GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 14a | Two Wall Street, New York, New York 10005 • www.grantspub.com | JULY 11, 2014

Sell to whom, Michael Hasenstab?

"Rather go to bed supperless than rise in debt," admonished Benjamin Franklin, spiritual founder of Franklin Resources (BEN on the New York Stock Exchange). The giant mutual fund company has made a fortune for itself and its investors by studiously ignoring Poor Richard's advice. Stewardship of the company's $355 billion in fixed-income investments is the subject at hand.

Skipping down to the bottom line, we are bearish on BEN on account of that stewardship. Illiquidity is the glaring fault we identify and document. Admittedly, it's a thesis that may meet with skepticism. Shareholders of the management company and investors in the company's bond funds alike could hardly ask for more than Franklin has delivered.

Since 2001, shares of Franklin Resources have produced a compound annual rate of return of 13.6%, more than double the 5% per annum turned in by the S&P 500 (in both cases, we assume that dividends were reinvested). It's an achievement attributable in part to the extraordinary success of the company's bond funds, notably the flagship Templeton Global Bond Fund. Over the past 10 years, shares of TPINX have returned 9.2% a year compared to 5.3% served up by the average global fixed-income portfolio.

Forty-year-old Michael Hasenstab is the star behind the stellar returns. Best Global Manager (Standard & Poor's/*BusinessWeek*, 2006), Top U.S. and Global Bond Fund Manager (Bloomberg, 2009), Global Bond Manager of the Year (*Investment Week*, 2010), Hasenstab first joined Franklin Templeton in 1995. Following a leave of absence to study at the Australian National University (he earned a Ph.D. in economics), he rejoined the firm in 2001.

Few of Hasenstab's many accolades are likely more bankable than the five-star rating Morningstar confers on the Templeton Global Bond Fund for superior 10-year, risk-adjusted returns (as measured by the so-called Sharpe ratio, about which more presently). Thus credentialed, Hasenstab oversees $190 billion in fixed-income investments, 80% of which are held by four big funds, foreign and domestic versions of the aforementioned Templeton Global Bond Fund and the Templeton Total Return Fund. Altogether, Hasenstab is responsible for 20% of total company AUM and the substantial income those assets produce.

"Management fees on the Hasenstab funds range from 50 to 75 basis points per year," colleague Charley Grant relates, "while the industry average for global fixed income was 57 basis points in 2013, as measured by Lipper Inc. Only global equity, at 60 bps, earned a higher industry average fee. Fifty-seven basis points on $190 billion comes out to $1.08 billion in annual fee revenue. Then there are sales and distribution fees—asset-based fees for BEN accounted for $1.7 billion, 20% of which amounts to another $340 million; adding that to the aforementioned $1.08 billion gives you $1.4 billion. At a 50% margin, we are talking about a $700 million contribution to the bottom line, nearly a third of the $2.2 billion that BEN booked in trailing 12-month net income." If Hasenstab isn't the perpetual Franklin Resources Employee of the Month, we'd like to know who is.

How does he do what he does? "What gives you comfort to pull the trigger on an investment?" an interviewer from *Barron's* asked the portfolio manager in a June 7 Q.&A. To which Hasenstab replied, "It's the feeling in the pit of your stomach when you are questioning yourself and everyone else thinks you are wrong. If we are confident in the fundamentals and the team has ripped it apart, that's usually a good check that

Illiquidity: an assortment
holdings of Templeton U.S. Global Bond Fund

	market value	% of portfolio	avg. daily Q1 volume	days to exit: 15% daily vol.	days to exit: 50%
Hungary	$5,188	7.5%	$438	79	24
Malaysia	4,966	7.1	831	40	12
Poland	7,082	10.1	1,087	43	13
Ukraine	3,231	4.6	845	25	8

sources: company reports, Trade Association for the Emerging Markets we are doing the right thing. If it's really easy and everyone is in agreement, it's probably not." Which *Grant's* reader could quarrel with that?

Is there anything else that might explain these outsize returns? "The vast majority of our assets," Hasenstab told the *Financial Times* last month, "are in deep liquid markets that we can move in and out of with ease—Japanese yen, Korea, Mexico, Poland, Canada, Australia, Sweden—and then we opportunistically rotate through special distressed opportunities." Morningstar echoes Hasenstab's self-assessment. The famous Morningstar style box rates the flagship Global Bond Fund "medium" in the article of credit quality; "limited" is the verdict on duration risk (and a good thing that would be if interest rates ever did turn up).

It's on the points of liquidity and concentration that *Grant's* parts company with BEN's boosters and joins the evidently small circle of its critics (we so judge by the small short interest in Franklin Resources common). The fact is that the Hasenstab-managed funds are heavily exposed to assets that could be sold only with difficulty.

Hasenstab—who, through a Franklin Resources spokeswoman, declined to come to the phone—readily acknowledges that some of his holdings are illiquid. They are conservatively counterbalanced with perfectly liquid ones, he contends. After analyzing his four major portfolios, position by position, we respectfully disagree.

What does "illiquid" mean? There's no hard and fast definition. To some risk managers, days to exit a position is the relevant criterion; if you need a month of trading days, assuming that your selling represents a conservative percentage of the assumed daily trading volume, that position would likely be judged hard to escape from. Percentage ownership of a given issue is another risk-management criterion. If you yourself own a commanding share of a certain issue, you yourself become the market. How can you objectively price the security? (You can't.) How could you easily sell it? (You couldn't.)

To the Securities and Exchange Commission, an illiquid asset is one "which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books."

Templeton U.S. Global Bond Fund
top 10 holdings

Issuer/coupon/maturity	market value (in billions)	TPINX holding (% outs.)	size of 2nd-largest holding
Ireland 5 Oct. 2020	$2.3	31.8%	1.6%
Poland 6.25 Oct. 2015	1.8	28.1	2.6
KMSB* 2.76 June 2015	1.7	36.5	0.5
Poland 5.5 April 2015	1.5	24.8	2.1
Ireland 5.4 March 2025	1.2	17.0	0.4
Sweden 4.5 August 2015	1.1	0.2	-
Poland 4.75 Oct. 2016	1.1	6.9	-
Hungary 6.375 March 2021	1.0	62.3	2.3
KMSB* 2.9 Dec. 2015	1.0	11.1	0.4
Ireland 5.9 Oct. 2019	0.9	15.1	0.4

*Korea Monetary Stabilization Bond
sources: company reports, the Bloomberg

The commission ruled in March 1992 that such assets may constitute no more than 15% of a mutual fund's portfolio.

"By regulatory lights, then," Grant observes, "the U.S. Templeton Global Bond Fund, with $72 billion in assets as of the end of May, should have no more than $10.8 billion in illiquid securities. Let's see about that.

"As of the Feb. 28 semiannual report, when the fund reported $69 billion of net assets," Grant continues, "TPINX disclosed large holdings of Hungarian bonds—sovereign debt worth $4.9 billion as well as a $262 million position in the Hungarian Development Bank. These positions, denominated primarily in the local forint (euro-denominated holdings were roughly $717 million), amounted to 7.5% of the portfolio. Bonds issued by the government of Poland, primarily denominated in the local zloty, summed to $7 billion—10.1% of the portfolio. An additional 4.6% of net assets were held in Ukrainian bonds—$3 billion in sovereigns and another $216 million in state enterprise infrastructure bonds. Again, these bonds were denominated primarily in the local hryvnia. The three positions alone constitute 22.2% of total portfolio assets. It seems like a pretty illiquid portfolio already, before we debate the marketability of bonds issued by South Korea (14% of the portfolio), Ireland (10%), Malaysia (7.1%), Brazil (4.7%), Indonesia (1.8%), Slovenia (1.2%), the Philippines (1.2%), Russia (1%) and Serbia (0.8%). U.S. money-market investments represented 14.2% of the AUM."

When illiquidity came up as a topic for discussion at the May 22 investor-day question-and-answer session, Hasenstab brushed it aside. "Oftentimes," said the portfolio manager, "a few of the positions kind of may be interesting to talk about or write about and so those get a lot of attention. [B]ut when you look at the whole portfolio and take Ukraine, for example, it's less than [a] 5% position. Eighty percent-plus of the portfolio is in deep liquid markets that we could move billions within minutes, if not hours."

Not so according to survey data on trading activity collected by the Trade Association for the Emerging Markets. Hungary, a double-B credit, makes a case in point. According to EMTA, euro bonds with a face value of $9.7 billion and local debt with a face value of $17 billion changed hands in the first quarter for a total of $26.7 billion. As there were 61 trading days in the three months, $438 million was the average daily volume. If Franklin could sell at a rate of 15% of the average daily turnover, the position would take 79 days to liquidate. If Hasenstab could somehow achieve 50% of daily average volume, an exit would take place in 24 days.

"We find a similar story in Ukraine, where $51.6 billion in par value traded in the first quarter," Grant goes on. "Again, we will count euro bonds, which accounted for slightly more than a third of this volume, although just $62 million of Hasenstab's $3.2 billion is euro-denominated. Counting all debt, average daily volume was $845 million—which would take 25 days to liquidate at 15% and 7.6 days at 50%. Counting local debt only, average trading volume would decline to $540 million; one would need 39 and 12 days to sell, assuming 15% and 50% of daily volume, respectively. Repeat the process with the $7 billion, A-rated Polish position, nearly all of which is, or at least was as of the statement date, zloty-denominated. Reported volume of $66.3 billion (local currency volume was just $48 billion) works out to an average daily volume of $1.1 billion. Under the 15% and 50% assumptions, that's 43 and 13 days to exit, respectively.

"Holdings in even relatively developed markets are large enough to potentially pose a problem," Grant proceeds. "South Korea, for instance, is a fairly rich country with a weak double-A local currency credit rating. EMTA reported $42.4 billion of total first-quarter trading volume. Under our now-familiar assumptions, average daily trading volume was $696 million, which implies 93 days to exit at 15% of average daily volume and 28 days to exit at 50% of average daily volume. Turning to A-rated Malaysia, EMTA found a total of $50.7 billion in first-quarter trading volume (we will include the $4.5 billion worth of euro bonds, which do not appear in this portfolio). Using the same procedure as before, we find an average daily trading volume of $831 million. At 15% of average daily volume, Hasenstab would need 40 days to sell, at 50% of the volume, 12 days."

The preceding pertains not to the entire Hasenstab-managed complex but to the U.S. Templeton Global Bond Fund alone, which represents only 38% of Hasenstab's AUM. TEMGINI, the Luxembourg version of the Global Bond Fund with $38.6 billion under management, holds $3.4 billion in Hungarian, $2.8 billion in Polish and $1.4 billion in Ukrainian bonds. Then, too, Hasenstab's funds hold positions in Ghanaian debt, both dollar- and cedi-denominated; local currency bonds have a par value of 1.5 billion cedis ($465 million). Bloomberg posts no prices for the relevant cedi-denominated securities. According to EMTA, $1.6 billion traded in the first quarter for an average daily volume of $26 million. A would-be seller would require the patience of a saint.

How might Hasenstab have defended his M.O. if he had chosen to speak up? Possibly to object that the EMTA volume data are no more reliable than most survey-derived statistics. What he actually did say—this was at the May investor day—is that "when you talk about volatility, I think it's important to talk about volatility [of] the whole portfolio. The global bond portfolio volatility is basically in line, [if] not often lower than U.S. Treasurys."

To which colleague Grant rejoins: "This statement belies one of the problems with the Sharpe ratio as a performance appraisal tool. The Sharpe ratio assumes that returns follow a normal (i.e. bell-shaped) distribution. For infrequently traded instruments, such as many of the bonds examined in this story, a normal distribution assumption could be considered inappropriate—emerging-market investments are characterized by negative skew-ness (meaning the left, or negative, tail of the distribution is longer than the right). The majority of observed investment outcomes might be positive, but the potential exists for sharply negative returns in any given period. Moreover, the absence of frequent transaction data leads to an understatement of the volatility of returns, not to mention the opportunity for acute pricing error. The 'risk-adjusted' returns of the Templeton Global Bond Fund look terrific, but Dr. Hasenstab might just find that entering into his chosen positions was easier than getting out."

You can infer as much by examining the individual holdings. The nearby table enumerates the top 10 positions of the U.S. edition of the flagship Templeton Global Bond Fund as of May 31. Hasenstab must love his positions; he apparently won't let anybody else near them.

"No analyst gets a CFA charter for pointing out that assets under management are likely to fall at mutual fund companies during market panics," Grant points out. "It is, however, worth noting that withdrawals do happen, even in the absence of a panic—and even in the absence of poor performance. Pimco's Total Return Fund, for instance, has suffered 14 consecutive months of outflows, reducing its assets to $225.2 billion from $293 billion before the exodus began. 'The Total Return Fund, long lambasted as underperforming, is outperforming its index by a decent margin,' a defensive-yet-fatalistic Bill Gross was quoted as saying by the *Financial Times*, 'and yet to complain and to whine, we're $50 billion poorer over the last 13 months. It makes you wonder why that would be.'"

What advice might we have for investors in the Franklin Templeton's star-spangled bond funds? Only that, in any future rush to liquidate, it would be better to be early than late. And for the Franklin Resources' stockholders, a question: Are you quite sure you know what you own?

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