



The Clifton Advisor

Newsletter of The Clifton Group

Winter 2007

Swaps – Getting Started

Institutional clients are showing increasing interest in learning about swaps, their applications (especially Alpha Porting and Liability Driven Investing), and the process for introducing this valuable financial management tool to portfolios. This article describes the last of these interests: the process for swap implementation. Investors should be aware that the swap implementation process can be rather lengthy and expensive, but a derivatives based overlay manager, often with the help of specialized external counsel, can help institutional investors navigate the swap process. This article is written assuming that a centralized risk manager (“CRM”) will be used. A CRM may be an existing manager charged with additional overlay management, an internal fund manager, or a third party hired for these specialized activities.

DOCUMENTATION

Most over-the-counter transactions are documented under the International Swaps and Derivatives Association (“ISDA”) documentation. ISDA documentation is comprised of a modular set of documents.

These documents include¹:

- ISDA Master Agreement Standard Terms
- Schedule
- Confirmations
- ISDA Definitions
- Credit Support Documentation

¹ Source: “Documentation of Over-the-Counter Derivatives,” Law Gazette, April 2001

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ISDA Master Agreement

The ISDA Master Agreement (“Master”) is the first document module. Once signed, it governs all past and future individual transactions agreed to between the counterparties.

The Master consists of the standard terms (‘Standard Terms’) and the Schedule. The Standard Terms include provisions relating to interpretation, conditions precedent, netting,

withholding tax, representation, undertakings, events of default, termination events, early termination, and governing law. Although these are ‘standard’ terms and conditions, they are meant to be negotiated and customized to suit both counterparties. Many of the Standard Terms are cross-referenced to the Schedule.

Schedule

The Schedule is used to customize the Master by amending the Standard Terms and specifying certain details for the Standard Terms.

Items negotiated in the Schedule include:

- Termination Events (e.g. Net Asset Value decline, Ratings decline)

- Agreements to Deliver Documents
 - Calculation Agent
 - Governing Law (e.g. New York or London)
 - Additional Representations
- Negotiating the Schedule is often the most contentious part of the ISDA

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documentation process. How favorable an agreement the manager working with legal counsel can negotiate often depends on the relative credit rating of the client. The negotiation of the Schedule typically takes weeks or months (or longer) depending on the particular situation. The time required to negotiate the Schedule and other documents (described below) is

typically longer for ERISA clients than for non-ERISA clients. This increased time is often necessary due to negotiation of representation relating to ERISA's prohibited transactions rules and the involvement of Directed Trustees (for example, in the post Enron era, Directed Trustees have a greater responsibility to independently evaluate certain financial transactions).

Confirmations

Individual transaction terms are typically agreed to over the phone. The oral terms of the transaction are documented in a Confirmation ("Confirm") by the initiating counterparty and forwarded to the other counterparty for its acceptance. The Confirm consists of mainly economic and financial payment terms and is usually only three to four pages long for non-complex transactions. All Confirms form part of the Schedule, which in turn forms part of the Master Agreement. Hence, while a Confirm contains mainly the economic

and financial payment terms, the legal aspects of the Confirm are governed by the Master Agreement via the Schedule. If there are any conflicts between the Master, Schedule, and Confirm, the Confirm takes precedence over the Schedule and the Schedule takes precedence over the Master. Thus, careful attention must be paid to each new transaction Confirm to ensure new or unacceptable terms have not been added by the counterparty.

ISDA Definitions

In the interest of keeping documentation manageable, relevant ISDA definitions are adopted into the

Confirmation. There are multiple ISDA Definitions booklets which apply to different classes of derivatives.

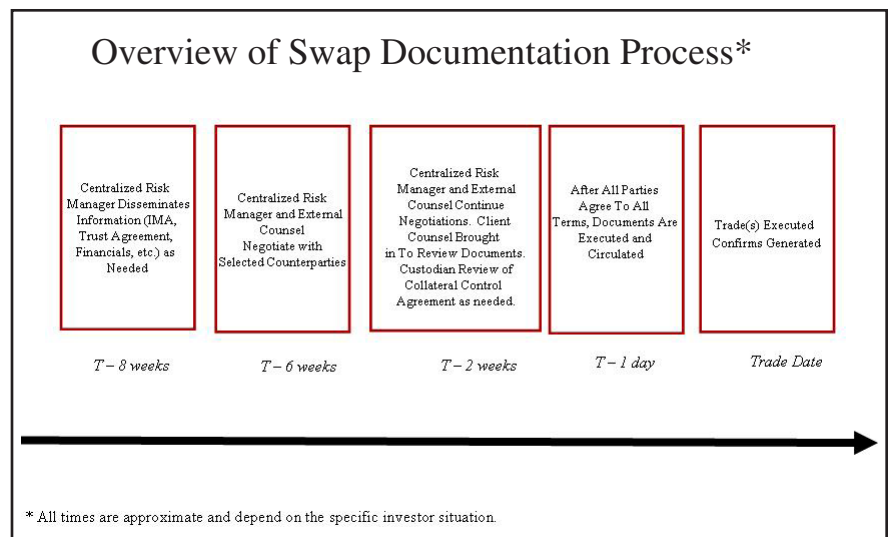
ISDA Credit Support Documentation

In many derivatives transactions, collateralization is required to mitigate credit risk. Most collateralization transactions are documented under the ISDA Credit Support Documents. In the United States, the most common collateral document is the Credit Support Annex ("CSA"). The CSA, like the Master, is divided into a boilerplate section and a negotiated section (Paragraph 13 of the CSA). These Credit Support Documents are 'master' agreements governing every collateral transaction between the parties. The ISDA Credit Support documentation contemplates a 'two way' collateralization. In other words, either party may, at any given time, provide or receive collateral because of the mutual rights and obligations under a swap contract. The underlying rationale is that when a party suffers an 'exposure' (i.e. value of the collateral at hand is less than the market-to-market value), which fluctuates from day to day or even hour to hour, the swap transaction is in its favor ('in-the-money') and the other party must transfer sufficient collateral to bring the exposure back down to the Threshold.

Items that are negotiated in the CSA include:

- Eligible collateral
- Thresholds, including Minimum Transfer Amount
- Valuation mechanics

In many cases an Account Control Agreement ("ACA") will need to be established between the custodian and the counterparties. This document outlines the specifics of collateral transfers and the guidelines for the holding of the collateral.



Comment on Multi-Account or “Umbrella” ISDA Agreements

A recent trend in the asset management universe is the creation of multi-account or “umbrella” ISDA Agreements by CRMs. These Agreements are executed by class of client (e.g. ERISA, 1940 Act, corporate entity, government entity) with approved dealers. The investor agrees to be bound to the terms of the umbrella documents. The CRM transacts directly with the swap dealer as an agent for the investor. This structure removes all negotiation between the investor and the swap dealer. Legally, the investor is entering into a contract with the swap dealer, but has delegated

the responsibility for negotiating terms to the CRM. When tailored language is required by a particular situation, an addendum to the schedule can be created. Many market professionals like this structure because it usually reduces the lead time of proposed transactions and creates uniformity in operational issues for the CRM, thus mitigating the chance of error post trade (see below). Negatives of this type of arrangement include the reduced ability to structure specific terms and operational issues arising from consolidated accounts.

Process

A CRM will generally assume control of the ISDA process. Experienced CRMs will have established relationships with outside legal counsel specializing in negotiating over-the-counter transactions. Working with counsel, the manager will seek to negotiate ISDA documents in a manner that is fair to the client and consistent across counterparties.

Negotiation factors include price, documentation negotiation history, and market presence in the relevant product arena.

Once the documentation phase is complete, the CRM stands ready to implement. Generally, the CRM will only trade with counterparties that have ISDAs in place. The manager will work with both the client and

their consultant, if applicable, to design a strategy that will attempt to meet client objectives in a low cost and flexible manner. Consideration is given to liquidity constraints, counterparty credit risk, yield curve coverage, and other factors that may impact performance.

The time required to set up swap documentation varies widely by the number and type of counterparties selected and underlying instrument. In some cases, documentation can be completed in a matter of weeks. Other situations can take more than six months, particularly if there are significant credit terms to be determined.

Post Trade Position Management

Clients should be aware that there are position management issues to consider regarding swap transactions. Although swap positions generally require far less ongoing management than futures positions,

the client and the CRM will need to track swap cash flows, credit exposure levels, collateral movements (if applicable), and information flow as required by the ISDA documents.

Conclusion

Every situation is unique. Clients should be aware that setting up swap documentation requires some cost.

This cost includes:

- Time and actual expense of setting up documentation
- Oversight of CRM on execution of swap transaction(s)
- Oversight of CRM on ongoing over-the-counter position management

The value of utilizing swaps must be weighed against the cost before the client can make an informed decision.

Further information can be found at the following web sites or by contacting The Clifton Group. Please note that these web sites are not sponsored by The Clifton Group.

www.isda.org

<http://www.cfapubs.org>

<http://www.finpipe.com/derivatives.htm>

A Corner of Interest

■ The Clifton Group is pleased to announce that **Chris Uhas** has joined the firm as Vice President, Sales and Marketing. He will pursue new business opportunities and support clients located in the Northeast, Mid-Atlantic, and selected Midwestern states.

■ In March, 2007, Clifton relocated from its turn-of-the-century residence at 309 Clifton Avenue in Minneapolis to more traditional office space in Edina, MN. The move was necessary due to steady growth over the past twenty years and the increasing technology requirements of the business. The new location, in the Centennial Lakes Office Park, meets Clifton's current and anticipated needs. It is conveniently located near the airport and the downtown areas of Minneapolis and St. Paul. The move occurred during non-market hours to ensure uninterrupted operations and client service. Clifton recently celebrated the move with an Open House. Clients were invited to tour the space, enjoy some refreshments and music, and mingle with Clifton staff.

■ Clifton Principals continued to be active participants at industry conferences and workshops over the past year. The topics included centralized beta management in the context of alpha port program commitments and indexing strategies.

Promotions

Rich Bartell was promoted to Portfolio Manager in January, 2007.

Jeff Rodgers, was promoted to Assistant Portfolio Manager in January, 2007. He successfully completed Level III of the CFA Program.

Additions

Chris Haskamp joined the firm as Assistant Portfolio Manager in May, 2007.

Andrew Foster, Investment Analyst, joined the firm in September, 2006.

Matthew Liebl, Investment Analyst, joined the firm in May, 2007.

Charlene Wu, Staff Accountant, joined the firm in July, 2007.

Kyle Wislocky, Staff Accountant, joined the firm in September, 2007.

Ashley Kimble, Assistant Marketing & Sales Coordinator, joined the firm in May, 2007.

Other News

Megan Zhou, Special Project Manager, successfully completed Level III of the CFA Program.

Justin Henne, Portfolio Manager, successfully completed Level II of the CFA Program.

Ben Lazarus, Director of Sales and Marketing, successfully completed Level I of the CFA Program.

Alex Zweber, Investment Analyst, successfully completed Level I of the CFA Program.

Departures

Kyle Gaffaney, Staff Accountant, left The Clifton Group in August, 2007 to go to law school.

The People of the Clifton Group

Our featured employee this issue is **Amanda Barhite Carter**, CFA, Special Project Manager. Amanda joined The Clifton Group in September, 2004. Her current responsibilities include: over-the-counter documentation, risk management audits, client service, requests for proposal, and newsletter articles.

Prior to joining The Clifton Group, Amanda worked for ten years as a consultant to investment banks and corporations. She taught derivatives, capital markets, and financial math courses at investment bank training programs and corporate continuing education classes.

Before that, Amanda was a Vice President at JPMorgan in New York City working on the institutional swap marketing desk. While at JPMorgan, she was a founding member of the Municipal Swap Group and was on the team that executed JPMorgan's first public sector swap. Additionally, Amanda worked as a Financial Analyst in Investment Banking at Merrill Lynch and in High Yield Capital Markets at Donaldson, Lufkin, & Jenrette.

Amanda holds a BA in Economics from Yale and an MBA with a concentration in Finance from The Wharton School at the University of Pennsylvania. She is a CFA Charter holder and a member of the Twin Cities Society of Security Analysts.

Amanda has lived in Plymouth, MN since 1999 when her husband's job brought the family to Minnesota. She is married and has two children, Samantha and Drew. When not at The Clifton Group, she is usually in her car driving her children to and from various activities.

The Clifton Advisor is a publication of The Clifton Group Investment Management Company and has been developed for our clients, prospective clients, and other contacts interested in our firm. The Clifton group specializes in the use of options and futures to create customized strategies for its clients in the areas of: **Enhanced Core Management, Policy Implementation Overlay Service, and Risk Management.**

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