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Asset Management ADVocate

“Odd Lots” and Valuation Déjà Vu--Part 1

The SEC's recent settlement (the "Order") with Pacific Investment Management Company ("PIMCO") reflects a new twist on an old issue: buying securities at bargain prices and then marking them up when calculating NAVs. The SEC first addressed this issue in 1969 in the context of what we now refer to as "PIPEs." The first part of this post examines the similarities and differences between PIPEs and the mortgage-backed securities ("MBS") addressed in the Order. The second part explains why "odd lot" MBS may be more problematic than PIPES.

PIPEs and ASR 113

"PIPEs" is an acronym for "Private Investment in Public Equity." A PIPE involves the private placement of publicly traded securities (or securities convertible into publicly traded securities). Public companies use PIPEs to raise capital without first registering the newly issued securities with the SEC. PIPEs are initially "restricted securities" insofar as they can be resold only pursuant to an exemption from SEC registration. PIPEs eventually lose this restriction, due to their subsequent registration by the issuer or the elapsing of the holding period in Rule 144. Investors won't pay as much for restricted securities as they will pay for freely tradable securities, so PIPEs are typically issued at a discount to the market value of the corresponding publicly traded securities. In the 1960s, some funds made it a practice to buy PIPEs at a discount and then immediately value them as if they were unrestricted securities, boosting their NAV by the amount of the discount. The SEC's Accounting Series Release No. 113 ("ASR 113") sought to curtail this practice. In addition to requiring funds to limit holdings of restricted securities to 10% (later 15%) of their assets, ASR 113 stated that:

> the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper."

ASR 113 also ruled out:

- Valuing restricted securities at cost;
- "Valuing restricted securities automatically to maintain the same percentage discount … that was received when the restricted securities were purchased;" or
- "Automatically amortizing the [discount] over some chosen period …."

Discounting "Odd Lot" MBS

Although the Order didn't involve PIPEs, the findings (which PIMCO neither admitted nor denied) described a similar trading pattern. According to the SEC, PIMCO's new Total Return ETF bought "odd lots" of MBS. The purchase price of these odd lots was less than the value at which the external pricing vendor was marking the MBS. The pricing vendor's marks represented its good faith opinion as to "what a buyer in the marketplace would pay for a security (typically in an institutional round lot position) in a current sale." The vendor considered an institutional round lot "as having at least *$1 million current face value*." Using the vendor's "round lot" mark to value the "odd lot" MBS had the same result as using the price of publicly traded securities to value a PIPE: it boosted the fund's returns by the difference between the purchase price and the round lot price. According to the SEC, "PIMCO did not have a reasonable basis to believe that it could exit these [odd lot] positions at round lot prices." In other words, failing to account for the odd lot nature of a holding, like failing to account for the restricted nature of a holding, resulted in an alleged overvaluation.

MBS Oddities

It was not a coincidence that the odd lots were MBS. Unlike most corporate and government debt, MBS are paid down each month upon receipt of monthly mortgage payments and prepayments. A Fannie Mae publication provides the following example of how monthly paydowns reduce the principal balance of an MBS.

Factor Month	Factor	Balance Using $1,000,000 Original UPB
September	0.92851152	$ 928,511.52
October	0.92756215	$ 927,562.15
November	0.92646835	$ 926,468.35
December	0.81232344	$ 812,323.44
January	0.81137201	$ 811,372.01
February	0.81047051	$ 810,470.51
March	0.80941592	$ 809,415.92

This example shows how an MBS that began as a "round lot" ("$1 million current face value") becomes an odd lot after the first month (when the current face value fell to $928,512), and grows progressively odder with each passing month. In contrast, PIPEs don't become more restricted; in fact, they normally become unrestricted securities over time.

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