Bushell's
Signature Report

Financial Alchemy Turns Lead into Gold
What Does it Mean for the Markets?

Conventional wisdom has it that powerful forces associated with globalization are depressing sovereign interest rates. The current low-yield interest rate environment has in turn led to an upward repricing of all income streams – from real estate and toll roads to corporate bonds and equities.

While we agree with the theory, there's another factor in the mix. Innovations in the debt markets in the area of structured asset-backed securities are contributing to lower credit spreads and more availability of capital than in the past. For the most part, equity market players are largely unacquainted with these innovations, and yet they likely hold the key to successful investing in 2007.

Globally, savers have been suffering for some time because of low interest rates and narrow corporate credit spreads. They resent not being compensated for inflation risk or corporate credit risk. These are symptoms of a dynamic that has been described by U.S. Federal Reserve Chairman Ben Bernanke as a global savings glut. The monies from the massive recirculation of OPEC trade surpluses, the high Asian savings rates and the buildup of China's foreign exchange reserves have found their way back into the global debt market and are depressing interest rates. Studies by the U.S. Federal Reserve have shown that these investors have helped keep interest rates one full percentage point lower than they would otherwise be at this point in the economic cycle.

This global trend of chasing yield is competing away income returns. The traditional strategies used by income managers to pick up extra yield, such as buying longer-term securities or purchasing securities with lower credit ratings, are no longer working well. The inverted yield curves and stable economic environments in most countries have seen to that.

Structured asset-backed securities are coming to the rescue of yield-hungry bond managers. In fact, both debt and equity markets are being reshaped by this important new trend in securitization.

In the past, asset-backed markets have seen tremendous growth as they evolved from mortgage-backed securities to the securitization of credit-card receivables and auto loans. Bankers' motivations to develop this market lay in the improved returns on capital and fees available when they repackaged and transferred assets from their balance sheets to other investors.

Because of that success, investment bankers are constantly looking for new securities to repackage and sell to bond investors. The latest trend – collateralized debt obligations (CDOs) or collateralized loan obligations (CLOs) – works just like other forms of securitization. A group of loans or bonds are combined into a pool, which is then packaged up and divided into tranches (or quality layers of the pool).

Each tranche is assigned a different credit rating depending on the amount of supporting collateral, from AAA for a low-risk tranche all the way down to a single B, or lower, for the riskiest tranche. These tranches are then sold to investors. The theory behind securitization is that by diversifying across 100 or so different issuers, in different industries and different geographies, a pool of high-risk loans or bonds that are rated BBB or lower takes on the risk characteristics of an A-rated security for a good portion of the pool.

The volume of new collateralized debt obligations was US$359 billion last year, up 56% year-over-year. Effectively, this means that investment bankers are buying corporate bonds non-stop to fill their latest CDO offering. All that buying has driven credit spreads lower and lower and lower.

So magically, through this financial alchemy, the structured finance experts at global investment banks are changing lead into gold. They are taking individual, low-grade credits and turning them into expensive, high-quality securities. In their wake, they leave big distortions in credit markets.

Large corporate lenders like Citigroup and JP Morgan are the real players behind this innovation in the loan repackaging business – after all, their balance sheets are full of loans that are ideal to sell into these structures. The fees related to this activity are quite healthy, and substantially better than holding the loans to maturity. In 2006, investment banking fees relating to debt capital markets set records, accounting for approximately 60% of all global investment banking fees (See Table 1).

The rating agencies – Moody's, Standard & Poor's and Fitch – are entirely on board with this new form of securitization, because the more securities that they rate,

Debt capital markets

Top 10 Investment Banks by Revenue – 2006

Rank	Bank	Revenue US$ million
1	Citigroup	1,554
2	JP Morgan	1,407
3	Deutsche Bank	1,398
4	Merrill Lynch	1,345
5	Credit Suisse	1,232
6	Morgan Stanley	1,169
7	Lehman Brothers	1,075
8	UBS	1,055
9	Goldman Sachs	1,039
10	Barclays Capital	933

Source: Dealogic

Table 1: According to the Financial Times, global investment banking fees were approximately US$22 billion in 2006.

the more fees they generate. A CLO or CDO is a windfall for a rating agency because they are required to assess all of the underlying bonds or loans in the pool, as well as each tranche in the pool. Because these agencies have developed models that argue for the credit improvement through diversification, they are enabling this innovation. Without their high-quality ratings on the final tranches, the buyers wouldn't be there. And it's very lucrative for them too. In 2006, Moody's recorded record profitability, with the highest growth emanating from structured credit products.

Who's buying these securities?

The buyers of these products are institutions – insurers, pensions, fund managers, banks, hedge funds and others that crave income and struggle to deploy capital. The CLOs and CDOs come with generous yields on highly rated products, which allow investment managers to beat

their benchmarks and still abide by their investment rating constraints – what more can you ask for?

Credit specialist hedge funds are also important buyers in this market. To fund their purchases, they borrow (from the same investment banks that are structuring the deals) at lower yields to capture the spread. This return is enhanced through the use of considerable leverage. The Federal Reserve Bank of New York is currently examining the controls, such as collateral requirements, that commercials bankers have surrounding this type of leverage. Any change of risk sentiment on the part of the rating agencies or lenders to hedge funds would send a shock wave of selling through the market. And then, how would debt markets behave?

This is undoubtedly something that Tim Geithner thinks about a lot. As president of the New York Federal Reserve Bank, which oversees U.S. financial markets, he has stated that today's low volatility environment is likely transitory. On the subject of structured finance, he believes that market participants are inexperienced with the risks that the inevitable shocks will bring, particularly given the amount of leverage that is embedded in these products. As more loans and financial assets shift into the hands of unregulated entities, there is a growing consensus on the part of central bankers that this type of structured finance is changing the nature of the credit cycle and compromising their ability to monitor risk levels in banking systems.

And who's selling?

Private equity and leveraged buyout investors couldn't be happier. Low interest rates mean that it's a borrower's market. In 2006, New York-based Kohlberg Kravis and Roberts (KKR), one of the world's largest private equity firms, borrowed US$26 billion for leveraged buyouts. Last year, the HCA Hospitals deal, which was done by a group of private investors that included KKR, was worth US$33 billion. Given the size of some of these deals, it's possible that leveraged buyouts could move toward the US$100 billion realm in coming years.

We feel that if the market was ever to see a US$100 billion leveraged buyout, now's the time, because borrowers have unprecedented access to credit. Powerful private equity firms such as KKR are lowering their borrowing costs and increasing the amount of leverage they put into capital structures. Covenants and other protections usually insisted upon by the banks are being waived and we are witnessing the birth of "covenant lite" leveraged loans. The lenders are sailing into uncharted waters when it comes to leverage.

To stay in the game and to remain competitive, banks are originating leveraged loans (rated BB and below) and are immediately off-loading them, either directly through syndication, or indirectly by packaging them into new CLOs. The JP Morgan CDO monitor shows that in 2006, over US$250 billion of high-risk bank loans were repackaged into structured products. That is roughly half of the US$572 billion in bank loans were made to private equity firms last year.

Is there really a market for all of these low-grade loans? The banks don't have the appetite, but they have found a new way to mask the volume of low-grade loans by selling them as high-grade securities through structured products to non-traditional players, such as insurers. The range of providers of capital and the amount of money that can be provided has been greatly expanded through this clever trick.

Are investors aware that the leveraged buyout phenomenon can exist only if risky debt financing, which is partially intermediated through the CLO market, is available?

Can this repackaging trend continue?

It's an important question, because equity markets are partly underpinned by expectations of further M&A activity, and if the availability of debt capital disappears, then the private equity game is over. At that point, lenders will regain the upper hand and insist on more conservative capital structures, meaning that they will insist on less leverage and increased levels of equity injections.

Christopher Garman, high-yield specialist at Merrill Lynch, was recently quoted in the Financial Times on the outlook for U.S. corporate leverage: "You've not seen anything yet. The floodgates to corporate leverage will likely be opened over the next two years."

Given the benign economic environment and the current default environment, we tend to agree with him. It is not just the firms doing leveraged buyouts, but also corporations that are going to take advantage of the reduced cost of borrowing. Back in 2004, we predicted that leveraged buyouts and mergers would flourish given the ultra-low borrowing costs. We also stated that, "We are in a position today where it makes sense for many corporations to increase the amount of their debt as a percentage of their overall capital structure. This reduces the drag of excess capital on their return on equity. These adjustments in a company's overall capital structure toward increased debt make economic sense given that the cost of debt financing has rarely been so much lower than the cost of equity."

We think that 2008 will be the climax of this trend, as companies respond to this aberration in credit spreads and interest rates that is a once-in-a-lifetime opportunity to secure ultra-low financing.

We believe that financial engineering is bordering on being out of control. Many market participants are getting involved with securities that we think are beyond their scope. They are underestimating the illiquidity that these structures are going to face when the inevitable downturn brings credit problems.

How this situation will unfold is, of course, highly uncertain. The ultimate clean-up may be a cooling off rather than any shock to the financial system. Within our funds, we are shying away from the investment banks and commercial banks that are most active in this area. We hold long positions in many underleveraged, stable companies with strong cash flow – which are becoming targets of activists and leveraged buyout groups. We are also increasing the quality of our credit portfolio.

No credit market innovation has had such importance for equity market participants since the high-yield bond market financed the telecommunications bubble in the late 1990s.

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