

INDEX BULLETIN

The impact of GM and Ford downgrades on the Lehman Brothers fixed income indexes and client portfolios

We have witnessed unprecedented events in the fixed income markets during the last two weeks. Two of the world's largest automakers, GM and Ford saw their debt downgraded to below investment grade by Standard & Poor's Rating Services. The following overview of the current situation will serve to provide clients with both the background on the ramifications of this event, as well as the steps we are taking to mitigate the impact and develop innovative investment solutions.

The information contained in this Bulletin is based on events that have taken place on or before May 19, 2005, additional communications will follow as the situation evolves.

Lehman Brothers Index Methodology

Current Methodology

The current methodology used by Lehman Brothers to determine a security's classification as investment grade uses credit ratings from two independent agencies, Standard & Poor's Rating Services and Moody's Investors Services. Lehman Brothers then assigns the most conservative rating, the lowest rating, of the two agencies to each index constituent.

New Methodology

On January 24, 2005, Lehman Brothers announced a change in its index methodology to include a third rating agency, Fitch Credit Market Research, effective June 30th. The introduction of this rule change as well as its timing creates an additional layer of complexity in managing fixed income portfolios. Under the new methodology, companies in the Lehman Brothers indexes will receive the "middle rating" of the three ratings agencies, S&P, Moody's and Fitch Ratings. In addition, migrations between Investment Grade and High Yield will require a change in rating by at least two of the three agencies.

Recent Events

On **May 5th** S&P announced that "it lowered its long-term and short-term corporate credit ratings" on both General Motors and Ford. The downgrade affected General Motors Corp., General Motors Acceptance Corp. and "all related entities" as S&P lowered their long term rating from 'BBB-' to 'BB'. Similarly, S&P downgraded Ford Motor, Ford Motor Credit, and "all related entities", except Hertz, from 'BBB-/ to 'BB+'. Both downgrades resulted in GM and Ford now carrying non-investment grade ratings from S&P.

On **May 12th**, Moody's downgraded Ford Motor Co. from Baa1 to Baa3, the lowest rating on their investment grade scale. However, Moody's reduced the rating on Ford Motor Credit from A3 to Baa2, the second lowest level for investment grade issues. Moody's is the only major rating company which issues a split rating, assigning a higher rating to the finance arms of the auto companies.

Current Credit Agency Ratings

	S&P	Moody's	Fitch
GM	speculative grade	investment grade	investment grade
Ford	speculative grade	investment grade	investment grade

Impact to the Lehman Aggregate Index

Assuming there are no additional ratings changes for these two securities, and based on the current index rules, on May 31st GM and Ford will move to the Lehman U.S. Corporate High Yield Index since both companies received below investment grade ratings by S&P. However, when Lehman Brothers implements its new index methodology by adding Fitch ratings, the “2 out of 3” rule will dictate that both names move back into the Lehman's investment grade indices (including the Aggregate Bond Index). Fitch currently rates both companies as investment grade, BBB- for GM and BBB for Ford.

Currently Ford and GM represent almost 1% of the Lehman Aggregate Index. As a result, removing these two names on May 31st and adding them back a month later on June 30th into the Lehman Aggregate Index will create close to 2% turnover for the index. For portfolios with index weights in Ford and GM, assuming the spreads in Ford and GM are 1-2 points wide and their weight in the index is almost 1%, we can expect transaction costs of selling the bonds to be approximately 1-2 basis points. Furthermore, if the bonds are purchased back into the portfolio at the end of June we can expect an additional 1-2 basis points of transaction costs.

Another way of gauging the impact of removing these two names is by looking at the expected tracking error of the current Lehman Aggregate Index to the same index without GM and Ford. The annual tracking error between these two indexes is almost 0.15% or approximately 0.04% monthly¹.

	Ford	GM	Total
Current Weight In Lehman Aggregate Index	0.46%	0.47%	0.93%
Projected Weight in High Yield Index	5.78%	5.82%	11.60%

Source: Lehman Brothers

As the two automakers join the high yield market, they will be the largest two issuers in the Lehman U.S. Corporate High Yield Index, representing more than 11%, as shown in the table above. The impact of moving Ford and GM to the High Yield Index is very significant. The current market value of these names in Lehman Aggregate Index is \$86.3 billion, while their value in the High Yield Index is \$76.6 billion². However, while there are large amounts indexed against the Lehman Aggregate benchmark, strategies managed against the High Yield Index are usually active, and hence do not require managers to hold all names in benchmark weights. As a result, market participants expect significant selling pressure on GM and Ford when they drop out of the Aggregate Index. Conversely, buying pressure could develop when they reenter the Aggregate Index at the end of June.

As this rapidly evolving situation unfolded, NTGI established a dialogue with the index provider and other market participants to express our views and concerns. Throughout this process we will seek to mitigate the impact to our client's portfolios and develop solutions to handle this unusual event. Our portfolio management team will be utilizing all of the sophisticated techniques of our **Intelligent Indexing**[®] approach in implementing changes in our portfolios. By engaging in a dialogue with the index provider, we jointly determined that providing several options to investors, and clear benchmarks to express those preferences, could mitigate some of the spurious impact of this change. As a result, we expect that Lehman will calculate a parallel benchmark that will continue to include both Ford and GM, providing investors with flexibility as to when to implement the upcoming index changes.

¹ Source: POINT, Lehman Brothers

² Source: Lehman Brothers

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