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credaris

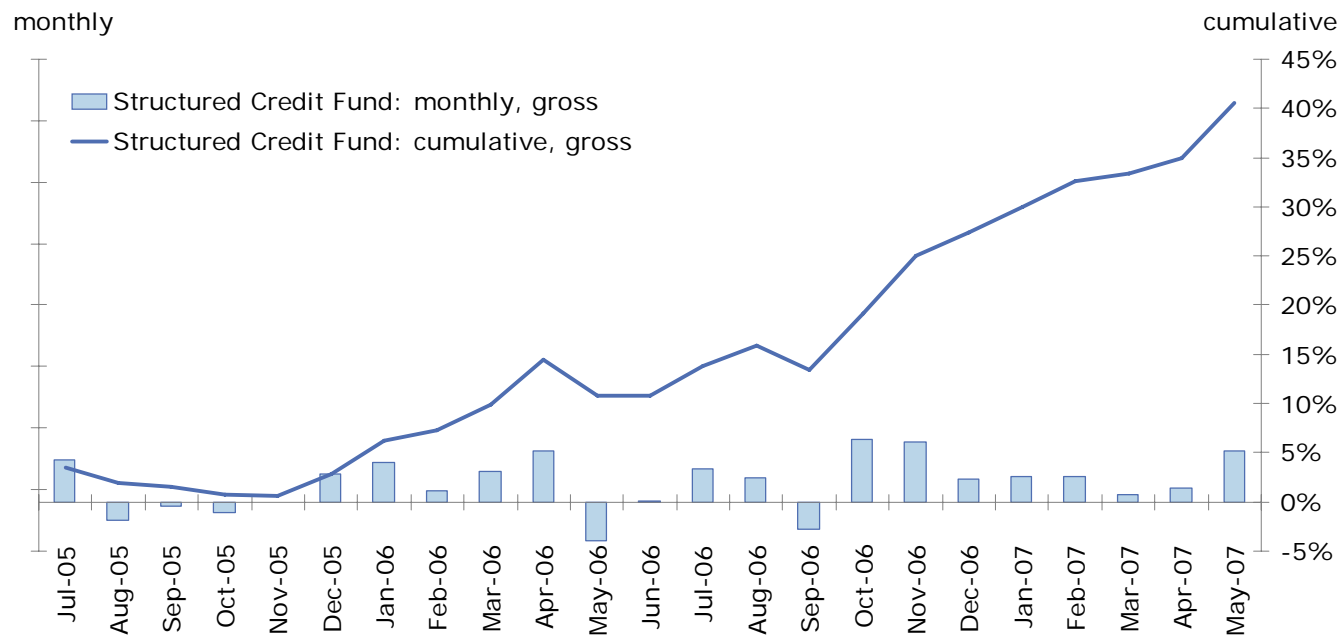


All about equity

5th July 2007

Structured Credit Fund Performance

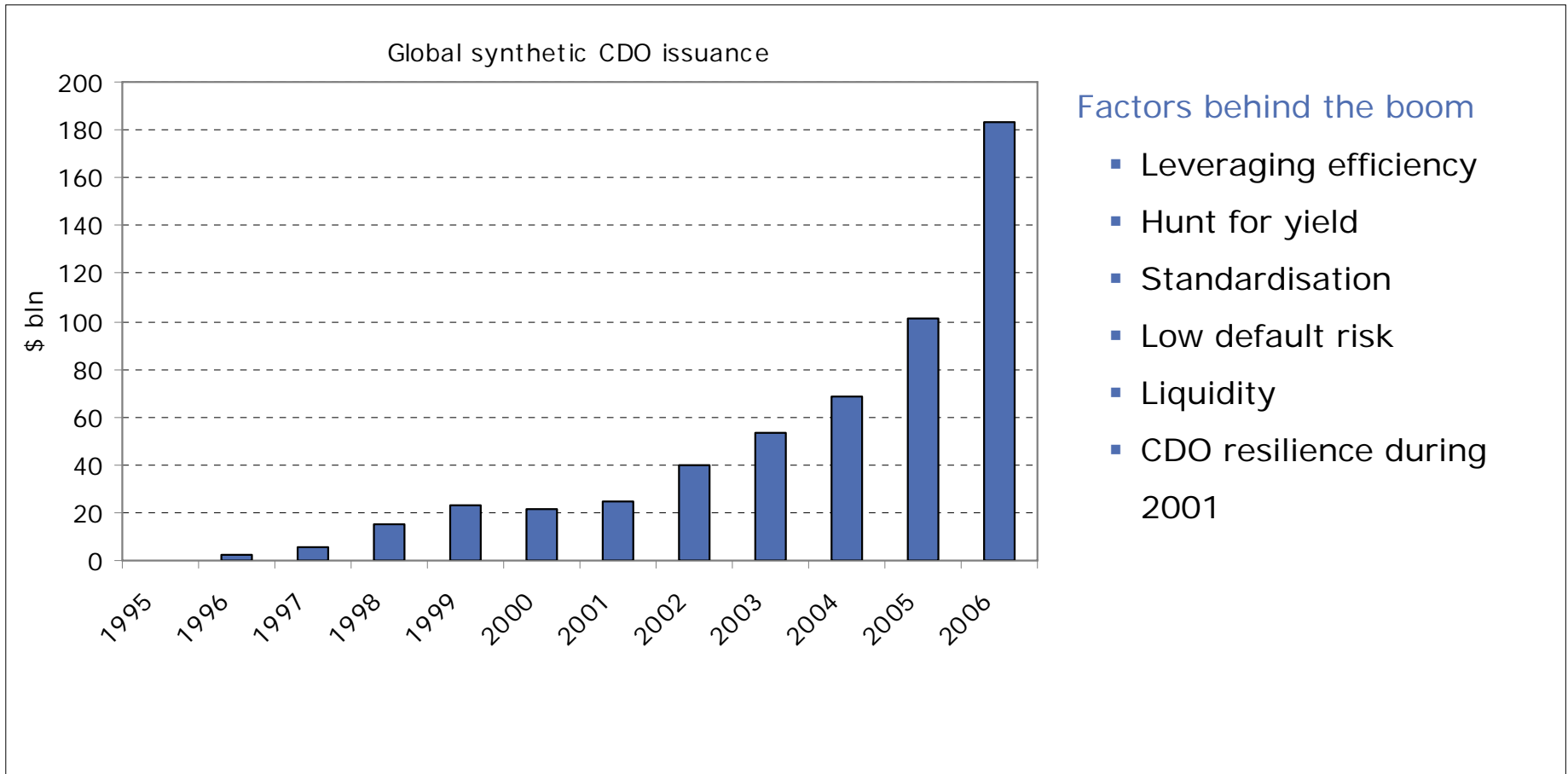
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- Cumulative return since inception: 40.5%
- Annualised return: 19.8%
- Annualised volatility: 7.70%
- Negative months: 2

Global synthetic CDO issuance

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Factors behind the boom

- Leveraging efficiency
- Hunt for yield
- Standardisation
- Low default risk
- Liquidity
- CDO resilience during 2001

Hedging CDO issuance

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Hedging CDO issuance and search for better risk adjusted returns from credit exposure

- Growth has been dramatic
- Investment banks needed to free up capacity after satisfying mezz buyers
- Dramatic product evolution across the capital structure
- Predominantly:
 - Monolines and Conduits invested in super senior tranches
 - Real money investors buy rated mezzanine and senior risks
 - Hedge funds are natural investors in equity tranches (carry trade)
- More balanced supply/demand in the capital structure

Structured credit equity

Main characteristics



- Carry
- Time decay + curve roll-down
- Jump to default
- Spread risk
- Correlation
- Convexity
- Interest rate sensitivity

Equity investment

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- Up-front + 5% running (standard)
 - most common structure
 - receive an upfront fee
 - fixed annual coupon of 5%
 - defaults require payment as they occur
- All running coupon
 - no exchange of an upfront fee
 - the premium is received as a running spread
 - defaults require payment as they occur
 - all running is more sensitive to time-to-default, spread and correlation
- All up-front
 - entire premium is received at inception as an upfront fee
 - no premium is received during the life
 - defaults require payment as they occur

Equity investment

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- **Principal only (zero-coupon)**
 - low initial payment
 - no coupon flow
 - principal redemption = notional at risk minus actual portfolio losses at maturity
 - popular due to structural simplicity
 - with lower sensitivity to spread and correlation
- **Interest only**
 - investor pays an upfront fee
 - receives running coupon on the tranche notional
 - there is no payment on default or at maturity
 - in the event of default the coupon adjusts to remaining notional

Equity investment

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- **Rated equity**
 - the underlying remains the equity tranche
 - but the income from coupon payments is diverted to build subordination over time
 - this instrument increases the accessibility of equity tranches for investors that requires investment grade ratings
- **Capital protected instruments**
 - generally these have been built in combinations of a risk free asset providing the PP
 - and a risky asset, usually principal only (zero coupon), providing the equity exposure

Structured credit

Main characteristics



Characteristic	Upfront+ 500bps	All running	Zero coupon	Interest only	All upfront
Carry	Medium	High	Zero	High	Zero
Time decay roll down	Medium	Medium	High	Low	High
Jump-to- Default	High	High	High	High	High
Time to default	Medium	High	Low	High	Low
Spread	Medium	High	Low	Low	Medium/Low
Correlation	Medium	High	Low	Low	Medium/Low
Convexity	High/Medium	High	Low	Low	Medium
Interest rates	Medium	Medium	High	Medium/Low	Medium

Concluding remarks

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- Market
 - high growth rates in global CDO issuance
 - increasing liquidity in the tranche market (secured and unsecured)
 - product innovation
 - more participants in the structured credit space
 - more balanced supply/demand dynamics

Concluding remarks

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- Investing in equity tranches
 - attractive risk/reward profile
 - very flexible in expressing market views
 - good liquidity and much more balanced supply and demand
 - JTD remains the key risk to an equity tranche investor
 - correlation risk very relevant at the top and bottom of the cap structure

Concluding remarks

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- Tools required
 - strong quantitative analytics
 - intensive credit research
 - trading capability

Structured credit Correlation

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