derivatives week

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UBS Hires CDO Marketer

UBS has hired **Sean Rice**, managing director in global structured products at **Bank of America** in New York, for a similar role.

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REPLICATION INDICES BEING USED FOR FUND HEDGING

Dealers that have structured portfolios to replicate hedge fund returns are looking at using them as a proxy hedge for derivatives they write on managed funds. **Goldman Sachs**, **Merrill Lynch**, and **JPMorgan** are among firms that have launched so-called hedge fund replication indices, based on algorithm-driven investment portfolios that seek to mimic hedge fund strategies. The indices were originally set up as a cheap way for investors to get hedge fund-like returns, but according to some fund of funds officials, dealers are looking to use the indices to hedge structured investments.

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ACA ADOPTS FULL-SPREAD ACCOUNTING METHOD

Credit insurer and asset manager **ACA Capital** has overhauled its accounting methods and, in a vote of no-confidence in the rating agencies, it is now valuing its credit portfolio by credit-default swap spread levels, rather than ratings. ACA officials said although this means its accounts are more volatile, they now more accurately reflect market valuations.

While Financial Accounting Standard 157 requires all financial institutions to mark instruments as close as possible to their sale price by January, ACA is among the first to opt for a method based entirely on spreads. Other firms such as **FGIC** use a method that combines a variety of factors including ratings, spreads and contractual terms, but FGIC has not yet adapted this method to FAS 157. Other firms have held off adopting the full-spread approach because revaluing books this way is likely to inject volatility into balance sheets and ACA's results, coming during the recent market turbulence, show this. Under the new

(continued on page 11)

INVESTORS SEE POSITIVES IN LCDS DOCS, BUT LIQUIDITY IS A CONCERN

European credit derivatives investors are approaching Monday's launch of a new market-standard loan-credit-default swap contract with caution. While largely pleased with the terms, most said they plan to wait and see before piling into trades. The main reason is concern about lack of liquidity—a problem in the current European LCDS market—being perpetuated under the new contract by its launch into a volatile credit environment.

"There has been a ton of pent up interest for the last two-and-a-half months," said one trader member of the **International Swaps and Derivatives Association** inter-dealer group that created the template. "We definitely expect more volume on Monday," he said Friday. "But I don't expect to see a huge number of new players right away."

(continued on page 12)

At Press Time

UBS Hires BofA CDO Marketing Head

Sean Rice, head of U.S. structured credit marketing at **Bank of America** in New York, has joined UBS in Stamford, Conn., as managing director and head of structured credit product management. Reached at UBS, Rice said he is starting a product management group for synthetics. He reports to **Steve Dugdale**, head of structured credit trading, and **Chris Ryan**, head of credit and fixed income.

At BofA, he reported to **Michael McLaughlin**, global head of structured securities in New York. It could not immediately be determined if he has been replaced.

Structured Correlation Market Drives Volatility

Credit officials believe volatility in the credit markets will not die down until the bid returns for bespoke single-tranche collateralized debt obligations. Several buy-side traders said trading has been driven by dealers rebalancing correlation books rather than preparing to issue new structures.

Dealers delta-hedge CDOs by selling single-name credit-default swaps to balance out the protection they hold through single-tranche CDOs. The amount of CDS they need to sell increases as spreads widen, which usually helps stabilize spread widening.

But last week when the seven-year CDX IG index jumped 10 basis points to 82 bps, the delta on the popular seven-year 7% to 10% tranche actually decreased, meaning dealers had to switch to buying protection, explained one trader. Correlation desks that had been sellers of protection throughout the year, had to now get short risk in CDS, said **Jeffrey Rosenberg**, strategist at **Bank of America**.

Tightened CLO Warehouses Lure Managers To LCDS

Collateralized loan obligation managers are starting to ask dealers to ramp up deals for them using loan-only credit-default swaps because warehouse lines for cash deals have been reduced in the past month. Dealers have been unable to move large chunks of syndicated loans from their books and cannot sit on any more loan exposure, according to secondary loan market traders. At the same time, the basis between LCDS and loans continues to increase, and structurers expect that some managers should soon return to the market with hybrid offerings to take advantage of that spread. One rating agency official said he has been fielding questions about deals that would include between 25-50% LCDS.

LCDS spreads were averaging 100 basis points in April but moved to around 225 bps by the end of June. In comparison, cash loan spreads have moved from about 200 bps to 250 bps in that same time period, according to one LCDS trader's estimate. For some names such as **Univision** and **Tribune Co.** LCDS is trading above their cash loans (DW, 7/6).

The basis between LCDS and cash loans is increasing because of the falling value of the prepayment option embedded in the cash loan. The prepayment risk is far lower with LCDS because the entire loan facility must be called for 30 days before the LCDS contract is canceled.

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EDITORIAL

TOM LAMONT
Editor

STEVE MURRAY
Deputy Editor

PETER THOMPSON
Executive Editor [Chicago] (773) 439-1090

ELINOR COMLAY
Managing Editor [New York] (212) 224-3208

ABIGAIL MOSES
Reporter [London] (44-20) 7303 1753

NICOLETTA KOTSIANAS
Reporter [New York] (212) 224-3274

HARRY THOMPSON
Associate Reporter and Hong Kong Bureau Chief (852) 2912-8097

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Sketch Artist

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ADVERTISING AND BUSINESS PUBLISHING

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LESLIE NG
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PUBLISHING

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Editorial Offices: *225 Park Avenue South, New York, NY 10003 Tel: (212) 224 3208 Email: ecomlay@euromoneyplc.com*

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Institutional Investor NEWS
INTELLIGENCE FIRST

Calyon, CAAM Close Short Strategy

Calyon and **Credit Agricole Asset Management** have closed a novel short strategy credit structure, issued both as a note and fund. The EUR400 million Solys notes and EUR180 million Structura Solys sub-fund closed last month and were placed with about 100 institutional investors globally. The firms are considering additional taps in the fall based on investor interest.

The strategy is called Solys for short-long-short, and consists of buying protection on two tranches and selling protection on one tranche of a bespoke portfolio. Portfolio managers at CAAM in Paris said the zero-cost strategy is unique because it allows investors to benefit from spread widening and volatility without negative carry.

The portfolio consists of on-the-run iTraxx Main and Crossover indices and up to 20% single-name credit-default swaps, chosen for expected spread widening. It consisted of 10% CDS at the outset. The initial strategy was buying protection on the 0% to 3% tranche, selling on 3% to 4% and buying on 4% to 5%, but the manager has flexibility to adjust attachment points to optimize its mark-to-market profile and attachment points were adjusted higher as spreads widened last month.

The first series of notes were issued in March and have cashed in and reset five times since then, capturing gains of as much as 3% each time. The notes earned 12% in July.

INVESCO Rolls Out Synthetic Deal

INVESCO is marketing a total-return swap collateralized loan obligation called Hudson Canyon Loan Funding. The portfolio will reference primarily floating-rate senior-secured bank loans with an expected life of six years. Synthetic deals are a little easier to market than cash deals now because "You can create the securities you need in a synthetic, plus in general CLOs are not marked to market," said **Kingman Penniman**, **KDP Investment Advisors** president.

Many deals that have been pushed through amid market pressures were likely able to lock in liability costs just before spreads widened considerably and were in a position to buy assets at attractive levels, Penniman added.

The deal has a USD47.8 million A tranche, a USD31.3 million BBB tranche and a USD4 million equity tranche. **Citigroup** is arranging the deal. **Greg Stoeckle**, INVESCO managing director, declined comment and Citi officials did not immediately return calls seeking comment.

In March, INVESCO was working on the second close of its first long/short synthetic collateralized debt obligation. INVESCO currently has USD8 billion of assets under management, including 10 U.S. cash CLOs totaling USD4.5 billion and four European CLOs worth USD1.6 billion.

RBC Takes Muni Swap Play To Retail

RBC Capital Markets is offering U.S. retail investors a novel note linked to U.S. dollar LIBOR and municipal bond swap rates, traditionally a trading strategy run by institutional investors. In the ten-year note, RBC is offering investors 100% capital protection plus potential coupons every six months. The coupon represents 65% of U.S. dollar LIBOR, minus the daily average of the **Securities Industry and Financial Markets Association** municipal swap index.

The municipal swaps rate is tax-exempt and historically trades at 68% of U.S. LIBOR. Playing the two rates against each other, often via range accrual notes, has been a popular trade for U.S. financial institutions and also with money managers abroad (DW, 3/23).

Laurence Kaplan, a structured products official at RBC in New York, noted the structure is relatively complicated and new to retail investors, so it remains to be seen how well it will be received by these investors. The notes have a minimum investment of USD1,000 and close at the end of the month.

Relative-Value Credit Said To Deck Sowood

Boston-based **Sowood Capital Management** reportedly was brought down by a relative-value credit strategy that backfired on both legs of the trade.

Rival funds and credit traders said the fund was long secured debt via cash and loan-only credit-default swaps. At the same time, it was short unsecured bonds via CDS and, as a hedge, long equity puts on the same entities. Sowood took a mark-to-market hit on these positions, prompting margin calls from brokers, because secured debt has widened out more than unsecured debt. In some cases, senior spreads are close to or wider than unsecured spreads.

Sowood had USD3 billion under management, but dropped over 50% last month, according to a letter sent to investors last week. When counterparties began to severely mark down the value of posted collateral, Sowood decided to sell its credit portfolio—some 15% of its total holdings—to Chicago-based **Citadel Investment Group**. Sowood officials could not be reached for comment by press time.

Citadel reportedly took over about USD3 billion in positions, according to dealers.

One credit investor noted only a handful of firms would be in the position to close such a deal over the course of a weekend. He added that several hedge funds have set aside dedicated vulture money in the past week and let it be known they are ready to buy from distressed sellers.

One-Year CDS Volumes Tick Up

There was an increase in trading of one-year protection last week as dealers continued to hedge correlation books by selling protection across single-names. One estimate pegged volumes at double the normal amount for one-year maturities.

One trader at a New York firm said typical sellers of five-year protection have switched to one-year maturities, because the more common tenors have been more volatile. Investors concerned about fundamentals in the long term—but looking to pick up yield in the short term—have also taken note of the new liquidity in the tenor and started selling one-year protection on some names.

Vintage ABX Drops On ARM News

The 06-1 series of the ABX index has dropped the most quickly of the four ABX vintages, due to mortgage lender announcements they are ending adjustable-rate mortgages. The 06-1—which was the first version of the index—references a large number of bonds backed by ARM mortgages, particularly those fixed for the first two years and then adjustable for 28. The BBB minus slice of the 06-01 was trading at 58.78% on Wednesday, down from 69.03% on July 20 and 77.59% on July 2.

Last week, **JPMorgan** joined **Wells Fargo**, **Option One Mortgage Corp.**, **First Franklin**, **Washington Mutual**, and **Countrywide Capital Markets** in announcing they will stop offering 2/28 and 3/27 hybrid ARMs to sub-prime borrowers, at least for the time being. Recent remittance reports showed that a large group of 06-01 borrowers are approaching reset, according to an investor. If ARMs are no longer offered, many borrowers will have less refinancing options to turn to.

Bespoke I-Grade CDO Interest Rises With Spreads

Collateralized debt obligation managers last week reported increased interest from investors in short-dated bespoke synthetic investment-grade CDOs. Managers, including **BNP Paribas Asset Management** and **Alliance Bernstein**, said investors were looking to push vanilla deals through quickly to capture value from wide spreads, despite volatility.

"Investors see more opportunity than risk," said one portfolio manager, explaining investment-grade fundamentals remain strong. "The repricing is sound, but the way it went is unrealistic. It has nothing to do with the real-world macro-economic condition."

It could not be determined, however, if many deals were actually being issued. "CDO bid lists are going around," said one credit-default swap trader at a European bank. "There is interest, but it's unclear if anyone is prepared to take the bull by the horns."

Vol Bolsters Reverse Convertible Returns

The recent uptick in implied volatility has improved terms for investment structures that sell volatility. U.S. investors have been big buyers of such structures in the form of reverse convertibles, which are notes embedded with put options usually referencing single stocks.

One structured product salesman said firms marketing these notes seek out volatile stocks, often technology or energy companies. Although these stocks allow the reverse convertible to pay a potential high coupon—usually between 10% and 15% a year—there is also a possibility the stock will drop below the strike on the put option, leaving the investor holding the devalued stock.

Sub-prime concern, however, has made financial sector stocks volatile although they are not traditionally associated with sharp losses in value. **Barclays Capital**, for example, has structured a five-month reverse convertible linked to **Bear Stearns** stock that is protected against a 20% drop in the stock's value and pays an annualized rate of 12%. **Citigroup** is marketing a six-month reverse convertible linked to **Countrywide Financial**, similarly protected against a 20% drop in the value of Countrywide stock and paying an annualized return of 13.5%. One New York-based structurer at another firm said, "These are fantastic terms." He said investors are attracted by the potential payoff, and also because they do not believe Bear Stearns stock is likely to drop below 80% of its current level.

On The Move

- **Merrill Lynch** in New York has hired **Jimmy Jusuf** from **Bear Stearns**. Jusuf joins in a new position, trading equity index exotics. A Merrill official said the firm is expanding its U.S. trading effort. Bear Stearns officials did not comment on a replacement by press time.

- **Mark Altan**, an exotic equity derivatives trader at **Deutsche Bank**, has joined **JPMorgan** in London in a similar role. Altan takes a new slot in one equity stratergic trading team. Details of the new group could not be confirmed.

- **Barclays Capital** in New York has hired **Andrew Mitchell** as a single-stock derivatives trader. Mitchell previously had a similar role at a hedge fund in the city, details of which could not be determined by press time. Barclays officials said Mitchell is an addition to the team.

Asia Pacific

Asian Investors Scope Credit Structures

Asian investors are cautiously eyeing credit investments in the light of current volatility and following the sub-prime fallout in the U.S. Dealers are keeping close tabs on investor sentiment, as uptake of credit structures in the region has traditionally lagged Europe and North America.

Ryan Chan, executive director in global credit derivatives at **UBS** in Hong Kong, explained, "Asian investors…have become more and more familiar with structured credit products such as synthetic corporate CDOs." He added, however, "Many of them are closely monitoring the performance of these products at the moment to assess if there is any contagious impact from the sub-prime fallout, and some might take advantage of the wider credit spreads." Conditions are causing arrangers to drop their prices, and spreads have widened after a protracted period of tightness, leading some to speculate that now is a good time to start investing.

Talking specifically about credit structures with a level of sub-prime exposure, **Stephen Wong**, managing director of structured credit and CDOs, Asia-pacific, at **RBS**, said it was hard to generalize about whether investors were being cautious with the investments. "We've seen and done trades with investors," he said. Wong highlighted the importance of good managers and strong portfolios in investor take up. "There are a lot of relative value opportunities…for investors that can put effort and resources into study."

Asian CPDOs Fail To Materialize

In spite of a lot of talk about Asian-arranged constant proportion debt obligations, no such deals have come to market. Rating agencies have been reporting inquiries from arrangers interested in producing the structures since the beginning of this year. A report from **Standard & Poor**'s last month also highlighted Asian investor interest in CPDOs, particularly those based on indices. Officials at the agencies said it is difficult to tell whether the absence of the structures is as a result of the recent uptick in volatility in credit markets, or simply because of the quiet summer period.

User Strategies

Wealth Manager Buys Into Leveraged Note

Blue Bell Private Wealth Management, a wealth manager based in Blue Bell, Pa., is investing in a leveraged note linked to the **Standard & Poor's 500**. The firm was launched in 2005 and initially invested in notes traded in the secondary market. As it has grown assets under management, however, it has found it harder to invest larger amounts in the secondary market and so is investing more in primary notes.

Justin Capetola, managing partner and cco, said it worked with **HSBC** on its most recent investment, a 13-month note linked to the S&P 500. He said equity volatility in the last few weeks meant Blue Bell could get good terms on the note. It pays two times the upside of the index, up to a maximum return of 21.2%. There is no protection on the downside.

Capetola said Blue Bell looks for shorter-dated notes in the primary market, usually with a maximum of 18 months. "We do not want to have our clients' money locked up for three years or so," he said, although the firm will invest in two- to three-year notes in the secondary market. Blue Bell only works with dealers with AAA or AA ratings and shops structures for competitive quotes to ensure it gets best pricing and terms, he added.

BNP, IXIS Plot Credit DPI Tap

BNP Paribas Asset Management and **IXIS Corporate & Investment Bank**, a subsidiary of **NATIXIS**, are planning additional taps of a capital protected credit deal. PARFLEX, which deploys dynamic portfolio insurance, initially closed at EUR250 million earlier this year and the pair expect to add about EUR10 million this month. They are planning several taps throughout the year to bring it to a target size of EUR300 million (DW, 5/18).

Stephane Blanchoz, project manager at BNP PAM in Paris, said PARFLEX fared well through the recent credit crisis because it references a high-quality portfolio of multiple credit classes, including corporates, emerging markets, high-yield, asset-backed securities and collateralized loan obligations. "Fundamentally, we are still seeing value in assets," he said. "It's good timing for another tap."

BNP PAM has increased its risk exposure from 80% at the outset to almost the full cushion as spreads have widened. PARFLEX provides capital protection through dynamic portfolio insurance and has a leverage factor of about 5%.

Institutional Investor News Presents:

the 2007 DERIVATIVES AWARDS

Derivatives Week is seeking nominations for its annual industry awards, which recognize the market's most outstanding professionals.

The editorial staff has already started scouring the market, but this is your chance to nominate the firms and people who you think have stood out.

We'll be recognizing the winners at a gala awards dinner November 28, 2007 at the Millennium Hotel, Mayfair, London.

There will be awards for the following categories:

- ❑ Equity Derivatives House Of The Year
- ❑ Credit Derivatives House Of The Year
- ❑ Fund-Linked House Of The Year
- ❑ Equity Fund Manager Of The Year
- ❑ Credit Fund Manager Of The Year
- ❑ Structured Investment Distributor Of The Year
- ❑ Synthetic CDO Manager Of The Year
- ❑ Law Firm Of The Year

Nominations must reach DW by August 24.
A shortlist of candidates will be drawn up by the editorial staff of DW,
and announced in the September 10 issue.

Please send nominations to
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Associate Reporter **Harry Thompson** in Hong Kong at 852 2912 8097 or harry.thompson@iihongkong.com.
All correspondence will be treated as confidential.

Foreign Exchange & Credit Derivatives Markets

Kiwi Falls As Carry Trade Unwinds

The New Zealand dollar bore the brunt of pressure last week as Kiwi-focused carry trades were unwound. Traders were focused on the currency and implied volatility across Kiwi pairs shot up. One-week implied volatility for NZD/JPY reached 18.12% Thursday, up from 15.92% Tuesday and 14.47% the week before. In the spot market, the New Zealand dollar was trading at JPY90.05 on Thursday.

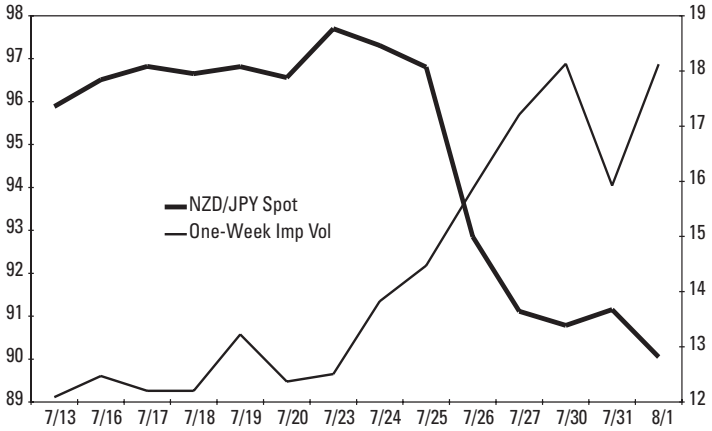
Options volumes also increased for NZD/JPY as realized volatility and implied levels have moved apart, one trader in New York noted. Realized volatility moved to above 20% for the pair from less than 15% a month ago. A trader in New York said investors have been buying short-dated options up to one-month to take advantage of the higher volatility without real directional views. The trader said both at-the-money puts and calls have been bought and sold. "The market has been paid for short-dated options as the carry trade has unwound," he added.

New Zealand Finance Minister **Michael Cullen** last week said the kiwi has peaked and will probably decline further over the medium term. The currency has dropped 6% against the U.S. dollar since reaching a 22-year high of USD0.81 July 24.

"After weeks of looking expensive, carry trade liquidation has seen kiwi/dollar fall closer to fair value," added another trader in New York. He expected that the currency should fall further but noted that everything is contingent on the equity markets.

Greg Anderson, fx strategist at **ABN AMRO** in Chicago, said with the New Zealand dollar at a low against the yen, this is an attractive entry point to sell three-month at-the-money kiwi forward calls because that is more liquid than setting up at-the-money spot trades right now.

NZD/JPY Spot & Implied Volatility



Source: **BNP Paribas**

Macro Hedging Drives Crossover Vol

Credit market drama continued last week, with two-way flows dragging European credit derivative index spreads to and from new wides. Traders said index volumes were about three times heavier than normal, with hedge funds, bank prop desks and real money accounts using indices to express macro views.

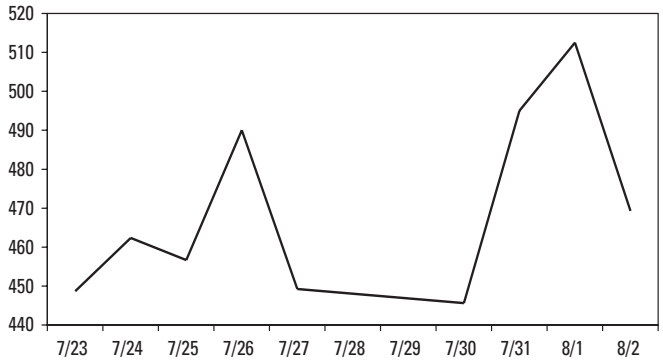
"Indices have been frantic all week," said one head of credit derivatives trading in London, noting bid/offer spreads were wide and liquidity was low. "Volatility has been unbelievable and volumes incredibly high."

Realized volatility on the iTraxx Crossover was around 125% each day last week, traders said, with intra-day moves greater than 10%. The five-year Crossover was trading at 397 basis points late Thursday morning from 430 bps at the open. It traded as high as 505 bps Monday and as low as 390 bps Tuesday, with swings of up to 80 bps each day.

Single-name stories were less important than the macro story, traders said. Most single-name CDS moved in tandem with, albeit lagging, the indices and most activity came from index components. **Alliance Boots**, for example, tracked the index with spreads tightening to 460/490 bps Thursday from 580 bps Monday and 400 bps the week before.

But there were some single-name stories. The most interesting was **EMI**, which tightened to 350/390 bps Thursday morning from 525 Wednesday on news **Terra Firma** had secured the 90% equity backing it needed to finance its takeover bid. **Moody's Investors Service** downgraded the name to B1 from Ba3. As of press time, **Standard & Poor's** had left its B plus rating unchanged.

Five-Year iTraxx Crossover



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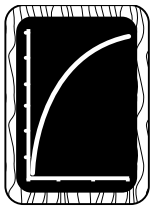

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Derivatives And Corporate Finance

Corporate Finance Practice Versus Theory

Corporate finance theory and practice exhibit significant discrepancies. In 2001 **John Graham** and **Campbell Harvey**, two **Duke University Business School** professors, surveyed approximately 4,440 companies representing a wide variety of firms and industries and received 392 completed responses from chief financial officers of those companies. Interestingly, the survey found that the major factors affecting their financing decisions in practice are not exactly those suggested by corporate finance theory.

Traditional corporate finance theory has roots in the Modigliani and Miller theorem that suggests, in modern terms, the choice between debt and equity financing is irrelevant in a tax-free world. Once taxes are introduced, however, debt financing adds value to a corporation through a "tax shield" i.e., the tax savings resulting from interest deductions on debt. Thus the M&M theorem implies that chief financial officers should optimize the capital structure to achieve a certain debt/equity ratio whereby the tax benefit of debt financing is maximized.

The survey results, however, revealed additional critical considerations aside from the tax shield. To be sure, the tax advantage of debt did appear as one of the important factors. But the survey also found that many chief financial officers actually considered maintaining "financial flexibility" as their first top priority in corporate finance decisions. A similar survey by two **University of Manitoba** professors on European companies also found financial flexibility among the most important factors for those companies' capital structure choice.

The strongest implication of these findings is that a company's optimal capital structure also has a dynamic aspect. This is extremely relevant to the corporate equity derivatives and convertible bonds markets, because with innovative features, they provide corporate issuers much more financing flexibility than straight equity or debt financing.

Finance Flexibility and Derivatives

Why is financial flexibility so important? The obvious reason is that chief financial officers naturally are concerned about unexpected business downturns. Debt brings with it a greater risk of distress for the firm because the obligation to make coupon payments on debt remains even if the firm's earnings are insufficient to finance the debt. In this context, zero coupon or payment-in-kind notes have increased in popularity as a solution from a financial distress standpoint. They retain the advantage of interest deductibility (unless the discount is too deep and the maturity is too long) but largely reduce distress costs because they do not create a burden on the firm's cash flows until maturity.

Financial flexibility is also important because the different stages of corporate growth require a different capital structure. This is most obvious for early-stage growth companies, as illustrated by their frequent use of convertible bond financing. Furthermore, the increasingly complex and fast-changing business world today inevitably requires corporations sometimes to take action without perfect information. In such context, corporations would like to put financing in place such that the financing terms can be modified to reflect future market conditions and new information (or, in extreme situations, undo the whole financing completely). As a result, innovative convertible securities and over-the-counter derivatives are continuously brought to the market to provide the customized solutions for such flexibility needs.

Equity-Linked Capital Markets: Convertible Securities

By combining debt and equity through the conversion option—essentially a call option—a convertible bond provides an issuer substantial financing flexibility. Because the coupon on a convertible security is generally lower than that of a straight debt financing, the company benefits from increased flexibility as the lower coupon reduces the threat of financial distress.

More importantly, the conversion option enables the issuer to manage its debt/equity ratio dynamically, i.e., when the stock performs, the increased leverage associated with the convertible debt can be cleaned up by its conversion into equity. Finally, additional derivative features (e.g., stock price-triggered call) can be incorporated to balance multiple financial flexibility considerations such as minimizing the cash cost of funding, limiting probability of share dilution, and achieving equity credit from ratings agencies.

Take the popular use of convertible financing by small cap growth companies, for example. These companies face an

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uncertain time horizon by which their growth potential may be realized. Thus from the financing perspective, these companies must plan for the possibility, but not the certainty, of major investments in a few years. A well-structured convertible offering provides the currently needed capital while giving management the option to retire debt and get an infusion of equity just when the company needs it. With a stock-price triggered call option, the convertible debt can be called as the stock price increases (effectivively forcing conversion into equity) and thus free up additional borrowing capacity to finance future growth.

OTC Equity Derivatives

To some degree, OTC derivatives can offer additional flexibility due to the fact the issuer faces a single counterparty instead of the broader capital markets. The complexity here is that the dealer typically will need to enter into hedging activities that may involve dynamic buying and selling of the underlying stock, in order to manage its risk. In 2003 the **Securities and Exchange Commission** issued an no-action letter providing clearer guidelines on such dealers' hedging activities, thus making OTC equity derivatives a feasible corporate finance tool.

For example, based on the 2003 SEC no-action letter, a few issuers entered into forward equity issuance contracts as a flexible financing vehicle. The forward issuance contract involves the issuer agreeing to sell shares at future dates to the investment bank at prices pursuant to pre-determined formula (naturally the investment bank would short sell the underlying stock to hedge). Anytime on or before the contract maturity, the issuer could issue shares to the investment bank and receive proceeds accordingly. In essence the forward contract creates an "equity line of credit" and provides immediate available capital for the issuer's contingent financing needs.

In addition, certain issuers have added a flexible-settlement mechanism in those forward contracts for further flexibility. One such issuer entered into a forward equity issuance contract in connection with a merger transaction pending regulatory approval. The forward share issuance was designed to be the acquisition capital for the merger. However, if the regulatory approval was not received, the contract provided that the issuer could net settle the contract, i.e., the issuer would only be required to issue shares (if any) with respect to the net value of the contract upon settlement, instead of issuing the full underlying shares and receiving the full notional amount of cash, which would otherwise become a suboptimal financing given the failed merger.

Interestingly, the attractiveness of "financing flexibility" to the company could itself be explained with derivatives theory. The financing flexibility enjoyed by a company allows it to view business decisions in particular capital investments with more freedom.

In derivatives terminology, such flexibility creates a "real option" for the issuer (in the sense of "choice"). In other words, financing flexibility creates real value for companies because it leads to business investment flexibility.

Conclusion

In making corporate financing decisions, empirical research has found chief financial officers make special considerations around "financial flexibility" as well as the debt tax benefits maximization suggested by standard corporate finance theory. The equity-linked capital markets and OTC equity derivatives are powerful tools for corporates' dynamic financing needs.

*This week's Learning Curve was written by **Winston Ma**, CFA, senior originator and structurer for equity-linked and derivatives solutions, and **Craig Orchant**, head of corporate finance and risk management, at **Barclays Capital** in New York.*

Winston Ma

Craig Orchant

ACA ADOPTS

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system, ACA reported a second quarter net loss of USD93 million last week, and USD109 in losses related to eight collateralized debt obligation equity positions.

Ted Gilpin, executive v.p. and cfo of ACA in New York, said during a conference call with shareholders and analysts last week that the firm made the switch to provide marks that are more reflective of the actual market. Gilpin added that since the firm intends to hold its derivative contracts to maturity, unrealized gains and losses will revert to zero once a transaction reaches contractual maturity, absent any credit losses.

An ACA analyst approved of the switch to spread-based accounting. "It was the right thing to do, especially now because marks across the market have been questionable for a while." He added, "Nobody trusts ratings anymore." Rating agency officials did not comment by press time. *—Nicoletta Kotsianas*

Market Data

Dividend Swap Prices

	SX5E		FTSE		CAC		SMI		AEX		SPX		NKY	
	Mid	Wk chg	Mid	Wk chg	Mid	Wk chg	Mid	Wk chg	Mid	Wk chg	Mid	Wk chg	Mid	Wk chg
2007	147.8	- 0.3	216.5	- 1.5	170.0	+ 0.0	193.0	+ 0.0	17.2	+ 0.0	27.8	+ 0.0	207.5	+ 0.0
2008	164.9	- 0.3	237.5	- 5.3	188.9	- 1.6	240.0	- 3.0	19.2	+ 0.0	30.5	+ 0.0	231.5	- 1.5
2009	174.0	- 3.9	252.8	- 7.0	200.9	- 1.6	263.5	- 3.0	20.3	+ 0.0	32.6	+ 0.0	250.5	- 2.0
2010	181.4	- 4.8	263.3	- 8.5	211.5	- 1.5	280.5	- 3.0	-	-	35.0	+ 0.0	270.0	- 2.5
2011	186.6	- 5.3	271.0	- 9.3	219.0	- 1.5	-	-	-	-	37.4	+ 0.0	290.5	- 3.0
2012	190.6	- 5.4	278.1	- 8.6	224.5	- 1.5	-	-	-	-	39.7	+ 0.0	-	-

Source: **Barclays Capital**

Five-Year Credit-Default Swap Levels

	Current Mid	Change On Week	Change On Two Weeks
U.S.			
American Express	44	17	25
AOL Time Warner	53	17	27
Bear Stearns	103	22	41
Citigroup	36	5	14
Disney	29	13	13
Federated Dept. Stores	132	-24	-30
Ford	749	-2	127
Ford credit	444	5	96
General Electric Cap Corp.	34	11	17
GMAC	425	26	173
Goldman Sachs	76	11	30
Hertz	379	59	133
Hewlett Packard	24	8	8
IBM	25	9	9
Lehman Brothers	90	10	34
Morgan Stanley	75	10	28
Philip Morris	45	14	18
Wal-Mart	13	0	0
Europe			
British American Tobacco	44	13	19
DaimlerChrysler	54	15	21
Deutsche Telekom	44	14	16
France Telecom	41	14	17
J Sainsbury	152	-6	50
Marks & Spencer	74	26	37
Telecom Italia	64	14	15
Vivendi Universal	68	17	23
Volkswagen	51	21	27

	Current Mid	Change On Week	Change On Two Weeks
Asia			
Amcor	51	3	10
Australia	3	1	1
BHP Billiton	25	3	1
China	26	11	13
Fujitsu	31	11	13
Hutchison Whampoa	41	15	18
Japan	3	0	0
Korea	32	13	16
Malaysia	36	17	20
Mizuho Bank	28	9	17
NEC	32	8	13
Philippines	197	64	77
Qantas Airways	75	2	9
Sony	24	6	11
Telstra	36	7	8
Thailand	57	14	19
Toshiba	30	3	8

North America	**Current Mid**	**Change On Week**	**Change On Two Weeks**
CDX.NA	79.75	22.74	32.25
CDX.NA.HY	247.95	-0.63	40.14
CDX.EM	187.00	38.00	72.00
Europe	**Current Mid**	**Change On Week**	**Change On Two Weeks**
iTraxx Main	56.00	20.00	23.50
iTraxx Crossover	420.00	57.00	103.00
iTraxx High Vol	76.00	14.00	20.00
iTraxx Sub Financial	61.00	23.50	33.00
Asia	**Current Mid**	**Change On Week**	**Change On Two Weeks**
iTraxx Japan	34.07	9.49	11.55
iTraxx Asia	80.11	21.04	31.45
iTraxx Australia	47.92	12.11	16.82

This data is updated every Wednesday.

Source: **JPMorgan**

REPLICATION INDICES

(continued from page 1)

Typically, a derivative desk that is creating a leveraged or capital-protected hedge fund structure for an investor will hedge this by investing in the fund itself. This is attractive to the fund, because it helps it boost assets under management. For the dealer, however, it may be more attractive to invest in a hedge fund-replicating index as a proxy hedge for its exposure to the managed fund, because the replicating index does not have lock-up or liquidity restraints.

It is unclear how many deals have been hedged this way or whether JPMorgan and Goldman, which also have replicating indices, are also looking to do this. Officials at Merrill and JPMorgan did not comment by press time and an official at Goldman declined all comment.

Fund-linked officials at other firms are skeptical hedging via replicating portfolios will become widespread, noting fund managers are likely to prefer a hedging method that increases their assets under management. Because the funds usually attract the structured product investor, they hold some sway as to whether or not the deal goes ahead. They also said hedge fund replication is relatively untested and however good the algorithms are, they are unlikely to match the returns generated by an active manager.

In spite of the difficulties, structurers are interested in other methods of managing hedge fund risk, noting that it is a competitive and lucrative business, even if there are significant risk management concerns.

"We have been looking at a variety of different ways of doing this," said one New York-based structurer. He said his firm has been looking to diversify its book by writing options on different types of funds, for example, and he added the firm sometimes hedges the interest-rate or volatility exposure of the whole book. Even with these precautions, a fund derivatives desk may still be exposed to an **Amaranth**-type event. "If [replication] works, it could be very exciting," he concluded.

—Elinor Comlay

INVESTORS SEE

(continued from page 1)

The combination of ISDA endorsement and new terms that do not force the contract to cancel when loans are restructured is expected to open the European LCDS market to a variety of new players. It is also expected to make the market more balanced, rather than dominated by protection buyers. Indeed, collateralized loan obligation managers, credit funds and other loan investors have started asking dealers about prices for selling protection outright or through synthetic structures.

"We are definitely doing our homework now in anticipation of next week," said **Appu Mundassery**, portfolio manager at **Highland Capital Mangement** in London, adding he is talking to dealers about names for inclusion in synthetic CLOs. "But it will depend on how much liquidity dealers provide."

In the current environment, investors expect that will not be much. Volatility in the cash loan market last week drove bid/ask spreads on flow names as wide as 200 basis points, Friday, one trader said, making it difficult to mark prices on derivatives. In the derivatives market, traders were seeing a flight to credit quality and a scramble to roll short positions on the old LCDS contract into shorts on the new contract. "Given turmoil in the market, few names have traded," said one asset manager at a French firm. "There is more interest in buying than selling protection in these conditions."

Dealers and investors, however, are hoping next month's roll of the iTraxx LevX into a second series with more names and based on the new documents will improve liquidity. "It's August, we're in the middle of a credit meltdown and investors are waiting to see how much liquidity dealers will provide," a trader said. "I expect to see good traction in a month-and-a-half."

—Abigail Moses

Calendar

Information Management Network is holding its ninth annual European CDOs & Credit Derivatives Conference at **Clifford Chance** headquarters in London, on September 6-7. To register, call +1 212 768 2800.

Quote Of The Week

"There are a lot of relative value opportunities…for investors that can put effort and resources into study."—**Stephen Wong**, *managing director at* ***The Royal Bank of Scotland*** *in Hong Kong, commenting on investment opportunities in Asia as a result of credit spread widening (see story, page 5).*

One Year Ago In Derivatives Week

The resilience of credit-default swap spreads opened the door for a burst of negative-basis trades. High issuance of single-tranche collateralized debt obligations caused CDS spreads to tighten and allowed players to pocket the difference between bond spreads and the cost of the CDS. [Single-tranche deals have come to a grinding halt amid a global spike in volatility. Credit officials believe the recent surge in volatility will not die down until the bid returns for these deals and new structures start to print.]