May 9, 2023

**TO:** UNM Board of Regents' Finance and Facilities Committee

**THROUGH:** Teresa Costantinidis, Executive Vice President for Finance and Administration and Chair of the University Debt and Investment Advisory Committee (DIAC)

**FROM:** Office of Planning, Budget & Analysis

**SUBJECT:** Action Item for Board of Regents' Finance and Facilities Committee – *AUTHORIZATION FOR REVISIONS TO REGENTS' POLICY MANUAL (RPM) – SECTION 7.21: INVESTMENT OF OPERATIONAL FUNDS AND BOND PROCEEDS*

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## Executive Summary

The Office of Planning, Budget & Analysis, on behalf of the University Debt and Investment Advisory Committee (DIAC), is seeking The University of New Mexico Board of Regents' approval of edits to the *Regents' Policy Manual – Section 7.21: Investment of Operational Funds and Bond Proceeds* that will permit certain investment categories that are currently prohibited and increase the average maturity of investments. These changes will provide attractive relative value opportunities, and enhance yield while minimally impacting investment risk, providing additional flexibility to move when markets move and allow investment decisions to be made in real time.

We are also recommending minor edits related to changes in position titles and removal of three sentences under Reporting and Accountability section that detail day-to-day administrative roles and responsibilities, which we believe is more appropriate in University Administrative Policy (UAP) 7610: Investment Management, under 3. Investment Responsibilities. The proposed changes to Regent policy as outlined above align with recommendations received from both of our investment managers, Loomis Sayles and SLC Management, and deemed to be reasonable requests from our investment consultant, Aon Investments. A redline version of the policy is shown as ATTACHMENT 1. A summary of the investment manager recommendations and Aon review is shown as ATTACHMENT 2.

## Background

Originally adopted in 2005, and not having been revised since 2010, the Regents' Policy Manual – Section 7.21: Investment of Operational Funds and Bond Proceeds governs the investment of operational funds and bond proceeds of the University of New Mexico. It does not apply to endowments held by the University and the UNM Foundation, which are invested in accordance with the Foundation's Consolidated Investment Fund Endowment Investment Management Policy.

Each of our accounts is managed in a manner that correlates to the three tenets of public funds that are, in order of priority:

- Preservation of Capital (Safety)
- Liquidity
- Yield or Return

Due to the nature of the funds  we are always obligated to ensure the safety of our portfolios by seeking out high credit quality investment opportunities, and we like to have an optimal mix of higher yield, less liquid investments and lower yield, highly liquid opportunities.

The University seeks market rates of return on its investments, consistent with its liquidity requirements and quality and duration/maturity constraints, in relation to the Fund's benchmark. In addition, the University tries to acquire securities with suitable characteristics corelated to Operating Fund cash flows, and to hold those assets until such time as market conditions or other factors create clear opportunities for increased returns.

As discussed in the April 10, 2023 Board of Regents meeting, it is important that we continue to seek alternative revenue sources to support the University's mission. Given the size of our investment balances with Loomis Sayles and SLC Management ($254.6 million and $117.4 million managed, respectively, as of February 28, 2023), we believe this is a great opportunity to diversify and expand this source of investment income, while minimally impacting investment risk because these balances represent operational funds that must be preserved for operational needs and intended long-term uses. In addition, this proposal aligns with the UNM 2040 Strategic Planning Framework Goal of Sustainability by ensuring the necessary financial resources to achieve our aspirations and mission.

Since December 2022, we've met separately with both investment managers, SLC Management and Loomis Sayles, to get a sense of what changes or recommendations they'd propose to allow more flexibility in managing our investment portfolios. We've also met with our investment consultant, Aon Investments, as well as Dr. Reilly White, Associate Professor of Finance at UNM's Anderson School of Management and faculty advisor for the $4.0 million student-run Regents' Portfolio. These discussions centered around the proposed changes and the reasonableness of these recommendations while still upholding our top two tenants with investing operational funds of safety (preservation of capital) and liquidity. On March 2, 2023 the DIAC met to discuss the investment recommendations and proposed changes to investment policy. The changes were voted on by the Committee and approved to move forward.

**Manager Recommendations and Related Policy Changes**

*Allow investment in private placements (144As)*

- By removing "Private placements" from the Prohibited Investments section, we would be able to take advantage of privately placed securities, giving our investment managers a greater supply of bonds to invest in.
- Rule 144A allows privately placed securities to be sold and traded to Qualified Institutional Buyers without SEC registration. The primary benefit of buying 144A securities is access to a greater supply of bonds. A white paper explaining the case for expanding 144A limits and additional background on what 144A securities are is shown as ATTACHMENT 3.

*Allow investment in securitized assets (asset-backed securities, mortgage-backed securities, etc.)*

- By removing "Mortgages—backed debt and pass-through securities or obligations", "Residual Tranche collateralized mortgage obligations", and "Collateralized mortgage obligations (CMOs) and other mortgage-backed securities…" from the Prohibited Investments section, we would be able to take advantage of higher yields that would come from allowing investments in securitized assets.
- Both of our investment managers recommend adding in the option to invest in securitized assets. Allocations within securitized assets (of which 90% comes to market as 144A) would provide attractive relative value opportunities and higher yields. Mortgage-backed securities (MBS) allow investors to benefit from mortgage business (i.e. principal and interest payments passed through) without the need to directly buy or sell home loans. We believe that existing investment guidelines

in our policy that call for an average quality of A1/A+ or better helps to mitigate any risk in investing in MBS, as low-quality MBS would not be considered. We can also manage our low tolerance for investment risk by implementing a preferred range and maximum percentage allowed of investment funds within this asset class in University Administrative Policy 7610.

*Increase maturity limit or neutralize duration of the portfolio.*

- Duration represents the weighted average term of maturity of bonds in a fixed-income portfolio. Portfolios with a shorter duration will typically be less affected by interest rate changes than a portfolio with a longer duration. However, when interest rates are expected to stabilize or stay low, longer duration bonds are a better choice, as bond prices move in the opposite direction of interest rates. While the portfolios have benefited recently from the short duration posture, this is essentially an interest rate bet. Should rates stabilize or decrease, there is a significant risk to the portfolio's performance.
- We acknowledge that our short duration posture that currently exists within RPM 7.21 opens our portfolio to risk in the event interest rates stabilize or decrease. We propose increasing *average* maturity from three years or less to five years or less. Refer to red line edit under the Investment Guidelines section that changes average maturity from three years or less to five years or less.

**Align University Administrative Policy with Regents Policy Manual changes**

If the Regents approve of the changes proposed, we will also put forward similar changes to University Administrative Policy 7610: Investment Management to bring both policies into alignment.

**ATTACHMENT 1**

Regents' Policy Manual – Section 7.21: Investment of Operational Funds and Bond Proceeds DRAFT of 05/11/23 (Redline Copy)

**ATTACHMENT 2**

Aon Investments - Review of Fixed Income Manager Recommendations (January 2023)

**ATTACHMENT 3**

AAM White Paper on 144A Securities (August 2019)

# ATTACHMENT 1

# Regents' Policy Manual - Section 7.21: Investment of Operational Funds and Bond Proceeds

Adopted Date: 12-13-2005

Amended: 05-11-2010

## Applicability

This policy governs the investment of operational funds and bond proceeds of the University of New Mexico. It does not apply to endowments held by the University and the UNM Foundation, which are invested in accordance with the Foundation's Consolidated Investment Fund Endowment Investment Management Policy.

## Policy

The University shall manage its cash flow in a manner which will maximize funds available for investments. The primary objective for investments of operational funds and bond proceeds of the University is capital preservation. In addition, available funds shall be invested with the following objectives:

1. Conformance with applicable laws and regulations, bond resolutions and indentures, and other pertinent legal restrictions.

2. Sufficient liquidity to ensure the University can quickly respond to cash demands and meet funding and operations requirements and emergency expenditures.

3. Recognition of differing objectives and needs of various operating funds and bond proceeds.

4. Maximization of investment returns.

The Board recognizes that in order to meet these investment objectives it may be advantageous to engage the services of investment consultants and managers who have appropriate training and expertise and who have access to specialized information and analysis or analytical tools and systems. Investment consultants and managers must be registered investment advisors with the Securities and Exchange Commission (SEC) and must have a minimum of $500 million of assets under management. Such contracts must be approved by the Board of Regents. All persons or entities, including investment managers and consultants, that have responsibility for investment of University funds shall be bound by this and other University policies, including conflict of interest policies RPM 1.8 and RPM 6.4, and federal and state laws and regulations.

## Investment Guidelines

The scope of authority for the types of investments that may be made with University funds is statutorily defined in NMSA 1978, Sections 6-8 and 6-10. University assets may be invested in any securities permitted by law, subject to the provisions of this investment policy. Individuals responsible for investment decisions shall exercise judgment, care, skill, and caution to invest and manage funds as a prudent investor would, by considering the objectives, terms, and distribution requirements while preserving capital. Operational funds and bond proceeds are primarily invested in high quality, relatively short-term fixed income securities not exposed to significant market risk. Investments should have an average duration of ~~three~~ five years or less, an average credit quality of A1/A+ or better, no use of leverage, and security ratings of investment grade.

## Prohibited Investments

Notwithstanding authority granted by law and elsewhere in this document, in order to mitigate exposure to interest rate risk, market risk, and liquidity risk, the following investments and investment practices are prohibited. Prohibited investments include, but are not limited to the following:

- Domestic or international equity securities (i.e. stocks)
- Commodities and futures contracts
- Options
- Speculative securities
- ~~Mortgages - backed debt and pass-through securities or obligations~~
- Non-government fixed income mutual funds
- ~~Private placements~~
- Limited partnerships
- Real estate properties

- Principal-only (PO) securities
- Interest-only (IOs) securities
- Planned amortization class (PACs)
- ~~Residual Tranche collateralized mortgage obligations~~
- Venture-capital investments
- Derivatives, except when utilized to protect the Global Fixed Income Portfolio
- ~~Collateralized mortgage obligations (CMOs) and other mortgage-backed securities, inverse floaters, leveraged floaters, capped and rate floaters, dual index floaters, and floating rate notes whose index is tied to a long-term interest rate or lagging index, e.g. Cost of Funds Index (COF1)~~
- Investment purchase on margin or short sales
- Leveraging the portfolio, lending securities with an agreement to buy them back after a stated period of time (reverse repurchase agreements from the perspective of the Operating Fund)
- Repurchase agreements are prohibited for operating funds, but are allowable for bond proceeds
- GICs are prohibited for operating funds, but are allowable for bond proceeds

## Reporting and Accountability

The University Debt and Investment Advisory Committee is responsible for ensuring University investments are managed in accordance with University policy and applicable laws and regulations. The Committee is also responsible for oversight of the investment process and distribution of investment income, monitoring investment activities, and reporting the results of investment activity annually to the Board of Regents. The Committee is chaired by the Executive Vice President for Finance and Administration~~/CFO/COO~~ and is composed of representatives from Financial Services, the Office of Planning, Budget and Analysis, and other members designated by the Executive Vice President for Finance and Administration~~/CFO/COO~~.

~~The Associate Vice President Director for Planning, Budget, and Analysis under the supervision of the Executive Vice President for Finance and Administration/CFO/COO is responsible for the day-to-day investment activities concerning University operational funds and bond proceeds. The associate vice presidents University Controller and the Chief Budget and Facilities Officer for Financial Services are responsible for ensuring proper internal controls are in place. The UNMH Administrative Chief Financial Officer is responsible for the day-to-day investment activities concerning UNM Hospital operational funds and bond proceeds and for ensuring proper internal controls are in place.~~ All investment transactions require prior authorization from two University administrators with signature authority on the University's depository account. All individuals delegated authority to make investment decisions must be bonded in accordance with NMSA 6-8-5.

## References

NMSA 1978, §§ 6-8 and 6-10; Uniform Prudent Investor Act, NMSA 45-7 (601-612); Internal Revenue Code IRC §148, Arbitrage; RPM 1.8 " Regent Code of Conduct and Conflicts of Interest Policy," RPM 6.4"Employee Code of Conduct and Conflicts of Interest Policy," UBPPM 3715 "Code of Conduct," UBPPM 3720 "Conflicts of Interest," UBPPM 7610 "Investment Management."

ATTACHMENT 2

# The University of New Mexico

# Review of Fixed Income Manager Recommendations

## January 2023

Investment advice and consulting services provided by Aon Investments USA Inc.



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# Statutory Rules and Requirements Relating to the Investment of the University's Operating Assets

<table>
<tr><th></th><th>Section 7.21</th><th>Policy 7610</th></tr>
<tr><td>Applicability</td><td colspan="2">▪ Governs investment of operational funds and bond proceeds of the University<br>– Does not apply to endowments held by University and the UNM Foundation</td></tr>
<tr><td>Objectives</td><td colspan="2">▪ Primary = Capital Preservation and Liquidity<br>▪ Secondary = Yield</td></tr>
<tr><td>Investment Guidelines</td><td>▪ Average Duration = 3 years or less<br>▪ Average Credit Quality = A1/A+<br>▪ No use of leverage</td><td>▪ Average Duration = 3 years or less<br>– Requirement to maintain duration of portfolio aligned with the benchmark<br>▪ Minimum Credit Quality = BBB/Baa2<br>▪ Allowable Investments (Maximum Allocation):<br>– U.S. Treasuries (100%)<br>– U.S. Gov't. Agencies (100%)<br>– Money Market Funds (100%)<br>– Corporate Bonds (50%)<br>– Municipal Bonds (25%)<br>– Global Fixed Income (20%)<br>– Industrial Floaters (10%)<br>– Certificates of Deposit (10%)<br>– Commercial Paper (10%)<br>– Federal Funds (10%)</td></tr>
<tr><td>Prohibited Investments</td><td colspan="2">Stocks, Commodities, Options, Speculative Securities, MBS, CMOs, Private Placements, Limited Partnerships, Real Estate, Principal-Only Securities, Interest-Only Securities, Investment Purchase on Margin or Short Sale, Repurchase Agreements* and GICs*</td></tr>
</table>

* Prohibited for operating funds, but allowable for bond proceeds

# Current State

- ≈$371 million in operating assets
  - Loomis Sayles = $254 million
    - 1-5 Year Gov/Credit Mandate
  - SLC Management = $117 million
    - 1-3 Year Gov/Credit Mandate

# Recommendations from Loomis Sayles

- Average portfolio credit quality shall be Aa3 or higher
- Permitted asset classes to include corporate bonds AND securitized assets such as agency backed mortgages, asset backed securities and commercial mortgage-backed securities
- Minimum credit quality for any security will be BBB- with exception of securitized assets which shall be AA-
- Sector limits shall be no more than 75% in corporate bonds, 25% in ABS, 25% in CMBS and 25% in Agency MBS
- 144a securities are permitted (not permitted today)
- Security maturity to be 7 years or less - securitized assets weighted average life must be 7 years or less

# Loomis Sayles – Comparison of “Standard Account” to UNM Account

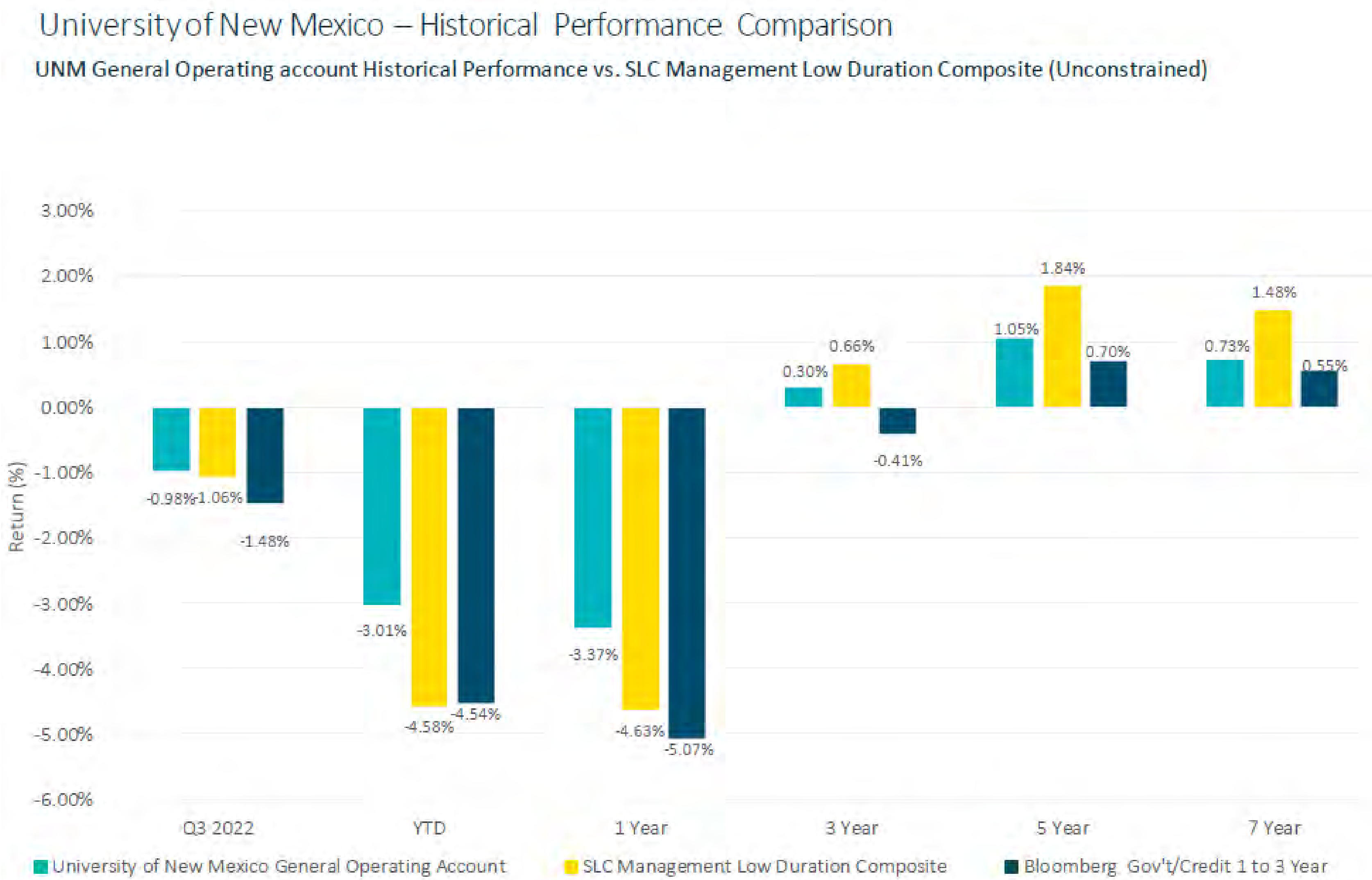
## comparison of short duration alternatives

### 3 YEAR STANDARD DEVIATION & TOTAL RETURN COMPARISON AS OF 9/30/2022

# Recommendations from SLC Management

- Add in structured products, inclusive of 144A's
  - Allocations within securitized (of which 90% comes to market as 144A) would provide attractive relative value opportunities, enhancing yield and carry specifically at the front end of the curve
- Increase exposure to full BBBs
  - Allowing for BBB- securities would increase yield within the portfolio while minimally impacting investment risk
- Open the opportunity set to allow flexibility
  - By loosening restrictions on permissible investments and liquidations, SLC Management would be able to move when markets move and allow investment decisions to be made in real time
- Neutralize duration of the portfolio to the benchmark
  - The current portfolio is running short to the benchmark by 0.46 years
  - While the portfolio has benefitted from the short duration posture, this is in effect an interest rate bet
  - Should rates stabilize of decrease, there is a significant risk to the portfolio's performance

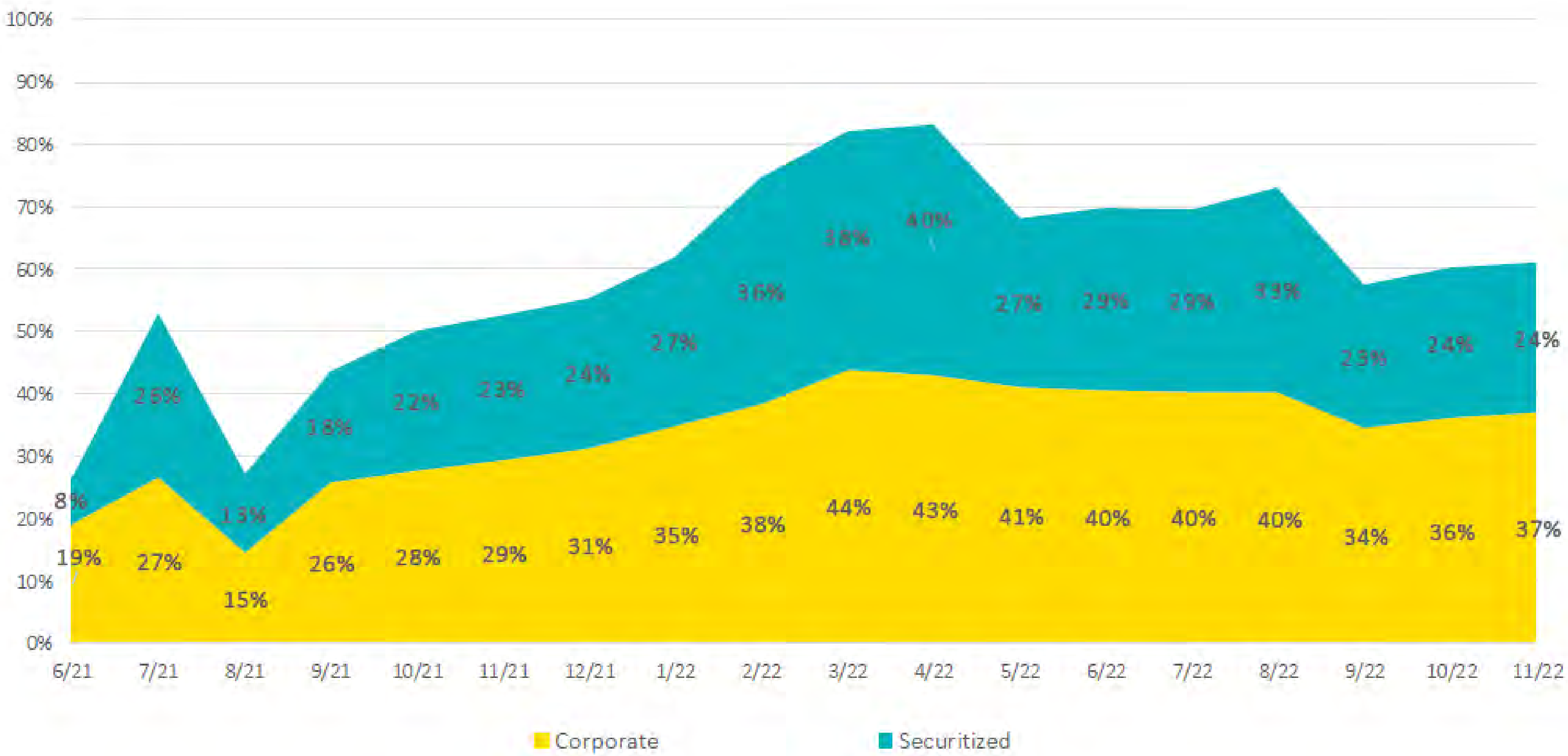
# SLC Management – Comparison of "Standard Strategy" to UNM Account



# SLC Management – Comparison of “Standard Strategy” to UNM Account (Cont’d)

## University of New Mexico – Historical Sector Breakdown

Historical sector breakdown of an unconstrained representative account





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# Summary of Manager Recommendations

- Allow investment in securitized bonds (ABS, MBS, etc.) – **BOTH**
- Allow investment in 144As – **BOTH**
- Allow investment in bonds rated BBB- – **BOTH**
- Increase maximum allocation to corporate bonds (50% → 75%) **– LOOMIS SAYLES**
- Increase maturity limit to 7 years or less – **LOOMIS SAYLES**
- Remove constraints on "selling at a loss" **– SLC MANAGEMENT**

***Aon believes all of these to be reasonable requests***

**Suggested Next Steps:**

1) What changes is UNM comfortable with?
2) What changes can be accommodated? (I.e., from a statutory rules and requirements perspective)
3) Draft account guidelines for Loomis Sayles and SLC Management
4) Execute guidelines; managers then transition portfolios as needed

# Appendix: Background Information on 144As from SLC Management

**Background**

- Rule 144A refers to a 2012 legal provision which allows for the trading of select securities among Qualified Institutional Buyers (QIB's)
- Unlike non-144A securities, 144A's do not require an SEC registration process prior to the transaction
  - After the market crash of 1929, the SEC enacted the Securities Act of 1933, requiring extensive documentation prior to transacting, in hopes of providing greater disclosure and protection for investors
- By waiving registration requirements, Rule 144A facilitates a more liquid and efficient resale market for QIB's to transact in the marketplace

**SLC Management's Approach to 144A Exposure**

- SLC Management buys and sells bonds based on sector and security relative value. Factors can be technical in nature (e.g. direction, trend) or fundamental (e.g. credit, volatility). With respect to credit selection, the Rule 144A classification has little impact on our investment process
- From a credit quality spectrum, there are both higher and lower quality 144A issues, similar to the public market
  - As a result, liquidity is determined by deal size, credit quality and fundamentals. The 144a issue does not necessarily impair liquidity alone
- While offerings in the 144A market do carry liquidity premiums, our investment process remains unchanged. Allocations must be investment grade and adhere to our investment philosophy
- Within the structured credit sector approximately 90% of the issues below AAA come to market with a 144A designation
  - Restricting 144A exposure in the portfolio limits our ability to fully capitalize on opportunities in nearly all issuance in the ABS, CMBS, RMBS and CLO markets
- Currently, spreads in securitized sectors offer attractive entry points for sophisticated QIB's such as UNM to further diversify while simultaneously adding risk-adjusted yield
- By permitting 144A securities, the portfolio is better positioned to achieve relative value with proper risk context and duration bands

# Appendix: Background Information on 144As from SLC Management (Cont'd)

Although exempt from certain registration requirements, The Financial Industry Regulatory Authority (FINRA)'s regulations do require dealers to report all transactions to their Trade Reporting and Compliance Engine (TRACE). This transaction data is distributed publicly on the date of issuance, giving investors full transparency of volume and price at the individual bond level. This added level of transparency is a strong positive for liquidity at the margin.

Corp Bonds | Agencies | Mortgage TBA | Mortgage Pool | ABS | CMO | Convertibles | ELNs

Tickers | Period: Last 5 Days
ABS Type: All | Coupon | Cpn Type: All
Sec Type: 144a only | Original Face: All Size

| Security | ABS Type | Rating | Orig(M) | Curr(M) | Factor | Price | Trd | Vol(M) |
|---|---|---|---|---|---|---|---|---|
| ABS 4 hr Delay | | 144A 4 hr Delay | | | | | 496 | 1,446,867 |
| 21) FLX 2021-1A C | Other | NR/NR/NR | 2000 | 2000 | 1.000 | 84.938 | 4 | 13,000 |
| 22) PAID 2022-5 A | Other | NR/NR/NR | 2000 | 2000 | 1.000 | 100.938 | 1 | 2,000 |
| 23) OSCAR 2021-2A A2 | Autos | AAA/NR/Aaa | 3000 | 837.39 | 0.279 | 98.625 | 1 | 3,000 |
| 24) TALNT 2019-1A A | Autos | NR/AAA/Aaa | 200 | 200 | 1.000 | 96.703 | 3 | 1,760 |
| 25) CACLN 2021-3 F | Other | NR/NR/Ba3 | 1000 | 1000 | 1.000 | 86.750 | 2 | 2,000 |
| 26) NAVSL 2021-A A | Student Loans | NR/AAA/NR | 450 | 207.85 | 0.462 | 87.750 | 1 | 450 |
| 27) CNART 2021-1A B | Autos | NR/NR/NR | 1180 | 759.701 | 0.644 | 99.527 | 1 | 1,180 |
| 28) AESOP 2018-2A A | Autos | AAA/NR/Aaa | 1405 | 1405 | 1.000 | 98.574 | 2 | 2,810 |
| 29) GFORT 2020-1 B | Autos | NR/AA/Aa1 | 6138 | 6138 | 1.000 | 97.281 | 2 | 12,276 |
| 30) FREED 2022-4FP D | Other | NR/NR/NR | 9120 | 9120 | 1.000 | 97.000 | 2 | 18,240 |
| 31) ACAR 2019-1 F | Autos | NR/AA+/NR | 3160 | 3160 | 1.000 | 99.906 | 1 | 3,160 |
| 32) NAVSL 2021-2A A1B | Student Loans | NR/AA+/Aaa | 262 | 208.118 | 0.794 | 95.250 | 1 | 262 |
| 33) EART 2018-3A F | Autos | NR/A+/NR | 5130 | 5130 | 1.000 | 100.000 | 1 | 5,130 |
| 34) ACAR 2019-4 E | Autos | NR/A+/NR | 4000 | 4000 | 1.000 | 97.781 | 1 | 4,000 |
| 35) FKH 2021-SFR1 A | Other | NR/NR/Aaa | 597 | 592.832 | 0.993 | 86.418 | 1 | 597 |
| 36) MFT 2020-2A D | Other | NR/NR/NR | 1651 | 1651 | 1.000 | 97.891 | 3 | 4,953 |
| 37) SREV 2019-A A | Autos | NR/AAA/Aaa | 2135 | 2135 | 1.000 | 94.855 | 1 | 2,135 |
| 38) HERTZ 2022-5A A | Autos | AAA/NR/Aaa | 10000+ | 10000+ | 1.000 | 94.457 | 2 | 20,000 |
| 39) NSLT 2021-BA C | Student Loans | NR/NR/NR | 10000 | 10000 | 1.000 | 83.813 | 1 | 10,000 |
| 40) CASL 2021-A D | Student Loans | NR/NR/NR | 1750 | 1750 | 1.000 | 91.625 | 2 | 3,500 |
| 41) HERTZ 2021-1A A | Autos | NR/NR/Aaa | 10000+ | 10000+ | 1.000 | 92.605 | 1 | 10,000 |
| 42) HNGRY 2021-1A A2 | Other | NR/BBB/NR | 1115 | 1098.275 | 0.985 | 80.012 | 1 | 1,115 |
| 43) SERV 2021-1 A2I | Other | NR/BBB-/NR | 1196 | 1181.05 | 0.988 | 80.492 | 1 | 1,196 |
| 44) ACAR 2021-1 C | Autos | NR/AAA/NR | 100 | 72.026 | 0.720 | 97.988 | 2 | 200 |
| 45) TAH 2020-SFR1 A | Other | NR/NR/Aaa | 3000 | 2993.886 | 0.998 | 88.906 | 3 | 13,106 |
| 46) BLX 2007-AA C | Other | NR/CC/WR | 3827 | 125.855 | 0.033 | 79.000 | 2 | 7,654 |
| 47) BLX 2007-AA A | Other | NR/CCC/WR | 10000+ | 328.86+ | 0.033 | 87.750 | 4 | 40,000 |
| 48) ONGLT 2018-A A | Other | AAA/AAA/NR | 500 | 71.711 | 0.143 | 96.215 | 4 | 4,260 |
| 49) UPSPT 2021-ST1 CERT | Other | NR/NR/NR | 7500 | 7500 | 1.000 | 30.000 | 2 | 15,000 |
| 50) SRFC 2022-2A A | Other | AAA/AAA/NR | 165 | 125.091 | 0.758 | 98.328 | 2 | 330 |
| 51) NAVSL 2017-3A A3 | Student Loans | NR/AA+/Aaa | 1000 | 993.589 | 0.994 | 98.000 | 8 | 41,300 |
| 52) OMFIT 2022-2A A | Other | NR/AAA/NR | 475 | 475 | 1.000 | 97.813 | 2 | 4,340 |
| 53) EFF 2022-2 A2 | Autos | AAA/AAA/NR | 1450 | 1450 | 1.000 | 98.918 | 2 | 2,900 |

ATTACHMENT 3

Insurance Investment Management

# A Case for Expanding 144A Limits

*Kevin Adams, CFA | Senior Portfolio Manager, Principal, & Vice President*

Given the persistent low interest rate environment, investment managers require flexibility to employ strategies that maximize a portfolio's income within the constraints of their clients' mandates. A segment of the market that is often overly constrained is 144A private placement issues. While not all investors are qualified to purchase 144A issues, the expanded opportunity set in these issues makes a compelling case for increasing 144A limits for those that do.

## What are 144A securities?

When a bond issuer offers a security to the investing public, the Securities Act of 1933 requires that the issuer register the bonds with the Securities and Exchange Commission (SEC). This process entails extensive documentation, review, and recurring disclosures. However, there is an exception for bonds issued under Rule 144A, which allows privately placed securities to be sold and traded to Qualified Institutional Buyers (QIBs) without SEC registration. QIBs are defined as institutions (not individuals), deemed to be an "accredited investor" under Rule 501 of the SEC's Regulation D. To qualify as a QIB under Rule 144A, an insurance company must have a minimum of $100 million in unaffiliated invested assets on a discretionary basis. The exception for QIBs is made because they are viewed as having more resources and access to information versus smaller institutions. As such, it is inferred that they can make sound investment decisions despite potentially having less information and ongoing required reporting provided by securities registered with the SEC.

144A securities can be issued with or without registration rights. For those issued with registration rights, the issuer hasn't filed for registration with the SEC but intends to do so within a specified time period after issuance. Once they are registered, the 144A securities are subsequently exchanged for newly created public securities. For those issued without registration rights, the securities will remain unregistered until maturity.

# What are the benefits for an issuer of 144A securities?

From an issuer's perspective, there are a number of advantages to issue bonds under Rule 144A. First, there is no required public disclosure of sensitive information, no SEC review process, and ongoing reporting requirements are reduced. Second, 144A issuance decreases the potential for liability under the Securities Act. Third, issuers can access the market more quickly since the process of registering a bond with the SEC can delay the timing of an issue. Finally, the issuers' costs are lower as they are able to forgo pre-issuance registration, significant underwriting fees, and ongoing reporting post-issuance.

# What are the benefits of buying 144A securities for QIBs?

With the advantages to the issuer being fairly straight forward, the primary benefit to the investor is access to a greater supply of bonds. Over the past decade, the amount of 144A issuance has accelerated at a much faster rate than public bonds. The outstanding issuance of investment grade 144A (excluding structured sectors: asset backed securities, commercial mortgage backed securities, and non-agency residential mortgage securities) since 12/31/08 has increased from $341B to $1,637B (380% growth) versus the Barclays Aggregate increase of $11,430B to $20,836B (82% growth).

In the structured sectors, the growth of 144A issuance since the financial crisis has been even more pronounced. In the Asset Backed and Commercial Mortgage Backed Sectors, over half of the bonds in 2018 were issued under Rule 144A (Exhibit 1). In the Non-Agency Residential Mortgage Backed Sector, almost all of the securitizations in the past few years have been issued under Rule 144A.

**Exhibit 1**

| Total ABS Issuance % 144A | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| Total ABS Issuance ($bil) | 142.79 | 140.38 | 106.22 | 136.15 | 195.59 | 174.72 | 192.96 | 178.80 | 188.20 | 221.62 | 229.34 |
| Total ABS Issuance 144A ($bil) | 20.82 | 57.65 | 49.42 | 58.05 | 69.45 | 56.93 | 68.15 | 79.85 | 96.71 | 112.92 | 124.76 |
| % Total ABS Issuance 144A | 14.6% | 41.1% | 46.5% | 42.6% | 35.5% | 32.6% | 35.3% | 44.7% | 51.4% | 51.0% | 54.4% |

| Total CMBS Issuance % 144A | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| Total CMBS Issuance ($bil) | 12.15 | 2.58 | 10.42 | 31.27 | 45.35 | 82.73 | 91.67 | 99.28 | 71.12 | 94.11 | 91.14 |
| Total CMBS Issuance 144A ($bil) | 1.44 | 2.58 | 5.03 | 6.53 | 13.20 | 29.66 | 34.66 | 37.77 | 23.27 | 45.58 | 50.72 |
| % Total CMBS Issuance 144A | 11.8% | 100.0% | 48.3% | 20.9% | 29.1% | 35.8% | 37.8% | 38.0% | 32.7% | 48.4% | 55.6% |

*Source: Source: J.P. Morgan, Bloomberg*

A greater supply of bonds is the primary benefit of 144A issues to investors, but it's not the only one. Underwriters of 144A structured securities typically provide more granular loan level data, which isn't made available for public issues. This feature allows investment management research teams to better understand the characteristics of the underlying collateral, model cash flows, and predict deal performance.

While some 144A issues may offer a yield benefit, increasing the limit on 144A issued securities is not necessarily a yield enhancement strategy. In an acknowledgement from the market that public issues versus 144A are nearly identical, there is very little or no yield premium for a given issuer whether they come with a 144A versus a public transaction. Increasing 144A limits is really about expanding the opportunity set, particularly in the ABS, CMBS, and Non-Agency RMBS sectors. For example, the entire single property CMBS market and nearly the entire ABS market outside of prime auto deals and credit card transactions are 144A.

Given the pool of potential investors in 144A is limited to those with QIB status, it would be reasonable to assume that 144A issues are less liquid than public bonds. However, liquidity for both fully registered and 144A securities is impacted primarily by the specific issue characteristics which include issue size and credit quality. Bid side indications for similar tenor public and 144A bonds are generally the same. An example is shown in exhibit 2.

**Exhibit 2**

| Issue Description | Type of Issue | Size (mil) | Bid indication | Adjustment to Bid for Yield Curve |
|---|---|---|---|---|
| Bristol Myers Squibb 3.25% 2/22/2027 | Registered | 750 | +64/ 7.6 yr | +86 |
| Bristol Myers Squibb 3.40% 7/26/2029 | 144A w/ Reg. Rights | 4,000 | +85/ 9.8 yr | +85 |

*Source: Bloomberg, AAM*

# Conclusion

As 144A private placements become a larger component of the bond market, they warrant consideration as a greater percentage of portfolios for QIB investors. Constraining 144A to a small percentage of a portfolios' holdings is an outdated restriction in today's market, limits the investment options for managers, and doesn't necessarily reduce a portfolio's risk profile. If your investment guidelines have restrictions on the exposure to 144A issues, ask your investment manager about whether increasing those limits would benefit your portfolio's diversification and opportunity set.

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