Creditflux
www.creditflux.com
structured credit • credit derivatives • credit trading
December 2008 Issue 88

North American pension funds suffer massive losses on CSOs

David Graubard

Several North American pension funds that invested in credit by selling protection on unfunded synthetic CDO (CSO) tranches have suffered mark-to-market losses of more than 90%, say well placed market sources. Some funds did $1 billion-size deals, typically on tranches with AAA S&P ratings, and attachment/detachment points in the order of 7-8%.

Pension funds typically bought lightly managed CSOs with 100-name portfolios. The weighted average rating of their portfolios was single A but the deals have suffered because their pools were heavy on financials and had buckets for double B assets. Traders say these deals are seeing markets in the area of 8-10 cents in the dollar.

Among the pension fund buyers were Florida State Pension Fund and Canadian pension fund, PSP Investments, a company which manages money for federal public service employees, such as the Royal Canadian Mounted Police. Banking sources close to the matter say these two funds were among the biggest CSO investors in North America. Officials at the two pension funds declined to comment.

Mounties: pensions hit

To date, the deals have yet to sustain actual losses. However, the defaults of Lehman Brothers and the Icelandic banks have eaten away significant amounts of subordination, given their very low recoveries.

Among the deals with the lowest marks are tranches of the lightly managed MACES (Managed Aces) series of CSOs sold by Morgan Stanley. These marks indicate a high probability that losses will breach the attachment points in the near future, requiring the investor to make credit protection payments, which could be sizeable.

The Florida fund carried out a deal of around $1 billion managed by ING Investments, for which UBS was the arranger, in 2007, say sources close to the institution.

Lehman re-hires credit specialists

A group of former Lehman Brothers staff have found a new employer: Lehman Brothers. According to market sources, the bankrupt firm has re-hired several structured credit specialists who were previously let go. Sources say that Steve Baker, Abhishek Kalra and Bryan Magliaro – all previously part of the CDO origination group – have re-joined. It is thought that Nitin Rangraj – previously on the CDO secondary desk – has also gone back.

Along with former Lehman employees from other areas, they are working on a contracted basis for varying periods to help consultants Alvarez & Marsal wind down the bank.

Cash credit collapse fells loan funds

Bond and loan credit hedge funds had a disastrous October, according to figures on the sector compiled by Creditflux. The sector as a whole fell by 25.6% on the month as a result of sharp falls in cash credit prices.

Many leveraged loans that were already trading at distressed levels fell a further 20 points or more as a result of forced liquidations by market value CLOs, hedge funds facing investor redemptions and banks looking to close their books ahead of year end.

Performance was exacerbated by a further widening in the cash-credit default swap basis, meaning that funds underperformed on both their cash positions and their hedges. The sell-off was indiscriminate in terms of credit quality, with many funds looking to sell anything that was liquid – typically the better credits – to preserve cash in case of redemptions.

All funds invested in high yield bonds and loans were hit. But those with the highest leverage were hit hardest. For example, NAC's European Credit Fund was down 64%, reflecting its greater leverage than other funds.

Some managers argue that mark-to-market performance has become irrelevant. What counts is whether the manager will be forced to sell before prices recover from this technical battering.