

Structural Features:

CMS Spread Floaters are a type of Corporate Structured Note issued by financial institutions whose returns or coupons are derived from values of Constant Maturity Swap (CMS) rates for different maturities. For that reason, they are also known as CMS-linked Notes. In most cases the coupon for CMS Spread Floaters is the difference between long maturity CMS (10-year or 30-year CMS) and short maturity CMS rates (2-year or 5-year CMS). The difference between long and short maturities (the CMS spread) is then multiplied by a leverage factor (multiplier) that typically ranges from 4x to 50x. The product of a multiplier and CMS spread is subject to a cap that ranges from 8% to 11%. In a case where the CMS spread is negative, the coupon is 0% (zero floor). During 2023 CMS rates were replaced by SOFR rates. In short, CMS Spread Floater coupon formula is $\text{Max}(0, \text{Min}(\text{Cap}, \text{Multiplier} * (\text{CMS long} - \text{CMS short})))$. In many cases coupon payments and a final principal payment made at the note's maturity are contingent upon stock market indices not dropping more than a prespecified percentage over the term of the note. The final principal payment is tied to the worst performing of 2 or more equity indices (equity barriers). If at the maturity of a CMS Spread Floater, any of stated equity indices drop more than a specified level (usually 50% or more from the issuance date) then the maturity payment is reduced by this percentage decline. If the worst of equity indices drops by less than 50% from the issuance date, then the full principal amount is received at the maturity date.

CMS Spread Floater Market:

CMS Spread Floater issuance reached almost \$5 billion between 2015 and 2020 (McCann & Yan study), The market is dominated by 5 major banks: Citigroup, Morgan Stanley, Goldman Sachs, Wells Fargo and RBC. These banks use CMS Spread Floaters to reduce their funding costs. CMS Spread Floaters are mostly sold by broker-dealers and RIAs to retail investors. At new issue, they can be over-valued by retail clientele because of their high initial coupon as retail investors are not equipped to accurately price the interest term structure, the steepness of the term structure, equity indices, the volatility and correlations between interest rates and equity indices. Many issuers add a call option to CMS Spread Floaters that allows them to call notes at par if their value appreciates considerably. Call options always work against investors.

Issuer	Issues	Amount	2015	2016	2017	2018	2019	2020
Citigroup	185	\$990	\$232	\$26	\$198	\$333	\$59	\$142
Morgan Stanley	137	\$904	\$382	\$219	\$150	\$137	\$15	\$0
Goldman Sachs	126	\$729	\$297	\$90	\$146	\$121	\$53	\$22
Wells Fargo	54	\$647	\$336	\$67	\$58	\$181	\$5	\$0
RBC	21	\$527	\$5	\$0	\$0	\$10	\$109	\$404
Barclays	15	\$273	\$147	\$1	\$28	\$97	\$0	\$0
Bank of America	33	\$264	\$37	\$0	\$27	\$188	\$9	\$3
Credit Suisse	25	\$201	\$110	\$50	\$31	\$10	\$0	\$0
BMO	6	\$196	\$5	\$0	\$0	\$0	\$0	\$191
JPM	40	\$180	\$147	\$33	\$0	\$0	\$0	\$0
Deutsche Bank	3	\$23	\$23	\$0	\$0	\$0	\$0	\$0
HSBC	4	\$9	\$3	\$0	\$0	\$6	\$0	\$0
UBS	2	\$6	\$0	\$0	\$0	\$0	\$6	\$0
Total	651	\$4,949	\$1,725	\$487	\$637	\$1,083	\$256	\$762



Orange CMS Spread Floater Trades/Positioning:

Our strategy in this sector focuses on seasoned (2013-2017 issued) CMS Spread Floaters trading in secondary markets. While the new issue market is inherently rich as financial institutions are trying to minimize their liability costs, the secondary market is rife with opportunities to add significant amount of excess return to our portfolio in this retail oriented corporate space. Oftentimes retail investors become impatient with CMS Spread Floaters as coupons are zero due to the inverted interest rate curve and are willing to sell these notes at prices well below creation value, ignoring the optionality of the future coupon payments. In particular, we like Morgan Stanley issued CMS Spread Floaters from 2013 to 2017 that mature from 2030 to 2037 (6 to 13 years): a) these MS spread floaters do not have embedded issuer call options and hence will not be called by the issuer when coupons are at the cap value (8-11%) b) MS spread floaters come with high multipliers, 10 to 20X, and hence a 10bp steepening can cause the coupon on CMS Spread Floater to increase by 1% or 2% and c) MS program is less liquid and presents us with better entry points from retail liquidations. Below are the most compelling reasons for our 12% portfolio allocation to CMS Spread Floaters:

- The yield to maturity (YTM) is close to that of “A” rated corporate bullet bonds issued by the same financial institutions with the coupon currently at zero due to the inverted curve. With the current low-price ranges, from high 50s to low 70s, the yield as zero-coupon bonds for our CMS Spread Floaters (assuming that coupons stay as zeros forever due to an inverted curve), is 4.76%. This yield is within 50bps of “A” rated corporate bullet bonds issued by the same financial institutions.
- CMS Spread Floaters pick up anywhere from 200bp to 300bp in OAS (option adjusted spread) over fixed-rate corporate with the same ratings/credit profile. Higher multiple CMS Spread Floaters (10-20X) pick up about 300bp over fixed-rate corporates. Option-adjusted spread accounts for all the differences between simple, fixed-rate Corporates with bullet principal payments at maturity, and CMS-linked Notes, with all their embedded options.

Because the bonds we current hold in the portfolio trade at YTM close to fixed-rate Corporates with similar credit profiles even with zero coupons, these bonds have significant positive optionality to curve steepening which will cause the coupons to increase at a multiple of any positive curve spread. While we typically don’t make interest rate bets in the portfolio, we find this trade compelling, given that the yield curve has been inverted for a record amount of time and the market consensus is that the Fed is about to enter an easing cycle, which we believe is likely to steepen the yield curve.