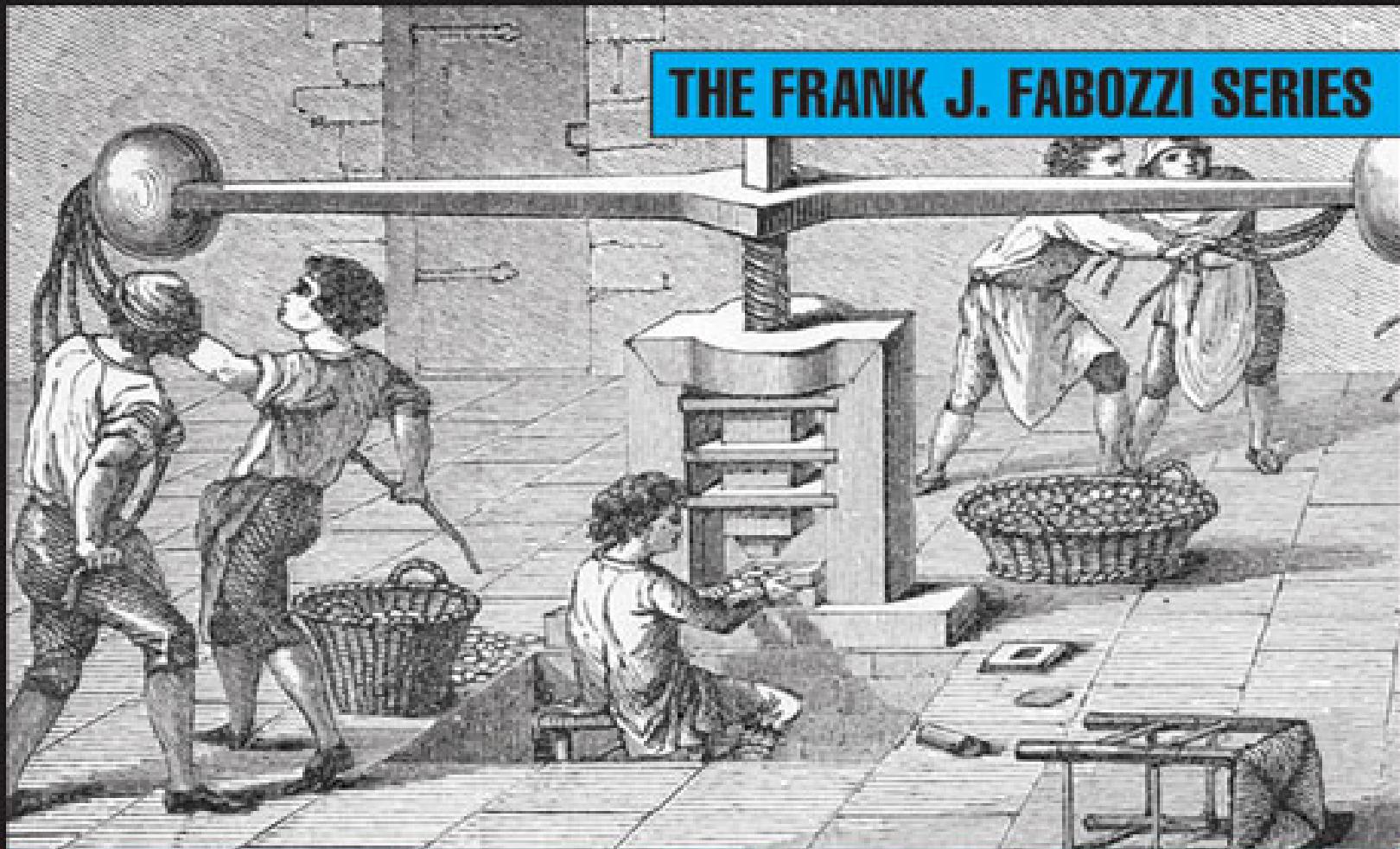


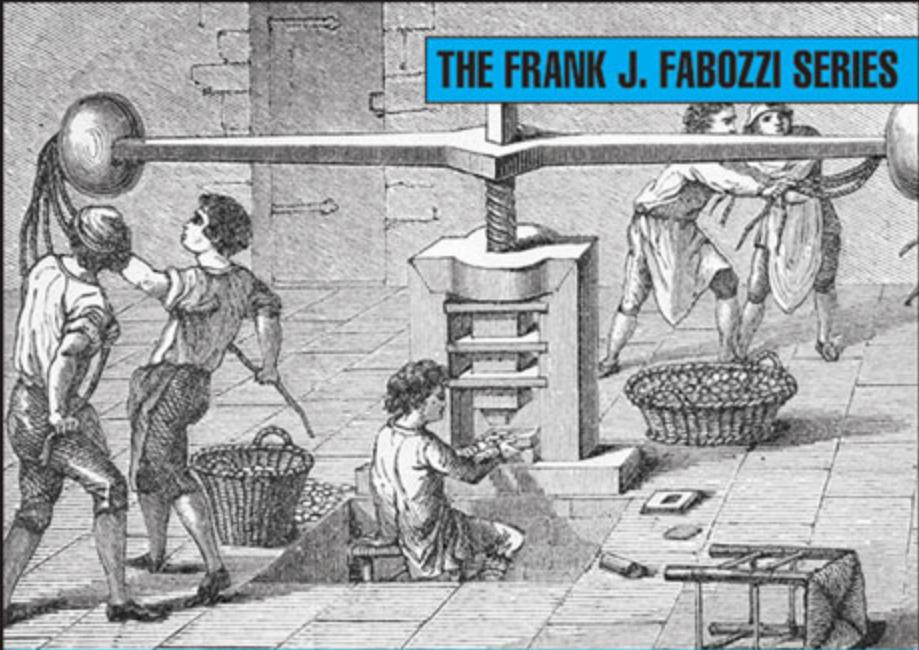
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QUANTITATIVE CREDIT PORTFOLIO MANAGEMENT

*Practical Innovations for Measuring
and Controlling Liquidity, Spread,
and Issuer Concentration Risk*

ARIK BEN DOR • LEV DYNKIN • JAY HYMAN • BRUCE D. PHELPS



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Additional Praise for Quantitative Credit Portfolio Management

“A first-class work on credit risk modeling and credit portfolio management. This book addresses real-world challenges that we face every day using extensive theoretical and empirical analysis. I strongly recommend the book to anyone who wants to understand how credit markets work and how to work in credit markets.”

-Benjamin Deng, Group Head of Investment Analytics, AIA Group, Hong Kong

“For many years this quantitative research team has offered new insights and helpful support to many institutional investors such as APG. Based on the extensive data base available to them and the truly two-way dialogue they have with end-investors like us, many empirical questions and dilemmas have been tackled. By introducing concepts such as Duration Times Spread and liquidity scores, the authors have improved our understanding of risk. Moreover, by applying these concepts to the portfolio construction process, we have gained more confidence in the robustness of our portfolios.”

-Eduard van Gelderen, CIO Capital Markets, APG Asset Management, Netherlands

“A must-read for all future and current credit portfolio managers. The book is a comprehensive review of the quantitative tools available to better manage the risks within a credit portfolio and combines the right amount of statistical work with practical answers to questions confronting credit managers.”

-Curtis Ishii, Head of Global Fixed Income, California Public Employees' Retirement System, USA

“For investors who struggled with managing credit risk through the 2007–2009 crisis, *Quantitative Credit Portfolio Management* offers practical answers to vexing questions. Duration Times Spread as a risk measure is one of those elegant innovations in finance that seem obvious in retrospect but have eluded the grasp of previous analysts. The liquidity analysis is the first robust attempt I have seen at quantifying this important factor in the OTC market of corporate bonds. All in all, a strong effort by what is arguably the best team of fixed income research analysts on the Street.”

-Randolph E. Wedding, Senior Managing Director, Fixed Income, Office of the Treasurer of the Regents, University of California, USA

“Lev Dynkin and his coauthors offer insights and practical solutions to critical issues in corporate bond risk analysis. In particular, the measurement of credit spread risk using Duration Times Spread is a powerful tool and a significant improvement over prior market practice. This book reflects top caliber analysis and has many useful applications.”

-John Brennan, Portfolio Manager, DB Advisors, USA

“The practical orientation of this book on institutional credit portfolio management makes it particularly useful for practitioners. All key areas of interest are well covered. An excellent effort by a team with extensive industry experience.”

-Lim Chow Kiat, President, GIC Asset Management, Singapore

“As an investor coming out of the financial crisis of 2007–2009, I began to wonder if our traditional risk models and fixed income assumptions about portfolio construction

and diversification were obsolete. Was this crisis the financial market's equivalent of discovering that the earth is round, or that the earth is not really the center of the universe? As practitioners rethink traditional credit views, it's a perfect time for a fresh approach and some new concepts backed fully by empirical evidence and, most importantly, common sense. It's no longer enough to demonstrate that a risk management framework is empirically sound based on historical data from more 'normal' times. In *Quantitative Credit and Portfolio Management*, the authors apply techniques developed prior to the crisis and pose the question: Would those measures provide insight to events that happened during the crisis itself?

"In short, the ideas presented here simply make sense. Risk managers, portfolio managers and credit specialists can benefit from this book, not to mention inquisitive CIOs. I found the recommendations to be theoretically sound and fundamentally practical to implement."

-Ron Joelson, CIO, Genworth Financial, USA

"This book provides enormous insights for beginning practitioners looking to learn the most advanced credit management techniques. For experienced professionals, it provides a great update and advancement. The empirical evidence and discussion of metrics, such as DTS and Liquidity Cost Scores (LCS), illustrate how these should be used to better manage credit risk as well as liquidity risk in portfolios. The global financial crisis of 2007-2009 and the ongoing sovereign crisis have taught us that the world has changed and more focus should be put on liquidity. Applying and testing their findings in the recent market turmoil strengthens the authors' conclusions and offers many critical tips for managers. The book is a must read for all active players in credit markets given the changes after the recent crisis."

-Jan Straatman, Global CIO, ING Investment Management, Netherlands

“Lev Dynkin and his team are of the highest authority on fixed income portfolio analytics. Their thoughtful and rigorous quantitative research, unparalleled access to high-quality data, and cooperative approach with leading fixed income managers sets them apart. This book provides the reader with new ideas to improve both risk management and alpha capture in credit portfolios.”

-Carolyn Gibbs and Rich King, Co-heads of U.S. Taxable Fixed Income and Global High Income, Invesco, USA

“Quickly and accurately identifying and measuring the risk exposures of credit portfolios has become even more critical in the post-crisis era of low government bond yields. As clients increasingly want pure credit exposure, divorced from the interest rate environment, the techniques described in this book are an important advance in successfully managing fixed income credit portfolios. I recommend this book for managers looking to outperform credit fixed income benchmarks.”

-Lisa Coleman, Head of Global Investment-Grade Credit, J.P. Morgan Asset Management, USA

“*Quantitative Credit Portfolio Management* is a one of a kind book addressing everyday issues and topics submitted by investors and practitioners to the QPS team. It presents a decade of research in a single volume. It is a must for portfolio managers willing to understand the nature of corporate bond spread risk (systematic, issuer specific, and liquidity). It introduces the concept of DTS, a superior measure of bond spread risk, and tests its validity across a wide spectrum of asset classes and time periods, including the recent crisis. The practical instructions advocated in this book are best practices that

we already rely on in our credit investment process for superior active management.”

-Ibrahima Kobar, CIO Fixed Income, Natixis Asset Management, France

“This is a convergence of in-depth analytical research and practical applications to comprehensively understand and quantify systematic and nonsystematic risks in credit and sovereign portfolios and benchmarks. This book is essential reading for investment professionals, portfolio managers, hedge fund managers, pension fund managers, and students of the industry in the post-global financial crisis environment. It shows the way to more effectively manage liquidity, downgrade, default, and derivative risks.”

-Susan Buckley, Managing Director, Global Fixed Interest, Queensland Investment Corporation, Australia

“The Quantitative Portfolio Strategy Group led by Lev Dynkin is considered by the fixed income industry to be the leader in the field of quantitative bond investing research. The strength of this book is that all the concepts described are not just theoretical but are used in practice. In addition, many of them, such as liquidity scores, empirical duration, issuer diversification, and fallen angels as an asset class are very topical in today's management of credit portfolios. We consider the joint effort that led to the development of the DTS concept as a breakthrough in the field of credit risk management. The DTS concept has improved our understanding of credit risk and led to better assessment of value in credit markets by our portfolio managers.”

-Edith Siermann, CIO Fixed Income, Robeco, Netherlands

“The authors' team has been a solid lighthouse for portfolio managers amid the rough seas of fixed income markets. Its gleam has never died, even in the recent credit turmoil, and guided us to a safe harbor. This book covers their new findings and developments on managing credit portfolios tested in practice during the 2007-2009 crisis, which all practitioners must read regardless of whether they are involved in corporate credit or sovereign markets.”

-Seiichiro Nemoto, Head of Pension Research Center, Sumitomo Trust & Banking Company, Japan

“This book addresses many of the questions every fixed income professional is faced with today, which includes optimal diversification, price behavior during rating changes, and measures of liquidity. The authors are especially well known for introducing the concept of Duration Times Spread for managing credit spread risk. This newest book shows a wide range of potential uses of DTS in constructing and managing a credit portfolio by looking at the results achieved with DTS in the recent crisis. I strongly recommend this book to every bond portfolio manager in the current environment of heightened credit risk even in the sovereign space.”

-Sandro Streit, Head of Asset Management, Swiss National Bank, Switzerland

“The authors...industry leaders from Barclays Capital...have done it again! Following up on their excellent book, *Quantitative Management of Bond Portfolios* (2006), which brought tremendous insight in the management of multisector bond funds, they have now done an even deeper dive into managing credit portfolios, which is not an easy task to be sure! They not only delve into improved risk management metrics, but also reveal helpful strategies to improve both passive and active fund

management. Once again, this team is taking our business to new levels of excellence."

-Ken Volpert, CFA, Head of Taxable Bond Group, Vanguard, USA

"This book tackles the Big C—CREDIT. Market relationships and yield spreads of corporate, sovereign and emerging market debt have morphed nearly beyond recognition over the last 15 years, culminating with the enormous devastation of the global financial crisis. Institutional bond investors have long known to go to Lev and his team with their thorniest and most complex portfolio problems. Here they lay out a very straightforward exposition of best practices in credit portfolio management. This is a must read for those charged with navigating today's global capital markets."

-Ken Leech, former CIO, Western Asset Management Company, USA

"This is another terrific contribution by an established team of Wall Street researchers. In their characteristic style, they masterfully combine rigorous empirical work with practical wisdom and clear intuition. This book should be of great value to both practitioners and academics interested in the cutting edge of thinking in the area of credit risk and portfolio management."

-Leonid Kogan, Nippon Telegraph and Telephone Professor of Management, Sloan School of Management, MIT, USA

"Clients of credit portfolio managers typically ask: What caused the performance and unexpected high volatility during the financial crisis? What have you learned? What changes have you made to your investment process so it doesn't happen again? The right answers lie in this comprehensive book of applied research. It will be required reading for credit portfolio managers interested

in risk management, superior performance, and high information ratios."

-Stanley J. Kon, Editor, Journal of Fixed Income, USA

"This volume will quickly become an indispensable reference for any fixed income investor. The authors are seasoned practitioners with many years of experience in helping clients manage risk, optimize expected returns, and solve real-world problems using the most sophisticated tools of financial engineering. The profession should be grateful that they're willing to share their insights with the rest of us."

***-Andrew W. Lo, Harris & Harris Group Professor,
Sloan School of Management, MIT, USA***

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Quantitative Credit Portfolio Management

*Practical Innovations for Measuring
and Controlling Liquidity, Spread,
and Issuer Concentration Risk*

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To my parents Lya and Ron, and my brother Oren, for their unconditional love, support, and encouragement, and to Shiraz and Shelly, my beloved daughters.

—ABD

To the blessed memory of my father David to whom I owe all my achievements and my motivation to reach them.

—LD

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—JMH

For my teachers

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necessary to produce the research in this book and prepare it for publication.

Foreword

The financial market crisis that began in 2007 delivered a rude shock to corporate bond investors, a constituency whose numbers had been swelled by an extended period of low interest rates and plentiful liquidity. The corporate bond asset class had offered coupon levels seemingly well in excess of any likely defaults, as well as a price volatility relative to government bonds, that was naturally dampened by the cyclical nature of credit quality. Enhanced by structural rigidities that offered well-known opportunities for active managers, these characteristics warranted a nearly permanent overweighting of corporate bonds. This worked until the credit crisis. Ever since, the corporate bond markets have misbehaved dramatically when viewed through traditional lenses, and the havoc wrought to investment portfolios is obvious given the strikingly poor performance delivered by active managers in 2007-2008.

So, is this asset class irreparably damaged? Or do we simply need to address it differently?

In this book, the authors demonstrate convincingly that the deployment of new tools enables investors to continue to harvest the benefits of corporate bond investing whose origins go back as far as the nineteenth century. Indeed, many of these tools were already available and others have been developed in response to investor experience in more recent times. While the approach here is strongly grounded in investment theory, it is also tethered to real-world experiences and does not stray into a merely academic consideration. The authors make extensive use of the rich databases available now to both develop and test the tools they recommend. These applications are eminently capable of practical deployment in day-to-day portfolio management

—and I have first-hand experience in their successful utilization.

The symptoms of investor distress provided a natural “to do” list, for which the authors have supplied the remedies. The volatility of individual corporate bonds bore little relation to that suggested by traditional risk measures. The impact of interest rate duration was often surprising. The relationship between the cash markets and derivatives was bent out of shape to the degree that risk-free arbitrage was seemingly on offer. Finally, market liquidity varied widely but uniformly deteriorated. An inability to quantitatively measure trading liquidity had led the industry to ignore this risk dimension with the result that investors were ill-prepared to manage their way through the market volatility. These symptoms were not limited to active portfolio managers. Investors who simply wished to build representative exposure to the asset class were equally challenged.

This book provides practical tools to address these issues and demonstrates new ways to manage well-established strategies in corporate bond markets. Of course, in this era of impaired national balance sheets, credit worthiness is no longer the exclusive preserve of the corporate bond investor. For this reason, the authors explore how sovereign credit risk can be better approached. With the concept of risk-free investing under threat, providing smarter tools for the management of credit risk could not be timelier.

Paul Abberley
Chief Executive
Aviva Investors
London, U.K.

Introduction

For more than 20 years, the Quantitative Portfolio Strategy Group (QPS) has been a part of Fixed Income Research at Barclays Capital and Lehman Brothers, two dominant providers of bond market indexes and fixed income analytics for institutional investors. Throughout this time, we have been actively involved in all aspects of index design and analytics, and engaged in a frequent dialog with investors benchmarked to both standard and customized indexes as well as managers with pure total return mandates. The benefit of ready access to detailed security-level historical data for index constituent securities has allowed us to address our clients' needs for sensible and implementable solutions to problems arising in managing their portfolios.

Our group's goal since its inception has been to offer objective solutions based on innovative modeling and empirical data analysis. Constant dialog with practitioners from around the globe has kept our research topics firmly grounded in the realities of asset management. In 2007, we published *Quantitative Management of Bond Portfolios* (Princeton University Press) in which we presented some of our most relevant methodologies and findings across a broad spectrum of issues covering portfolio construction, risk management, performance evaluation, and benchmark customization. Since then, the capital markets have suffered the worst calamity since the Great Depression. The tumultuous period of 2007-2009 not only raised many new questions for portfolio managers but also starkly revealed previously overlooked sources of risk and performance. Perhaps most importantly, this period provided quantitative analysts with valuable observations of extreme behavior of fixed income securities. Analysts can now base their studies

on a rich historical fixed income data set that includes several “crisis” and “normal” market periods.

In this book, we focus exclusively on management of credit portfolios. Credit portfolio managers traditionally rely on fundamental research for decisions on issuer selection and sector rotation. Quantitative researchers tend to use mathematical techniques for the purpose of pricing and quantifying credit risk. Our research bridges the two approaches. Each chapter in this book is based on questions brought to our attention by credit portfolio managers and reflects our original research aimed at answering them in an objective, quantitative way. Despite our quantitative orientation, we present all our conclusions and recommendations in an intuitive way that is implementable by all credit managers.

The book is structured in two parts. In the first part, we focus on new measures of spread risk, liquidity risk, and Treasury curve risk. We present empirical and theoretical evidence of the benefits these measures offer to portfolio managers compared to established approaches. In the second part, we turn our attention to portfolio management applications of these new risk measures as well as some new ideas for capturing more of the spread premium in credit portfolios. Throughout the book, we maintain a sharp focus on new research results and their practical implications, especially during the 2007-2009 credit crisis, and do not present a complete overview of existing approaches to each topic. Individual chapters, while often cross referenced, were written such that they can be read independently even if this meant some repetition of earlier material.

PART ONE: MEASURING THE MARKET RISKS OF CORPORATE