

Collateralized Fund Obligations: A Future Alternative to Fund of Funds?



Looking for options?
Philip Niles explores
the risks and rewards
of CFOs.

Philip Niles
Butterfield Fulcrum

Following a credit crisis that reared its ugly head so venomously in recent years, a number of investment products have been blacklisted from many investors' portfolios. Truly, the pain felt recently was too much for some to bear, and in an effort to spare themselves a second lashing, a number of money managers have avoided particular asset types altogether. Moreover, the heightened awareness of risk management in the alternative investment industry has led some to disavow all assets that cannot be easily categorized or understood.

One notable (and now infamous) example is collateralized obligations. Collateralization in general led to many of the difficulties over the past couple of years and, by extension, the appetite of the investing public for these products has diminished significantly. There are far fewer collateralized obligations being placed for initial offerings and the secondary market for these vehicles has shrunk considerably. This is certainly not surprising, as many investors, ranging from private endowments to government bodies, were severely burned by the rapid decline in the values of these assets. However, an important question remains: were the assets themselves flawed, or rather were they simply misused and misunderstood? This author would argue the latter, and along those lines, that collateralized obligations are a worthy investment alternative within an established risk management framework, given rational return expectations.

Furthermore, the time may have come in the alternative investment industry for a sober look at collateralized fund obligations (CFO). With some widespread experience under the public's belt using and managing collateralized obligations, there is now sufficient knowledge to properly take advantage of the benefits found in CFO investments.

The Basics

The structure of a collateralized fund obligation is really no different than any other collateralized obligation. Very generally, investors allocate money to one of several tranches of ranking seniority. These funds are then invested in a special purpose vehicle (SPV) which is created just for the CFO. From the SPV, the funds are generally invested in a typical fund of funds vehicle which, like the SPV, has been specifically designed for the CFO. This fund of funds has an appointed investment manager to allocate the investment capital. From there, the fund of funds (as directed by the investment manager) invests the capital in accordance with the prescribed investment methodology in external hedge funds.



Presented visually, the CFO would be structured as outlined below (Exhibit 1).

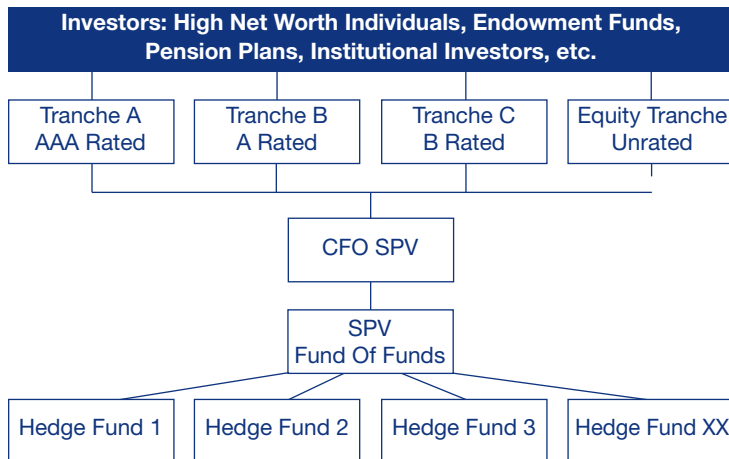


Exhibit 1: Basic Structure of a Collateralized Fund Obligation

As mentioned above, each investor elects to invest in a specific tranche as appropriate given their risk tolerance and return objectives. As with most collateralized obligations, the priority of payment starts with the most senior tranche (in this case, Tranche A) and continues from there. In Exhibit 2 presented below, the obligations of Tranche A must be satisfied before moving to Tranche B, following which Tranche B must be satisfied before moving to Tranche C, etc. Any residual amount is allocated to the most junior tranche, here referred to as the equity tranche. As an example, taking our mock CFO structure created above with an assumed capital base of \$1 billion, the tranches may be broken out as follows:

Tranche	Rating	Amount (Millions)	Interest Rate
A	AAA	\$500.00	LIBOR + 100
B	A	\$125.00	LIBOR + 200
C	B	\$125.00	LIBOR + 300
Equity	Unrated	\$250.00	7.50%
		\$1,000.00	

Exhibit 2: CFO Tranches

Benefits and Risks of Collateralized Fund Obligations

There are immediately some obvious benefits to a hedge fund manager. Alternative investments are an industry plagued by “hot money”, where money moves in and out of funds due to market volatility or investors chasing performance. As has been seen over the last couple of years, a sudden and substantial amount of redemptions can adversely impact the ability of an investment manager to enact the fund’s strategy effectively. Additionally, to meet these redemptions, the manager could be forced to liquidate positions in a less than efficient fashion, which can negatively impact the investors remaining in the fund. CFO structures offer the hedge fund a far “stickier” form of money; though investors can trade in and out of the CFO notes, the ending amount invested in the fund does not fluctuate, at least not until the maturity of the CFO. An additional benefit to the hedge fund manager is that CFOs can offer a way to diversify the investor base in a given fund. Some managers see a large benefit in having a mix of investors (high net worth individuals, institutional investors, fund of funds, etc.) to balance the ebbs and flows of capital activity. Collateralized fund obligations represent an additional type of “investor” to diversify this mix.

The benefits to investors are also numerous within the CFO framework. First, an investment in CFO notes offers the opportunity for instant diversification, since the underlying investment is in a variety of hedge funds; this offers some of the same diversification benefits as found in a fund of funds. Also, the prospect of side pockets, gated redemptions, etc. is less of an issue since their investment is in the CFO note and not directly in the hedge fund. As long as a buyer for the note can be found, the investor can exit the investment.

Perhaps most notably, the CFO structure offers access to the hedge fund and alternative investment industry for groups of investors who might otherwise be restricted. As an example, many insurance companies and pension funds are restricted to investing the vast majority of their assets in low-risk fixed income investments so that they are able to fund their policy payouts or benefits. However, these investors who otherwise cannot invest directly in hedge funds can indirectly do so through a CFO as they are generally not restricted from investing in bonds issued in a private offering (the curious reader can consult Regulation 144A of the *Securities Act of 1933* for the U.S. perspective on this detail). This simple distinction would allow billions of extra dollars to flow into alternative investments through CFOs and groups of investors, such as insurance companies and pension funds, to target higher expected returns and greater diversification.

Of course, as with any investment, there are risks associated with collateralized fund obligations. Naturally, there are the risks associated with the underlying hedge fund investments as made through the fund of funds. Should the net asset value of these investments decline, so too would the value of the notes. Really, this risk would be present with any investment, but still it is certainly one worth noting.

Another risk with respect to an investment in collateralized fund obligations revolves around the secondary market for the CFO notes. One of the benefits presented above was greater liquidity for exiting the investment through the use of a secondary market, but of course there must be a buyer for every seller. As we have seen over the past few years, liquidity cannot be taken for granted. Should an investor wish to exit an investment in a CFO during a less than desirable time, the going price may be less than during other better circumstances and, to quickly exit the position, the investor may need to accept a substantial discount over the pro rata net asset value of the underlying fund of funds.

A third risk comes in the form of counterparty risk. Though the CFO SPV and the CFO fund of funds are separate and uniquely created entities, they are managed by external parties. Generally, there would be a trustee for the CFO notes that are issued for investors (usually an investment bank) and there is a distinct investment manager charged with managing the allocations to fund managers within the fund of funds. Undoubtedly, there is default and counterparty risk any time external service providers are utilized and this is true within a collateralized fund obligation structure.

Conclusion

The collateralized fund obligation structure can offer a real alternative to investors seeking diversified alternative investment exposure. The major obstacles blocking the way for the CFO structure is a current distrust and lack of familiarity with collateralized obligations in general as well as the relatively few issuances of CFOs to date. However, given the advantages to fund managers and investors as noted above, this type of investment could be a veritable alternative to the hedge fund of funds structure in the near future. In all likelihood, with the maturation of the alternative investment industry and a returning appetite for measured investment risk, collateralized fund obligations will become a more accepted and promoted form of indirect hedge fund investment. *