Financial News by William Hutchings on 19 Nov 2012

European and US banks created nearly $2 trillion of asset-backed securities in the past decade, and much of it, of undetermined value, remains on their balance sheets, according to BlueMountain Capital Management, a credit manager with offices in the US and the UK. No one has been lining up to take it off their hands.

Kerrin Rosenberg, UK chief executive of investment consultant and solvency management firm Cardano, said: "Structured credit was the epicentre of the financial crisis.

There's a real stigma attached to it, and it is less liquid, more complex and harder to assess than most assets. Therefore, there isn't a hugely long queue of buyers. Demand is a lot less than supply."

Greg Branch, a managing partner at Scio Capital, a UK hedge fund manager with €150m that focuses on structured credits like ABS, said there are only a few buyers: "It has suffered from investors' perceptions of a very bad market, arising from the 2007/08 US sub-prime mortgage crisis.

Everyone's running from it. But people will look back years from now and say, 'it's one of those asset classes I should have been in'."

High yield

The attraction is yield. With European structured mezzanine credit typically trading at a discount of 30% to 35% of face value or more, low-credit risk ABS can generate a yield of Libor plus 500 percentage points, Branch said. Some ABS can generate even more.

Rosenberg said: "We are not reliant on a rebound in markets to make money. In our central scenario, provided you bought these assets cheaply enough, they should give you a decent return."

Those managers looking to buy ABS have found more availability in the US than in Europe, but this is about to change.

The European Central Bank's willingness to take ABS as collateral for attractively priced loans has allowed Europe's banks to delay their disposals of ABS, but the implementation of the Basel III bank capital adequacy rules means they cannot hold out for much longer.

Basel III's minimum capital requirements are scheduled for a gradual introduction from the start of 2013 and a finish date in 2015, and although there is talk of an easing in the rules and their implementation, the direction of travel seems clear.

Banks will have to hold significantly more capital against their ABS portfolios than against many of their other assets. The trickle of ABS disposals seen over the past few years has already begun to swell.

Chenavari Investment Managers, a UK hedge fund manager with $2.4bn under management, has reopened the regulatory capital fund it set up last year, raising new capital to invest in a growing pipeline of deals.

Loic Fery, Chenavari's managing partner, said: "We see opportunities and we are putting money to work. The banks have to meet the deadline at some point."

Scio Capital has also witnessed more interest from investors in recent months, according to Branch.

Perilous

The strategy is risky. Short-term price fluctuations can be disastrous. UK hedge fund manager Peloton Partners was forced out of business in early 2008 after using 4.5 times leverage to buy ABS that looked cheap but quickly became much cheaper, prompting its banks to make margin calls that it could not meet.

Managers mitigate this now by using much less leverage. Tim Beck, a senior research analyst at UK fund of hedge funds manager Stenham Advisors, said: "You do see people with 1.5 times, but not multiples, they don't need it."

Managers are also running funds to long time horizons, partly because the shortage of buyers means the funds may have to hold the paper to maturity: BlueMountain, Scio and Chenavari have five-year locked-up money.

This might not protect them from a prolonged economic recession or a eurozone break-up – for which there is little effective protection – but it should help them ride out short-term dips.

Rosenberg said: "You have to have a buy-to-hold mentality. You're looking more at a private equity structure, where the manager is rewarded only at the end."

Managers are more worried about rival buyers entering the European market and pushing prices up to unattractive levels.

There are no more than a handful of European managers investing in this market – Fery counts "maybe five credible managers", Rosenberg knows "about 10 that have some credibility, of which we have invested in five" and Beck sees a total of "10 to 20 with more than $100m".

Among UK managers, in addition to Chenavari and Scio, Cheyne Capital and GLG Partners are involved in this area.

But there may be scores of managers who want to invest in the European ABS market, Fery said, with multi-strategy hedge funds and US managers eyeing it up as a source of yield.

Last month BlueMountain, which has offices in the US and the UK, raised $1.4bn to invest in illiquid debt securities.

US interest

Beck said: "US banks are a couple of years ahead of Europe in deleveraging. The easy money has been made and there are fewer opportunities, so some US hedge funds are now looking at Europe. We're worried about them coming to Europe just because it looks cheaper."

Rosenberg said he would get nervous if he saw a manager trying to raise $10bn for this market, but said: "Funds feel they can deploy $1bn or $2bn comfortably."

Fery said: "When I see there is too much buying I say it's time to sell. We closed subscriptions on the Toro Capital 1 fund [a diversified structured credit fund] early last year because we were concerned by the flow of money from US multi-strategy funds buying at prices we thought we should sell at. There are not many people buying at the moment."

Chenavari has raised another $250m for its Regulatory Capital fund and is still taking in money, Fery said: "We think we can deploy maybe $300m or $400m, we have a pipeline that we like." Beck, however, says he is wary of hedge funds that are entirely dependent on "an asset class that won't exist after a certain time".

He added: "It's predominantly a long-biased strategy, you can hedge but there's a lot of basis risk. You don't want managers that are forced to invest because it's the only thing they do, we want them to have a broad enough universe that they can invest in other assets."

Structured credit opportunities are much wider than ABS. They include investment in synthetic collateralised debt obligations and collateralised loan obligations; and opportunities to fill the gap left by the retreating banks, such as mezzanine lending for property transactions or corporate takeovers or leveraged buyouts, or direct lending to companies.

Strong performance

ABS hedge funds as a whole have generally outperformed the hedge fund industry, according to figures published by data provider Hedge Fund Research.

After losing 3.42% in 2008, ABS made 23.92% in 2009, 12.95% in 2010, 6.01% in 2011 and 12.97% in the first nine months of this year.

Chenavari reckons itself the top performer among European structured credit fund managers. It made 80.12% in its first six months, to December 2009, 90.56% in 2010, 24.71% last year and 19.76% for the first nine months of 2012.

Its regulatory capital strategy lost 2.86% in its first seven months, to December last year, and is up 28.18% for the first nine months of this year.

• The nuts and bolts of asset-backed securities

Hedge fund managers working in the asset-backed securities market typically charge 2% management fees and 20% performance fees, but they say doing well at this strategy requires an unusually high degree of expertise.

Good contacts at the banks and skills in analysing the legal and financial aspects of an asset-backed security are a prerequisite to avoiding high-priced rubbish.

Loic Fery, managing partner of UK hedge fund manager Chenavari Investment Managers, said: “The main opportunity is in RWA trades, risk-weighted asset transactions, where the banks share some of the risk so the capital they need is less.

It takes a lot of negotiation. We have a team of structurers and portfolio managers who are plugged into all the banks.

“It’s not good just because it’s cheap – you have to be very specialised. You can’t compare UK CMBS [commercial mortgage-backed securities] with German auto loans and Spanish RMBS [residential mortgage-backed securities].”

Many different things can go wrong. Kerrin Rosenberg, UK chief executive of investment consultant and solvency management firm Cardano, said: “If a structure gets into difficulty, different tranches take control over different points in time, which may mean you have to do something.

“If you have the right to seize the underlying collateral, you have to know what you’re going to do with it – you’ll have to work it through to foreclosure and negotiate with householders.”

He said managers have to be clear about the underlying collateral pool, understand the legal structure of the security, and combine that with financial modelling expertise.

Matt Eagan, a portfolio manager in the fixed income group of US-headquartered mainstream asset manager Loomis Sayles, whose fixed income funds will invest in CMBS, said: “We spent 18 months just building the system to look at these deals. In the US, you have to go down to the zip code level where each mortgage is held.”