

PRACTITIONER'S POINT

Asset Backed Securities



George Tintor has 15 years of experience in originating, developing, executing complex structured financial transactions

Based on your experience, what makes an investment in asset-backed securities lucrative?

The basic value in asset-backed securities, including collateralised debt obligations and collateralised loan obligations, is derived from the ability to tranche the capital structure transactions, from AAA to "equity" classes. This allows for an efficient distribution of the underlying risk to investors with varying risk profiles. As a result asset-backed securities achieve a higher yield at any given rating level than traditional fixed income securities.

Skilled fund managers go a step further as they are capable of identifying and exploiting relative value opportunities prevalent in the asset-backed security market. These can be very profitable and are caused by: supply/demand imbalances, complexity premiums, rating agency inconsistencies, etc.

How sensitive are such investments to economic fundamentals? Are such investments capable of delivering "uncorrelated" returns?

The collateral underlying asset-backed securities can be very sensitive to economic fundamentals. Collateral can range from portfolios of corporate bonds and loans to residential and commercial mortgages. When investing in asset-backed securities, it is important to determine how the value of the security will be affected by deterioration in the value of the collateral.

"Uncorrelated" returns can be achieved either by employing relative value strategies in the asset-backed security market or by investing in junior or distressed tranches on a value-oriented basis. The

latter approach requires an in-depth bottom-up security analysis as the objective is to "buy cash flow" cheaply enough to cover hedging costs, withstand collateral losses and still meet return targets.

The underlying risk of an asset can be transferred; transformed, spread, diversified, diminished - but it still exists. Elaborate.

The development of the credit default swap market and securitisation techniques have actually improved the ability of banks and investors to manage credit risk. The emergence of a very active, liquid and efficient credit derivative market gives the financial system the ability to price, hedge, buy and sell credit risk - something that did not exist a decade ago. As a result, credit risk is distributed far more widely today than ever before.

Can one systematically control, mitigate and even eliminate unwanted asset-backed security risk?

The main risks faced by hedge funds investing in asset-backed securities are credit default risk, credit spread risk and liquidity risk. The first two can be mitigated by diversification: the holding of short-spread-duration securities, portfolio and security-specific short positions in the credit default swap market and by implementing sophisticated surveillance systems. Liquidity risk can be mitigated by embracing term financing facilities and by holding excess capital.

What criteria do you apply to managers you are looking to invest with?

A key element of our due diligence process is to determine how a fund will perform during a period of market stress. In the current benign credit environment, with tight spreads and low default rates, we seek funds that are positioned to generate consistent positive performance during a period of widening credit spreads and increasing default rates. We assess the manager's ability to withstand a severe market shock and to benefit from the distressed opportunities that would emerge.

Credit rating agencies play a pivotal role in analysing and assessing risk. Do you agree? How well do they play this role?

Credit rating agencies do indeed play a key role in assessing risk. In fact, the increasing demand for structured credit products can be partly attributed to the rating agencies' ability and willingness to rate new structures. Nevertheless, those investors who buy asset-backed securities based on ratings alone, do so at their peril. From our experience, the value generated by top fund managers can often be attributed to what is called "rating agency arbitrage."

Is liquidity still a major constraining factor?

No. Today it is possible to get multiple dealer quotes for almost all asset-backed securities. This represents a substantial improvement over the situation a few years ago, when junior and distressed asset-backed security tranches were generally illiquid. Nevertheless, in a period of market stress, liquidity could dry up fairly quickly.

What are the new instruments? What are their limitations?

The pace of innovation and technological advancement experienced by credit markets since the late 1990s has been extraordinary. New instruments, such as asset-backed security credit default swaps and synthetic structured credit tranches, are constantly being developed and offer new ways of getting exposure to or hedging credit risk.

The main limitation of some of the newer instruments is that the market for them can be thin and there is a potential lack of liquidity. Investors need to be aware of this.

Remarks, comments... Our outlook for the performance of asset-backed security hedge funds over the next 12 to 24 months is positive. Relative value and distressed investment opportunities are expected to rise. In particular, significant distressed opportunities are expected to present themselves in the second half of 2007, in the US asset-backed security market, as recent vintages backed by sub-prime mortgages suffer from deteriorating collateral pools. The best managers have already positioned themselves for this downturn by investing in short-duration, seasoned securities and by hedging their portfolios against credit spread and default risk.