



Bespoke boost opportunity

The search for yield is driving activity in bespoke CDS tranches, referred to as bespoke tranche opportunities (BTOs) post-financial crisis. The sector is expected to receive a further boost if single-name CDS liquidity continues to improve.

"The reasons why investors are attracted to bespoke investments are the capacity to attain leverage and the ability to create their own portfolio, by choosing names and the risk profile that they are comfortable with. It is possible to achieve a decent spread, with a two- to three-year maturity," confirms Frederic Couderc, co-cio at Chenavari Investment Managers.

The main differences between pre-crisis and post-crisis BTOs is that now dealers sell the entire capital structure and the trades are not driven by ratings arbitrage but are coherent with bank funding needs, according to Malek Meslemani, partner and senior portfolio manager at Chenavari. "Dealers are more disciplined than they were before the crisis and there is better equilibrium between the buy-side and the sell-side," he adds.

BTO portfolios are usually split into three sections - equity, mezzanine and 'seniors', including super senior - and sold to different types of investors and funds. Chenavari has historically been involved at the lower part of the capital structure, depending on the investment.

"A buyer of risk that masters the idiosyncratic risk (a hedge fund, for example) is preferable on the lower tranches of a BTO, as such an investment requires deep single names fundamentals expertise, whereas senior tranches express more a systemic risk. Some pension funds and insurers play in the senior tranche section, as there is less exposure to idiosyncratic risk at this level," Meslemani observes.

He points out that sectorial idiosyncratic risks are cyclical: for example, concerns over US retail names have overtaken concerns over US energy names - although not to the same amplitude. "With crude oil prices recovering to around US\$50 a barrel recently, the risk of portfolio dispersion coming from energy names has decreased."

Chenavari's convexity strategy comprises mostly of four buckets: tranches on investment grade iTraxx and CDX indices; the Crossover index; and bespoke portfolios. Index tranches remain observable and the most liquid, while bespokes are less observable, as dealers initiate the primary trades and provide the bid/ask in secondary ones.

"We're a long/short and market-neutral player, mainly engaged in investment grade tranches combined with hedging trades," Meslemani continues. "We believe tranches offer value across these strategies, which is harder to achieve in other asset classes and instruments. We tend to favour investment grade credits, as they typically exhibit less dispersion."

Couderc adds: "Whether we invest in index or bespoke tranches depends on which is cheaper at any given time. If there's no liquidity premium on offer for a bespoke tranche, we'll invest in an index tranche."

One area that has seen a rise in activity in recent years is iTraxx Crossover tranches, as they exhibit relatively less realised defaults than CDX.HY tranches. "Additionally, the number of constituent names in Xover series has increased to 75, so there has been a pick-up here," Meslemani confirms.

Looking ahead, he suggests that if single-name CDS liquidity continues to improve, the BTO market will grow and attract more dealers (only a handful are involved at present). "There had been a deterioration of CDS liquidity, due to the withdrawal of a few banks since the financial crisis. However, the single-name CDS market is becoming little by little more efficient, thanks to clearing being introduced across different names and sectors. Consequently, we're starting to see brokers becoming involved to support clients - which may, in turn, encourage more clients to clear CDS."

Couderc concludes: "We're positive about the future of index tranches and the BTO sector, although a question remains regarding the pace of growth. The direction is clear, but it depends on clearinghouse and dealer participation."

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