Collateralized Debt Obligations

BY MARC SUMERLIN AND LOREN M. KATZOVITZ

Who's to blame when the market blows up?

Who is to blame? That undoubtedly will be the question we will be asking about the excesses of the current credit cycle. The events of late June show that one of those questions will be why we didn't look more closely at the financial engineering that could take a pile of CCC-grade credits and turn a significant portion into investment-grade securities without reducing the overall level of risk in any material way. Wall Street of course was reacting to a fundamental challenge—and opportunity. Since 2003, the riskless rate of return has been abnormally low as central banks kept overnight rates low for a long time after a brief deflation scare in the United States and a prolonged scare in Japan. With pension funds and other institutional investors needing to hit 8 percent returns in a 4 percent world, the demand for innovation was there. Pension funds had to find a way to take on risk without looking like they were.

What they needed was an asset class with low volatility. Low volatility produces all kinds of good results from traditional ways of analyzing financial products, and provides good marks from the ratings agencies as well. Limited transparency and limited market liquidity have often resulted in producing what appears to be low volatility. The illiquidity in the assets requires model pricing, which has numerous subjective inputs. Models are almost inevitably less volatile than reality because it is difficult to factor in gap risk and behavioral response.

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THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

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ative security. The seller of the security, who doubtless was a quantitative wiz compared to the old-timer, argued back that his model said that the security was worth so much more. The old timer's response: "Then sell it to your model."

Once a product's price has low volatility, Wall Street can simply apply leverage to produce what looks like very high, very attractive risk-adjusted returns. The final step in this process is to add opacity by allowing the products to be managed after they are sold so that the investor never knows exactly what collateral is behind the structure. It is alchemy at its best, and it is called the Collateralized Debt Obligation market.

The investment banks and rating agencies involved in selling these products were able to make billions off the innovation. The hedge funds and funds of funds employing these strategies to the fullest were able to produce 13 percent returns or more net of fees for the last three years, or about three times the average risk-free rate over the same time period. The return investors received was higher than that earned on third-world sovereign debt such as that of Argentina (a country with a recent default), yet no one asked why. Perhaps it was Alpha, the Street's name for the extra return that good money managers make over the market. In general these managers were consistently beating the S&P 500 with significantly less than half the volatility. Perhaps an entire generation of managers got smarter suddenly. But careful studies show that only about a quarter of hedge funds generate true Alpha over time.

Today, there is more than a trillion dollars of CDO exposure sitting in the markets. Who exactly owns these securities is a mystery—one hears about European banks and Japanese retail investors. But given the size, the answer is probably everyone, either directly or indirectly through their ownership of financial stocks or pension funds. Institutional investors should have known better. It will only take a modest pick up in defaults or widening of credit spreads, both of which are natural occurrences at this late stage in an economic cycle, to cause severe pain similar to what happened in the Bear Stearns structured credit fund.

Fundamentally, the CDO market is linked to the U.S. housing market. The lower-rated tranches of subprime asset-backed securities form 50 percent to 60 percent of the collateral for CDOs. These are extremely sensitive to a deterioration in mortgage credit quality. On that front, the housing sector has still not bottomed. Housing is fundamentally going through a classic inventory cycle, and the latest housing data shows that the inventory-to-sales ratio is still worsening. As long as the inventory situation builds, there will be a risk that prices could fall more rapidly. A more substantial fall in prices would accelerate the uptick in delinquencies and foreclosures and spell doom for the CDO market.

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Models have the added advantage of no one actually having to put up their own money. Indeed, there is a widely circulated story of an old-timer in the market who was putting in a particularly low bid on an illiquid and new-fangled derivative security. The seller of the security, who doubtless was a quantitative wiz compared to the old-timer, argued back that his model said that the security was worth so much more. The old timer's response: "Then sell it to your model."

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CDOs, middle-market lending, and subprime debt have all been fad asset classes over the past few years because they displayed artificially low volatility characteristics. This was helped by an excess of liquidity created by the world's central banks and a relative shortage of traditional financial assets as firms bought back their own stock and more countries started running external surpluses. Wall Street filled the gap by replacing a shortage of equities and sovereign bonds with a plethora of derivative products. With global central banks slowly but surely draining the swamp of liquidity, it is much safer to assume that historically tight credit spreads will rise going forward. These highly leveraged illiquid products will suffer, and the pain will not be limited to the subprime sector.

So who will we blame when it happens? Responsibility should fall squarely on the shoulders of the institutions that purchased the assets and should have known better. Where were the financial experts who

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should have been asking questions that probed beyond the simple Sharpe and Sortino ratios, both of which understate the risk of their respective return streams because they don't adequately capture gap risk? Given the quantitative nature of their business, one would have thought that the auto correlation of the return streams would have been more than enough to scare off any quant worth his or her salt, particularly in a world where the words "hedge" and "diversify" carry a lot of weight.

The sad fact is that everyone bought in for fear of being left behind. A history of the market shows that financial innovators will always design new products that churn out excellent results using the most common risk assessment techniques. The products are built to fit the model. This is why investors must also rely on common sense. Institutions and their consultants know what a traditional fixed income portfolio yields, and that over time the market as a whole cannot do wildly better than this using some pixie dust called Alpha.

The next group to blame should be the rating agencies who were making fees based on the volume of structured products they rated. There have been substantial questions raised about how they rated these structured products and the false comfort they gave by using ratings similar to simpler corporate debt securities. But, looking forward, since they were keen to rate the paper, why aren't they as active in re-assessing its credit quality today so that the same investors that relied on them to make their original investment decisions can assess whether or not the ratings are still relevant? After all, their value added is in helping investors understand what is in their portfolios on a real-time basis. The truth, though, is that everyone on Wall Street is fighting to prevent a market price from being discovered—the ultimate sign that there is a lot to worry about.

Greed is a funny thing and can drive a market farther than anyone not in that market would expect. Last year's blowup with Amaranth should have been a wakeup call to investors to understand what is driving

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their high returns. Investors were stunned to see the energy bets Amaranth was making, yet no one questioned the returns when they were positive. In the case of Amaranth, the firm was actually very transparent about the energy bets they had on, both on the way up and on the way down, and people chose to ignore information out of greed. Yet despite Amaranth, no one wanted to ask how a portfolio of fixed income securities could produce such lofty returns.

The root causes here are not very appealing—a lack of common sense, greed, or just plain ignorance—or maybe a pinch of all three comprise this stew. But let's be clear: The investor is ultimately responsible for understanding what he or she is purchasing, especially if the investor is a sophisticated institution. Investors have had the opportunity to demand more transparency in order to understand how returns are generated for some time now. There was enough concern on the topic to convince the U.S. Treasury to review the issue last summer along with their European counterparts. Correctly, the Securities and Exchange Commission and Treasury elected not to pass regulation, concluding that more transparency should happen, but it is the job of the institutional investor to demand it and not the federal government. Ironically, recent behavior by some of the biggest market players was aimed at reducing transparency and price discovery, not providing it.

It may take another San Diego County before investors and taxpayers wake up. After all, when a public pension loses a bunch of money in one of these funds, it is the taxpayer who must make the pension whole. But those same governments were able to consistently underfund their pension plans by taking risks that produced an 8 percent return when the risk-less return was 4 percent. Politics and the media will begin the blame game soon enough. But the truth about who to blame is in the mirror. Pension fund mangers, governments, and the financial community all had an incentive to overlook the obvious problems until it was too late. We will all vow never to do it again and pass regulations to make sure it doesn't happen. Until the next time. ◆