FIXED INCOME

Adding Transparency to an Opaque Market

Bond markets lack the transparency of equity markets; most fixed income securities still trade in dealer-dominated, over-the-counter markets. Without a centralized exchange or transparency in pricing, finding the best price can be difficult. Hiring a transition manager like Northern Trust can help.

At Northern Trust, your transition management process starts when we discover the market value for each bond in transition. We then identify counterparties with the most interest in each particular bond, tapping into our knowledge of the markets and recent trading flows.

EXPERIENCE VALUING, TRADING BONDS

A transition manager needs bond trading expertise to understand and analyze fundamentals to determine a bond's value; experience soliciting bids and making judgment calls (plus the client's consent) about when and how to trade; and patience working on the bidding process. Because no single market-maker or investor will offer the best price for each bond in an entire portfolio, managers use many relationships to gather the best prices available. Depending on the security characteristics of each bond in your portfolio, Northern Trust will canvass multiple counterparties and select the counterparty offering the best price. If pricing diverges from our estimated fair market value, we may solicit additional bids. We undertake this time-intensive process for each bond regardless of the number or size of holdings in the transition.

Following are examples of bonds Northern Trust sold during recent transition events, which highlight some of the issues in bond trading and ways transition management can add value.

Know the bond's structure – Health & Education Municipal Bond

Understanding the structure of a bond is critical to evaluating how and where it will trade. This state municipal bond featured a 30-day rolling call that permitted the issuing agency to call the bond at par once every 30 days. Because this bond was callable at par, we believed a price of 100 was attainable for the client.

On the first day of trading, we reached out to multiple potential buyers to solicit bids. The highest bid received was 99.777 with a cover bid of 99.575. Because these prices fell short of our goal of selling at par, we did not accept this bid and our traders decided to try another method. The muni-bond was offered out on an electronic offer platform at a price at 100.125. Using this approach, we received queries in the following days from five different counterparties at varying prices and sold the bond at an average price of 100.083.

Evaluate fundamentals – Commercial Mortgage-Backed Security

Evaluating fundamentals – difficult and time-consuming for many asset-backed bonds – is necessary to determine fair value of any security. Our transition client held a commercial mortgage-backed security (CMBS) issued with a long maturity of 2045. Our analysis of the bond did not identify any significant weaknesses or issues in the bond's collateral. In fact, less than 1% of the commercial loans were on a watch list. Furthermore, similar CMBS tranches had outperformed other fixed income sectors at the time of the transition. Based upon our analysis, we expected to receive bids near the price of 105.48, which the client's custodian estimated this bond was worth.

Initial bids received at the outset of the transition were low, in our opinion. After several days of trading, the best bid received was 105.25 with a cover bid of 104.03. Because our traders felt this bond should trade at a tighter spread than the bids being received, they contacted several investors who currently held positions in the same security. From these buyers, we received two additional bids of 106.97 and 106.00 – more in line with our estimate of this bond's value. Because fundamentals were stable, we were able to take more time "working" this bond to find higher bids.

Evaluate fundamentals, part 2 – Fixed Rate CMO

Sometimes thorough analysis of fundamentals indicates declining values that are actually worse than they first appear. Such was the case with a recent transition portfolio that contained a senior class of a collateralized mortgage obligation (CMO) issued in 2006. At the time of transition, the bond was rated at CCC (originally rated AAA by Moody's and Standard & Poor's). The client's custodian had a price estimate of 60.95.

Our analysis identified problems with the bond not reflected in this price estimate. It had delinquencies in payments of 60-plus days exceeding 42.4%, including 21% of underlying loans in some stage of foreclosure, and rising. Nearly 70% of the loans outstanding were non-conforming sizes, which were particularly difficult to refinance at the time due to credit conditions. Some 67% of the borrowers obtained a loan despite providing limited or no documentation during the application process, a sign that many loans were probably fraudulently obtained. Even geographic exposure was disadvantageous: 69% of the remaining mortgages were in states facing some of the greatest declines in market values – California, Nevada, Arizona and Florida.

Much of the subordinated tranches had already eroded. During the prior six months, the default rate exceeded the voluntary prepayment rate by a nearly five-to-one ratio. Stress testing the bond indicated principal losses would likely result from any further defaults.

We sought and evaluated multiple bids. The best bid was 50, with cover bids at 49.5, 48.75 and 40.625. Because fundamentals were weak and declining, we consulted with the client and decided to sell the bond before fundamentals, and thus the price, would potentially deteriorate further.

Finding the best price takes time – Student Loan Security

Simply receiving multiple bids does not ensure the best bid. When selling an AAA-rated (by Moody's, Fitch and Standard & Poor's) student loan bond as part of a transition, we received multiple bids in the low 90s with a best bid of 94. Buying interest was muted because of the low coupon rate of 67 basis points. Because the bond was due to mature in four months, we were reluctant to sell much below par because full value would be received shortly. However, the client wished to conclude the transition by the end of the month.

We presented the client with three different options. The first option would take the current best bid at 94. The advantage to this strategy is to lock in the sell price and ensure liquidation by the client's stated deadline, but the downside is a certain loss of value. The second option was to continue to try to improve the bid. The upside here is that we might improve the price, but the downside is continued exposure to the bond and delay in execution. The third option was simply to hold the bond until maturity. We recommended, and the client agreed, to continue working the bond to find a better bid, but if none was found we would hold the bond until maturity. Three days later, we secured and executed a bid at 98.5.

It's not always about the name – A Large Corporate Bond

Sometimes the timing of a transition means trading in an unfavorable environment. This corporate bond was part of a liquidation right after the company had negative publicity related to its business operations. With a single A credit bond (as rated by Moody's, Fitch and Standard & Poor's) maturing in 2013, trading this bond did not need to result in a fire sale. The best dealer bid was 107.95, less than our expectation – primarily because dealers did not want to hold this volatile bond in inventory given current company news. So we solicited bids from numerous buy-and-hold investors. We identified an end-buyer more interested in taking a position in this security and sold the bond at 108.65.

There's no such thing as an easy bond trade – Mortgage-Backed Security

Even a simple bond must be carefully traded. This CMO was about as straightforward as they come. It was issued by a government-sponsored agency, had quality seasoned underlying collateral from 2003 and was based on 15-year mortgages with a short final maturity in 2018. With so much historical data for the bond, we could see it was paying down steadily, with a very predictable average life. A bond like this gives investors better current cash flow than other fixed income options. This looked like an easy trade, yet the best bid from dealers was 105.625.

Based upon similar bonds we had traded recently, we thought we could find better pricing by searching for the right buyer. This bond's structure made us think there was value in taking the extra time to show it to other investors who could appreciate its value. We eventually sold it at 106.125. When a bond like this comes across our desk, our traders are able to identify its value and market it to its full potential before accepting a bid. Our hands-on approach means our clients can receive the maximum value for their portfolio.

FOR MORE INFORMATION

To learn more about managing transitions, please contact Northern Trust's Transition Management team at 312-557-5173 or email ntgi_transition_management@ntrs.com.

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