GRANT'S
INTEREST RATE OBSERVER
Vol. 24, No. 18c | Two Wall Street, New York, New York 10005 • www.grantspub.com | SEPTEMBER 22, 2006

Age of Aquarius

ACA Aquarius 2006-1 is the subject under discussion. Are you still with us? Good! A short catechism will serve to introduce the fine points.

To start with, what is it? ACA Aquarius 2006-1 is a $2 billion, mezzanine-structured, hybrid collateralized debt obligation, or CDO. What is a CDO? A CDO is a kind of bond, the collateral of which is debt. In the case at hand, the underlying, or reference, collateral is residential mortgage debt. What does it mean to call this contraption a "hybrid?" It means that Aquarius holds not only mortgages, and structures packed with mortgages, but also options on mortgages.

Here is another question: Why should anyone care about something so very much unlike a good, cheap value stock—anyone, that is, not directly involved as a basis-point-grubbing bond investor, collateral manager, mortgage scientist, rating-agency quant or member of the immediate families of such as the foregoing? One should care because (*a*) complexity in financial instruments sometimes obscures risk for which an investor may or may not be adequately compensated; (*b*) the issuance of complex mortgage structures is booming when house prices are not; and (*c*) the visible and looming difficulties in residential real estate have not yet depressed the prices of such instruments as these mezzanine-structured hybrid CDOs. Investors in the senior tranches of ACA Aquarius 2006-1 earn a few dozen basis points over Libor. Holders of the junior tranches earn 300 basis points, more or less, over Libor. Equity holders have come to expect 15% to 20% (of which more below). Expressing a personal preference, we would feel undercompensated holding any portion of the ACA Aquarius 2006-1 capital structure, in view of the risks and rewards, as we understand them.

Others have a different understanding. The progenitor and collateral manager of this transaction, ACA Management LLC, manages 19 CDOs with a cumulative par value of $12.75 billion. Not once, says ACA, has any rated note in any ACA-managed CDO been downgraded or placed on negative credit watch. Standing by its merchandise, ACA has invested $200 million in the equity portions of the CDOs it manages. And some smart money has invested in ACA, including Bear Stearns Merchant Banking, Stephens Group and Third Avenue Value Fund.

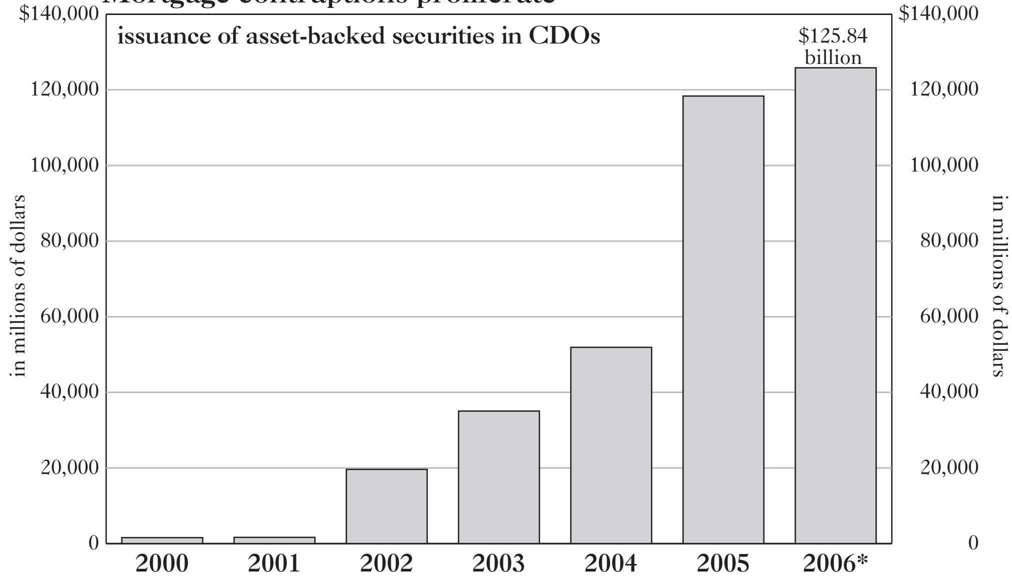
The deal at hand caught our eye not because its genus is so rare—this year, through September 15, $126 billion of asset-backed securities in CDOs have come to market, vs. $118 billion in all of 2005, according to Thomson Financial. Rather, what piqued our interest was the species. The new Aquarius offering is a hybrid CDO. Its assets consist chiefly of credit default swaps. Actual slices of cash mortgages furnish only 10% of the portfolio.

It takes a little doing to visualize a derivative of a derivative, but that's what this hybrid CDO is. The CDO itself is a derivative—and so are its assets. Credit default swaps are credit derivatives. They resemble insurance policies. The underwriter of CDS sells protection against a default or other defined credit event with reference to a stipulated security, index or portfolio of securities. The buyer of protection writes checks to the seller—unless, and until, such credit event occurs, at which time the seller of protection writes checks to the buyer. In the case at hand, the underwriter is ACA Aquarius 2006-1, and the referenced credit items are clumps, or tranches, of residential mortgages. Thus, for as long as the mortgages pay on time, Aquarius receives money from the buyers of pro-

Such a deal
ACA Aquarius 2006-1

securities	principal balance	interest rate	rating
Class A1S notes	$ 1,266,000,000	3-mo. Libor + 0.32%	Aaa/AAA
Class A1J notes	255,000,000	3-mo. Libor + 0.43	Aaa/AAA
Class A2 notes	177,000,000	3-mo. Libor + 0.53	Aa2/AA
Class A3 notes	80,000,000	3-mo. Libor + 1.55	A2/A
Class B1 notes	17,500,000	3-mo. Libor + 2.60	Baa1/BBB+
Class B2 notes	74,500,000	3-mo. Libor + 3.25	Baa2/BBB
Class B3 notes	20,000,000	3-mo. Libor + 3.70	Baa3/BBB-
Class I subordinated notes	86,000,000	6.00	NA/BBB-
Class II subordinated notes	24,000,000	NA	NA
	$ 2,000,000,000		

Mortgage contraptions proliferate



*through September 15
source: Thomson Financial

tection, and these funds it distributes to its investors. Money cascades down the totem pole of credit, with the highest-rated securities (the Class A1S notes, in this case) receiving first priority—after payment of fees and expenses to the managers and trustee, of course. If enough homeowners stop paying on time, Aquarius must make whole the buyers of protection, at which point the Aquarius investors (starting with the lowest-rated tranches) stand in line for a haircut.

There are plenty of loans in the Aquarius constellation—loans held outright or only referenced. The structure is, as noted, only 90% synthetic; 10% of its assets are invested in actual mortgages, or, more exactly, in actual tranches of mortgage-backed securities. Do you wonder if, by investing 90% in CDS and only 10% in cash CDOs, you bear any additional credit risk—not only the risk of the mortgages going bad but also the risk of a counterparty keeling over? Bulls insist not.

Anyway, the Aquarius structure has 51 issues behind the cash CDO component of the structure and another 129 issues that serve as reference entities for $1.4 billion in CDS contracts, for a grand total of 180. Colleague Dan Gertner sampled 40 of them. California dominated, he relates; one issue was 50% exposed to the Golden State. The 40 had an average of 6,500 loans at origination, he says. Projecting that number to all 180 issues suggests that Aquarius has exposure to about 1.2 million loans.

Performing due diligence on 1.2 million loans sounds like just the thing that nobody would do, not even in this age of "liars' loans," and interest-only and negative-amortization loans. Bulls would reply that structures like Aquarius' are stress-tested for changes in mortgage prepayment speed as well as for the timing and incidence of defaults. "We have a default probability generator model that runs a Monte Carlo multi-step simulation default probability model. . . ," a man from Fitch advises Gertner. What we wonder is whether the stress tests take full account of the unprecedentedly open-handed lending practices of recent years. Possibly not.

Demand for the junior-most tranches of these mortgage structures is reported to be red hot. "Magnetar Financial, an Evanston, Ill.-based multi-strategy hedge fund, is dominating the market for asset-backed securities collateralized debt obligations by buying bespoke deals in massive sizes," discloses the August 11 *Derivatives Week*. "The fund has enlisted a clutch of Wall Street firms to structure full-capital structure deals in which it buys the equity slice. . . . The deals are being pushed through in such size that spreads are tightening and structurers gripe it is becoming difficult to ramp. It is also becoming difficult to place the rest of the capital structure."

Reports have it that Magnetar hedges its equity exposure by buying protection on the BBB-rated tranches in the deals in which it invests. (The fund did not respond to Gertner's requests for comment.) If so, its management may reason that the world is not coming to an end and the equity tranches will likely pay 20%, but that, if worse came to worse, the BBB tranches, too, would get wiped out. Even absent such a calamity, the cost of the hedge is hardly onerous compared to the hoped-for equity return; the BBB slice yields Libor plus 300 points or so.

Of course, timing is critical. Bulls observe that the equity gets paid in relatively short order, after the so-called step-down, or trigger date, which typically falls three years after the issue date. "Everyone is playing the same game," a non-bullish practitioner tells Gertner, "which is: 'As long as the problems don't occur too soon, we are all okay.' This is a very important thing to understand."

We do understand that, at least.

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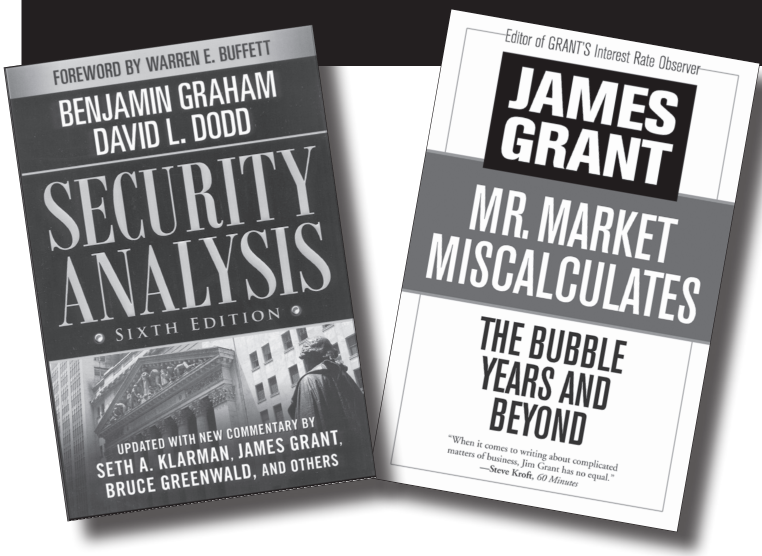

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