



ESM Management LLC

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Disclaimer

This advisory services brochure (“BROCHURE”) has not been approved by the Securities and Exchange Commission (“SEC”) or any state securities authority. It should not be relied upon to make any specific investment, legal, business, or tax decisions. Although ESM Management LLC is an SEC-registered investment advisor, this qualification does not imply a certain level of skill, training or track record.

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Advisory Services

ESM Management LLC (“ESM”) provides investment advice on acquiring, analyzing, or liquidating portfolios of non-agency residential mortgage backed securities (“NARMBS”).

For these services, ESM typically charges a fixed asset management fee ranging between 1% and 2% per annum on the asset value under advisement.

Some clients give ESM discretionary trading authority, and some do not. In the case of discretionary trading authority, ESM will build and maintain, and at times partially or fully liquidated an investment portfolio according to client preferences. For accounts where ESM has trading authority, clients may also choose to pay an incentive fee in exchange for a reduction in or elimination of the fixed management fee. Incentive fees are accrued as a percentage of the absolute return, either measured against a mutually agreed benchmark or against a hurdle rate.

If a client does not extend trading authority to ESM, ESM generally will make trade recommendations on an ad hoc basis as opportunities arise. In either case, ESM will work with the client to understand the risks and opportunities involved in the NARMBS market and provide periodic reports and market commentary (at least quarterly, but generally whenever a client requests).

ESM manages several small hedge funds, for which it has custodial control, although the fund assets are held at a qualified custodian. Most of ESM’s clients, however, hold their portfolios in their own accounts at a broker-dealer. ESM has several strong relationships with broker-dealers who are willing to execute trades in NARMBS for high net-worth retail customers off of their private banking platform.

We feel that the managed account structure works best for accounts who plan to invest \$1MM or more. It is possible to build a diversified portfolio of 8-10 securities, and the client has full control over his portfolio at all times, and, unlike in a hedge fund, is not exposed to problems caused by other investors’ liquidity needs.



Client Assets under Management

ESM currently manages 3 small hedge funds with a total of \$24MM in assets.

ESM also has about a dozen institutional and retail managed accounts with total assets of about \$122MM.

Most of the managed accounts are discretionary in that ESM has authority to trade the assets in the account subject to client-specified guidelines. Each of the managed accounts is custodied at either a Wall Street broker-dealer or a regional broker-dealer. ESM has no authority (except in the case of the hedge funds) to withdraw money or any other assets from any of the managed accounts.





Fees and Compensation

ESM generally charges a fixed asset management fee, which is an annual percentage of assets under management (“AUM”) or advisement varying from 1% to 2%. AUM for a particular account is determined by the book value of the portfolio on a daily basis (with adjustment to market value at the start of each calendar year) plus any cash that the client tells us is available for investment (which could be less or more than the total cash in the client’s broker account).

For discretionary trading accounts, ESM is willing to enter into alternative fee arrangements, which include a performance based (or incentive) fee coupled with a reduced fixed management fee.

Possible fee arrangements include 0.5% fixed plus 10% incentive fee; or 0.0% fixed plus 20% incentive fee; or 0% fixed plus 40% incentive fee subject to a 10% hurdle rate.

ESM has also entered into incentive fee arrangements where the performance is benchmarked against an index (e.g. the Merrill Lynch High Yield Corporate Index).

ESM currently has no other fee or compensation arrangements, although we may in the future do consulting work for a one-time fee.

ESM bills clients directly for management fees. ESM endeavors to do this at least semiannually, but no more frequently than quarterly, but in the case of very small absolute amounts, ESM may only bill at the end of each calendar year. Clients may pay by check, ACH transfer, or by wire.



Side by Side Management and Potential Conflicts

ESM has different fee arrangements with different accounts. However, we are committed to treating all accounts equally. Investment opportunities are allocated first and foremost according to the needs of each client's portfolio. Fee considerations (performance-based or otherwise) are completely ignored.

Some of the factors we consider when making allocations of a particular bond that we plan to purchase at an attractive price are as follows:

- 1) Does the bond fit the client's portfolio in terms of diversification, risk, and client preferences?
- 2) Does the client have enough available cash, and if so, does a particular allocation either use up that cash optimally or leave enough for the purchase of reasonable amount of another bond?
- 3) Is the bond a matcher for a position that the client currently holds, or does it create a new line item?
- 4) If the client must authorize the purchase (i.e. a non-discretionary account), will the seller give us enough time to get the necessary approval?

ESM weighs these factors against each other when determining how to make allocations among client accounts for bonds which are offered to us by brokers or bonds which are being auctioned. However, our main goal is to treat all clients on an equal footing without regards to fee arrangements or personal relationships.



Types of Clients

ESM has both institutional clients and retail clients.

Institutional clients include a pension fund, which has given us a small percentage of a multi-billion dollar portfolio to manage, a family office, and the three small hedge funds ESM manages.

Retail clients run the gamut from accredited investors with on the order of \$2MM in investable assets to ultra-high net worth investors with over \$100MM of assets.

Clients invested in the hedge funds merely have to be accredited investors, as that term/class is defined by the SEC.



Investment Strategies and Risk

ESM's main goal is to introduce and expose clients to the non-agency mortgage backed securities market, which we believe is one of the cheapest asset classes in the world.

Our strategy is simply long-only and buy-and-hold. As such, we do not generally hedge, and we usually aggressively reinvest principal paydowns and interest payments as long as we judge the market to be cheap on a fundamental basis. We feel it is up to each client to decide how much of his net worth he wants to invest in mortgage backed securities, but we will help him to gauge the risks and rewards and keep constant vigilance over his portfolio.

The reason we charge fees commensurate with many mutual funds is that our trading volume is very low, and once we have an account fully invested, it is not so labor-intensive to monitor the portfolio and reinvest monthly cash flows.

Most of modeling work is done for three purposes:

- (1) To make sure the investment is expected to get an adequate absolute return;
- (2) To make sure the investment is attractive relative to similar opportunities within the same asset class; and
- (3) To assess risk and limit losses due to a market downturn or a catastrophic decline in mortgage loan performance.

One of the key advantages we believe we have over competitors is that we are very experienced in and diligent about analyzing and understanding the operating documents behind every security. We have found literally dozens of examples where the market did not properly understand the documentation and was simply mispricing a bond. We have even found several examples where the Trustee and Trust Administrator was misreading the documents and was paying out cash to various tranches incorrectly.

Needless to say, such market inefficiencies present opportunities for significant outperformance.



Disciplinary Information

Neither ESM nor any of its principals or employees has had any disciplinary action taken against them by any regulatory authority. Nor has there been so much as a single complaint by any client, former or current.

Other Activities and Affiliations

ESM has no other material affiliations, in the financial world or otherwise. Although ESM has contemplated entering into other businesses, including Emerging Market fixed income, as well as investing directly into real estate or exchange traded mutual funds, it has not taken any significant steps in any of those directions.

Focusing on mortgage backed securities is a full-time job for both principals.

Code of Ethics

ESM has a Code of Ethics (“Code”) on file, which is reviewed periodically by the principals, especially the Chief Compliance Officer, Eric S. Meyer.

Basically, the Code lays out procedures for treating all clients on an equal footing, regardless of the fee structure. Also, the Code proscribes any trading in the subject securities for the principals’ personal accounts.



Brokerage Practices

ESM does not receive any direct compensation from brokers for either client referrals or for trades.

ESM does, however, receive research, market analysis, and even the use of certain proprietary models from brokers. We have found that the dozen or so brokers that we have used compete intensively for our business, and that we have not felt the need to direct any business to a particular broker in order to remain in good standing.

Review of Accounts

ESM reviews client accounts on an almost daily basis, at least when new price information comes in concerning any securities in the client's portfolio.

Each morning, the principals review how much cash each client has to invest, and whether there are any good candidate bonds on bid-wanted-in-competition lists (i.e. auctions).

Every month, the principals review the principal paydowns and loan performance as detailed on Bloomberg and in master servicer remittance reports. Also, each client portfolio is priced monthly using our internal valuation methodology.

Clients are invited to contact ESM at any time to review their accounts, preferences, and goals. Quite often we have had clients who needed to raise cash quickly for some personal reason, and we have been able to sell a portion of their portfolios at good prices in a timely fashion.



Client Referrals

ESM will make referrals to clients who need to establish a brokerage account suitable of trading and holding mortgage backed securities. ESM does not receive any compensation for these referrals, although there is no doubt that such referrals earn us some good will with the referred broker, which we attempt to monetize for the benefit of all clients.

Custody

Except for the hedge funds ESM manages, ESM does not have effective custody of any client assets. Even if the client grants trading authority to ESM, the client assets remain in the client's own brokerage account, and ESM has no authority to withdraw cash or any other assets at any time.

Financial Information

ESM is considered a Qualified Professional Asset Manager (QPAM), which is necessary for some types of trading for ERISA (i.e. pension fund or other retirement benefit) accounts. As such, ESM must maintain net equity of at least \$1MM at all times. ESM generally has no debt except for bills payable, and its gross assets are generally in the range from \$1MM to \$1.5MM.