危機 [Wēijī]
How to turn risks into opportunities in today's derivatives markets

Bertrand Delarue, Patrik Sandin and Nick Tranter look at four of the lessons learnt and the opportunities for investors in times of increased volatility, decreasing liquidity and heightened credit and counterparty risk

The two Chinese characters 危機 mean 'crisis'. Some like to think that one signifies 'danger' and the other 'opportunity', the idea being that the best opportunities can emerge out of difficult times.

In today's global financial crisis, the dangers are still evident. The fallout from the credit crunch continues, with high volatility and lower liquidity persisting in most parts of the credit and equity markets.

Add to this the recent resurgence of inflation fears, triggered by Jean-Claude Trichet's remarks in June, and a dramatic inversion of the EUR interest rate curve has prompted new panic levels in interest rate derivative markets.

While we are still in the midst of turmoil, it is difficult for many asset and liability managers to clearly see where future opportunities lie.

In this article, BNP Paribas identifies four main lessons and suggests the opportunities that arise from them.

Lesson one – Liquidity cannot be taken for granted

One of the most immediate impacts of the financial crisis that started in the US subprime sector has been on banks' willingness and ability to lend to each other and to their clients. Access to funding, even the cheap funding that for so long has been taken for granted, now comes at a premium. And, as a result, liquidity comes at a premium.

Opportunity – offering higher liquidity products

In this context, products that offer genuine market liquidity (at least daily) are more likely to appeal to investors who want the freedom and flexibility to move their investments quickly, as reflected in the increasing volumes of listed exchange derivatives.

There are a growing number of highly liquid vanilla investment products available (swaps, futures, certificates, exchange-traded funds, exchange-traded notes and open-ended funds). BNP Paribas has also introduced more advanced structured products where liquidity is guaranteed at predetermined dates, such as option-based structures with guaranteed liquidity conditions.

Some banks have responded to market demand and have begun to launch their own sources of liquidity. BNP Paribas – in addition to having its own dark pool, BNP Paribas Internal Exchange – is also active across many multilateral trading facilities, for example, Chi-X in the equities space.

Lesson two – Historically high levels of volatility

With the squeeze continuing on liquidity and credit, the markets have become increasingly choppy and volatility levels have reached new highs in equity, credit and interest rate markets.

Between July 2007 and April 2008, the DJ Eurostoxx 50 volatility strongly increased, exceeding the 25% bar. Banks' value-at-risk (evaluation of probable losses through statistical analysis of previous incomes) has also risen drastically.

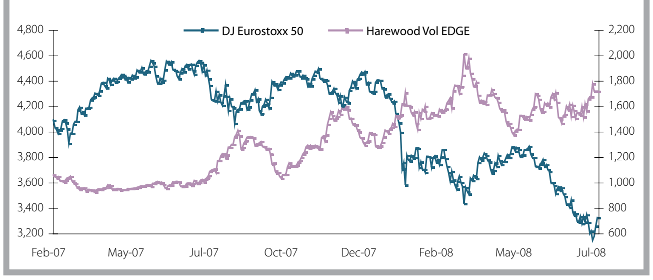
Opportunity – new ways of investing in volatility

Relative stability in interest rates, foreign currency movements and stock markets for the five years leading up to the 'crisis' led many companies and institutions to become complacent about the need for hedging against volatility, but the recent tumultuous markets have forced people to reconsider their view on risk.

For several years, BNP Paribas has been offering clients investment opportunities – as well as hedging tools – using volatility as an asset class. In equity derivative markets, products that facilitate investment in implied volatility (which offers more reactivity to markets than realised volatility) have proven particularly successful.

For example, BNP Paribas Harewood Vol EDGE, which provides long exposure to the implied volatility of the DJ Eurostoxx 50 through a fund with daily liquidity, was an ideal product to invest in during low volatility periods as it provides a hedge against rising volatility in the current falling market (see figure 1).

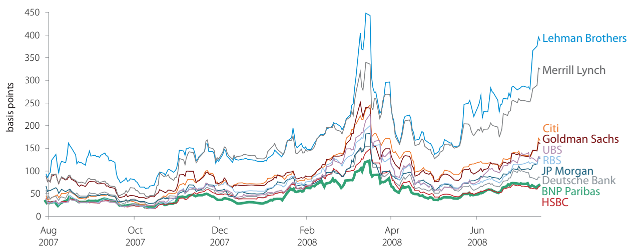
1 Performance of Harewood Vol EDGE



Lesson three – Credit and counterparty risk matter

Credit fears have led to a sharp widening of spreads in the iTraxx and CDX credit default swap (CDS) indexes since August 2007. At the same time, several banks started to experience massive write-downs and credit losses. As a result, investors have become much more sensitive to credit and counterparty risk, choosing their investments – and the structuring banks with which they do business – more carefully than ever before.

2 Five-year senior bank CDS spreads



Source: Markit

Opportunity – growth in listed derivatives

The listed derivatives market has fared well as investors have sought trades on transparent and liquid exchanges. Volumes on Deutsche Börse's Eurex and Liffe rose by 52% and 29%, respectively, in Q1 2008 compared to Q1 2007.

BNP Paribas provides a full range of listed derivatives as well as over-the-counter products on a wide range of underlyings, such as indexes, systematic strategies, baskets of stocks, global and emerging equity markets, currencies, commodities and funds.

In times of investor nervousness, institutions with strong credit ratings, such as BNP Paribas (AA+/Aa1), can offer additional reassurance to clients. The BNP Paribas five-year CDS spread has remained low and stable in the past 10 months, in contrast to those of many of its peers (see figure 2).

Lesson four – Track record is not very reliable after all

Rapid changes in liquidity, volatility and credit risk have all presented new challenges to the investment community over the last year. The combined effect has led to the blow-up of several well-respected money managers, highlighting that even the track record of the most established funds cannot always be trusted.

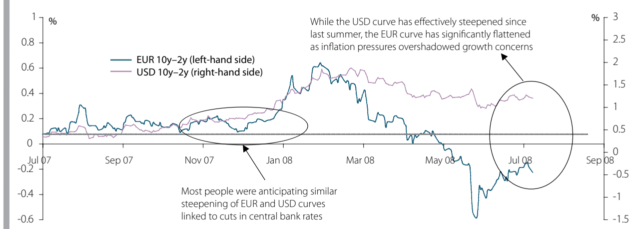
Opportunity – dynamic quantitative and fundamental strategies that adapt to market cycles

Until recently, most structured products on the market limited clients to taking views through static payouts, in which the exposure to the underlying asset would remain the same for the entire life of the structure. This exposes the clients to considerable risks if market conditions change suddenly.

Over the past 12 months, BNP Paribas pioneered structured products based on fundamental dynamic strategies, creating a range of strategy indexes across equities, commodities, credit, foreign exchange and interest rates that help clients to access new markets, diversify their investments or restructure their exposures in an efficient and cost-effective way. These are either carry strategies that exploit market bias or momentum strategies that rapidly adapt to market cycles.

The BNP Paribas STAR indexes, for instance, provide algorithmic 'rule-based' strategies, which extract value from the movements (direction, steepness and convexity) of the interest rate curve.

3 10y–2y EUR versus USD spreads



Demand for these products has taken off as asset managers look to diversify their portfolios and liability managers hedge against increased volatility. These have been particularly relevant with the EUR curve's recent inversion, which has left many clients that took steepening positions on the EUR curve in anticipation of European Central Bank rate cuts in underwater positions (see figure 3).

In one recent example, a client had an existing position linked to the EUR 10y–2y spread. With the curve inverting, there was a risk of breaching the barrier on the spread and the client having to pay above market interest rates. BNP Paribas proposed a replacement structure using one of its indexes, which combines a curve slope with a curve direction strategy. This allowed the client to continue to pay a low interest rate as long as the strategy continued to perform well.

Crucially, the yield curve inverted dramatically following Trichet's comments on euro inflation in June shortly after the restructuring. The client thereby benefited from having taken off the exposure to the 10y–2y spread and from the strong performance of the index, which was positioned for further inversion.

Conclusion

The two Chinese characters for 'crisis', 危機, in fact mean 'dangerous moment'. Rather than indicating 'opportunity', 機 refers to a point where many elements hang in the balance and the outcome may be positive or negative. Combined with 危, or 'dangerous', it means 'crisis'.

With the financial market crisis far from over, there is a risk that the new products developed today – if they are merely 'strategies of the month' – will have little value tomorrow.

Derivatives have their place in this new and uncertain world: as a way to protect against the downside, to capitalise on high-volatility levels, to access diversifying assets and, above all, as a way to control risk. The new generation of structured products is today more than ever an integral part of asset and liability managers' portfolios.

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