

March 27<sup>th</sup> , 2006

Volume 5, Issue 2

# Intelligent Money

*Current thinking from Haven Financial Advisors*

## Credit Derivative Markets



Louis Kokernak CFP, CFA  
Haven Financial Advisors  
Austin ~ Dallas

voice 512 514 6250

toll-free 800 898 5480

fax 800 888 5480

[louis@havenfinancial.com](mailto:louis@havenfinancial.com)

### **Special Notes of Interest:**

- From 1995 to 2002, The US lost 11% of its manufacturing jobs. *China lost 15% of its manufacturing jobs over the same period.*
- Russia's Gazprom is the largest producer of natural gas, accounting for 20 per cent of global production. Its market capitalization is over \$200 billion – more than Wal Mart. .

One of the most powerful trends in today's fixed income markets is the explosion in credit derivatives. Credit derivatives can be viewed against insurance policies against a default on a loan or a bond. They are only about ten years old - spawned as a result of a brainstorming session at a retreat for JP Morgan derivatives specialists in 1995. Credit derivatives now insure over \$12 trillion in fixed income product today.

One of the first credit derivatives contracts allowed JP Morgan to lay off the default risk of a basket of European bonds to a third party investor. The well-capitalized investor received a periodic fee in exchange for compensating JP Morgan in the event that one or more of the bonds in the basket defaulted.

Ultimately credit derivatives have had a significant effect on the trading and lending practices of financial institutions. Banks can now make loans and thereafter shift the credit risk to a third party – at a cost. It allows for more lending while, at the same time, distributes default risk across thousands of market participants rather than a single lender.

Portfolio managers might similarly remove the credit risk from a portfolio of corporate bonds if their expertise lay elsewhere – say interest rate risk management. In some cases, the size of the credit insurance market dwarfs the actual cash market for bonds. GM has about \$30 billion debt yet there are \$200 billion in credit derivatives linked to the company.

A byproduct of the credit derivatives market is the availability of quantitative measures of credit risk for a wide range of financial entities. We now have numerical

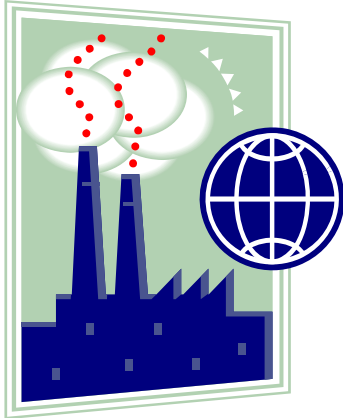
assessments of the likelihood of a bond or loan default. A company that entertains a leveraged buyout typically sees the cost of its credit default swap skyrocket. Bondholders see this too and demand indentures prohibiting additional leverage or additional interest compensation.

Credit derivatives can be an important tool in corporate finance. Trade receivables, fixed price forward sales contracts, and deferred employee compensation pools, for example, all create credit exposure in the normal course of business of such companies. Credit derivatives now allow intermediaries to strip out such unwanted credit exposure and redistribute it among banks and institutional investors who find it attractive as a mechanism for diversifying investment portfolios.

Why might a retail investor be interested in contracts undertaken almost exclusively by institutions. A key reason is that credit derivatives allow for the rapid reassignment and pricing of risk in the open market. This might pave the way for the widespread securitization of whole loans that banks routinely make. Already asset-backed securities are one of the fastest growing investment segments. Yet over 90% of the collateral is already investment grade. The pool of potential collateral might grow if credit derivative markets expanded to protect investors against default. Securitized whole loans might offer a liquid and higher yielding supplement to the fixed income products available to today's retail investors. As an investment advisor, I would be interested in the securitization of an entirely new pool of income-producing assets.

The rapid growth of the credit derivatives market has caused concern among regulators and industry players alike. "Risk

**Credit Derivatives (Cont)**



transfer through derivatives is effective only if the parties to whom risk is transferred can perform their contractual obligations," Former Federal Reserve Chairman Alan Greenspan said in a 2005 speech. "These parties include both derivatives dealers that act as intermediaries in these markets and hedge funds and other non bank financial entities that increasingly are the ultimate bearers of risk."

This month, leading credit derivatives dealers committed that by October all standard trades with active customers would be processed electronically and fully

confirmed within five days. They also endorsed the idea of a central database of credit derivative transactions. Many regulators had become alarmed that lagging back offices were too slow to confirm agreed upon derivatives trades.

On a positive note, the ratings downgrade of Ford and GM in May 2005 did not impair the functioning of the credit derivative markets. That was an important test to pass. I am hopeful that the dispersal or credit risk throughout the world economy will ultimately make it possible to deliver an expanding array of investment products to the retail investor.

**Corporate Earnings on the Rise**

America's largest companies have posted an uninterrupted recovery from the corporate earnings recession at the beginning of this decade. In fact, Price/Earnings multiples of the S&P 500 have fallen substantially since 2002 despite the rather healthy recovery of price levels among the index's constituent stocks. The earnings recovery is robust to the definition of earnings employed (See the April 20<sup>th</sup>, 2003 Intelligent Money) whether it be operating earnings, GAAP earnings, or Core earnings. The latter measure is an innovation by Standard and Poors and is the most conservative calculation.

In my 2003 article, I pointed out that there was a growing disparity between a company's reported earnings and core

earnings prepared by S&P. The most notable source of the difference is the rather large expense that S&P recognized in its core calculation for employer stock options. Thanks in part to a reduction in scope of options issuance, the disparity between the various earnings methodologies has begun to close.

If first quarter 2006 operating earnings come in as expected, it will mark the 16<sup>th</sup> consecutive quarter that the S&P 500 has posted a double digit gain on the quarter one year prior. This has never happened before and is especially impressive in light of the economic dislocation caused by Hurricane Katrina. last year.

*"Credit derivatives allow for the rapid reassignment and pricing of risk in the open market. This might pave the way for the widespread securitization of whole loans that banks routinely make."*

*Price/Earnings multiples of the S&P 500 have fallen substantially since 2002 despite the rather healthy recovery of price levels among the index's constituent stocks.*

