Barclay Managed Funds Report

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BARCLAY ROUNDTABLE

Historic Low Yields Have Improved Outlook for Structured Credit

Lack of Investor Interest Over Past Few Years Has Made Valuations More Attractive

If you consider the massive amount of regulation that has occurred in the financial sector since the 2008 market debacle, you would be hard pressed to believe that certain areas of the capital markets could survive. Dodd-Frank, in particular, tackled a number of key areas including agency oversight, derivatives regulation, investor protection, rating agencies, executive compensation, bank proprietary trading (Volcker rule), bank capital requirements, and last but not least, asset securitization and credit structuring.

This last area warrants special attention due to the fact that the media and vote-seeking politicians alike have put the brunt of the blame for the 2008 crisis on certain areas of the securitized market, namely sub-prime mortgages and derivatives based on this market (think AIG). During the past couple of years the mere mention of securitization and structured credit may have earned you a big hush from the investment club crowd, and those not in the know would even argue that this market was all but dead.

But alas, yesterday's pariah is today's pot of gold. Slowly but surely, securitized product and structured credit allocations are creeping up in traditional fixed income portfolios, and hedge fund managers specializing in these areas are back on the capital raising trail. No doubt the lack of investor interest over the past few years has made valuations attractive, but will increased regulation, lack of liquidity, and collateral quality keep risk levels elevated? To explore these issues and discuss the securitized and structured credit markets in more detail, we have assembled a panel of expert and experienced fund managers. Our panelists include:

Dr. Lestor Coyle, III Associates. Dr. Coyle is a principal of III and portfolio manager for the III Credit Funds. He joined III in 2005 from Commerzbank where he was New York head of credit correlation trading. Dr. Coyle holds a PhD in mathematics from the University of Michigan and a BA in mathematics from Trinity College, Dublin. He is co-author of the book Lectures in Contemporary Probability and has published numerous articles in probability and finance.

Michael Craig-Scheckman, Deer Park Road Corporation. Mr. Craig-Scheckman is President and Owner of DPRC. He has operated DPRC as an investment advisor, focused exclusively on deeply discounted fixed income securities, from July 2003 until the present. Prior to founding DPRC, he worked at Millennium Partners from 1993 where his focus was mortgage-backed and asset backed securities. Mr. Craig-Scheckman earned a BA in Physics at Queens College, New York, in 1975 and a MA in Physics at Columbia University, New York, in 1977.

Hiram Hamilton, Alcentra, Ltd. Mr. Hamilton joined Alcentra in March 2008 and is Global Head of Structured Credit. He is the portfolio manager for the Structured Credit Opportunity funds and oversees investments in structured products across Alcentra's funds. Previously, he was an executive director at Morgan Stanley and head of the CDO Group in London. Mr. Hamilton graduated cum laude from Bowdoin College with a dual major in philosophy and neuroscience.

Leon Hindle, Oracle Capital Limited. Mr. Hindle cofounded Oracle in June, 2009. Previously he was Managing Director and Head of the Structured Credit and CDO Group for the Pan-Asia-Pacific region at Lehman Brothers. In addition, he served as a member of Lehman's Global Credit Products Management Team and its Pan-Asia-Pacific Fixed Income Management Committee. Mr. Hindle qualified as a barrister at the London Commercial Bar.

Gyan Sinha, KLS Diversified Asset Management, LP. Mr. Sinha is a partner and portfolio manager of structured products at KLS. Prior to joining KLS in 2008, he headed the Global Structured Credit Research group at Bear Stearns. Over the past decade, he was consistently one of the top ranked analysts in Institutional Investor's (II) All-America Fixed Income Research survey for his work in asset-backed securities. Prior to his Wall Street career, Mr. Sinha was an assistant professor in the faculty of commerce at the University of British Columbia. He received a Bachelor's degree in Economics in 1985 from Delhi University and a PhD in Economics in 1991 from Syracuse University.

Q: Structured credit issuance has increased substantially in 2012, many speculate as the result of investors searching for yield in a prolonged low-rate environment. Which areas of the market have seen the strongest issuance? What is the level of collateral quality relative to pre-2008 issuance? What areas of the structured credit market have not seen any new issuance since 2008? In your opinion will there ever be issuance in these areas in the future? What areas of the market are hedge funds most focused on and why? What are the most attractive ways to take hedged positions in these areas of the market?

Coyle: US CLOs have seen the strongest issuance with 2012 total projected to be close to $40 billion, similar to 2004 and 2005 issuance. Overall collateral quality is higher, especially in CMBS and RMBS. The US RMBS market has had very little new issuance since 2008, and European issuance has generally also been very low. We do ultimately expect nearly all structured credit issuance to return in the future as there is a fundamental need for this type of financing. Some markets, such as subprime RMBS, will just take longer to cure. We believe most hedge funds are focused on equity and junior tranches of CLOs, and junior tranches of RMBS and CMBS. These are the main products that have potential double digit yields. In addition, as repo leverage comes back to the market, some funds are applying leverage to mezzanine tranches. We believe that the most attractive areas of structured credit currently are two- to three-year weighted average life senior and senior mezzanine tranches of more off-the run areas of structured credit, such as mixed asset CDOs, whole loan commercial real estate CDOs, and CDO-squareds hedged versus out-of-the-money CDX IG put options. Because they are short-dated, we believe the mark-to-market volatility will be relatively muted. Additionally, we believe the bonds have lower fundamental risk and are self-liquidating in nature. In essence, we do not believe that credit curves are sufficiently steep in structured credit to warrant going further out the curve, given the current global uncertainties.

Dr. Lestor Coyle

III Associates

" In essence, we do not believe that credit curves are sufficiently steep in structured credit to warrant going further out the curve, given the current global uncertainties."

Craig-Scheckman: We have not looked at any new issuance or even recent issuance so far. We are seeing plenty of opportunity in seasoned deals. I will also add that in the past (pre-crash), new issuance was a very small part of my investments. I wait for bad deals to become evident.

The two areas of new issuance I will talk about are RMBS and CMBS. CMBS has seen new issuance, while RMBS has seen very limited new issuance. We expect that going forward, as the housing market continues to stabilize, RMBS issuance will start up again.

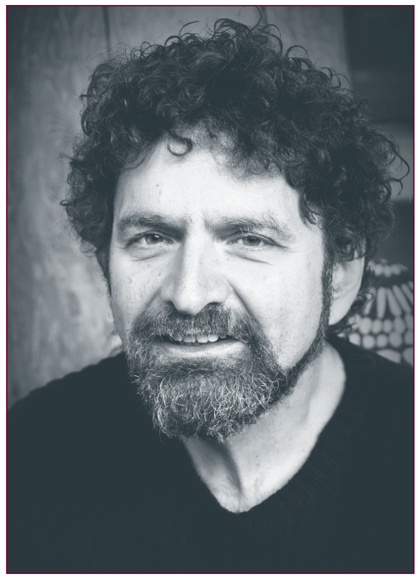
Hamilton: New issuance of US CLOs has had a major resurgence. Last year over $10 billion was issued, and this year we expect around $35 billion. In contrast, new issuance of European CLOs has been nearly zero. The main hurdle in Europe is that expensive CLO liabilities, with mezzanine CLO debt trading at double digit yields, has minimized the arbitrage available to CLO equity tranches. This should change soon, as we have seen a major repricing of European CLO Mezzanine over the last 3 months. Hedge funds have been major buyers of CLO mezzanine and equity in US CLOs for the last 3 years. Only recently have we seen some of that capital flow to Europe with a distinct jump after Draghi's constructive comments on "doing whatever it takes" to protect the euro in July.

Hindle: We focus on instruments backed by corporate credit only, rather than mortgage backed securities. This is because our experience is in the corporate credit world, and we see the structured products we trade as related to vanilla corporate credit trading from a macro and micro risk perspective, rather than as a part of the generic asset backed securities market. That means we focus on active trading and hedging using a variety of instruments, from less liquid securities such as synthetic CDOs and CLOs through to very liquid instruments like index derivatives and futures. We are different from some funds in the structured credit space in that we operate a true absolute return fund which, while directional, does not have a long bias.

The reason this area is interesting and has a great future for hedge funds is twofold: it is systemically important as structured credit instruments are the only way for institutions to manage credit risk without outright sale of an asset or termination of a lending relationship, and it is very poorly understood given its short history and the turmoil experienced in 2007/8. The size of the asset class and its non-homogenous nature means there will always be opportunities for sophisticated traders, even if the obvious beta-plus long only opportunity ceases to be attractive. (The flow of money into structured credit opportunity funds suggests this is a while away.)

Issuance continues in CLOs in the United States, and in bank regulatory capital deals globally, and there is continuing interest in lightly structured derivative trades like credit linked notes. Issuance has yet to return in synthetic CDOs, but if history tells us anything, it is only a matter of time, although in their next incarnation they probably will be called something different. There is plenty of secondary paper around meanwhile.

Sinha: New issuance has rebounded most in asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and collateralized loan obligations (CLO). In all sectors, the initial revamp of these markets was almost always characterized by improvements in collateral quality and better structures, but the credit box has gradually expanded to encompass a broader mix of borrowers. Collateral quality in new deals still represents an improvement over the state of markets pre-crisis. The private label RMBS market remains a shadow of its former self, with the slack taken up by Agency MBS (Fannie Mae/Freddie Mac) and Government Guaranteed MBS (GNMA) which now represent the lion's share of financing for homes in the US.



Michael Craig-Scheckman

Deer Park Road Corporation

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In ABS, the mix of issuance has shifted away from credit card and student loan backed ABS towards auto loans and leases as financing volumes have risen to very robust levels post-crisis. In addition, more esoteric subsectors such as equipment lease financing, whole business securitizations, and container lease transactions continue to find sponsorship from a relatively wide audience of investors attracted by greater structural protections and the potential yield pickup relative to corporate bonds. After ABS, CMBS has seen the next-most robust post-crisis rebound, albeit to a much smaller fraction of its boom year volumes, with almost $31 billion of origination in 2012 YTD as compared to over $230 billion in 2007. With current origination volumes still a fraction of 2007 volumes, post-crisis issuance has shifted to include a notably higher share of single borrower deals built upon the appeal of "trophy" properties in a still-recovering market. Conduit deals have reverted back to pre-bubble era style transactions that include traditional conduit collateral (secondary market properties), more simplified structures with fewer, thicker classes, more subordination, more reliance on current net cash flow, and less reliance on the proforma underwriting and optimistic valuations that had become prevalent during 2007. While the credit box has loosened noticeably from the first post-crisis deals in 2009, underwriting standards are still decidedly stronger versus pre-crisis deals.

Similar to CMBS, CLOs saw something of a rebirth of structure, with post-crisis deals being comprised of fewer, thicker tranches with higher subordination, as well as lower overall leverage in the structure. While pre-crisis deals typically saw 12-15x leverage in the equity class, post-crisis deals are typically levering only 8-10x and are typically more uniform than legacy deals. Underlying asset underwriting is somewhat cleaner than in pre-crisis days, with generally lower leverage and some element of "credit burnout". As with CMBS, the credit box has loosened in recent quarters, with leverage creeping higher, "Covenant-Lite" loans becoming more prevalent, and a higher share of CCC borrowers among new issue. However, a much diminished 2013-14 maturity calendar has kept a lid on near-term default expectations, with surveyed managers still projecting 2013 defaults to run below long-term averages. Between their crisis tested structures, increased subordination levels, significant market pruning of weaker managers, and cleaner collateral pools, new issue CLOs are proving themselves to be an asset class that's here to stay, even as new issuance of other types of CDOs seems unlikely to rebound anytime soon.

Issuance in the private label RMBS market has been stymied by a combination of factors. First, the Agency and GNMA MBS markets still represent the best execution for originators for conforming loans. Second, the bank whole-loan bid for prime non-conforming loans is very strong. Banks are attracted by the yield pickup and relatively strong credit quality of new originations. Third, still pending Qualified Residential Mortgage (QRM) regulations required by the Dodd-Frank legislation which determines risk-retention rules for a securitization by depositories and originators has taken away the incentive to securitize while the rules are still in flux. As a result, only a handful of securitizations sponsored by mortgage REITS have been brought to market. Longer term, issuance in the private label RMBS market should increase as the impediments laid out earlier dissipate over time. We would not be surprised if a significant portion of the agency-backed US housing finances market transitions to the private sector over the course of the next 5 to 10 years.

Traditionally, most players have tended to be specialists in particular sectors of the market (e.g. RMBS, Mortgage Derivatives, CMBS, etc.), but more recently we have seen a trend among firms towards broadening the asset base. In general, hedge funds are natural participants in the mezzanine and junior portions of new issue securitizations. In addition, hedge funds may also take a total return view on more senior parts of the capital structure and make more opportunistic investments if they perceive a spread tightening bias due to temporary dislocations in the pattern of real-money flows (e.g. from banks, insurance companies, and money managers). As far as hedging is concerned, the most liquid index (and where there is creation of new vintages or series) in the structured product markets is CMBX and is a tool that is often used by both hedge funds and dealer desks to hedge mark-to-market risk across a range of structured products. Other often cited indices are the corporate high-yield (HY) and investment-grade (IG) indices. These hedging flows can themselves provide pockets of opportunity for hedge funds to trade in and out of various tranches of the CMBX index as short-term, relative value trades.

Hiram Hamilton

Alcentra, Ltd

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Q: One of the primary sources of turmoil from 2008 was the real estate crisis, and in particular, sub-prime lending. More recently, however, investment in residential mortgage backed securities (RMBS) has increased by a number of institutional investors. While there are some signs that the real estate markets are improving in the US, it is clear that the economy is still on shaky ground and real estate continues to be susceptible to another downturn. To what extent has the search for yield and capital flows masked the actual performance of underlying collateral? How attractive is general RMBS pricing today.

Coyle: We believe that the US real estate market has begun to recover and is unlikely to suffer another downturn. Being based in South Florida we are able to witness first-hand the turnaround in residential real estate. In general, home valuations are consistent with rental rates and income levels, so we would expect that it would take a significant drop in the economy to cause home valuations to drop nation-wide again. Considering global uncertainties, this is certainly possible, but it is not our base case. We do not believe that the current search for yield has masked the performance of the underlying collateral, as pricing assumptions are generally consistent with fundamental performance. However, earlier in 2012 technical flows did drive RMBS tighter than fundamentals might suggest. Currently, relative to other general areas of ABS, RMBS pricing still seems somewhat attractive. However, ambiguities in servicer behavior and potential changes in government regulations lead to greater uncertainty in RMBS cash flows, and this has made us reluctant to make RMBS a large allocation in our portfolio as we find the shorter-dated average life bonds we mentioned earlier more attractive.

Craig-Scheckman: The search for yield and investment in RMBS comes more in fits and starts, while the improvement in the US housing market has been a gradual, slow process. Recently, interlaced with this are changes in servicer behavior, which doesn't affect the quality of the underlying collateral as much as creating changes to the bonds in the deals.

So, the answer to this question is complex. During certain times, the times of strong rallies, there is a certain measure of the market getting ahead of fundamentals, but during other times the fundamentals are leading. Overall, the more liquid components of the market are probably a bit ahead of themselves, the less liquid sectors are probably fairly valued, and the longer duration, less liquid parts are probably overvalued.

Hamilton: The focus of the Alcentra Structured Credit Strategy is exclusively on structured credit securities backed by corporate credit. Our philosophy is to invest only in structured credit securities where we believe we have an edge on analyzing the risk in the underlying assets. We don't invest in RMBS or CMBS because we aren't experts in residential real estate or commercial real estate. We really question funds who play a relative value strategy among different types of structured credit asset types. A structured security is not cheap in and of itself but only in relation to the assets which secure it. Analyzing a company's ability to repay its debt obligation is our core skill and the area where we believe we have a real edge over other investors – so we restrict ourselves to structured credit backed by those assets.

Hindle: We are not involved in RMBS.

Sinha: The fundamentals in residential housing have improved steadily from the peak of the crisis in 2009. Ultimately, two things matter for a distressed sector; is the inflow into delinquency still increasing, stable, or declining, and for the segment of the borrower pool that has fallen too far behind and unlikely to recover, what recoveries can be expected from the sale

Leon Hindle

Oracle Capital Limited

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of the collateral on which the lender has a lien? On both fronts, the fundamental underpinnings of residential MBS have improved considerably over the last few years.

On the first question, one way of measuring a credit trend on a pool of loans is to track the rate at which borrowers who have never missed a payment are going delinquent. The delinquency roll rates have improved as labor markets have healed, and fewer borrowers are moving from the never late into the delinquent category. The other category of borrowers we care about are the chronic delinquents where the only recourse for the lender may be to the underlying collateral value. The stagnation in the job market and the lack of meaningful growth in payrolls implies that it is very hard for chronic delinquents to escape the foreclosure cycle. The transition rate from seriously delinquent to a better state has bottomed out at around 5%, from pre-crisis highs of 15-50%. This pattern of inflows and outflows has led to persistently large seriously delinquent buckets in most legacy RMBS transactions. This implies that the prognosis for collateral values is increasingly important to the longer-term performance of RMBS securities. This is another area where the news over the past year has generally surprised to the upside, for several reasons. It is to these that we now turn.

First, the US housing market has gone from being a 'bubble' (where prices were not capable of being supported by fundamentals) to a stage where traditional metrics like price-to-rent ratios and price-to-income ratios all point to the asset being cheap. This turnaround in housing fundamentals on the demand side has no doubt been helped by two developments. First, housing affordability has risen to all-time highs, primarily as a result of three factors: housing prices have declined dramatically, in some instances by as much as 20 – 30% where they were most overvalued; upward pressure on rents, especially as former homeowners become renters; and declining mortgage rates driven by the general drop in interest rates. Second, the substantial decline in housing starts and new construction has also served to mitigate the negative impact of distressed inventory on housing prices, reducing available supply in many markets. In addition, the onslaught of federal, state, and local initiatives against aggressive foreclosure actions by lenders has served to gum up the distressed supply, especially in states where judicial action is needed to repossess properties. Thus a confluence of both demand and supply factors have created a strong environment for housing to form a bottom and lay the groundwork for a sustainable recovery in the future. Of course, while the health of the broader economy will have a role to play in the fortunes of any sector within it, given the strength of the core fundamentals for housing, it will still likely outperform other sectors of the economy on a relative basis in the event of a broad-based slowdown in economic activity.

Putting all of this together, we can surmise that the improvement in valuations in RMBS has been driven not only by the search for yield but also by the improvement in underlying fundamentals regarding borrower behavior and collateral values. Valuations are still attractive, with loss adjusted yields in the 3.75-6.5% range, assuming still substantial amounts of defaults and losses. In closing, the question of whether the RMBS sector is attractive has to be framed in the context of the broader fixed-income markets. As our analysis reveals, while absolute yields have declined, they still represent loss-adjusted yields which bake in relatively high levels of defaults and losses and thus have potential upside to any improvement. The sector provides a valuable diversification alternative for investors who may not want to put all their higher-yielding, recovery bets into the high-yield corporate basket.

Q: High yield bank loans have generated increased interest in the investment community over the past few years, and more recently collateralized loan obligation (CLO) issuance has increased. To what extent are underlying loan values being supported by CLO issuance? In your opinion, are CLO valuations still attractive, in general, or are they becoming rich? How does the risk in the lowest quality tranches compare to the risk pre-2008?

Coyle: New issuance in CLOs is strong – stronger than at any point since 2008, but the net outstanding of CLOs is only increasing slightly as many older deals either mature or get called. It is certainly a positive for the loan market that the CLO market is up and running strongly, but we do not believe that CLO issuance is supporting loan prices. The US levered loan default rate remains very low, and overall there has not been any net new issuance of loans in the last few years. However, we have seen a significant rise in high yield bond issuance, and some of these proceeds have been used to pay down loans. Therefore, overall we believe that loan prices are being driven by fundamentals. We believe that first-pay AAA CLO valuations are attractive at L+120-130 as these remain significantly wide relative to pre-2008 levels (L+35-50). We have seen yield compression throughout the rest of the capital structure, and we believe in general that the remaining parts of the capital structure are rich. In particular, equity base yields (11-13%) are lower than pre-2008 levels (perhaps 13-15%).

Gyan Sinha

KLS Diversified Asset Management, LP

"...the fundamental underpinnings of residential MBS have improved considerably over the last few years."

Craig-Scheckman: I cannot really comment on this since we are not involved in this sector.

Hamilton: We believe CLO tranches are still cheap but much more so in Europe than in the US. Take for example European BBB CLOs which currently trade at a discount margin of approximately 1000 bps over EURIBOR. We believe these assets are generally safer than owning a portfolio of leveraged loans outright due to the subordination and protective coverage tests embedded within a CLO. European Loans trade close to a discount margin of 500 bps over EURIBOR which implies a large spread tightening to come on CLO securities.

Going into the summer, the spread differential between where European and US BBB CLO tranches traded in the secondary market reached an incredibly wide 700 bps. In the current low rate environment, we believe that yield differential is astounding and indicates the extent to which market participants were pricing in very bad outcomes for Europe. By the end of the third quarter, as the market absorbed the impact of greater ECB powers, this differential shrank to 550 bps, and we expect this to shrink again in the 4th Quarter.

Hindle: CLOs were a major driver of the bank loan market prior to the crisis and continue to play a significant role today given secondary demand. However, I do not think loan prices are currently driven by

CLO issuance. CLO valuations are probably still attractive in the context of where yields are for other assets today. The CLO market also benefits from reasonable secondary market activity. Equity tranches today are less levered than prior to the crisis. Generally speaking, we have not been particularly active in US CLOs recently given that the secondary market is fairly efficient and headline yields are not compelling.

Sinha: An interesting dynamic has played out in the CLO and bank loan markets over the past several months, with a number of CLOs that had begun marketing in the spring finally finding the footing to price in late August and September on the heels of the summer rally. In loans, August was one of the busiest Augusts on record for new issuance, and a number of M&A transactions were building in the wings for post-Labor Day pricing, keeping September's calendar flush as well. This heightened demand for assets coupled with a more readily available supply of assets spurred the summer rally into something of a frenzy for CLO managers looking to capitalize on the persistence of the arbitrage and the market's strong demand for paper. Roughly one third of 2012's total CLO new issuance priced in the months of August and September alone, and at its current pace new CLO production stands at roughly 50% of the demand in the bank loan market. This is up from around 35-40% in 2011 but still below the 65% peak that was reached in 2007. To that end, CLOs have certainly been a strong supporting factor in the strength of loan prices, but one cannot discount the tandem support provided by loan funds alongside the strong rally in corporate credit.

With loan spreads so tight, the high cost of ramping CLO assets has put pressure on the creation arbitrage and, certainly, returns for investors. Lower-rated debt tranches in CLOs are still pricing wide of their 2011 tights (even adjusting for Libor) by some 100-150 bps, so despite their strong run in 2012, additional tightening seems feasible on a simple historical basis. More importantly, low rates for the foreseeable future, more or less open-ended QE, and CLOs' spread pick-up relative to comparably-rated assets combine to suggest that the sector could see additional tightening beyond these previous tights as investors find themselves with few alternatives with comparable risk-return profiles. So while current valuations may seem rich on a short-term historical basis, we think these assets are poised to grind tighter over the medium term for lack of attractive alternatives. Relative to pre-crisis deals, today's new issue subordinates have credit enhancement comparable to that of pre-crisis bonds one tranche higher, so today's BB would be more akin to a new issue BBB in 2007. This puts them in the same ballpark for all-in yields at pricing, but today's new issue BBs should be a more attractive risk at these levels for their less levered collateral, tighter deal structures and more benign near-term default environment. Additionally – and this is important – in the pre-crisis market, untested managers could easily garner the demand to print new CLOs, but nowadays the majority of new issue deals are being issued by managers with average to strong performance during the last credit cycle. For any managers looking to throw their hats in the ring in the current market, investors can expect to pick up additional risk premia.

Q: The ratings agencies came under considerable pressure following the events of 2008 for not fully understanding the securities they rated or the risks involved. In your opinion, have ratings agencies improved their efforts to fully understand the more esoteric areas of the structured credit markets? Are current ratings more reflective of the risks? To what extent has the astute investment community moved on from placing any credence in agency ratings? How relevant will ratings agencies be going forward?

Coyle: We believe the biggest failure of the rating agencies was in rating second level securitizations such as CDO-squareds and CDOs of RMBS or CMBS. For instance, in subprime CDOs consisting of BBB subprime securities, the agencies were assuming some level of recovery on the securities when in fact there typically was no recovery. They also assumed lower correlations when actual correlations were much higher. However, for first level securitizations such as CLOs, RMBS, and CMBS, their ratings were more accurate, though clearly they made many errors such as assigning investment grade ratings to many RMBS securities. On the whole, their ratings on CLOs have been reasonably accurate, and while ultimate defaults in CMBS are still to be determined, their ratings seem to have been fairly reasonable. One has to remember that the housing market underwent a downturn unlike anything we have seen in this country before, so some rating inconsistencies are to be expected. We believe ratings now are more reflective of the risks for new issuance as the agencies have modified their recovery and correlation assumptions. However, we believe many secondary deals are incorrectly rated, especially as they get closer to maturity. This may be due to a resource issue at the rating agencies as the 2005-2007 issuances produced a large number of deals to rate while the lack of issuance in 2008-2011 has led to lower fees for the agencies. We believe most hedge funds place little to no credence on ratings (except to determine whether a bond may be attractive for a resale). However, many other market participants such as banks and insurance companies are very dependent on ratings from a capital usage point of view, so their investment decisions are greatly influenced by ratings. In addition, ratings can also play a significant role when a hedge fund is looking to source repo leverage on a structured credit bond. Thus, ratings will likely continue to be very relevant going forward.

Craig-Scheckman: We have never had any faith in rating agencies or ratings. So, to us, ratings from the agencies will have the same effect going forward. I think that the ratings agencies today are more interested in protecting themselves rather than making the banks happy. To that extent, ratings are probably more protective of investors, but even this CYA approach has its drawbacks – witness the US Treasury downgrade which preceded a huge rally in Treasuries.

Hamilton: Overall the ratings in the CLO market were more appropriate and accurate compared to the ABS CDO market where major errors occurred. Having said that, we don't rely on credit ratings when analyzing investments. At a given credit rating, we find a wide range of asset quality and subordination levels. In our opinion, rating agencies will typically be a lagging indicator of transaction quality. So as a transaction improves the ratings are understated, and as a transaction worsens the ratings overstate the quality of the transaction.

The fact that many regulated institutions determine capital ratios based on ratings is worrisome. These rules lead to investors focusing on purchasing assets with a certain rating without fully understanding the risks of the investment.

Hindle: We do not place any reliance on rating agencies in making our assessment of structured credit instruments. The financial industry prior to the crisis used to create many new esoteric instruments to take advantage of the demand from global investors for highly rated product and the narrow focus of the rating agency mindset in rating these products. This was called ratings arbitrage. Today the demand for structured finance instruments is much less, and ratings for these products no longer carry a great deal of weight. Therefore there is little product innovation associated with ratings criteria happening at present. But again, it is only a matter of time.

Sinha: The crisis of 2008 was caused as much by a failure of the rating agencies to fully understand what they were rating as it was by the wholesale abdication of investment responsibilities by the ultimate takers of risk. The systemic risk was further exacerbated by highly rated A-1/P-1 Asset-Backed Commercial Paper Conduits (ABCP) that added external leverage onto internally leveraged securitization structures.

In an ideal world, the role of rating agencies would be much like that of auditors and accountants within the broader financial markets. In this respect, they perform a delegated underwriting function for a broad class of participants, centralizing the information gathering process and providing expert opinions about the likelihood of interest and principal repayment for a securitization. In order to do this, they use a combination of both objective (hard data) and subjective (soft data) information to arrive at their conclusions. To this extent, they serve a useful and necessary purpose in that they allow for a more efficient sharing of the costs of this information gathering across investors.

Where the process breaks down in the real world is when the information gathering process becomes shoddy (or corrupted) and/or where there are actual flaws in the conceptual framework surrounding the understanding of collateral loss distributions itself. The financial crisis of 2008 exposed both of these problems as far as the rating agencies were concerned. A fundamental tenet of credit markets is asymmetric information – that in most instances, the borrower knows more about his/her credit quality than a lender does. In order to resolve this information asymmetry, lenders typically ask borrowers to put their money where their mouth is (so to speak) in the form of a down-payment (or a deductible, in insurance parlance). By 2006, vast swathes of the private label market were dominated by high LTV loans where the borrowers simply stated how much they made. This should have alerted the rating agencies that the quality of hard, objective information was deteriorating quickly. While the rating agencies did penalize riskier loan attributes and demanded higher loss cushions, the magnitude of the risk layering was obfuscated by the information asymmetry between borrower and lender. This aspect was ignored in the rating process, and the higher enhancement levels ultimately proved inadequate, as demonstrated by realized loss levels that were unprecedented by historical standards.

This basic error in fully comprehending the nature of mortgage contracts was further compounded by one of the largest and most significant failures ever in the history of the rating process - the treatment of correlated risks. This was seen in particularly acute fashion in CDOs backed by mezzanine and junior tranches from subprime and alt-A securitizations. That default correlation within ABS CDOs could be a function of the absolute level of housing related defaults was fundamentally misread. For example, if housing related losses remain low enough, a portfolio of junior MBS will display very low correlation of defaults, but if they reach high enough levels due to a broad based decline in housing prices, they may ALL default at the same time, as the subordination cushion for each security is eroded away. The advent of CDS on RMBS made the propagation of this error throughout the financial system even more widespread as it allowed the notional size of bets being made to grow exponentially. Thus, the conceptual seeds of the crisis can be traced directly back to the rating agencies.

As we look ahead, the crisis of 2008 provides several lessons for investors in this respect. First, investors need to focus on the nature of the underlying contract (are they 'incentive-compatible'?) to determine to what extent they should rely on the hard objective data regarding the credit quality of the borrower. If proven unsatisfactory in this regard, ratings are as good as guesses, and one might as well rely on one's own guess as opposed to a third party. Second, they need to be very skeptical of complicated structures (i.e. those where raters rate the product of other raters (such as re-securitizations) and where the rating may be too reliant on fragile correlation assumptions. Finally, the more senior the rating, the less investors should trust structures that rely on complicated, dynamic triggers to arrive at the high rating level. Simplicity is a virtue in these situations.

To what extent have the rating agencies improved? Obviously, the financial crisis has not been kind to their reputation, and ultimately this is a business built on reputational capital. To that extent, while the most obvious cases of venality may have been weeded out, it is much harder to root out incompetence, and as consumers of these ratings, investors need to be constantly on the watch. We don't particularly care that rating agencies continue to be paid by issuers – after all, so are accountants and auditors. The ultimate responsibility for evaluating the Good Housekeeping Seal of Approval that a rating represents lies with the buyer - Caveat Emptor!

"We analyze the charts on a technical base and research the fundamental drivers at work. Only when we recognize the pattern and we understand the fundamentals will we consider a position."

— Alex Moisseev

Q: Following the events of 2008 a multitude of new bank regulations were enacted including certain capital and liquidity requirements and the elimination of proprietary trading. To what extent has the lower amount of investment capital from banks changed the investment opportunity for structured credit? How has their diminished role impacted the overall liquidity profile of the markets? Have other institutional investors and hedge funds stepped in to provide liquidity?

Coyle: Hedge funds have arguably been the greatest beneficiaries of the banking regulation changes, as their largest competitor now has significantly reduced capacity in structured credit. However, the entire structured credit market has been hurt by generally lower liquidity. While some hedge funds such as ours will now make two-way markets in structured credit bonds, this does not nearly replace the liquidity that the dealers once provided. In addition, we are still seeing a number of strong regional dealers become more specialized in certain areas of structured credit, filling a role that the larger dealers once played but can no longer due to their reduced capacity (as a result of regulations and a reduction in staff). This means that liquidity is more dispersed, pricing clarity is more challenging, and the barriers to entry in structured credit are higher since the main dealers play a less significant role. However, as securitization returns, we expect the main dealers to play a larger role in the market and for liquidity to improve in the coming years.

Craig-Scheckman: Hard to say on this. I would say that this has created more investment opportunity – we do more business with the big banks now than in the past.

Hamilton: I would argue that the secondary market in structured credit securities today is more liquid than it is has ever been. There are more buyers and more capital focused on this part of the market as a result of the compelling risk/returns offered in this space since the credit crises. This transition of the buyer base from predominately a ratings driven buyer prior to 2008 to a total return oriented buyer didn't occur overnight. At the start of 2009 there were virtually no buyers of this type of paper. Previous investors were reeling with losses, banks and dealer desks were reducing risk, and most funds didn't have the expertise to analyze these types of investments. But over time funds began investing in systems and hiring in expertise. People like me (I was formerly head of European CDOs at Morgan Stanley prior to joining Alcentra) moved to the buy-side to help funds find compelling investment opportunities.

Bank trading desks are the major conduit of liquidity in this asset class. Banks source paper from sellers in the market and distribute paper to new buyers. This risk transfer can occur via back to back 'cross' trades but often also occurs with the trading desk taking a position "for book" and then distributing the position overtime. This later activity is a big source of market liquidity, and if a bank's ability to do this is significantly curtailed, it would lead to a smaller and less active secondary market. Trades would only occur when the end buyer and end seller were lined up ahead of trade.

Hindle: The changing regulatory and capital landscape has hugely impacted the banks as intermediaries in this area. The proposed capital requirements imposed on banks for many types of structured credit product make their participation in the area extremely difficult. This is beneficial to some extent for hedge funds. Meanwhile, the number of investors active in this area means liquidity is reasonably high at the present time. The issue will be when these investors look to exit the products en masse. At that time one has to ask who will provide the liquidity. I believe this is a problem in the credit markets in general, which have continued to grow rapidly over the past few years, while investment banking balance sheets have continued to shrink.

Sinha: While the scale of involvement of the dealer community has shrunk since the crisis, the nature of their involvement has changed as well. To this extent, the opportunity in structured credit for hedge funds is not necessarily worse than it used to be. In the aftermath of the crisis, dealers suddenly withdrew liquidity and net balance sheet from the structured arena given they were already burdened with product, leaving the customer base mostly to its own devices. While their participation has increased over time (but is still lower than pre-crisis levels) , they are more likely to serve as true liquidity providers today and to more actively attempt to match buyers and sellers rather than positioning on a proprietary basis. This is not surprising given an environment where below investment grade positions attract very large capital charges and seasoned inventory is likely to attract significant scrutiny and internal penalties.

In this respect, the dealer community is no longer competing with other intermediate and longer-term risk takers (such as hedge funds) in the structured product space but continues to remain engaged and provide liquidity, albeit on a more limited basis relative to the heady pre-crisis days. In addition, the well developed bid-wanted-in-competition (BWIC) process for transactions in the structured product markets also provides an opportunity for customers to step in and provide liquidity in situations where dealers may temporarily step away. As a result, legacy markets have remained active throughout the post-crisis phase, even during temporary bouts of market panic (driven by, for example, developments in European sovereign debt markets), in contrast to the high yield sector where liquidity holes appear to be more common. ◊

The organization of this roundtable was assisted by Jeffrey F. Kuchta, CFA, a consultant with Strategic Capital Investment Advisors.