

# Are You Exposed to Credit Default Swaps?

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They're likely in your portfolio. Here's what that means

To advocates, they're a necessary part of managing risk. To critics, they're a financial roadside bomb. They're invisible, unregulated, and largely untraceable, at least until they blow up. They're credit default swaps (CDS), and they're at the heart of the bankruptcy of Lehman Brothers ([LEH](#)) and the bailout of insurer AIG ([AIG](#)). Odds are they're lurking somewhere in your portfolio. To help you assess whether you're exposed to swaps and what it could mean if you are, here's the lowdown on what they are and how they work.

**What are credit default swaps?** They're insurance for bonds. Just as drivers buy insurance to cover the costs of a crash, bond owners buy swaps to protect themselves in case a company can't pay its debt. But unlike traditional buyers of insurance, financial institutions can insure a bond even if they don't own it (imagine buying an auto policy on a friend's new sports car and collecting the cash when he wrecks it). This kind of speculation has pushed the value of outstanding CDS to \$58 trillion, a number that dwarfs the \$6.2 trillion in outstanding U.S. corporate debt.

**What do credit default swaps have to do with my investments?** Nine of the largest taxable bond funds in Morningstar's ([MORN](#)) database—and nearly 10% of all the taxable bond funds it tracks—list swaps in their portfolios. That includes funds from companies such as Pimco, Vanguard Group, Fidelity Investments, and T. Rowe Price ([TROW](#)).

**What are the risks?** For starters, CDS don't trade on exchanges. Each is a privately negotiated contract, with the buyer of protection paying monthly or quarterly premiums to the seller. Exiting a position requires a new contract—not always easy to get when financial companies are zealously guarding their balance sheets. Then there's the risk that the holder of a swap will need to put up more collateral. When selling insurance, companies must put up enough assets to cover the current liability. If a bond trades at 95 cents on the dollar, the fund would be required only to post the difference: 5 cents for every dollar. But with prices moving by leaps and bounds, 5 cents can quickly become 50 cents. Managers could be forced to dump assets to raise collateral.

Finally, there's the danger that the company on the other side of the contract won't pay up, known as counterparty risk. Standard insurance companies are regulated to make sure they can meet obligations. No such oversight exists for swaps. Mutual funds say they research partners to reduce counterparty risk, but there's fear in the market that an insurance seller won't have the capital to pony up, starting a chain reaction that ripples through the entire swap market. "Credit default swaps are the last bubble," asserts risk analyst Christopher Whalen of Institutional Risk Analytics.

**Why would my fund own swaps?** Some use them to insure their bonds. Others use them to boost returns by pairing a swap with other bonds. They're also used for finetuning. As market conditions change, managers buy and sell bonds, modifying everything from the average length of time until its bonds expire to sector exposure. But a swap that replicates the features of the desired bond could act as a cheaper alternative. "Swaps are an integral part of good risk management," says Pimco CEO Mohamed El-Erian. "They allow you to position the portfolio in a much more refined process."

**How do I know if my fund uses swaps?** It's not easy. The usual sources of information, such as Morningstar and Lipper, don't include derivative exposure. While the Securities & Exchange Commission doesn't require every single fund to disclose its use of swaps, there's a good chance the information will be in SEC documents if credit

default swaps are an important part of the fund's strategy. Intrepid investors should dig into the fund's prospectus and the holdings listed in its Form NQ, which managers file with the SEC (you can find it at [sec.gov](http://sec.gov)). But an NQ is a snapshot of the portfolio on a single day, not a real-time view, warns Edwin Elton, Nomura professor of finance at New York University's Stern School of Business.

**Should I sell my funds that have swaps? Some advisers think so. Roundview Capital's Stephen Shueh, a Princeton, N.J., financial adviser and devotee of Warren Buffett, won't invest in anything that he can't quantify. "If I can't handicap the risks, then I would just as soon avoid it," he says.** Others take a more nuanced view. "If used in the wrong way, they're risky," says Michael Walther, a financial adviser with Balasa Dinverno Foltz in Itasca, Ill. "If used properly, they mitigate risk and cut down on volatility." Of course, investors may have a tough time distinguishing between the ways swaps are used. Listening in to your fund's conference calls can provide a glimpse of its strategy. And managers who have their own money invested in a fund are less likely to take unreasonable risks. Financial adviser Lawrence Glazer of Boston-based Mayflower Advisors thinks that having more than 5% of a fund's assets in swaps or other derivatives is a red flag. "Don't be complacent," says Glazer. "If you are uncomfortable with something, it's O.K. to make a change."

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