

Changing on The Fly: Canadian Credit Markets

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As a bond guy, I had the good fortune to move to sunny Southern California last year to join one of the world's premiere bond shops. And as a hockey guy, my good fortune has continued with my local team, the Anaheim Ducks, advancing beyond the second round of the NHL playoffs. While my allegiances will always be with the Canadian contenders, I think the Ducks have a good shot at winning the Stanley Cup this year. Hockey provides a good way to think about the subject I'd like to address in this article – the transformation of the Canadian credit market.

The NHL has gone through a remarkable transformation from the days of my youth and the original six teams to today's fast-paced game. Until the turn of the millennium, Canada's credit markets were like the old-fashioned NHL, before the expansion of the league and the influx of players from Europe and the former Soviet Union. Trying to differentiate oneself as a corporate bond manager was as difficult as trying to come from behind in the 3rd period against the 1976 Montreal Canadiens with Larry Robinson and Serge Savard on defense and Ken Dryden in goal. With the market dominated by issuers in the highly regulated financial and utilities industries, and with investors trapped by the Foreign Property Rule, Canadian credit markets were expensive, tranquil and relatively immune from the forces affecting other global markets.

Over the years, the NHL has expanded from the original six of my youth to the current 30 teams and the game has evolved from its traditional roots as a Canadian sport (where toughness and canny were most important) to a global sport with a focus on fitness, speed and a wide-open style of play imported from around the world. The same is true in credit, which is now truly global. In the old days, one of the main determinants of credit risk was the country in which the company was headquartered. Local regulations defined the level of competition. Local markets dictated the ability of a company to raise financing. The cost structure was imposed by the local labor pool and local cyclical conditions.

Today, portfolio managers must view credit risk as global. Industries from auto manufacturing to financial services have significant operations outside their home countries and face competition from around the world. Just as globalization has wrought changes in the NHL, the Canadian credit markets are in the process of normalizing to global standards. These changes are happening quickly. Just as the industrialization of Asian countries is happening in a fraction of the time it took G7 countries to develop, the Canadian credit

markets are evolving to global standards in a fraction of the time that it took some of the larger markets to develop. This creates large opportunities as well as large pitfalls – exactly the kind of environment that PIMCO likes to see.

As Canadian credit markets transition from the backwater of the global capital markets to joining the mainstream, issuers from across the globe come to Canada to diversify their funding sources and Canadian investors have the opportunity to seek returns abroad. The latest financial technologies, such as credit derivatives and securitization, are becoming universal and are creating enormous opportunities for savvy investors. But the new world will also present challenges for investors without the considerable resources needed to assess these new credits and instruments.

Changes We Have Seen To-Date

At PIMCO, we like to stay on the leading edge of innovation. This does not mean we are an early adopter of all new products, but that we spend time to rigorously understand how to value new instruments developed in the capital markets. If we find there are excess risk premiums that can be captured by being a first mover, we will invest in an effort to capture

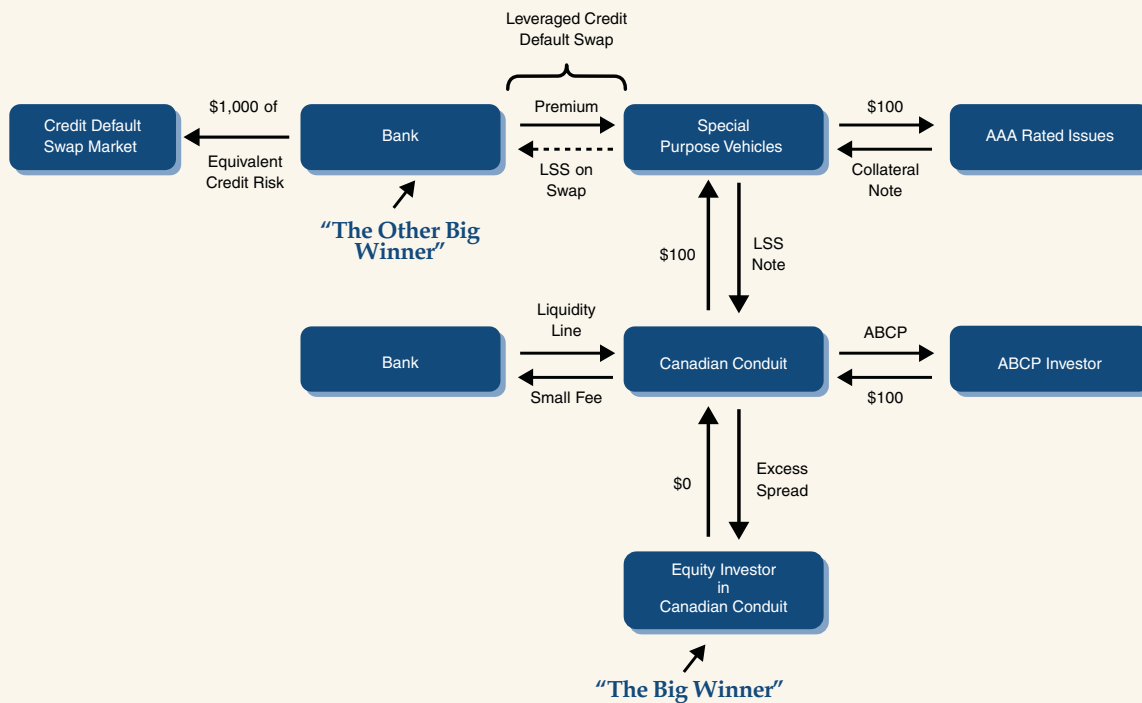
this value for our clients. If, on the other hand, we do not see value, we will avoid, or even short these investments with the goal of outperforming the benchmarks we are measured against.

To date, some of the innovations adopted in the Canadian credit market mainly benefit issuers and dealers, rather than investors. In such cases, PIMCO declines to invest, or takes the “other side” of the trade. I want to focus here on two examples of these less investor-friendly innovations: Asset-Backed Commercial Paper (ABCP) issued by independent conduits (these are thinly capitalized entities, as opposed to the bank-sponsored conduits) and Maple bond issuance (a term that refers to non-Canadian

entities issuing Canadian dollar-denominated bonds into the local market).

Asset-Backed Commercial Paper

Independent Canadian conduits have issued many billions of dollars of R1-High rated commercial paper to a broad range of investors in Canada offering a modest yield enhancement of approximately 5-10 bps compared to traditional bank ABCP or corporate CP. Often these conduits invested the proceeds from ABCP issuance into AAA-rated leveraged super senior (LSS) notes of synthetic Collateralized Debt Obligations (CDOs). The process of creating these notes is complicated (see the diagram below), but simply put, for every \$100 dollars invested by the conduit, they were exposed to



\$1000 of credit risk. You don't have to be a financial engineer to understand that, by definition, these are risky investments.

This was a great deal for equity investors in the independent conduit – they captured the spread between the rate of return on the notes and the return they paid on the ABCP. At one point so many of LSS notes were arranged by Wall Street and Bay Street on behalf of Canadian conduits (thanks to the cheap financing provided by the ABCP investors) that they became the marginal price setter in the global market for credit risk!

The leveraged tranches of CDOs are not necessarily bad in and of themselves. It is when they are held in conduits with poor disclosure and leveraged by another 100% by the issuance of ABCP that one starts to worry about the prudence of such an arrangement. As one of my early mentors once said to me "Ed, leverage is like booze – a little bit can be fun, but too much will mess you up!" The problems arise if default rates increase dramatically. In that event, which is unlikely but not impossible, the equity investors in these conduits would walk away from their small investment, leaving the ABCP investors holding the bag. How many

ABCP investors understood this dynamic? My guess: very few. I bet they just thought they were buying R1-high commercial paper at a small pick-up to similarly rated commercial paper.

The reason conduits were able to exploit this spread differential between LSS notes and ABCP was that Dominion Bond Rating Service (DBRS), who rates the ABCP, allowed narrowly defined terms in the liquidity lines to support these conduits. In January, DBRS changed their rating criteria to effectively prevent conduits from purchasing LSS notes (although, notes already purchased are grandfathered – tick, tick, tick).

Needless to say, PIMCO has not invested in the ABCP of any Canadian conduits, but we have found a way to capitalize on their market impact. Demand for leveraged synthetic CDOs has resulted in the compression of credit default swap premiums relative to spreads on corporate bonds. PIMCO has been able to buy a corporate bond, buy credit protection against the default of the bond, and pick up a positive spread over the swap curve. Basically, we invested in a bond, fully hedged the credit risk, and still earned a spread comparable to what

could be achieved by investing in the SUBORDINATED debt of a Canadian bank. We think this is a much wiser way to exploit innovation in the marketplace.

Maple Market

Another innovation in the Canadian market is the growth of the so-called Maple market. Once the Foreign Property Rule was repealed in 2005, non-Canadian issuers began to ramp up their issuance in the Canadian market. This has been widely heralded as a way for Canadian investors to diversify their credit risk, and increase portfolio performance. While PIMCO agrees in principal, it is not as simple as that. Most of the issuers that have come to the Canadian market to-date have been AA- and AAA-rated “arbitrage” issuers. These are sophisticated entities that are constantly looking around the world for the cheapest source of funding. When the Canadian market opened up to them, they were more than happy to issue into the market at substantially cheaper funding levels than they could achieve in other, more developed markets around the world. The arbitrage issuer, who has no need for Canadian dollar funding, uses the swap market to convert the CAD funding into the currency in which they need the money.

Philosophically at PIMCO, when we take credit risk, we want the best possible compensation. Why buy a bond in Canadian dollars if we can buy the same bond in U.S. dollars with a higher rate? We can do exactly the same arbitrage as the Maple issuer, using the swap market to convert an attractive U.S. bond into a Canadian dollar bond. When arbitrage issuers issue in the Canadian market, almost by definition, the investor is accepting a lower return than what could have been achieved by purchasing their bond in another currency and “swapping” it back to Canadian dollars. This is not to say that all Maple issuance has been priced to the detriment of the Canadian investor. But much of it has, and that is why PIMCO has been very selective in our Maple investments. Again, the Maple market is another example of where experience in the global credit markets makes a difference. The right question an investor should be asking when a dealer calls with a Maple bond for sale is not “what is the spread to Ontario,” but “what is the spread when compared to similar issues in Euro or U.S. dollars.”

Changes We Expect to See

We are at an exciting time in the history of the Canadian credit markets. Until now, most of

the Maple issuance has been quasi-sovereign and financial credits rated AA or higher. This made sense in the past because most domestic asset managers did not have the credit research staffs to be able to analyze lower grade international credits. But this will change. We have already seen some issuance of lower rated credits in Canada and we will see more in the future. Of course, whether or not these are good investments will depend on the pricing, but the Canadian market will certainly become more integrated into the global market for credit. With this integration, spreads in the Canadian market should normalize to levels seen around the world. Conceptually, Canadian investors are “paying up” to get new credits into their portfolios that are denominated in Canadian dollars. At some point in the future, the process will end as demand from Canadian investors matures. When we reach that point, spreads for securities in Canada’s secondary market will widen to be comparable to other markets.

We will also see an end to the enormous bull market for credit, probably due to a combination of a peak in the current business cycle and a withdrawal of global excess liquidity. When this happens, credit spreads in Canada will

likely become much more volatile. No longer will the Canadian credit market be an island unto itself, it will be part of the global market for credit that will react to events in Asia, Europe and the U.S. My sense is that this will be a shock to many market participants who are not used to such volatility.

As a matter of fact, we are seeing this play out in a small way as I write this article. For the first time, the Canadian credit market is reacting to leveraged buyout (LBO) risk. Canada has seen some private equity deals in the past, but never a major transaction affecting the spreads of investment grade bonds. BCE, Canada’s telecom giant which recently confirmed that it is reviewing strategic options, could be Canada’s version of the “Barbarians at the Gate” (the famous book by Bryan Burrough and John Helyar that described the takeover of RJR Nabisco by buyout firm KKR). Just as the RJR Nabisco transaction stood as the beacon of the debt crazed buy-outs of the 1980s, so too could the BCE takeover stand as the wake-up call for credit investors in Canada. We are seeing credit spreads widen on several names as investors who have been hurt by the widening of Bell Canada credit spreads sell now, and ask questions later. PIMCO has virtually no

exposure to BCE/Bell Canada and will be carefully monitoring events to see whether the credit markets are properly reflecting the risks in the new capital structure of the firm (whatever it turns out to be). Given that Canada does not have a well-developed high yield market, a leveraged buyout of BCE could result in many forced liquidations of Bell Canada bonds by investment grade only asset managers. This could result in a very ugly situation for current investors (and an opportunity for new investors). As Baron Von Rothschild once said, "The best time to invest is when the blood is flowing in the streets."

The Dawn of a New Day

Yes, the Canadian credit markets have changed dramatically, and the pace of change is only set to increase. A small part of me thinks fondly back on the simple old days of investing in the market, just as I look back fondly on the days of watching the Leafs play the Habs in black and white on CBC. But life moves on, the NHL has never been more exciting to watch with Sidney Crosby, Evgeni Malkin and Alexander Ovechkin blazing across my flat screen TV in high definition. Each new day, I look forward to finding exciting opportunities to generate alpha, whether in corporate bonds, asset-

backed securities or credit derivatives. While we at PIMCO may not be as much fun to watch as professional hockey players, we do train hard in an effort to maintain our competitive edge in the credit markets.

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¹ Bay Street, where the Toronto Stock Exchange (TSE) is located, is the Canadian equivalent to Wall Street.

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Past performance is no guarantee of future results. Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries, TIPS and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed. Mortgage-backed securities are subject prepayment risk and may be sensitive to changes in prevailing interest rates, when they rise the value generally declines. With corporate bonds there is no assurance that issuers will meet their obligations. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Investing in non-U.S. securities may entail risk as a result of non-U.S. economic and political developments, which may be enhanced when investing in emerging markets. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Investments in Collateralized Debt Obligations ("CDOs") may involve a high degree of risk and are intended for sale only to qualified investors capable of understanding the risks entailed in purchasing such securities. Such securities can principally cause a decrease in income, which result in a decrease in residual profits. If the collateral performs inadequately, investors may lose some or all of the investment and there may be periods where no cash flow distributions are received. Investors investing in CDOs and the underlying asset classes are exposed to the following risks a) default risk; b) limited liquidity risk; c) management risk; d) existence of actual and potential conflicts of interest between the collateral manager and other issuers and affiliates; e) the dependence on certain key personnel managing the CDO; f) investment restrictions imposed on the acquisition, disposition, and holding of portfolio collateral; g) volatility of the market value of the portfolio collateral and the securities; h) interest rate risk; and i) credit risk by the underlying portfolio. Leverage Buyout ("LBO") is a takeover of a company that uses borrowed funds. Often, the target company's assets serve as security for the loans taken out by the acquiring firm, which repays the loan out of the cash flow of the acquired company.

Swaps are a type of derivative in which a privately negotiated agreement between two parties takes place to exchange or swap investment cash flows or assets at specified intervals in the future. There is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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