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Regions Morgan Keegan:
The Abuse of Structured Finance

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Innovations in financial engineering have allowed investment banks to create securities backed by other securities rather than by bricks and mortar and business plans. These innovations have increased funding available to homeowners and businesses and provided investors with more varied opportunities. As these structured securities become more complex and opaque though, they allow advisors and managers, including mutual funds portfolio managers, to take on significant undisclosed risks.

Investors in six Regions Morgan Keegan ("RMK") bond funds lost $2 billion in 2007. This paper explains how extraordinary and undisclosed risks allowed these funds to generate higher returns than their competitors for many years but ultimately caused the funds' collapse in 2007.

These losses were not the result of a "flight to quality" or a "mortgage meltdown." The RMK funds suffered massive losses because they held concentrated holdings of low-priority tranches in structured finance deals backed by risky assets. RMK did not disclose the risks it was taking until *after* the losses had occurred. In fact, it misrepresented hundreds of millions of dollars of leveraged asset-backed securities as corporate bonds and preferred stocks thereby making the funds seem more diversified and less risky than they were. It also appears that RMK was smoothing the returns of its mutual funds by smoothing the valuation of its portfolio holdings.

I. Introduction

Six RMK bond funds – four closed-end funds (RMH, RHY, RMA and RSF) and two open-end funds (MKHIX and MKIBX) - collapsed spectacularly in 2007. The six funds had higher returns and yields than their peers in years prior to 2007, but lost 62% on average in 2007 while their peers had positive returns or only modest losses. [2]

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[2] These losses in the RMK funds relative to their peers in the mutual fund and closed end fund universe are explored in more detail in "The Implosion of High Yield Funds 2007 – 2008" by Edward O'Neal, available at www.slcg.com.

The apparent superior performance of these funds in earlier years and the spectacular losses in 2007 resulted from the funds' holdings of hundreds of low-priority *tranches* of structured finance deals. The structured finance deals held by the RMK funds included *collateralized debt obligations* (CDOs), c*ollateralized mortgage obligations* (CMOs), and *asset-backed securitie*s (ABS). The low-priority tranches that RMK purchased significantly leveraged up investors' exposure to the credit risk in mortgages, loans and bonds backing the tranches. The funds' prospectuses did not disclose the extraordinary amount of credit risk to which fund shareholders were exposed as a result of the low-priority tranches the funds' portfolio manager was purchasing.

Section II describes the six funds and illustrates their reported returns. Section III explains why the structured finance securities purchased by the RMK funds were dramatically more risky than investors were led to believe from the disclosures in the funds' filings with the Securities and Exchange Commission. Section IV provides a few examples of the securities held in the RMK funds. Section V highlights some of the deficiencies in RMK's public filings.

II. Regions Morgan Keegan Bond Funds

A. Investors Lost Over $2 Million in Six RMK Funds

The six Regions Morgan Keegan bond funds that collapsed in 2007 are listed in Table 1a. The four closed-end funds were initially offered between June 24, 2003 and January 19, 2006 and had net assets of $1.6 billion as of December 31, 2006. Morgan Keegan was the lead underwriter for the four closed-end fund offerings. The two open-end funds were issued on March 22, 1999 and had net assets of $2.2 billion as of December 31, 2006. The closed-end funds lost $1 billion in market value in 2007. The open-end funds net assets declined even more although some of the decline was due to investors redeeming shares.

Table 1a
Regions Morgan Keegan Bond Funds

Fund Name	Ticker	Inception	Net Assets		2007 Returns	
			12/31/2006	12/31/2007	Capital Appreciation	Total Return
Closed-end Funds						
High Income	RMH	6/24/2003	$311.6 m	$115.5 m	-70.7%	-65.5%
Strategic Income	RSF	3/18/2004	$366.0 m	$134.2 m	-72.1%	-67.2%
Advantage Income	RMA	11/8/2004	$423.8 m	$161.9 m	-71.6%	-66.8%
M-S High Income	RHY	1/19/2006	$478.8 m	$159.5 m	-72.2%	-65.4%
			$1,580.2 m	$571.1 m		
Open-end Funds						
Select High Income	MKHIX	3/22/1999	$1,251.6 m	$156.7 m		-58.4%
Select Intermediate	MKIBX	3/22/1999	$913.8 m	$168.7 m		-49.6%
			$2,165.4 m	$325.4 m		
			$3,745.6 m	$896.5 m		

The nearly $3 billion drop in the funds' net assets reported in Table 1a are largely as a result of $2 billion in losses on securities held in the mutual funds' portfolios. These portfolio securities losses along with our estimate of investor losses are listed in Table 1b.[3] Investors in these six funds lost more than $2 billion between March 31, 2007 and March 31, 2008.

Table 1b
Investors in the Six RMK Funds Lost $2 Billion
From March 31, 2007 to March 31, 2008

	Portfolio Securities[4]		Investor Losses	
Fund Name	Capital Gain/Loss	Net Gain/Loss	Capital Gain/Loss	Net Gain/Loss
Advantage Income	$(313,565,152)	$(270,000,647)	$(379,307,019)	$(281,465,563)
High Income	$(224,919,545)	$(194,593,637)	$(271,456,298)	$(238,037,475)
Strategic Income	$(272,382,430)	$(235,249,944)	$(327,115,002)	$(376,890,153)
Multi-Sector High Income	$(363,776,576)	$(317,940,696)	$(417,380,060)	$(327,419,955)
Select High Income	$(458,786,433)	$(415,321,470)	$(458,786,433)	$(415,321,470)
Select Intermediate Bond	$(404,876,746)	$(370,825,120)	$(404,876,746)	$(370,825,120)
Total	$(2,038,306,882)	$(1,803,931,514)	($2,258,921,558)	$(2,009,959,736)

B. The Losses Were Not From "Flight to Quality" or "Mortgage Meltdown"

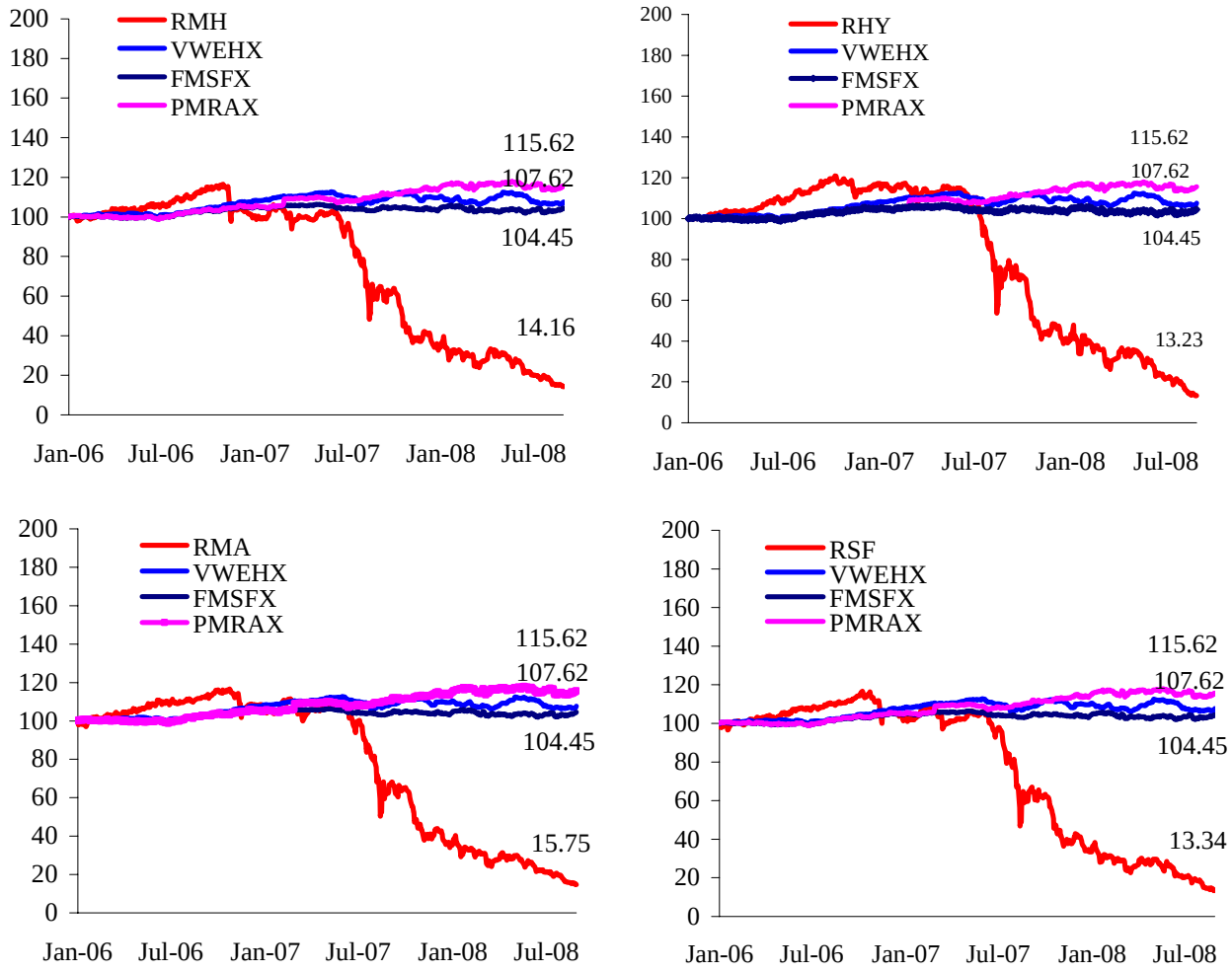
The losses suffered by investors in the RMK funds were not the result of a "flight to quality."[5] The values of $100 invested in each of the four RMK mutual funds on January 1, 2006 with re-invested dividends from January 1, 2006 to August 30, 2008 are plotted in Figure 1 along with Vanguard's High Yield fund[6] and two mutual funds which track the mortgage-backed securities. Investors who invested $100 in RMK's closed-end funds on January 1, 2006 and reinvested their dividends had between $13.23 and $15.75 on August 30, 2008. The same $100 invested on January 1, 2006 in Vanguard's high

[3] The portfolio securities losses for the two open-end funds are for the 10-month period from June 30, 2007 to April 30, 2008. Adding investment losses in these two funds during the period from March 31, 2007 to June 30, 2007 adds about $100 million to the RMK funds' investment losses.
[4] These losses are virtually all in the funds' holdings of low-priority, highly leveraged asset backed securities. The corporate bonds in the portfolios suffered only modest losses while the low-priority tranches became largely worthless.
[5] The "flight to quality" is said to have depressed the price of all securities with credit risk as investors sold high-yield securities to buy US Treasury securities.
[6] The four closed-end bond funds benchmarked themselves to the Lehman Brothers Ba Index, an index of high yield corporate bonds. VWEHX tracks the Lehman Brothers Ba Index.

yield bond fund with reinvested dividends was worth $107.62 on August 30, 2008. The RMK losses were, therefore, not the result of a collapse in the high yield bond market.

The losses in the RMK funds were also not the result of a "mortgage meltdown." $100 invested on January 1, 2006 in Fidelity's mortgage-backed securities mutual fund with reinvested dividends was worth $104.45 on August 30, 2008; $100 invested in PIMCO's mortgage-backed securities mutual fund on January 1, 2006 was worth $115.62 on August 30, 2008.

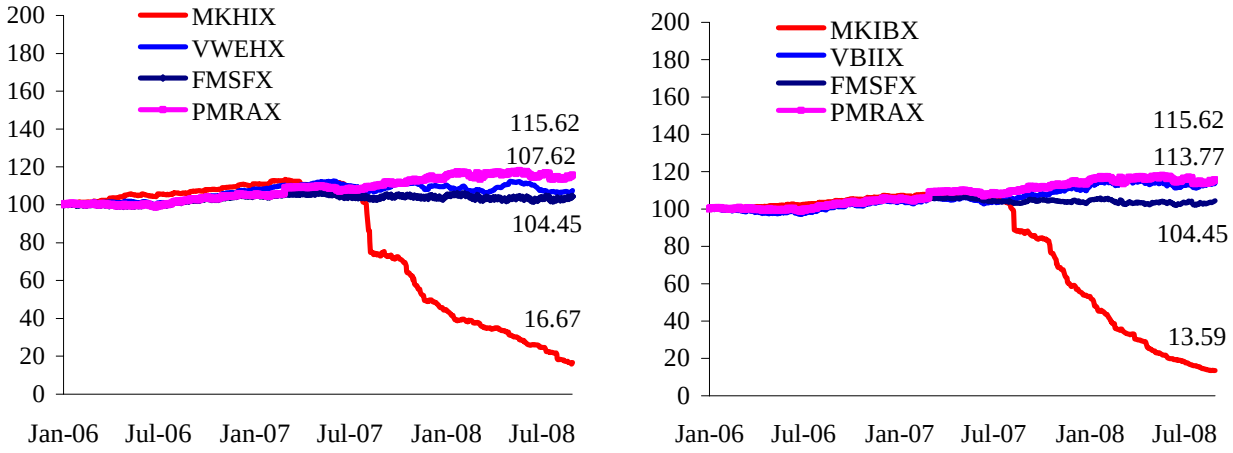
Figure 1
Regions Morgan Keegan Closed-end Funds' Closing Prices
and Vanguard's High Yield Bond Fund Net Asset Values (NAV)



The value of $100 invested in the two open-end funds from January 1, 2006 to August 30, 2008 is plotted in Figure 2. These open-end funds tracked their claimed benchmarks more closely than did RMK's closed end funds until July 2007 and then fell

off precipitously just like the closed-end funds.[7] As with the losses in the closed-end funds, the open-end funds' losses were not, the result of a "flight to quality" or a "mortgage meltdown."

Figure 2
Regions Morgan Keegan Open-end Funds' NAV
and Benchmark Funds' NAV



C. The Six RMK Funds Were Extraordinarily Risky

Table 2 reports the standard deviation of daily returns for the four closed-end funds and the Vanguard fund that tracks the Lehman Brothers benchmark for three six-month periods ending September 30, 2006, March 31, 2007 and September 30, 2007.

Table 2
RMK Funds Were Much More Volatile Than Benchmarks
(annualized standard deviations of daily returns)

	April 2006 to September 2006	October 2006 to March 2007	April 2007 to September 2007
RMH	9.6% (3.6 ×)	20.6% (8.0 ×)	55.0% (12.3 ×)
RSF	7.1% (2.7 ×)	16.4% (6.9 ×)	56.7% (12.7 ×)
RMA	9.3% (3.5 ×)	16.2% (6.3 ×)	54.4% (12.7 ×)
RHY	8.2% (3.1 ×)	14.8% (5.8 ×)	59.1% (13.2 ×)
MKHIX	3.4% (1.3 ×)	3.5% (1.4 ×)	21.8% (4.9 ×)
Benchmark (VWEHX)	2.7%	2.6%	4.5%
Benchmark (HYG)			8.8%
MKIBX	2.2% (0.6 ×)	2.4% (0.6 ×)	15.7% (3.4 ×)
Benchmark (VBIIX)	3.8%	4.0%	4.6%

[7] The four closed-end funds had substantially the same investments as the Select High Income Fund (MKHIX) but were leveraged up approximately 33%. This leverage, in part, explains why the four closed end funds plotted in Figure 1 exceeded the value MKHIX plotted in Figure 2 in 2006.

The closed-end funds were substantially riskier than their benchmark even before the sharp declines in 2007. The RMK funds were three times as volatile as their benchmark from April 2006 to September 2006, and six times as volatile between October 2006 and March 2007 (even before the dramatic losses in the summer of 2007). From April 2007 to September 2007 the RMK funds were twelve times as volatile as their benchmark.[8]

The statistics reported in Table 2 suggest that RMK was smoothing the NAV of its funds by not using reasonable estimates of market prices in its NAV calculations.

- From April 2007 to September 2007 when all five RMK high yield funds lost approximately the same amount, the open-end fund's NAV was only about 35% as volatile as RMK's four closed-end funds' market prices.
- The RMK closed-end fund's market prices were 232% more volatile than MKHIX's NAV during the 18 months covered by Table 2 even though they all held substantially the same portfolios. This suggests that MKHIX's true NAV was approximately twice as volatile as its reported NAVs.[9]
- Since RMK's closed-end funds had substantially the same portfolio holdings as its open-end fund and placed the same values on the individual holdings in their periodic reports, Table 2 suggests that RMK misstated the valuations of its closed end funds as well.[10]
- The RMK open-end high yield fund, MKHIX, was only 1.4 times as volatile as the Vanguard fund that tracks the Lehman Brothers benchmark from April 2006 to March 2007 but was 4.9 times as volatile after March 31, 2007 even though MKHIX's portfolio holdings did not change that much during this time period.[11]

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[8] The Vanguard fund used to benchmark the RMK closed-end funds is an open-end fund. HYG, an early ETF that tracks the high yield bond market, IPO'ed on April 11, 2007. The annualized volatility of HYG's daily returns from April 11, 2007 to September 30, 2007 was 8.8%. During this period RMK's closed-end funds were more than 6 times as volatile as the directly comparable HYG. Only a small part of the extraordinary volatility in the closed end funds can be attributed to the leverage in those funds.

[9] Jeffrey Pontiff, "Excess Volatility and Closed-End Funds," *American Economic Review* March 1997 pp. 155-169. Closed-end funds are typically 65% more volatile than their NAVs so, other things equal, the four RMK high yield closed-end funds will be 65% more volatile than the Vanguard open end fund used as a benchmark if the RMK portfolios are typical of high yield bond mutual funds.

[10] The suggestion that RMK was smoothing its valuations is consistent with the substantial devaluations applied by the funds' subsequent portfolio managers.

[11] Though the volatility of the mutual funds in the period prior to the losses was not drastically different from the benchmark, there was at least one very strong warning sign of the ultra-high level of risk being taken on in the mutual fund portfolios. Edward O'Neal finds that the yield on the RMK Select High Income Fund in the 2004 – 2006 period was far higher than that of other high yield mutual funds,

III. Asset-backed Securities

A. Pass-through Asset-backed Securities

The simplest asset-backed securities are pass-through securities. Collateral assets are contributed to a trust which issues undifferentiated securities. Investors who purchase these securities receive a pro-rata share of the net cash flows from the underlying pool of collateral assets. A wide range of assets including residential mortgages, credit card debt, automobile loans and aircraft leases have been used as collateral to issue securities. The process of issuing securities backed by pools of assets is referred to as *securitization* and the underlying assets are said to be securitized. *Residential mortgage-backed securities* (RMBS) were the first, and remain a common, pass-through security.

Investors in pass-through securities are exposed to the risks of the underlying assets. Asset-backed securities have interest rate risk, credit risk and prepayment risk because of the behavior of borrowers and the features of the mortgages, loans or contracts. For example, a pool of mortgages has the interest rate risk, prepayment risk and credit risk of the individual mortgages in the pool. If 100 investors each purchase 1/100th interest in a pool of mortgages, the owner of each interest bears the same interest rate risk, prepayment risk and credit risk as the owners of the other interests and collectively they own all the risks of the entire portfolio.

B. Structured Finance Asset-backed Securities (CMO/CDO/ABS)

The cash flows coming out of a portfolio of assets – whether they are residential mortgages, credit card debt, auto loans or aircraft leases – do not have to be paid out in the strictly pro rata fashion of pass-through securities. In securitization, the issuer customizes the to-be-issued securities and defines payment priorities and loss protection levels among them. These customized classes of securities backed by a common pool of assets are referred to as tranches after the French word for "slice". It is common for the tranches to receive payments sequentially and to suffer losses in the reverse order sequentially.

As long as every dollar of principal and interest received from the underlying assets after servicing costs – but not a dollar more – is allocated to a security holder (or to the residual or equity interest), any pool of underlying assets, however homogenous, can support a wide variety of complex structured securities. When issuers create classes of securities that have less than a pro rata share of interest rate, credit or prepayment risk in the underlying pool of assets, they have to include classes with more than a pro rata share

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indicating that the risk of this fund was clearly evident in the years prior to the fund's meltdown. See "The Implosion if High Yield Funds 2007 – 2008" available at www.slcg.com.

of interest rate risk, credit or prepayment risk in the same deal since the underlying assets are the only source cash flows for the tranches.[12]

C. Synthetic Asset-backed Securities

The asset-backed securities described above are *cash* asset-backed securities; these securities hold underlying portfolios of assets that expose investors to risks and generate payoffs. Synthetic asset-backed securities - synthetic CDOs, for example - do not actually hold the underlying debt that generates the risk and risk premia. Instead, the issuer of a synthetic CDO invests the proceeds from issuing tranched securities in high-quality assets such as treasury securities or AAA-rated securities, which is used as collateral for the tranched securities issued and takes on the credit risk associated with an underlying virtual debt portfolio through the use of credit default swaps (CDS).[13]

D. Tranching and the Impact of Defaults

The impact of structuring securities and prioritizing losses from a pool of underlying assets on the returns to investors can be illustrated with a simple example. Consider a mutual fund company holding $1 million in each of 200 corporate BBB-rated bonds and issuing $200 million in undifferentiated securities. An investor who purchases $2 million of the issued securities will receive 1% of the principal and interest payments paid by the underlying bonds less the issuer's expenses. The investor will also suffer 1% of any credit losses on the bonds. If one of the corporate bonds defaults and half the face value is recovered, the net assets of the fund will drop by $500,000 and the interest proceeds will fall by the difference between the interest previously paid on the defaulted bond and the interest that will be received on the re-invested recovered proceeds. If our example portfolio suffers two defaults per year and the mutual fund company recovers 50% of the face value of the defaulted bonds, the mutual fund's assets will be reduced by 0.5% per year as a result of the defaults and will be receiving only roughly 99% of the

[12] For a complete discussion of the securitization of mortgage-backed securities, see Adam B. Ashcraft and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," *Federal Reserve Bank of New York Staff Reports*, Staff Report no. 318, March 2008.

[13] I say *virtual* bond portfolio because the bond portfolio may not be held by any party to the transactions. The CDS is a bet on the value of these bonds. The tranching is also *virtual* in that, unlike cash CDOs, synthetic CDOs do not need to be fully subscribed for a deal to close. A tranche in a synthetic CDO can be completely customized without regard to other tranches which might be created from the same portfolio of reference securities.

A CDS is one of many types of credit derivatives that transfer credit risk from one party to another. Under the CDS the credit protection buyer makes periodic payments (the CDS premium) to the credit protection seller in exchange for a contingent payment triggered by a credit event such as a default on the underlying debt. Interest and principal from the portfolio of risk free securities combined with credit default swap premiums paid by the credit protection buyer are used to pay interest and principal to the synthetic CDO investors.

portfolio's weighted-average coupon interest. Five or even ten defaults in a portfolio of 200 bonds do not have much impact on the returns investors receive.

Now consider the same portfolio of bonds being held in a trust and used as collateral to back $200 million of three classes of securities. The first class of securities – Class A – has a face value of $150 million. There are also $45 million face value of Class B securities and $5 million face value of Class M securities. Class A investors receive scheduled principal and interest payments before Class B investors who receive their principal and interest payments before Class M investors receive any payments. Once any overcollateralization and excess interest is consumed, the principal value of the Class M securities is written down as defaults in the underlying portfolio of assets occur.[14] After the Class M securities are written down to zero, the Class B securities start suffering write-downs with further defaults in the underlying assets.

Given the default and recovery rates assumed above, the Class M securities will be written down to zero within 5 or 10 years and so the interest received on the securities - and/or the discount in price paid for them - will have to compensate for this risk. If defaults increase and/or recovery rates decline, the Class M securities will be written down even faster and the interest received on the Class M securities will decrease more rapidly than expected as the principal is written down. Thus, the defaults in the bond portfolio which had relatively minimal impact on the investors in undifferentiated shares can have a dramatic effect on investors in low-priority tranches of structured deals. The magnification of the impact of defaults in the underlying portfolio on the value of the tranche is leverage of the underlying assets' credit risk.

E. Risk Calculation Example: Synthetic CDOs

Investing in the low-priority tranches - like the M tranche in our example and most of the securities held in RMK's 6 funds - is extremely risky. If the tranches are fairly priced, their prices will reflect the expected value of cash flows discounted at a rate which reflects their risk. Other things equal, a tranche will be worth more the better the quality and diversification of the collateral assets and the more credit support the tranche receives from lower tranches, overcollateralization, excess interest or other credit enhancements. If defaults turn out to be higher than predicted by the models, the low-priority tranches get written down more rapidly. The negative impact on face value is foreshadowed by declines in the market value of the tranche.

[14] Overcollateralization occurs when the value of the underlying assets backing a deal exceeds the face value of the tranches issued. Initial losses occurring in the underlying assets will not cause write-downs to the tranches until the underlying assets are written down enough that the overcollateralization is eliminated. Also, in most deals the interest received on the underlying pool of assets is expected to exceed the interest paid to investors in the tranche. This excess interest is available in some deals to partially protect investors against initial losses in the underlying assets.

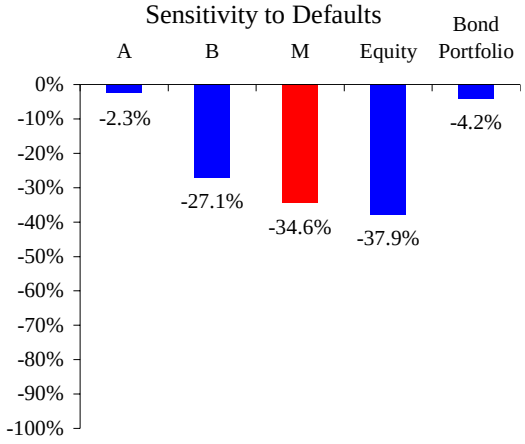
To illustrate the use of tranching to redistribute credit risk, consider the 10-year synthetic CDO described in Table 3.

Table 3
Example Synthetic CDO
Capital Structure

Tranche	Face Value	Par Spread	Sensitivity	Expected Loss	Unexpected Loss
A	$90,000,000	0.13%	-2.3%	1.4%	5.7%
B	$7,000,000	3.75%	-27.1%	32.7%	73.1%
M	$1,000,000	8.98%	-34.6%	59.5%	107.0%
Equity	$2,000,000	17.40%	-37.9%	77.9%	113.2%
	$100,000,000				
Bond Portfolio	$100,000,000	0.60%	-4.2%	5.7%	12.2%

The CDO references a portfolio of 100 corporate bonds, with a credit default spread on the bonds of 0.60% (corresponding to an annual 1% failure rate on the bonds) and a correlation of defaults across the bonds is 0.30. The CDO issues four classes of securities. The $90 million A tranche is the most senior and receives its scheduled principal and interest payments before the other tranches. The A tranche suffers principal write downs only after the equity, M and B tranches are written off completely. The $7 million B tranche is the next most senior and receives its scheduled principal and interest payments after the A tranche has received its scheduled payments but before the equity and M tranches and suffers principal write downs only after the equity and M tranches are written off completely.

Figure 3
Sensitivity to Defaults



We calculate four standard risk measures for each tranche and for the entire bond portfolio.[15] The first risk measure is the sensitivity of the market value of each tranche to changes in credit spreads compared to the sensitivity of the underlying bond portfolio. A 0.60% increase in the credit spread on the underlying bonds (corresponding to an increase in the annual failure rate on the bonds from 1% to 2%) would cause a 4.2% drop in

[15] Michael S. Gibson, "Understanding the Risk of Synthetic CDOs" Federal Reserve Board working paper available at http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf. The risk analysis is slightly sensitive to assumptions about default rates, recovery rates, credit spreads and correlations. This example is similar to the IndyMac 2005-C M11 tranche described below which was the first-to-lose 1% of the capital structure in a deal with 2% overcollateralization.

the value of the bond portfolio but would cause a 34.6% drop in the value of the M tranche. *See* Figure 3. By this measure, the M tranche is 8.2 times as risky as the underlying assets. Notice that even though the A tranche is 90% of the capital structure it only drops in value half as much as the bond portfolio because 10% of the capital structure bears half the losses.

The second risk measure is the expected loss on the issue date over the life of the tranche. The expected capital loss on the underlying assets over 10 years is 5.7% while the expected loss on the M tranche is 59.5%. *See* Figure 4. By this measure, the M tranche is 10.4 times as risky as the underlying assets and more than 40 times as risky as the A tranche.

The third risk measure is the loss suffered if credit losses on the underlying bonds were one standard deviation greater than expected. This is referred to as the unexpected loss although it is not that unusual since roughly 15% of the time the losses are expected to be greater than the unexpected loss. The unexpected loss on the underlying portfolio over 10 years is 12.2% while the unexpected loss on the M tranche is a greater than 100%. By this measure, the M tranche is more than 8 times as risky the underlying bond portfolio and 19 times as risky as the A tranche. See Figure 5.

The fourth risk measure is the additional interest above LIBOR required to compensate for the credit risk in the security. This is referred to as the par spread and was 0.60% for the bond portfolio. The par spread for the A tranche is only 0.13% reflecting the credit support (protection from credit losses) it receives from the more junior tranches. The 8.98% par spread for the M tranche is 15 times the par spread on the underlying bonds, reflecting the leveraged credit risk born by the M tranche. See Figure 6.

Figure 4
Expected Loss

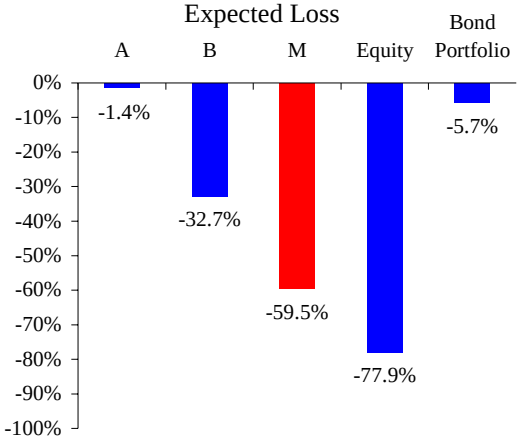


Figure 5
Unexpected Loss

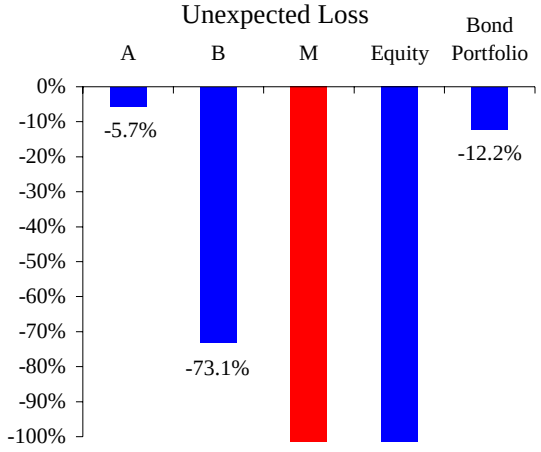
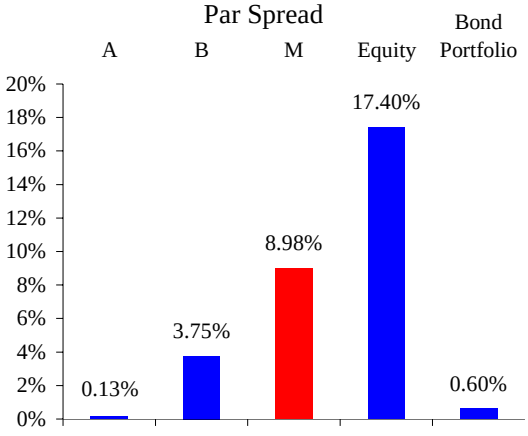


Figure 6
Par Spread



The M tranche in our illustration had 10 to 15 times as much credit risk as the underlying bonds. Even the B tranche in our illustration had 6 times as much credit risk as the underlying bond portfolio. As we will see next, virtually all of the RMK holdings had as much leveraged credit risk as the B and M tranches - and some of RMK holdings had as much credit risk as in the Equity tranche - in our example

IV. The RMK Fund's Portfolio Holdings

A. RMK Misrepresented its Funds' Asset Allocations

We have analyzed the portfolio holdings for the six RMK funds and determined that they all held heavy concentrations of highly leveraged, low-quality debt. RMK purchased low-priority tranches in asset-backed and mortgage-backed securities deals. These tranches are virtually always the smallest slices in a deal because the issuer is trying to create larger slices of the more marketable senior slices. RMK frequently purchased all or almost all these relatively small, unique tranches. As a result of the mutual funds' portfolio manager's investment decisions, the funds' holdings were illiquid and could not be valued by reference to market prices of substantially similar assets.

We also found that Regions Morgan Keegan misrepresented $446 million on asset-backed securities as corporate bonds and preferred stocks. For example, RMK significantly understated the extent of RHY's holdings of asset-backed and mortgage-backed securities. Regions Morgan Keegan reported RHY's portfolio holdings on March 31, 2007 as summarized in Table 4a.[16]

Table 4a
RHY Misrepresented $67.5 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$364,472,540	**77.7%**	$431,970,558	**92.1%**
Corporate Bonds	$174,108,322	**37.1%**	$129,527,163	**27.6%**
Common Stocks	$54,977,849	11.7%	$54,977,849	11.7%
Preferred Stocks	$25,436,859	**5.4%**	$2,520,000	**0.5%**
Cash	$2,202,458	0.5%	$2,202,458	0.5%
Gross Assets	$621,198,028	132.5%	$621,198,028	132.5%
Margin Debt	$(152,319,346)	-32.5%	$(152,319,346)	-32.5%
Net Assets	$468,878,682	100%	$468,878,682	100%

[16] RHY's net assets could be, and were, leveraged 33%. Thus, investors in RHY were exposed to leveraged credit risk implicit in the portfolio's asset-backed securities holdings, further leveraged by the explicit borrowings.

$67.5 million of securities held by RHY RMK reported as corporate bonds or preferred stocks on March 31, 2007 were actually asset-backed or mortgage-backed securities. Virtually all of the securities RMK classified as "Corporate Bonds – Special Purpose Entities" are asset-backed securities. Similarly, almost all the securities RMK classified as "Preferred Stocks" are equity tranches – i.e. the most highly leveraged tranches – in asset-backed deals.[17] The asset-backed securities' offering documents and ratings agencies' releases clearly identify the securities RMK misclassified as asset-backed securities. RMK acknowledged its prior misclassification of these securities when it reclassified any remaining holdings in March 2008. RHY actually held 92.1%, not 77.7%, of its net assets in asset-backed and mortgage-backed securities on March 31, 2007.

Table 4b lists the Advantage Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $59.3 million of RMA's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 4b
RMA Misrepresented $59.3 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$306,132,730	**73.4%**	$365,461,619	**87.6%**
Corporate Bonds	$163,210,458	**39.1%**	$122,467,428	**29.4%**
Municipal Bonds	$787,500	0.2%	$787,500	0.2%
Common Stocks	$50,057,309	12.0%	$50,057,309	12.0%
Preferred Stocks	$20,965,859	**5.0%**	$2,380,000	**0.6%**
Cash	$10,895,909	2.6%	$10,895,909	2.6%
Gross Assets	$552,049,765	132.4%	$552,049,765	132.4%
Margin Debt	$(135,051,124)	-32.4%	$(135,051,124)	-32.4%
Net Assets	$416,998,641	100%	$416,998,641	100%

Table 4c lists the High Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $44.1 million of RMH's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks.

[17] Preference shares are not preferred stock. Preferred stock is typically more risky than corporate bonds but less risky than common stock. Preference shares in asset-backed securities deals on the other hand are equivalent to purchasing the entire portfolio of underlying assets with a margin loan equal to the face value of the other tranches offered and with margin interest payments equal to the interest paid to investors in the tranches. Preference shares thus are investments in the underlying assets leveraged up 50 or more times.

Table 4c
RMH Misrepresented $44.1 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$217,523,259	**71.7%**	$261,617,844	**86.3%**
Corporate Bonds	$126,116,806	**41.6%**	$95,708,081	**31.6%**
Municipal Securities	$630,000	0.2%	$630,000	0.2%
Common Stocks	$37,463,032	12.4%	$37,463,032	12.4%
Preferred Stocks	$15,545,860	**5.1%**	$1,860,000	**0.6%**
Cash	$7,665,224	2.5%	$7,665,224	2.5%
Gross Assets	$404,944,181	133.5%	$404,944,181	133.5%
Margin Debt	$(101,685,277)	-33.5%	$(101,685,277)	-33.5%
Net Assets	$303,258,904	100%	$303,258,904	100%

Table 4d lists the Strategic Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $44.1 million of RSF's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 4d
RSF Misrepresented $44.1 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$274,847,988	**76.5%**	$318,926,042	**88. 8%**
Corporate Bonds	$139,415,826	**38.8%**	$109,023,632	**30.4%**
Municipal Securities	$630,000	0.2%	$630,000	0.2%
Common Stocks	$44,526,722	12.4%	$44,526,722	12.4%
Preferred Stocks	$15,865,860	**4.4%**	$2,180,000	**0.6%**
Cash	$11,885,850	3.3%	$11,885,850	3.3%
Gross Assets	$487,172,246	135.6%	$487,172,246	135.6%
Margin Debt	$(127,942,304)	-35.6%	$(127,942,304)	-35.6%
Net Assets	$359,229,942	100%	$359,229,942	100%

Table 4e lists the Select High Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $139.6 million of MKHIX's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 4e
MKHIX Misrepresented $139.6 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$661,308,326	**55.0%**	$800,901,653	**66.6%**
Corporate Bonds	$344,923,469	**28.7%**	$262,427,297	**21.8%**
Municipal Securities	$1,143,450	0.1%	$1,143,450	0.1%
Common Stocks	$108,727,164	9.0%	$108,727,164	9.0%
Preferred Stocks	$62,157,155	**5.2%**	$5,060,000	**0.4%**
Cash	$22,055,000	1.8%	$22,055,000	1.8%
Other Assets & Liabilities	$2,060,865	0.2%	$2,060,865	0.2%
Net Assets	$1,202,375,429	100%	$1,202,375,429	100%

Table 4f lists the Select Intermediate Bond funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $91.4 million of MKIBX's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 4f
MKIBX Misrepresented $91.4 Million of Asset-Backed Securities
March 31, 2007

	As Reported by RMK		Corrected	
Asset-backed Securities	$551,776,086	**54.3%**	$643,126,861	**63.3%**
Corporate Bonds	$372,954,691	**36.7%**	$292,363,916	**28.8%**
Government & Agency Securities	$24,576,742	2.4%	$24,576,742	2.4%
Preferred Stocks	$27,372,060	**2.7%**	16,612,060	**1.6%**
Cash	$36,830,000	3.6%	$36,830,000	3.6%
Other Assets & Liabilities	$2,103,178	0.2%	$2,103,178	0.2%
Net Assets	$1,015,612,757	100%	$1,015,612,757	100%

B. RMK Misrepresented the Riskiness of its Funds' Holdings

In addition to being understated, the asset-backed securities held by the RMK funds were virtually always the most risky tranches in asset-backed securities deals. For example, we were able to identify whether the tranches held were senior or subordinated for 147 of the 161 asset and mortgage-backed securities in RHY's portfolio. Only nine of these 147 tranches were senior; 138 of the 147 were subordinated.

We illustrate how the majority of funds' holdings of structured securities lost virtually all their value in six months with five examples which are completely typical of the rest of the holdings:[18]

- **Webster CDO I Preferred Shares.** The Preferred Shares were the equity portion of Webster CDO I and were equivalent to an investment in the subprime debt backing the CDO leveraged up 23 to 1. RMK misrepresented this RHY holding as a *Preferred Stock* on March 31, 2007 but reclassified it as an *Asset-Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations* on March 31, 2008.
- **Eirles Two Ltd. 263.** RMK misrepresented this synthetic CDO to be a corporate bond in its SEC filings on March 31, 2007 for each of the four closed-end funds and for the Select High Income open-end fund. RMK reclassified this security as an *Asset-Backed Securities–Below Investment Grade or Unrated, Collateralized Loan Obligations* on March 31, 2008.
- **Preferred Term Securities XXIII.** RMK does not fully identify this $24 million CDO investment but misrepresented it to be a corporate bond, classified in RHY's March 31, 2007 holdings as a *Corporate Bonds–Investment Grade or Unrated*. RMK reclassified this security as an *Asset-Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations* on March 31, 2008.
- **IndyMac 2005-C M-11.** This holding illustrates RMK's concentration in tranches with highly leveraged exposure to subprime mortgages. RMK classified this RHY holding on March 31, 2007 as an *Asset-Backed Securities–Investment Grade, Home Equity Loans (Non-High Loan-To-Value).*
- **Kodiak CDO 2006-IA G, H, Income.** These three Kodiak tranches illustrates the complexity of RMK holdings. RMK classified these RHY holdings as *Asset-Backed Securities–Investment Grade - Collateralized Debt Obligations* on March 31, 2007 and as an *Asset-Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations* on March 31, 2008.

C. Webster CDO I

Webster CDO I issued $1 billion in securities listed in Table 5. The Webster CDO was a hybrid cash/synthetic asset-backed portfolio, holding some asset-backed securities such as subprime RMBS with weighted average FICO scores less than 600, CMBS, downgraded BBB securities, small business loan securities directly and entering into

[18] The prospectus or offering document for each of these five deals is available along with this paper at www.slcg.com/research.php?c=1b&i=44.

credit default swaps to bring the portfolio's asset-backed securities credit exposure up to $1 billion.

Table 5
Webster CDO I
Capital Structure

Tranche	Face Value	Interest Rate	Ratings	
			Moody's	S&P
A-1LA	$609,000,000	3M LIBOR + 0.34%	Aaa	AAA
A-1LB	$158,000,000	3M LIBOR + 0.45%	Aaa	AAA
A-2L	$70,000,000	3M LIBOR + 0.54%	Aa2	AA
A-3L	$59,000,000	3M LIBOR + 1.45%	A2	A
A-4L	$10,000,000	3M LIBOR + 2.75%	Baa1	BBB+
B-1L	$32,000,000	3M LIBOR + 3.40%	Baa2	BBB
B-2L	$10,000,000	3M LIBOR + 3.85%	Baa3	BBB-
B-3L	$9,000,000	3M LIBOR + 6.50%	Ba1	BB+
P1 Comb (A3L & B3L)	$10,000,000		A2	N/A
Preference Shares	**$43,000,000**		**B2**	**N/A**
	$1,000,000,000			

The RMK funds held $14.5 million face value of the equity tranche in Webster CDO I, Ltd which RMK misrepresented until March 31, 2008. *See* Table 6. The preference shares were the most illiquid, most risky portion of an illiquid risky deal. Three features of the preference shares magnify risk. The preference shares were ranked the 15th out of 15 items in the interest waterfall and not eligible to receive any interest payment if default occurred. In addition, the preference shares will receive principal payments, if any, only on the final maturity date. The capital structure of this deal as described in Table 10 above placed the preference shares in fragile position: the $43 million preference shares were effectively an investment in the underlying subprime assets leveraged 23 to 1.

Table 6
RMK Funds Held
$14.5 million of the Webster CDO I Preference Shares

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
3/31/2007	3,500,000	$3,150,000	2,000,000	$1,800,000	2,000,000	$1,800,000
9/30/2007	3,500,000	$525,000	2,000,000	$300,000	2,000,000	$300,000
3/31/2008	3,500,000	$35	2,000,000	$20	2,000,000	$20

	RMA	
Date	Face Value	Reported Value
3/31/2007	2,000,000	$1,800,000
9/30/2007	2,000,000	$300,000
3/31/2008	2,000,000	$20

	MKHIX	
Date	Face Value	Reported Value
12/31/2006	5,000,000	$4,500,000
3/31/2007	5,000,000	$4,500,000
6/30/2007	5,000,000	$3,875,000
9/30/2007	5,000,000	$750,000
3/31/2008	5,000,000	$50

RMK valued this equity interest in the Webster CDO I deal at $13.05 million on March 31, 2007, $2.175 million on September 30, 2007 and only $145 on March 31, 2008. As with the valuations of the Kodiak and IndyMac tranches, RMK's March 31,

2007 $0.90 valuation of the preferred shares in the Webster CDO is highly suspect since the claims of investors in the preference shares were subordinated to the claims of the investors in the rest of the deal.

D. Eirles Two Ltd. 263

Eirles Two Ltd. 263 was a synthetic CDO in which the returns to investors depended on credit default swaps issued on a $1 billion notional value portfolio of loans and bonds. See Table 7. Regions Morgan Keegan misrepresented these holdings as corporate bonds until March 31, 2008, when it was reported correctly as asset-backed securities.

Table 7
Eirles Two Ltd. 263
Capital Structure

Tranche	Face Value
A	$897,500,000
B	**$17,500,000**
C	$85,000,000
	$1,000,000,000

RMK's four closed-end funds and the Select High Income open-end fund purchased the entire $17.5 million B tranche in the Eirles Two Ltd. 263 series deal. During the half year period from September 20, 2007 to March 31, 2008, RMK suffered a steep loss of over 40% value of the securities they held.

Table 8
RMK Funds Held
$17.5 million of Eirles Two Ltd. 263

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	3,500,000	$3,500,000	2,300,000	$2,300,000	3,500,000	$3,500,000
3/31/2007	3,500,000	$3,500,000	2,300,000	$2,300,000	3,500,000	$3,500,000
9/30/2007	3,500,000	$3,325,000	2,300,000	$2,185,000	3,500,000	$3,325,000
3/31/2008	3,500,000	$1,955,000	2,300,000	$1,311,000	3,500,000	$1,955,000

	RMA	
Date	Face Value	Reported Value
9/30/2006	3,500,000	$3,500,000
3/31/2007	3,500,000	$3,500,000
9/30/2007	3,500,000	$3,325,000
3/31/2008	3,500,000	$1,955,000

	MKHIX	
Date	Face Value	Reported Value
9/30/2006	4,700,000	$4,700,000
12/31/2006	4,700,000	$4,700,000
3/31/2007	4,700,000	$4,700,000
6/30/2007	4,700,000	$4,664,750
9/30/2007	4,700,000	$4,465,000
12/31/2007	4,700,000	$3,196,000
3/31/2008	4,700,000	$2,679,000

E. Preferred Term Securities XXIII

In September 2006, Preferred Term Securities XXIII (PreTS XXIII) issued the $1.56 billion in securities listed in Table 9. PreTS XXIII was the 23rd in a related series of cash flow trust preferred CDOs. The trust held trust preferred securities and senior and subordinated notes of banks, thrifts, insurance companies and REITs.

Table 9
Preferred Term Securities XXIII
Capital Structure

Tranche	Face Value	Interest Rate	Ratings		
			Moody's	S&P	Fitch
A-X	$33,500,000		Aaa	AAA	AAA
A-FP	$321,000,000	3M LIBOR + 0.20%	Aaa	AAA	AAA
A-1	$544,000,000	3M LIBOR + 0.31%	Aaa	AAA	AAA
A-2	$141,000,000	3M LIBOR + 0.39%	Aaa	AAA	AAA
B-FP	$57,600,000	3M LIBOR + 0.38%	Aa2	N/A	AA
B-1	$67,400,000	3M LIBOR + 0.62%	Aa2	N/A	AA
B-2	$31,000,000	5.792% / 3M LIBOR+0.62%	Aa2	N/A	AA
C-FP	$52,800,000	3M LIBOR + 0.73%	A3	N/A	A-
C-1	$81,200,000	3M LIBOR + 1.15%	A3	N/A	A-
C2	$28,000,000	6.322% / 3M LIBOR+1.15%	A3	N/A	A-
D-FP	$35,050,000	3M LIBOR + 1.60%	N/A	N/A	BBB
D-1	$72,500,000	3M LIBOR + 2.10%	N/A	N/A	BBB
Subordinate	$95,500,000	N/A	NR	NR	NR
	$1,560,550,000				

The RMK funds held $24 million face value in PreTS XXIII notes which RMK misrepresented as corporate bonds until March 31, 2008. *See* Table 10. RMK valued these securities at $0.99 on September 30, 2006 and then at $0.95 on December 30, 2006, March 31, 2007, and June 30, 2007. RMK finally lowered the value to $0.50 on September 30, 2007 and to $0.42 on December 30, 2007.

Table 10
RMK Funds Held
$24 Million of the Preferred Term Securities XXIII

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	3,000,000	$2,964,000	2,000,000	$1,976,000	2,000,000	$1,976,000
3/31/2007	4,800,000	$4,560,000	3,200,000	$3,040,000	3,200,000	$3,040,000
9/30/2007	3,800,000	$1,900,000	3,200,000	$1,600,000	3,200,000	$1,600,000
3/31/2008	3,800,000	$1,581,940	3,200,000	$1,332,160	3,200,000	$1,332,160

	RMA	
Date	Face Value	Reported Value
9/30/2006	3,000,000	$2,964,000
3/31/2007	3,800,000	$3,610,000
9/30/2007	3,800,000	$1,900,000
3/31/2008	3,800,000	$1,581,940

	MKHIX	
Date	Face Value	Reported Value
9/30/2006	5,000,000	$4,940,000
12/31/2006	6,000,000	$5,712,180
3/31/2007	9,000,000	$8,550,000
6/30/2007	5,000,000	$4,737,500
9/30/2007	5,000,000	$2,500,000
3/31/2008	5,000,000	$2,081,500

The RMK filings do not identify which of the PreTS XXIII notes its funds held but the notes held lost 60% of their value between March 31, 2007 and March 31, 2008. As such, the RMK funds might have purchased the lowest priority tranches, such as Class C-FP, Class D-FP, and Income Notes. Besides the common risks of subordination in all CDOs, some negative features of this transaction created additional potential risks for investors in lowest tranches. According to the Presale Report published by Fitch on September 12, 2007, the collateral lacked diversification in the REIT and insurance portion and was over-exposed to refinancing derivatives which can dramatically reduce the excess spread.

F. IndyMac 2005-C

In September 2005, IndyMac 2005-C issued $686,700,000 in securities listed in order of priority in Table 11. The net proceeds from the sale of these securities were used to purchase an underlying pool of mortgage loans. At origination, the IndyMac 2005-C deal had 1.9% overcollateralization. Once losses on the underlying pool of mortgages exceeded 1.9%, augmented or depleted by any net excess interest, the M-11 tranche would start being written down.[19]

Table 11
IndyMac 2005-C
Capital Structure

Tranche	Face Value	Interest Rate (LIBOR plus)		Ratings		
		Margin 1	Margin 2	Moody's	S&P	Fitch
A-I-1	$268,995,000	0.260%	0.520%	Aaa	AAA	AAA
A-II-1	$130,700,000	0.110%	0.220%	Aaa	AAA	AAA
A-II-2	$136,550,000	0.270%	0.540%	Aaa	AAA	AAA
A-II-3	$21,655,000	0.370%	0.740%	Aaa	AAA	AAA
M-1	$25,550,000	0.480%	0.720%	Aa1	AA+	AA+
M-2	$22,400,000	0.500%	0.750%	Aa2	AA+	AA+
M-3	$15,050,000	0.520%	0.780%	Aa3	AA	AA
M-4	$11,200,000	0.610%	0.915%	A1	AA	AA-
M-5	$11,200,000	0.650%	0.975%	A2	AA-	A+
M-6	$9,800,000	0.720%	1.080%	A3	A+	A
M-7	$10,500,000	1.200%	1.800%	Baa1	A	A-
M-8	$7,350,000	1.350%	2.025%	Baa2	BBB+	BBB+
M-9	$6,300,000	1.750%	2.625%	Baa3	BBB	BBB
M-10	$3,450,000	3.000%	4.500%	Ba1	BBB	BBB-
M-11	**$7,000,000**	**2.500%**	**3.750%**	**Ba2**	**BBB-**	**BB+**
	$687,700,000					

The M-11 tranche was only 1% of the capital structure and was highly likely to suffer losses as 75% of the underlying mortgages were 2/28 and 3/27 hybrid adjustable

[19] As illustrated in Tables 6, 14 and 15 long before principal write-downs start being taken the market value of the tranche will fall significantly, perhaps to zero.

rate mortgages. This type of mortgage had high probability of defaults because the mortgage interest rates had low teaser rates for the first two or three years followed by resets to market rates or higher for the twenty-seven or twenty-eight years left in the amortization schedule.[20] In addition, the borrowers whose mortgage notes backed the IndyMac tranches were lower credit quality borrowers. About 66% of the borrowers of the borrowers had FICO scores below 620. Over 39% of the mortgage loans were approved without adequate income or asset verifications. About 30% of the borrowers had Loan-to-Value ratios higher than 80% at the time of origination. The IndyMac CDO prospectus described the credit quality of the debtors as follows.

> Over 98% of the mortgage loans in the mortgage pool were made to borrowers with prior credit difficulties. We expect that the rates of delinquency, bankruptcy and foreclosure for such mortgage loans will be substantially higher than those of mortgage loans underwritten in accordance with Fannie Mae and Freddie Mac standards. [S-11]

The Multi-Sector High Income fund purchased the entire $7,000,000 M-11 tranche and suffered a nearly complete loss by September 30, 2007. *See* Table 12.

Table 12
RHY Held All $7 Million of the
IndyMac 2005-C M-11 Tranche

Date	Face Value	Reported Value
3/31/2006	7,000,000	$5,600,000
9/30/2006	7,000,000	$5,600,000
3/31/2007	7,000,000	$5,320,000
9/30/2007	7,000,000	$965,720

RMK's purchase of the entire M-11 tranche illustrates the opportunity for abuse created by trading illiquid securities. The M-11 tranche was offered in October, 2005 at $0.71 per $1.00 of face value. RMK valued its M-11 holding at $0.80 in its reported holdings for March 31, 2006. This would imply a $630,000 unrealized gain (a 13% return) and an equal increase in the reported assets over the intervening five or six months. It's highly unlikely that the M-11 tranche was worth the $0.80 or $0.76 RMK valued it at on March 31, 2006, September 30, 2006 and March 31, 2007.

G. Kodiak CDO I

Kodiak CDO I issued $775 million in securities listed in Table 13. The $28,000,000 in Combination notes are created by combining $10,000,000 of the H notes and $18,000,000 of the Income notes.

[20] For a discussion of the likely high default rates on 2/28 and 3/27 ARMs, see Christopher Cagan, "Mortgage Payment Reset" *First American Real Estate Solutions*, February 8, 2006.

The $752 million net proceeds from the sale of the Kodiak CDO 2006 securities was used to purchase trust preferred securities issued by real estate investment trusts (REITs) and home builders and commercial mortgage-backed securities (CMBSs).[21] The Kodiak CDO prospectus has extensive discussions of the risks associated with trust preferred securities issued by REIT. These securities are subordinated to the other indebtedness of the REIT and typically do not in any way restrict the ability of the REIT to issue additional senior debt. Trust preferred securities are a highly leveraged investment in the issuing REIT's assets. The low-priority tranches in the Kodiak CDO were thus highly leveraged investments *in highly leveraged investments* in REITs.

Table 13
Kodiak CDO 2006-1A
Capital Structure

Tranche	Face Value	Interest Rate	Ratings		
			Moody's	S&P	Fitch
A-1	$338,500,000	LIBOR + 0.36%	Aaa	AAA	AAA
A-2	$103,500,000	LIBOR + 0.48%	Aaa	AAA	AAA
B	$83,000,000	LIBOR + 0.65%	Aa1	AAA	AAA
C	$30,000,000	LIBOR + 0.90%	Aa3	AAA	AAA
D-1	$13,000,000	Fixed 6.549%	NR	AA-	AA-
D-2	$5,000,000	Fixed 6.425%	NR	AA-	AA-
D-3	$29,000,000	LIBOR + 1.20%	NR	AA-	AA-
E-1	$5,000,000	Fixed 6.721%	NR	A	A
E-2	$29,000,000	LIBOR + 1.50%	NR	A	A
F	$7,000,000	LIBOR + 2.20%	NR	BBB+	BBB+
G	**$50,000,000**	LIBOR + 3.50%	NR	BBB	BBB
H	**$27,000,000**	LIBOR + 5.00%	NR	BB+	BB+
Income	**$54,700,000**	N/A	N/A	N/A	N/A
	$774,700,000				
Combination	**$28,000,000**	**N/A**	**NR**	**BB+**	**NR**

The RMK funds purchased $46 million of the three first-to-lose tranches issued by Kodiak CDO I.[22] *See* Table 14 and Table 15.

[21] According to Fitch Ratings, the total collateral consists of 78% trust preferred securities issued by real estate entities, 17% senior REIT debts, and 5% CMBS. Industry and obligor concentrations will accelerate the failures of the investments because of the high correlation of defaults.

[22] The RMK funds' holdings of the Combination tranche provided it with underlying investments in the H and the Income tranches. The Kodiak Combination tranche is listed in the RMK funds' holdings as a zero coupon bond without G, H, Income or Combination qualifiers.

Table 14
RMK Funds Held
$18 Million of the Kodiak CDO 2006-1 G Tranche

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
3/31/2007	3,000,000	$2,910,000	3,000,000	$2,910,000	3,000,000	$2,910,000
9/30/2007	3,000,000	$810,000	3,000,000	$810,000	3,000,000	$810,000
3/31/2008[23]	3,133,608	$7,834	3,133,608	$7,834	3,133,608	$7,834

	RMA	
Date	Face Value	Reported Value
3/31/2007	3,000,000	$2,910,000
9/30/2007	3,000,000	$810,000
3/31/2008	3,133,608	$7,834

	MKIBX	
Date	Face Value	Reported Value
12/31/2006	6,000,000	$5,850,000
3/31/2007	6,000,000	$5,820,000
6/30/2007	6,000,000	$5,460,000
9/30/2007	6,000,000	$1,620,000
12/31/2007	6,000,000	$570,000
3/31/2008	6,267,216	$15,668

The funds valued their $46 million face value investment in this CDO deal at $43.1 million on March 31, 2007 but at only $0.1 million by March 31, 2008. The loss of $43 million (99.7%) in one year can easily be understood given the disclosures in the 232-page prospectus the Kodiak CDO 2006-1 deal. There were virtually no credit enhancements of Class G, H and Income Notes and the failure of the overcollateralization (OC) tests diverted cash flow from the tranches RMK purchased to pay principal of the senior tranches when defaults occurred in the underlying collateral.

Table 15
RMK Funds Held
$28 Million of the Kodiak CDO 2006-1 Combination Tranche

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	6,000,000	$5,400,000	4,000,000	$3,600,000	4,000,000	$3,600,000
3/31/2007	6,000,000	$5,490,000	4,000,000	$3,660,000	4,000,000	$3,660,000
9/30/2007	6,000,000	$1,380,000	4,000,000	$920,000	4,000,000	$920,000
3/31/2008	6,000,000	$15,000	4,000,000	$10,000	4,000,000	$10,000

	RMA	
Date	Face Value	Reported Value
9/30/2006	4,000,000	$3,600,000
3/31/2007	4,000,000	$3,660,000
9/30/2007	4,000,000	$920,000
3/31/2008	4,000,000	$10,000

	MKHIX	
Date	Face Value	Reported Value
9/30/2006	10,000,000	$9,000,000
12/31/2006	10,000,000	$9,250,000
3/31/2007	10,000,000	$9,150,000
6/30/2007	10,000,000	$8,200,000
9/30/2007	10,000,000	$2,300,000
3/31/2008	10,000,000	$25,000

[23] The face value of the G tranche increased as of March 31, 2008 because interest payments due to investors in the G tranche were deferred as cash was diverted to pay promised principal and interest on the more senior tranches when defaults in the underlying assets caused cash flow shortfalls.

The Income tranche had no claim on the collateral assets and virtually no claim on the cash flow generated from the assets. The prospectus lists 28 prioritized claims on interest payments paid by the collateral assets; the Income tranche's claim on interest payments is 28th out of 28. That is, if after all the taxes, fees, expenses and interest on the A-H securities described in categories of claims 1 through 27 are paid in full, the Income tranche will receive payments. The prospectus lists 12 prioritized claims on principal payments from the collateral; the Income tranche's claim on principal payments is 12th out of 12. Again, only if every other category of claim on the payments paid by the collateral assets is paid in full, will the Income tranche receive payments.

The funds purchased all of the $28 million Combination tranche and valued it at $0.90 per $1.00 on September 30, 2006 and incredibly at $0.915 on March 31, 2007. A simple calculation suggests that this tranche was worth substantially less than the value Regions Morgan Keegan placed on it. There was $752 million in collateral backing $720 million in rated securities. This leaves $32 million in underlying value at most backing the $54.7 million face value of Income notes. Thus, there was, at most, $0.58 in value backing each $1 of Income notes. Assuming $1 in value backing each $1 of H notes, there was at most $0.73 in value backing each $1 of Combination notes since the Combination notes are 35.7% H notes and 64.3% Income notes.[24]

V. RMK Funds' Prospectuses And Statements of Additional Information Failed to Disclose Substantial Risks

A. Prospectus

The RHY prospectus dated January 19, 2006 describes the investment philosophy and process of the newly issued fund as follows.[25]

Investment Philosophy and Process

> ….
>
> The Adviser's ""bottom-up" strategy focuses on identifying special or unusual opportunities where the Adviser decides that the market perception of, or demand for, a credit or structure has created an undervalued situation. *The analytical process concentrates on credit research, debt instrument structure and covenant protection.* Generally,

[24] This calculation is not to imply that there were assets actually backing the Income note component of the Combination notes but assuming the underlying collateral and all the rated tranches were fairly priced - and the deal was costless – there would be $0.73 in value at the offering for each $1.00 of the Combination tranche. Given the potential mispricing and the significant costs in the deal it is highly likely that the Combination notes were worth much less than $0.73 despite RMK's $0.90 valuation.

[25] Both the RHY Prospectus and Statement of Additional Information can be found at http://www.morgankeegan.com/MK/Investing/IProducts/RMKCEF/multi_sector.htm.

> when investing in below investment grade debt securities, the Adviser will seek to identify issuers and industries that it believes are likely to experience stable or improving conditions. Specific factors considered in the research process may include general industry trends, *cash flow generation capacity, asset valuation, other debt maturities, capital availability, collateral value and priority of payments.*
>
> …. [p.16, *emphasis added*.]

Most of the securities the Multi-Sector High Income ultimately invested in were complex structures that provide very little information on underlying collateral and which require sophisticated modeling to understand and value.

The Multi-Sector High Income Fund prospectus contains 14 pages of description of the risks to which investors in the fund would be exposed. There are 26 categories of risks described in the prospectus:

> "Risks
>
> 1. General. ...
> 2. Newly Organized. ...
> 3. Investment Risk. ...
> 4. Value Investing Risk. ...
> 5. Stock Market Risk. ...
> 6. Management Risk. ...
> 7. Leverage Risk. ...
> 8. Credit Risk. ...
> 9. Interest Rate and Related Risks. ...
> 10. Inflation/Deflation Risk. ...
> 11. Below Investment Grade Securities Risk. ...
> 12. Distressed Securities Risk. ...
> 13. Mortgage-Backed Securities Risk. ...
> 14. Asset-Backed Securities Risk. ...
> 15. Corporate Bonds Risk. ...
> 16. Equity Securities Risk. ...
> 17. Common Stock Risk. ...
> 18. Preferred Stock Risk. ...
> 19. Convertible Securities Risk. ...
> 20. U.S. Government Securities Risk. ...
> 21. Municipal Securities Risk. ...
> 22. Foreign Securities Risk. ...
> 23. Illiquid and Restricted Securities Risks. ...
> 24. Derivatives Risk. ...
> 25. Market Disruption Risk. ...
> 26. Anti-Takeover Provisions. ..."

The RHY prospectus does not mention the extraordinary credit risk the fund was going to take on through its purchase of low-priority tranches in a wide range of structured finance deals. The prospectus does not even mention that cash flows from pools of assets including mortgages can be tranched. Instead, the prospectus describes the risks of investing in mortgage-backed and asset-backed securities as if investors were exposed to the average interest rate risk, prepayment risk and credit risk of the underlying assets. Many of the investments selected by Regions Morgan Keegan for this fund exposed investors to the credit risk equivalent to an investment in the underlying portfolio of assets leveraged up 10-to-1. The discussion of Leverage Risk reflects a limit of 1.33-to-1 on portfolio leverage but RMK's use of low-priority tranches in structured finance deals allowed the portfolio manager to dramatically leverage the credit risk in these bond portfolios. This leveraging of credit risk explains the high returns earned on the RMK funds in 2004-2006 despite the high annual expense ratios and the spectacular collapse of the funds in 2007.

B. Statement of Additional Information

Regions Morgan Keegan also filed a Statement of Additional Information (SAI) dated January 19, 2006 for the Multi-Sector High Income fund. The SAI has 31 pages of descriptions of the securities the fund will invest in. The 78-page document explicitly mentions tranching in one paragraph and alludes to it in a second.

> The following pages contain more detailed information about the types of instruments in which the Fund *may* invest, strategies the Adviser may employ in pursuit of the Fund's investment objectives and a discussion of related risks. The Adviser may not buy these instruments or use these techniques unless it believes that doing so will help the Fund achieve its goals. [p. 5, emphasis added.]

> In a CMO, a series of bonds or certificates is issued in multiple classes. Each class of CMO, also referred to as a "tranche," is issued at a specific fixed or floating coupon rate and has a stated maturity or final distribution date. Principal prepayments on the Mortgage Assets may cause CMOs to be retired substantially earlier than their stated maturities or final distribution dates. Interest is paid or accrued on all classes of a CMO (other than any principal-only class) on a monthly, quarterly or semi-annual basis. The principal and interest on the Mortgage Assets may be allocated among the several classes of a CMO in many ways. In one structure, payments of principal, including any principal prepayments, on the Mortgage Assets are applied to the classes of a CMO in the order of their respective stated maturities or final distribution dates so that no payment of principal will be made on any class of the CMO until all other classes having an earlier stated maturity or final distribution date have been paid in full. In some CMO structures, all or a portion of the interest attributable to one or more of the CMO classes may be added to the principal amounts

attributable to such classes, rather than passed through to certificate holders on a current basis, until other classes of the CMO are paid in full. [p.9]

And

Investments in Subordinated Securities. The Fund *may* invest in subordinated classes of senior-subordinated securities ("Subordinated Securities"). Subordinated Securities have no governmental guarantee, and are subordinated in some manner as to the payment of principal and/or interest to the holders of more senior mortgage- or asset-backed securities arising out of the same pool of assets. The holders of Subordinated Securities typically are compensated with a higher stated yield than are the holders of more senior securities. On the other hand, Subordinated Securities typically subject the holder to greater risk than senior securities and tend to be rated in a lower rating category (frequently a substantially lower rating category) than the senior securities issued in respect of the same pool of assets. Subordinated Securities generally are likely to be more sensitive to changes in prepayment and interest rates, and the market for such securities may be less liquid than is the case for traditional debt securities and senior mortgage- or asset-backed securities. [p.11, emphasis added.]

Neither reference to tranching in the SAI tells investors that RHY will be concentrated in the lowest priority, highly-leveraged tranches in deals backed by assets with significant credit risk and that as a result investors will be exposed to extraordinary credit risk.

C. Semi-Annual Reports

RMK filed a semi-annual report for RHY as of September 30, 2006 wherein it describes the fund's risks as follows.[26]

INVESTMENT RISKS: Bond funds tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price. Bond prices and the value of bond funds decline as interest rates rise. Longer-term funds generally are more vulnerable to interest rate risk than shorter-term funds. Below investment grade bonds involve greater credit risk, which is the risk that the issuer will not make interest or principal payments when due. An economic downturn or period of rising interest rates could adversely affect the ability of issuers, especially issuers of below investment grade debt, to service primary obligations and an unanticipated default could cause the Fund to experience a reduction in value of its shares. The value of U.S. and foreign equity securities in which the Fund invests will change based on changes in a company's financial condition and in overall market and economic

[26] RHY's self-descriptions for the periods ending September 30, 2006, March 31, 2007 and September 30, 2007 are excerpted in Appendix 1.

> conditions. Leverage creates an opportunity for an increased return to common stockholders, but unless the income and capital appreciation, if any, on securities acquired with leverage proceeds exceed the costs of the leverage, the use of leverage will diminish the investment performance of the Fund's shares. Use of leverage may also increase the likelihood that the net asset value of the Fund and market value of its common shares will be more volatile, and the yield and total return to common stockholders will tend to fluctuate more in response to changes in interest rates and creditworthiness.

This description of investment risks is typical of each of the other RMK funds. Nowhere in this description is there any mention of the leveraged credit risk investors were exposed to as a result of the fund's concentration in low-priority tranches in structured securities. In the same semi-annual report as September 30, 2006, RMK described the fund's recent returns as follows.

> During the first half of RMK Multi-Sector High Income Fund, Inc.'s fiscal year 2007, which ended September 30, 2006, the Fund had a total return of 15.39%, based on market price and reinvested dividends. For the six months ended September 30, 2006, the Fund had a total return of 6.16%, based on net asset value and reinvested dividends. For the six months ended September 30, 2006, the Lehman Brothers Ba U.S. High Yield Index 1 had a total return of 4.12%. The Fund's strong market performance is a reflection of investor's desire for cash distributions as well as the stability of the Fund's net asset value offered by a very diverse portfolio.
>
> During the first six months of the 2007 fiscal year, corporate high yield debt and common stocks were the best performing asset categories. Credit spreads (the yield premium required for risky assets over riskless assets such as U.S. Treasuries) contracted, or shrank significantly in the corporate sector providing meaningful outperformance for corporate securities. In the asset-backed sector, however, concerns over the slow down in housing and real estate in general caused credit spreads to expand and acted to depress overall performance from our portfolio of mortgage related securities. Asset-backed bonds secured by aircraft leases, medical equipment leases and ship leases continued to perform very well.
>
> During the same period, we made substantial allocation shifts away from home equity loans and into collateralized loan obligations focusing specifically on packages of senior secured corporate loans, both domestic and international. Further allocation shifts will focus on moving out of some floating rate assets and into more fixed rate assets as we expect the Federal Reserve to begin lowering short term rates at some point in 2007.

As of September 30, 2007 - one year later - RMK slipped this sentence into the paragraph describing RHY's risks.

> The Fund's investments in mortgage-backed or asset-backed securities that are "subordinated" to other interests in the same pool may increase credit risk to the extent that the Fund as a holder of those securities may only receive payments after the pool's obligations to other investors have been satisfied.

RMK, in part, described RHY's recent returns as follows.

> The turmoil in the mortgage market that began in December 2006 and the credit crunch that began during the Fund's first fiscal quarter has continued to plague the performance of both the Fund's net asset value and market valuation. Although below investment grade corporate debt has held up reasonably well, any asset related to residential real estate has been materially devalued. This is especially true for mortgage-backed securities and collateralized debt obligations.
>
> The market's appetite for credit sensitive assets has totally reversed course from the prevailing environment of 2006. A massive unwind of leverage has literally evaporated market liquidity in all structured finance assets and put selling pressure on virtually all credit-sensitive assets. Although this has been a sector of the fixed income markets that has provided very satisfying results in past periods, 2007 has proven to be much more difficult than we could have anticipated.

Even these belated disclosures do not accurately reflect what happened to investors in RHY and the other RMK funds. RMK invested a substantial majority of the portfolios in low-priority tranches. It is not that these securities *may* increase credit risk, these securities dramatically do increase credit risk. Also, as RMK acknowledges that the 2007 losses were suffered because of the subordinated structured securities it held, it says for the first time that its prior returns were due to investments in the same risky structured securities. This leveraged credit risk was not previously disclosed to investors but would be well known to the portfolio managers who ran the funds.

Finally RMK gets closer to full disclosure a few months later when it filed the December 31, 2007 semi-annual report for its Select High Income fund.

> … The structured finance category has taken the hardest hit so far due to the implicit (i.e., built into the structures) and explicit (i.e., financed, or bought on margin) leverage employed for this asset category. ...

This appears to be the first disclosure by RMK that it was investing in securities that had the effect of leveraging up the credit risk investors in its funds faced.

VI. Conclusion

Investors in Regions Morgan Keegan's six bond funds lost two billion dollars in 2007 because of losses on poor-quality asset-backed securities, leveraged up many times over by complex capital structures. A rudimentary analysis of the type RMK claimed to perform on its holdings would have determined that it was exposing investors to as much as 10 times the credit risk of the underlying, already risky, debt in exchange for 1% or

2% higher returns than a diversified, transparent high-yield bond portfolio would have earned.

In addition, Morgan Keegan told investors that it did in depth evaluation of the mutual funds it recommended to its retail customers.[27] Such an evaluation of any of the six RMK funds discussed herein would have uncovered RMK's misrepresentation of risky asset-backed securities as corporate bonds and preferred stocks and the highly-leveraged credit risk in the low-priority asset-backed securities held in the funds which RMK had not disclosed.

The losses suffered by investors in these funds were not the result of a "flight to quality" or a "mortgage meltdown" as has been asserted. Investments in diversified portfolios of junk bonds and mortgage backed-securities did not suffer significant losses during the time period investors in RMK funds suffered catastrophic losses.

RMK did not fully or accurately inform investors in its bond funds of the risks of the subordinated tranches the funds held until well after the losses had occurred. Moreover, prior to March 31, 2008 RMK affirmatively misrepresented hundreds of millions of dollars of risky securities it held in these portfolios as corporate bonds and preferred stocks.

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[27] *See* www.morgankeegan.com/MK/Investing/Newsletters/mor_invest0406.htm#1

> **Mutual Fund Research Sets Morgan Keegan Apart**
>
> Your Morgan Keegan financial advisor has just recommended that you add a certain mutual fund to your portfolio to strengthen your assets and increase the diversity and stability of your holdings. But how do you know that the mutual fund your advisor is offering is best for you? The answer: Morgan Keegan's exceptional due diligence. At Morgan Keegan, mutual funds are subject to one of the most detailed, thorough and exhaustive due diligence processes in the industry. It is just another example of how Morgan Keegan puts the interests of our clients before everything else.
>
> …
>
> "We go beyond the past performance records provided by services like Morningstar," explains Gary Stringer, Director of Investments, Wealth Management Services at Morgan Keegan. "We're not so much concerned with what funds have done in the past, but with what they will do for us in the future. And the best way to do that is to really get to know the people managing the funds and learn as much as we can about how they intend to earn our clients money."
>
> …

RMK Closed-End Funds Securities and Exchange Commission filings:
March 31, 2007 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1343602/000119312507130990/dncsr.htm
March 31, 2006 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1343602/000119312506125929/dncsr.htm
September 30, 2006 Semi-Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1343602/000119312506248511/dncsrs.htm
September 30, 2007 Semi-Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1343602/000119312507259683/dncsrs.htm
March 31, 2008 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1343602/000119312508127309/dncsr.htm

RMK Open-End Funds Securities and Exchange Commission filings:
June 30, 2006 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1072377/000119312506185976/dncsr.htm
December 31, 2006 Semi-Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1072377/000119312507046246/dncsrs.htm
June 30, 2007 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1072377/000119312507213143/dncsr.htm
December 31, 2007 Semi-Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1072377/000119312508048822/dncsrs.htm
April 30, 2008 Annual Report N-CSR
www.sec.gov/Archives/edgar/data/1072377/000119312508148682/dncsr.htm.