'Dealing with the tremors from a complex market'

Fund Managers are faced with extra issues in light of the rapid growth in credit derivatives, says Paul Temperton, CFA*

The rapid growth of credit derivatives raises key issues for fund managers, especially those who have little or no ability, or desire, to participate in the market for these new products.

First, the construction of many of these new financial products changes the pattern of demand in the markets and makes an assessment of the factors driving the pricing of credit risk more complex.

Many long-only, traditional fund managers bemoan the fact that "fundamentals" now seem to have little impact on the level and direction of credit spreads.

This seems to be more than just the phenomenon we have all become used to over the last decade or two - of the derivatives tail wagging the cash market dog.

Take CPDOs (constant proportion debt obligations), launched by ABN Amro late last year, as an example. These are AAA-rated instruments, with the first issues paying as much as Libor plus 200 basis points. Clearly, the combination of AAA risk and such a wide spread was an appealing combination. CPDOs invest in a range of CDSs (credit default swaps), typically those that are the constituents of one of the widely followed credit indices such as the iTraxx or US CDX. The life of the CPDO is typically 10 years.

The impact on the underlying credit market comes from the fact that these instruments typically use high degrees of leverage to enhance returns in the early years of the product's life. This means that demand for CDSs is inflated as the products are constructed, compressing CDS spreads and hence feeding back to a compression of spreads in the cash market.

The impact on cash markets is magnified further as such instruments appeal to hedge funds, which themselves use leverage when buying such instruments. Fund managers investing in the underlying credit markets can find that spreads become dependent on the extent of demand from the financial engineers constructing these new products.

The second impact is that at times, and often for prolonged periods, credit spreads can appear to be unrelated to the "fundamentals" that normally drive these markets: economic growth, inflation, the direction of interest rates and corporate earnings.

Third, those frustrated by the narrowness of credit spreads tend to be persistently on the lookout for an event that leads credit spreads to widen, making credit markets more attractive.

The problems in the subprime market looked, in March, as though they may provide one such instance. With many subprime mortgages packaged into CDOs, and with subprime delinquency rates rising, the default rates on CDOs' lower-rated tranches could be expected to rise. That, it was thought, might provide a catalyst for a more general widening of credit spreads. So far, however, the contagion from the subprime to the credit markets has been limited and spreads have, in general, remained tight.

It could be, of course, that there will be a delayed reaction to the subprime mortgage problems. LTCM, after all, failed on September 28 1998, several weeks after the shake-out in credit markets that began with Russia's default on August 17. Of course, credit derivatives are supposed to provide a means for diversifying risk within the financial system, reducing the chance of such an event. The extent to which that diversification can be relied upon remains unclear but the experience of previous financial crises - when correlations between markets have had the (now well-documented) tendency to polarise at plus or minus one - is not encouraging.

The fourth issue relates to whether the credit rating agencies have correctly assessed these new instruments. The article "ABN's latest CPDO has AAA rating" (Financial Times, April 19 2007) highlighted that two agencies had concerns that rating of the early CPDOs may have been too sanguine.

Long-only fund managers waiting for more attractive buying opportunities in credit markets may well have to remain patient. But at the same time they will share the concern of everyone in the market that this spread widening should be achieved without a destabilising, LTCM-type event.

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