
Worried about sub prime
washing up in your portfolio?

An ABC of CDOs
(and sub-prime)

What factors gave rise to the proliferation of CDOs over the last few years?

The short answer is investor greed and declining interest rates.

Historically low yield levels and risk premiums meant that investors were forced to look outside their traditional investment opportunity set to achieve the investment returns that they had become accustomed to in an era of higher interest rates. It seemed that many CDOs offered an alternative source of "high quality" yield in many traditional cash portfolios. The higher yields offered by these structured products, relative to similarly rated term deposits, were achieved through the use of leverage (i.e. borrowing) within the structure and by investing in areas where the risk of capital loss was higher (such as low quality mortgages, otherwise known as sub-prime).

The use of leverage or borrowings within a portfolio carries with it increased levels of risk and volatility. While there is certainly a place for these types of products in a well diversified portfolio, many investors allocated a larger proportion of their portfolio than prudence would suggest (usually at the expense of truly defensive fixed interest securities such as bonds, bank bills and term deposits). Furthermore, these sorts of products were finding their way into the portfolios of clients who wouldn't typically be associated with them, such as charitable organisations, universities and councils.

This highlights what is now becoming evident through mounting legal action – clients were being sold these CDOs, possibly on the basis of a misunderstanding of the level of risk contained within them, rather than buying them.

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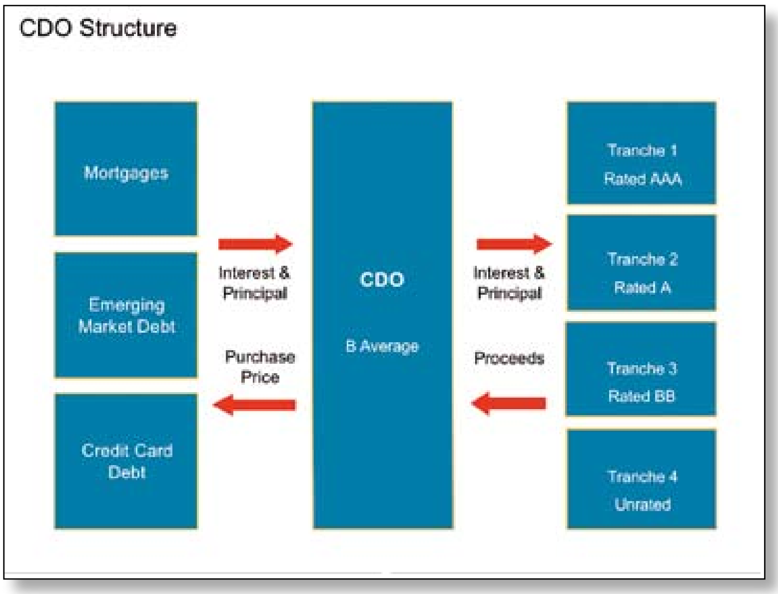
Exactly what is a CDO, sparing me the finance jargon?



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CDO stands for **Collateralised Debt Obligation**. A CDO is basically a bundle of loans or bonds, packaged up and re-sold to investors. The investment return comes via the repayment of the loans by the loan holder. For example, XYZ bank makes a number of loans to its customers. In order to shift the risk off its balance sheet, the bank will bundle them all together in a special purpose investment vehicle (SIV) and on-sell them to investors. Although crudely defined here, this is the basic process.

The CDO market in Australia is valued at around $6Bn and is estimated worldwide at around USD $2 Trillion. The US and Europe are the biggest markets.

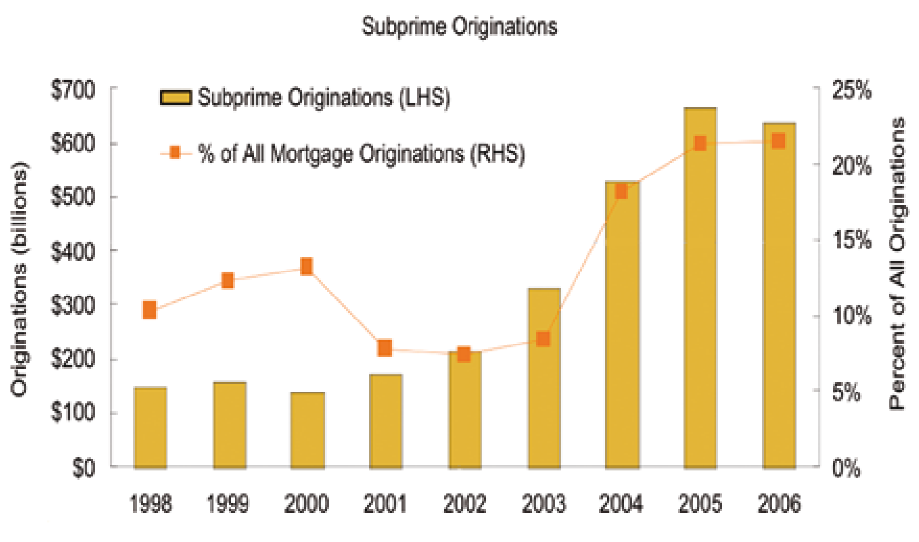
What type of debt backs these CDOs?

Any and all. CDOs can be backed by corporate bonds, emerging market debt, mortgages, car loans, credit card debt – the list is endless. Certainly the CDOs that are attracting the most attention at the moment are those with exposure to (i.e. backed by) sub-prime mortgages.

Sub-prime is another buzzword doing the rounds. Just what is a sub-prime loan?

What sparked all the fuss?

A large and rapid rise in sub prime lending….



Source: Inside B & C lending

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A sub-prime loan is a loan made to an individual who has a less desirable credit profile or wouldn't normally qualify for bank finance. They may have previously filed for bankruptcy or have a low credit score. There were even loans being made dubbed NINJA loans, which in regard to the applicant, stood for "No Income, No Job, no Assets!"

The problem is being exacerbated by continued weakness in the US property market. Falling house prices mean people have less incentive to make payments (which they are already struggling to make) on an asset which is declining in value.

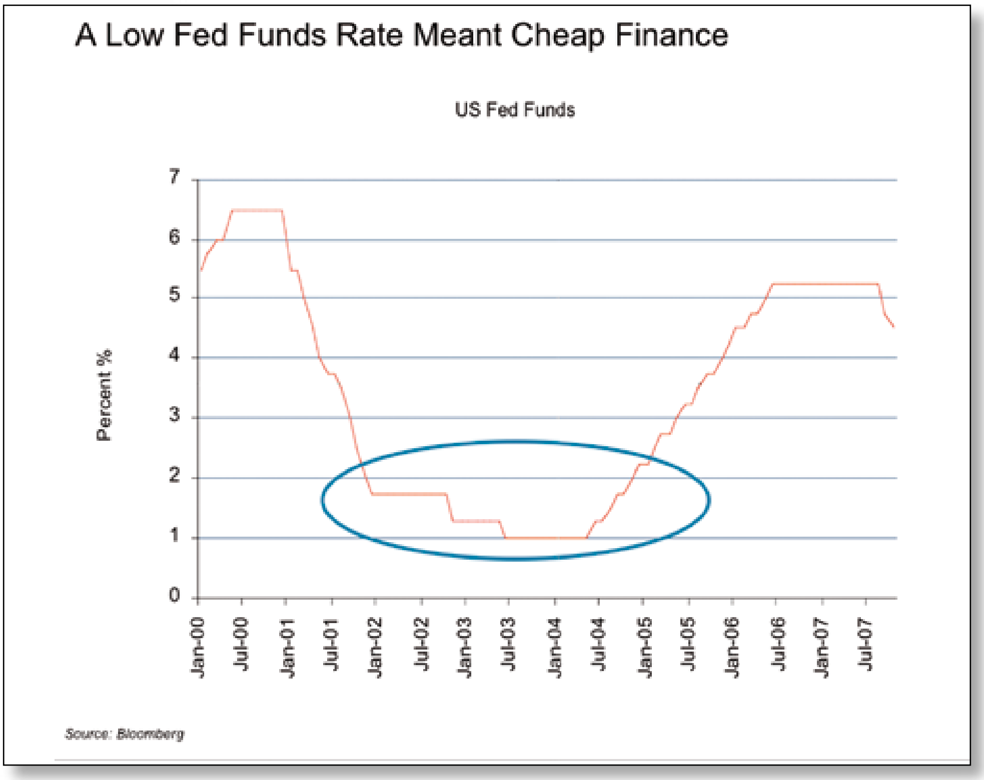
Why would a bank make loans to these individuals?

It all comes down to cheap finance. The Fed Funds rate, the US equivalent of the cash rate set by the RBA, was at extremely low levels. This meant that banks were able to borrow and subsequently loan out money at extremely cheap levels. Because there was so much money floating around and home prices were appreciating, banks and other non bank lenders relaxed their lending criteria.

Why is this now becoming an issue?

Quite often, banks attracted customers with very low "teaser rates" which were fixed for the first two or three years. Once this time period was up, the loan would re-set at a new market based rate. This was otherwise known as an ARM, or Adjustable Rate Mortgage.

Let's assume that a bank made a loan in January 2005, when the Fed rate was just 1%. Let's say that the bank offered a teaser rate of 2% locked in for two years. A sub-prime loan was made and the customer made good on all their payments over the next two years. Then suddenly, the ARM component of their loan kicks in. Now, instead of an environment where the Fed Funds rate is at 1%, official rates are at 5.25%. The bank readjusts their interest rate accordingly and the borrower finds that their interest rate has suddenly gone from 2% to 8, 9 or 10%. Even higher in some cases! Let's keep in mind too that these loans were made to people who wouldn't normally qualify – no income, no job, etc. So in many cases, these people were struggling to afford their monthly mortgage repayments at an interest rate of 2%, let alone 10%. The fact that the Fed has aggressively cut rates has done little to ease the pain. Ongoing liquidity shortages and risk aversion have meant that non-bank lenders continue to face high borrowing costs, which are being passed onto mortgage holders.



What has been the result?

The result is that there has been a huge spike in loan defaults, as many people simply cannot afford to repay their mortgages. It is true that all the headlines we have been seeing are focusing on sub-prime mortgages but alarmingly, we are now seeing defaults on prime loans as well. The problem is being exacerbated by continued weakness in the US property market. Falling house prices mean people have less incentive to make payments (which they are already struggling to make) on an asset which is declining in value.

Say you take out a mortgage and purchase a house for $400K. In the US, if you cannot afford to make your repayments and the bank repossesses the house, it is very difficult for the lender to take away any of your other assets. So if home prices have dropped by 10% and your house is now worth around $360K, there is little incentive to continue making repayments on a $400K mortage when you can simply walk away from your home and, in many cases, avoid having to pay any more.

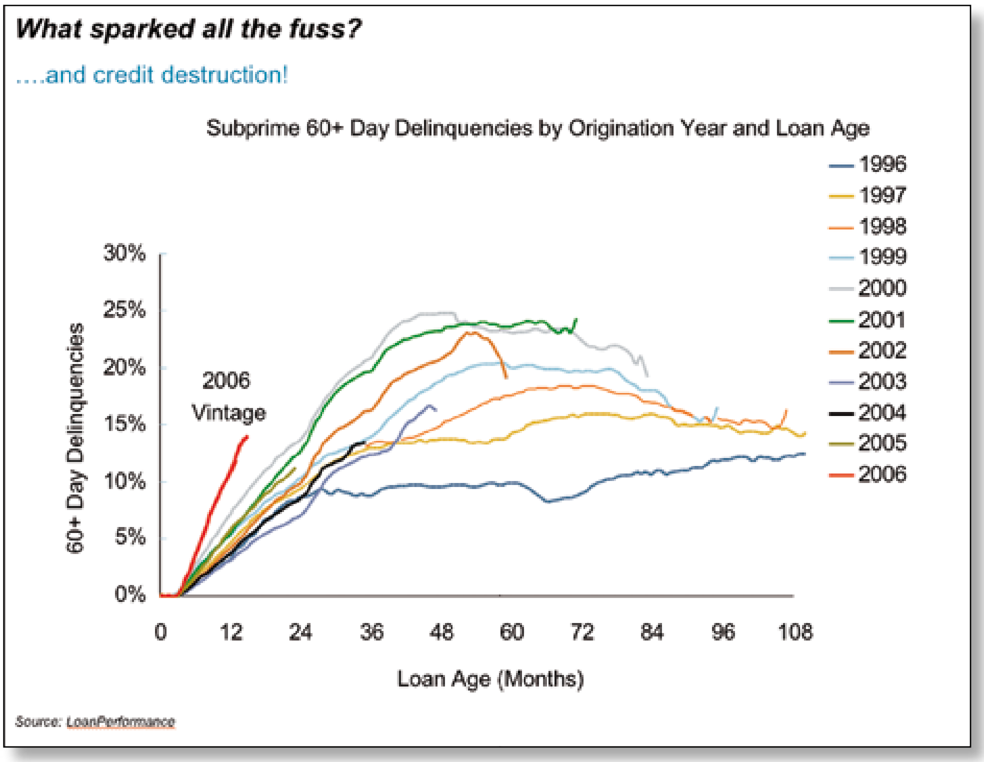
In Cleveland Ohio, one in twenty homes is in foreclosure, with foreclosure rates up 300% on recent years. In one part of California, house prices have fallen 30 to 40%.

I understand these sub-prime issues, but how is Joe Bloggs defaulting on his home loan in Cleveland Ohio related to CDO investment here in Australia?

Remember I discussed the structure of CDOs and mentioned that they were backed by loans? Some investors have found that the CDOs they hold are backed by sub-prime loans – the loans that we are now seeing large numbers of defaults on. Let's say a CDO is comprised of 100 loans. As the borrower defaults on his loan, this default wipes off some of the value of the CDO. One thing that is important to mention here is that CDOs are often divided up into tranches, each with a differing credit quality. The lowest level, or equity tranche (aptly nicknamed "toxic waste" within the industry) will be the first to suffer when defaults occur, cushioning the more senior debt holders. As defaults rise though, they can start eating into the capital of the more senior holders of debt, depending on the structure of the CDO and the number of defaults.

How long will this crisis last?

Well that's the million dollar question. We certainly feel that the full effects of the sub-prime meltdown are yet to be felt. Every day it seems that another large investment bank is declaring multi billion dollar losses. Between September 2007 through the end of 2008, $900Bn in sub-prime loans are due to reset at new, higher interest rates, further increasing the burden on borrowers. I mentioned earlier that we are now starting to see defaults on prime mortgages as well, as house prices continue to decline. As the US economy continues to slow and head towards possible recession, the situation will likely get a lot worse before it gets better and CDOs without sub-prime exposure will also be at risk.



Why would I sell now and realise a paper loss? Aren't I better to just hold onto my investment and ride out the storm?

It depends on a number of circumstances. It is true that if you hold onto your investment you will receive your capital back at maturity PROVIDED you are sufficiently protected against defaults in the portfolio. As mentioned though, we expect the situation to significantly worsen before it gets better. Even people holding more senior tranches of certain CDOs may experience reduced coupon payments or capital erosion and loss. Another risk is one which we have already started to see – the ratings agencies will downgrade the rating on these securities. Many organisations have strict investment guidelines which state that investments with minimum credit ratings must be held. A downgrade in the rating of various CDO tranches may mean that organisations are no longer able to hold them. The subsequent unloading of these securities by forced sellers into the marketplace will further depress the prices received for them.

What are the options then for investors finding themselves holding unwanted CDO investments?

That's a question that we have been hearing a lot lately and there is no perfect answer. We have basically been looking at each request on a case by case basis. In some instances we feel that the CDO is of sound quality and there is no apparent risk to the investor. Some of the portfolios we have been examining have been comprised of less desirable underlying assets. Understandably, some clients have been reluctant to sell at current low prices. However, we are often able to identify and place them into similarly priced portfolios which we believe will benefit from significant price appreciation. What we have found is that there are many good quality assets out there trading at very cheap prices. They've just been sold off in sympathy with lesser quality CDOs and also to raise money to fund margin calls on CDO investments.

For further information, please contact Matthew McLenaghan
(matthew.mclenaghan@au.pimco.com) • 612-9279-1771
PIMCO Australia Pty Ltd ABN 54 084 280 508 AFS Licence 246862
LEVEL 19, 363 GEORGE STREET SYDNEY, NSW 2000 AUSTRALIA

PIMCO