

**Presenting
debate on
contemporary
and emerging
portfolio
construction
issues**



portfolio
construction

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15 & 16 August 2007 | AJC Convention Centre, Randwick, Sydney

[Portfolios]

**I've been thinking about...
when to buy/hold/sell**

Presentation

**I've been thinking about...
managing credit risk in a
portfolio**

Tim Farrelly, Principal, farrelly's



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Presentation to PortfolioConstruction Conference 2007

**I've been thinking about...
managing credit risk in a portfolio**

Tim Farrelly
August 2007

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Avoiding credit disasters

- Get expert help?
- Only buy issues you really understand?
- Be quick on your feet?
- Don't take risks?
- Manage your risks?

Get expert help...

10 year default rates (1970 to 2004)		
Securities originally rated	Average 10 year default rate	Worst 10 year default rate
AA	1.0%	2.4%
A	2.0%	2.9%
BBB	5.5%	8.4%
BB	17.8%	25.1%
B	29.2%	35.3%

Source S&P

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Only buy issues you really understand?

No of issues	Probability of zero failures
1	80%
2	64%
3	51%
5	33%
10	11%
15	3%
30	0%
50	0%
100	0%

Assume chance of failure is 20% and likely loss is 70%

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Only buy issues you really understand?

No of issues	Probability of zero failures	Pr of losing more than 15% of capital	Likely loss
1	80%	20%	70%
2	64%	36%	35%
3	51%	49%	23%
5	33%	67%	14%
10	11%	62%	14%
15	3%	45%	14%
30	0%	39%	14%
50	0%	28%	14%
100	0%	26%	14%

Assume chance of failure is 20% and likely loss is 70%

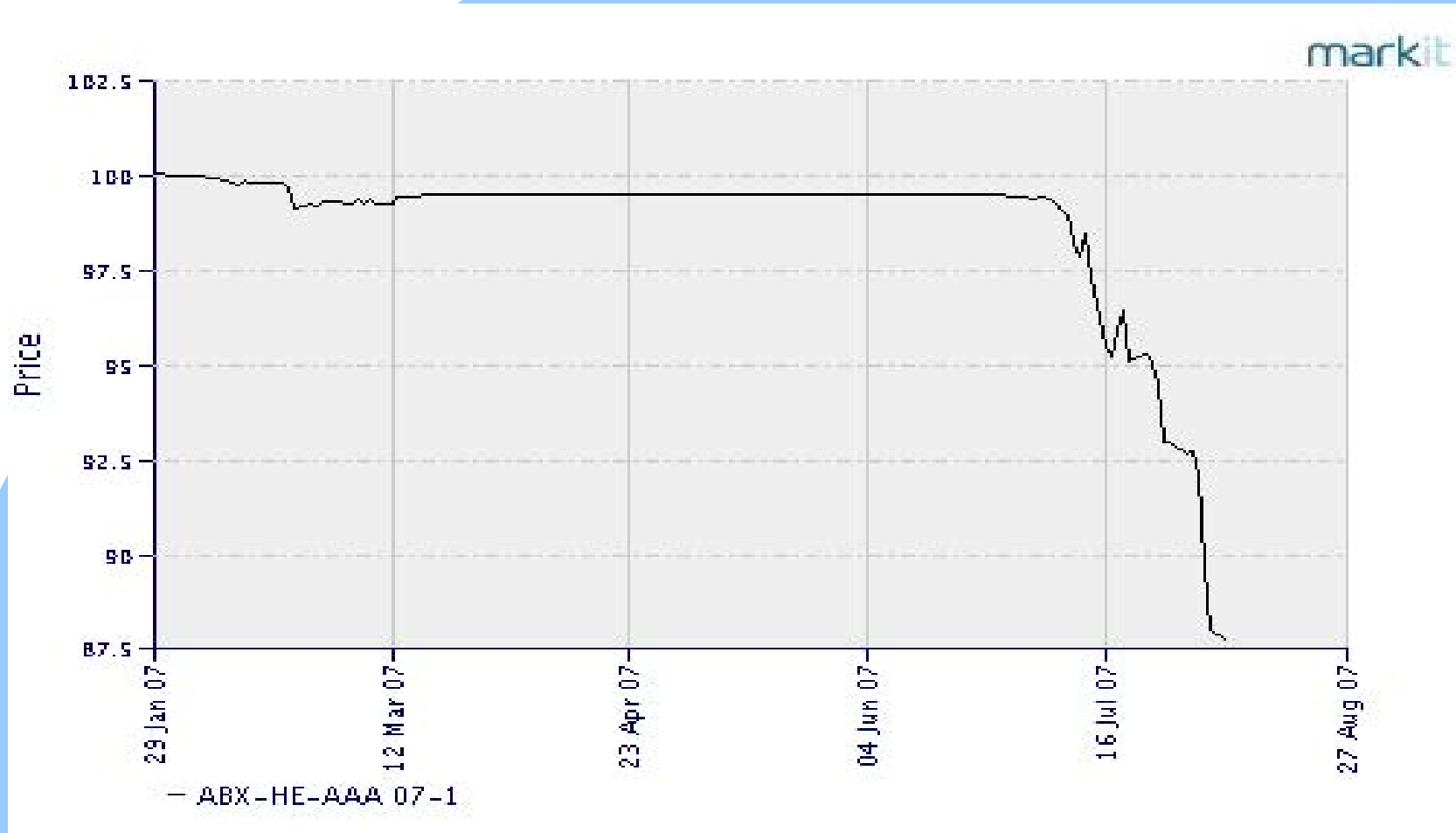
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Be quick on your feet...



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Be quick on your feet...

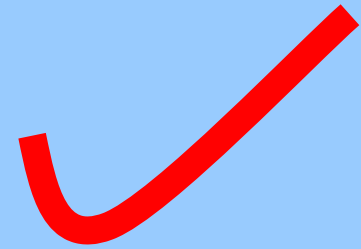


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Don't take any risks...

	Govt bonds	BBB Securities	Hi Yield	T2 Fixed Interest
Govt Bonds	6.0%	6.0%	6.0%	6.0%
Yield Pickup	0.0%	1.5%	4.5%	3.0%
Effect of defaults	0.0%	-0.5%	-2.2%	-1.3%
Forecast return	6.0%	7.0%	8.3%	7.7%

Manage the risks



- Decide how much pain you can stand from any one investment
- Do a back of the envelope credit assessment
- Do a back of the envelope worst case analysis
- Determine maximum exposure to any one issue

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Back of the envelope credit assessment

Question
1. What's the rate on BBB securities?
2. Junk bonds?
2. What's the rate on the security or underlying securities in the fund?
3. Are the assets higher or lower risk than BBB?
4. How much diversity is there in the fund?
5. Is there any gearing?

Back of the envelope credit assessment

Question	Case 1
1. What's the rate on BBB securities?	Bonds + 1.3%
2. Junk bonds?	Bonds + 4%
2. What's the rate on the security or underlying securities in the fund?	Bonds + 1.4%
3. Are the assets higher or lower risk than BBB?	Lower than BBB
4. How much diversity is there in the fund?	Single issuer
5. Is there any gearing?	No

Back of the envelope credit assessment

Question	Case 1	Case 2
1. What's the rate on BBB securities?	Bonds + 1.5%	
2. Junk bonds?	Bonds + 4.5%	
2. What's the rate on the security or underlying securities in the fund?	Bonds + 1.4%	Bonds + 2.4%
3. Are the assets higher or lower risk than BBB?	Lower than BBB	Lower than BB
4. How much diversity is there in the fund?	Single issuer	Well diversified by issuer
5. Is there any gearing	No	No

Back of the envelope credit assessment

Question	Case 1	Case 2	Case 3
1. What's the rate on BBB securities?	Bonds + 1.3%		
2. Junk bonds?	Bonds + 4%		
2. What's the rate on the security or underlying securities in the fund?	Bonds + 1.4%	Bonds + 2.4%	Bonds + 1.3%
3. Are the assets higher or lower risk than BBB?	Lower than BBB	Lower than BB	Around BBB
4. How much diversity is there in the fund?	Single issuer	Well diversified by issuer	Single issuer
5. Is there any gearing	No	No	50%

Back of the envelope worst case analysis

- Single issuer A or better – very low risk of loss.
- Single issuer BBB or less – loss 100%
- Well diversified issue BBB – 10% loss
- Well diversified issue BB – 30% loss
- Well diversified issue B – 50% loss
- Gearing ratchets up the losses

Manage the risks

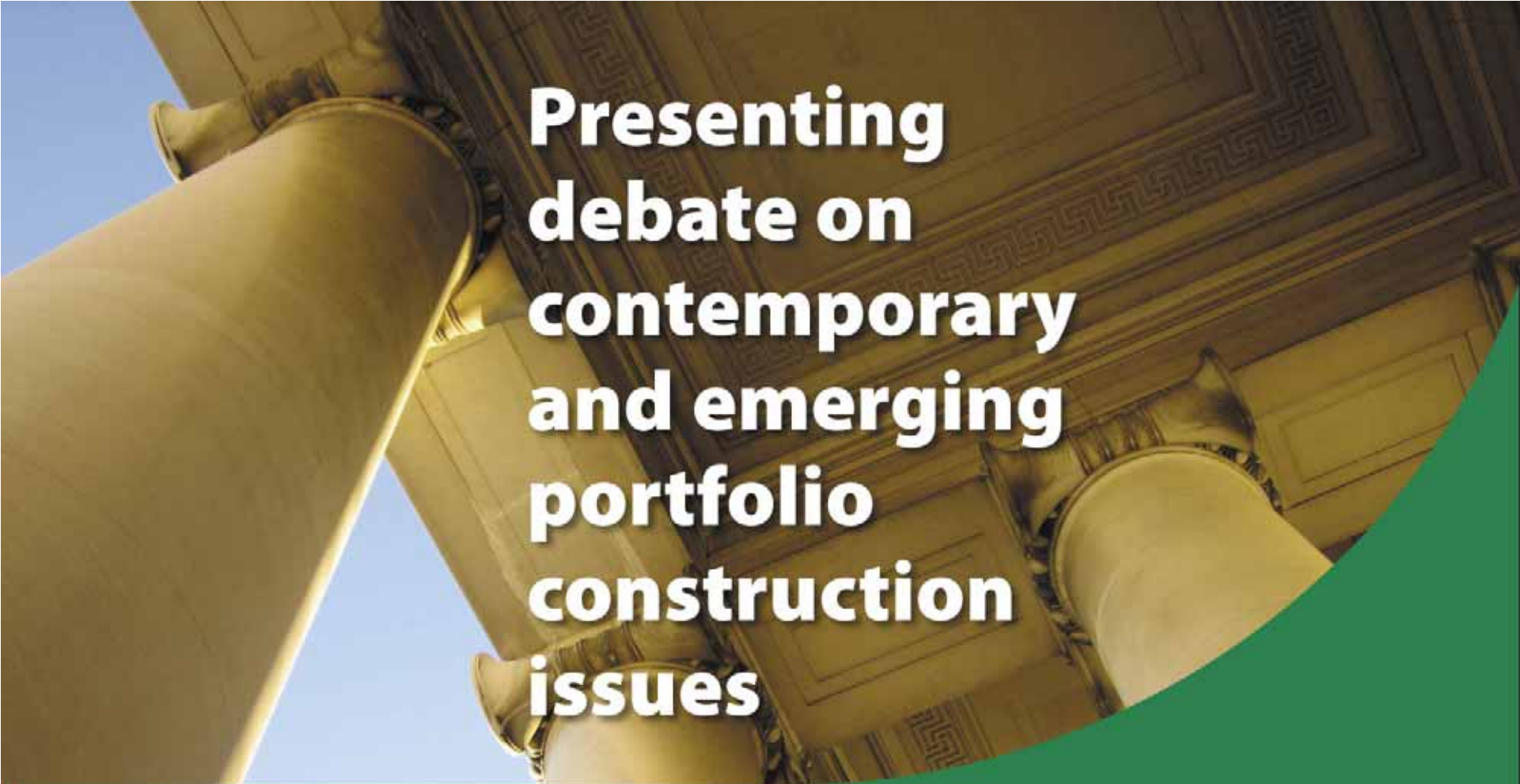
- Decide how much pain you can stand from any one investment
- Do a back of the envelope credit assessment
- Do a back of the envelope worst case analysis
- **Determine maximum exposure to any one issue**

Maximum exposures if loss capped at 2% of portfolio.

	Case 1	Case 2	Case 3
Credit estimate	BBB single issue	BB diversified	BBB geared, diversified
Maximum loss	100%	30%	10% x 4 = 40%
Maximum holding	$2\% / 0.1 =$ 2%	$2\% / 0.3 =$ 6.6%	$2\% / 0.4 =$ 5%

Avoiding credit disasters

- The experts aren't foolproof
- Don't roll the dice
- The markets will get there first
- The risks are worthwhile taking
- Risks must be managed



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