

Stop selling bonds to retail investors

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The Uruguayan debt exchange in April 2003 was one of the most impressive pieces of sovereign liability management ever seen. Because Uruguay is a small country, however, the exchange never really got the international recognition it deserved¹. The exchange was not all good, however. One aspect of the deal in particular has received no publicity, as far as I know: it actively and shamelessly discriminated against retail bond investors.

The risk – indeed, the probability – that such a thing would happen has been clearly spelled out by Adam Lerrick in his attempt to aggregate large numbers of German and Benelux investors in Argentine bonds. Without a high-profile advocate with a significant chunk of debt to represent them, Lerrick says, these investors can expect second-class treatment if and when Argentina finally launches its exchange offer.

Why does Lerrick say this? Look at the main reasons why any country would want to come out of default. Firstly, there's the prospect of regained access to the international capital markets. Those markets are controlled by the large institutional investors: it is they who will ultimately control when and whether Argentina will ever be able to issue a bond again. Argentina, then, has every incentive to favor institutional investors who might lend it money in the future, giving them preference over retail investors who, having been burned once, are never going to buy Argentine bonds again.

Even if the country doesn't intend to issue any new debt, it will still care about the spreads at which its debt is trading: a country's EMBI level is the universal indicator of country risk, and helps to determine everything from levels of trade credit and domestic interest rates to the strength of the stock market. And the level of the EMBI is set by institutional, not retail, investors.

There's also the credibility of creditors' threats to consider. When Ecuador defaulted, it was a group of institutional investors which banded together and used their substantial holdings to accelerate the country's

¹ At the risk of blowing my own trumpet, the most comprehensive article about the exchange I know of is my own, in the February 2004 issue of Euromoney Magazine.

bonds: the process was complicated, and no one bothered even trying to get retail investors on board. The chief legal opponent of Argentina right now is Kenneth Dart – for our purposes, very much an institutional investor, who plays the game of buying and selling emerging-market debt with an extremely high degree of sophistication and aggression.

Lawyers in such cases can be extremely expensive: Elliott Associates claimed many millions of dollars in legal fees at the end of its protracted fight against Peru. And while the lawsuits of smaller bondholders might play a larger role in the Argentina case than they have in the past, the country would still be well advised to concentrate on minimising the threat from the largest players first. Once again, Argentina has an incentive to be nicer to institutional investors than it is to individuals.

More prosaically, the larger the investor, the more access it has to the debtor, the more it can ask questions and make demands, and the more likely it is that its concerns will be listened to. If someone with \$1 billion in bonds wants a clause rewritten, there's a good chance that will happen. If someone with \$10,000 in bonds wants the same thing, no one will notice.

Finally, there's the simple fact that debt restructurings are, to a large extent, a zero-sum game. Money that a country withholds, at the margin, from its retail investors can then be redirected towards institutional investors who are much more capable of putting a valuation on an exchange offer. A sovereign debtor structuring an exchange offer will probably have the opportunity to give retail investors slightly less than institutional investors, thereby rewarding its friends and penalising the people it has no reason to care about. With the means, motive and opportunity, it would probably be surprising if a country didn't follow that route.

In Uruguay's debt workout, investors who held bonds maturing in 2003 were offered a choice: a menu of options. On the one hand, there was a retail-friendly offer where the investors would keep their coupons and principal, and receive a new bond maturing in 2008. On the other hand, there was an offer which was more attractive to institutions which mark their assets to market. This involved switching into a benchmark bond with a longer maturity (2011) and a lower coupon – but which carried a higher principal amount. The institution-friendly offer was worth a good 5 points more than the bond which the retail investors got.

Essentially, Uruguay was betting that retail investors would shun complicated things like step-up coupons, and would simply elect to push out the maturity of their bonds to the nearest date available. Institutions, remember, buy and sell their bonds the whole time; individuals, on the other hand, almost never cash out until maturity. In effect, Uruguay was making

its retail investors pay 5 points for the privilege of having a bond which would automatically pay out in 2008, rather than having a bond which, if they wanted to monetize it before 2011, they would have to try to sell on the secondary market.

In a perfectly liquid market, of course, a retail investor would have been better off swapping into the 2011s, selling them, and using the proceeds to buy the new 2008s. That, however, was impossible. Only retail investors switched into the 2008s, which means that trading volume in them is negligible. If you wanted a 2008, the only way to get it was to switch into it at the time of the exchange, accepting the 5-point difference in value between the 2008s and the 2011s.

It's not only individuals who buy the debt of countries which go into default who lose out. Even those lucky enough to avoid such countries have probably not been well served by the market in emerging-market bonds, at least when their returns are compared to those of the professionals.

Institutional investors in emerging sovereign debt have been doing extremely well of late, in stark contrast to the hundreds of thousands of retail investors who have found themselves financially devastated by Argentina's default. It might have been "the slowest train wreck in history," but it wasn't so obvious to buy-and-hold retail bond investors, who hate to get out far below where they got in.

The fact is that retail investing in emerging market bonds is not like investing in the stock market, where individuals who get it right can make lots of money, outperforming lots of professional money managers who might have got it wrong. When you hold your bonds to maturity, the best you can hope for is that you get your original investment back, with interest. As a result, almost no retail investors outperform the professionals. Institutional investors can trade these bonds, can lend them out to short-sellers, and can hedge their positions with credit default swaps, just for starters. Moreover, as qualified institutional buyers, or QIBs, they have access to a much wider universe of bonds than retail investors do.

More profoundly, emerging market debt is a highly volatile asset class, where the most successful investors use enormous amounts of information to help them move in and out of positions and countries the whole time. Argentina was a superstar five years ago, while Russia was a dog; today, the roles are reversed. These are simply not the kind of securities which you can buy, hold, and sleep soundly owning. And in any case, retail investors always pay a premium for their bonds: bid-offer spreads on small quantities of euro-denominated debt are enormous compared to those on large dollar bond issues.

What's more, many retail investors are quite astonishingly ignorant as to what, exactly, they're buying: many of them believe that they're buying this debt from the bank or broker who sells them the bonds, rather than the actual borrower. In the cases of Ecuador, Uruguay and Argentina, banks have often been criticised at least as much as the debtors by retail bondholders who thought there was some kind of implicit guarantee involved. (For the retail holders of the synthetic sovereign bonds which were briefly popular in 1997, the situation is even worse, but that's another story.) When Turkey, say, issues retail-targeted bonds, to a significant degree it's arbitraging the ignorance and avarice of individuals who have nowhere near the kind of risk profile which might justify such an investment.

In sum, then, retail investors make less money than institutional investors, and are second-class creditors in workout situations. No professional would ever do what many retail investors do, and put all of their eggs into one basket, buying just a single bond issue. What's more, retail investors in emerging-market bonds generally have far too much money in the asset class: total-return bond funds almost never have more than 5% of their assets in emerging-market debt, and individuals who can't afford to lose their money should probably have less.

Part of the problem is that many Europeans made a lot of money on the EU convergence trade when they bought Italian and Spanish bonds in the 80s. That, however, was a one-off situation which is not going to repeat itself in emerging markets. Especially now, when the smart money is moving into local markets (which, needless to say, are almost entirely inaccessible to retail investors), anybody putting their own money directly into emerging-market bonds probably needs their head examined. If that's an asset class you're interested in, there's no shortage of mutual funds which can be bought instead, managed by people who know what they're doing. And if you're allergic to fees, there are even index funds, now, as well.

A much bigger part of the problem is that retail banks, especially in Switzerland, Italy, Austria, Germany and Benelux, as well as Japan, still make a lot of money from buying up euro- (or yen-) denominated bond issues and then reselling them in tiny pieces to their clients. The bankers love it, as it's very profitable for them. And the underwriters and institutional investors like it too, telling the issuers that it's important to "diversify their investor base".

Ultimately, however, all of these people are playing on ignorance and greed by selling securities to people who shouldn't be buying them. It might be legal, and it might even make good economic sense, but it's not ethical.

It is worth noting that selling bonds to retail investors does not diversify

the investor base in the sense of reducing systemic risk and moral hazard. Institutional funds are ultimately owned by individuals: nearly all of us own a tiny bit of Brazilian debt in our retirement plans or the fixed-income part of our mutual fund portfolios. There is no reason why individuals should not own emerging-market debt; there is every reason why individuals should not own emerging-market debt *directly*.

Certainly, more regulation, on a national level, would help. It may or may not be a coincidence that the country where such sales are the most regulated – the US – is also the country where they're rarest. But more broadly, a powerful international organisation should pressure emerging market sovereigns not to continue with retail-targeted bond issues; pressure underwriters not to pitch such issues any more; pressure the big European and Japanese banks no longer to sell them to their clients; and expend time, money and effort educating the public. Retail investors should be taught not to buy these securities, and pointed instead to alternative ways of getting exposure to emerging market debt.

Who should do this job? That's a harder question. National regulators, for one, although they have no leverage over sovereign issuers. Maybe larger organisations, like the BIS, the IMF, the G20, or the EU might be more effective.

The people who bought Argentina's debt are not multimillionaires with large Swiss bank accounts and sophisticated hedging strategies. Most of them are normal middle-class investors who used to get high coupons in the days of high inflation, and who were guided down the credit scale as investment-grade sovereign bonds generated diminishing returns. Their total investment portfolios were tiny, and the proportion of those portfolios which was made up of emerging-market debt was vastly greater than any investment professional would ever advise. But there was an unholy alliance of powerful institutions all of whom had a vested interest in keeping these people buying. On the other side, there was no one to tell them not to touch this stuff, and that what they were doing was incredibly foolish.

Now, those same retail investors are an enormous obstacle to any successful restructuring of Argentina's debt. Many are in no position to take a haircut: unlike the country's institutional creditors, they bought at par and need their money back.

In the language of crisis management, it is important to make sure that when crises do happen, they cause as little damage as possible, both inside and outside the country concerned. One way to do that is to get rid of the entire class of retail investors to as great a degree as is practicable. For their own sake.