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Web Exclusive

Cheyne Capital Management in London has hired **Patrick Vickers**, a credit trader at **Goldman Sachs** in New York, as a portfolio manager.

For the full story, go to *DW's* Web site (www.derivativesweek.com).

A Managed Wave

JPMORGAN, CAIRN LINK UP FOR CPDO WITH TWIST

JPMorgan and **Cairn Capital** are in discussions with investors about their first constant proportion debt obligation. The deal, preliminarily called Cairn CPDO, is a rarity in that it will be managed instead of static although other firms are preparing similar launches. Officials at the firms declined comment on the deal and the potential size could not be ascertained.

CPDOs offer highly levered exposure to a credit portfolio, with a high rating and potential for high returns.

Barclays Capital and **Deutsche Asset Management** are also in the market with a managed CPDO, which is expected to reference a bespoke portfolio of investment-grade corporate credit-default swaps. **Heikki Monkkonen**, head of credit correlation products at

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DRAWDOWN PROTECTION CONTRACTS DEBUT

An over-the-counter contract that would protect against the maximum loss on an underlying has started to appear on Street structurers' radar. The instrument would reference the so-called maximum drawdown which measures the difference between the peak and trough of an asset's price. The idea is users could buy a hedge linked to the maximum loss of their own investments or against the maximum loss of an equity index like the **Standard & Poor's** 500, for example.

The idea is being plugged by **Jan Vecer**, an associate professor in statistics at **Columbia University** in New York, who recently published a research paper on maximum drawdown and its possible applications.

Methods of measuring the maximum drawdown of an index or portfolio have been

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U.S. PENSION PLANS EYED AS RIPE FOR INFLATION HEDGES

Corporate pension plans in the U.S. may be driven to use inflation hedges, according to wishful bankers and dealers. They reason that because companies will soon be required to match pension assets and liabilities and include pension deficits on their balance sheets, the need to show that something is being done to mitigate inflation will drive them to the marketplace.

In Europe, similar legislation has already been passed, and many funds' liabilities are indexed to retail prices. In the U.S., however, only a handful of funds are indexed to cost-of-living, but sales officials say these funds could be big users of Consumer Price Index-linked swaps.

The swaps themselves cannot make up existing deficits but they can limit even greater

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U.S. PENSION

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erosion exacerbated by excess inflation, structurers point out.

European firms including **ABN AMRO**, **BNP Paribas** and **Barclays Capital**, which have established inflation desks in New York, are among firms pitching the swaps to potential U.S. users and officials at these firms expect their experience in Europe to give them a head start. "No one is doing this yet; it's more on a discussion basis," admitted one senior sales trader. He noted he has also met with pension fund actuaries to discuss inflation swaps.

Paul Morgan, senior consultant at Norwalk, Conn.-based **Evaluation Associates**, said the FASB and Pensions Protection Act changes have got pension plans thinking more seriously about hedging liabilities, but he noted the firm has not seen any application for inflation swaps from a fund. "From a theoretical standpoint, it makes a great deal of sense," he noted, adding it may take some time for pension funds to get up to speed with inflation hedging. "Everyone is still in an education mode right now."

Julia Coronado, inflation-linked strategist at Barclays in New York, said the firm expects pension funds in the U.S. to move slowly toward inflation hedging. Corporate funds will likely be driven by pressure from constituents and investors to clear up deficits. "Pension funds do not move over night," she noted. "That's probably where the market is going, it's just not going there quickly," she added. *—Elinor Comlay*

DRAWDOWN

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around for some time and hedge funds are increasingly using the measurement to give investors an indication of the risks of investing in their funds. The latest idea, however, is that the measurement itself could be used as a reference for derivatives.

A handful of officials said they have heard of the measurement. One risk manager at a U.S. firm said he has started looking at using maximum drawdown contracts. "It's expensive, but less expensive than a lookback option," he said. He also noted his firm would be able to offer such a contract to clients, if requested.

Lookback options and out-of-the-money put options are commonly used as so-called crash protection by portfolio managers. There are some downsides to these strategies. For example, with put protection, the put may not be in-the-money even if the reference entity loses, say, 30% of its value, if it has already gone up by 50% from its strike level. A lookback option will pay the investor the difference between the reference entity's value at the end of the contract and the entity's highest level—but this means investors may not receive compensation for the maximum loss over the life of the contract.

Vecer said he envisions an over-the-counter contract structured like a future, with the exchanges between counterparties based upon the difference between an expected maximum drawdown and the actual measurement over the life of the contract. *—Nicoletta Kotsianas*

JPMORGAN

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Barclays in London, declined comment, as did officials at **ABN AMRO**, **Deutsche Bank** and **Citigroup**, who are also said to be working on managed deals.

All CPDO deals issued since ABN introduced the structure last summer have referenced static investment-grade corporate credit derivative indices. CPDOs were the subject of a lot of buzz last fall, with nearly every dealer reportedly working on a deal. But few actually printed and only about USD2 billion has been issued to date.

Managers said that despite the appeal, investors were reluctant to invest because of roll risk (DW, 11/17). "There are significant benefits to managed CPDOs," said **Andrew Jackson**, credit risk manager at Cairn in London. "A manager alleviates some, if not all, of the concern on static deals."

The first batch of managed CPDOs is likely to come in two varieties: index-based and bespoke. Jackson declined comment on which variety the Cairn deal will be, but market participants expect it to reference the CDX and iTraxx indices and incorporate long/short single-name strategies. In such a deal, the managers would alleviate roll risk by timing execution and also manage single-name risk. Proponents of index-based structures say they provide greater liquidity than those referencing bespoke portfolios. *Abigail Moses*

Quote Of The Week

"[Hedge funds] are having the biggest impact on the market [and] don't always understand the impact of seasoning on pool delinquencies and their short-term trades are not necessarily research based." —**Allan Berliant**, *portfolio manager at asset management firm* ***GMO****, on how short-term trading is affecting prices in the synthetic ABS market (see story, page 2).*

One Year Ago In Derivatives Week

JPMorgan Asset Management launched a collateralized debt obligation business in Europe. [The unit marketed its first CDO in the summer, structured by **Calyon** (DW, 7/14).]

TRADING TALES
...With Steve Spread

Steve Spread made buckets of cash as an arbitrageur at a bulge-bracket firm in the early 1990s. Over-worked, over-paid and wondering what to do with his millions, The Wizard—as he was known—bought the remote Scottish Isle of Lucre from where he trades his own book and passes judgment on the far away financial hubs. Feel free to email him at sspread@iinews.com

While rooting through my sock drawer this week I was reminded of an incident that happened over Christmas. I had all of the Spread family over to Lucre. Cousin Frank had just unwrapped his present from Aunty Em—a pair of argyle socks, the standing family joke—in which as per tradition she had craftily hidden a twenty pound note. We were all amused by the label, which read 'argyle socks, made in China.' Clive—the black sheep of the family since spurning investment banking for law—demanded advice from the rest of the family on investing his gains.

"Of course China! China is going to be huuuuge!" my inebriated brother Frank bellowed, echoing the sentiments of newspapers, bankers and well-read hobos everywhere. "Wouldn't you agree, Steve?" I told him—just to stir a little—I thought this was a load of hokum, saying India was a far safer bet with its trustworthy, comprehensible, and predictable, legal system. "How can you trust a Chinese firm with a 10-year deal when it hasn't even been around for 10 years?" I asked.

"Yes," Frank shot back, "but look at the Indian government. It acts as if it's scared foreign investment will take it back to the suppression of the British raj!" And so the after-dinner conversation somehow slipped into a familiar argument about the virtues of China tea as opposed to Indian. My time in the States means I'm rather partial to PG Tips, but that's another matter...