



Quarter 2, 2008, Volume 23, No. 2

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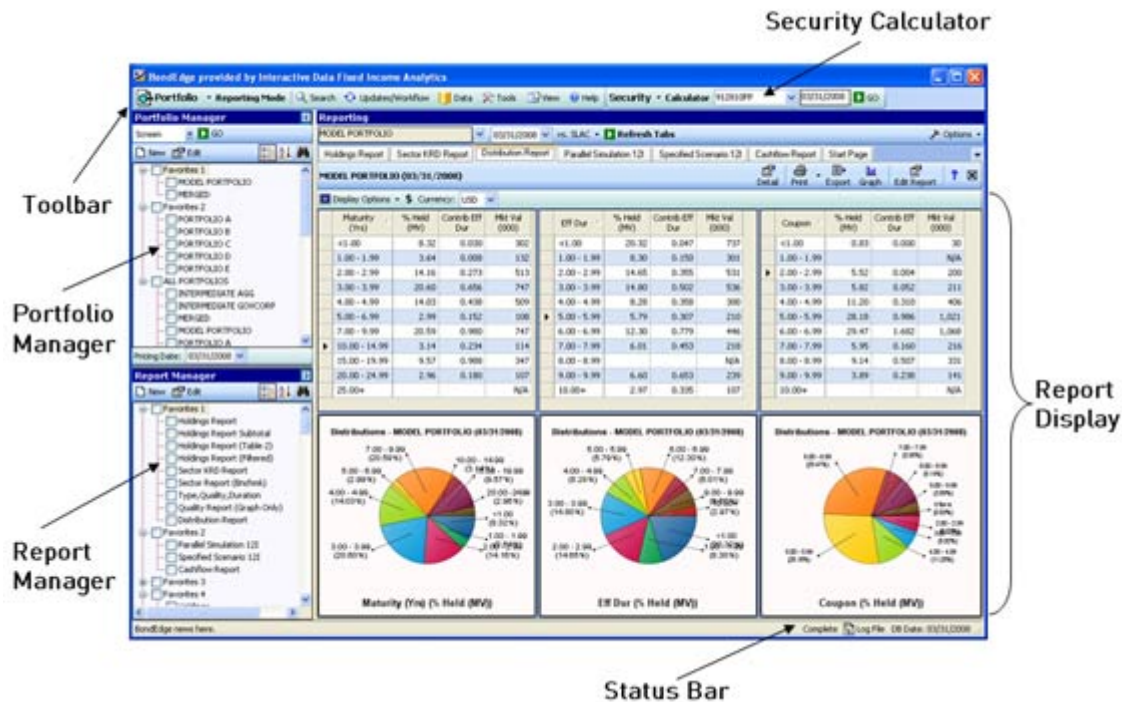
## Letter from the President: **Official Launch! BondEdge® Next Generation**

I wanted to communicate some significant developments at Interactive Data Fixed Income Analytics and invite you to join us for our official launch of the Next Generation of BondEdge® at the 2008 BondEdge Annual Fixed Income Workshops.

During 2007, we invested heavily in the re-development of the BondEdge product. While it will remain a desktop application in response to client demand, in its next generation deployment BondEdge utilizes a more modern technological framework which employs Microsoft® .NET development tools and C# as the programming language. Since 1979, this is the fourth deployment of our products, having previously delivered mainframe, then DOS, then Windows® generations.

The benefits that clients will receive from this new product include:

- a more intuitive graphical user interface with greatly expanded functionality and easier navigation incorporating feedback from every segment of our client base
- a re-architected report generation capability which will reduce the time to market of new enhancements
- a much more powerful report writer which will allow clients to create their own look to all types of reports including holdings, aggregation, simulations and cashflows



We will continue to support the Windows version of BondEdge that is presently being utilized by your organization; database structures are being maintained between the old and new products such that this will be the case. While we fully expect that clients will be interested in rapidly transitioning to the new platform, we would like this to be on your time schedule rather than ours.

Concurrent with the re-developed BondEdge product, we have commenced work in our Research Group to re-architect the analytical engines that operate behind the scenes. While this will pave the way for us being able to deliver proprietary analytical enhancements more rapidly, it will also open up the ability for clients to integrate third party prepayment models and cashflow engines into the BondEdge platform.

If you are interested in joining us at the workshops, please visit <http://www.interactivedata-fia.com/ws08> to register.

We remain completely committed to delivering you improved tools to assist you with your business challenges. As always, I welcome feedback from you in terms of how we can improve our services.

Best regards,

Laurie S. Adami  
President  
Interactive Data Fixed Income Analytics

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## 2008 BondEdge Annual Fixed Income Workshops: *Time is Running Out!*

**Time is running out to register** for the **2008 BondEdge Annual Fixed Income Workshops** in New York and Chicago. Last year's workshops were a great success and we are certain that our upcoming New York and Chicago events will be no exception.

The Annual Fixed Income Workshops will be presented in **three tracks**, and will cover fixed income theory as well as practical applications of various BondEdge features. This year we are featuring sessions specifically designed to address current issues in fixed income as well as a dynamic and interactive demonstration of **BondEdge Next Generation** with real-world examples of how BondEdge clients will benefit. And! We have secured a **lunchtime guest speaker, Andrew Davidson, founder and president of Andrew Davidson & Co., Inc.**, a quantitative research and prepayment modeling firm. Mr. Davidson will share insights on the mortgage market, including the subprime mortgage lending crisis, from his unique perspective. We hope you will be able to join us this year at one of the following locations:

**Tuesday, May 13**

New York (New York Financial District)

**Thursday, May 15**

Chicago (Magnificent Mile)

While the topics are presented in lecture format, the event is intended to be as interactive as possible; we encourage attendees to ask questions during the sessions or during the break times provided. This year's workshop sessions are:

	TRACK A	TRACK B	TRACK C
8:00a	Registration & Breakfast Begin		
8:30-9:00a	Keynote Address – breakfast room		
9:00-10:30a	BondEdge® Next Generation – breakfast room		
10:30-10:45a	AM Break		
10:45a-12:00p	Performance Attribution in BondEdge	Quantitative Modeling Enhancements	Analytix Direct™ Case Studies
12:00-1:30p	Lunchtime Guest Speaker! Mortgage Market Insights		
1:45-3:00p	Corporate Spreads & Default Risk	Liability-Driven Investing in BondEdge	Quantitative Modeling Enhancements
3:00-3:15p	PM Break		
3:15-4:30p	Private Wealth Management Trends & BondEdge Applications	Derivatives in Portfolios – Measuring the Impact	Performance Attribution in BondEdge
4:30-5:30p	Cocktails & Hors d'oeuvres		

To view detailed session descriptions, please [click here](#).

To register, please [click here](#).

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## Interactive Data Fixed Income Analytics to Participate in Spring Municipal Conference

We are pleased to announce Interactive Data will serve as **Silver Sponsor at the NFMA Annual Conference** on May 6-9 in Miami Beach, FL. Interactive Data Fixed Income Analytics will exhibit alongside Interactive Data Pricing and Reference Data and will **sponsor a luncheon on May 7**. The event will be a great opportunity to interface directly with Interactive Data representatives in an interactive setting.

<b>Date(s):</b>	<b>Event:</b>	<b>Location:</b>
May 6-9	National Federation of Municipal Analysts (NFMA) Annual Conference	Miami Beach, FL

For more information about the NFMA conference, please contact Lisa Good at (412) 341-4898 or via email at [lgood@nfma.org](mailto:lgood@nfma.org) and mention Interactive Data Fixed Income Analytics.

**For the complete Interactive Data Fixed Income Analytics 2008 Tradeshow, Seminar & Conference**

Schedule, please [click here](#) or call Interactive Data Fixed Income Analytics Marketing at (310) 479-9715.

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## FAS 157 – Fair Value Measurements

FAS 157, the accounting standard that defines fair value reporting of financial assets and liabilities, became effective as of November 15, 2007. FAS 157 requires that companies disclose the methodology used to value their investments, so it is not surprising that we have fielded a number of inquiries recently about the source of prices in BondEdge. Also, given the crisis of confidence caused by plummeting sub-prime mortgage valuations and the market's outright inability to price many ABS and CDOs of ABS, it is understandable that portfolio managers, their clients and their auditors are focusing on the issue of valuation. While BondEdge is not a pricing source and therefore cannot be relied upon to respond to FAS 157-related requirements, we thought it would be useful to provide some background about FAS 157.

### FAS 157 Overview

In a nutshell, FAS 157 is designed to give investors and other stakeholders information about the source of information used to price investments as well as other assets and liabilities. One goal of FAS 157 is to indicate how objective or subjective are the valuations presented in financial statements. As explained below, FAS 157 establishes a hierarchy of inputs, recognizing that some prices can be obtained directly from exchanges, some are observable from actual, same-day trades, while in many cases only a "modeled" price is available.

FAS 157<sup>1</sup> defines *fair value*, establishes a framework for measuring fair value, and requires statement preparers to disclose information about their fair value determinations in their financial statements. It establishes a fair value hierarchy based on the nature of data inputs used to determine fair value, and statement preparers are required to value assets using assumptions that market participants would employ to value that asset. When other assumptions are used to value an asset, FAS 157 requires that additional information about the assumptions be disclosed, along with the effects on earnings or changes in net assets for the period.

### Inputs to Fair Value Determinations

FAS 157 states that "*inputs* refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk..." It characterizes inputs as observable or unobservable, and requires that statement preparers "maximize the use of observable inputs and minimize the use of unobservable inputs."<sup>2</sup>

- "**Observable inputs** are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity."
- "**Unobservable inputs** are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances."<sup>3</sup>

### Fair Value Hierarchy

FAS 157 sets forth a fair value measurement hierarchy for inputs. When a valuation utilizes inputs that are in different levels, the fair value hierarchy level is "determined based on the lowest level input that is significant to the fair value measurement in its entirety."<sup>4</sup> The fair value hierarchy levels are summarized below.

- **Level 1 inputs** are "quoted prices (unadjusted) in active markets for identical assets" for the

instrument or security to be valued. A commonly cited example is a New York Stock Exchange closing price.<sup>5</sup>

- **Level 2 inputs** are inputs that are “observable for the asset or liability, either directly or indirectly”. FAS 157 provides several examples of level 2 inputs, including: “quoted prices for similar assets and liabilities in active markets”; “quoted prices for identical or similar assets or liabilities in markets that are not active...”; “interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks and default rates”; and “inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).”<sup>6</sup>
- **Level 3 inputs** are “unobservable” and contain the assumptions of the party fair valuing the asset or liability. FAS 157 states: “Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any market activity for the asset or liability...”<sup>7</sup>

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As noted above, BondEdge is not a pricing service. The prices in BondEdge are intended to be indicative of current market levels and are provided as a courtesy in support of our analytics but are not intended to be used as an official source for the purpose of reporting investment values. Therefore, we cannot offer any official pricing methodology papers for FAS 157 purposes. For questions regarding how the various security types in BondEdge are modeled, please refer to the document “A Quick Guide to Security Models in BondEdge” (updated October 2007, available via the BondEdge Private Client Website).

<sup>1</sup> Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 157: Fair Value Measurements*, (September 2006), effective for financial statements for fiscal years beginning after November 15, 2007.

<sup>2</sup> *Ibid.*, 9.

<sup>3</sup> *Ibid.*, 9.

<sup>4</sup> *Ibid.*, 9.

<sup>5</sup> *Ibid.*, 10.

<sup>6</sup> *Ibid.*, 11.

<sup>7</sup> *Ibid.*, 11-12.

If clients have FAS 157 designations in their accounting system, values can be imported via the Expand file into the Custom Report Writer for reporting, scanning, etc. Please contact your BondEdge Consultant for assistance.

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## ABS vs. CMO: What is the Difference?

As the mortgage market continues to be roiled by the credit woes of the sub-prime sector, a number of clients have asked us how we determine whether a structured finance deal should be classified as an asset-backed security (ABS) backed by Home Equity Loans, or a non-Agency CMO. While it seems like a simple question, the answer is not as straightforward as one might think. The bottom line is, we often have to make a judgment call, based on information in the prospectus, the deal’s name, and knowledge of the type of collateral associated with a given issuer to classify a deal as either a home equity ABS or a non-Agency CMO.

Deals that are unequivocally backed by sub-prime collateral are labeled as Home Equity Loan deals, which are classified as a type of ABS. This classification has historical roots based on the original meaning of a Home Equity Loan as a second lien on the property that was supported by the property’s value in excess of the balance on the first lien mortgage. These original home equity loans (the proceeds of which were used by homeowners for a variety of purposes) were seen as qualitatively different than the first lien mortgages which typically had longer tenors and more interest rate sensitive prepayments so they were justifiably viewed as a separate asset class, an ABS. Over time, the market evolved to the point where home equity loans are now first lien mortgages issued by lenders to homeowners whose credit-worthiness does not qualify them for conforming loans; issuers rely on the property’s value as the source of repayment on the loans (and as long as home prices continued to appreciate this seemed to be a good lending strategy, but we all know how that story has turned out...).

On the other hand, non-Agency CMO deals are backed by various kinds of non-conforming first lien

mortgages. If a loan does not meet the conforming criteria due to size it is a Jumbo loan. This collateral has the same (or greater) propensity to prepay than standard conforming loans with equivalent terms and since there is no reason to believe that jumbo loan borrowers are of sub-prime credit quality, if a prospectus specifies that the deal is backed by these loans we readily classify it as a non-Agency CMO. However, the gray area is with deals that are backed by Alt-A loans, those that failed to meet FNMA/FHLMC criteria for conforming loans due to insufficient documentation or other reasons but are not labeled as B/C loans (loans made to borrowers who have filed for bankruptcy or have negative credit histories). Alt-A loans may not be "sub-prime" per se, but they may not be too far off in terms of average FICO scores, etc., from sub-prime loans. On the other hand, Alt-A's may be quite a bit more credit-worthy than the HEL sector and should not be combined with them. It used to be that HEL deals were structured with an over-collateralization (OC) feature while non-Agency CMO deals relied solely on the credit support of the subordinate tranches. However, this is no longer true as we now see OC structures in both HEL and non-Agency CMO deals.

As the market continues to shake out, there is an understandable need to report one's exposure to sub-prime mortgages. However, to the best of our knowledge, there is no standard way of definitively classifying deals as either sub-prime HELs or non-Agency CMOs for the reasons described above. On a positive note, we continue to expand our coverage of these assets and, as of year-end 2007, we have modeled 97%-98% of deals classified as either Alt-A or HEL. As always, we welcome your comments and feedback.

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## ***Now Available!* Interest Rate Swap Indices**

As of version 5.60, *BondEdge* will provide interest rate swap indices. Construction of both par swap indices and zero coupon swap indices with maturities of 1, 2, 3, 5, 7, 10, 15, 20, and 30 years is now complete. In this article, we describe the design of these indices and motivate their use.

Compelled by anxious investors, new accounting rules, and pension fund legislation, investment managers are switching from traditional investing to liability driven investing (LDI). LDI mandates benchmarking with indices that have durations similar to liabilities. Since the swap indices, like interest rate swaps themselves, have both short and long durations, they are appropriate for use with a variety of liabilities.

By definition, interest rate swaps are private two-party deals that allow one party to exchange variable rate income based on LIBOR, the London Interbank Offered Rate, for fixed payments from the other party. The swap is described as a *receiver* swap for the party receiving fixed amounts and paying variable amounts and as a *payer* swap for the other party. The variable payments are typically made quarterly using the 3-month LIBOR rate observed at the beginning of each quarter, while the fixed payments are made semiannually. At the swap's inception, the parties agree on a *notional amount*, a fixed value of hypothetical principal that is used to calculate payments. For par swaps, the interest rate of the fixed side is the *swap rate*, determined by equating the present values of the cash flows of the variable and fixed sides of the swap based on expectations of the LIBOR over the life of the swap. The cash flows used in this calculation are the actual payments made throughout the life of the swap plus the notional amount paid hypothetically at maturity. At the beginning of every quarter, the price of the variable stream of payments is par because the payments match the expected interest. For a fair trade, the price of the stream of fixed payments made at the swap rate must also be par at the swap's inception. As a result, this swap is called a *par swap*. Suppose instead that one party makes the variable payments as above while the other party makes no payments. This trade, a *zero coupon swap*, would not occur in a competitive market because the present value of the fixed stream of payments is less than that of the floating stream; it is just the discounted notional value.

Although interest rate swaps are private party deals that are not listed on any exchange, they are highly standardized for several reasons. The swap market has high liquidity and, with over \$200 trillion outstanding notional value at the end of 2006, high volume. Unlike the Treasuries or agencies markets, the swap market has many equal participants. Finally, swap rates are well publicized. As a result, the bid/ask spreads for swaps are very low. Swap rates and their bid/ask spreads can be accessed within *BondEdge* by creating a new security of type "Interest Rate Swap" in the *Security Calculator* and clicking on "Swap Rates". Due to low variability, the swap market for a particular maturity can be captured by a single par swap.

*BondEdge* swap indices are designed to capture returns of generic receiver swaps. Each *BondEdge* swap index can be viewed as a portfolio containing a single receiver swap and a cash investment of the notional amount at 3-month LIBOR. The cash investment is necessary because swap prices include the receipt of the notional amount at maturity. At the end of three months, the LIBOR payment required by the receiver swap is exactly cancelled by the amount received from the cash investment. The net effect is a bond with price equal to the present value of the stream of fixed semiannual payments made at the rate of the swap (either the swap rate or 0%) plus the notional amount paid at maturity. Swap indices are implemented in *BondEdge* in this bullet bond equivalent form.

On the last business day of the month, a *BondEdge* portfolio of a swap and a cash investment at LIBOR (equivalently, a bullet bond portfolio) is created for each swap index. Returns are calculated daily based on swap rates for that day. Since swap rates derive from LIBOR, an average lending rate for AA banks, the swap index returns are related to the long term expectations of the returns of leading banks. Suppose swap rates increase on the first business day of the month. The price of a receiver par swap decreases from its par price at inception, and the total return for that day is the amount of this decrease. We emphasize that the swap indices provide the returns of *receiver* swaps. In fact, there is no need to model the returns of a payer swap: Regardless of swap maturity, the returns of a payer par swap plus a cash investment of the notional amount in a bond with coupon equal to the fixed rate of the swap are just that of investments at 3-month LIBOR. To ensure the swap indices represent the active portion of the market, they are rebalanced monthly. On the last business day of the next month after the daily total return is calculated, the swap and the investment at LIBOR are replaced by new ones based on the LIBOR and the swap rate for that day.

*BondEdge* users will be able to benchmark their portfolios against the swap indices in the *Indices*, *Compare* and *PART* modules. Pension funds implementing LDI and investment managers with long-term investment goals may find the long maturity par swap indices and the zero coupon swap indices useful, while money managers and banks evaluating their funding costs may find the short duration indices useful. Swap indices can be blended using the "Weighted Indices" option to give intermediate duration benchmarks. Blending equal amounts of all swap indices will give an index similar to existing total return indices for swaps. For a precise comparison of the excess returns of a portfolio to swaps, users can blend the swap indices to match the key rate durations of the portfolio.

The *BondEdge* interest rate swap indices constitute a new toolbox of benchmarks with durations ranging from less than 1 year to 30 years. By using duration matched benchmarks, the investment manager may obtain clearer comparisons of portfolios, individual securities, and market slices.

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## BondEdge News

**BondEdge Version 5.60 –  
Pre-release scheduled for May 31st**

*BondEdge version 5.60 includes a number of enhancements related to mortgage-backed securities analysis as well as new Issue-level Performance Attribution custom report engine, among other features.*

**Mortgage-Backed Security Analytics** – As the turmoil in the RMBS market continues to challenge investors, we have taken a number of steps to provide enhanced analytical capabilities in this area:

- **Credit triggers for sub-prime/Alt-A deals**
- **Loss Modeling** – Ability to input a forward-looking default rate and loss-severity assumption.
- **Incorporating Recent Historical Prepayment Speeds** – With this version, we will now modify the base-case speeds generated by our non-Agency and HEL prepayment models to reflect the average prepayment speed over the most recent six months for the collateral backing the deal.
- **Agency Prepayment Model Adjustments**

**Factors-Based, Issue-Level Attribution Reports** – Ability to build customized reports showing the various sources of return for the individual issues in your portfolios, including Income Return, Paydown Effect, Sector/Quality Effect, etc.

**CDS and Interest Rate Swap Import** – Ability to import credit defaults and interest rate swaps into BondEdge, reducing manual data entry.

**Weighted Indices in Returns-Based Attribution Reports** – Clients who use custom weighted indices as performance benchmarks can now include these indices in a Returns-Based Attribution analysis.

**Enhanced Analytics for Callable Bonds** – We have added a new Call Announce tab on the Security Calculator screen to show Call Announcement information for Corporates, Agencies and municipal bonds.

**Liability-Driven Investing Optimization with Interest Rate Futures and Swaps** – Ability to construct optimal portfolio structures that include Interest Rate Swaps and/or Futures contracts.

**Credit Default Swap Analytics** – BondEdge Enhanced CDS analytics now incorporate the spread duration of CDS in the Tracking Error with Correlations analysis to help quantify Sector/Quality mismatches affected by CDS exposure.

[Click here](#) for a complete list of release features with detailed descriptions.

*Clients who need assistance upgrading to version 5.6x or wish to install a test version before upgrading a production system should contact their BondEdge Representative or the Client Services Group for assistance.*

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