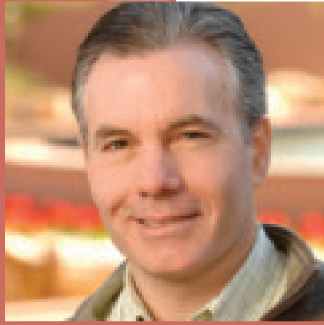

GOING INTO DEBT

Alpha can be found in credit-based debt strategies.

JOHN PLUTA
Senior vice-president, Declaration Management & Research LLC

2006 ALTERNATIVE INVESTMENT CON
Fairmont Princess, Scottsdale, Arizona

In practice, pure alpha is difficult to achieve. Entry points are important, and these are driven by macroeconomic factors and market liquidity. In fixed income, market exposures also include issuer size, newness or complexity in deal structure, and dislocations in risk premiums for credit or volatility. An active manager expresses a view in light of these factors, but they are remnants of beta or exotic beta. Portable alpha thus involves active management of both systematic and idiosyncratic risks across diverse assets and operates outside of conventional index boundaries.

As plan sponsors search for alpha, modest innovations are possible using low-volatility credit solutions. For alpha targets in the 50-125 basis point range, investment grade debt is a potential value source.

In building credit-based alpha products, the focus tends to be on the following four criteria:

(a) Scale, since high-skill areas such as security selection are prone to capacity constraints.

(b) Zero or low duration, which promotes mark-to-market stability and matches well with overlays.

(c) Flexibility, liquidity and transparency at the security and product level.

(d) Low correlation with the active risks already present in a given pension plan.

Benefits of ABS

Within investment-grade debt, greater scale and diversification can be gained using structured credit, also referred to as structured finance or asset-backed securities (ABS). The typical ABS transaction involves a pool of assets (e.g., credit card receivables or mortgage loans) held in a bankruptcy remote trust, wherein cash flow from the assets is distributed to debt and equity investors according to a waterfall. Senior debt holders have a priority claim on all cash flow, and their notes are usually rated AAA or AA. Their claim cannot be weakened nor their cash flow diminished by actions of the subordinated classes. Subordinated debt and equity investors expect to receive higher returns than the seniors, but their distributions are paid lower in the waterfall and are more sensitive to the performance of the underlying assets in the collateral pool.

Structured credit represents a huge universe of investment-grade assets. The vast majority of such credit is AAA and AA, while most corporate issues are A and BBB. On the demand side, total-return bond managers and spread lenders (banks and insurance companies) have relatively light exposure or commitment to structured credit. Due to supply and demand dynamics, ABS issues tend to trade at wide spreads per unit of risk and may offer good relative value. Alpha strategies with access to both corporate and structured credit have the advantages of scale and a broad universe for sector rotation or bottom-up trades.

Structured credit is predominantly a floating rate market. Most ABS issues have durations of 0.0-0.2 years, which implies low price volatility. In portable alpha programs, the overlays usually consist of swaps or futures. These derivative instruments are priced assuming an implicit financing cost based on LIBOR. Therefore, an alpha strategy which has floating rate assets is a natural fit with most overlays. With regard to price transparency and liquidity, structured credit is actively bid by investors, arbitrage vehicles (e.g., hedge funds or CDOs) and brokers. Recent growth in synthetic credit default swaps is also contributing to price transparency in the ABS sector. Finally, the correlation characteristics of structured credit versus corporate credit are relatively low, and in some cases have been negative. This suggests meaningful diversification can be achieved by integrating ABS into a broader fixed income strategy. ■

ALPHA STRATEGIES WITH ACCESS TO BOTH CORPORATE AND STRUCTURED CREDIT HAVE THE ADVANTAGES OF SCALE AND A BROAD UNIVERSE FOR SECTOR ROTATION OR BOTTOM-UP TRADES.