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Credit Derivatives Get Popular Among Hedge Funds, Insurers

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NEW YORK -- Having established their credentials during a torrid cycle of credit downgrades and corporate bankruptcies, credit derivatives are continuing to attract entrants and volumes keep growing.

What is different, though, is that the entrants largely are coming from the buy side. Hedge funds, insurance companies and other aggressive managers of risk are joining this market -- created during the mid-1990s by Wall Street banks looking for a way to hedge credit risk -- to augment their fixed-income strategies. A derivative is a financial contract with a value that is based on the performance of an underlying financial asset, index or other investment.

The presence of banks in the credit-derivatives market has declined to 47% from 66% five years ago, according to Risk Magazine's most-recent survey. During that time, the overall size of the credit-derivatives market has risen to nearly $2 trillion from $180 billion, according to the British Bankers Association.

The arrival of the buy side is leading to better dealing flows in single-name credit-default swaps and structured-finance vehicles such as synthetic collateralized-debt obligations, or CDOs. That boost in liquidity is creating a potent cycle -- as entrants are added, the market becomes more liquid, more accessible and more attractive to more participants. A synthetic CDO is a leveraged pool of single-name credit-default swaps funded by the issuance of subordinated debt tranches. CDOs raise money through an equity tranche that offers a targeted but not guaranteed return. Within the CDO structure, the equity tranche is the riskiest segment as it bears the first loss associated with credit defaults. Hence, holders of subordinated mezzanine and senior notes in a CDO are better placed than equity investors in the current tough credit environment, although they aren't immune from losses if defaults ravage the CDO's portfolio. Conversely, should credit conditions stabilize and improve, equity investors stand to generate substantial returns on their investment.

Underpinning the rapid growth of the market has been the default-swap market's successful negotiations and

settlements this year of the Enron Corp. and WorldCom Inc. bankruptcies and the sovereign-debt default of Argentina.

Looking ahead, market participants are flagging a growing presence from three classes of end user: Insurance companies, asset managers and hedge funds are growing in size and influence within the credit-derivatives market. Insurers and asset managers make up 14% of the market, according to Risk Magazine. They largely are net sellers of credit protection. This level of participation is expected to rise to 20% to 25% within the next two years, said James Vore, executive director at Morgan Stanley in New York. "We are seeing significant increases in volume from insurers," and the "key for asset managers is getting everything in place to be a participant in this market," he said.

Once asset managers have set up the laborious documentation process of being able to trade credit derivatives, "they're finding a wealth of opportunities to generate investment returns," Mr. Vore said.

Money managers in particular are starting to notice how liquid and accessible credit derivatives are becoming, making them at times more attractive than the cash-bond market, where thin trading conditions can create expensive inefficiencies.

"People have a lot more confidence in the product and that the protection they buy will perform well." said Andrew Palmer, managing director at J.P. Morgan Chase & Co. in New York.

The downside of buying and selling credit protection is linked to the performance of the credit in question. For sellers of protection, a default by the corporate or sovereign entity will trigger a credit event and holders of protection will require compensation from sellers. In the case of investors paying an annual premium for credit protection, there is a risk that the entity will remain solvent over the life of the default-swap contract and not trigger a credit event.

Aside from buying credit protection to hedge a bond portfolio against default, money managers also can use the default-swap market to sell protection as a way to leverage their exposure to credit whose cash bonds may not be liquid or be in limited supply. Whereas buying protection is a short position in a bond, selling it is a way to put on a long position.

"We are seeing asset managers become more total-return orientated instead of maintaining a traditional buy-and-hold approach to corporate bonds," Mr. Palmer said. He predicts asset managers and insurers will become the largest area of market growth during 2003. Hedge funds have experienced the largest degree of growth so far this year.

Money managers readily acknowledge the versatility of the product. "It is one of the tools that a risk manager needs to have in order to reduce risk," said Michael Materasso, executive vice president of Fiduciary Trust Co. International in New York. "We are currently looking at credit derivatives as a way to control and manage credit risk in the future."

Credit derivatives have been a crucial tool for hedge funds, enabling them to isolate the equity volatility of convertible bonds. This has led many hedge funds to buy protection, and they make up 8% of the market, Risk Magazine said.

Thus, hedge funds have built an initial platform within the market that is set to grow and become better balanced between buying and selling protection, said Andrew Pernambuco, principal at Alexandria investment management, a convertible-bond hedge fund in New York.

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