



A Repeat Performance?

The following briefly notes that the curtain may be rising on Act II of the same play we saw over the recent past, namely the conversion of lower rated collateralized debt obligations into bonds with the top AAA rating.

We have heard this song before – downgraded loans being turned into AAA bonds. This happened prior to the credit meltdown of 2007 with, for example, mortgage-backed securities, which have been cited as one of the major causes of the problems in the credit markets. Companies bundled high-risk mortgages (such as subprime and Alt-A mortgages) together and sold them to investors as fixed income instruments backed by AAA credit ratings. Unfortunately, this same style of security (lesser credit quality and increased collateral protection to create new AAA bonds) is being touted in the press.

Banks urgently want to get toxic assets off their balance sheets. There have been federal programs designed to help banks get liquidity such as:

- s The Term Asset Loan Facility program, which uses asset-backed securities as collateral for non-recourse borrowings.
- s The Public Private Investor Partnership (PPIP) program, which buys toxic assets from banks' balance sheets. However, the PPIP program has been slow to develop and recently lost the support of PIMCO, the world's largest bond manager.¹

Now there is a new private approach to the problem, whereby troubled assets are being transformed into new debt instruments that have the highest credit ratings and once again will be sold to the public. Bloomberg reported on July 8 that Morgan Stanley will sell \$87 million of these repackaged and AAA (expected) rated securities.² A successful sale would likely mean more will be manufactured.

While there is nothing inherently wrong with creating tranches with specific attributes – such as expected cash flow, yields and credit quality – there has been an issue with the credibility of the ratings agencies to properly account for and accurately evaluate risk on complicated structures such as these. The ratings agencies' record on rating such securities has been questioned during this credit crisis. For example, they have been sharply criticized for giving high credit ratings on more complicated structures including such risky securities as subprime debt.

Given that they are paid by the issuers to rate the bonds, their objectivity has also been called into question. To address this concern, the SEC announced on July 14 that it is considering new rules to prevent debt underwriters from “rating shopping,” where ratings agencies gain business from underwriters in return for generous credit ratings.³ Finally, the ratings agencies have also been criticized for being too slow on corporate bond downgrades in years past.

In conclusion, it is important to keep in mind that risk and expected return are related and that the most appropriate role of fixed income is capital preservation not capital appreciation. Investors who want to take incremental risk in search of higher expected returns should take it on the equity side where it can be done more efficiently.



Sources

The following sources were used by the author(s) to arrive at the above conclusions.

- ¹ Sree Vidya Bhaktavatsalam. **U.S. Treasury Opens Toxic-Debt Program Without PIMCO.** Bloomberg.com. Available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=agt0DDxEov6g#>. Accessed July 9, 2009.
- ² Pierre Paulden, Caroline Salas and Sarah Mulholland. **Morgan Stanley Plans to Turn Downgraded Loan CDO Into AAA Bonds.** Bloomberg.com. Available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aeTzfvEedKpQ#>. Accessed July 9, 2009.
- ³ David Scheer. **SEC Considering Rule to Curb Credit-Rating 'Shopping.'** Bloomberg.com. Available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ai4oQzR5jKKg#>. Accessed July 14, 2009.

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