

## Growth of Portfolio Swaps: Fundamentals, the Appeal and What You Need to Know

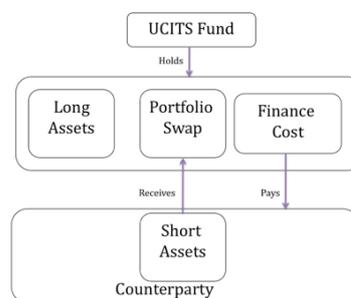
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*The use of portfolio swaps is growing among investment managers. Subbiah Subramanian of Eagle Investment Systems explains the appeal and potential pitfalls in using portfolio swaps.*

As investment managers try to understand the post financial crisis landscape and 'the new normal', the industry as a whole is seeing a rise in usage of portfolio swaps. Fundamentally, portfolio swaps allow managers to gain exposure to assets without physically holding them in their portfolio. The portfolio manager can create a basket of assets (assets can be either long or short) and have a counterparty hold the basket. This basket will be held and treated operationally as any other portfolio by the counterparty. As a part of the deal, the manager enters into a swap with the counterparty to receive the return on the basket and in turn pay a negotiated financing cost in addition to a spread. The manager will hold the swap but economically it is equivalent to holding the basket. As far as the counterparty goes, they will pass on any gain/loss from the basket (including dividends) to the investment manager. The counterparty charges a finance cost/fees for administering the basket. They have no direct financial risk in this deal other than the counterparty risk (addressed later in the article). The financing cost is calculated based on the outstanding value (referred to as swap notional) of the basket at the end of the day. Since there is generally active trading in the basket, the notional amount can change on a daily basis.

### Drivers of portfolio swap:

UCITS III approved the use of short exposure (typically via the use of derivatives) to manage down side risk and to help generate alpha. This has driven traditional 'long only' asset managers to use portfolio swaps in order to gain short exposure. Portfolio swaps provide them the flexibility to invest in short positions without actually having to own them on their books. In the example of a UCITS fund, the manager holds long assets and the portfolio swap. The combined effect is equivalent to holding both long and short positions directly in the fund. Please note that UCITS stipulates limitation on the percentage of exposure allowed with a single counterparty. The actual amount varies from 5% to 10% of notional depending on the type of the derivative instrument and the institution acting as counterparty. Portfolio swaps are well suited to meet this requirement as each deal can be structured to exactly meet individual needs.



Another driver for use of portfolio swaps is increased popularity of 130/30 funds and market neutral strategy funds. In the case of the 130/30 strategy, a manager will short poor performing stocks and use the proceeds to buy long assets. Portfolio swaps allows traditional 'long only managers' to implement this strategy without needing a separate infrastructure to trade and account for short positions. Therefore, a 130/30 fund will hold 100% long positions and a portfolio swap. This swap provides managers with exposure to 30% short assets.

Portfolio swaps are evolving in the market, with wide ranging application in risk management and alpha generation space. For example, if fund managers want to alter the duration of their portfolios and stay within certain credit bands, they can enter into a portfolio swap based on a basket of fixed income instruments. Since they are in control of the basket, they can achieve their target with laser-like precision.

### What makes portfolio swaps attractive?

#### Business flexibility:

The holder of a portfolio swap not only constructs the basket of assets, but they can actively trade the basket components on a daily basis. The counterparty can either execute the trade on the manager's behalf or replicate the trade with other derivatives. This helps a holder of the portfolio swap to dynamically maintain the basket to accommodate changing market conditions and strategies. This is one of the biggest differences between a traditional total return swap (TRS) and a portfolio swap. A TRS is typically based on a single instrument or market index. This

limits the ability of the portfolio manager to exactly match individual needs. Another hindrance to using TRS on an index is the unavailability of a particular index to match the needs in terms of Industry/Sector/Country exposure. This constrains the manager's ability to attain the exposure they set out to achieve.

Terms and conditions of a traditional TRS are generally governed by standardized agreements. For example, the exchange of payments typically happens monthly or quarterly. This leaves the holder of the swap open to counter party risk. In the case of a portfolio swap, cash flow exchanges (typically called a reset) are triggered by accumulated gain/loss on the return leg. This helps keep counterparty risk in check. For example, a portfolio swap can be structured to reset every time the gain is over 10% of the notional amount.

#### **Operational Flexibility:**

As noted earlier, a traditional 'long only' manager might not have the system and operational infrastructure to handle short positions. Portfolio swaps move the operational overhead of managing short positions to the counterparty. However the holder of the swap is still responsible for providing trading instructions to the counterparty.

#### **What you should be aware of?**

One main pitfall of portfolio swaps is what Eagle refers to as "hidden risk". Since the fund does not directly hold the short positions, the risk involved is not very apparent. Nevertheless, the fund is exposed to the same risks involved in directly holding short positions. Appropriate risk management processes should be put in place to provide full transparency into the short basket held by the counterparty. Risk management should not only be from a market valuation perspective, but should also consider other risk measures like sector, country, currency and interest rate exposure (if basket contains bonds). This is key to the success of portfolio swaps.

General counterparty risk, which exists with other derivatives, also exists with portfolio swaps. However this risk is magnified because portfolio swaps are often central to a manager's strategy. To mitigate this risk, portfolio swaps are structured to trigger an exchange of payments if the outstanding gain is greater than a certain threshold.

Regulators all around the world are taking a close look at derivative markets. In the United States, a major tax change was passed as a part of the HIRE Act (Hiring Incentives to Restore Employment) of 2010. Dividends of US stocks that are part of an equity swap will be subject to Internal Revenue Service (IRS) tax withholding. This applies to deals where at least one of the parties is based in the US. One of the goals of this legislation is to tax the dividends at a higher 30% tax rate. These changes have to be

considered closely before entering into a portfolio swap.

#### **Conclusion**

Though precise trading volume figures are not available, this is a fast growing market. As the portfolio swap market evolves, it is expected that operational standardization will make it more transparent. Risk management is also maturing rapidly to handle some of the hidden risks associated with portfolio swaps. With appropriate controls and risk management in place, a portfolio swap can be a great tool for managers looking to implement their investment strategies in an efficient way.

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