

# Fixed Income Transitions – Analysis of a Growing Market

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As one of the largest global fixed income houses, fixed income restructures have always represented a significant proportion of J.P. Morgan's overall transition management business.

Here, we discuss how fixed income and equity transitions compare and the key points pension funds should consider.

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## Administrative set up

In many ways administrative preparation for a fixed income event is simpler than for an equity event. Many emerging market bonds trade in USD, for example, reducing some degree of currency management.

Settlements are also streamlined, with most bonds settling via DTC, Fed or Euroclear.

## Security universe and substitutability

The fixed income universe is composed of different segments, typically divided into government bonds, quasi government bonds, mortgage / asset-backed securities and corporate bonds. The corporate segment when compared with equities is quite large, with multiple securities per issuer, resulting in additional challenges and opportunities for portfolio creation and implementation.

Should a fund manager request a bond with limited availability, then suitable substitutes with similar characteristics e.g. duration, sector, rating, can generally be identified. Conversely, opportunities exist to maximize in-kind transferability to target managers by examining the characteristics of the target portfolio construction and relaying common characteristics of the legacy portfolio to find suitable / substitutable securities. For fixed income events, in-kinds are not simply based on common security identifiers.

Other security universe-relevant considerations include quality of the issuer, credit rating, the bond age, issue size, order size relative to issue size and the issuer / sector liquidity.

## Assessing trading risk

Fixed income restructures face many of the same risk factors as equity events, as well as issues unique to this opaque market. The following risk factors are inherent in both equity and fixed income transitions, the mitigation of which should be a core focus when designing each trading strategy.

### Risk factors common to both equities and fixed income

- Regional allocation shifts
- Country and currency allocation shifts
- Operational coordination
- Economic releases and earnings

### Fixed income-specific risk factors

In addition to the common factors above, there are considerations unique to fixed income events:

- Duration exposure shifts in the transition
- Credit shifts in the transition
- Sub-asset class shifts

It is important to manage trade timing so that the client is fully invested. For example, to maintain exposure in a transition out of government bonds into credit securities, the trader would stage the sells to match the speed at which target securities are located. This also mitigates duration risk.

**Pricing differences:** security prices will only be known when the trader goes to the market to execute and will be different from the historic prices fund accountants and custodians use. This gap between the accounting or custody value of the legacy portfolio and the value of the portfolio based on achievable execution prices can represent a cost to the fund when it realizes updated valuations through the transition process, and should be highlighted in the preliminary cost estimate stage, prior to execution.

**Bond Liquidity:** bond liquidity is a function of the original issuance size, parties willing to buy and sell securities and the availability of suitable substitutes for the target portfolio. When the legacy portfolio contains an illiquid “tail”, a transition manager should be able to offer solutions to facilitate the client requirements. For example, over the past couple of years it was quite common for clients to experience difficulty selling asset and mortgage backed securities from their legacy portfolios.

At J.P. Morgan, we help clients manage illiquid tails as follows:

- **Ongoing transition:** for small illiquid tails, J.P. Morgan can hold the securities in the transition account and periodically review market price levels with the client, selling based on the client instructions
- **Cooperation with Asset Management:** for larger portfolios J.P. Morgan Asset Management can take over the ongoing management of an illiquid portfolio and sell the securities when market conditions improve
- **Currency hedging to base currency:** fixed income portfolios commonly hedge the local currency exposure using forwards. The transition manager needs to work with target and legacy managers to ensure that when required, the appropriate swap transactions is executed and coordinated.

## Execution methodology

Whereas the equity markets typically manifest in centralized execution venues frequently tied together through “smart order routing”, fixed income markets are fragmented with institutions negotiating prices bilaterally for each transaction. Agreed prices may be posted publicly and available via tools such as Bloomberg, however institutions are not obliged to post trades. Furthermore, prices are not posted at all for some security classes, such as mortgage-backed or asset-backed securities.

Orders can be implemented on a principal or agency basis, although not all transition managers are equally skilled at both:

**Principal:** in a principal solution, a transition manager’s affiliated brokerage firm commits capital to take a client’s order on their proprietary trading book. Principal trades are traditionally used when a client seeks to sell securities or purchase very large positions of liquid names, this is due to the difficulties associated with shorting fixed income securities, mainly around availability of bonds to borrow.

**Agency:** in an agency solution, the transition manager executes with a counterparty on the client's behalf and an explicit commission is charged based on value of assets traded. Typically, multiple quotes are obtained and the best price selected.

Multiple quotes help demonstrate best execution and provide confidence around the bids and offers received. Proactively obtaining quotes carries risk of information leakage – the detrimental impact on price increasing as the number of parties familiar with the intended trade increase. As such, for agency execution it is imperative that the transition manager has a strong universe of brokers, understands their respective strengths and targets only those counterparties most likely to transact.

## Conclusion

Transition managers work to preserve asset value and introduce operational efficiencies for all restructures. As transition management becomes progressively recognized as industry best practice, transition principals have been appointed to manage a broader range of asset classes.

Fixed income transition events introduce challenges specific to that asset class that require different skills from equity transitions. Critical in selecting a transition manager is assessing each manager's capabilities in addressing these challenges and experience in successfully implementing cost-effective restructures.

At J.P. Morgan, we have applied our expertise and infrastructure towards the development of fixed income-specific solutions to make this a core competency of our global transition management business.