Investing Bond Proceeds: Structured Investments and GICs

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To gain a better understanding of structured investments, including guaranteed investment contracts (GIC), we conducted the following Q&A with Christopher Harris, CFA, CAIA. Chris is a director in the Structured Products Group with PFM Asset Management LLC (PFMAM). He manages projects related to structured investments and is the firm's primary liaison to the structured investment community.

Could you describe for readers what a structured investment is and, specifically, what a GIC is?

Harris: A structured investment is a highly customized agreement that is typically procured through a competitive bidding process and entered into with a financial counterparty. The agreement offers a specified rate of return on the investment over time. Typically, these are issued as fixed-rate contracts, but variable-rate contracts do exist. The main types we see are uncollateralized guaranteed investment contracts, collateralized GICs, flexible repurchase agreements (or flex repos), and forward delivery agreements (or FDAs).

GICs are unsecured agreements typically provided by insurance companies or banks. Collateralized GICs have collateral in an amount equal to the invested balance, plus a cushion, to attempt to provide protection against fluctuations in the market value of the collateral. This collateral is typically pledged to a third-party custodian and is accessible to the investor in certain instances of counterparty default.

Flexible repurchase agreements (flex repos) are similar to a collateralized GIC because securities are posted against the invested balance, but mechanically and operationally, it is the purchase and future resale of securities from the counterparty at a specified yield.

A forward delivery agreement (FDAs) shares some characteristics of a flexible repurchase agreement, but instead of reselling the securities back in the future, the securities purchased from the counterparty are done so on an outright basis – meaning the provider typically has no recourse to those securities once they are sold to the investor. This is an important distinction from a risk perspective.

These are all passive strategies with no ongoing management or monitoring after procurement. This means there are certain features that should be carefully considered, such as downgrade triggers that require the counterparty to take remedial action if its credit ratings fall below certain thresholds. This could include posting additional collateral, obtaining a guarantee of its obligations, or outright terminating the contract.

What are some situations where an investor might choose to utilize a structured investment?

Harris: The highly customized nature of these agreements means they can be tailored to meet investment objectives that may not otherwise be possible with money market funds or managed portfolios. For example, in a rising interest rate environment, Treasuries and other fixed-rate investments typically experience market value losses due to the inverse relationship between price and yield: as yields rise, prices — and by extension, market values — fall. Structured investments are typically carried at face value, which means there are no unrealized gains or losses that occur as long as the agreement remains outstanding. Structured investments may therefore allow for exposure further out the yield curve without subjecting an account to market value fluctuations.

These structures can also eliminate reinvestment risk because the invested balance under the contract will earn a fixed rate of return. For example, for a project fund, if draws are delayed, then the balance remains invested at whatever the contract rate is. For a managed portfolio or money market fund, this isn't the case, and any excess balances would be invested at prevailing yields, which could be higher or lower. For accounts like debt service funds, structured investments could potentially eliminate reinvestment risk because they can be used to lock in a rate of return on future deposits – even deposits that occur many years in the future – which otherwise isn't possible using traditional fixed-income investments.

Accounts that have fixed cash flows – such as capitalized interest funds – could also be a good fit for a structured investment because it can provide passive exposure to the credit curve, allowing issuers to take advantage of higher yields and wider spreads.

On the flip side, because this is a passive strategy, it is incredibly important to understand the risk profile of the investment agreement and to make sure the agreement is structured in a way to manage risk. This also means risk-reward analyses versus other alternatives like money market funds and portfolios of fixed-income securities to make sure that a structured investment is being chosen because it is a prudent solution that adds value to our clients.

Can you outline some of these risks that investors should keep in mind?

Harris: Different types of risk to consider include credit risk, performance risk, liquidity risk and tax risk.

First, as an investment advisor and fiduciary to our clients, we are always thinking about managing credit risk, and in this context, we mean the risk of the loss of principal. GICs, collateralized GICs, and flex repos all have credit risk. The collateral posted under the latter two types is designed to be accessible if the counterparty defaults under the agreement, but there is no guarantee that the collateral won't be clawed back or subject to a bankruptcy stay in the event of default. As such, we always recommend our clients engage counsel – including potentially bankruptcy counsel – to talk through these considerations.

Also, depending on the type of collateral posted, it is possible that the proceeds, upon liquidation of the collateral, may not be enough to keep the client whole. For example, if 30-year securities are posted to the account at a margin of 104% of the invested balance, then it is possible that a 20 to 40 basis point (0.20% to 0.40%) increase in interest rates will mean the market value of the collateral is no longer equal to the invested balance. Collateral typically needs to be marked to market at least weekly, but this can still subject the investor to risk from sudden moves in the market between valuation periods. So, for these reasons, we always treat these structures as having credit risk.

On the other hand, FDAs are typically accompanied by an opinion of counsel indicating that the securities sold under the contract are done so free and clear. This means we are more concerned about the counterparty's ability to perform its obligations under the contract and deliver the securities. For this reason, we always consider the securities that are sold under the contract. There is a difference between having Treasuries versus, say, commercial paper or other instruments that carry credit risk.

In this context, GICs, collateralized GICs, and flex repo are viewed as having credit risk, whereas FDAs – with Treasuries as underlying deliverables – are viewed as instead having performance risk.

You mentioned downgrade triggers – can you talk about how that comes into play?

Harris: The downgrade triggers are designed to provide added security against a deterioration in the credit quality of the counterparty. During the height of the financial crisis in 2008 and 2009, these downgrade triggers were useful because they provided clients with additional protection or the ability to terminate agreements if counterparties were hit with significant downgrades. On the other hand, these downgrade triggers may not work if a counterparty files for bankruptcy overnight, as in the case of Lehman Brothers – they went from being "A"-rated to in default, so a downgrade trigger at the "triple B" category did not have value in that situation.

What about liquidity and tax risk?

Harris: Because the agreements are usually competitively procured and highly customized for each transaction, there is no secondary market, and the liquidity is provided entirely by the agreement counterparty. This means that there is no other source of liquidity than the counterparty. This also ties into tax risk – with no secondary market, there is no trading data or history for these structures, and valuing the contracts can be difficult. This could come into play if the underlying tax-exempt bonds are audited or when arbitrage rebate calculations are performed. Katia Frock and I talked about this briefly back in April of 2022 when we discussed Tax Compliance for Bond Proceeds. Ultimately, our job as the investment advisor is to make sure we are discussing all these risks and considerations to determine if an investment agreement is a good fit for our clients.

What do these discussions typically include?

Harris: We talk in great detail about suitability. This means considering our client's risk tolerance and transaction-specific circumstances.

We think about the ability to lock in positive arbitrage, the potential benefit of budgetary or cash flow certainty because of the fixed rate of the agreement, and if the agreement is the most efficient way to meet a specific investment objective – for example, using a GIC for a reserve fund to eliminate fluctuations in market value because the agreements are typically carried at par.

We also talk about things like risk-adjusted returns. We try to determine if there is a compelling economic reason to invest in a GIC or structured investment instead of actively managed or passively structured portfolios. I talked about this during the podcast about investing bond proceeds, and it is definitely applicable here.

From there, we bring in counsel to talk about structural differences between the agreement types. What is the credit risk, how can the agreement be structured to mitigate that credit risk, what are appropriate downgrade triggers, etc.?

And the last piece discusses the bidding and tax considerations, which typically means bringing in the rebate analyst as well as bond and tax counsel. Ultimately, we want to make sure the necessary due diligence is being performed on these agreements. We only proceed if we get satisfactory answers to all of our questions and the agreement's risk profile matches our client's risk tolerance and investment objectives.

Can you talk about what the implementation process would look like?

Harris: For a typical engagement, we start by looking at the permissibility of the different structured investment types, which means looking at trust indentures and official statements. As a reminder, we typically recommend reviewing this language every time new bonds are issued to make sure it is consistent with market standards and industry best practices.

From there, we have strategy discussions to think about investment objectives, transaction specifics, risk tolerances, and so on. This includes conversations with counsel to make sure we are walking through the considerations I previously mentioned.

This typically ends up being the first decision point – is this a prudent approach, or is there a different investment type that may be a better fit?

From there, we talk about potential bidders and different agreement structures, such as deliverables in the FDA. The next step is working with counsel to draft the term sheet and release it to the potential bidders. We request supplemental conditions from bidders that then need to be reviewed with counsel, which may take several rounds of comments before counsel ultimately provides their approval from a legal perspective. The next step is receiving bids and running through the economics in real-time to make sure the structured investment is still the best alternative. This also includes reviewing the investment with tax counsel to see if they have any outstanding concerns. If the agreement is still determined to be a good fit, then the client will direct us to award; if not, we will reject all bids and prepare to implement a different investment strategy.

Finally, we work with counsel to review the agreement documents, and once counsel and the client provide approval, the documents can be executed. It is worth repeating that counsel needs to be involved throughout the entire process because there are multiple instances when their legal advice and expertise is required.

If readers want further information about this particular topic, what do you recommend they do?

Harris: For more information about how we can help, please contact your PFMAM representative or reach out to me at harrisc@pfmam.com.

To learn more or discuss in greater detail, please contact us:

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