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Market Facts

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Understanding the Problems in Credit/CDS

"Pathologists know everything and do everything, but too late"... medical student witticism

"Past performance does not predict future results"... SEC knee-slapper

Wall Street's forensic scientists are out in full force for the post-mortem on this past week's events in the credit and Credit Default Swap (CDS) markets. A number of conference calls have been organized for CDS directors and senior traders to explain terms such as "correlation trading," "mezzanine tranche" and "iTraxx 0 to 3% equity." While a belated education certainly has its value, we should not let it impede the bigger picture of how and why these problems came into being.

Morphing Equity and Debt Into One

CDS and the CDX index derived therefrom neutralize the normal issues of corporate bond analysis such as duration and convexity and leave behind a pure play on a corporation's credit. These instruments therefore have equity-like properties and as we have shown can rise and fall with both the stock's price and its volatility.

These common factors have tempted many into confusing correlation with causality; the former has the distinct advantage of being easy to calculate and therefore easy to misapply. An entire class of "correlation trader" is dedicated to constructing statistical hedges of debt with equity. The assumption is made – after the common admonitions regarding the word "assume" are ignored – that a stressed future will behave like the non-stressed past.

CDS, however, are **not** equities, and the relationship between them and equities is neither linear nor stable under all conditions. Many events can be bullish for equities and bearish for bonds, and vice-versa.

While Wall Street understands this risk, and has even developed the phrase "idiosyncratic risk," in description, it is next-to-impossible to model. The large number of path dependencies precludes a single or "closed form" solution and demands a stochastic simulation to create the statistical self-delusion cherished by risk managers.

Enter Tracinda

The relationship between CDS and equities and the hedge strategies between them are changing trading patterns for both markets. No longer is the credit market an interesting curiosity for equity players. Thanks to CDS, the credit markets have a direct role in pricing equities. This is new and only now being understood.

We posit one player who did not understand the CDS-equity relationship, at least not last week, was Kirk Kerkorian.

When Kerkorian's Tracinda tendered for 28 million shares last week, many investors understood his gambit. He was looking to "enhance shareholder value." These are words that send bondholders running for cover. They usually mean leveraging up the company and worsening its credit rating. GM believes Tracinda plans to use GM's own huge cash reserves to fund the acquisition of the shares. In other words, leverage up the company to the benefit of the shareholders at the expense of the bondholders.

But now bondholders now have a seat at the equity table and can change the dynamic for "enhancing shareholder value."

Dissecting GM Problems

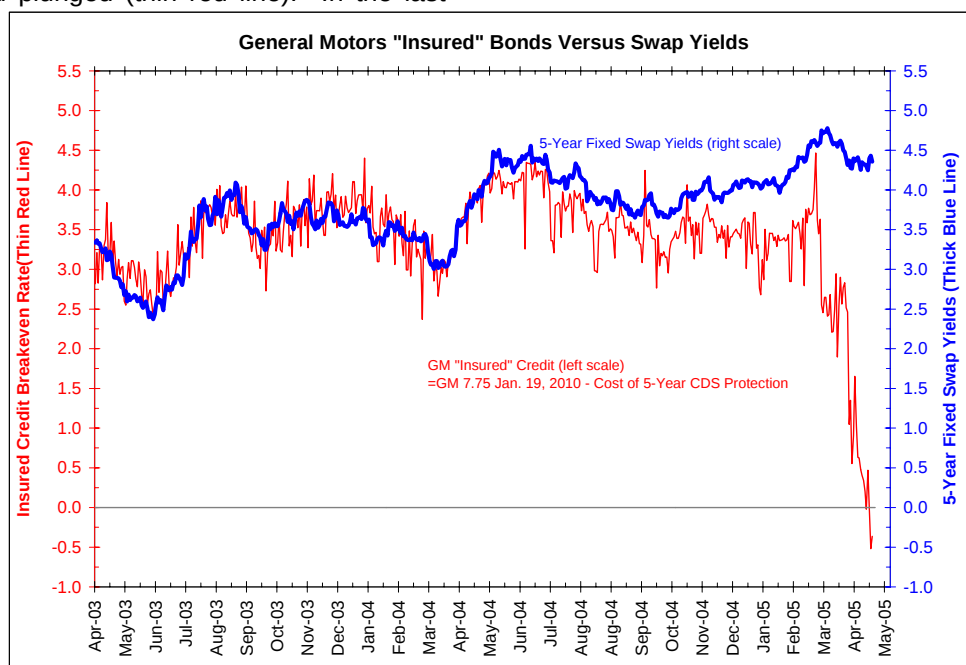
The thick blue line on the chart on the next page is the yield of the 5 year fixed-rate swap. The thin red line shows the yield of owning the GM 7.75% of Jan. 19, 2010 **with** 5-year CDS protection.

Normally, the cost of owning debt with CDS protection **should** equal the yield of an equivalent maturity fixed-rate swap. For GM, as the chart shows, this was largely the case until late last year. As the red line falls below the blue line, it signifies that CDS protection is garnering a larger and larger premium. Why would investors pay outsized premiums for CDS protection? Either they are forced to do so, or they believe the underlying

market is too illiquid to sell without taking a loss greater than the cost of CDS insurance.

Since the March 16th earnings warning, the cost of CDS protection has risen so much that the after protection yield plunged (thin red line). In the last

few days it has gone negative. **This means CDS protection now costs more than the yield of the underlying bonds.**

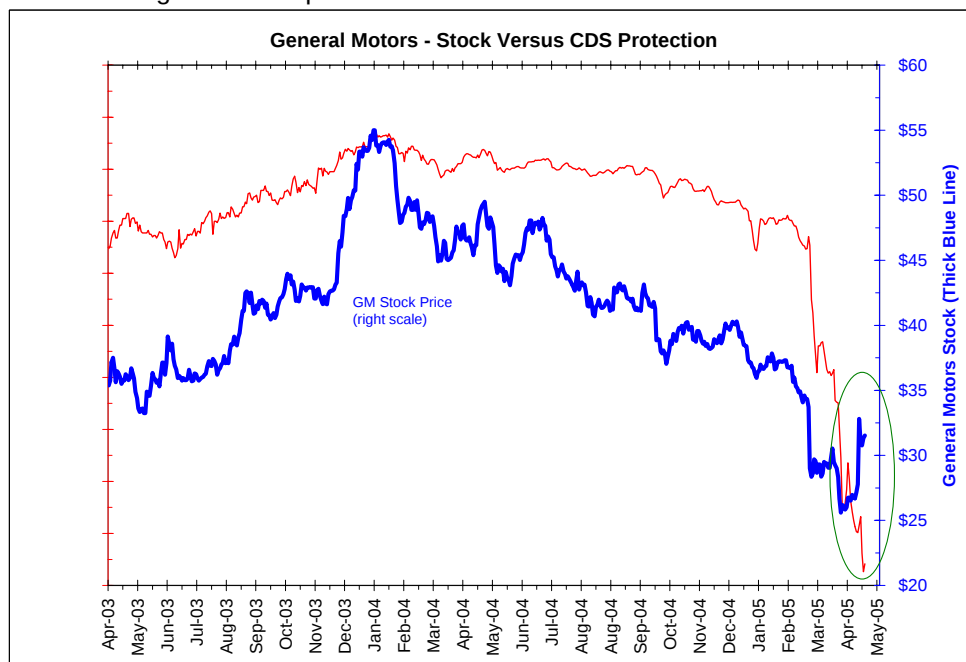


That CDS protection for GM was commanding huge premiums should have been a warning to all this market was having problems. Instead, many saw it as an irrationally priced market presenting a great profit opportunity.

As the thin red line sank further and further below the blue line, it became more and more compelling to sell (write) GM CDS protection. Sellers were exposed to further widening of CDS spreads and

presumably to wider credit spreads. Since the bonds are too illiquid to short, they turned to the equity market as a hedging vehicle.

As the next chart shows, the relationship between GM equity and debt "hold together." As CDS costs rose and credit spreads widened, the stock fell. More specifically, it worked until the Tracinda tender broke this relationship (green oval).



When this relationship broke last week, everything changed. The hedge against widening credit spreads stopped working and losses mounted on both sides of this trade. Furthermore, GM CDS is a component of many CDS indices. With the relationship between the equity and the stock broken, many of the relationships between these indices, their tranches, and GM CDS and GM equity also broke down.

Conclusion

What have learned from this episode? Let's be blunt: A lot, little of which is encouraging.

First, the idea CDS can unify equity and debt is flawed. This is true both conceptually and in practice. We should have learned this from the convertible bond market years ago. Corporate bonds and stocks are **not** the same thing. You can only hedge one with the other when you **don't need to hedge them**. When the markets are calm, a relationship seems to exist. Once problems and stresses appears, however, the statistical relationship between these markets disappears and you are left with two independent positions. This is an insurance policy incapable of activating during an adverse event, which may be one of the better definitions of "useless" in existence.

Second, for all the talk of risk controls, VaR calculations, DV01 measures, etc, three days after the first real stress in this market, everything went to hell. Did these players really understand these markets beyond their self-comforting calculations? Or, when they saw signs of obvious stress, like the commanding CDS premiums for GM, why didn't they run away? They had two months to exit these positions, but instead they looked at the irrational

pricing not as a sign of trouble, but rather of opportunity. In hindsight, this was a mistake.

Third, until these instruments and their limitations are understood better, those looking to "enhance shareholder value" should be careful. Typically a stock that begs for "enhancing shareholder value" is one under stress. The CDS for these issues already have been trading at outsized premiums, often by those with heavy exposure to the stock as well. Attempts to increase shareholder value often are associated with unusual trading activity. Witness Tracinda's tender for 28 million shares at \$31. Tracinda is operating under the old model that shareholders can and will do anything they want to bondholders to enrich themselves. Now, however, GM stock is influenced heavily by bondholders hedging CDS. Maybe this is why the stock cannot trade above its tender price and looks set to sink as soon as the tender has been filled.

What happens next? The final chapter of this story has not been written. Recall that wire stories were detailing LTCM losses in June 1998, but the crisis peaked in early October 1998. These episodes take time to develop – even months. **For things to return to normal, the relationship between GM stocks and bonds need to go back to the pre-tender relationship. Right now that means either the stock has to plunge or the bonds need to rally. With Kerkorian looking to "enhance shareholder value" don't count on the bonds rallying. So, the act of enhancing shareholder value" will only deepen this problem.**

Heads I win, tails you lose.

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