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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.

The investors' losses were not the result of a "flight to quality" or a "mortgage meltdown." Diversified portfolios of high yield bonds and mortgage-backed securities did not suffer significant losses as the RMK funds suffered massive losses. The RMK funds collapsed because they held concentrated holdings of low-priority tranches in structured finance deals backed by risky assets.

RMK did not disclose in its Securities and Exchange Commission filings the risks it was exposing investors to by investing the majority of its portfolio in subordinated tranches of asset-backed securities until *after* the losses had occurred. RMK also misrepresented hundreds of millions of dollars of asset-backed securities as corporate bonds and preferred stocks in its SEC filings thereby making the funds seem more diversified and less risky than they were.

RMK further misled investors in its SEC filings and marketing materials by comparing its funds to the Lehman Brothers Ba Index. This index contains only corporate bonds - no asset-backed securities which dominated the RMK funds' portfolios and which resulted in virtually all the investors' losses. RMK also misled investors by claiming that its funds were diversified.

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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]

The apparent superior performance of the RMK 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 misrepresentations in RMK's public filings and marketing materials.

II. Regions Morgan Keegan Bond Funds

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

The six Regions Morgan Keegan bond funds that collapsed in 2007 are listed in Table 1. 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.

[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.

Table 1
Regions Morgan Keegan Bond Funds

Fund Name	Ticker	Inception	Net Assets 12/31/2006	Net Assets 12/31/2007	2007 Returns Capital Appreciation	2007 Returns 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 $3 billion drop in the funds' net assets reported in Table 1 are largely as a result of $2 billion in losses on securities held in the mutual funds' portfolios. These securities losses are listed in Table 2 with our estimate of investor losses.[3] Investors in these six funds lost more than $2 billion between March 31, 2007 and March 31, 2008.

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

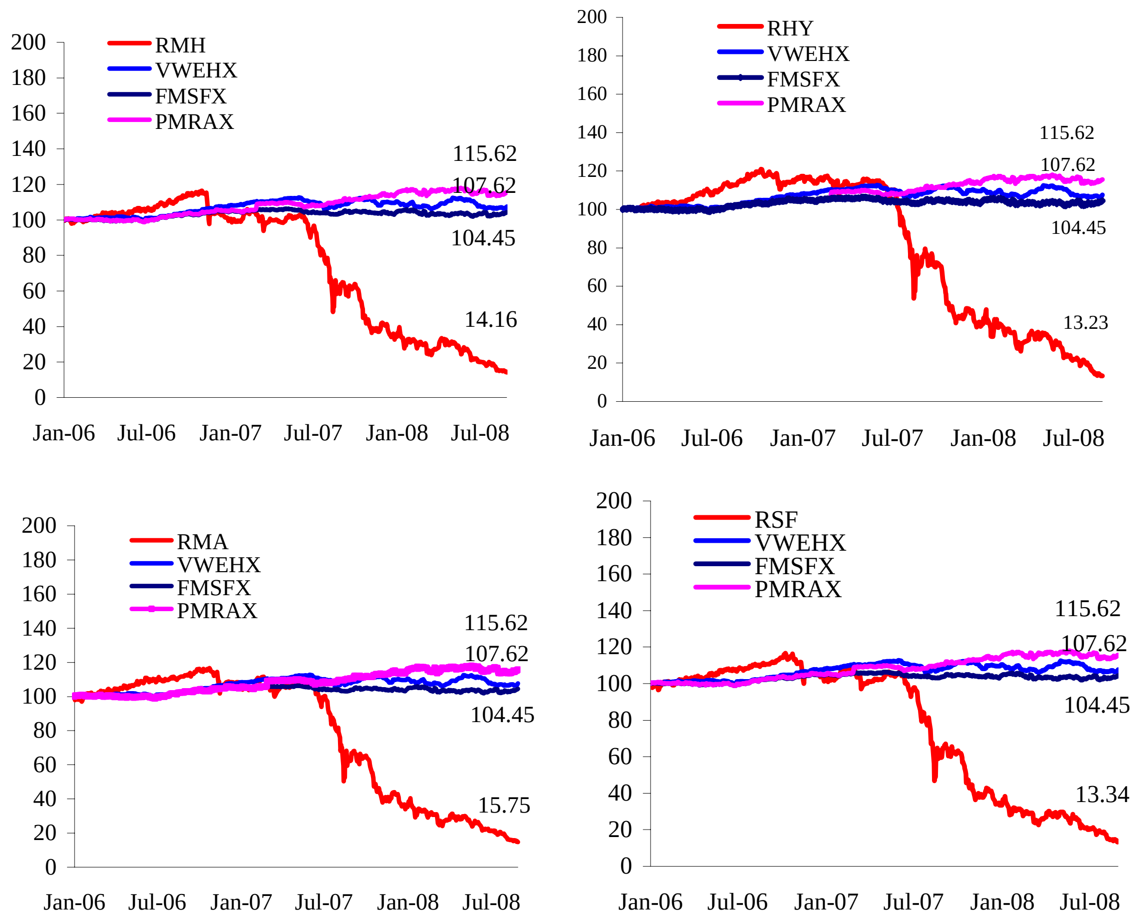
Fund Name	Portfolio Securities[4] Capital Gain/Loss	Portfolio Securities[4] Net Gain/Loss	Investor Losses Capital Gain/Loss	Investor Losses Net Gain/Loss
Advantage Income	$(313,565,152)	$(270,000,647)	$(379,307,019)	$(281,465,563)
High Income	$(224,919,545)	$(194,593,637)	$(271,456,298)	$(238,037,475)
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)	$(1,803,931,51	($2,258,921,558)	$(2,009,959,73

[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 asset-backed securities. For example, 97% of the unrealized losses between March 31, 2007 and September 30, 2007 in the Multi-Sector High Income fund's portfolio were in asset backed securities, only 3% were in corporate bonds.

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." 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[5] 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 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.

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

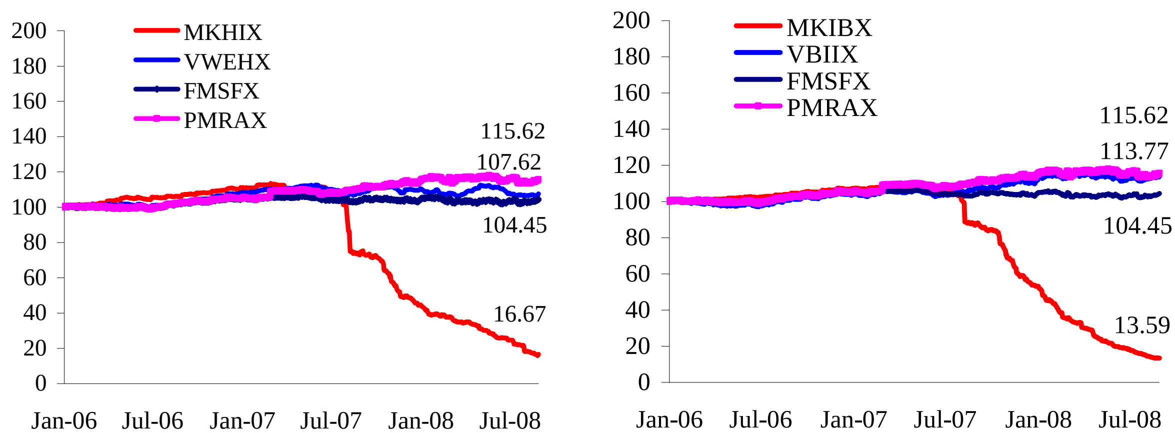


[5] The four closed-end bond funds benchmarked themselves to the Lehman Bros Ba Index, an index of high yield corporate bonds. VWEHX tracks the Lehman Ba Index.

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.

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.[6] 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

The closed-end funds were substantially riskier than their benchmark even before the sharp declines in 2007. Table 3 reports the standard deviation of daily returns for the four closed-end funds and the Vanguard fund that tracks the Lehman Brothers benchmark for 1-year, 2-year and 3-year periods ending March 31, 2007. The RMK funds were four to six times as volatile as their benchmark during the 1-year, 2-year and 3-year periods

[6] The four closed-end funds had substantially the same investments as the Select High Income Fund (MKHIX) but were leveraged up 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.

ending March 31, 2007. From April 2007 to September 2007 the RMK funds were more than 12 times as volatile as their benchmark.[7]

Table 3
RMK Funds Were Much More Volatile Than Benchmarks
(annualized standard deviations, ending March 31, 2007)

	Prior Three Years	Prior Two Year	Prior One Year	April 2007 to September 2007
RMH	13.8% (4.8 ×)	14.0% (5.2 ×)	16.1% (6.2 ×)	55.0% (12.3 ×)
RSF	12.0% (4.2 ×)	11.7% (4.3 ×)	12.7% (4.9 ×)	56.7% (12.7 ×)
RMA	12.2% (4.3 ×)	12.0% (4.4 ×)	13.2% (5.1 ×)	54.4% (12.7 ×)
RHY	11.3% (4.2 ×)	11.3% (4.2 ×)	12.0% (4.6 ×)	59.1% (13.2 ×)
MKHIX	3.5% (1.2 ×)	3.4% (1.3 ×)	3.5% (1.3 ×)	21.8% (4.9 ×)
Benchmark $_{(VWEHX)}$	2.8%	2.7%	2.6%	4.5%
Benchmark $_{(HYG)}$				8.8%
MKIBX	2.4% (0.5 ×)	2.3% (0.6 ×)	2.3% (0.6 ×)	15.7% (3.4 ×)
Benchmark $_{(VBIIX)}$	4.5%	4.0%	3.9%	4.6%

The statistics reported in Table 3 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 more than 3.5 times as volatile as the Select High Income (MKHIX)'s NAV during the periods covered by Table 3 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.[8]
- 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

[7] 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.

[8] 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.

their periodic reports, Table 3 suggests that RMK misstated the valuations of its closed end funds as well.[9]

- The Select High Income was only 1.2 times as volatile as the Vanguard fund that tracks the Lehman Brothers Ba Index prior to March 2007 but was 4.9 times as volatile afterwards even though Select High Income's portfolio holdings did not change that much during this time period.[10]

III. RMK Misrepresented *At Least* $446 Million in Asset-Backed Securities as Corporate Bonds and Preferred Stocks as of March 31, 2007

We have analyzed the portfolio holdings for the six RMK funds and determined that they all held heavy concentrations of low-priority tranches in asset-backed and mortgage-backed securities. These tranches were virtually always the smallest slices in a deal because issuers try to create large tranches of the more marketable senior securities.

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.

Regions Morgan Keegan misrepresented $446 million of these highly-leveraged, illiquid asset-backed securities as corporate bonds and preferred stocks as of March 31, 2007 in its filings with the Securities and Exchange Commission.

A. RMK Misrepresented $44.1 Million in Asset-Backed Securities Held by High Income fund as Corporate Bonds and Preferred Stocks

Table 4 lists the High Income funds' holdings on March 31, 2007 reported by RMK and as corrected by SLCG. RMK misclassified $44.1 million of asset-backed and mortgage-backed securities held by the High Income fund as corporate bonds or preferred stocks on March 31, 2007. 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

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

[10] 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, 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.

leveraged tranches – in asset-backed deals.[11] 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. The High Income fund actually held 64.6%, not 53.7%, of its net assets in asset-backed and mortgage-backed securities on March 31, 2007.

Table 4
RMK Misrepresented $44.1 Million
of the High Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$217,523,259	**53.7%**	$261,617,844	**64.6%**
Corporate Bonds	$126,116,806	**31.1%**	$95,708,081	**23.6%**
Municipal Securities	$630,000	0.2%	$630,000	0.2%
Common Stocks	$37,463,032	9.3%	$37,463,032	9.3%
Preferred Stocks	$15,545,860	**3.8%**	$1,860,000	**0.5%**
Cash	$7,665,224	1.9%	$7,665,224	1.9%
Gross Assets	$404,944,181	100.0%	$404,944,181	100.0%
Margin Debt	$(101,685,277)[12]	-25.1%	$(101,685,277)	-25.1%
Net Assets	$303,258,904	74.9%	$303,258,904	74.9%

Morgan Keegan (the brokerage firm) created quarterly brochures for each of the closed-end funds.[13] Our re-classification of the RMK-reported holdings slightly understates the extent to which RMK misrepresented the High Income fund's holdings. The Morgan Keegan quarterly brochure for the High Income fund reports that corporate bonds account for only 22.4% of the portfolio's holdings and preferred stock accounts for only 0.4% of the portfolio's holdings as of March 31, 2007. Thus, Morgan Keegan knew that the High Income fund's holdings were not as reported by RMK on its SEC filings at the time Morgan Keegan was recommending the High Income fund to its clients.

[11] 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.
[12] The closed-end funds' net assets could be, and were, leveraged 33%. Thus, investors in the closed-end funds were exposed to leveraged credit risk implicit in the portfolio's asset-backed securities holdings, further leveraged by the explicit borrowings.
[13] The four reports for March 31, 2007 are attached as Exhibit 1.

B. RMK Misrepresented $44.1 Million in Asset-Backed Securities Held by Strategic Income fund as Corporate Bonds and Preferred Stocks

Table 5 lists the Strategic Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $44.1 million of Strategic Income fund's asset-backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 5
RMK Misrepresented $44.1 Million
of the Strategic Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$274,847,988	**56.4%**	$318,926,042	**65.5%**
Corporate Bonds	$139,415,826	**28.6%**	$109,023,632	**22.4%**
Municipal Securities	$630,000	0.1%	$630,000	0.1%
Common Stocks	$44,526,722	9.1%	$44,526,722	9.1%
Preferred Stocks	$15,865,860	**3.3%**	$2,180,000	**0.4%**
Cash	$11,885,850	2.4%	$11,885,850	2.4%
Gross Assets	$487,172,246	**100.0%**	$487,172,246	100.0%
Margin Debt	$(127,942,304)	**-26.3%**	$(127,942,304)	-26.3%
Net Assets	$359,229,942	**73.7%**	$359,229,942	73.7%

Our re-classification of the RMK-reported holdings slightly understates the extent to which RMK misrepresented the Strategic Income funds' holdings. Morgan Keegan's quarterly brochure for the Strategic Income fund reports that corporate bonds account for only 21.6% of the portfolio's holdings and preferred stock accounts for only 0.4% of the portfolio's holdings as of March 31, 2007. Morgan Keegan thus knew that the Strategic Income funds' holdings were not as reported by RMK on its SEC filings at the time Morgan Keegan was recommending the Strategic Income fund to its clients.

C. RMK Misrepresented $59.3 Million in Asset-Backed Securities Held by Advantage Income fund as Corporate Bonds and Preferred Stocks

Table 6 lists the Advantage Income funds' holdings on March 31, 200. RMK misrepresented $59.3 million of the Advantage Income funds' asset-backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 6
RMK Misrepresented $59.3 Million
of the Advantage Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$306,132,730	**55.5%**	$365,461,619	**66.2%**
Corporate Bonds	$163,210,458	**29.6%**	$122,467,428	**22.2%**
Municipal Bonds	$787,500	0.1%	$787,500	0.1%
Common Stocks	$50,057,309	9.1%	$50,057,309	9.1%

Preferred Stocks	$20,965,859	**3.8%**	$2,380,000	**0.4%**
Cash	$10,895,909	2.0%	$10,895,909	2.0%
Gross Assets	$552,049,765	100.0%	$552,049,765	100.0%
Margin Debt	$(135,051,124)	-24.5%	$(135,051,124)	-24.5%
Net Assets	$416,998,641	75.5%	$416,998,641	75.5%

Our re-classification of the RMK-reported holdings slightly understates the extent to which RMK misrepresented the Advantage Income funds' holdings. The Morgan Keegan's quarterly brochure for RMA reports that corporate bonds account for only 21.2% of the portfolio's holdings and preferred stock accounts for only 0.4% of the portfolio's holdings as of March 31, 2007. Morgan Keegan, thus, knew that the Advantage Income funds' holdings were not as reported by RMK on its SEC filings at the time Morgan Keegan was recommending the Advantage Income fund to its clients.

D. RMK Misrepresented $67.5 Million in Asset-Backed Securities Held by Multi-Sector High Income fund as Corporate Bonds and Preferred Stocks

Regions Morgan Keegan reported the Multi-Sector High Income fund's holdings on March 31, 2007 as summarized in Table 7. RMK misrepresented $67.5 million of the Multi-Sector High Income fund's asset-backed securities on March 31, 2007 as corporate bonds or preferred stocks.

Table 7
RMK Misrepresented $67.5 Million
of the Multi-Sector High Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$364,472,540	**58.7%**	$431,970,558	**69.5%**
Corporate Bonds	$174,108,322	**28.0%**	$129,527,163	**20.9%**
Common Stocks	$54,977,849	8.9%	$54,977,849	8.9%
Preferred Stocks	$25,436,859	**4.1%**	$2,520,000	**0.4%**
Cash	$2,202,458	0.4%	$2,202,458	0.4%
Gross Assets	$621,198,028	100.0%	$621,198,028	100.0%
Margin Debt	$(152,319,346)	-24.5%	$(152,319,346)	-24.5%
Net Assets	$468,878,682	75.5%	$468,878,682	75.5%

Our re-classification of the RMK-reported holdings slightly understates the extent to which RMK misrepresented the Multi-Sector High Income fund's holdings. The Morgan Keegan quarterly brochure for the Multi-Sector High Income fund reports that corporate bonds account for only 20.2% of the portfolio's holdings and preferred stock accounts for only 0.4% of the portfolio's holdings as of March 31, 2007. Thus, Morgan Keegan knew that the Multi-Sector High Income fund's holdings were not as reported by RMK on its SEC filings when Morgan Keegan was recommending this fund to its clients.

E. RMK Misrepresented $139.6 Million in Asset-Backed Securities Held by Select High Income fund as Corporate Bonds and Preferred Stocks

Table 8 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 8
RMK Misrepresented $139.6 Million
of the Select High Income funds' Asset-Backed Securities

	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%

F. RMK Misrepresented $91.4 Million in Asset-Backed Securities Held by the Select Intermediate Bond fund as Corporate Bonds and Preferred Stocks

Table 9 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 9
RMK Misrepresented $91.4 Million
of the Select Intermediate Bond Fund's Asset-Backed Securities

	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%

IV. 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. 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 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.[14]

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).[15]

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

[14] 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.
[15] 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.[16] 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-

[16] 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.

priority tranches get written down more rapidly. The negative impact on face value is foreshadowed by declines in the market value of the tranche.

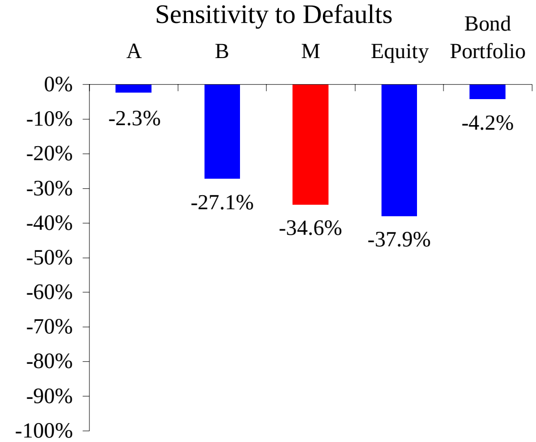
To illustrate the use of tranching to redistribute credit risk, consider the 10-year synthetic CDO described in Table 10.

Table 10
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.[17] 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

[17] Michael S. Gibson, "Understanding the Risk of Synthetic CDOs" Federal Reserve Board working paper 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.

4.2% drop in 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

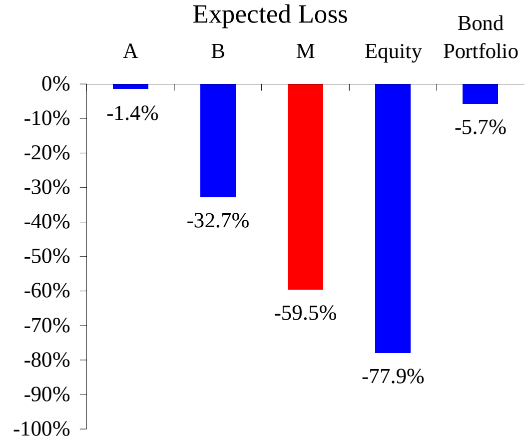


Figure 5
Unexpected Loss

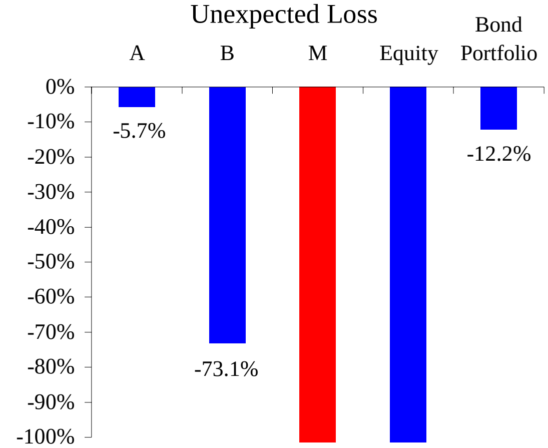
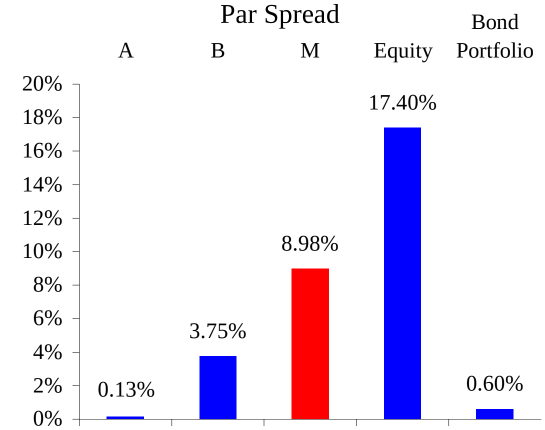


Figure 6
Par Spread



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.

V. RMK Misrepresented the Riskiness of its Funds' Asset-Backed Securities 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 the Multi-Sector High Income fund. 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. 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.

- **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.

A. Webster CDO I

Webster CDO I issued $1 billion in securities listed in Table 11. The RMK funds held $14.5 million face value of the equity tranche in Webster CDO I, Ltd which RMK misrepresented on March 31, 2007 as preferred stock. *See* Table 12.

Table 11
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			

Table 12
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

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 credit default swaps to bring the portfolio's asset-backed securities credit exposure up to $1 billion. 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 were to receive principal payments, if any, only on the final maturity date. The $43 million preference shares were effectively an investment in the underlying subprime assets leveraged approximately 23 to 1.

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.

B. 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 13. RMK misrepresented these holdings as corporate bonds until March 31, 2008, when it was reported correctly as asset-backed securities.

Table 13
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. *See* Table 14.

Table 14
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

Table 14
(continued)

	RMA			MKHIX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
9/30/2006	3,500,000	$3,500,000	9/30/2006	4,700,000	$4,700,000
3/31/2007	3,500,000	$3,500,000	12/31/2006	4,700,000	$4,700,000
9/30/2007	3,500,000	$3,325,000	3/31/2007	4,700,000	$4,700,000
3/31/2008	3,500,000	$1,955,000	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

C. Preferred Term Securities XXIII

In September 2006, Preferred Term Securities XXIII (PreTS XXIII) issued the $1.56 billion in securities listed in Table 15. 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 15
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 16. 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. 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.

Table 16
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

D. IndyMac 2005-C

In September 2005, IndyMac 2005-C issued $686,700,000 in securities listed in order of priority in Table 17.

Table 17
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 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.[18]

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 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.[19] 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 18.

Table 18
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

[18] As illustrated in Tables 12, 18, 20 and 21, long before principal write-downs start being taken the market value of the tranche will fall significantly, perhaps to zero.
[19] 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.

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.

E. Kodiak CDO I

Kodiak CDO I issued $775 million in securities listed in Table 19. 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.

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).[20] 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 19
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**

[20] 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.

The RMK funds purchased $46 million of the three first-to-lose tranches issued by Kodiak CDO I.[21] *See* Table 20 and Table 21.

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 20
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[22]	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

Table 21
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

[21] 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.
[22] 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.

Table 21
(continued)

RMA				MKHIX		
Date	Face Value	Reported Value		Date	Face Value	Reported Value
9/30/2006	4,000,000	$3,600,000		9/30/2006	10,000,000	$9,000,000
3/31/2007	4,000,000	$3,660,000		12/31/2006	10,000,000	$9,250,000
9/30/2007	4,000,000	$920,000		3/31/2007	10,000,000	$9,150,000
3/31/2008	4,000,000	$10,000		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

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.[23]

[23] 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.

VI. 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.[24]

> **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, 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. If the portfolio manager had performed the rigorous analysis described in the "Investment Philosophy and Process" in each funds' prospectus, the highly concentrated credit risk collected in these portfolios would have been readily apparent.

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. ...

---

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

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 highly concentrated 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.[25]

> 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 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

---

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

> 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.

VII. RMK Funds' Prospectuses Contained Other Material Misrepresentations

A. RMK's Misleading Performance Comparisons

RMK compared the performance of its four closed end funds and the Select High Income fund to the Lehman Ba index. The Lehman Ba index contains only corporate bonds – no structured finance securities.[26] As we illustrated in Tables 4-9 above, the five RMK "high yield" funds invested 65% to 70% of their portfolio in structured finance securities and only 21% to 24% in corporate bonds. The SEC previously found that Piper Capital Management's comparison of one of its fund's returns to an index that contained none of the asset type that dominated its Institutional Government Income Fund's ("PJIGX") holdings was materially false and misleading.

Piper Jaffray marketed PJIGX in the early 1990s to investors who wanted to invest in short and intermediate term fixed-income securities issued by the U.S. government and government agencies. Over time, Piper Capital Management invested substantially all its portfolio in CMOs and leveraged up its portfolio with repurchase agreements. Many of the securities PJIGX loaded up on were inverse floaters. These securities were especially poorly described by the risk characteristics Piper Jaffray reported to investors. Prior to 1994 PJIGX reported high yields and returns and its portfolio manager, Worth V. Bruntjen, was proclaimed an industry superstar. As interest rates rose in 1994, PJIGX's net asset value plummeted well beyond what a true portfolio

[26] The Lehman Brothers fact sheet for the Ba Index identifies its constituents as only corporate bonds. *See* Exhibit 2.

of short and intermediate term government bonds would have declined.[27] Ultimately, in settlement with the SEC Bruntjen was barred from the industry for five years.

The Administrative Law Judge (ALJ) found that Piper Capital Management's choice of benchmark was material to investors and was misleading because it didn't contain the same type of securities as the mutual fund held and because the comparison implied a lower interest rate risk than the portfolio actually had.

> "Similar reasoning would apply to PCM's use of the Merrill Lynch 3-5 Year Treasury Bond Index as a benchmark for Fund performance. PJIGX annual/semi-annual reports to shareholders systematically compared Fund performance to that index. … PJIGX marketing materials and sales presentations made similar comparisons. … I find and conclude that expressly comparing Fund performance to the Merrill Lynch 3-5 Year Treasury Bond Index establishes a substantial likelihood that reasonable investors would consider the comparisons important in making PJIGX investment decisions and would view the comparisons as significantly altering the total mix of available information. It follows that PPJIGX/Merrill Lynch 3-5 Year Treasury Bond Index comparisons were material to investors.
>
> The record casts doubt on PCM's claim that the Merrill Lynch 3-5 Year Treasury Bond Index was an appropriate risk/performance benchmark for PJIGX. The Fund's distinguishing feature was an extremely high proportion of CMO derivative securities. … The Merrill Lynch 3-5 Year Treasury Bond Index contained no CMOs/CMO derivative securities whatsoever. … Moreover, the record indicates that PJIGX exhibited *multiples* of the interest rate sensitivity exhibited by the Merrill Lynch 3-5 Year Treasury Bond Index. …" [28]

The Securities and Exchange Commission affirmed the ALJ's findings in a strongly worded Opinion that included the following.

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[27] PJIGX's NAV fell in part because of the undisclosed interest rate risk in its portfolio and in part because of undisclosed liquidity risk. CMOs are not thickly traded and prices are approximations at best of what could be realized. Some of the prices Piper used to report its NAV had become stale in March 1993. The crisis at PJIGX became apparent with the coincidental failure of Askin Capital management when fresh prices turned out to be much lower than Piper had been reporting.

[28] *In the Matter of Piper Capital Management, Inc., et al.* Initial Decision Release No. 175 File No. 3-9657 November 30, 2000 available at www.sec.gov/litigation/aljdec/id175hpy.htm#P218_14823

> PCM further misled investors by comparing the Fund's performance to the Merrill Lynch three- to five-year Treasury Bond Index. The Merrill Lynch three- to five-year Treasury Bond Index, unlike the Fund, did not include CMOs. Thus, the Fund's increasing proportion of CMOs exposed it to interest-rate sensitivity not exhibited by the Merrill Lynch three- to five-year Treasury Bond Index. [29]

RMK's choice of the Lehman Ba index as its benchmark for the four closed end funds and for the Select High Income fund is virtually identical in all material respects to PCM's comparison of PJIGX's returns to the Merrill Lynch 3-5 Year Treasury Bond Index. 65% to 70% of the RMK funds' portfolios holdings by March 31, 2007 were asset-backed securities and other structured finance and virtually all of these securities were at or near the bottom of the deals' capital structure. The Lehman Ba index contained only corporate bonds making RMK's comparison materially false and misleading.

B. RMK's Misleading Diversification Claims

RMK claimed that its high yield funds were diversified by virtue of investing in multiple asset classes. In the Piper Capital Management case, the ALJ found:

> Further, the report states that PJIGX "is invested in more than 200 different securities which offset one another and help the fund to perform well in a variety of economic scenarios" …, again implying diversification in the familiar sense. Further undermining PCM's reliance on technical accuracy is the fact that Bruntjen's unorthodox strategy of purchasing a variety of CMO derivative securities at a discount and actively managing the cash flows as they accreted to par … mystified even peer fund managers.
>
> … Finally, it was affirmatively misleading to characterize Bruntjen's cash flow management "diversification" and Fund leverage as risk/volatility hedges. …

PCM did not challenge the ALJ's conclusion on the materially misleading nature of PCM's diversification claims for PJIGX and so the Commission accepted the ALJ's findings on this point. RMK's repeated claims that the four high-yield funds and the Select High Income fund were diversified rise and fall on the same hyper-technical defenses PCM advanced before the SEC. As with PJIGX, the RMK funds were highly

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[29] *In the Matter of Piper Capital Management, Inc., et al.,* Securities Act of 1933 Release No. 8276, August 26, 2003 available at http://www.sec.gov/litigation/opinions/33-8276.htm.

leveraged bets on credit risk and were not "diversified" in the sense investors are encouraged to understand that term.

Morgan Keegan repeated many of the same diversification claims. If Morgan Keegan performed the due diligence required before recommending these bond funds[30] to its clients, it would have known that the claims of diversification it was advancing were materially false and misleading.[31]

VIII. 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.[32] Such an evaluation of any of the

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[30] FINRA Notice to Members 04-30 *Sales Practice Obligations NASD Reminds Firms of Sales Practice Obligations in Sale of Bonds and Bond Funds* available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003130.pdf

[31] There are other parallels between the RMK funds and the Piper Jaffray fund highlighted by the SEC ALJ Findings and the Commission Opinion. For example, The SEC found that Piper Jaffray's use of weighted average life and duration were incomplete and misleading measures of interest rate risk for a portfolio that contained significant amounts of inverse floaters. Likewise, the RMK funds repeated references in its marketing materials to the funds' average credit ratings was incomplete and misleading since the ratings on structured finance – especially of the lowest priority tranches purchased by the funds – meant something very different than ratings on corporate bonds.

[32] *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

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. RMK also misled investors by repeatedly comparing the performance of its funds to an index that contained none of the securities that dominated the RMK funds and by claiming that its funds were diversified.

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the people managing the funds and learn as much as we can about how they intend to earn our clients money."
…

Volume 11 · March 31, 2007

RMK Strategic Income Fund, Inc.

Seeking a High Level of Current Income

A diversified portfolio of income-producing securities from multiple asset categories.

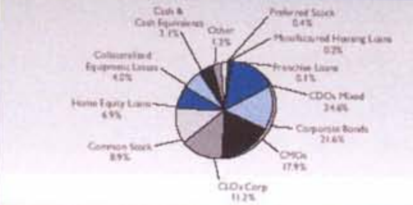
- Attractive monthly income plus capital appreciation potential
- Portfolio management by one of America's leading high-yield fund managers
- A value investing approach
- Exchange-traded liquidity (NYSE Listing: RSF)

Portfolio Statistics*

Portfolio Credit Rating	BB
Portfolio Current Yield	11.34%
Portfolio Yield to Maturity	12.15%
Portfolio Duration	4.30
Percentage of Levered Assets	28%
Total Number of Holdings	**326**

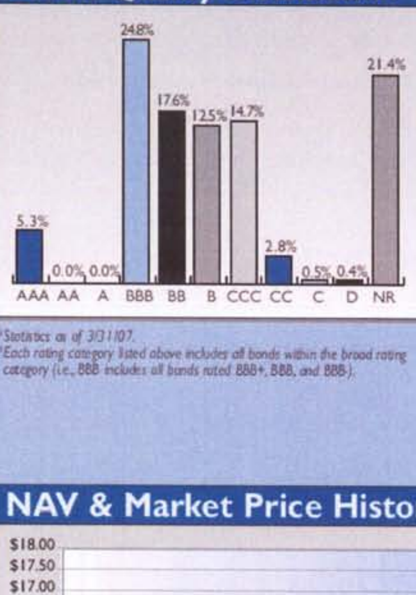
*Statistics as of 3/31/07.

Portfolio Allocation*



*Statistics as of 3/31/07.

Credit Quality Distribution*



*Statistics as of 3/31/07.
†Each rating category listed above includes all bonds within the broad rating category (i.e., BBB includes all bonds rated BBB+, BBB, and BBB-).

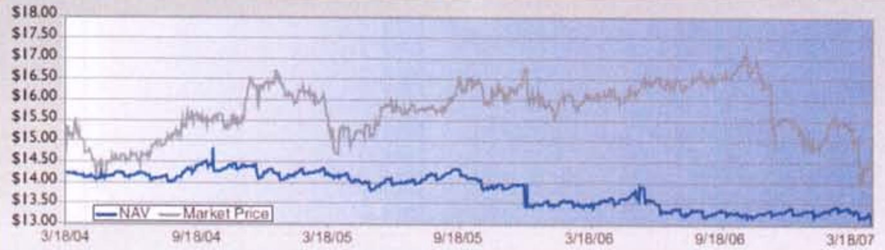
Fund Facts & Performance*

Performance	RSF
Quarter	-0.91%
One Year	-1.09%
Three Year Annualized	9.97%
Annualized from Inception	12.20%
SEC Yield**	11.34%
Expense Ratio	**3.48%**
Date of Inception	**3/18/04**
NYSE Symbol	**RSF**
Cusips	**74963H102**
Portfolio Manager	James C. Kelsoe Jr., CFA
Asst. Portfolio Manager	David Tannehill, CFA

*Statistics as of 3/31/07; assumes dividends are reinvested.
**SEC Yield assumes purchase at market price and an annualized current monthly dividend; it does not take into account any commissions paid to purchase shares of the fund.
Total return performance calculations assume an investment at the common share market price or net asset value at the beginning of the period, reinvestment of all distributions for the period in accordance with the Fund's dividend reinvestment plan, and sale of all shares at the closing common share market price (excluding any sales loads) or net asset value at the end of the period.

Past performance is not indicative of future results.

NAV & Market Price History



Net Asset Value is calculated after the close of the exchanges each day by taking the closing market value of all securities owned plus all other assets such as cash, subtracting all liabilities, then dividing the result (total net assets) by the total number of shares outstanding. The market price is the last reported price at which a security was sold on an exchange.

Call 1.800.564.2113 or contact your financial advisor for more information on RMK Strategic Income Fund, Inc.

General: Certain risks associated with investing in the Fund are summarized below. Before investing, please read the Fund's prospectus carefully, especially the sections on risk, and consult your financial advisor. You may lose money by investing in the Fund.

Newly Organized: The Fund is a newly organized, diversified closed-end management investment company and has no operating or trading history. It is designed primarily as a long-term investment and not as a trading tool.

Investment Risk: An investment in the Fund's common shares is subject to investment risk, including the possible loss of the entire principal that a stockholder invests. The value of these securities, like other market investments, may move up or down, sometimes rapidly and unpredictably.

Stock Market and Equity Securities Risks: Because the Fund's shares are expected to be listed on the NYSE and the Fund may invest in stocks of U.S. and foreign companies, it will be subject to stock market risk. The value of such securities will be affected by changes in the stock markets, which may be the result of domestic or international political or economic news, changes in interest rates or changing investor sentiment. Factors that may have an adverse impact on a particular common stock's or preferred stock's price include poor earnings reports by an issuer, loss of major customers, major litigation against an issuer, or changes in governmental regulations affecting an industry. Adverse news affecting one company can sometimes depress the stock prices of all companies in the same industry. Stock prices typically fluctuate more than other securities.

Management Risk: The Fund is subject to management risk because it is an actively managed portfolio and there can be no guarantee that the investment techniques used and the investment decisions made will produce the desired results.

Leverage Risk: Unless the income and capital appreciation, if any, on securities acquired with borrowed funds or other leverage proceeds exceed the cost of the leverage, the use of leverage will diminish the Fund's investment performance. Fund stockholders will bear the cost of any leverage. Successful use of leverage depends on the ability of Morgan Asset Management (the "Advisor") to correctly predict interest rates and market movements, and there is no assurance that the use of a leveraging strategy will be successful during any period in which it is used.

Interest Rate Risk: Prices of debt obligations and other instruments in which the Fund may invest tend to fall as interest rates rise and rise as interest rates fall. Obligations with longer maturities tend to fluctuate more in price in response to such changes. In addition, the Fund's anticipated use of leverage will tend to increase interest rate risk.

Risks Associated with Below Investment Grade Debt Securities: The Fund may invest a significant portion of its assets in below investment grade debt securities, which are considered predominately speculative and may involve major risk or exposure to adverse conditions. The yields and prices of these securities may tend to fluctuate more than those for higher rated securities. Changes in economic conditions or developments regarding the individual below investment grade issuer are more likely to cause price volatility and weaken the capacity of such securities to make principal and interest payments than is the case for higher grade debt securities. The secondary market for below investment grade debt securities may not be as liquid compared to more highly rated securities, a factor that may have an adverse effect on the Fund's ability to dispose of a particular security when necessary to meet its liquidity needs. Factors having an adverse impact on the market value of below investment grade debt securities may have an adverse effect on the Fund's net asset value and the market value of its common shares.

Distressed Securities Risk: Distressed securities are generally rated CC or lower by S&P, comparably rated by another rating agency or are unrated but considered by the Advisor to be of comparable quality. Distressed securities frequently do not produce income while they are outstanding and may require the Fund to bear certain extraordinary expenses in order to protect and recover its investment. Therefore, to the extent the Fund seeks capital growth through investment in distressed securities, the Fund's ability to achieve current income for its stockholders may be diminished.

Value Investing Risk: The Fund's approach to value style investing involves risks that those securities may remain undervalued. Value securities as a group may be out of favor and underperform the overall equity market for a long period of time, while the market concentrates on other managed investment vehicles that pursue growth style investments and/or flexible style mandates.

Asset-Backed Securities Risk: Payment of interest and repayment of principal on asset-backed securities may be largely dependent upon the cash flows generated by the assets backing the securities and, in some cases, by certain credit enhancements. The value of these securities may also be affected by the creditworthiness of the servicing agent for the pool, the originator of the loans or receivables, or the entities providing the credit enhancement.

Mortgage-Backed Securities Risk: The value of mortgage-backed securities may change due to shifts in the market perception of issuers, changes in interest rates and regulatory or tax changes. Mortgage-backed securities may have less potential for capital appreciation than comparable fixed income securities due to the likelihood of increased prepayments of mortgages as interest rates decline. In addition, mortgage-backed securities are subject to the credit risk associated with the performance of the underlying mortgage properties.

Convertible Securities Risk: Convertible securities generally have less potential for gain or loss than common stocks, are subject to credit risk and are often lower-quality securities. Convertible securities generally provide yields higher than the underlying common stocks, but generally lower than compatible nonconvertible securities.

Foreign Securities Risk: The Fund's investment in securities of foreign issuers involve special risks, including the risk that they may decline in value in response to unfavorable political and legal developments, unreliable or untimely information, or economic and financial instability. These risks may be particularly pronounced to the extent that the Fund invests in securities of developing or "emerging market" countries.

Illiquidity Risk: Illiquid securities may be difficult to dispose of at fair prices at the times when the Fund believes it is desirable to do so. The market price of illiquid securities generally is more volatile than that of more liquid securities, which may adversely affect the price that the Fund pays for or recovers upon the sale of illiquid securities. Illiquid securities, including those securities purchased through a private placement, are also more difficult to value and the Advisor's judgment may play a greater role in the valuation process.

Market Discount Risk: Shares of closed-end investment companies often trade at discounts from their net asset values, and the Fund's shares may trade at market prices that are less than their initial public offering price. This risk may be greater for investors who sell their shares in a relatively short period of time after completion of the public offering.

Market Disruption Risk: The terrorist attacks in the U.S. on September 11, 2001 and other related events, including the aftermath of the war in Iraq have led to increased short-term market volatility and may have long-term effects on U.S. and world economies and markets. Additional terrorist attacks may adversely impact the Fund's operations and service providers, as well as other factors relating to the common shares such as interest rate, credit risk, and inflation.

Anti-Takeover Provisions: The Fund's Articles of Incorporation and By-Laws include provisions that could limit the ability of others to: acquire control of the Fund, cause it to engage in certain transactions or modify its structure. Such provisions may limit the ability of stockholders to sell their shares at a premium over the then-current market prices.

Derivatives Risk: Even a small investment in derivatives can have a significant impact on the Fund's exposure to fluctuations in interest rates or currency exchange rates. If changes in a derivative's value do not correspond to changes in the value of the Fund's other investments, the Fund may not fully benefit from or could lose money on the derivative position.

Volume 13 · March 31, 2007

RMK High Income Fund, Inc.

Seeking a High Level of Current Income

A diversified portfolio of primarily high-yield debt securities from multiple asset categories.

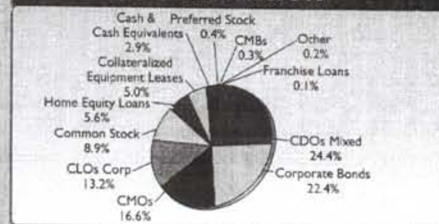
- Attractive monthly income plus capital appreciation potential
- Portfolio management by one of America's leading high-yield fund managers
- A value investing approach to the high-yield markets
- Exchange-traded liquidity (NYSE Listing: RMH)

Portfolio Statistics*

Portfolio Credit Rating	BB
Portfolio Current Yield	11.05%
Portfolio Yield to Maturity	12.05%
Portfolio Duration	4.26
Percentage of Levered Assets	27%
Total Number of Holdings	**311**

Statistics as of 3/31/07.

Portfolio Allocation*



Statistics as of 3/31/07.

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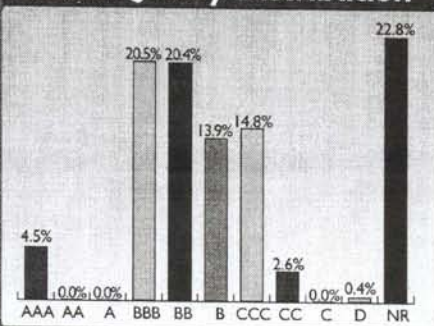

*Statistics as of 3/31/07.
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Fund Facts & Performance*

Performance	RMH
Quarter	-0.36%
One Year	-3.26%
Three Year Annualized	11.84%
Annualized from Inception	14.74%
SEC Yield**	11.05%
Expense Ratio	**3.46%**
Date of Inception	**6/24/03**
NYSE Symbol	**RMH**
Cusips	**74963B105**
Portfolio Manager	James C. Kelsoe Jr., CFA
Asst. Portfolio Manager	David Tannehill, CFA

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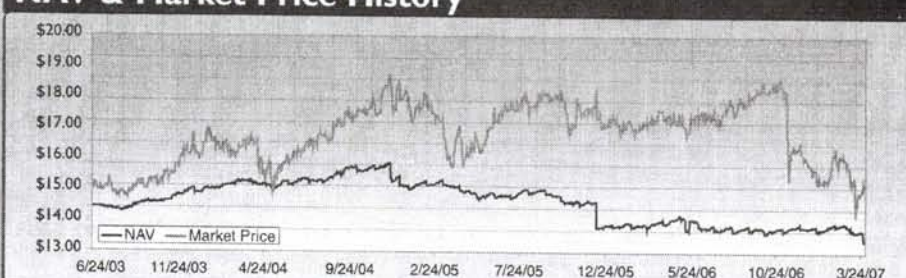

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Volume 5 • March 31, 2007

RMK Multi-Sector High Income Fund, Inc.

Seeking a High Level of Current Income

A diversified portfolio of primarily high-yield debt securities from multiple asset categories.

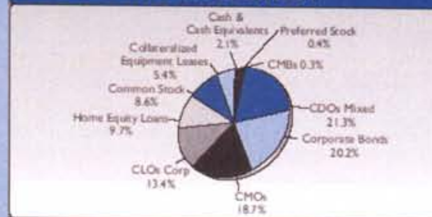
- Attractive monthly income plus capital appreciation potential
- Portfolio management by one of America's leading high-yield fund managers
- A value investing approach to the high-yield markets
- Exchange-traded liquidity (NYSE Listing: RHY)

Portfolio Statistics*

Portfolio Credit Rating	BB
Portfolio Current Yield	10.69%
Portfolio Yield to Maturity	12.40%
Portfolio Duration	4.49
Percentage of Levered Assets	26%
Total Number of Holdings	**301**

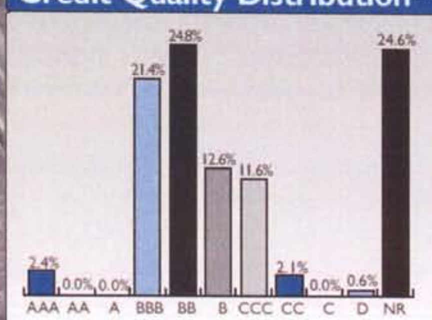
*Statistics as of 3/31/07.

Portfolio Allocation*



*Statistics as of 3/31/07.

Credit Quality Distribution*



*Statistics as of 3/31/07.
*Each rating category listed above includes all bonds within the broad rating category (i.e., BBB includes all bonds rated BBB+, BBB, and BBB-).

Fund Facts & Performance*

Performance	RHY
Quarter	-2.09%
One Year	10.96%
Three Year Annualized	N/A
Since Inception Annualized	15.76%
SEC Yield**	10.69%
Expense Ratio	**2.38%**
Date of Inception	**1/19/06**
NYSE Symbol	**RHY**
Cusips	**74963Q102**
Portfolio Manager	James C. Kelsoe Jr., CFA
Asst. Portfolio Manager	David Tannehill, CFA

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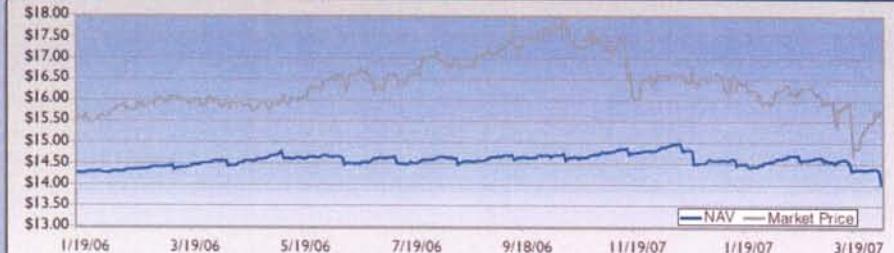

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Securities and insurance products offered through Morgan Keegan are:

Not FDIC Insured | May Lose Value | Not Bank Guaranteed

Past performance is not indicative of future results. An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending money. This and other important information about the investment company can be found in the Fund's prospectus. To obtain a prospectus, call 1-800-564-2188. Please read the prospectus carefully before investing.

Call 1.800.564.2113 or contact your financial advisor for more information on RMK Multi-Sector High Income Fund, Inc.

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Volume 10 • March 31, 2007

RMK Advantage Income Fund, Inc.

Seeking a High Level of Current Income

A diversified portfolio of primarily high-yield debt securities from multiple asset categories.

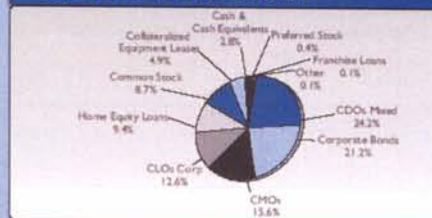
- Attractive monthly income plus capital appreciation potential
- Portfolio management by one of America's leading high-yield fund managers
- A value investing approach to the high-yield markets
- Exchange-traded liquidity (NYSE Listing: RMA)

Portfolio Statistics*

Portfolio Credit Rating	BB
Portfolio Current Yield	10.98%
Portfolio Yield to Maturity	12.13%
Portfolio Duration	4.29
Percentage of Levered Assets	26%
Total Number of Holdings	**306**

*Statistics as of 3/31/07.

Portfolio Allocation*



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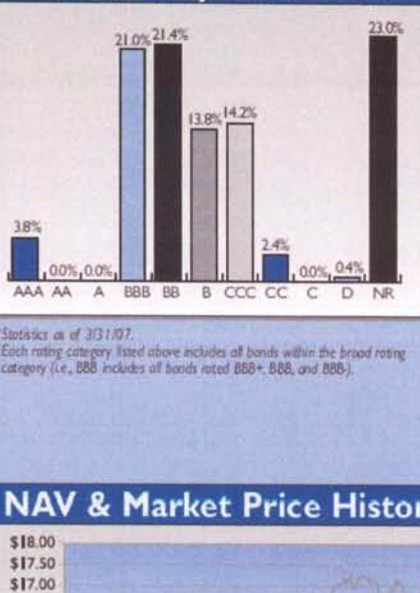

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†Each rating category listed above includes all bonds within the broad rating category (i.e., BBB includes all bonds rated BBB+, BBB, and BBB-).

Fund Facts & Performance*

Performance	RMA
Quarter	-1.08%
One Year	1.53%
Three Year Annualized	N/A
Since Inception Annualized	13.10%
SEC Yield**	10.98%
Expense Ratio	**3.22%**
Date of Inception	**11/08/04**
NYSE Symbol	**RMA**
Cusips	**74963L103**
Portfolio Manager	James C. Kelsoe Jr., CFA
Asst. Portfolio Manager	David Tannehill, CFA

*Statistics as of 3/31/07; assumes dividends are reinvested.
**SEC Yield assumes purchase at market price and an annualized current month's dividend; it does not take into account any commissions paid to purchase shares of the fund.
Total return performance calculations assume an investment at the common share market price or net asset value at the beginning of the period, reinvestment of all distributions for the period in accordance with the Fund's dividend reinvestment plan, and sale of all shares at the closing common share market price (excluding any sales loads) or net asset value at the end of the period.

Past performance is not indicative of future results.

NAV & Market Price History

Net Asset Value is calculated after the close of the exchanges each day by taking the closing market value of all securities owned plus all other assets such as cash, subtracting all liabilities, then dividing the result (total net assets) by the total number of shares outstanding. The market price is the last reported price at which a security was sold on an exchange.

Call 1.800.564.2113 or contact your financial advisor for more information on RMK Advantage Income Fund, Inc.

General: Certain risks associated with investing in the Fund are summarized below. Before investing, please read the Fund's prospectus carefully, especially the sections on risk, and consult your financial advisor. You may lose money by investing in the Fund.

Newly Organized: The Fund is a newly organized, diversified closed-end management investment company and has no operating or trading history. It is designed primarily as a long-term investment and not as a trading tool.

Investment Risk: An investment in the Fund's common shares is subject to investment risk, including the possible loss of the entire principal that a stockholder invests. The value of these securities, like other market investments, may move up or down, sometimes rapidly and unpredictably.

Stock Market and Equity Securities Risks: Because the Fund's shares are expected to be listed on the NYSE and the Fund may invest in stocks of U.S. and foreign companies, it will be subject to stock market risk. The value of such securities will be affected by changes in the stock markets, which may be the result of domestic or international political or economic news, changes in interest rates or changing investor sentiment. Factors that may have an adverse impact on a particular common stock's or preferred stock's price include poor earnings reports by an issuer, loss of major customers, major litigation against an issuer, or changes in governmental regulations affecting an industry. Adverse news affecting one company can sometimes depress the stock prices of all companies in the same industry. Stock prices typically fluctuate more than other securities.

Management Risk: The Fund is subject to management risk because it is an actively managed portfolio and there can be no guarantee that the investment techniques used and the investment decisions made will produce the desired results.

Leverage Risk: Unless the income and capital appreciation, if any, on securities acquired with borrowed funds or other leverage proceeds exceed the cost of the leverage, the use of leverage will diminish the Fund's investment performance. Fund stockholders will bear the cost of any leverage. Successful use of leverage depends on the ability of Morgan Asset Management (the "Advisor") to correctly predict interest rates and market movements, and there is no assurance that the use of a leveraging strategy will be successful during any period in which it is used.

Interest Rate Risk: Prices of debt obligations and other instruments in which the Fund may invest tend to fall as interest rates rise and rise as interest rates fall. Obligations with longer maturities tend to fluctuate more in price in response to such changes. In addition, the Fund's anticipated use of leverage will tend to increase interest rate risk.

Risks Associated with Below Investment Grade Debt Securities: The Fund may invest a significant portion of its assets in below investment grade debt securities, which are considered predominately speculative and may involve major risk or exposure to adverse conditions. The yields and prices of these securities may tend to fluctuate more than those for higher rated securities. Changes in economic conditions or developments regarding the individual below investment grade issuer are more likely to cause price volatility and weaken the capacity of such securities to make principal and interest payments than is the case for higher grade debt securities. The secondary market for below investment grade debt securities may not be as liquid compared to more highly rated securities, a factor that may have an adverse effect on the Fund's ability to dispose of a particular security when necessary to meet its liquidity needs. Factors having an adverse impact on the market value of below investment grade debt securities may have an adverse effect on the Fund's net asset value and the market value of its common shares.

Distressed Securities Risk: Distressed securities are generally rated CC or lower by S&P, comparably rated by another rating agency or are unrated but considered by the Advisor to be of comparable quality. Distressed securities frequently do not produce income while they are outstanding and may require the Fund to bear certain extraordinary expenses in order to protect and recover its investment. Therefore, to the extent the Fund seeks capital growth through investment in distressed securities, the Fund's ability to achieve current income for its stockholders may be diminished.

Value Investing Risk: The Fund's approach to value style investing involves risks that those securities may remain undervalued. Value securities as a group may be out of favor and underperform the overall equity market for a long period of time, while the market concentrates on other managed investment vehicles that pursue growth style investments and/or flexible style mandates.

Asset-Backed Securities Risk: Payment of interest and repayment of principal on asset-backed securities may be largely dependent upon the cash flows generated by the assets backing the securities and, in some cases, by certain credit enhancements. The value of these securities may also be affected by the creditworthiness of the servicing agent for the pool, the originator of the loans or receivables, or the entities providing the credit enhancement.

Mortgage-Backed Securities Risk: The value of mortgage-backed securities may change due to shifts in the market perception of issuers, changes in interest rates and regulatory or tax changes. Mortgage-backed securities may have less potential for capital appreciation than comparable fixed income securities due to the likelihood of increased prepayments of mortgages as interest rates decline. In addition, mortgage-backed securities are subject to the credit risk associated with the performance of the underlying mortgage properties.

Convertible Securities Risk: Convertible securities generally have less potential for gain or loss than common stocks, are subject to credit risk and are often lower-quality securities. Convertible securities generally provide yields higher than the underlying common stocks, but generally lower than compatible nonconvertible securities.

Foreign Securities Risk: The Fund's investment in securities of foreign issuers involve special risks, including the risk that they may decline in value in response to unfavorable political and legal developments, unreliable or untimely information, or economic and financial instability. These risks may be particularly pronounced to the extent that the Fund invests in securities of developing or "emerging market" countries.

Illiquidity Risk: Illiquid securities may be difficult to dispose of at fair prices at the times when the Fund believes it is desirable to do so. The market price of illiquid securities generally is more volatile than that of more liquid securities, which may adversely affect the price that the Fund pays for or recovers upon the sale of illiquid securities. Illiquid securities, including those securities purchased through a private placement, are also more difficult to value and the Advisor's judgment may play a greater role in the valuation process.

Market Discount Risk: Shares of closed-end investment companies often trade at discounts from their net asset values, and the Fund's shares may trade at market prices that are less than their initial public offering price. This risk may be greater for investors who sell their shares in a relatively short period of time after completion of the public offering.

Market Disruption Risk: The terrorist attacks in the U.S. on September 11, 2001 and other related events, including the aftermath of the war in Iraq have led to increased short-term market volatility and may have long-term effects on U.S. and world economies and markets. Additional terrorist attacks may adversely impact the Fund's operations and service providers, as well as other factors relating to the common shares such as interest rate, credit risk, and inflation.

Anti-Takeover Provisions: The Fund's Articles of Incorporation and By-Laws include provisions that could limit the ability of others to: acquire control of the Fund, cause it to engage in certain transactions or modify its structure. Such provisions may limit the ability of stockholders to sell their shares at a premium over the then-current market prices.

Derivatives Risk: Even a small investment in derivatives can have a significant impact on the Fund's exposure to fluctuations in interest rates or currency exchange rates. If changes in a derivative's value do not correspond to changes in the value of the Fund's other investments, the Fund may not fully benefit from or could lose money on the derivative position.

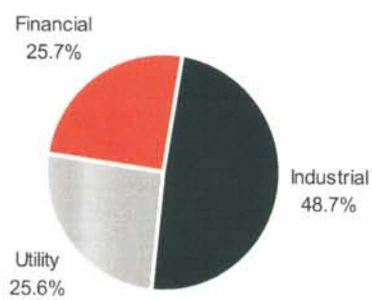
LEHMAN BROTHERS

U.S. Corporate High-Yield Index

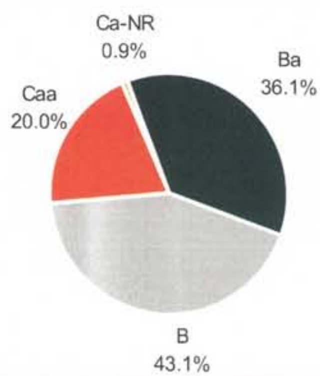
Overview

The U.S. Corporate High-Yield Index the covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High-Yield Index is part of the U.S. Universal and Global High-Yield Indices.

Sector Breakdown as of 12/31/2007



Quality Breakdown as of 12/31/2007



Access to the Index

LehmanLive Website
www.lehmanlive.com

KEY FEATURES
- Daily index returns and statistics
- Historical index time series downloadable into Excel
- Standardized market structure reports
- Fully customizable views
- Index primers and shelf reference documents
- Latest index and portfolio strategies research publications

Bloomberg Index Page <LEHM> <15>
Key statistics and returns
<LF98> <INDEX>

TICKERS
- Total Return Index Value: LF98TRUU
- Since Inception Total Return: LF98SIUU
- Month to Date Excess Return: LF98ER
- Market Value: LF98MVU
- Yield to Worst: LF98YW
- Mod. Adj. Duration: LF98MD
- Returns Mod. Adj. Duration: LF98RMD
- Average OAS: LF98OAS
- Maturity: LF98MAT

POINT (Portfolio and Index Tool)
Long Name: US HY
Short Name: hi-all

KEY FEATURES
- Index level returns and statistics
- Historical index constituents
- Fully customizable market structure reports
- Index dynamics and turnover reports
- Portfolio upload/analysis
- Multi-factor Global Risk Model
- Portfolio performance attribution
- Automated batch processing

Pricing and Related Issues

Sources & Frequency	All bonds are priced by either Lehman Brothers traders or FT Interactive Data (IDC) on a daily basis.
Pricing Quotes	Bonds can be quoted in a variety of ways including nominal spreads over benchmark securities/treasuries, spreads over swap curves, or direct price quotes as a percentage of par. In some instances the quote type used is a spread measure that results in daily security price changes from the movement of the underlying curve and/or changes in the quoted spread.
Timing	3:00 pm (New York time) each day. If the last business day of the month is a public holiday in the U.S. market, prices from the previous business day are used.
Bid or Offer Side	Bonds in the index are priced on the bid side. The initial price for newly issued corporate bonds entering the index is the offer side; after that, the bid side price is used. Fallen angels use the bid side prices.
Settlement Assumptions	T+1 settlement basis
Verification	Multi-contributor verification: The primary price for each security is analyzed and compared to other third-party pricing sources through both statistical routines and scrutiny by the research staff. Significant discrepancies are researched and corrected, as necessary. On occasion, index users may also challenge price levels, which are then reviewed by the pricing team. Prices are then updated as needed using input from the trading desk.

Contacts

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U.S. Corporate High-Yield Index

Rules for Inclusion

Amount Outstanding	Minimum outstanding par value of at least USD 150 million.
Quality	Must be rated high-yield (Ba1/BB+/BB+ or below) using the middle rating of Moody's, S&P, and Fitch, respectively (before July 1, 2005, the lower of Moody's and S&P was used). ◆ When a rating from only two agencies is available, the lower ("most conservative") of the two is used. ◆ When a rating from only one agency is available, that rating is used to determine index eligibility. ◆ A small number of unrated bonds is included in the index; to be eligible they must have previously held a high-yield rating or have been associated with a high-yield issuer, and must trade accordingly.
Maturity	At least 1 year until final maturity, regardless of optionality.
Seniority of Debt	Senior and subordinated issues are included.
Coupon	Fixed-rate. Original issue zero coupon bonds, step-up coupons, and coupons that change according to a predetermined schedule are also included.
Currency	Denominated in USD.
Market of Issue	SEC-registered, fully taxable issues or SEC Rule 144A securities (with and without Registration Rights).
Security Types	**Included:** ◆ Corporate bonds ◆ Fixed-rate bullet, puttable and callable bonds ◆ SEC Rule 144A securities ◆ Original issue zeros **Excluded:** ◆ Non-corporate bonds ◆ Structured notes with embedded swaps or other special features ◆ Private placements ◆ Bonds with equity-type features (e.g., warrants, convertibility) ◆ Floating-rate issues ◆ Eurobonds ◆ Defaulted bonds ◆ Emerging market bonds (sovereign rating of Baa1/BBB+ and below using the middle of Moody's, S&P, and Fitch) ◆ Pay-in-kind (PIK) bonds
Issuer-Capped Indices	Lehman Brothers provides a rules-based methodology for limiting issuer exposures to specified maximum levels where excess market value is redistributed either index-wide on a prorated basis or according to a sector-neutral basis. 1%, 2%, 3%, and 4% capped versions using the index-wide distribution method have been published for the U.S. HY, U.S. HY Ba, U.S. HY Ba/B, and U.S. HY B indices.

Rebalancing

Frequency	The composition of the Returns Universe is rebalanced monthly at each month end and represents the set of bonds on which index returns are calculated. The Statistics Universe changes daily to reflect issues dropping out and entering the index, but is not used for return calculation. On the last business day of the month, the composition of the latest Statistics Universe becomes the Returns Universe for the following month. Fallen angels do not enter the index until the next monthly reset.
Index Changes	During the month, indicative changes to securities (maturity, credit rating change, sector reclassification, amount outstanding) are reflected in both the Statistics and Returns Universe of the index on a daily basis. These changes may cause bonds to enter or fall out of the Statistics Universe of the index on a daily basis, but will affect the composition of the Returns Universe only at month-end when the index is rebalanced.
Reinvestment of Cash flows	Interest and principal payments earned by the Returns Universe are held in the index without a reinvestment return until month-end when it is removed from the index.
New Issues	Qualifying securities issued, but not necessarily settled, on or before the month-end rebalancing date qualify for inclusion in the following month's Returns Universe.

Index History

July 1, 2005	Fitch ratings added to Moody's and S&P to determine index eligibility.
October 1, 2003	Started using the most conservative rating of Moody's and S&P to determine index eligibility instead of Moody's only for split-rated securities.
July 1, 2000	Liquidity constraint raised to USD 150 million from USD 100 million. Defaulted securities removed.
January 1, 1998	SEC Rule 144A securities added.
January 1, 1986	U.S. Corporate High-Yield Index introduced, with historical data backfilled to 1983.
January 1, 1983	Inception date of U.S. Corporate High-Yield Index.

Indices are unmanaged and cannot accommodate direct investments. Past performance is not indicative of future results.