MBS Mantra, LLC

Viewpoint

Flaws in Fixed Income Asset Management

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Samir Shah, CIO, MBS Mantra, LLC

Those of you who have seen MBS Mantra's marketing materials know that, at its core, our strategy seeks to exploit flaws in the structure of Fixed Income Asset Management ("FIAM"). **One of these flaws results in the loss of many Billions in returns to the Pension System. We have an ambitious long term plan to solve this structural flaw in Fixed Income to improve returns to the Pension System, and thus disrupt Fixed Income Asset Management.**

I have hinted at this flaw in a previous Viewpoint – ***Where are the Bonds***, dated October 19, 2016.

The flaw is the suitability mismatch between the custody and management structure of most bonds, namely in Separately Managed Account (SMAs), and in the structure of the US bond market.

The result of the flaw is this: money managers break up blocks of bonds – Roundlots - into Oddlots (typically less than $1mm in size) to allocate to their clients – typically Long Only Pensions and Endowments – in their SMAs.

<u>**Such investors are, in essence, buying Oddlots at Roundlot prices.**</u>

Since Oddlots usually trade at discounts to Roundlots, this allocations process locks in Negative Alpha for the Pension system. These losses remain unrealized until Oddlots are sold in the secondary market to satisfy a redemption request from an investor. However, they are real, and probably cost the pension system many tens if not hundreds of Billions of expected but lost returns.

Most institutional investors are unaware of these losses as they are masked by the cumulative returns from coupon and Beta-driven price changes. My constant questioning of consultants, trustees, and pension board members, at the conferences I attend and in office visits, suggests that many of these fiduciaries are unaware of this issue and do not compare their holdings statements from before a redemption with the realized proceeds of the redemption. **This lack of awareness allows this systematic flaw to persist.**

<u>What is the magnitude of this Problem</u>

I cannot directly find the size of Fixed Income assets held in SMAs, so we have to guess by working backwards.

The total size of the US Fixed Income Market is approximately $39.36T. (SIFMA Q4 2016)

http://www.sifma.org/research/statistics.aspx

Of this, \$3.74T is owned by Bond and Income Mutual Funds, according to ICI data (Bloomberg Ticker IF02IOS3 Index). (2/2017)

According to the NAIC, bonds owned by Insurance companies total \$3.5T (year end 2010)

http://www.naic.org/capital_markets_archive/110819.htm

The Fed owns \$4.2T in its SOMA account.

https://www.newyorkfed.org/markets/soma/sysopen_accholdings.html

Banks – approx. \$2.7T in US securities

https://www.federalreserve.gov/econresdata/releases/combanksal/current.htm

Foreign Holders of US debt - \$5.9T

These holders total \$20T, leaving us with about \$19.3T unaccounted for. Most of these are probably held at Fixed Income Asset Managers, in SMAs.

Most large asset managers do not show their AUM in SMAs on their website (one exception is Doubleline). Based on conversations with fixed income asset managers, many managers have a large percentage of their assets in SMAs, and not mutual funds.

In my estimation, on average, most Oddlots probably trade 1% (or point) cheaper than round lots. This does vary by asset class, and FINRA has been attempting to make this market more transparent through TRACE. The only asset class where Oddlots might not trade at a significant discount is US Treasuries, as the UST market is mostly electronically traded.

To be conservative, let us assume that the FIAM system's non-UST bond AUM in SMAs is \$10T.

1% of \$10T is \$100B - a sizable problem and significant amount of lost returns, and worth the effort to fix!

Why does this problem exist

I do not believe that this systemic problem is intentional in any way.

The first investment management companies probably all started out with SMAs, as they are ideal for equities and active management of equities. The structure probably got reused for Fixed Income as it was already there.

All subsequent entrepreneurs that started Fixed Income managers probably came from other Fixed Income management firms, and recreated what they knew and had experienced, instead of analyzing the market and identifying the appropriate way to manage Fixed Income assets.

In our opinion, the SMA investment structure is not suitable for the current structure of the fixed income market.

Let's first examine market structure of equities.

- There are a limited number of public equities, with a few thousand companies constituting the majority of the market capitalization.
- A company usually has a limited number of different share classes.
- As capital grows or is raised, a company continues to issue more of the same shares.
- A new share is no different than an old share.
- Since most shares are exchange traded, the price of a single share will not differ significantly from the price of a larger quantity of shares.
- Portfolio value can be ascertained with precision.
- In addition, each stock has many holders, improving liquidity.
- **The SMA structure can work well in the confines of this market structure. Large or small SMA accounts to be created with identical portfolios, risks and liquidity, without much friction. Active management and investor constraints can easily be facilitated. Holders of small SMAs can have returns that are similar to those of large SMAs.**

With bonds, this is not true. The SMA structure does not work well in the bond market framework, where there are over a million individual and unique bonds.

The problem lies with the way bonds are created – every new financing need results in a new bond. Bloomberg shows 279,950 individual corporate bonds, and 958,039 muni bonds. Any given issuer will have many bonds outstanding. For example, there are 583 GE bonds, each trading uniquely and with a limited number of holders. Almost all bonds trade in the OTC market, with limited liquidity.

The problem is even worse in the MBS markets, where the number of bond holders can be less than 5. A majority holder of a bond can effectively manipulate the price of an oddlot as he can be the best buyer is he so chooses, or not provide any liquidity at all.

To add insult to injury, a small SMA will realize different (and lower) total return than a larger SMA with the same bond portfolio, as smaller Oddlots trade at greater discounts compared to larger Oddlots.

As described above and previously, the allocation of unique bonds into a large number of SMAs leads to the fragmentation of bonds, and approximately 80% of all Non Agency MBS that trade in the secondary markets are Oddlots (using 2014 FINRA data). I suspect that other bond sectors have similar statistics.

Solutions

I have thought about this problem for many years, and founded MBS Mantra to solve this. I have identified two possible solutions to eliminate this problem that can work within the existing FIAM SMA structure.

The first solution is unlikely to happen, but is a good thought experiment. It will likely require regulation and control by the SEC, although socially conscious companies could easily implement it right away.

The proposal is to change the bond market structure to more resemble the structure of stocks, by reducing the number of bonds per issuer, thus reducing the total number of bonds, and increasing the size and fungibility of each bond.

This would also increase holders, and make the bonds more liquid. Bond issues could be large enough to be exchange and electronically traded. This would also reduce the cost of FIAM and fees for SMAs would drop.

One way to accomplish this would be for the SEC to mandate that each issuer only have a limited number of corporate bonds (plus money markets for operating capital needs) outstanding at any time. One limit could be 30 bonds, one for each year, although I would prefer maturity buckets and even fewer issues, maybe limited to 5 or 10 per issuer. A new long bond would only be issued when the shortest one matured, with the others rolling down the maturity ladder. To handle the premium/discount and income needs of investors, maybe all bonds should be zero coupons, with coupon streams being built synthetically from zeros.

If the company needed more debt capital, it could reopen one or all outstanding issues and issue more of any specific bond. They would get better execution, as liquidity would improve with larger outstanding bonds and more holders.

In mortgages, you could make all MBS a covered bond of the issuer. This is the norm in many countries, and was proposed in the US during the financial crisis, but never took off.

Such a bond market structure would work very well in a SMA landscape, or at least certainly better than the current market structure.

There is no chance this will happen, and it is almost a ridiculous suggestion given the powers in the market: the underperformance from illiquidity and oddlot trading is primarily captured by large banks, brokers and hedge funds that participate in the secondary markets. They will lobby to keep fixed income markets non transparent and illiquid, as the trading of Fixed Income bonds is a large part of their revenue.

Our analysis of the problem has led us to the identification of a second solution that is possible to execute within the SMA structure, in a market with a million bond cusips. The goal of this new solution will be to prevent the creation of Oddlots in the future by keeping Roundlots intact. We are not giving details here, as we believe that this is our IP. We have not come across any other Fixed Income manager that appears to have intentionally tried our solution.

Ironically, MBS Mantra currently exploits the fragmented nature of the bond markets and manages secondary market MBS bonds in SMAs, as they are already of a size that can be used in SMAs.

However, as MBS Mantra increases AUM and earns revenues, we will be investing in the creation of such an optimal Fixed Income Asset Manager. We hope to identify forward thinking sources of capital to realize this disruptive dream. Our success will also perform a social function of improving returns to the pension system.

I would love to hear your comments.

Samir Shah, CIO

MBS Mantra, LLC

sshah@mbsmantrallc.com

203-388-8356

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