Derivatives & Alternative Investment

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12:23 AM

Reading 56 Derivative Markets and Instruments

Credit derivatives:

A credit derivative is a class of derivative contracts between two parties, a credit protection buyer and a credit protection seller, in which the latter provides protection to the former against a specific credit loss.

Total return swap: buyer - pay all returns on int+principal + any changes in bond's market value

Seller - pay either a fixed or floating int rate

Credit spread option on diff between bond's yield and yield on a benchmark default-free bond

Buyer - pay option premium on the desired strike spread

Seller - pay established payoff

Credit-linked note: linked with a default risk bond, and if the bond/loan defaults, the principal payoff is reduced accordingly

Credit default swap (CDS)

Asset-backed securities: payments divided into slices, called tranches.

An asset-backed security is a derivative contract in which a portfolio of debt instruments Is assembled and claims are issued on the portfolio in the form of tranches, which have different priorities of claims on the payments made by the debt securities such that prepayments or credit losses are allocated to the most-junior tranches first and most-senior tranches last.

Mutual funds

Exchange-traded funds(ETFs)

Collateralized mortgage/bond/loan/debt obligation(CMO)

Hybrids

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| Reading 57 | Basics of Derivative Pricing and Valuation |

Reading 58 Alternative Investment

* Hedge fund: private investment managing portfolios of securities and derivative positions.
* Private equity funds: not listed on a public exchange, or intending to take private
* Venture capital: start-up with high growth potential
* Real estate: private commercial real estate equity, private commercial real estate debt, public real estate equity, public real estate debt
* Commodities: physical commodity products
* **Infrastructure**: **greenfield** of building new; **brownfield** of expanding or improving exist, publicly listed master limited partnership(MLP) is brownfield existing with lower return, but emphasize more on income generation.
* Other

Exit strategies:

* Trade sale
* IPO
* Recapitalization
* Secondary sales
* Write-off/liquidation

Due diligence:

**A Typical Due Diligence Process**

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| Organization | * + Experience and quality of management team, compensation, and staffing   + Analysis of prior and current funds   + Track record/alignment of interests   + Reputation and quality of third-party service providers (e.g., lawyers, auditors, prime brokers) |
| Portfolio management | * + Investment process   + Target markets/asset types/strategies   + Sourcing of investments   + Role of operating partners   + Underwriting   + Environmental and engineering review process   + Integration of asset management/acquisitions/dispositions   + Disposition process, including its initiation and execution |
| Operations and controls | * + Reporting and accounting methodology   + Audited financial statements and other internal controls   + Valuations—frequency and approach(es)   + Insurance and contingency plans |
| Risk management | * + Fund policies and limits   + Risk management policy   + Portfolio risk and key risk factors   + Leverage and currency—risks/constraints/hedging |
| Legal review | * + Fund structure   + Registrations   + Existing/prior litigation |
| Fund terms | * + Fees (management and performance) and expenses   + Contractual terms   + Investment period and fund term and extensions   + Carried interest   + Distributions   + Conflicts   + Limited partners’ rights   + “Key person” and/or other termination procedures |