

Credit Derivatives

Strategies
and
instruments

September 2006

EuroHedge
special report

in association with



CREDIT DERIVATIVES: STRATEGIES AND INSTRUMENTS



Managing editor Neil Wilson
nwilson@hedgefundintelligence.com

Editor, EuroHedge Nick Evans
nevans@hedgefundintelligence.com

Production editor Kim Gross

Subscriptions Gary Charalambides
gcharalambides@hedgefundintelligence.com

Group publisher John Willis
jwillis@hedgefundintelligence.com

Chief operating officer
Peter Highland
phighland@hedgefundintelligence.com

For reprints, please contact
Rachel Byrne
rbyrne@hedgefundintelligence.com

Published by HedgeFund Intelligence,
Nestor House, Playhouse Yard,
London EC4V 5EX

Email info@hedgefundintelligence.com

Telephone +44 (0) 20 7779 7330

Fax +44 (0) 20 7779 7331

Disclaimer: This publication is for information purposes only. It is not investment advice and any mention of a fund is in no way an offer to sell or a solicitation to buy the fund. Any information in this publication should not be the basis for an investment decision. EuroHedge does not guarantee and takes no responsibility for the accuracy of the information or the statistics contained in this document. Subscribers should not circulate this publication to members of the public, as sales of the products mentioned may not be eligible or suitable for general sale in some countries. Copyright in this document is owned by HedgeFund Intelligence Limited and any unauthorised copying, distribution, selling or lending of this document is prohibited.

Contents

Panellists' biographies	3
1 The credit derivatives market	5
2 Opportunities and strategies in credit	12
3 Risk management	18
Sponsor profile	23

Introduction

The credit sector has been at the epicentre of innovation in the financial markets in recent years, with the rise of credit derivatives leading the way. And hedge funds have been both major beneficiaries of the new array of trading and investment tools that have been created – as well as being among the major drivers of the innovations.

According to the *EuroHedge* asset survey last January, credit hedge funds in Europe alone had grown to assets of over \$18 billion – over 5% of the total assets managed by European funds. And this may be only the tip of the iceberg – given that the market capitalisation of credit instruments globally comfortably exceeds even that of global equities.

The potential for the credit hedge fund sector to grow looks like it could be huge, especially if the credit derivatives market becomes ever more standardised and hence more liquid. However, the credit markets – the instruments, strategies and the risks involved – are also somewhat more complex than other markets. And this makes understanding the opportunities – and the potential pitfalls – much more of a challenge.

For these reasons, we are delighted to have assembled such a distinguished team of leading market players – including credit hedge fund managers, specialist credit investors, plus representatives of a major dealer and an exchange which is planning the first listed credit futures contract – to participate on this roundtable. We hope you find their discussion both entertaining and informative.

Neil Wilson, managing editor

Credit terms – some of the alphabet soup

- ABS – asset-backed securities
- CDS – credit default swaps
- CBO – collateralised bond obligation
- CDO – collateralised debt obligation
- CLO – collateralised loan obligation
- CPPI – constant portfolio protection insurance
- MBS – mortgage-backed securities
- OTC – ‘over-the-counter’, ie not exchange traded

PANELLISTS' BIOGRAPHIES



Cyril Armleder, GLG Partners

Cyril Armleder joined GLG in June 2005 as an asset manager. Previously, he worked at Goldman Sachs for four years where he was instrumental in developing the secondary trading European credit desk and trading the European Auto & TMT sectors. During his last year at Goldman Sachs he set up the iTRAXX credit index-trading platform. Armleder began his career at Commerzbank where he worked for six years, starting as quantitative analyst, and subsequently becoming an asset-side structurer. He became progressively more focused on credit and for his last three years at Commerzbank he was a credit trader, taking part in the early stages of the development of many aspects of the credit derivatives market. Armleder holds a masters in finance from the University of London and a degree in macro economics from HEC Lausanne. His other educational background includes law, psychology and sociology.



Mark Benson, CQS

Mark Benson is CIO of fixed income at CQS. In this role he is responsible for overseeing all aspects of fixed income and credit fund management. He is also a member of the firm's operating committee. Prior to CQS, he worked for Lehman Brothers for 16 years in a variety of roles including head of European fixed income for six years and head of fixed-income derivatives trading for four years. In addition, he held a number of other roles including head of asset management and private equity, head of mortgage capital, and head of risk management. Benson was also a member of the European Executive Committee, Global Management Committee and Global Investment Committee. He joined Lehman Brothers in 1989 as a swaps and options trader. Prior to this, he worked at Chemical Bank as a swaps trader. Benson holds a BA (Hons) in history from University College London.



Patrick Brennan, NewFinance Capital

Patrick Brennan joined NewFinance Capital in 2004 following three years managing convertible and credit arb strategies with two hedge funds: Pioneer, a \$150m convertible arb fund, and Santoma, a \$40m convertible/credit arbitrage fund. Before this, Brennan was a director and co-founder of credit market analysis, a leading data and analytics provider to the credit market. He spent five years at Merrill Lynch from 1995-2000 where he was a vice president in international credit trading, running a proprietary book of investment grade, high yield, and emerging market credit risk. He began his career at Peregrine Securities, Taiwan as a researcher in 1994. Patrick has a Masters degree from Oxford and the College of Europe, and diplomas from Harvard and Stanford.



Guy Cornelius, UBS

Guy Cornelius joined Midland Montagu in 1988 as a government bond trader after graduating from Nottingham University. In 1990 he moved to SG Warburg, where he specialised in sterling credit markets. In 1995 Cornelius joined BZW, also in a credit market role, but went on to join SBC Warburg later that year to run sterling credit sales. In 2000, he was promoted to head up European credit sales at UBS Warburg and in 2003 became head of European sales at UBS. Cornelius is currently head of European distribution, focusing his time on major clients. He serves on the UBS committees for FI EMEA management, credit fixed income and global distribution, and is also a trustee of the UBS Pension Fund.



Mehtap Dinc, Eurex

Mehtap Dinc is a product designer at Eurex with a focus on fixed-income derivatives. She is responsible for the design and implementation of the first exchange traded credit derivative. She has been in the financial industry for over 11 years, working in different positions at JP Morgan and Commerzbank prior to joining Eurex in 1999.

Dinc holds a degree in business studies from the University of Applied Sciences in Munich, Germany.

Carlo Georg, KBC
Alternative Investment
Management

Carlo Georg is chief investment officer and managing director for KBC Alternative Investment Management. He is responsible for overseeing global trading and portfolio management functions, as well as developing global investment strategies. Georg has 16 years' trading and portfolio management experience focusing on credit, equity and volatility strategies. He was one of the senior managers who transferred to KBC Financial Products in connection with the acquisition of the business from D. E. Shaw in 1999. He joined D. E. Shaw & Co in 1998 as head of Asia and founded its Hong Kong office. After spending two years developing the Asian business, he relocated to Tokyo as head of trading for Asia and Japan. In 2001, he came to London as global head of trading for KBC Financial Products UK. His career in the securities industry began at Diagram, Paris in 1990 as a consultant for derivatives trading and risk management systems. He then joined Citibank Milan in 1993 as an equity derivatives trader on the European desk and later went on to become head of Asian equity derivatives in Hong Kong. Georg graduated from the University of Karlsruhe, Germany, with a Masters in computer science and business administration.

Mike Hodges, Arundel
Iveagh Investment
Management

Mike Hodges has 18 years' experience in the financial markets and has set up and managed fixed-income credit proprietary trading desks at IBJ, Citibank, Dresdner and DLJ. From 1985-1990, Hodges was an executive director covering accounts in Germany and Canada. From 1990-1995, Hodges was a senior manager and was responsible for the special situations desk at IBJ, trading in the full spectrum of the credit markets – including structured products. In 1998, he was appointed as a director at Dresdner Bank, responsible for floating business, asset swap business and proprietary credit business. In 2000, Hodges was part of a two-man prop team at DLJ trading the credit markets.

Neil Wilson, HedgeFund
Intelligence

Neil Wilson is managing editor for the HedgeFund Intelligence publications and editorial director for *Absolute Return*. He has over 20 years' experience as a financial journalist, mainly specialising in derivatives and alternative investments. Wilson was formerly European editor of *MAR/Hedge*, editor of *Futures & Options Week*, editor of *Futures and Options World* and assistant editor of *The Banker*. He has also worked for *Risk Magazine* and has contributed to a variety of other publications such as *The Financial Times* and *The Economist*.

THE CREDIT DERIVATIVES MARKET

The credit derivatives market has grown exponentially in recent years, with both new innovations and increasing standardisation. Panellists debate where the innovation will lead next, including prospects for the first exchange-traded credit contract

Neil Wilson, EuroHedge

Why has there been such explosive growth in the credit derivatives market in recent years? Will it continue – and in what sort of ways?

Mehtap Dinc, Eurex

When we started to look at the credit market a few years ago, the market was still quite small. Since then, the volumes have continued to increase and the credit derivatives market has experienced tremendous growth, especially during the last couple of years. The recent ISDA figures show an outstanding notional value in credit derivatives of around \$17 trillion, coming from a level of \$0.9 trillion in 2001. It has reached a stage which makes this market now interesting for an exchange-traded product.

Recent ISDA figures show an outstanding notional value in credit derivatives of around \$17 trillion, up from less than \$1 trillion in 2001. It has reached a stage which makes this market interesting for an exchange-traded product



Mehtap Dinc,
Eurex

With the increasing number of new types of credit instruments being available, we believe that the real potential of the market has not been reached yet and there is room for complementary exchange-traded products.

Guy Cornelius, UBS

One area to examine when looking at where the credit derivatives market started is the convertible market. Convertible arb players looked at companies who were selling cheap, long-dated volatility – and those hedge funds wanted to buy that vol and remove all of the other risks associated. Convertible bond asset swaps were not a particularly efficient way of doing that, because – as with other fixed-income asset swaps – they're done on a bespoke package basis and therefore aren't really a tradable credit product.

But when credit default swaps (CDS) became available from banks, they didn't have those sorts of restrictions and were therefore seen as a much neater way of hedging out credit risk. I think that's really the essence of where the growth came from. One of the other attractions of the CDS market that people don't really focus on anymore is that the bond market is very finite – whereas the derivative market, by its very nature, allows much more flexibility in trading, both in terms of expressing credit views, hedging out, or for using those instruments in structuring high yielding products.

And in terms of where growth could come from in the future? The market is currently dominated by hedge funds, prop desks and market-making banks. But the only 'real money' asset management part of the market – the insurance companies and pension funds –

are small users of the market at the moment. I think we would see a huge growth from them, particularly as there's more confidence now in the settlement process. And also, with new products coming online, such as CDS on asset-backed securities (ABS) and loans, I think we're set for the next stage in what is still a rapidly expanding market.

The bond market is very finite – whereas the derivative market, by its very nature, allows much more flexibility in trading, both in terms of expressing credit views, hedging out, or for using those instruments in structuring high yielding products

Cyril Armleder, GLG Partners

I myself was a dealer until last year – and I don't want to sound like a dinosaur – but the very first part of the growth of this credit market was very much driven by banks buying protection, off-loading liabilities for regulatory capital initially and, increasingly, actual credit risk and passing them on to insurance companies. In the first phase – from about 1997 up to 1999, as ISDA worked with the dealer community on the first set of definitions for CDS – we were not doing a great amount of volume because of a lack of standardisation. The market is probably eight to 10 years old in Europe,

Cyril Armleder,
GLG Partners



though in the US, business has been going on for decades. Okay, the volume is booming, but a lot of the activity is inter-dealer – so the volume figures have to be put in the right context.

Then the bear market started. This is when the CB arb guys started to buy a lot [of CDS protection] and this in turn brought in a lot of supply into the market in Europe. This bear market and increase in demand for CDS created the urge for the standardisation of the contract and increase in liquidity. There was a massive structural imbalance between supply and demand which incentivised marketing efforts for structured products and risk taking by correlation 'traders' with big fees sponsoring partial CDO capital structure warehousing. Demand for credit ballooned as the supply normalised. There was a big imbalance at the beginning, in the bear market, and now an imbalance again in what is a fairly benign credit environment as demand for structured credit remains insatiable.

I think the next phase will be far more balanced between those two blocks: the sellers of CDS risk and the buyers of CDS risk. And I think the market will boom further – and the volume will be even more massive.

Mark Benson, CQS

Cyril makes a lot of good points. The banks really started the market – and it was the first time they actually started pricing credit right. That drove a lot of people to start thinking about the hedging of their books – in a market that was not then standardised.

If you go back to 1998, the Russia crisis was probably the first big wake-up call for people – because, for the first time, a lot of the documents (the old non-standard documents) got tested. And I think a lot of people got a big fright, because they realised they had a lot of things that didn't match. That was a great spur towards the standardisation of the CDS contract and that's, ultimately, what people needed. You needed to get the thing commoditised to the point where people could use it efficiently.

I think the CDS market is very important because the risk in credit is not very symmet-

rical in terms of the downside, upside. The downside is far, far greater than how much you can make. If you've got something 100 over LIBOR, it's only going to make you 1%, whereas the loss on a default can be huge.

Guy Cornelius, UBS

It's an asymmetric risk profile. Skewed the wrong way.

Mark Benson, CQS

Yes. Very much skewed the wrong way. And the question is: Are you being paid to take that credit risk? Or are you paying to take that credit risk, and at what level can you take that credit risk? The CDS and derivatives of it allow you to be able to take out that sort of risk.

The other thing I'd say in the background of all this is that the capital markets themselves have changed a lot. If you go back to the early 1990s, the credit capital market didn't really exist in the way that it does now. You had mainly AAA and AA bonds and some single As. A lot of the rest of the market was being done in bank loans. If you think about it, the high yield market probably didn't start in Europe until 1998. So, one of the concurrent drivers, along with derivatives, was the fact that the underlying sources of credit have changed quite a bit.

And although it hasn't changed quite as much as we thought it might have done eight or nine years ago, it's still been quite a dramatic shift in the completeness of the cash instruments, as well as the derivatives. I think that's been another spur for the use of credit derivatives.

If you go back to 1998, the Russia crisis was probably the first big wake-up call for people

The other point is that new technology has meant we're able to distribute risk, much more efficiently, to different types of people – who, prior to this, maybe couldn't or wouldn't buy it. The structured credit piece of the market is a case in point – where people who were constrained by ratings are still constrained by ratings, but the sort of portfolios that can be trad-

ed by them are very different now. In that sense, it's completely opened up the universe of buyers. That has allowed insurance companies, pension funds and banks to play in a different way from the way they used to play. And, of course, firms like our own – hedge funds.

Carlo Georg, KBC Alternative Investment Management

I want to add a few comments on the volume numbers. We've mentioned \$17 trillion in notional outstandings. If you compare that with what is outstanding in other asset classes, we have \$200 trillion outstanding in fixed income, which shows what is still possible. The underlying market in corporate bonds and bank loans is huge.

But I think we should also compare that with what's happened in the equity world, which is another benchmark, where there's only about \$5 trillion in notional outstandings in equity derivatives – that's the ISDA number. Even more interesting, if you go back three years, equity derivatives was \$2.5 trillion, about the same as credit derivatives.

One thing, in my mind, that really contributed to why credit has grown faster is that regulatory capital in the bank loan books obviously drove the securitisation market, which in turn drove CDO issuance – and together with the credit derivatives market, that's fuelled the enormous growth we've seen.

I also wanted to come back to something



Carlo Georg,
KBC Alternative
Investment
Management

Credit futures – contract specifications

Contract underlying	The recent iTraxx Europe 5-year index series
Contract value	€100,000
Price quotation	Similar to the dirty price quotation of a bond
Premium	Premium payments are part of the settlement prices
Maturity months	The nearest quarter to the end of the December cycle. Trading in the back-month contract is the continuation of the front-month contract
Settlement	Based on the observed credit index value. Index value is based on the survival of the underlying assets
Contract termination	If a contract which suffered a credit event continues to trade within the original futures contract (the price quotation will be adjusted accordingly); an additional futures contract based on a reduced basket will be tradable as a separate product in parallel

For up to date product information: www.eurexchange.com

Guy mentioned. The convertible funds were early users of credit products, and they found that asset swaps were not adequate instruments to use. There were a lot of issues with them, and there was no standard documentation. Every dealer had completely different documentation. It was a very complex product to price correctly, because you had optionality, and a lot of different structures that were all generically referred to as callable asset swaps. In the early days, nobody knew how to price the callable feature and, even today, I think there's a lot of people who undervalue the optionality. But with the CDS contract, we've got the standardisation we wanted.

Cyril Armleder, GLG

I think it's very important to recognise the fact that credit derivatives are very intensive – in terms of systems required. And, in the early days, very few people had appropriate systems.



Mark Benson, CQS

The only limit now for the growth of the market is the ability to risk manage, and from the dealers' perspective, to book and process trades.

Carlo Georg, KBC

I agree but want to make a comment. I think that there are two key elements for any product to work. Firstly, there has to be a real need and a real application for it. For example, take recovery swaps, clearly people trading credit have real exposure to recovery risk, so that type of product will work. The second big thing is that you have to be able to replicate and arbitrage it. In other words, you have to be able to deconstruct the product, and hedge the different components.

Mark Benson, CQS

Why did the market exist? It existed because the banks needed to find ways to offset a bunch of risk exposures, and so a market was created. It was also helpful from an accounting perspective – so people could release reserves. Then it came to the point where hedge funds would take up the products, where they were useful. A recovery swap is a useful and practical innovation. Frankly, the tranche market is a useful and practical innovation. Credit index products are also useful and practical innovations.

Cyril Armleder, GLG

It's quite normal, in the end, that it's for the banks and the brokers to innovate. They've got access to every part of the market, and they're

getting well paid for it – but the question is: Who takes the risks in the end?

Neil Wilson, EuroHedge

It's interesting then how you all left to go into hedge funds [laughter]. When you look at this market, in terms of the ISDA survey last year, 50% was in single-name CDS but it is interesting that 21% was already in indices – and growing quite fast. Maybe Mehtap can just explain to us what the thinking is for a market which seems to thrive on some further levels or types of standardisation. You're trying to take that a step further with an exchange-traded contract?

Mehtap Dinc, Eurex

Looking at the ISDA year-end figure for 2005, the proportion of index trading has increased significantly. So, the idea of developing an exchange-traded credit product really results from the underlying liquidity, the level of standardisation in those products and, of course, the demand we have identified in the market place.

The feedback we've received from asset managers indicates that there are mandates which do not allow them to use OTC derivatives, but wouldn't have any problems using an exchange-traded futures product. Moreover, even if OTC derivatives can be utilised, a credit future would help to significantly decrease the amount of administrative work and associated costs. In addition, a lot of players are looking for ways to cut down their costs on the high volume they currently trade in the OTC market. Therefore, dealers are also interested in these products. Considering the developments of the credit derivatives market, exchange-traded credit derivatives seem to be the next logical step towards commoditisation. It can help to increase transparency, but also help to bring the cost base down a lot as we will be offering the whole value chain, from trade execution to clearing.

Neil Wilson, EuroHedge

I think all the managers are keen on more liquidity. Maybe we can get Guy to give us the

dealer's perspective on whether a standardised contract would be a welcome addition?

Guy Cornelius, UBS

Absolutely. Very welcome, I would say. And as to your question about whether the dealer community would support such a thing, I think very much so, because real money – traditional funds, like pension funds, mutual funds, insurance companies – will have enormous confidence in that. I think you can take it as read that we would be very receptive to that sort of product, because it opens up another product line with a very important client base.

A lot of attention has been focused on hedge funds trading with investment banks over the past few years. And yes, they are a key client base. But let's not forget that it is these other people who control the majority of money in Europe. We definitely look forward to seeing it.

Cyril Armleder, GLG

Is it going to be just increasing liquidity or also reducing the costs? I think it would be good to try to bring more solidity and robustness to the market. But what would happen if we go into a down market? Would you give me down prices? I'm not very good with futures, but, if things move fast... On equities, there are price limits [where trading is halted]. Will there be limits in the credit futures market? If the OTC market goes crazy, trading is difficult. Will the futures market continue to function at all?

Mehtap Dinc, Eurex

Just when you need it, you mean? [laughter]. Depending on the product, different security measures are applicable at Eurex. We will also make sure to apply safety measures for the credit products wherever market and product characteristics deem them necessary but, generally, we don't have price limits on our contracts.

Carlo Georg, KBC

We've talked a lot about the right construction for the contract. The point I want to make is

Mike Hodges,
Arundel Iveagh



that the design of the contract has to be simple; and it has to be cash settlement only, so that everybody can use it easily. If you want to get new players into using it, the futures contract can't be physically settled into bonds for example.

At the moment, the way I understand it – maybe getting a bit technical – there are situations where we can settle in something other than cash. I think that is a significant issue for people.

Mehtap Dinc, Eurex

One of the objectives in designing the contract was to mimic the risk structure of an OTC index credit default swap and to reflect the same cash flows. Therefore, an important element in addition to the present value change will be the premium component included into the futures price. After intensive consultation with the market place, we decided for simplicity reasons, as well as considering all the potential issues involved with physical settlement at expiration, to design a futures contract which will be purely cash settled. We also believe that, in order to bring new entrants into the market, the most reasonable way is an offering based on cash settlement.

Without the occurrence of a credit event, the contract will be tradable like any other index futures contract. After a credit event has occurred, there is a special situation when a single-name futures contract would be created, but

only to cover a period between the expiration of the original contract and the date until an auction takes place to determine the recovery value of the reference entity suffering a credit event. After the auction takes place, the single-name contract would be cash settled immediately based on the determined recovery value.

Mark Benson, CQS

That sounds very encouraging, because, obviously, what we're talking about here is the means to commoditise the market.

Neil Wilson, EuroHedge

Do the managers here anticipate this market to be mainly used by the dealers? Or will it be like the equity futures and options market, which is used by both funds and dealers?

Carlo Georg, KBC

I think that it will lead to a broader range of market participants.

Cyril Armleder, GLG

And will the OTC market disappear?

Mark Benson, CQS

I think it will evolve in different ways. And OTC volumes would probably go up, because there would be another way to hedge.

Neil Wilson, EuroHedge

How many contracts will be listed, and do you anticipate activity in longer-dated contracts?

Mehtap Dinc, Eurex

To start with, one futures contract is being planned with one expiration month tradable and the back-month contract being listed a few days prior to expiration of the front-month contract. Once liquidity is established and demand for longer-dated contracts has been identified it is rather simple to extend the number of tradable contracts very quickly.

Neil Wilson, EuroHedge

I'd like to get the views of our investors here on the evolution of the market, and in partic-

ular on the proposed new innovation from Eurex?

Mike Hodges, Arundel Iveagh

One thing that is really going to be interesting for us, with a futures contract, is that right now we have asymmetrical treatment for margins. When you buy or sell, the prime brokers don't treat you the same way. Clearly, it's different risks. If you had a clearing house, it would be symmetrical. That looks like a big step forward.

However, whenever there's a new product coming in, there's always a risk of a problem. It could potentially distort the market; for example, if it attracted more end users as sellers of the product, it could create a one-sided market. There is also the risk at expiry – of having a massive squeeze on one side, and if you've got the contract trading at say five basis points wider, you have to ensure that there's no dislocation between the underlying market and the expiring contract.

Mehtap Dinc, Eurex

One of the challenges in exchange-traded contracts is to establish a well balanced, two-sided market. We are paying great attention to not only have the buy side on board, but also have market makers and dealers represented. The response we have received so far indicates interest from the dealers as well. We are convinced that we will have market participants on board representing different areas of the industry.

Mike Hodges, Arundel Iveagh

From an investor's perspective, any product that increases transparency in a complicated space (credit) is a major positive. The more instruments you have that are priced cleanly and accurately the greater the comfort level for investors. Accurate market pricing and liquidity are always an investor's concern, particularly in credit funds, and any product that improves these provides real value to the investment and monitoring process.

Credit is a very complicated product. It's a

Credit default swaps

(notional amount outstanding in \$ billion)

Year	Month	Semi-annual ISDA figures	Growth year on year (%)
2000	June	200	
	Dec	480	
2001	June	631	216
	Dec	919	91
2002	June	1,600	153
	Dec	2,192	139
2003	June	2,688	68
	Dec	3,779	72
2004	June	5,442	102
	Dec	8,422	123
2005	June	12,430	128
	Dec	17,096	103

Source: ISDA market survey results

hard product for people in the business to manage, and it's a difficult product for investors in general to master.

Another quite interesting thing about the contract is that it will change the regulatory environment slightly as well – because, although OTCs are still regulated under the FSA, if you think back to the point about squeezes, once the contract gets listed, it reduces the ability to manipulate the market when you have a listed contract on a regulated exchange.

Patrick Brennan, NewFinance Capital

I don't know if anyone has made the point yet, but what we care about, in terms of market evolution, is not so much transparency as much as liquidity, and in our ability as investors to be able to execute gamma hedge at the wings.

What we often find is that, given the few nexuses that there are in the credit derivative market for liquidity in market stresses – and by nexuses I mean the major investment banks with trading capability and market-making capability – there is a great risk for us of those small liquidity points being closed down, which they were in 1998 and 2002.

As investors, we find it very difficult to recapture gamma when we really need to. So this contract would be great for transferring that liquidity responsibility away from six risk managers in New York and London to no one in particular – but to an exchange.

OPPORTUNITIES AND STRATEGIES IN CREDIT

The credit sector offers a multitude of trading instruments and ways to play the market – with varying risk/return characteristics

Neil Wilson, EuroHedge

What is so compelling about credit? Why should investors be interested in strategies that try to exploit opportunities in the credit market? I know the managers here all have varying approaches, so maybe we could talk about what they are.

Cyril Armleder, GLG

GLG is a fundamental equity house. Everything is based on balance sheets and fundamental analytical work. So everything is done bottom up. On the credit fund, that means selecting names where we think we have an edge, and then on which parts of the capital structure we're going to put our bets on. It can be on one part of the capital structure, it can be at the very senior end of the debt structure, it can sometimes be very junior high yields. It can have various shapes.

We have the ability to flip from net short to net long the market using the index, as an example, or using benchmark credits. In our case, we need instruments such as options or equity to hedge strength or leverage.

Neil Wilson,
EuroHedge



Neil Wilson, EuroHedge

But the key thing is your ability as fundamental analysts – to identify the best directional opportunities?

Cyril Armleder, GLG

Yes, but not necessarily directional. They can be structural too – across the different parts of the capital structure.

Neil Wilson, EuroHedge

We'll come back to specific opportunities in the current environment. But I'd like to ask Mark and then Carlo to outline the differences in their strategies.

Mark Benson, CQS

Ours is much more of a market-neutral arbitrage-based strategy. It's not directional, to the extent that you can be non-directional, which is quite hard to achieve.

What's compelling about it are the returns. There are some quite attractive returns associated with it. It's certainly correlated with other strategies, but it's not correlated with equities, or other parts of the fixed-income market, so it's potentially attractive to risk-averse investors. And I think the market's still growing and it's still inefficient, though much more complete than it was several years ago.

I would suggest these are quite attractive dynamics to trawl for any strategy. You want efficiency, but you also want more complexity to give you the opportunity to exploit that.

Neil Wilson, EuroHedge

It's similar to Cyril's approach – essentially, to identify the fundamentals and directional

opportunities, but putting the trades on in a different way?

Mark Benson, CQS

Yes to both. We use a research level quantitative screening, but we always apply fundamental research too. Credit is too idiosyncratic to apply naïve quantitative strategies to it. However, I think it's definitely additive to apply a quantitative approach to your fundamental processes as well. That's what we try to do.

Neil Wilson, EuroHedge

But, at the end, you have a market-neutral portfolio?

Mark Benson, CQS

Ours is much more market neutral, and probably we're more skewed to trying to capture the asymmetry the other way round.

Carlo Georg, KBC

Our approach is much closer to what Mark is doing than to what Cyril's doing. We're also in the relative-value arbitrage space. We do clearly use fundamental overlays, but to a much smaller extent. It's not driven by fundamentals, looking at companies' balance sheets. It's driven by looking at where we can identify arbitrage opportunities.

Actually, arbitrage is probably the wrong word, because there are no closed arbitrage opportunities any more. It's really about relative value. And credit, I think, is the most interesting space right now. There's so much new product development happening, and at the initial stages there are inefficiencies. They're not arbitrages in any closed or strict sense, but you can clearly identify if various products are cheap or expensive relative to each other – either in a company's capital structure or versus the general market. If you identify enough of these opportunities, on average, you should be making money. That is what we try to do.

In the credit space, what we've seen over the last few years is that there are a lot of opportunities. The whole structured credit market has been developing, the tranche market develop-



Carlo Georg, KBC

ing, and now we have CDS also on loans and ABS.

What we have tried to do is identify situations where you can extract cheap options. That's really the key – and with the current pace of new products coming to the market, you do find opportunities. In CDS on loans, for example. There are a lot of different things to trade here – options is one way, tranche trading is another way.

In that sense, it's similar to what Cyril said. We want to make money in the two, three, five-sigma events. That's what we try to identify. And you want to identify these opportunities without paying away too much time decay while you're waiting for the event to happen. And have smart trades which pay carry for low risk in order to balance the overall portfolio exposures.

Ultimately, we can end up having similar trade types such as curve trades or capital structure arbitrage positions, but we're coming from a different approach in trying to identify these trading opportunities.

Mark Benson, CQS

I think, ultimately, there are sub-strategies that exist within probably all of our funds. Similar to you guys, we run specific strategies against things like curve trades, or basis or capital structure.

Mehtap Dinc, Eurex

Do you see a lot of potential in the capital structure arbitrage business?

Patrick Brennan,
NewFinance

Carlo Georg, KBC

I think capital structure arbitrage becomes more interesting when you get into a more distressed environment again. It's been very benign for a couple of years, and I think we're all waiting for the stress to come. I think that's when you're going to get big opportunities again in that particular sub-strategy. When everything is going well, when equity markets are booming, when credit is tightening, it's harder to find capital structure opportunities. But we are starting to see some of these opportunities – in the recent May/June credit correction for example.

Mark Benson, CQS

I would say that there are big opportunities in creating options because I think there are big mispricings in risk between asset classes – which, to a point, will only manifest themselves in a difficult environment. But I think they exist.

The potential is enormous. First of all, they can take out the asymmetry of the trade – that exposure to much more downside risk than upside gain. You can actually get the probability to work much more in your favour. But, more importantly, it allows you to take the tail risk out as well by using these instruments – which is very, very important.

Neil Wilson, EuroHedge

Patrick, from an investor point of view, do you agree with that analysis?

Patrick Brennan, NewFinance

My general helicopter view of credit opportunities is that there seems to be a lot of activity in the centre of the market involving structured products, derivatives and CDO tranches. Maybe there are opportunities there but we think it's a pretty crowded place.

The beauty of the credit markets comes from a couple of factors. First of all, it comes from the forcing of a major transfer of risk from bank balance sheets to institutional balance sheets. It has already happened in the US, it's happening in Europe slowly now, and in emerging markets. But it hasn't happened yet in Asia. We found a statistic yesterday that revealed 90% of corporate borrowing is still through the banks in Hong Kong. There's a huge opportunity out there.

The reality for us is that we try to find alpha not through a manager's capability to create value in the middle of the jungle, but to go to the edge of the jungle, and see if we can find much simpler credit opportunities where the risk is much more binary. It's default or no default, and whether you have collateral or no collateral. We try and manage our exposures on a capital structure basis as well. We use the capital structure as a risk tool, and we try to collateralise our exposures in order to prevent the three, four or five-sigma events beating up our portfolios.

Collateralised credit is good risk to have, because rather than relying on the market to bail you out of a position, you can rely on the quality of your assets to bail you out in the event of a default.

The second point that's interesting from a credit hedge fund point of view is that, if you compare the saturation levels in the hedge fund markets, I think the number of equity hedge funds is 6,000 globally – something like that. And maybe they have about \$750 billion of capital. And the amount of equity in publicly-traded markets is probably about \$25 trillion. The number of credit hedge funds out there is maybe 400. They manage about \$150 billion. And the credit market is \$40 trillion plus. That level of under-saturation, in terms of the oppor-

tunity scope, is remarkable compared to what equity hedge funds are facing.

Mark Benson, CQS

It is a \$40 trillion asset cluster – but with a lot less liquidity than the equity market.

Patrick Brennan, NewFinance

Absolutely. And so what it needs is a slightly different type of investor base – which is prepared to commit to a two or three-year period, rather than only quarterly or monthly. And that will enable everyone to pick up these opportunities, as the managers have been noting, when the market goes through a period of stress. It's at precisely those moments that you want to step in and buy assets. But right now, some hedge funds are offering investors too much liquidity, and it's simply not appropriate for a lot of the credit strategies out there.

Neil Wilson, EuroHedge

Before we go on to the risks in credit – and how to manage them – maybe we should look at the opportunities in the near term? This year and over the next 12 months, in terms of how you guys see the market?

Cyril Armleder, GLG

Clearly, the market is at an inflection point. There's a de-coupling of investment grades and high yields coming ahead, but I think there is a lot of complacency. You can see it through the credit spread levels but, furthermore, issuance is being done at record levels of leverage. There are a lot of high-yield bonds where, effectively, you are an equity holder and you're getting only 200 basis points, which is a bit worrying.

Neil Wilson, EuroHedge

So, how do you position yourselves to play this market?

Cyril Armleder, GLG

You have to be very defensive in the market right now. We're buying secured loans, the highest points of the capital structure and we

try to get short in some junior parts of the capital structure when we see mispricing – based on our working assumptions.

Neil Wilson, EuroHedge

Mark, how do you see the next six to 12 months?

Mark Benson, CQS

I put the market into two parts – investment grade and non-investment grade. In investment grade, the opportunity is that people are selling the credit option cheaply, and spreads are pretty tight, but I don't think there's necessarily a lot of real credit risk, in terms of things going bankrupt. But I think there's plenty of event risk out there. It's probably gone up with equities going down. Private equity players can also get back in action. They've got a lot of money to put to work. So, investment grade is about: Can you capture those event risks? It's trying to find smart strategies to do that.

In non-investment grade, similar to Cyril, my own view is that the debt structures being applied are getting very stretched. Leverage is going up, so subordinated debt holders must be getting more subordinated, given where we've been on the equities side. Risk premiums are at their most compressed, probably, between senior and unsecured debt. I think it's an accident waiting to happen, not because companies are bad but just because the more leverage you throw on something, the less room there is for error.

Where do the opportunities lie there? They lie in trying to look for those mispricings that exist within the capital structure, and also given the very little dispersion that there is right now between names. For example, history tells you that certain sectors tend to do worse [when markets fall], and certain companies tend to do worse. But, if you were to look right now at pricing amongst credits, you certainly wouldn't believe that.

If you can position trades, and you can construct them in a way that you can hold them – because timing is obviously crucial – then there are some very attractive opportunities. There's lots of interesting things to do. The

fact that credits, generically, are compressed is probably an opportunity – while other people are thinking: Why would you want to be in credit right now?

Mike Hodges, Arundel Iveagh

Spreads are as tight as they're going to get – but that's looking at it from the long-term perspective.

Carlo Georg, KBC

I think we all pretty much agree on how we see the market. We're coming to the end of the current credit cycle. That much is clear. How long it is going to extend is anyone's guess. I think we've been a very long time now in quite a benign environment. We've had zero defaults for multiple years now. It's unbelievably benign in Europe. That explains why we are at the current spread levels.

Looking ahead, for me, a major factor will be understanding the impact of the enormous increase we had in structured credit. The structured credit bid is getting bigger all the time, and I think trying to identify when and why that is going to change is the key to understanding when the market will turn.

We've been a very long time now in quite a benign environment. We've had zero defaults for multiple years now. It's unbelievably benign in Europe. That explains why we are at the current spread levels

In May and June, we clearly had a dislocation in other asset classes – in equity, in commodities and to a lesser degree in fixed income. Credit widened too but only marginally. There's only been a little bit of a dislocation, because there's still so much 'real money' coming into this space.

One of the issues that I think is going to turn this market is that this 'real money' is going into a lot of the structured products at the mezzanine level – it's actually quite leveraged. On the typical single A kind of paper, it's probably

around five times leveraged on a five to seven-year tranche. And my guess is that a lot of the banks and insurance companies who are buying these mono-tranches don't realise that they're five-times levered. It's a ratings arbitrage, but the moment the credit market weakens the negative mark-to-market impact will be quite significant on these products.

When that happens, real money won't buy any more, and may even start to liquidate. That will accelerate the downturn. At the moment, it's all dealer and hedge fund driven. There is no real money actually liquidating or selling off positions, which indicates that what we see now is probably only a technical correction.

Mark Benson, CQS

I think one of the things you saw last year was the fact that those holders, typically the guys on the other side of the trade [from us], don't live in the same mark-to-market world as we do. It takes quite a lot to shake them out.

And often you can restructure tranches – so you don't necessarily get the rating events. All you do then is cumulatively take more and more risk into the system.

Neil Wilson, EuroHedge

Guy – do you want to make any points, or ask any questions here?

Guy Cornelius, UBS

Some brief ones. First, on Mark's point about the real-money sector. They're not quick sellers, and I think the reason for that is that such

Guy
Cornelius,
UBS



a tiny percentage of their assets under management are in this asset class anyway. It's not a meaningless amount, but it's not enough to dent them. They're still on a learning experience and, I believe, still net positive investors. There's also a lot of consensus thinking. We're all looking for the cycle to turn and spreads to move out. History and experience shows that when a lot of market participants have the same view, that view may well prove correct, but it just takes longer to get there. So we may all have these trades on for a while longer.

I think that the nervousness surrounding global markets means that, within our business, constant portfolio protection insurance (CPPI) trades will remain popular. I think there will be a lot of focus on that area. I think there will also still be a lot of attention on what are called bear trades – where we put, for instance, 100+ names in a CDO and allow the manager to go short too, with a CPPI wrap. We're selling a lot of these into banks and insurance companies.

Neil Wilson, EuroHedge

Mike, how do you see the market outlook – and how the managers that you're with are positioned?

Mike Hodges, Arundel Iveagh

Let me summarise our view of the problems facing us in allocating to credit.

The market has been distorted by the structured market – CBOs, CDOs and credit structures have created a false sense of where credit should be priced. I think that's a big, overriding problem for credit markets. People are buying loans and credit products with loose covenants. The environment is quite relaxed and people aren't looking for intrinsic value, they are searching for spread.

So why is this a problem? Portfolios with market risk tend to have normal returns because losses due to market risk are often normally distributed and have the familiar bell-curve shape. The distribution of credit losses, and therefore expected returns, are not normally distributed. Credit returns are skewed with long fat tails. Mean and standard deviation

calculated assuming normal distribution do not adequately reflect credit risk.

The probability of these fat tails being experienced has been increased by the distortion of credit spreads due to the structured activity and the increased leverage in the system. The chances of reaching credit inflection points are therefore higher. Any credit volatility will challenge the return profile in credit funds.

Interest rates, in real terms, have already increased significantly in the US. The correlation between defaults and spread widening is highly correlated to a 5%-plus level, the full impact of which are yet to feed through to the credit spreads.

How do we handle the re-pricing of credit risk at some point of time in the future? The strategies behind how people employ credit derivatives structures, and use credit derivatives, is very important in providing the opportunity to hedge credit exposure and actually make returns from negative 'fat tail' events.

It is now possible as an investor to invest in a credit fund when your overriding view is negative (i.e. widening spreads) due to instruments available that allow them to take advantage of both negative and positive moves. Our overriding investment objective is to identify funds that preserve capital through those moves and that are using these instruments to generate strategies that take advantage of these credit nuances to produce consistent returns.

Patrick Brennan, NewFinance

In keeping with everyone's view on the state of the market, we are generally still seeing a lot of opportunity out there. Where we care about market risk, we are trying to position ourselves up the capital structure at a senior secured level. Where we care about market liquidity, we're trying to go short public credit and go long private credit risk. That's generally the trend. If you can collateralise your exposures, you're in reasonably good shape. Not at whatever the default rate – but where the default rate has to move significantly for you to be seriously impaired. That's the attitude and the strategy we're taking.

RISK MANAGEMENT

The risks in credit are various and complex – from settlement risk to the differing risks of the strategies and instruments. How to manage them is crucial to the survival and success of any credit hedge fund player

Neil Wilson, EuroHedge

Where are the risks in the credit strategies sphere? Are they mainly to do with event risk and leverage? Or is it concentration of trades? Are there still big worries over settlement risk – or are we close to reaching a solution on that?

Guy Cornelius, UBS

Let's start with settlement risk. When the Fed tells you to do something, you do it. And, whilst the issues haven't been completely solved, I think the market now has significantly more confidence in its operating systems. I see some of these issues going away, and I see products coming out and helping a great deal.

In terms of risks in various strategies, there's a lot of variety. I made a list of what we think are vanilla strategies, and structured strategies. Vanilla strategies are CDS versus bond basis, CDS versus the CDS curve, CDS versus equity or vol, loans versus loan CDS, CDS pairs trading, index arb and CDS momentum trading.

When the Fed tells you to do something, you do it. And, whilst the issues haven't been completely solved, I think the market now has significantly more confidence in its operating systems

And then on the structured side, you've got CDO tranches versus delta, CDO tranche versus tranche, CDO tranche curve trades and CDS swaptions. With these products, some are

commoditised, some are less commoditised.

As an investment bank, at UBS we don't actually run enormous amounts of risk. We're more interested in putting through a lot of volume.

Cyril Armleder, GLG

Yes, the risk appetite from dealers is as low as it's ever been.

Guy Cornelius, UBS

I think that reflects what I'm saying. We have a simpler approach now – we're not trying to be a prop-trading organisation.

Patrick Brennan, NewFinance

You're not stupid, either.

Guy Cornelius, UBS

Maybe not.

Mike Hodges, Arundel Iveagh

I just want to throw one risk in here as well, which is not specific to the strategies, which is that of liquidity financing risk. If you think about it, generically, banks are funding every-

Mike Hodges,
Arundel
Iveagh



body. At present there does appear to have been a transfer of funding risk to the prime broking business. This may or may not be a much smarter place to take that risk. But that's definitely an intrinsic risk. If somebody woke up tomorrow and decided margins ought to be twice as wide for these products as they are now, tremendous risk could be placed into the system.

If somebody woke up and decided margins ought to be twice as wide for these products as they are now, tremendous risk could be placed into the system

Patrick Brennan, NewFinance

We're jumping ahead a bit, but let's just define what the real core components of risk are. The point is, when you're trading credit, the first risk you've got is to a spread-widening environment. Then you always have event risk. Something happens, you're not quite sure, and it goes down 10%. And then you have jump-to-default risk.

So you have three types of risk that are occurring all at the same time. Then you can start splicing that into single names and multiple names, or tranche it out and try to offload that risk in some sophisticated way. But, those are the three basic types of risk. My question is: What products are being used to make sure those things don't happen, in what sequence and how well?

Mark Benson, CQS

One of the things I want to ask about is the counterparty risk from a settlement perspective. Is there any risk of re-pricing, for instance – in the sense that, if I've got credit protection with Bank A, and I've got credit protection with Bank B, everything's all right now – but if there was any credit spread movement, and concerns over whether a bank's settled or not, is there a re-pricing risk with credit derivatives? Could exchange-traded contracts help take that risk out? How will the central coun-



Mehtap Dinc, Eurex

terparty work – to give everybody more protection – whether you're a fund or an investor, or a dealer?

Mehtap Dinc, Eurex

An exchange-traded product is ideal to eliminate direct counterparty risk. By entering into a credit derivative, one buys or sells protection for credit risk but at the same time takes the credit risk of the counterparty onto their books.

By offering the whole value chain from trading to clearing for the planned credit futures, our clearing house will act as a central counterparty for all transactions, thus eliminating the direct counterparty risk.

But there are also additional issues keeping the dealers very busy, which are the number of outstanding confirmations and a standardised settlement procedure in case of a credit event. There has already been significant work done to reduce the number of outstanding confirmations and the market is also working together with ISDA to establish a standardised cash settlement procedure for index and single-name CDS. The cash settlement procedure is especially important as it has been seen in past credit events that the outstanding number of credit derivatives on specific names has been up to 10 times bigger than the outstanding bonds available.

Carlo Georg, KBC

I think the market has recognised this. It's moving towards having a cash settlement

Guy Cornelius, UBS



process in all the contracts, which is very similar to how you would deal with it in on an exchange-traded contract.

Mehtap Dinc, Eurex

An exchange-traded contract would significantly ease the administrative procedures related to credit derivatives. Even if cash settlement is going to be established in the OTC market one day, the straight-through processing and the completely standardised features of exchange-traded derivatives are a big advantage.

Carlo Georg, KBC

I think we all agree with that. I think it's going to be a successful product, but that is of course only one part of what we trade. That's going to be the index product. But if you look at all the single names, where the majority of our activity is, I don't see all of that going to an exchange. I think that will continue to be OTC – where the issues raised still apply.

Neil Wilson, EuroHedge

So what's being done on the settlement side? Obviously, the regulators have got involved. So should we be worried about a lot of unsettled trades, if there's a big market move? If a bank gets in trouble, or something, is it going to be every man for himself? Is there a lot being done to avoid that kind of situation occurring?

Mike Hodges, Arundel Iveagh

I think the Fed is clearly right to highlight the issue. They were the first people to recognise it.

Guy Cornelius, UBS

I think we should all be conscious of the fact that the outstanding problem is so large. This is going to take a couple of years to sort out. I don't have all the answers, but you need to hope that there are no major systemic problems.

If so, I think that banks themselves would offset [with each other]. They post the margins between each other – so effectively, the incremental credit risk in giving up UBS *vis-a-vis* Deutsche Bank is pretty small.

As soon as you enter into a contract, everybody has tapes of the conversations, and you have legally entered into a contract. Yes, you've got to get your documentation right, but we are now pretty much on standard documentations as well. So, there shouldn't really be any big differences from contract A to contract B. It's something that we've got to deal with, but I don't see it as the major, primary issue of the credit world.

Neil Wilson, EuroHedge

One key thing. We've gone quite a long way through the list of key risk issues for investors here, but do you really need to be a credit specialist to understand them? Do credit funds really only belong in a credit fund of funds – managed by a credit specialist? Or are they an asset class that the generalist investor can use – like they do equities?

Patrick Brennan, NewFinance

That's probably about the most risky thing they can do!

Cyril Armleder, GLG

Remember that investors also take a lot of credit risk in their equity long/short portfolios.

Neil Wilson, EuroHedge

I'd be interested to hear Mark, Cyril and Carlo's views about whether the investors they see coming through the door actually do know what they're looking for – on the risks in relation to strategies?

Mark Benson, CQS

I think they do. One issue is that you do get a lot of focus on liquidity risk, and the technicals.

Carlo Georg, KBC

It's hard to explain relative value in credit. You've got a lot of technical issues, and when you start drilling down into it, people ask the next question and then there's a derivative of that question. It is a very complicated product to explain in a simple way.

Cyril Armleder, GLG

And credit people are sometimes bad communicators!

Mike Hodges, Arundel Iveagh

Credit is principally about risk management, and controlling the three components of credit risk – spread risk, jump-to-event and jump-to-default. It is a more complicated product to manage and understand versus everyone's understanding of, say, equity long/short funds. There is a greater need to manage the risk on a portfolio basis and use horizon analysis and various credit risk management tools. The point is that the entry cost in developing credit funds is increasing, and the infrastructure and support required is significant. These systems need to be adequate enough and flexible – to be able to handle the addition of first and second-generation credit derivative products.

Credit is principally about risk management, and controlling the three components of credit risk – spread risk, jump-to-event and jump-to-default

Patrick Brennan, NewFinance

We've been investing in credit funds for four years or so now. And we've had probably, at max, about 6% to 8% exposure to arbitrage strategies and about 25% exposure maximum to credit derivatives. We invest globally, we invest across different strategies, in event driven, or distressed, we invest in structured



Patrick Brennan,
NewFinance

credit, in asset-based lending, trading and emerging markets. This, we think, demonstrates not so much what the opportunities are, but just how wide the range of the opportunity is, and how insignificant arbitrage or derivative strategies are within the credit universe. So, people who are looking at credit funds, or credit funds of funds, should understand that only a very small part of the opportunity and the credit risk universe is driven by, say, quantitative or derivative-driven strategies. We will invest more in these spaces – but only when we think the opportunity is there.

Neil Wilson, EuroHedge

We've been talking about how CDS and other credit derivatives can help you hedge against market dislocations – and about how credit strategies appear to be relatively uncorrelated not only to other asset classes, but also often



Cyril Armleder, GLG

quite uncorrelated to each other. Yet there have been periods, like in May 2005, when a lot of the credit funds seem to have got hurt simultaneously. Shouldn't some funds, which are more market neutral, be able to absorb shocks – and maybe take advantage in such circumstances?

Mark Benson, CQS

Yes, but you'll still get some temporary dislocation. I think the interesting thing about what happened in May last year, though, is the degree to which, and the speed with which, the market recovered. I think this was quite a good testimony to its robustness. Whatever the levels, the market started to function quite quickly again – which, given how it was looking at one point, you might not have thought it was capable of.

Mike Hodges, Arundel Iveagh

The other major risk that showed up in May 2005, which we haven't really touched upon, is the investors in this space. It's very difficult to figure out how investors are going to react if we have another blow-up or event in the market. But it is incumbent upon us as managers of credit risk to try and educate our investors as much as possible in understanding what risks they are taking.

Neil Wilson, EuroHedge

What about the more recent events of this year – in May and June – when there was a lot of dislocation in other asset classes such as equities

Mark Benson, CQS



and commodities, but when credit funds continued to perform very steadily. Does that prove the non-correlation? Or will there be a delayed effect? Will the drop that we had in equities hit credit later?

Mark Benson, CQS

I think the answer would be yes, if equities did continue to fall really badly. But again, I'd differentiate between the different parts of the market – where investment grade and non-investment grade might well behave quite differently. There's definitely faster money in the high yield space, and the degree to which people might get a general contagion in terms of liquidity – so you might see the correlation there.

Carlo Georg, KBC

I think May was more noise than signal. You would need a much larger movement in equities to have a real impact on how credit should be priced. What we've seen in equities is probably more also a function of the dynamics specifically in that market. There were a lot of long funds out there.

Mike Hodges, Arundel Iveagh

We are a little bit more cautious. You're in an environment where leverage is increasing in the system. You're also in an environment where we don't know what the impact of the CDS product will do when dislocation occurs – whether it will potentially create more volatility or less. Is it actually going to increase the risk in the markets or reduce it? The impact depends on how the products get used by the market. Is there the potential risk of a re-pricing in the CDS market at some point in time in the future?

I see the first cracks in credit markets developing from consumer debt. Consumer debt is high and mortgage defaults will increase. The corporate debt is less of a problem – we are not seeing significant earnings declines and no real evidence of weakening balance sheets. Those strategies are therefore probably still interesting.

SPONSOR PROFILE



Eurex is the world's leading futures and options exchange and features open, democratic and low-cost electronic access worldwide. It offers a broad range of international benchmark products and operates the most liquid fixed income markets in the world. With market participants connected from 700 locations worldwide, trading volume at Eurex exceeded 1.25 billion contracts in 2005. Therefore, it is the market place of choice for the derivatives community worldwide.

Aside from operating a fully electronic trading platform, Eurex provides an automated and integrated joint clearing house. Eurex Clearing AG offers central counterparty services for instruments traded on the Eurex exchanges, Eurex Bonds and Eurex Repo as well as the Frankfurt Stock Exchange (Xetra and floor) and the Irish Stock Exchange (ISE). With this structure, Eurex participants benefit from a high quality, cost efficient and comprehensive value chain of trading and clearing services via a single electronic system.

Together with leading international financial institutions, Eurex operates the electronic trading platform Eurex Bonds, an ECN (electronic communication network) for off-exchange, wholesale trading in fixed income securities and treasury discount papers. Through the basis trading Eurex Bonds offers a direct link between the cash market and the futures market, this enables electronic basis trading via a central order book.

Eurex Repo, which is a separate segment, is the electronic trading solution for repos (sale and repurchase agreements). Eurex Repo is among the forerunners in providing an integrated trading and clearing platform for Repo transactions. Furthermore, Eurex Repo offers the entire value chain from trading through clearing and settlement in the CHF and Euro market.

Products

The exchange's electronic trading platform provides access to a broad range of global benchmark products such as interest rate, equity index, exchange-traded fund (ETF) and equity products: The Eurex Euro-Bund, Euro-Bobl and Euro-Schatz derivatives comprise the world's leading fixed income complex and have developed into the benchmark for European fixed income trading. Eurex's equity index products include futures and options on blue chip Finnish, German, Swiss, European and global indexes such as the DAX® and Dow Jones EURO STOXX® 50. Eurex is also a leading stock options market globally with an ever increasing range of underlying products and turnover.

Eurex aims to be the partner of choice for the global derivatives community and will continue to provide the best possible products, services and solutions to investors and intermediaries in the derivatives business worldwide.

Key Contacts

Eurex Frankfurt AG
 Neue Börsenstraße 1
 60487 Frankfurt/Main, Germany
 Tel: +49 (0)69-211-156 00

Eurex Zürich AG
 Selnaustrasse 30
 CH-8021 Zurich, Switzerland
 Tel: +41 (0)58 854-29 48

US Representative Office
 190 South LaSalle; Suite 1720
 Chicago, IL 60603, USA

UK Representative Office
 One Canada Square, Floor 42
 Canary Wharf
 London E14 5DR
 Great Britain

French Representative Office
 17 Rue de Surène
 75008 Paris
 France

Websites
www.eurexchange.com
www.eurex-bonds.com
www.eurexrepo.com

Pick what you like –

Eurex Flexible Options



Bring individual taste to your trading with Eurex equity and equity index derivatives: Our new flexible options facility offers all the possibilities to personalize your contract terms. Implemented for OTC trading flexible options allow you to specify the exercise price and style as well as the expiry date. So take the chance to customize your investment and gain from a remarkable flexibility. **Wishing you an abundant business!** www.eurexchange.com

The information published in this publication is for general information purposes only. It is not intended to constitute investment advice nor is it intended for solicitation purposes. Eurex is not responsible for any errors or omissions contained in this publication. Before trading, persons should consider the risks involved and the legal requirements of the relevant jurisdiction. The product mentioned in this publication is currently not available for offer or sale to, or trading by, United States persons.

