

Leveraging experience

Sara Bonesteel, head of alternative products, and Mike Collins, senior investment officer and credit strategist at Pramerica Fixed Income Management, answer SCI's questions



Q: How did Pramerica become involved in the structured credit market?

SB: Pramerica has been involved in fixed income for more than 100 years. Our management of fixed income goes back to 1875. In terms of structured credit, we have managed CLOs/CBOs since 2001 and we currently have 23 deals under management and have around 40 people in our leveraged finance and CLO teams.

Our engagement in this market is quite extensive. We started our work on CLOs in the US, but in 2005 we began managing European CLOs. We now have a number of European or hybrid CLO portfolios (Euro/US) under management. We found this was a natural extension of our existing capabilities in high yield and in credit.

MC: We are a very large credit shop - we manage nearly US\$100bn between corporate bonds and HY bonds and leveraged loans (as of 30 September 2009). We already had a very deep infrastructure in terms of credit research and credit selection and portfolio structuring skills, and we thought we should leverage that by growing into the structured products and CLO businesses.

Q: What are the firm's key areas of focus today?

MC: In traditional businesses, we've seen the pendulum swinging back from some of the more esoteric products, which include some of the structured products and hedged vehicles. Investors seem to be favouring some of the more traditional fixed income products and our investor base consists of large institutions around the globe, big companies and state and government pension plans.



We're seeing a lot of interest from these types of investors in traditional fixed income products, whether they are enhanced index products going against the Barclays aggregate bond index, or short duration corporate bonds in order to increase yields vis-à-vis money markets. In particular we're seeing a lot of interest in credit-related products, whether they're high yield, emerging market debt or investment grade corporate bonds.

We're also seeing strong demand from corporate pension plans for long-duration corporate bonds. The demand side of the equation has really shifted into traditional fixed income vehicles and we're well positioned for that.

Q: What has been the most transformative change in the credit markets in 2009?

SB: The liquidity-driven proliferation of structured products over the past five years has been a very significant factor in the market, followed by the bursting of the credit bubble. Although this bubble clearly caused a lot of harm, it has also provoked a lot of changes that from an investment mentality are very healthy, such as the reversion to the basics, getting back to fundamental credit research and truly understanding what you're buying.

We're also seeing a big uptick in the amount of due diligence and transparency that are demanded by investors and I think that's ultimately healthy for end-user investors as well and for the market as a whole.

MC: I don't know if it's transformative or more cyclical in nature, but the bursting of the credit bubble has forced investors to reduce leverage and reduce reliance on leveraged products because it's more difficult, if not impossible, to get leverage in certain areas of the market. Long-only products have come back into vogue.

But that's not to say that the pendulum won't start swinging back the other way. The strong performance of the credit markets, the access companies now have to credit markets and the strong demand for yield are already bringing increased interest to leveraged vehicles again.

We're seeing Wall Street firms offer total-return swap products; we're getting more queries into synthetic collateralised vehicles using CDS and ultimately it seems the CLO market will probably come back to life as well. Even though there have been a lot of defaults through the down-part of the cycle, recoveries have started to pick up and leveraged loans and bank loans are migrating towards par, which adds credence to the rebound in the CLO market.

SB: It's our view that there will be a CLO market in 2010. There are, to our knowledge, a number of parties that are working on these deals that will close in 2010.

I think we should expect lower leveraged deals, with initial deals being 'clubby'. There will be a transaction that is just one step out of a TRS. For example, if a bank will offer you three- or five-year funding on a TRS, it's not so far from there to go and get term funding in the form of a CLO - even if it's a very simple two- or three-tranche structure that might be only three- or four-times levered.

MC: The thing that has surprised us most in this cycle is how fast it happened - both on the way down and on the way back. This year alone we're going to see a record amount of new gross issuance in IG and HY corporate bonds. The European markets are picking up with a vengeance as well.

Q: Will Pramerica be involved in CLO manager consolidation?

SB: We have recently taken on management of a CLO where a key-man provision had been breached. We were contacted initially by an investor who didn't have control of the replacement manager assignment, but that investor recommended us to the investor that had the control over the appointment. We worked closely with the equity investor in this case and were able to show him our ability to manage the portfolio and get the assignment.

There are several other opportunities out there currently that we're working on and we see this as an area where we have a strategic advantage. We have a critical mass of deals on our platform already and have the added experience of coming in as replacement manager on deals back in the 2004 cycle of consolidation.

We go through an extensive process when we're looking at a portfolio to take on, which starts with triaging the existing portfolio, but also extends into looking at trading strategies before making suggestions for potential amendments that could be made to the deals to make them perform. We don't intend to be a passive manager. We come with ideas to improve the performance.

Q: What is your strategy for 2010?

SB: We can expect to see further manager replacement opportunities. I think this round has taken a lot longer than expected and the improvement in the market is what is encouraging some management platforms to trade now.

I think to the extent that new employment opportunities are opening up for individuals in smaller platforms, the motivation to hang on to a small number of deals diminishes - that dynamic has been very helpful in getting the consolidation process started. We'll have to see what happens in 2010 and whether that will continue, but I think it will at least for the first part of the year based on some situations that we're seeing.

In addition, we are looking at opportunities to manage new portfolios. I believe the CLO product is going to be proven out - if not in the highly leveraged form, then in the low leverage form.

When we look at our portfolio of deals, our low leveraged deals actually performed quite well through the crisis last year and the lowest levered deals did not turn off cashflows to any classes. That is going to be our touchstone - it's not the product in itself that's flawed: it is possible to create a structure that can withstand a lot of stress and create attractive tranches for investors.

Q: Do you envisage that new rating agency standards will cause difficulties in the new-issue CLO market?

SB: It helps that everyone's perception of acceptable leverage has fallen. Anyone that expects to get a senior bond rated triple-A (or attract potential buyers) if it has subordination comparable to the 2007-2008 era will find it difficult. The trick will lie in being able to create an attractive senior bond for senior investors and generating enough return for

the equity investors.

Q: Which key trends do you expect to see in 2010?

MC: Broadly speaking, we see the economy on a sustainable recovery path - albeit one that will probably not result in strong growth. In the credit market, fundamentals should continue to improve and spreads in corporate bonds, HY bonds and bank loans - which are still wider than their general averages - will gradually grind tighter.

There should be a more sanguine, low volatility environment for structured product investors. The one caveat to that would be if the US Fed starts increasing rates. We think the market may have temporary setbacks too from 'growth-scares', where there is a knee-jerk fall back in fixed income markets - whether that be in the mortgage market or at the front-end of the treasury curve, but we think this will be a temporary phenomenon.

SB: In terms of the regulatory environment, it may remain very volatile. Already we've been warned of a number of potentially troubling changes that could affect structured credit - FAS 167 has caused a lot of concern, for example.

Although some of that fear has now simmered down, I think we'll continually face challenges that could impact the business. However, not all of them will necessarily ultimately come into effect.

MC: Regulatory reform, in our experience, tends to be eventually quite watered down. Our view in general is that it's not going to be a game-changer for the high yield market or for our products.

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