

Demystifying the Structured Credit Jargon and Identifying the Opportunities

May 2007

Robert
Mead



A rampant proliferation of jargon has accompanied the evolution of the credit market in recent years. The coining of new words is showing few signs of slowing down. In many ways, learning all the jargon for “non-credit folk” is like a continental European, Japanese or American trying to decipher a Cricket scoreboard (LBW, ODI, C&B, etc.) or like an Englishman or Australian faced with an MLB stats sheet (RBI, HR, ERA, etc.). What do all these acronyms mean? I have barely begun the *Credit Perspectives* and am personally already looking forward to the Seventh Inning Stretch!

In this edition of *Credit Perspectives*, I will provide a brief glossary of terms that are regularly bandied about the structured credit market and a high level summary of the types of investors that have been active in the space. I will close by describing some investment opportunities that have been created by the advancements in the credit derivatives market. This piece, however, is only the first inning. Later in the game, in future installments of *Credit Perspectives*, I will focus on the credit market evolution in more depth.

Building Blocks

OK, let’s start with a brief warm-up by explaining the basic building blocks to help us cut through the credit jargon.

Corporate Bonds – Corporate bonds are a way for a company to borrow money by issuing securities. These bonds are issued by individual corporations from developed or emerging markets and can come in a variety of different currencies, with different maturities and different terms and conditions. The issuer pays interest for the borrowed sum through the so-called coupon. The underlying issuer of the bonds receives a rating of Investment Grade (BBB- or higher) or High Yield (BB+ or lower) from rating agencies such as Moody’s or Standard & Poor’s, which indicates the risk of default of an issuer with AAA being the least risky rating.

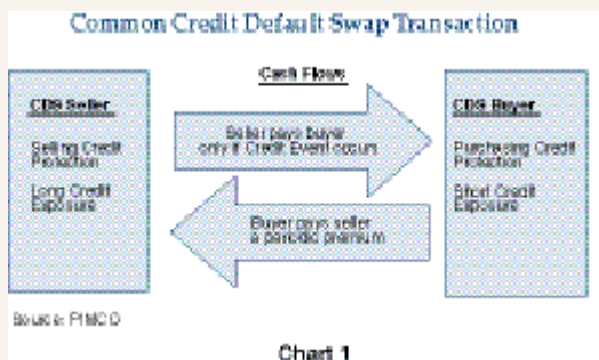
CDS – Credit Default Swaps – In its most basic terms, a credit default swap is similar to an insurance contract against default of the issuer. A credit default swap is an over-the-counter (OTC) agreement, which means that it is not traded on an exchange. CDS contracts are documented under guidelines from ISDA (International Swaps and Derivatives Association), using standard terms, which depend upon the asset class and domicile associated with the underlying reference entity. The two parties of the agreement transfer the credit risk of an issuer or basket of issuers from one party to the other without transferring the underlying bond or other credit asset. The buyer of CDS protection pays a periodic fee (“premium”) in return for a contingent payment by the seller upon a credit event (such as a default) occurring in the reference entity.

CDS allow for the transfer of pure credit risk of an underlying issuer independent from interest rate risk. CDS are quoted on virtually all companies and sovereigns with bonds outstanding, and occasionally for companies with no tradable debt.

Credit Indices – An index is in its most simple terms a basket of securities that tracks the performance of a broad asset class. The most commonly used indices are those created by large broker-dealer firms such as Lehman Brothers, J.P. Morgan, Merrill Lynch and Citigroup. Investment products based on such indices enable investment in a broad asset class rather than specific securities. In the credit markets, “tradable” credit indices provide extremely liquid ways to invest in (or short) credit markets.

One such index is the iTraxx Europe Main Index, which is a CDS on a portfolio composed of 125 equally weighted investment grade entities. Alternatives of this index with higher expected market returns exist, for example “HiVol” (a 30 name subset of the most volatile issuers from the Main Index) and “Xover” (an index of the most liquid high yield issuers). The U.S. counterpart of the iTraxx is the CDX North America with 125 names and in Australia, the iTraxx Australia Index with 25 names. New indices are created every six months to reflect changes in the index composition. The current version of the index is called “on-the-run” index.

Leveraged Loans – As an alternative to bonds, a market for tradable loans has developed. Leveraged loans (or bank loans) are most easily described as loans sold by investment banks to investment companies that pay an interest spread over a floating or fixed rate. Though they are technically not securities, lever-



aged loans are generally considered to be more senior than bonds in a company's capital structure.

The issuance of leveraged loans has exceeded growth in the high yield bond market in recent years, driven by the activity in the private equity and leveraged buy-out (LBO) space. Not all leveraged loans receive an independent rating but generally the credit quality is approximately equivalent to a high yield exposure (typically BB or B). Leveraged loans are issued from different levels within a company's capital structure (secured, senior, or subordinated).

LCDS – Loan CDS – In response to the increase in issuance, a derivative version of leveraged loans has developed, referred to as Loan CDS or LCDS. The main difference between CDS and LCDS is the underlying asset, which is a loan rather than a bond. As a result, there are some specific issues for the buyer and seller to consider, such as the refinancing of the underlying obligation, which has different ramifications in Europe versus the United States. LCDS provide a mechanism to synthetically short loans, hedge long positions and create fully synthetic CLOs, which I will explain below.

Structured Credit Products

Now that we have the building blocks we are ready to take on a structured credit product and really begin the first inning. To create a structured credit product, we first build a reference portfolio (also

referred to as a collateral pool) by using one or a multiple of the above-mentioned securities. We then issue securities backed by the collateral pool and – presto! – have what we refer to as a Structured Credit Product. These come in multiple forms, including the following:

CDO – Collateralized Debt Obligation –

A CDO is a special purpose investment vehicle or SPV. This vehicle is a company established for the special purpose of purchasing and holding a portfolio of assets, in this case debt obligations. The purchase of these assets is funded through the issuance of several classes of securities, so called “tranches”. In a full capital structure CDO, issued tranches range from the least risky AAA (Super Senior) tranche through to the most risky, unrated “equity tranche”, which absorbs any first losses before the next higher tranche absorbs any higher losses. The repayment of the securities or CDOs is linked to the performance of the underlying reference portfolio that serves as collateral for the CDO liabilities.

CLO – Collateralized Loan Obligation –

A CLO is a specific form of CDO where the underlying collateral pool comprises loans.

Synthetic CDO – A Synthetic CDO is a specific form of CDO where the underlying collateral pool comprises CDS contracts.

Single Tranche CDO – A Single Tranche CDO is a specific form of Synthetic CDO

where the full capital structure is not issued to investors. In this case, the “residual” exposure from the tranches that were not issued is “hedged” by the investment bank involved with the transaction.

CPDO – Constant Proportion Debt

Obligation – As referenced in the December 2006 *Investment Outlook* by Bill Gross, the original form CPDO was offered as a high coupon (LIBOR + 200 basis points), highly rated (AAA) and highly levered (approximately 15x) 10-year security, comprising formulaic rolling of positions in 5-year iTraxx and CDX indices.

Rolling describes the selling of the current contract at maturity and reinvesting into the new “on-the-run” contract with a later maturity. The indices were required to be rolled every six months in order to maintain the AAA-rating of the note, which is achieved due to the “self-cleansing” nature of the index roll. In every roll, companies downgraded below Investment Grade are replaced by higher quality names in the new index. The high leverage generates carry in excess of the coupon. This enables the CPDO to “cash-in”, i.e., repay the investor, and to de-lever before maturity, in the absence of losses due to defaults or excessive roll costs.

Following some detailed analysis and a lengthy discussion at PIMCO’s Investment Committee, it was calculated that credit spreads could only afford to tighten a further 3 to 4 basis points before the combination of coupon and rating could no longer be achieved.¹ As it turned out, we were correct.

Since the original CPDO was launched in late 2006, the product has evolved even further to now allow for investment manager involvement in the bespoke construction of the underlying collateral pool and the trading of the pool over time. These managed structures can reduce the risk considerably to the extent that leverage can be adjusted over time, longs and shorts can be implemented in the portfolio, curve trades may be used and positions may be rolled opportunistically.

Credit CPPI – Credit Constant Proportion Portfolio Insurance – this type of structure generally consists of two parts:

- A zero coupon note (i.e., a bond, without coupon, that pays no interest) that is sold at a discount from its face value and pays full face value at maturity, and;
- A "risky asset" that consists of a levered instrument in a portfolio of CDS.

The leverage is increased if the portfolio performs well and reduced if it underperforms. The performance of the note derives from the risky portfolio and can be due to a combination of long credit exposure (also known as market beta, which mirrors the market performance) and so called “alpha”, which is generated by actively managing a long/short portfolio.

Who Buys Structured Credit Products?

Now that we know the game, let’s look at

structured credit products since 1996 across a broad variety of underlying asset classes, including: high yield and investment grade bonds, asset-backed securities, leveraged loans and synthetic CDOs comprising investment grade, crossover and emerging market collateral. As a result, we have an extensive database of the types of investors that have participated in our transactions to date.

From this database, we can offer the following insights:

- Banks, insurance companies, asset managers and private investors have – in that order – tended to dominate the activity.
- Investors have been domiciled in all regions of the world and specifically in the following countries: Australia, Austria, Belgium, Canada, China, Denmark, Finland, Germany, Hong Kong, Israel, Japan, Korea, Luxembourg, Malaysia, Netherlands, New Zealand, Philippines, Portugal, Saudi Arabia, Singapore, Switzerland, Taiwan, Thailand, United Kingdom and USA.
- There has been global interest in the full capital structure, from AAA “Super Senior” tranches through to unrated equity investments, including principal protected versions.

Investment Opportunities

Credit derivatives and structured credit products are here to stay, so let us take a

look at some of the technical intricacies of the sport. The impact of the flows from these products can have direct influences on the pricing of all credit markets. As a result, whether an investor is directly invested in these areas or not, it is still essential that they themselves – or more likely their fixed income manager – is ahead of the curve in terms of understanding the pitfalls and investment opportunities these advances have created. I outline a sample of these below:

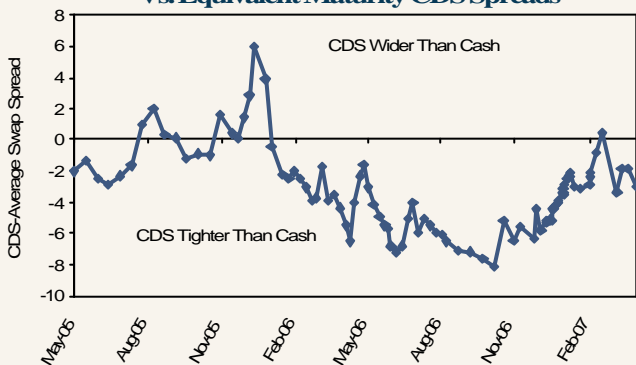
Static Versus Managed Portfolios –

Advancements in credit derivatives have facilitated the construction of so called static transactions (where the initial reference portfolio is not changed throughout the life of the transaction) and managed transactions (where the initial reference portfolio is actively managed over time by an independent investment manager). The technological development in the structured credit arena has increased the flexibility of the investment manager in terms of trading the underlying collateral pool.

Despite the numerous innovations in the credit markets, the credit cycle is NOT dead. As a result, we believe portfolios that are actively managed by third party investment managers with dedicated credit resources will be the outperformers over time. Also, considering that many such structures have final maturities of 10 years, the expectation of a benign default environment for the next two years should not provide too much comfort for the “buy-and-hold” investor.

Basis Trades – “Basis” is in this context a measure of the difference in spread (or interest rate differential to LIBOR) between a physical security and the derivative equivalent, for example of a bond and the equivalent CDS. Basis is not stable over time, so it can generate investment opportunities. In a negative basis trade, for example, a CDS trades at tighter spread levels than cash bonds. We can then buy the wider bond and buy the cheaper protection through CDS.

Average Swap Spread of 70 Non-Financial iTraxx Europe Reference Obligations Vs. Equivalent Maturity CDS Spreads



Source: Merrill Lynch

Chart 2

Positive carry, where the returns on a position exceed the financing cost, with very low risk, is the type of trade we focus on when implementing basis trades across all PIMCO portfolios.

Long / Short – In a long/short strategy, an investor buys one asset and sells another asset that he will buy back at a later point in time. This implies that the investor expects a price increase in the long

position, while he expects the short position’s price to fall. If the forecast proves correct, it allows the investor to buy the shorted asset at a cheaper price in the future than the current sales price. In the credit world, long/short can be implemented in many different guises, for example:

- Buy/long corporate bond versus sell/short CDS of the same issuer with the same maturity;
- Buy/long CDS of company A versus sell/short CDS of company B with the same maturity;
- Buy/long 5-year CDS versus sell/short 2-year and 10-year CDS, which is also known as a “butterfly” trade.

Summary

It is time to catch our breath now. This edition of *Credit Perspectives* is meant as a guide to deciphering some of the jargon used in today’s credit market. We hope this serves as a starting rather than ending point in terms of unraveling some of the mysteries of the credit markets so that you can start enjoying the structured credit products game. In the second inning, we will immerse you further in the game and introduce you to some of the moves and tactics like correlation and tranche trading.

Robert Mead, CFA
Executive Vice President

¹Spreads were calculated based on the 5-year iTraxx main index and the CDX ig7 index.


Past performance is no guarantee of future results. This article contains the current opinions of the author but not necessarily those of Pacific Investment Management Company LLC. Such opinions are subject to change without notice. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Structured Credit Products such as Collateralized Debt Obligations (CDO), Collateralized Loan Obligations (CLO), Constant Proportion Portfolio Insurance (CPPI), and Constant Proportion Debt Obligation (CPDO) are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated and qualified investors who are capable of understanding the high degree of risks involved. Use of these instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, volatility risk, management risk and the risk that a portfolio could not close out a position when it would be most advantageous to do so. Portfolios investing in these products could lose more than the principal amount invested in those instruments. The market value of any structured products may also be affected by changes in economic, financial, and political environment (including, but not limited to spot and forward interest and exchange rates), maturity, market condition and volatility, and the credit quality of any issuer.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660. ©2007, PIMCO.

P I M C O

840 Newport Center Drive
Newport Beach, CA 92660
949.720.6000

A company of  Alliant
Global Investors