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Asset Management ADVocate

“Odd Lots” and Valuation Déjà Vu--Part 2

In the first part of this post, I explained how trading odd lot MBS can create the same valuation issue as trading PIPEs. I also touched on some important differences between MBS and PIPEs. In this part, I'll examine why these differences may make the valuation of odd lot MBS more problematic than the valuation of PIPEs. The Order is significant for investment advisers as well as investment companies, insofar as the SEC asserted that PIMCO's valuation procedures violated Rule 206(4)-7.

Inadvertent Odd Lots

As explained in the first part, monthly payments and prepayments will eventually reduce a "round lot" MBS holding to an "odd lot." Although the Order dealt with trading odd lots, its premise was that funds should not use the estimated trading value of an institutional round lot as the fair value of an odd lot. In other words, a purchase of an odd lot MBS at a discount to a vendor's mark calls into question not only the buyer's use of the vendor's mark, but its use by holders of other odd lots (if there are any) of the MBS as well. Funds may therefore want to consider including monitoring for MBS positions that have paid down to odd lots in their pricing procedures. As odd lots are identified, they should no longer be valued at the vendor's mark for that CUSIP.

How Should Funds Fair Value Odd Lots?

Once an odd lot is identified, how should it be fair valued? The Order implies that a vendor's mark should be reduced to reflect the discount that would be required to exit the odd lot position. What would provide a "reasonable basis" for this discount? A fund purchasing an odd lot MBS has a baseline, the difference between the purchase price and the vendor's current mark, for determining a discount. Although the fund might apply this baseline discount to subsequent vendor marks, ASR 113 warned against "valuing restricted securities automatically to maintain the same percentage discount …." The fund should find some reasonable basis to reevaluate the discount periodically. Broker "quotes" would be an alternative valuation method. However, the Order quotes a trader's note explaining that "we typically can't get dealers to bid unless they line up buyer on other side …." In my experience, few dealers want to spend time providing marks for odd lot positions they are unlikely to trade. This may make it difficult for a fund to obtain reliable broker marks. The holder of an "inadvertent" odd lot MBS may face even greater valuation challenges. Because the holder did not purchase an odd lot, it does not have a baseline discount to start with. Unless the holder can find another odd lot trade in that CUSIP, it could not base the discount on an actual trade. If the holder cannot find such a trade, it might look at the discounts incurred in odd lot trades for other MBS. The findings of the Order suggest, however, that other discounts may not be comparable. The Order identified one trade at a 27% discount (probably the largest), but the average discount for 43 trades was only 9% and the fund resold some of the odd lots at an average discount of 3.81%. Holders of "inadvertent" odd lots would also need to reassess any discount periodically. Perhaps the cleanest solution would be to try to buy more of that CUSIP, so as to reestablish an institutional round lot position that could be valued at the vendor's mark.

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