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Merganser is an institutional asset manager with over $10 billion in assets under management. Our team has been investing in Investment Grade Floating Rate Securities since the 1980s. We launched a dedicated Floating Rate Bond strategy in 2013.

So Far So Good For SOFR

The sunset for the London Interbank Offered Rate (LIBOR) is set for the end of 2021, creating one the most sweeping challenges for financial markets in recent history. The Secured Overnight Financing Rate (SOFR) has been positioned as its successor in the U.S. market and the transition to a new reference rate is progressing steadily, though substantial hurdles still lie ahead for the benchmark that impacts more than $200 trillion of underlying floating rate instruments.

Leaving LIBOR

LIBOR is a common reference rate utilized around the globe for decades. Tens of millions of floating rate contracts worth over $200 trillion USD are tied to LIBOR[1], ranging in scope from derivatives, business loans, adjustable mortgages, to student loans. Each LIBOR rate is derived daily from a survey of 20 participating banks that estimate the cost of interbank unsecured borrowing for various tenors and currencies. With the onset of the financial crisis in 2007, many questioned LIBOR's credibility, and investigations eventually exposed widespread rate over-fixing and market manipulation within the panel banks. LIBOR's direct borrowing activity among the panel banks consequently decreased over time, creating a reference rate that is based largely on hypothetical transactions and not robust, observable transactions. In July 2017, the head of the U.K. Financial Conduct Authority stated that they would "no longer compel banks to submit quotes for LIBOR after 2021."[2] This statement has fueled an international focus on establishing concrete plans to transition away from LIBOR as we know it.

The Alternative Reference Rates Committee (ARRC) was formed to determine how markets in the U.S. should prepare for life without LIBOR. After exploring various alternatives, the ARRC officially endorsed SOFR as the foundation for a move away from LIBOR, laying out a five-year transition plan. This raises numerous questions for investors. In this memo, we will outline what SOFR is (and isn't), where SOFR is in terms of its development, and key components of the transition that remain unclear.

What is SOFR?

SOFR is a broad measure of the cost of borrowing cash overnight against Treasury bonds posted as collateral. SOFR is published by the Federal Reserve Bank of New York and is based on observable market transactions. The market activity measured by SOFR has an average daily trading volume of $750 billion, compared to LIBOR's underlying market volume of $500 million.

[1] ARRC – Roundtable July 19, 2018
[2] Andrew Bailey, Chief Executive of the Financial Conduct Authority – Speech July 27, 2017

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There are several fundamental differences between SOFR and LIBOR:

1. SOFR is an overnight rate whereas LIBOR has a term structure of rates (e.g. 6-month LIBOR)
2. SOFR is based on actual transactions whereas LIBOR is based on a survey of participating banks
3. SOFR is a secured borrowing rate, meaning it is based on overnight repurchase agreements (overnight repo) which are collateralized (secured) by Treasury securities. LIBOR is unsecured: it is based on interbank loans that do not require collateral

Daily SOFR tends to be more volatile than LIBOR since SOFR is based on real transactions and subject to market movements. Month-end and quarter-end supply variations and Treasury-bill issuance have proven to increase SOFR at times when LIBOR is less affected. These technical drivers can exacerbate the volatility for brief periods (i.e., a few days). Exhibit 1 compares overnight SOFR with overnight LIBOR and 1-Month SOFR futures. All three rates tend to have the same general direction, yet SOFR's daily variability can be observed, particularly for the most recent year-end period. The data also shows that 1-Month SOFR futures, which can be used as an indication of what SOFR will average over a month's time, have traded efficiently despite SOFR's daily volatility. Daily volatility in a benchmark rate for floating rate instruments can cause investor consternation, even if the actual impact of those fluctuations is largely immaterial. We expect additional outreach/term structure development to allay these concerns as the ARRC continues down the path of transition.

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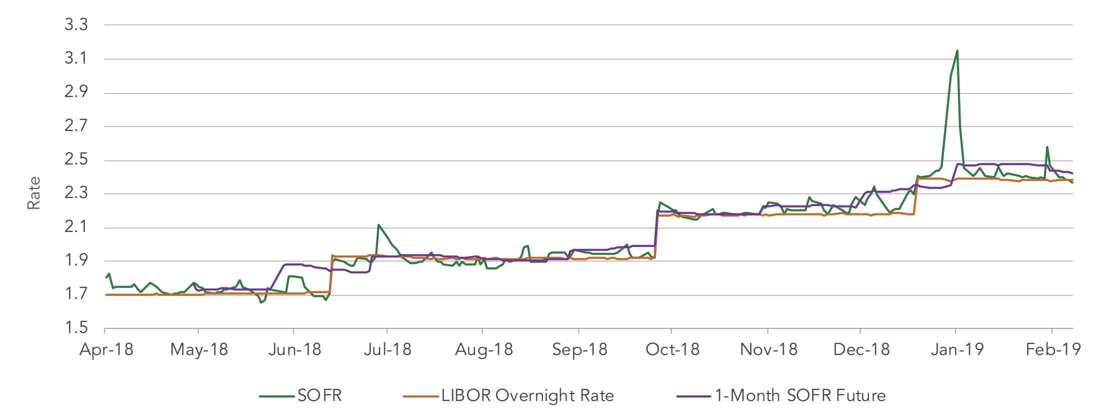
Exhibit 1: Rate comparison



Source: Bloomberg

SOFR Progressing but Questions Remain

The path to adoption of SOFR as a broadly utilized reference rate is well under-way. Exhibit 2, on the next page, summarizes the major milestones of the ARRC's plan and SOFR-linked debt issuance. Despite reaching many significant milestones, SOFR-related issuance remains a fraction of the floating rate market. Since the first SOFR bond issuance from Fannie Mae in July of 2018, LIBOR has remained the dominant reference rate with more than $473B of issuance compared to SOFR which represented $45B[3]. We expect LIBOR to remain the reference rate for the majority of floating rate issuance through 2019 (and possibly 2020). And while the ARRC's transition plan is progressing, hurdles remain that may impede seamless acceptance of the transition to SOFR:

SOFR has yet to develop a term structure (i.e. various tenors) to replace the various tenors of LIBOR.

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[3] Bloomberg. Issuance data from July 31, 2018 – Jan 23, 2019

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tenors of LIBOR. The launch of SOFR Futures was the first step in providing this framework. The ARRC is already using futures and cleared swaps data to educate market participants about how the term rates might "look and behave."

- Approximately 18% of instruments tied to LIBOR mature beyond the 2021 target of transitioning away from LIBOR[4]. Terms and fallback language for those outstanding instruments must be analyzed and, in some cases, amended. This process is a significant moving piece in the transition and will be of material consideration for fixed income investors. The ARRC is working with trade groups and banks to develop robust and standardized fallback language, which is scheduled to be published in 2019.

Exhibit 2: Major transition milesones

April 2018	• 4/3: Federal Reserve Bank of New York begins publishing daily SOFR
May 2018	• 5/7: SOFR futures begin trading on the Chicago Mercantile Exhchange (CME)
July 2018	• 7/26: Fannie Mae issues first agency SOFR-linked floating rate notes
August 2018	• 8/14: World Bank issues first supranational SOFR-linked bonds • 8/20: Credit Suisse issues first SOFR-linked yankee certificates of deposit • 8/30: MetLife issues first SOFR-linked corporate bonds
September 2018	• 9/20: Wells Fargo issues SOFR-linked bank notes • 9/21: Triborough Bridge & Tunnel Authority issues first SOFR-linked municipal bonds

Source: Merganser Capital Management

As is often true in fixed income investing, inefficiency presents opportunity for value...

The replacement of a reference rate as large and internationally ingrained as LIBOR comes with financial risks and uncertainty. The ARRC, Federal Reserve, global regulators and major market participants have followed the introduction of SOFR and the LIBOR transition plan with close attention. The focus will now be on market participants for widespread adoption, trading and liquidity. To date, SOFR has yet to demonstrate the level of adoption necessary to be assured the role of LIBOR's replacement. As a result, we expect challengers to emerge, including ICE's recently proposed "U.S. Dollar ICE Bank Yield Index" (BYI). Does this mean that LIBOR's replacement might result in a VHS versus Betamax situation? We view this as unlikely due to the largely aligned interests of market participants and regulators alike.

Conclusion

As is often true in fixed income investing, inefficiency presents opportunity for capturing value, and we view this transition period as one that will present meaningful opportunity to generate excess returns, either through existing floating rate securities or newly issued SOFR notes that provide a concession to existing securities.

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[4] Alternative Reference Rate Committee (ARRC) – Second Report, March 5, 2018