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Financial Analysts Journal > Volume 57, 2001 - Issue 1

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VALUATION

Risk and Valuation of Collateralized Debt Obligations

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Pages 41-59 | Published online: 02 Jan 2019

66 Cite this article Ahttps://doi.org/10.2469/faj.v57.n1.2418

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securities. Our analysis may provide useful approaches to valuation and diagnostic measures of risk.

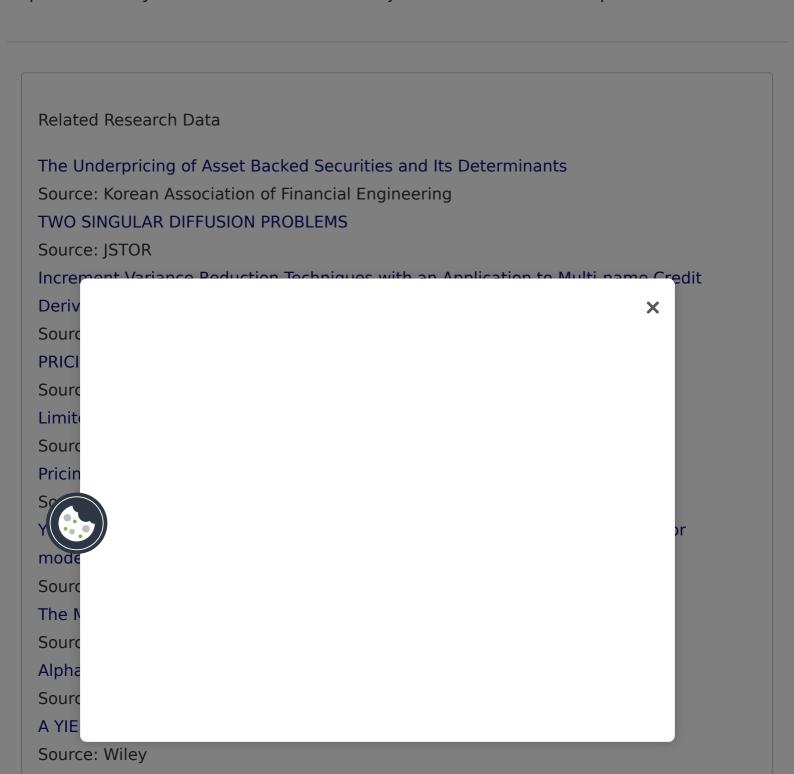
We concentrate on cash flow CDOs-those for which the collateral portfolio is not subjected to active trading by the CDO manager. The implication of this characteristic is that the uncertainty regarding interest and principal payments to the CDO tranches is determined mainly by the number and timing of defaults of the collateral securities. We do not analyze market-value CDOs, those in which the CDO tranches receive payments based essentially on the marked-to-market returns of the collateral pool as determined largely by the trading performance of the CDO manager.

In our analysis of the risk and market valuation of cash flow CDOs, we illustrate the effects of correlation and prioritization for the market valuation, "diversity score" (a measure of the risk of the CDO collateral pool that has been used for CDO risk analysis by rating agencies), and risk of CDOs in a simple jump diffusion setting for correlated default intensities. The main issue is the impact of the joint distribution of default risk of the underlying collateral securities on the risk and valuation of the CDO tranches. We also address the efficacy of alternative computational methods and the role of diversity scores.

We show that default-time correlation has a significant impact on the market values of The priority of the senior tranche by which it is effectively "short a individue! + call option X market f the equity value to has no clear piece, w effect or tion "written or sufficier Spre sitive to the ng the contribu nstant the relatively degree small ro Regardir diversity framework scores c

we propose, these scores can be used to obtain good approximate market valuations for reasonably well-collateralized tranches.

This work was supported in part by a grant from the Gifford Fong Associates Fund at the Graduate School of Business, Stanford University. We are grateful for discussions with Ken Singleton of Stanford University, Reza Bahar of Standard and Poor's, and Sergio Kostek of Morgan Stanley Dean Witter. Helpful comments and research assistance were provided by Jun Pan. We are also grateful for several helpful suggestions for improvement by Kazuhisa Uehara of the Fuji Research Institute Corporation.



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