



## Counterparty Risk in Large Total-Return Funds

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September 20, 2011

We can add another to the list of concerns facing advisors: counterparty risk – a potential loss from the failure of a bank or broker-dealer. Underscoring this threat, DoubleLine's founder and chief investment officer, Jeffrey Gundlach, recently warned advisors to avoid all funds with counterparty risk. Heeding his warning, however, is not easy; it is virtually impossible to gauge the extent of counterparty risk in most funds.

Counterparty risk is the possibility that the broker or bank with which a fund transacts will fail to live up to its contractual obligations, usually because it is insolvent and faces bankruptcy. Firms that transacted with Lehman prior to its 2008 bankruptcy, for example, suffered losses because they had counterparty risk.

Long-only mutual funds and ETFs that hold individual securities – either stocks or bonds – have no counterparty risk. But more complex funds, including many of the total-return funds that compete with DoubleLine's Total Return Bond Fund (DBLTX), have counterparty risk to varying degrees.

Those funds hold derivatives, such as credit-default swaps (CDS) and interest-rate swaps, in order to gain exposure to certain segments of the market. A CDS is a promise by a bank (the counterparty) to pay a specified amount in the event that another entity defaults. But the CDS is only as good as the counterparty's ability to fulfill its obligation.

Gundlach's made his [comments](#) about counterparty risk several weeks ago, when the European debt crisis was worsening and investors had become particularly concerned about France. Those fears have not abated, and it is not hard to see how events in Europe could affect US mutual fund holders.

A Greek default followed by restructurings in other weak European countries would force banks to write off bad loans. As Gluskin Sheff's Dave Rosenberg reported last Thursday, French banks have assumed a 20% write-off on their Greek debt holdings, but Moody's, in deciding to downgrade those banks, assumed a 60% write-off. Such a write-off could trigger a contagion that could result in the failure of US banks or brokerage firms with exposure to European sovereign or bank debt.

And when a rogue trader can lose \$2 billion, as happened recently at UBS, it may not take a sovereign default to drive a firm into bankruptcy.



## Is your fund at risk?

Surely, every advisor would like to know the counterparty risk of the funds they consider. The challenge, however, is that mutual funds rarely disclose the counterparties for their derivative transactions.

The SEC requires every mutual fund to disclose its holdings quarterly. One can see the [holdings](#) of the PIMCO Total Return Fund (PTTRX, for the institutional shares), one of Gundlach's closest competitors. In it you'll find a list of the derivatives the fund holds – \$25 billion in notional amount of CDS listed as "sell protection on corporate, sovereign, US municipal and Treasury bonds," for example.

But you won't find the identities of the counterparties to those transactions in their quarterly reports. PIMCO is not required to disclose them, although they do in their annual and semi-annual reports.

Many fund companies don't disclose counterparties at all, according to Adam Cohen, Director of Fixed Income Investments at Fortigent, a Maryland-based provider of consulting and investment analytics. Cohen cited Driehaus as another fund that discloses counterparties voluntarily, in its case on an annual basis.

Even if funds did disclose their counterparties, Cohen said it might be of limited value, since those positions can change quickly.

"You can pretty much assume the counterparties are the largest banks and broker-dealers," Cohen said, at least for a fund as big as PIMCO's.

Cohen said that counterparty risk is very important for advisors to consider, and that Fortigent – whose clients are mostly large RIAs – concentrates on the process in place at fund companies, to make sure their exposure is not overly aggressive to a particular third party. His team also looks at the process to ensure the fund company is reviewing the credit and fundamentals of the counterparty and that operational aspects, such as a legal review of agreements with counterparties, are in place.

Another issue Cohen considers is the collateral that a fund posts against its CDS and other derivative positions. That collateral must consist of holdings in the fund, but funds are not required to disclose which of its positions are pledged as collateral. According to Cohen, many funds use Treasury bills, but others are more aggressive, using securities other than Treasury bills, such as corporate bonds, and those with durations up to 1.0 (which means maturities can be more than a year). This puts the fund at greater risk, in the event they are forced to liquidate collateral in the event of an adverse price movement in their CDS positions.



Advisors might be able to get counterparty information in a fund directly from fund companies, Cohen said, but they would have to ask for it on a regular, periodic basis in order to maintain an accurate ongoing assessment of risk.

Even then, though, an advisor might not get the full picture. Cohen said that some funds may hold CDS agreements to insure against the collapse of their counterparties themselves. Those contracts, he said, are typically held at the fund company level – rather than by any individual fund – so as to protect exposures across multiple funds.

In the event of a large-scale systemic failure, however, none of this may matter. The CDS market is largely unregulated, and contracts trade over-the-counter and not on an exchange. Counterparties to a CDS contract are not required to maintain reserves sufficient to collateralize their total exposure. Let's say a fund has CDS protection against the failure of one its counterparties. If the counterparty to that CDS fails as well, the original protection will be worthless.

As for Gundlach's railing against counterparty risk, Cohen said it's hard to judge how much of that is saber-rattling and marketing. Cohen said it's unlikely that Gundlach is able to avoid counterparty risk entirely in his total return fund. If the fund were to purchase mortgage-backed securities, for example, in to-be-announced (TBA) transactions, it faces some risk (in terms of the opportunity cost of funds it commits) regarding the eventual delivery of securities. Indeed, DoubleLine has had counterparty exposure through derivative transaction in its Multi-Asset Growth fund (DMLAX); it owned a swap transaction as of March 31, but there were no such positions as of June 30.

For advisors, counterparty risk should be viewed in the same context as traditional fund diversification, such as by asset class, sector or issuer. The default of a counterparty may be just as likely as the default of any of the issuers in the fund's portfolio.

All else being equal, less counterparty risk is better. Common measures of risk and return may not fully reflect a fund's a fund's exposure to derivatives and hence its level of counterparty risk. Employing derivatives is akin to using leverage in portfolios, magnifying returns when things go well, but exposing a fund to greater risk in adverse conditions. Gundlach should be commended for the superior performance of his total-return fund, especially considering its lack of derivatives and counterparty risk.

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