SEC Probes Small Bond Trades That Lead to Big Returns

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When AlphaCentric Income Opportunities fund made its debut in late May 2015, it began to beat its peers almost immediately, an unusual development for the slow-moving world of bond investing.

By June 30 of that year, the fund was up 5.6%. In that same period, its benchmark fell by nearly 1%, according to Morningstar Direct.

The key to the AlphaCentric fund's hot start: a basket of 22 bonds backed by residential and commercial mortgages that accounted for about three-quarters of its portfolio as of June 30. In each instance, the fund bought those mortgage securities in small "odd lots," or increments of less than $1 million, according to a securities filing.

Because they are of little use to many of the giant investment firms that tower over the markets, odd lots often trade at a discount to larger, "round-lot" positions.

Money managers, though, don't always apply those discounts to the prices they use to mark the value of those bonds. Instead, they rely on the marks provided by third-party pricing services that often look at how the round lots of that same security trade. Using those higher marks can juice the fund's return; a bond bought at a discount is suddenly worth its full price.

It is a practice that's now drawing the ire of securities regulators, who have argued in a pair of cases that funds used those higher marks to inflate their performance, and then failed to tell investors enough about the reasons for their impressive starts.

In April, Semper Capital Management LP settled Securities and Exchange Commission claims that its MBS Total Return fund had overstated returns. The firm agreed to pay about $500,000 without admitting or denying the SEC's findings.

Photo: Eric Lusher/William & Mary

Betting on odd lots is a common practice among startup bond funds, particularly for a generation of mortgage funds that launched in the years following the 2008 financial crisis, according to Vladimir Atanasov and John Merrick, from William & Mary, and Philipp Schuster of the University of Stuttgart. The professors shared their preliminary findings with the SEC in late 2016, using the Semper fund to highlight their concerns.

The scrutiny has brought new attention to an age-old dilemma: How managers value investments that aren't widely held or frequently traded. Many debt markets lack the steady flow of prices found on exchanges, giving investors more discretion over their marks. Mindful of the obvious conflicts of interest, investment firms have long viewed third-party marks as a safe way to avoid those issues.

Now, how those independent prices are used has been called into question as well.

An AlphaCentric spokeswoman said that its fund averaged about $8 million in assets during its first three months, and therefore needed to buy odd lots to ensure its portfolio was diversified. It was common for managers to buy those bonds at a discount when many firms were eager to unload mortgages.

For that reason, the spokeswoman said, "a significantly discounted purchase price does not necessarily reflect the price that one would expect to receive in a later sale transaction." What's more, the fund followed its strong start with an even better 2017, returning 14% that year.

The AlphaCentric spokeswoman said the fund relied on a third party, Intercontinental Exchange, to provide marks for all of its bond purchases. "When we sold our odd lot positions, we typically received actual prices at or above the pricing service valuations." the spokeswoman said. A spokesman for ICE declined to comment.

The professors published a paper on their full findings in 2019 and updated their work earlier this year.

From a list of funds that launched since January 2010, they identified those that bought odd lots or so-called single-fund securities. Single-fund securities, the professors wrote, are those that are only owned by one fund. For that reason, they should be marked at a discount to similar, more widely traded, bonds, the professors have argued.

Finally, they narrowed the list to those funds that produced returns well in excess of their benchmark in months when they had snapped up large quantities of odd lots or single-fund securities. The result? Twelve funds managing a combined $75 billion.

AlphaCentric Income, Semper MBS Total Return, Deer Park Total Return Credit Fund and Performance True Strategic Bond Fund were among the funds on that list, Mr. Merrick said. None of the funds have existed for more than a decade, but most have drawn billions of dollars in investors' money and won high ratings from Morningstar for their strong early returns.

Photo: Amadeus Bramsiepe/Karlsruhe Institute of Technology

Semper, a mortgage-bond specialist owned by former Time Warner Inc. Chief Executive Richard Parsons and billionaire businessman Ronald Lauder, launched its MBS Total Return fund in July 2013. In three months, odd lots accounted for 74% of its portfolio, according to the professors' research.

Spokespeople for Semper, Deer Park Road Management Co. and PT Asset Management LLC, which runs the Performance Trust fund, declined to comment.

The SEC actions reflect the need for firms to have robust systems in place in both how they assign marks to the securities they buy, and what they take from third-party pricing firms, said Eric Jacobson, a strategist with Morningstar Research Services.

Mr. Jacobson said he's concerned, though, that the cases may place the onus on bond marking back into the fund manager's hands and away from third-party firms. There are many examples in Wall Street history where mismarked bonds made by money managers directly ended poorly for firms and their investors.

Some mortgage-bond traders and academics have disputed the professors' claims. Some of the bonds the professors flagged as odd lots were likely purchased in larger, round-lot quantities and then allocated to multiple funds, they said. And any discounts managers might have once found in buying odd lots have all but disappeared over time, they said.

An executive at one of the firms that appeared high on the professors' list said that the SEC had reviewed the fund's policies on marks several times since it launched, most recently in 2018, and hasn't voiced concerns. Still, the executive also said his firm doesn't rely heavily on the round-lot prices recommended by its third-party pricing firms.

Odd lots had already been on the SEC's radar when the professors presented their findings to the agency's enforcement staff.

Earlier Bond Battles

- Hedge-Fund Manager Spars With BlackRock, Neuberger (Aug. 28, 2019)
- How Third Avenue Fund Melted Down (Dec. 13, 2015)
- Inside the Showdown at the Biggest Bond Firm (Feb. 24, 2014)

In a December 2016 settlement with Pacific Investment Management Co., the regulator found that a fund run by the firm's former investment chief, Bill Gross, overstated the value of 43 mortgage bonds it bought in odd lots in 2012. Pimco then failed to tell investors those inflated marks were responsible for the exchange-traded fund's early success.

The story behind the SEC's inquiry began in March 2013, when a former Pimco vice president named Jason Williams filed a wrongful-termination lawsuit against the bond manager.

Mr. Williams, who withdrew his suit within days, said that Pimco had retaliated against him after he reported the alleged mismarking tactics to special agents for the inspector general for the Treasury Department's Troubled Asset Relief Program. SigTarp agents eventually referred the complaint to the SEC. Mr. Williams, who left the industry and now runs a bar in Montana, declined to comment.

Pimco settled the SEC probe without admitting or denying the claims.

The professors came across the issue independently, while overseeing a student-run investment fund. The fund bought up a bunch of odd lots at a discount to where they traded. Yet when the fund's brokerage calculated the fund's net asset value, it relied on marks provided by a third-party pricing firm. Those marks matched the round-lot price.

"We saw that in action," Mr. Merrick said.

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