CREDIT-BASED SOLUTIONS

A new breed of solutions embraces credit instruments

Ope Agbaje outlines some of the innovative credit-based solutions available as alternatives to traditional sovereign and credit fixed income strategies to fill the satellite space

Traditional approaches to asset allocation have tended to focus on packaging together risk and return into one portfolio in the pursuit of outperformance. However, there has more recently been a gradual shift towards separating out these two key components into distinct strategies, whereby the portfolio is composed of a highly risk-controlled 'core' products, combined with more flexible 'satellite' products that are focused on alpha generation.

This asset allocation strategy is typically composed of a core portfolio that incorporates strategies invested against liquid benchmarks and managed within very tight risk parameters. Such core strategies include traditional equity and fixed income products that are either passively or actively managed against benchmarks such as S&P 500 and the JP Morgan Government Bond Index, respectively. The satellite portion allows the investor to select more aggressive and often less liquid strategies that have lower correlations with the core component and provide the portfolio manager with the flexibility to generate attractive returns. Within this space, investors have the opportunity to add more specialist asset classes, including absolute return products, hedge funds, commodities and property depending on individual risk budgets (see figure one).

NEW CREDIT-BASED PRODUCTS

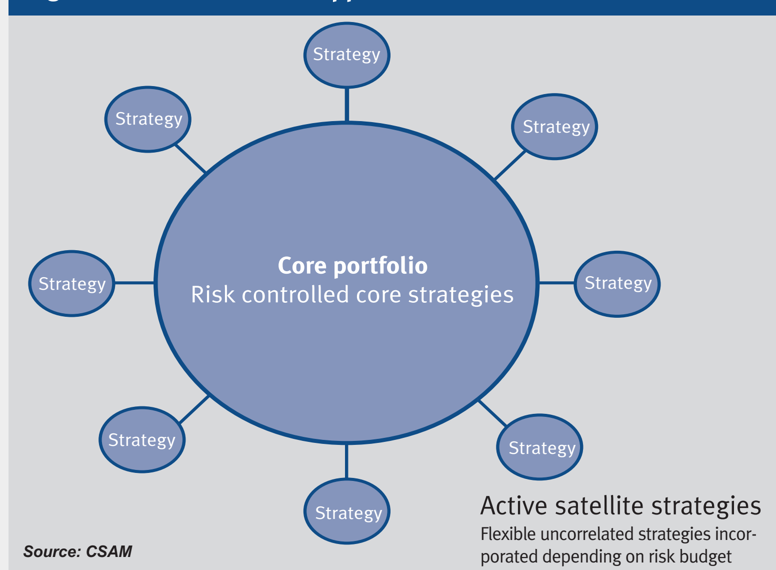
Within the fixed income world, a broad range of innovative alpha generating strategies can be employed as the satellite component of a diversified portfolio. However, while investors are becoming more familiar with asset classes such as convertibles, high yield and emerging market debt, a number of new credit products also make attractive satellite components.

"INVESTORS IN ASSET BACKED SECURITIES GAIN EXPOSURE TO A LIQUID FIXED INCOME POOL OF ASSETS"

One asset class that is beginning to receive more attention is asset backed securities (ABS). These products have been developed from a financing technique called securitisation, whereby a company will pool its assets together to guarantee the issuance of bonds, which are then sold to investors. A common example is a financing company that issues auto loans and wishes to raise new finance so that it can continue to issue more loans. By packaging a large number of loans together, it can sell interests in the pool through the issuance of bonds to investors.

The key advantage for corporations is that this process frees up the balance sheet in order to develop new sources of capital. For financial services organisations, this has a further benefit in that by removing assets from their balance sheet, the need to retain a large amount of capital on the books to meet strict banking regulations is substantially reduced. Other common issuers within the market include finance companies dealing with credit cards

Figure one: Core satellite approach to asset allocation



Source: CSAM

and home loans and as with the autos example, these loans are packaged together as the collateral for securities and sold in the capital markets as floating-rate or fixed-rate bonds.

BENEFITS FOR INVESTORS

There are a number of important advantages for investors holding asset backed securities. Firstly, they gain exposure to a liquid, fixed income investment in a diversified pool of assets, such as auto loans, which make an attractive alternative to a corporate bond or other fixed income investment. In some cases illiquid assets, or assets which investors would not ordinarily have access to, such as loans to small and medium enterprises, make up the pool of assets. However, unlike unsecured bonds, which are fully dependent on the operating, payment ability and ultimately bankruptcy risk of a company, asset backed securities to various degrees tend to be removed (fully or partly) from those risks.

Typically, they are legally separated from the originator and rely entirely on the performance of the ring-fenced assets, transferred and pledged as bond collateral. Simply put, the investor buying the securities is not exposed to the credit risk

A NUMBER OF ABS ISSUES ALSO BENEFIT FROM EXTERNAL PROTECTION IN THE FORM OF INSURANCE"

associated with originator of the assets and, thus, ABS bonds represent one of the more secure forms of fixed income securities from a credit quality standpoint.

A number of ABS issues also benefit from external protection in the form of insurance, such as a credit enhancement provider that ensures the quality of the issue, as well as a liquidity provider that covers certain cashflow shortfalls. Features such as these contribute to a higher rating stability of this asset class, when compared to similarly rated corporate bonds. This is highlighted in figure two, where 99.15 per cent of structured finance ratings maintain an Aaa rating, while 91.68 per cent of corporate finance ratings retain an Aaa rating. An additional point, is that around 90 per cent of the ABS universe is AAA rated, while there are few similarly rated corporate bonds.

A further benefit for the investor is that the risk associated with consumer credits, such as credit cards and home loans, can be more easily calculated using advanced quantitative techniques, without the same level of subjectivity often associated with other fixed income debt such as corporate bonds. This is because a statistical approach can be more relevant for some asset back bonds that have a homogenous underlying collateral consisting of thousands of loans.

While ABS bonds have long been a key component of many fixed income strategies, the search for new sources of yield have led many investors to the ABS market. This growing demand has been met with

Figure two: Global structured finance annual ratings stability compared to global corporate annual ratings*

Structured finance in 2004:

Ratings from	Aaa	Aa	A	Baa	Ba	B	Caa or below
Aaa	99.15%	0.33%	0.22	0.09%	0.11%	0.08%	0.03%
Aa	6.67%	90.52%	1.46%	0.39%	0.18%	0.30%	0.48%
A	1.45%	4.56%	91.30%	1.55%	0.52%	0.17%	0.45%
Baa	0.29%	0.92%	3.70%	90.58%	2.48%	0.73%	1.29%
Ba	–	–	0.11%	0.22%	3.65%	81.07%	14.94%
Caa or below	–	–	–	–	–	0.70%	99.30%

Corporate finance: 1983-2004 average

Ratings from	Aaa	Aa	A	Baa	Ba	B	Caa or below
Aaa	91.68%	7.53%	0.76%	–	0.02%	–	–
Aa	0.92%	90.61%	8.03%	0.32%	0.08%	0.01%	0.03%
A	0.04%	2.50%	91.09%	5.52%	0.62%	0.19%	0.03%
Baa	0.04%	0.25%	5.66%	87.62%	5.01%	1.06%	0.36%
Ba	0.01%	0.03%	0.55%	5.60%	83.30%	8.41%	2.09%
B	0.01%	0.05%	0.21%	0.55%	6.00%	82.27%	10.90%
Caa or below				0.88%	2.25%	6.44%	90.43%

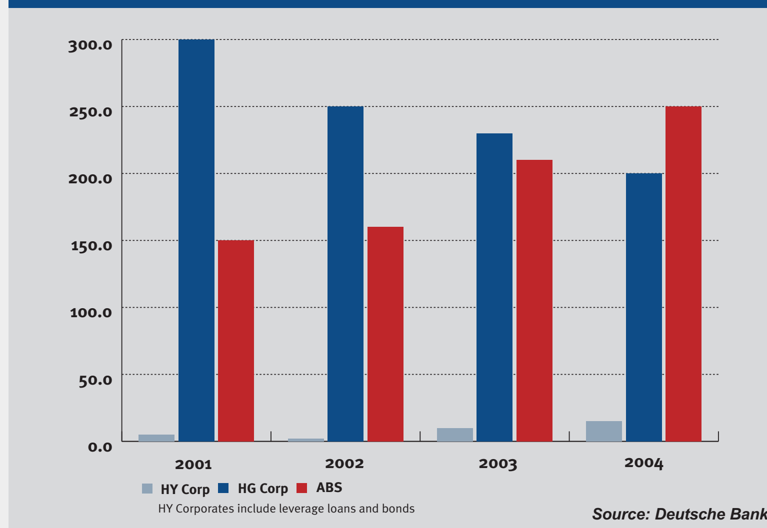
Source: Moodys

**Figure shows transition matrices for both products*

year-on-year increases in issuance, particularly since low interest rates in the Europe and the US have encouraged higher levels of liquidity and personal credit demands (see figure three). This in turn has developed the ABS universe further, deepening the market and offering better diversification opportunities.

With both demand and issuance rising, a new appetite for ABS-only fund products has been seen from investors who wish to incorporate them into their portfolio and benefit from a potential pick-up in yield. Given the breadth of the ABS universe, a number of possibilities exist to create satellite type products with cash plus benchmarks. For instance, at the plain vanilla end are residential mortgage backed securities (RMBS) or other traditional ABS bonds, which are typically backed by consumer debt such as credit cards and auto loans.

Figure three: European fixed income issuance



At the other end of the scale are collateralised debt obligations (CDOs), which are structured securities mostly backed by corporate bonds or other corporate debt, including ABS securities, and subject to more idiosyncratic risk.

When compared to non-sovereign bonds with similar maturities, these ABS sub-sectors offer attractive risk/return profiles and their inclusion within a portfolio provides the potential to enhance returns. This is a particularly important feature in the current credit market that is characterised by tight spread levels and low volatility, particularly amongst European bonds. In fact, some ABS issues carry higher yields than many corporate bonds of comparable quality and maturity.

This is partly as a result of the level of intensive fundamental analysis required to fully evaluate the ABS structure and underlying collateral. For instance, a broad range of expertise is required to fully understand and quantify the risks within ABS issues. Default risk represents one of the major sources of risk within credit markets, and its analysis is particular important for ABS structures that have multiple bonds packaged together to form the collateral.

One common approach to risk analysis used is Monte Carlo simulation, a technique used to randomly simulate the likely default, recovery or loss behaviour within a portfolio of assets. In performing such calculations, the performance of the underlying collateral can be modelled and evaluated in terms of probable distribution of default risk, correlations between the underlying collateral bonds and recovery expectations. However, what separates the ABS universe from other fixed income sectors is the breadth of analysis required. For instance, analysis must also include a legal perspective, given that ABS bonds are essentially the product of structured finance deals. Also, for some ABS issues, such as managed CDOs, further analysis may be required in order to determine the risk of poor management of the CDO in question. For these reasons, asset managers such as Credit Suisse Asset Management have focused on developing a global credit research platform that has the capability to undertake this level of multiple risk analysis.

In conclusion, for investors considering the core-satellite approach to asset allocation, a wide range of innovative solutions are now available to fill the satellite space. While asset backed securities are only now beginning to appear on the radar screen of mainstream investors, the search for yield will see a growth in new credit based solutions that offer distinct advantages over traditional sovereign and credit fixed income strategies.

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