OP-ED: Let's Be Reasonable About CDOs
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(This is one in a series of occasional opinion columns by market participants.)

By Mark Adelson

"Unreasonable" is a harsh term.

Yet, it's one that some, including money managers who have profited from the subprime troubles, are throwing around to describe complicated models that ratings agencies, Wall Street banks and investors used to evaluate complicated securities known as asset-backed collateralized debt obligations.

But if using historically based assumptions about how securities react to changing market conditions to model the performance of products like ABS CDOs was unreasonable, then the majority of the investing community lived in a state of lunacy during the housing boom years.

Instead of being "unreasonable," perhaps it was rigid adherence to models that led smart people to lose billions of dollars on such securities.

It's easy to understand why so-called correlation models were appealing. The highly evolved techniques of data analysis and statistical inference developed by scientists, engineers, and mathematicians are 100% rational and objective. Their results are repeatable. They are not vulnerable to influence by extraneous emotional or psychological factors. Accordingly, it is almost never unreasonable to tackle a problem in finance with quantitative tools.

Even though it is reasonable to use such modeling, the credit shakeout this year illustrates an important lesson: it is sometimes better to supplement the quantitative analysis with more qualitative tools.

Judgment, imagination, experience, and common sense are powerful tools that can improve an analysis that starts with historical data and statistical tools.

For example, market participants could readily observe that the major subprime lenders were offering loans on the same weak terms, to the same weak customers, through the same brokers, and applying nearly the same weak underwriting standards.

Although the trend toward uniformity of (weak) practices wasn't readily quantifiable, common sense argues that the performance correlation of ABS backed by the loans could be much higher than had been previously observed. Thus, the common-sense consideration of qualitative factors would support using a higher correlation assumption than could be justified by historical data alone.

Members of the "quantitative crowd" disagree with my view. They argue that judgment, imagination, experience, and common sense are non-rigorous, non-repeatable, and susceptible to influence or distortion by irrelevant psychological and emotional factors. I understand those arguments and I think they have some merit, but I still disagree. My disagreement, however, stops far short of viewing the purely quantitative approach as "unreasonable."

Research analysts (including me) generally are not shy about criticizing points of view with which we disagree. Several research analysts (including me) have sharply criticized the correlation assumptions used in the mainstream approaches for analyzing CDOs. If any of us could have called them "unreasonable," we likely would have done so eagerly.

The recent assertions that the mainstream correlation assumptions were "unreasonable" are unfair and unjustified on several levels. Disparaging a forward-looking analysis with the benefit of hindsight is inherently a cheap shot. Moreover, such criticism completely lacks credibility when it comes from someone who was silent on the subject at the time when expressing a view could have mattered. That is just what is happening now.

The bottom line is this: There is a lot of distance between "wrong" and "unreasonable." Reasonable professionals can differ about the best way to analyze complex financial transactions such as CDOs. The fact that one analysis turns out to have been more predictive after the fact doesn't mean that the alternatives were necessarily "wrong." It certainly doesn't mean that the alternatives were "unreasonable."

There is always room for fair criticism and debate in the realm of analyzing complex financial structures. Indeed, the anticipated level of losses on ABS CDOs should prompt a measure of introspection and reassessment by CDO professionals and other analysts who favor purely quantitative approaches. Introspection and reassessment are necessary and appropriate responses to the current situation, but they are hardly encouraged by unwarranted attacks.

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