Cool heads rule in CDO land

While many who invested in the collateralized debt obligations market in the 1990s are bailing out after heavy losses, new players with a less emotional approach are enjoying some attractive gains. • ***Antony Currie** reports*

RON D'VARI IS your typical investor in CDOs. Anyone who attended February's ABS West conference in Phoenix is probably thinking that means D'Vari hates CDOs, or collateralized debt obligations, to give them their rather more cumbersome full title.

But that would make him your typical *former* investor in CDOs. There are certainly plenty of those around, who have lost heavily on CDOs and given up on the market. D'Vari, on the other hand, is very active in the CDO market, both as an investor and, more recently, a manager of CDOs.

On the morning *Euromoney* spoke to D'Vari, who runs the CDO group for State Street Research and Management, he had been looking at seasoned cash tranches in the secondary market, as well as synthetic CDOs. The latter are particularly attractive. "We like synthetic, highly diversified deals run by seasoned managers. The financing of super triple-A tranches is very helpful. It's cheaper financing, which cash deals don't have. You can get 20bp to 30bp of additional reserves from cheaper liabilities. That could be worth half of any potential defaults. Two or three names could break a deal at the margin, so any additional advantage is very helpful."

Synthetic CDOs, or CSOs as some call them, are the growth area of the market. Alex Reyfman, CDO analyst with Goldman Sachs in New York, estimates that $56 billion-worth of CSOs were issued in the US last year and €64 billion in Europe. The vast majority, he says, came from static synthetic CDOs, which are usually private placements for which no accurate figures are available. His figures suggest that $38.42 billion was issued in the US and €53.85 billion in Europe, but he says that "these estimates are almost certainly much too low, missing many private transactions".

Many of those who invested in CDOs in the 1990s simply aren't taking part in this market any more. They have watched as tranche after tranche of what they were assured was solid investment-grade securitized paper underwent multiple downgrades. Last year Moody's and Standard & Poor's downgraded 150 cashflow transactions, 108 more than in 2001. "There's a pretty large portion of the population of investors who have suffered losses on highly rated paper who say they won't buy CDOs any more," says Greg Mount, managing director and global head of CDOs at Goldman Sachs.

A lot of them seem to have been at the February conference, and the impression they left was that investors loathe CDOs: the bad structures, the overselling, the multiple downgrades forcing them to sell their holdings at a substantial loss, the poor oversight by both trustees and the rating agencies.

Admittedly, investors were venting their frustration and fury at the asset-backed market in general. They've been badly burnt by the collapse of online bank and credit card company NexCard and by the mess at healthcare company National Century. And they're mad. "They were blaming everyone from underwriters to rating agencies to trustees," says a banker who attended the conference. "They were silent about their own culpability, of course."

But the asset class that investors were most annoyed with was CDOs. And they're getting out. "The ones pulling out are what we call the yield chasers," says Jeff Bohn, managing director at Moody's KMV. "By which we mean those that were just hunting for a good spread on the triple-A to triple-B tranches. Usually it's the large funds which fall into that category, such as insurance companies, some of the big bond funds, and even some commercial banks."

Quant views rule

Now, he says, "those stepping into the market are usually those with quant views who are less emotional about the market". He mentions hedge funds and asset-management arms of European financial institutions as two categories of new players. But, he cautions, "there probably are still some gunslingers out there taking bets". Goldman Sachs's Mount adds: "Most of the new investors in the market are more the structured-credit professionals who are getting involved in the structuring of the deals."

D'Vari belongs very much in the latter category. He's a managing director in SSRM's structured finance group, which was opened in 1997, and was put in charge of the CDO unit when it was set up in the second half of 2001. That was several months after problems with the CDO market first came to light, when American Express admitted to taking a loss of nearly $1 billion from its investments in the product. So, purely as a matter of timing, D'Vari and his team have avoided almost all the pitfalls that have soured so many earlier investors' attitudes to the asset class.

One of the main reasons that he and his institution didn't get involved earlier was that he didn't think it made much sense. "Up until about 12 to 18 months ago we thought we could get access much more efficiently from our own underwriting," he says. His team has around $4.3 billion invested in structured finance

products as a whole, with CDOs making up just a portion of that. "If you can get the diversity yourself, and underwrite or invest in the underlying assets yourself, there's no need to invest in carved-out tranches of those securities via a CDO. If it doesn't serve a purpose, I won't do it," he says.

D'Vari's interest, though, was not so much the traditional CDOs that had caused most of the trouble. Almost all investors' venting of spleens is directed at CDOs backed by corporate credit, and especially high-yield paper. "The high-yield deals have left a taint on the market, and investors clearly have concerns," says Jeremy Gluck, managing director at Moody's Investor Services. "But there are active participants, and both high-grade CLOs and structured finance CDOs are getting done." In fact, for all the market's setbacks, Moody's rated more CDOs last year than in 2001, largely because of an increase in these two sub-sectors.

There's also some movement in another sector of the market. "There are about six CDOs of CDOs in the pipeline at the moment. Spreads on high-yield CDOs are now trading at very wide levels, if at all. There are a limited number of buyers but the potential gains are substantial," says Gluck.

Quickly growing sector

The structured finance CDO sector has grown particularly quickly. Reyfman at Goldman Sachs calculates that ABS deals accounted for $22.9 billion of the cash CDO market last year, or 36.5% of the total. That's an increase of 14.7% on 2001. It has not escaped scot-free, however. Several deals launched last year quickly received multiple downgrades from Fitch; all were backed primarily by manufactured housing debt, a sector that ranges in scope from upscale mobile homes to the kind of low-end trailer parks that provide Jerry Springer with some of his more colourful guests.

That aside, most structured finance deals appear to be performing well, and the most successful thus far appear to be those backed by commercial real estate debt. "We haven't downgraded any commercial real estate CDOs," says Gluck at Moody's. "In fact, we've upgraded a couple of them recently."

It was the structured finance sector that D'Vari chose to provide the assets for his institution's first CDO, launched on October 24 last year. "Structured finance is our favourite type, and residential and commercial real estate are our favourite spaces within that," he says. "There's a good deal of transparency and a rich amount of information about these sectors, all the way down to the property level in the CMBS land. That means we can be precise on how our security will perform in the future under different economic scenarios."

Commercial real estate CDOs are one of the newer sub-sectors of the market. The first deal was launched just four years ago, and to date only about $14.5 billion has been issued. Of that, $9 billion was launched last year, and there have already been three deals this year, which have raised a total of $1.4 billion with another $1 billion in the pipeline.

One advocate of the benefits of commercial real estate CDOs is Ed Shugrue. After six years as CFO at Capital Trust, an investment management and finance company specialising in commercial real estate, Shugrue left in February to set up a commercial real estate hedge fund. He grounds his faith in the product in the much more rigorous structuring compared with CDOs backed by corporate credit. "Rating agency diversity score models aren't nearly as liberal for commercial real estate deals as they are for corporate CDOs," says Shugrue. "They have the same subordination and the same spread, but there is 12 times coverage in commercial real estate versus four times for high yield. So if they're the same price, why not buy the real estate CDO? There's a new market arbitrage for you right there." And now, he says, is the time to get in: "Triple-A spreads have widened to Libor plus 70 basis points from L+40bp. It smells like an opportune moment to buy."

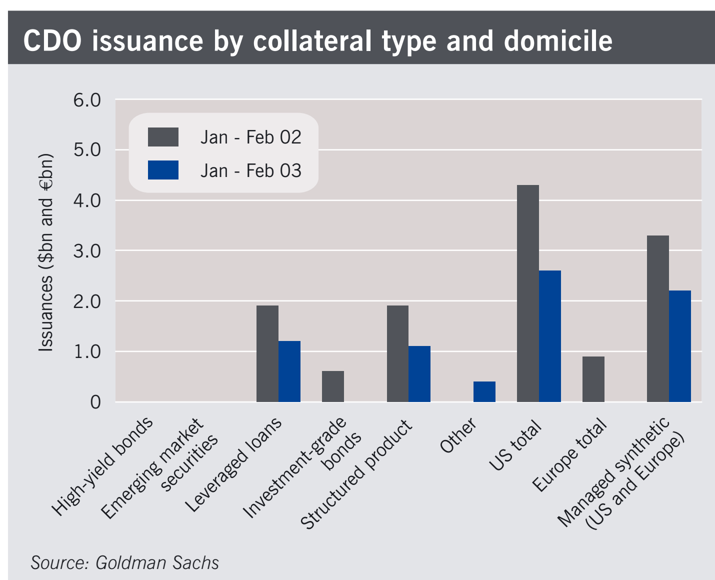
But that doesn't make doing these deals easy. One banker, when talking about this year's three real estate CDO deals, compares getting them done with hand-to-hand combat. Shugrue has heard those stories "It's the high-yield hex," he says. "So many of those deals got repriced that it has spooked the whole asset class. These first three real estate CDOs were launched by well-known, seasoned issuers with good track records and good management teams. The commercial real estate CDO market needs to find a new name."

Its practitioners have, though, learnt some lessons from the problems in the high-yield space. For one thing, there's little desire to allow managers the same kind of freedom to change the portfolio. In fact, says Shugrue, "in commercial real estate CDOs, people just don't want managed deals". Almost all the deals are static, with a degree of light management in case of defaults. GMAC Commercial Mortgage, though, one of the best-known and respected real estate CDO managers, launched its first ever managed deal in February.

There's also more desire to see more banks get involved in the deal from the start. "We're seeing more joint underwriters. Most of the deals in our sector have two names on the cover of the prospectus," says Shugrue. It's a far cry from the world of corporate credit CDOs where having a single underwriter was the norm.

That, too, though, is beginning to change, says Jimmy Frischling, US head of CDOs for Société Générale. "Investors are concerned first that additional consolidation of investment banks could result in there not being anyone around who actually worked on the deal," he says. "Second, there's a general feeling that the more pairs of eyes there are looking at deals the better, whether as joint leads or co-managers. It gives added comfort." There are, he says, a few investors now refusing to take part in single-led deals.

Investors have learnt to be extremely watchful of dud cash market investments being dumped into CDOs. >



Source: Goldman Sachs

D'Vari has an apt tale about his first foray into his role as a CDO manager. By the end of 2001 he was preparing the company's first deal. "We had a warehousing agreement in October 2001, and we had people showing us all kinds of structures," he says. "Invariably, though, everyone had, for example, 10% given over to manufactured housing, 5% for aircraft ABS, and there had to be some mutual fund fee deals and some tobacco ABS in there as well. We told them that we hadn't invested in them, didn't like them, and so weren't going to put them in our CDO. They thought we were mad."

Synthetic CDO issuance

	2001	2002
Static synthetic CDOs (US)	$21.8bn	$38.2bn
Static synthetic CDOs (Europe)	€25.48bn	€53.85bn
Externally managed synthetic CDOs (US)	$3bn	$13.8bn
Externally managed synthetic CDOs (Europe)	€2bn	€6.3bn
Sponsored managed synthetic CDOs (US)	$1bn	$3.7bn
Sponsored managed synthetic CDOs (Europe)	€1.9bn	€3.8bn
US total		**$56bn**
Europe total		**€64bn**

Source: Goldman Sachs

This was, according to many players, a great way to improve the diversity score, the method developed by Moody's to allow investors to judge whether the deals they were buying were too concentrated in one name or one industry. Allowing managers to buy completely different asset classes seemed to offer the ultimate diversity. This was a regular feature of all types of CDOs. "A large number of the high-grade and high-yield cash arbitrage CDOs had other buckets they could dip into," says Frischling at Société Générale. "So there could be an allowance for investing 10% to 20% of a deal in ABS, or Reits, or it might not even specify any particular asset class."

One manager that had such latitude was Deerfield Capital. For most of its life it had been a hedge fund involved in arbitraging government securities. In 2000 it invested in CDO groups to manage high-yield and high-grade CDOs. Heading the high-grade effort is managing director Paula Horn. She says: "The structures which we and others did in 2001 and before now look aggressive, with their ability to take emerging-market exposure, or with a 10% bucket allowed for buying junk bonds. Not that we used them all. We did have some high-yield deals in our investment-grade CDOs, but we didn't do too much. Overall, we stuck to our knitting."

D'Vari was even more determined to stick to his. The deal, a structured finance CDO, focused on the four asset classes that his structured finance group specializes in: residential and commercial mortgage-backed securities, some regular asset-backed and some real-estate investment trust debt securities. His reticence proved well-judged. Within months of rejecting all the varied catch-all structures, D'Vari's conservative approach had been proved right.

Diversity is no protection

"All those assets [manufactured housing, aircraft ABS etc] came under pressure in 2002, but we could justify every single credit we had in our portfolio." Says Horn: "What seemed like prudent investment decisions two or three years ago are now looking disastrous, such as EETCs ."

Enhanced equipment trust certificates are issued by individual airlines. Many have been hit by the problems affecting airlines and some are now priced as low as 60 cents on the dollar.

Investors are cottoning on to the potential destabilizing effects of these buckets: "The market doesn't want the unspecified pool," says Shugrue. "We don't want surprises. Everyone's getting gun shy, looking for transparency and core competency." And it's not just in structured finance CDOs, but across the board: "Investors have become concerned that managers don't understand these other markets, and might use them more as a way to reach for spread or to add diversity for diversity's sake," says Frischling. "These buckets are beginning to disappear from a number of new deals."

In happier times, investors and managers were content to rely on the Moody's diversity score to tell them whether their deals were diverse enough. That method, while useful, failed to predict the problems that beset the corporate credit market. Managers could game the structure, playing around with the rules of the deal rather than developing a coherent investment philosophy.

One observer says: "Only a third to half of the bonds would be needed to get the right diversity score, the rest could be as concentrated as you like." And that could be exacerbated by the person running the CDO, says Bohn at Moody's KMV: "A lot of cash deals were managed by repurposed sector fund managers. So there'd be a former telecoms guy in charge of managing the CDOs, who would only buy telecom bonds after launching the deal. That was fine, of course, until 2001."

Horn at Deerfield Capital explains how the structure of the deals and the guidelines from the rating agencies even seemed to encourage CDO managers to concentrate their investments: "Look at the indentures. We had huge latitude. We could take five or 10 names up to 2.5% of the portfolio each if we chose to." And this would be for portfolios that, no matter who the manager, rarely had more than 70 or 80 credits in them.

The hot phrase now, which has replaced diversity, is correlation. "More people understand the issue of correlation," says Dik Blewitt, managing director in global structured products at Banc of America Securities. "Most banks run KMV's EDF analytics. And there are those who agree in principle but not necessarily that KMV is the best route."

Correlation risk is something the folks at KMV have been banging on about for several years. "Size is a better correlation, especially within one country," says Bohn. "So for example you might have IBM, Microsoft, General Electric and ConocoPhillips in a deal. Even though they're from different sectors, the correlation between them is quite high, but is only seen when the economy is in trouble."

So did Deerfield Capital give much thought, at the time, to diversity scores versus correlation risk? "We did think about it, but there's a difference between high-yield and high-grade when it comes to correlation," says Horn. "We took some of our industry exposures up to 8%, although most were at 5% to 6%. The agencies allowed us to take exposure up to 12% in three or four industries, had we wanted to. But we didn't push the limits on any deals we did."

That has helped Deerfield Capital stay in the market as a manager, although it has now shifted to doing managed synthetic deals.

For some, diversity as defined by the CDO investment trends of the late 1990s is better avoided. "I'd rather be less diverse in defensive industries than more diverse in high alpha," says Shugrue.

Market dislocation boosts CDO trading

The lack of real-time information has always meant that trading CDOs has never been for the faint of heart. Goldman Sachs led the charge to improve the situation last summer by making data on all its deals available to investors on data service provider Intex. Three other underwriters have followed suit.

It's a start, but what has acted as a real boon to trading CDOs is last year's deterioration in credit prices. For some investors, it's an opportunity too good to pass up.

"Secondary trading really has picked up, especially for senior pieces," says Greg Mount, global head of CDOs at Goldman Sachs. Several factors are driving this. First, there are investors getting out of the market, because they have been burnt or because, as Mount says: "They are concerned that under the FASB rule Fin 46 they will have to bring these assets onto their balance sheets. The ABS conduit vehicles especially are concerned about this."

A second reason for discounted prices is that some deals might now be lacking a manager, either effectively or in reality. "Some are being liquidated, some have had the manager thrown off the deal," says Mount. "And some, such as the 1997 vintage deals that have performed badly, are beyond their reinvestment period, or the managers have given up because their fees are subordinated and they're not getting paid any more."

Unloading after disastrous losses

One institution many believe is unloading its CDOs is Abbey National. The UK bank decided to close its capital markets operation last year after disastrous losses in its high-yield portfolio, including CDOs. Last month, say several bankers and investors, Abbey was in the market trying to offload about $100 million.

The risks for the new investors are much the same as those that forced the initial owners to get out: overexposure to certain names and industries, and more correlation between them than diversity scores showed. "You could, as a new investor, go in and buy these securities at pretty good prices," says Jeff Bohn, managing director at Moody's KMV. "If you picked up 50 deals, though, all could have exposure to Ford, for example. What does the diversity of the deal look like? Systems like ours allow you to analyze those risks. And you might be able to pick the securities up at such a good price that the risk-reward is attractive."

Hedge funds and asset management arms of larger institutions are just two of the players Bohn says are now in the market. It's a fair bet some of the proprietary trading arms at investment and commercial banks are jumping in as well. According to CreditSights' banks and brokers analyst David Hendler, Lehman Brothers appears to be the most aggressive in this field. Having reviewed Lehman's 2002 10K annual report filing with the SEC last month he concludes that, in proprietary trading, Lehman "is not only a powerhouse in mortgages but has also fallen in love with cash and synthetic CDOs".

What's assisting in bringing this to light is the imminent application of the Financial Accounting Standards Board's rule Fin 46, which attempts, in the wake of Enron, to force a more acceptable form of accounting on off-balance-sheet vehicles it dubs variable interest entities. The gist of the ruling is that variable interest entities must be brought onto the balance sheet of any institution deemed to hold exposure to the majority of the risks or rewards in the vehicle. As a result, public companies are starting to disclose how much they have tied up in such vehicles. Of Lehman Hendler says: "It has about $10.1 billion notional exposure to variable interest entities. These exposures are much larger than those more clearly disclosed by Goldman Sachs and Morgan Stanley, both of which disclosed lower notionals and maximum exposure less than one-fifth of Lehman's. About half, or $5.1 billion, of Lehman's notional exposure is to synthetic CDOs."

Cash CDO exposure makes up some of the rest, although Lehman did tell Hendler that FASB rule 46 would reduce its ability to take on such large exposure in the future.

D'Vari agrees: "Diversity scores are meaningless if you bought things that you don't like. For example, buying aircraft ABS or CMBS to put in a CDO purely to add diversity rather than because you know the credit. I'd rather have less diversity and a high knowledge of every single credit in the portfolio." D'Vari continues: "I believe in diversity in credit land, but you have to understand in full the correlation matrices of the underlying assets and how it affects the overall integrity of the deal."

It's worth asking what is the purpose of buying a CDO rather than simply investing in various assets yourself. According to Moody's KMV, in general there would seem to be little point in investing in CDOs unless there are a substantial number of credits in the structure. "It's a question of economics, getting the right risk-return," says Bohn. "In our view, having 100 assets in a CDO is still too few, although you can find 100 assets which are reasonable."

KMV executives have been pushing this line for some time, even before the problems with arbitrage corporate credit CDOs materialized in 2001. Back then they would hold up Bank of Montreal as an example of a manager with a more diversified pool of CDOs. The Canadian bank was one of its clients, and had used KMV's tools to build CDOs with more than 200 names in them.

Even that, though, is not enough. The ideal, says Bohn, would be to have a super-diversified fund of, say, up to 5,000 names. It's something that KMV and notably one of its founders, Mac McQuowen, has been advocating for some time. It wouldn't be so much a CDO as a mass index tracker, which would probably not appeal to many of the new CDO investors confident of their ability to use quant tools to pick what they think are the best credits. But it might appeal to those who were burnt by CDOs and are getting out, and to those who avoided CDOs from the start.

And many of those investors need all they help they can get. Blewitt at Banc of America Securities, says: "From a capital standpoint, things don't look great for some banks and insurers. Insurers are wider spread buyers, yet their mindset seems to have become: 'I need spread, yet spread is risky and caused me pain.' So they pulled back somewhat. But by definition they need to invest, and spread inherently is generated from one or more of three basic choices: credit risk, increased optionality, and moving out the credit curve." There is, he says, a compelling argument that credit risk offers significant value as the economy goes forward and that as a result "CDOs and structured products are excellent vehicles to express such a view". But investors have heard this before. ■