

## COLLATERALISED DEBT OBLIGATIONS THE ART OF VALUATION

**Do you believe CDOs (collateralised debt obligations) on Wall Street are probably marked 30% higher than where they should be?**

In our opinion, the above statement is incorrect and undifferentiated. There are only three reasons why independent valuations are "significantly off" those offered by the market:

- a) The rare occasion where valuations vary significantly from the market due to severe, short term market disruptions. This may be the case in very particular segments, but is not the case for the market as a whole.
- b) In the rare case a valuation is not done independently. This is a compliance issue that is not of concern in wellrun companies.
- c) If the underlying volume of the market transaction is insignificant and as such bears no relevance to the fair market value of a security

### Valuation Fundamentals

One should not forget that certain financial institutions can value securities based on criteria other than mark- to-market, in particular if they intend to hold them to maturity. These valuations, of course can be very different to where a security should trade.

In order to understand why it is possible to value securities even if they do not trade - certain fundamental principles should be reconsidered: Any reasonable buyer and seller of structured credit instruments such as collateralised debt obligations, mortgage backed securities and other types of securitisations (in short, "asset backed securities") will likely base their sale and/or purchase price on the following principles:

- The value of asset backed securities fundamentally depends on the value of the underlying instruments and their expected development over time
- Typically, an investor will base their decision to buy or sell on the present value of the future cash flows generated by such investments
- In order to assess this present value, a number of factors play a vital role:

Default expectations of the underlying collateral, recovery assumptions of such defaulting collateral, spread development of the underlying collateral, prepayment and reinvestment assumptions of underlying collateral, discount rates (based on forward rates and spreads applicable for the security to be valued)

Typically, the valuation department of any investment bank will test the parameters used for their soundness and will cross-check with actually observed data from trades in the market. Often, the sensitivity of valuations to various parameters is tested, too.

If there is a considerable difference between a valuation and that traded by the market; one can assume that market participants have changed their assumptions for one or several parameters relevant to the valuation.

On the other hand, those that have actually made valuations may not have adjusted the parameters for a number of reasons:

- a) they believe the change in the parameters has no bearing on that particular transaction
- b) they believe the volume of the market transaction to be irrelevant, or
- c) they lag behind in observing a significantly changed parameter.

### Observations from a practical viewpoint

Valuations are not an exact science. Differences between valuations and the market will always occur.

Some securities exhibit a high degree of sensitivity to even the slightest change in a parameter. An informed investor can take this into account. Our experience suggests that our weighted average sales price of CDO securities has been around one per cent above valuations received. Sometimes differences of several points can occur. This is a normal phenomenon - and is just as likely as intra-day volatility in a stock's price.

What we have seen in the US sub-prime mortgage market is a commonly observed phenomenon: The market has, following a review of the underlying securities, decided that the default assumptions and recovery assumptions have changed significantly.

### The role of rating agencies

The rating agencies express their opinions based on their own assumptions, and these assumptions are based on a very long term (over a full credit cycle) view. A change in their assumptions, therefore, by design takes longer than any market participant's would do.

However, ratings have no bearing on market prices of securities: For instance,



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one can observe that the same time AAA rated security could trade anywhere between 6 and 65 basis points in spread. The difference can, most likely, be traced back to the difference in collateral. But other factors such as the collateral manager, vintage year of the security play an important role. As such, ratings are no guidance for market value of securities.

### Fall out of the current sub-prime mortgage market crisis?

First and foremost, the problems stem from loose underwriting standards in a very particular segment in mortgages. The sub-prime segment bears little relevance for the US economy and even less relevance for the European or global markets. There may be some technically driven spill-over effect - but more importantly the market has a chance to learn from its mistakes and can take home an important lesson:

In any structured credit instrument, the performance of the underlying collateral is crucial to its outcome. If the fundamentals of these instruments change, they will have an impact on the structured credit instrument as well. Basing investment decisions only on ratings, structures and management of such structures without an understanding of the underlying collateral is not the right approach to investing in these instruments.

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