result of Lehman's bankruptcy filing, the first money market fund to 'break the buck' in 14 years.

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Additional News out of the Financial Sector

Goldman Sachs and Morgan Stanley posted third quarter profits ahead of expectations. However, both firms explicitly stated that these are the most challenging market conditions they have seen. Goldman Sachs and Morgan Stanley have said they do not believe they need to team up with a deposit funded commercial bank. Both firms continue to de-leverage their balance sheets and strengthen liquidity.

Despite commentary to the contrary, we believe that striking a partnership deal with a commercial bank may be likely and even necessary given current sentiment and risk aversion to wholesale funded institutions. We are monitoring their situations and will actively incorporate any additional data into our analysis.

Current Financial Sector Outlook

As sentiment in the market grew more negative around AIG's prospects for securing necessary funding, prices saw a precipitous decline. However, following the announcement of the Federal Reserve liquidity facility, we saw some improvement in pricing across the AIG complex (particularly in operating company debt). We are monitoring the situation closely, and may reposition or reduce our exposure to AIG as appropriate.

The \$1.75 billion that Barclays agreed to pay for various Lehman assets fell short of market expectations, and has potentially negative implications for recovery levels on Lehman bonds. We are monitoring the situation, and may look to liquidate remaining positions should we deem it appropriate.

Additionally we have identified derivative options for implementing a macro-hedge versus volatility in the global financial sectors, and may execute that strategy across eligible portfolios during this period of heightened uncertainty.

The opinions expressed herein constitute the Firm's judgment as of September 18, 2008, and are subject to change without notice based on market, economic and other conditions. This report is for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, sector, strategy or investment product. Information contained in this report is not guaranteed as to its accuracy or completeness. Hartford Investment Management has not independently verified the accuracy of third party data cited herein.