industry INSIGHTS 2023 | Q2

DDW DUE DILIGENCE WORKS

View From the Top

BY MICHAEL FREEMAN • PRESIDENT, DDW

DDW is Always There to be Your Eyes and Ears

Last month, DDW attended the FINRA Conference in Washington DC. One session that caught our eye was with SEC Chairman Gary Gensier who was interviewed by FINRA President Robert Cook. Their conversation took many turns, but the most significant discussion circled around Reg Best Interest. Chair Gensier expressed his views that Reg BI is not a check to box exercise or suitability with a new wrapper, it is more.

Reg BI needs to focus on costs, conflicts, reasonable available alternatives, commission vs advisory, account (type) opening recommendation, product recommendations, and more.

WHAT DOES THIS MEAN:

1. Documentation is key and needs to include everything stated above.
2. Really difficult to satisfy the reg without software to help you. Manual efforts will certainly lead to errors, mistakes and missed steps.
3. System cannot be rote, just checking the box. Be warry of systems that lead you down the same path all the time, or if advisors have already reverse engineered the system to get the answer they want.

Reg BI tools need a careful balance between automation, customization, and enabling the advisor to record their decisions and perspective on a client by client basis. Please give us a call if you fall into one the bullets above, let us help you now.

Navigating Changing Investment Landscapes: *Insights from Jeffrey Gundlach*

Renowned investor Jeffrey Gundlach, popularly known as the "Bond King" and CEO of Doubleline Capital, recently shared his macro views during a talk attended by DDW. Overall, he was bearish on the outlook for the economy, predicting a recession and trouble ahead for markets. Below are key insights from Gundlach that provide valuable guidance for navigating the evolving investment landscape.

1 > Impact of Rising Rates on Investment Behaviors

- In a rising rate environment, Gundlach highlights two significant changes in investment behaviors:

  i. **High Yield Bonds:** Refinancing becomes difficult with higher rates, affecting the ability to refinance and possibly leading to increased defaults.

  ii. **Housing Market:** Contrary to expectations, higher rates do not necessarily lead to reduced prices as they restrict housing supply as homeowners prefer to hold on to current low-rate mortgages.

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View From the Top, continued

2 > Credit Concerns

- Issuance in the High Yield market has been extremely low this year, he wonders if it is the canary in the coalmine.
- He has observed credit standards tightening, which tends to lead increased default rates by a year.

3 > Equity Market and Outlook

- He believes the current market sentiment feels frothy and compared it to a sugar high. He referenced NVDA as an example of this sentiment.
- He thinks there is a good chance that the stock market will be lower in three years.

4 > Currencies, Commodities, and Emerging Markets

- Gundlach is very bearish on the dollar, predicting that the dollar index will hit an all-time low, dropping to 70 from its current level of about 104.
- He favors emerging markets, excluding China, as he views China as a "heads you win, tails I lose" scenario.
- Gold is the only commodity on his radar, as he believes "owning commodities going into a recession does not make sense."

5 > Upgrade in Quality

- When asked how he is currently investing, he answered he is systematically upgrading in quality when there is liquidity in the market. He says he has more exposure to government bonds than ever before.

View From Product Management

Is Issuer Diversification Enough?

With broad-based indices, such as the S&P 500, becoming more prevalent within the Market Linked CD space, there has been an odd occurrence gatekeepers have had to work through over the past few months regarding increased competition between issuers. This specific occurrence is due to multiple issuers with nearly identical MLCD issues using a common underlier (thus far, the S&P 500), with a notable delta between the cap rates. Each month there have been multiple offerings of identical structure, tenor, and underlier where the cap rate and issuer are different. Gatekeepers need to determine whether the delta of cap rates between the different issuers is too great, then determine which to keep and reject to ensure the cap rates are within range of each other.

> Gatekeepers need to determine whether the delta of cap rates between the different issuers is too great...

To many, this may not sound like a large issue, and others may feel this is redundant, but the presence of FDIC insurance and issuer diversification may not be enough to justify the wide deltas. Taking a step back, the root of the issue goes back to the evolution of the algorithmic or proprietary indices, which many issuers began to gravitate towards due to preferential option pricing during the previously experienced low-interest rate environment. Each issuer began to migrate towards their prop index, creating unique offerings each month as no product was alike. With the increased availability of broad-based indices, gatekeepers can no longer approve all MLCDs because FDIC protection is provided and must screen and evaluate each offering against its comparable peer. Of course, issuer diversification could be relevant for firms with clients bumping up against the FDIC insurance limits, though the FDIC insurance is on each MLCD sold and not aggregated at the depositing bank so that reasoning could be limiting for most clients.

State-Funded LTC is Coming to Town?

Washington State was the first to step into the arena of State-Funded LTC programs in 2019, and it is likely that other states will soon join them. While admirable, all within the insurance industry could quickly tell that WA Cares was not enough to cover LTC expenses, as the maximum lifetime benefit per individual was a whopping $36,500 ($100 a day for a year), which is comically not nearly enough to cover most critical LTC needs. The funding of this program was also equally frustrating, as the state planned to take a static 58bps from each paycheck, regardless of the total amount, and was based on the average taxpayer's annual income of $50k.

Additionally, Washington state originally offered the ability to 'opt out' if an individual purchased their own LTC insurance, which caused a strain on many insurance carriers, and Washington state subsequently removed. While the program cost was paused and is set to begin collecting their fees on July 1, it will be interesting to see how this develops and how other states will follow.

Other states will likely follow this trend, notably Alaska, California, Florida, Kansas, Florida, Minnesota, and New York, which have indicated that they are considering or intend to invoke such a plan. California is the likely front-runner to enter the State-Funded LTC programs, as they have a task force and at least five iterations. New York has also made indications they are not far behind, and while the details are forthcoming, a major difference is that New York may not exempt non-New York state residents from paying the payroll tax, which would be incredibly frustrating for those who work in New York and reside outside. Another potential difference is that New York may add a post-date exception, where a private LTC policy must have been held before a specific date and may require a specific amount of coverage.

While the other 49 states contemplate the State-Funded LTC space, one additional concern would be if California and New York launch programs in the proximity of one other (or, God forbid, on the same day). The resources required for banks, broker-dealers, distributors, and insurance carriers for both states simultaneously would be truly astonishing.

New Features for RILAs

Which Ones Really Matter, and When is it Too Much

RILAs are once again trending especially over the last quarter. Not so much as new RILAs coming to the market; rather, carriers enhancing their existing product(s). The main features that are being enhanced are additional indices, new innovative crediting methods, and Performance Lock options.

Crediting methods are changing from the traditional buffer, floor, and point to point with cap that have been the staple of RILAs since they first launched. There are a number of enhancements to the protection levels including upside protection. Crediting methods are evolving to include new ways to achieve upside gain. These strategies mostly benefit a client in a market with high returns which includes one tier for a specific return and if the return is higher, the client can get a higher credit on their annuity (a form of tier participation). On the downside protection, carriers are enhancing these to allow clients to earn interest even on a downside market. One such involves earning interest in a down market as long as the index loss remains within the buffered protection. If it is outside the buffered protection, the client absorbs the loss, as normal.

PERFORMANCE LOCK FEATURES ARE BEING ENHANCED AS WELL AS BEING ADDED TO PRODUCTS THAT DID NOT HAVE THIS FEATURE PREVIOUSLY.

Performance Lock features are being enhanced as well as being added to products that did not have this feature previously. Of those carriers that had a form of Lock, the common enhancement is changing the way a client can re-enter the market. Previously, a client would have to remain in a fixed type of account until the end of the segment term. The enhanced feature is allowing the client to re-enter sooner than the end of the term, some as early as the following business day.

As the Q1 drew to a close and Q2 began, a number of companies filing for a new RILA annuity has increased as many companies are looking to expand their offerings. DDW will continue to keep an eye on the RILA space as these new players begin to enter the space.

What Happens to a REIT When Markets Get Scared

According to Stanger Investment Banking, non-traded REITs raised almost $12bn in 2019 and nearly $11bn in 2020. In 2021, Blackstone Group's BREIT fund raised just short of $25bn. Real estate research firm Green Street estimates that, at the peak of fundraising in the fourth quarter of 2021, non-traded REITs were taking in astonishing net flows of $4bn per month.

In September 2022, when the federal reserve started to raise rates, that had significant consequences for real estate over the next six months. The 1st Quarter 2023 report from CBRE on the capital market stated the following:

- U.S. commercial real estate investment volume fell by 57% year-over-year in Q1 to $78 billion.
- The annualized NCREIF total return fell to -1.6% in Q1 from 5.5% a year ago.
- The annualized total return for office and multifamily fell to -8.8% and -0.4%, respectively, in Q1.
- Returns are expected to weaken throughout 2023 as private funds write down property values and cap rates continue to expand.

With the news of large inflows to the non-traded REITs over the last four years, interest rates increasing since last September 2022, and the CBRE report mentioned above, DDW wanted to look at the Blackstone Real Estate Investment Trust ("BREIT") and see how the previous statements have affected that specific REIT. The reason why DDW chose BREIT is because it is the largest non-traded REIT in the market and has been very successful at raising money.

As of March 31, 2023, the BREIT had $51.6 billion in total equity. The offering has $140 billion in total assets and a loan-to-value ratio of 59%.

In September 2022, the I shares NAV for the offering reached $15.11. The I shares were chosen because it is the share class with the lowest fees and no upfront commission. As of April 2023, the last NAV per share reported for the I shares was $14.56, which equates to a decrease in value of 3.64% over eight months. As of March 2023, the offering has lost -2.54% for the year, which is better than the NCREIF Fund Index - Open End Diversified Core Equity which lost -3.91% over the same period.

In a letter dated May 1, 2023, (view letter) management for the REIT stated,

...the Share Repurchase Plan (the "Repurchase Plan") has allowed for repurchases up to 2% of net asset value ("NAV") in any month and 5% of NAV in a calendar quarter, subject to BREIT's majority independent Board of Directors' broad repurchase discretion. This structure was designed to both prevent a liquidity mismatch and maximize long-term shareholder value. BREIT has paid out $6.2B to redeeming shareholders since November 30, 2022 when proration began. An investor who began submitting repurchase requests when proration began has received ~84% of their money back and the semi-liquid structure is working as intended.

BREIT received repurchase requests of $4.5B in April, which is flat month-over-month and 15% lower than the peak in January 2023 despite market volatility. Importantly, ~96% of our U.S. investor base and ~93% of investors overall elected to remain invested in BREIT this month. In accordance with the Repurchase Plan, BREIT is fulfilling approximately $1.3B, which is equal to 2% of NAV and represents 29% of the shares submitted for repurchase. Repurchases were fulfilled at the March 31, 2023 NAV per share for your applicable share class.

View from Product Management

	Percentage Tendered	Amount of Shares Repurchased	Percentage Not Tendered	Amount Tendered	Total Shares	Average Share Price	Dollar Amount Tendered	Percentage of Shares Tendered
Oct 2022	100%	120,150,357	100%	120,150,357		15.07	1,810,665,880	
Nov 2022	43%	89,083,671	57%	207,171,328		15.02	3,111,713,345	
Dec 2022	4%	10,118,654	96%	252,966,350	4,631,900,000	14.84	3,754,020,634	5.46%
Jan 2023	25%	88,867,641	75%	355,470,564		14.80	5,260,964,347	
Feb 2023	35%	92,474,903	65%	264,214,009		14.71	3,886,588,066	
Mar 2023	15%	45,161,904	85%	301,079,360	4,786,978,000	14.77	4,446,942,147	6.29%
	TOTAL	445,857,130					**AVERAGE**	
							3,711,815,737	
	Amount Repurchase vs. Total Shares		9.31%					

Source: Blackstone Real Estate Investment Trust Quarterly and Annual Financial Statements

The table above shows the number of shares repurchased since October 2022 and the number of dollars possibly tendered. To calculate the dollar amount tendered, DDW assumed the Average Share Price of the tendered shares to calculate dollar amount tendered. That is the best estimate of the dollar amount tendered because management does not disclose that specific number within their quarterly or annual financial statements.

With the decrease in NAV since September 2022, the offering has experienced a decline in NAV of 3.64% but an additional withdrawal of 9.31% of AUM. Over the last six months, 445 million shares have been repurchased by management. That equates to around $6.6 Billion of shares repurchased or 9.31% of the total shares as of March 2023.

The troubles facing the offering are further compounded by the offering not covering its distribution. The following table shows the distribution amount in the 1st Quarter of 2023 and the annual distribution in 2022, 2021, and 2020. The table shows the Adjusted Funds from Operation AFFO for the offering. AFFO is an industry-accepted calculation of how much the underlying real estate pays as a dividend.

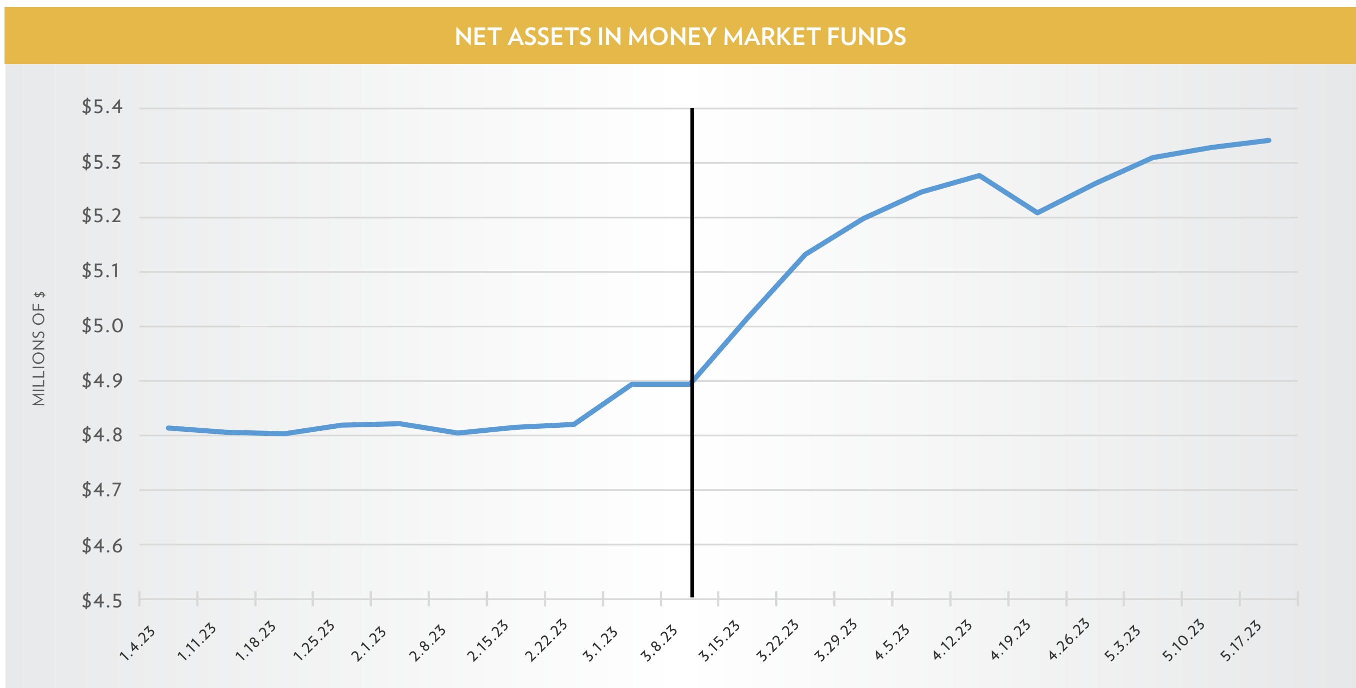
DDW does not know where real estate is going over the next five years, and current underperformance could be a blip on the radar. Still, with the offering having a large percentage of shares not being redeemed, a broker dealer might want to look and see what amount of shares your broker dealer has tendered over the last six months and if that amount is increasing or decreasing. From that information, a broker dealer should consider the options available to the firm, their advisors, and their clients.

($ in thousands)	1st Quarter 2023	2022	2021	2020
Total Distribution	$719,445	$2,681,486	$1,601,913	$948,034
AFFO	$458,673	$2,132,484	$1,286.347	$732,421
Difference	$ (260,772)	$ (549,002)	$ (315,556)	$ (215,613)
Distribution Coverage &	63.75%	79.53%	80.30%	77.26%

Source: Blackstone Real Estate Investment Trust Quarterly and Annual Financial Statements

Money Market Flows vs Commercial Bank Deposits

One trend that DDW has observed in 2023 is the massive flows into money market funds, particularly since the collapse of Silicon Valley and Signature Banks in early March. As of the latest numbers, U.S. Money Market funds have $5.34 trillion in total AUM, 9.2% more than the $4.89 trillion on March 8. In other words, 8.4% of all assets currently in U.S. Money Market funds have been from purchases since the bank failures. Interestingly, the net flow of $450 billion into Money Market funds is very similar in size to the $510 billion flow we've seen out of commercial bank deposits.



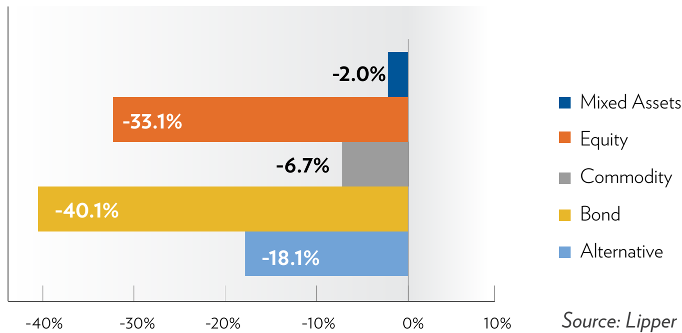
Our belief is that the failure of the banks caused households and corporations with cash to reassess 1) if their money is safe where it is, and 2) what yield they are earning on that money. The dramatic flows indicate the answer to these two questions in investors' minds has been clear: Money Market funds. The money market reform enacted after several funds "broke the buck" in the Great Financial Crisis has given investors confidence in the safety of the asset class.

Given the investor appetite for safety, and a competitive yield on their cash, it is imperative that Broker Dealers review their offerings to ensure they have options available that meet these two criteria, whether that be through BDSP rates, Money Market Sweep options, or a list of position Money Market funds for clients to purchase. Firms that do not have competitive offerings will be at a disadvantage compared to their peers that do. Schedule time with DDW today to talk through your cash offerings and how they compare to the industry.

Overview of US ETF and Mutual Fund Asset Flows from March 31, 2021, to March 31, 2022

In the past year, the combined mutual fund and ETF flows by asset class for the United States were moving in the direction of outflows. The majority of flows have turned negative. No combined asset class saw inflows, excluding money market asset class. DDW excludes money market asset class because money market funds are specific to mutual funds, not ETFs.

ASSET CLASS FLOWS AS A PERCENTAGE*

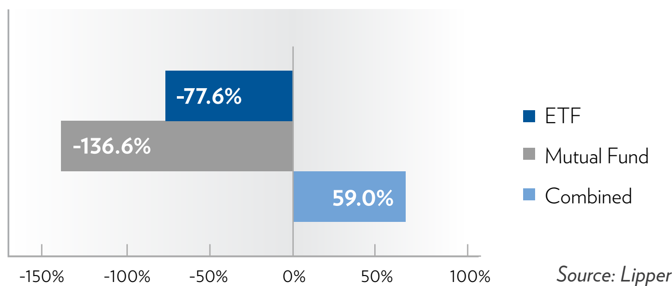


Source: Lipper

When combining mutual funds and ETFs, the asset classes that saw the largest outflows during this period were Equities, Bonds, and Mixed Assets. The combined bond asset class flows were negative for the third time since DDW started reporting flows in March 2019.

When digging into the numbers and looking at mutual funds and ETFs separately for bonds, the flows for mutual funds were negative and positive for ETFs. That shows investors do not find value in bond mutual funds since that category saw the second largest outflows. The flows into bond ETFs were positive, but the amount of outflows from Bond Mutual Funds greatly outweighed the inflows making the combined flows negative.

ETF & MUTUAL FUND BOND FLOWS*

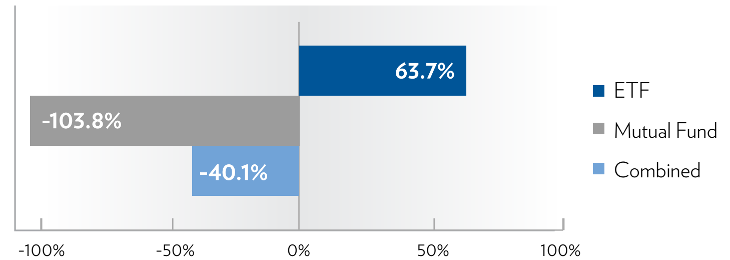


Source: Lipper

In analyzing the bond mutual fund and ETF flows, the three asset classes within the bond category that saw the most significant inflows were General U.S. Treasury Funds, Short Municipal Debt Funds, and General Bond Funds. The asset class within bonds that saw the largest outflows was Flexible Income Funds.

The combined flows for Equity were similar to Bonds, whereas the flows into equity ETFs were positive. Still, the amount of outflows from Equity Mutual Funds greatly outweighed the inflows making the combined flows negative.

ETF & MUTUAL FUND EQUITY FLOWS*

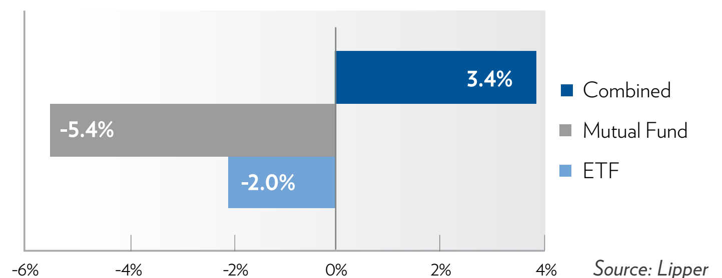


Source: Lipper

In analyzing the equity mutual fund and ETF flows, the asset classes within the equity category that saw the most significant inflows were Multi-Cap Core Funds, International Multi-Cap Core Funds, and Equity Income Funds. International Large-Cap Growth Funds was the asset class within Equity that saw the most significant outflows. Interestingly, the whole growth sleeve of International and Domestic represents the six largest asset classes in outflows. Investors are dumping growth but investing in Core Strategies, where the funds still allocate to stocks within the growth sector.

The combined flows for alternatives were negative. Mutual funds were negative, while ETFs were positive. This is due to the outflows within the following categories of Mutual Funds: Alternative Credit Focus Funds, Alternative Global Macro Funds, and Absolute Return Bond Funds.

ETF & MUTUAL FUND COMMODITY FLOWS*



Source: Lipper

On the ETF side, more than half of the inflows were into Dedicated Short Bias Funds. That is interesting because the S&P 500 was up 3.51% in March 2023, bringing its YTD return to 7.03%, but the 1 year performance was down -9.29%. If those offerings were purchased between March 31, 2023, and December 31, 2022, an investor would have lost out on the possible gains the market achieved.

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