



Credit Default Swaps in Traditional Fixed Income Management

by David Bowser, CFA

Credit default swaps

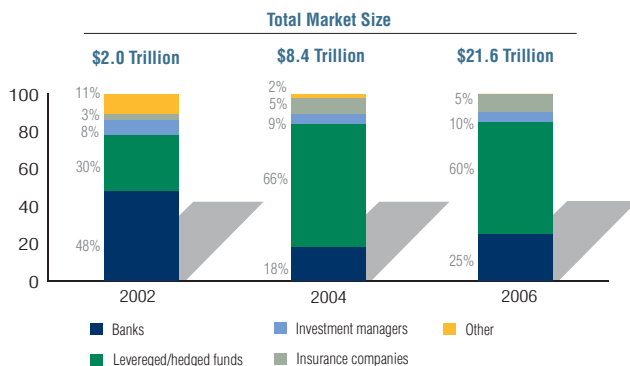
The Credit Default Swap (CDS) market was born out of the banking business and the need to hedge and redistribute credit risk. A single name credit default swap is an “over-the-counter” contract between the seller and buyer of protection against the risk of default on a set of debt obligations issued by a specified reference entity.¹ The insured, or buyer of protection, pays a quarterly spread or premium for the duration of the contract (typically 1, 3, 5, 7 or 10 years) in return for the guarantee of full principal return in the event of default. The CDS market grew significantly in the 1990s when the banks looked for ways to reduce credit exposure following a tough default experience in the early part of the decade. The growth of the synthetic CDO market in the late 90s and into this

decade increased demand for the long side of the trade (sellers of protection) and the market exploded in size.

CDS in fixed income management

In traditional Fixed Income portfolio management, we use CDS for various purposes including hedging credit risk, shorting credits we view as deteriorating or overvalued, and creating synthetic long positions. The most exciting use and the most significant change in fixed income CDS occurs on the short side. Without borrowing bonds, the manager can now take advantage of negative views on specific names. With the pair trade, we can pay for the trade or part of the carry and take the market or industry bias out of the equation. Using CDS to replace cash bonds is the least attractive use, in our view. Cash bonds benefit from tenders, options, or covenants, while the CDS, a derivative independent of corporate actions, is subject to credit downside. The CDS market has enhanced the power of the credit research team, adding performance or alpha leverage in an efficient and liquid market.

CDS market participants



Source: Merrill Lynch, Morgan Stanley and Lehman Brothers

Credit work and the use of shorts

Prior to the growth in the CDS market, a traditional money manager would find it difficult to express a negative view on a specific credit. If credit research turned up deteriorating credits, event risk candidates, or overvalued issuers, avoidance was the

¹ Morgan Stanley Credit Derivative Insights, 2/7/2005

primary strategy, if not the only one available. Being positioned effectively short a name versus the index rewarded the manager with some relative performance if spreads widened. However, broad issuer diversification in the indices means that the credits we avoid are small positions that have little effect on the overall portfolio. As an example, if we own 100 credits in a portfolio, our long positions have the potential to be significantly overweight versus the benchmark because we have control over the amount of the overweight. Our underweights, however, remain small; the most negative strategy we can adopt is to not own a position, and the size of each short on a stand alone basis is nearly insignificant. The credit work done on the non-attractive or deteriorating credits is underutilized. The CDS market lets us make more of the negative views by buying protection on names we view negatively, with the potential to make money for our clients on credits we analyze and don't like, thereby more fully utilizing the credit research resources. Given the asymmetrical profile of corporate bond pricing (lots of downside, limited upside), the ability to express negative views is powerful. The cost in the short run is the payment of the yield spread from the portfolio, though this can be offset by other long positions in the portfolio.

The pair trade

The pairing of a long and short position to express a credit view using CDS is a less expensive trade, from a yield perspective. For example, if we thought the market undervalued an issuer relative to another issuer, we could buy protection on a fair or rich issuer (shorting the default risk) and sell protection on the attractive issuer. In the market today, if we view risks at two companies as similar, but spreads as significantly different, we can capitalize on spread convergence. By shorting (buying protection) on the richer of the two and going long the cheaper credit, we earn the difference and take the other market factors like spread direction and interest rates out of the equation. If nothing happens, we earn the carry; if spreads converge, we

earn a capital gain. These trades let us express a relative value view between two issuers and remove the other variables.

Synthetic longs and the disadvantages of long CDS vs. cash bonds

The CDS market also allows managers to build synthetic long positions. We can combine an interest rate swap and a long credit CDS to create a cash bond-like position. We take on the counterparty risk of both swaps, but these typically trade cheap to the cash market for that reason. With this trade we can take advantage of a cash/CDS pricing imbalance or simply add exposure that is tough to get in the cash market. In general, however, we view this Long CDS position as inferior to cash bonds. CDS does not benefit from many of the positive corporate actions that cash bonds of the actual issuer can benefit from. In leveraging transactions, the cash bonds can be tendered or repurchased at higher prices by the issuer, while the CDS usually travels with the surviving entity, often at wider spreads and a lower rating.

Risks in the CDS market

Risks in the CDS market include liquidity and counterparty risk. This is a relatively young market and clearly could be



tested in the event of a counterparty default or in a weaker credit environment. Since we analyze and invest in brokerage debt in the cash market, we can monitor these companies to gauge those risks. Although the counterparties are strong, highly rated entities, there is some risk; all things equal, we believe CDS should trade cheap to cash instruments.

Credit default swaps here to stay

CDS serves many functions in the market, most importantly the redistribution of default risk. We believe the market is here to stay and think fixed income investors should take advantage of the opportunities the market provides. From a fixed income credit perspective, we view the ability to profit from a negative view on an issuer by effectively taking the positive side of the asymmetrical return profile of corporate debt as a revolutionary change in the corporate bond market.



David Bowser, CFA

David is a Vice President and senior member of our credit team. Since joining the company in 2000, David has been the portfolio manager for investment grade strategies, including our U.S. Select Credit strategy, and a co-portfolio manager for a number of custom strategies that utilize both investment grade and high yield credit. In addition to those duties, he is the sector strategist for investment grade credit and a member of the credit committee responsible for review of all corporate holdings in our portfolios. David's previous experience includes seven years as an investment grade and high yield credit analyst at Loomis, Sayles & Company, L.P. He has an M.B.A from Boston University and a B.A. from Rollins College.

For more information about any product or services at Standish Mellon, please contact Jim Kohley at 412.234.0341.

Note: Standish Mellon Asset Management Company LLC provides this article as general information to clients. It is not meant to be tax advice for any particular investor, which can only be provided by qualified tax counsel. The securities discussed in this bulletin are among many in which Standish Mellon has invested client funds under management as part of an overall investment program designed to suit the objectives and needs of each client. This bulletin does not constitute investment advice, an offer to sell or a solicitation of an offer to buy any security. The preceding information is based upon the analysis of historical performance of various asset classes and assumptions with respect to future economic conditions. Past performance is not an indication of future results. This information is not intended to provide specific advice, recommendations or projected returns of any particular Standish Mellon product.



Boston ■ Pittsburgh ■ San Francisco
One Boston Place, Boston MA 02108
617.248.6000 www.standishmellon.com