Competitive Advantage in Investing
B8424-001
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Course Description

Successful investing almost always depends on operating with some distinct competitive advantage. And nowhere is that clearer than in the competition between institutional fixed income investors, where many investment models compete to extract return from available assets. Advantage can arise from better information or analysis. But advantage also arises more clearly and more sustainably from the cost and structure of an institution’s leverage and funding, its tax and accounting framework and its regulatory and political environment.

This course approaches investing from the perspective of institutional fixed income portfolio managers trying to capitalize on comparative advantage. It introduces a framework that fits comparative advantage into classical finance theory. It leads students through the advantages held by money managers and hedge funds, banks and insurers, GSEs, sovereign wealth funds and broker/dealers. Through case studies and industry data, the course examines how those advantages shape the investment behavior of these institutions.

To develop practical appreciation for managing a portfolio, students will use actual fixed income market offering to construct a series of portfolios appropriate to different institutions. Students will come to understand how to build a fixed income portfolio appropriate to particular institutions and how the distinct behavior of different institutions can drive pricing, liquidity and other general aspects of the fixed income markets.

This course is excellent preparation for any student considering a career in fixed income or equity investment management or for students considering sales, trading or research.

Prerequisites:
• B6301 Corporate Finance
• B6302 Capital Markets

Recommended:
• B8308 Debt Markets
Selected Course Materials and Other Resources


- Handouts, broker/dealer offering sheets, guest speakers

Evaluation

- Attendance and class participation: 20%
- Team and individual weekly assignments: 20%
- Team portfolio management assignments: 30%
- Individual final paper: 30%

Optional Short Workshops (likely scheduled for weekends)

- *Tools for fixed income analysis* including Bloomberg and Deutsche Bank’s MBS Analytics on Bloomberg
- *Constructing relative value trades in fixed income*

Course Outline

*A Conceptual Framework for Fixed Income Investing*

- The classics of finance: Markowitz and CAPM

- The flaws in CAPM and the alternative Local CAPM

- The key sources of comparative advantage in fixed income investing including funding and liability structures, accounting and tax regimes, regulatory and legal constraints and their impact on asset choice, holding period and other aspects of investment behavior.

*Risk, Reward and Portfolio Construction*

- Scenario construction: developing expectations about the yield curve, volatility, swap spreads, credit and mortgage spreads and funding markets

- Estimating risk and return: calculating expected returns and volatility in Treasury, agency and corporate debt and MBS; estimating risk and return in funded portfolios

- Hedging components of risk: hedging corporate debt, agency callable debt and MBS
Portfolio Management for Total Return

- Sources of comparative advantage for money managers, hedge funds and others: evaluating fund performance; understanding hedge fund performance; growth and future prospects for providers of alpha and beta.

Portfolio Management for Banks

- Sources of comparative advantage for banks: funding through retail and wholesale deposits, FHLB advances, debentures, government programs; potential for informational advantages; accounting/tax considerations; regulatory and political considerations.

- Portfolio behavior at banks: the conflicting objectives of managing capital, ROE and net interest margin; observed differences in funding structure; observed differences in asset mix; observed differences in trading behavior.

- Case study: hedging a mortgage servicing portfolio on a bank balance sheet: characteristics of the asset; methods to hedge the risk; accommodating the offsetting impact of new mortgage originations; the influence of accounting.

Portfolio Management for REITs and GSEs

- Sources of comparative advantage for REITs: regulatory exemptions, source and quality of capital, sources of funds, limits to allowable assets.

- Sources of comparative advantage for GSEs: funding through the agency debt markets; impact of debt issuance process on funding costs; use of derivatives to minimize funding costs; accounting/tax considerations; regulatory and political considerations.

- Portfolio behavior at GSEs: observed differences at FNM and FRE over time; observed differences between FNM/FRE and the FHLBanks.

Portfolio Management for Insurers

- Sources of comparative advantage for insurers: funding through insurance premiums, annuities and other vehicles; impact of rating agency capital charges; differences between life and P&C liability structures.

Portfolio Management for Sovereign Wealth Funds

- The varying investment objectives of sovereign wealth funds: from foreign reserve management to fiscal stability, from monetary policy to wealth preservation.
• The varying approaches of sovereign wealth funds: asset allocation and response to financial crisis

• The role of moral hazard in the investment strategies of sovereign wealth funds

*Portfolio Management for Broker/Dealers*

• Sources of comparative advantage for brokers/dealers: information, liquidity and transaction costs; sources of funding; position flexibility; observable differences over time in the aggregate broker/dealer portfolio

*Turning the Tables: The Impact of Market Structure on Asset Value*

• Understanding the impact of market structure: case studies of GSE, bank and Fed impact on value in MBS; case studies of GSE and mortgage servicer impact on value in swaptions; case studies of foreign central bank and Fed impact on value in U.S. Treasury debt.

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