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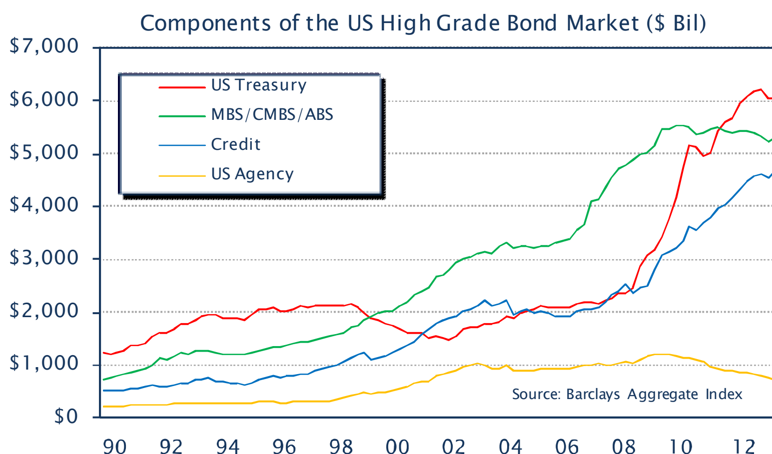
# INVESTMENT UPDATE

The time has come to talk about mortgage-backed securities. We know that any discussion of MBS will mean that a large percentage of our readers will either a) fall asleep, b) tune out, or c) run in a serpentine fashion from the room, yelling "The horror, the horror!" We appreciate that not everyone (heck, not even every bond manager) wants to hear about prepayments, negative convexity, fixed versus floating rate, or most other minutiae that is part-and-parcel of most any MBS discussion. We get it; mortgage bonds are boring.

And yet, mortgage securities represent nearly 1/3 of the market value of the high-grade US bond market, $600 billion larger than the investment grade corporate sector (see chart). And, we are not ashamed to say, we like MBS; US Agency mortgage bonds will, over most intermediate and longer time periods, outperform other US Government-issued securities, and do so with the US Treasury backing up the ultimate payback of principal and interest to the bondholder. What's not to like?




OK, if we're being completely honest, there are a few things that make MBS less than perfectly lovable. Their main issue is their inherent complexity. Unlike most bonds which pay a coupon (usually twice per year) and principal on an unwavering predetermined schedule, a holder of a mortgage-backed bond cannot be sure exactly when they will get their money back. If everyone who owned a home made their monthly mortgage loan payment exactly on schedule, and if nobody ever paid off or refinanced their home, or ever missed a payment or had their house foreclosed, then bondholders would have a tidy, predictable payment stream each month, as the scheduled mortgage payments would simply be "passed through" to the bond holder. But in the real world, people do miss payments, and they do pre-pay when they have extra cash. Houses occasionally are destroyed, and homeowners often sell their houses; and, especially when interest rates fall, they certainly do refinance their home loans. Whenever these things happen, the old loan is paid off, in whole or in part. In the case of Government-backed MBS, if the homeowner fails to make a full payment on time, the agency guaranteeing the mortgage bond steps in and makes up the difference. As a result, mortgages pay their principal back in an unpredictable way, sometimes quickly, sometimes slowly, based on several factors, including the path of interest rates, personal income, job security, home prices, and homeowner mobility.

But bond managers don't like unpredictable. We like being able to calculate, to the second decimal place, the duration of a bond; we want to know precisely how a bond's price will change in various interest rate environments. Back in the 1980s, when the MBS markets were in their infancy, Wall Street came up with a way to soften the unpredictable nature of mortgage pools by re-directing, or "tranching" the cash flows into classes of semi-specific effective maturities, some shorter, others longer, creating the first collateralized mortgage obligation bonds ("CMOs"). Over the years, the CMO model became widely accepted by investors, and eventually became the de facto outlet for securitizing home mortgages that didn't qualify for inclusion in the programs offered by GNMA, FNMA or FHLMC. But in the run-up to the meltdown of the US housing market, the CMO machine became corrupted, with brokerage firms placing all manner of *dreck* into CMO deals, with insufficient and/or poor collateral to protect bondholders (these "private label" MBS had no government backing) despite the ratings agencies' "AAA" ratings. When the housing market collapsed, so did the CMO market; most CMOs created from 2005 to 2008 can now be found trading at distressed levels, and carry junk bond ratings.

Because of these factors, many unsophisticated, risk-averse investors shy away from the mortgage market. They don't have the analytics, or the experience, or the stomach to manage these types of securities in their portfolios. Our opinion of MBS is purely value-based: When they offer enough yield to compensate us for all their quirks, we buy them; when they don't, we sell them and replace them with something with better relative value.

Currently, the MBS market, like so much of our market, is in transition. Over the past few years, the amount of mortgage-backed securities in our market has declined (see chart) while the market value of corporate credits and Treasuries have continued to grow (although Treasuries have fallen a bit lately,

mostly due to price declines). Meanwhile, mortgage bonds (specifically, Agency-backed mortgage securities) have been supported by the Fed's QE/asset purchase program, which has been sucking up as much as $40 billion in newly-issued MBS every month. And while that number is scheduled to decline by $5 billion every month as the program is tapered over the rest of 2014, the new supply of MBS has fallen as rates have risen and refinancings have ground to a halt. Home sales, the other main supplier of new mortgage loans (and new MBS) have also slowed down of late, adding to the lack of supply of new mortgage securities. In fact, it is estimated that the amount of MBS the Fed is expected to purchase over the next few months will exceed the entire net supply of newly-created conforming mortgage securities. In other words, until the Fed stops buying, there is a supply-demand mismatch, which is highly likely to keep MBS prices inflated relative to prices of other investment-grade bonds.

Not only are MBS offering below-average value right now for investors, but new regulations are being introduced into the mortgage market that are likely to make them even less attractive for money managers. It's a bit complicated (of course—they're mortgage bonds!), so bear with us.

Mortgages securities, since they were created in the 1970s (and unlike most every other security type), have traditionally settled on a specified date only once every month. Uniform standards were set up among the broker/dealers, investment managers and banks to settle on a pre-determined day; the exact day changes month-to-month, and will be different depending on the issuer and the final maturity date of the bonds. As an example, if we buy 30-year GNMAs this month for "normal" settlement in March, they will settle on March 20th; FNMAs backed by 15-year mortgages bought any time in the next couple of weeks will settle on March 18th. The reason for this unconventional settlement arrangement is that mortgage originators need extra time to aggregate the raw loans to be delivered to whichever agency is pooling the loans and packaging them into the "pass-through securities," which, in turn, will be delivered to investors.

Now, we realize that we've led you, dear reader, into the "sausage factory," and that your interest in the vagaries of the mortgage securities market is rapidly diminishing, and for that, we apologize. But there is a reason for all of this descriptive minutia: The settlement rules for MBS are changing, and everyone involved—including our clients—is likely to be annoyed and more than a little inconvenienced by these changes.

You have probably heard that there are new rules and regulations going into place to try to prevent a repeat of the financial crisis of 2007-2008. While we welcome changes that protect the financial system from the excesses and poor risk management caused by inadequate checks and balances, the settlement standards for US Agency-backed MBS were never a major source of risk, nor did these settlement rules lead to significant losses by any party that we're aware of. Poor underwriting—yes; mislabeled and over-rated subprime-backed private label MBS—certainly; but once-a-month settlement of Agency MBS—no.

Nevertheless, every bank custodian we deal with (and there are many) will, under these new regulations, have to set up margin accounts for each of our clients in order for us to settle MBS. The powers-that-be (specifically, the New York Fed's *Treasury Market Practices Group*) have determined that MBS's once-a-month settlements, because they don't adhere to the typical "T+3" timeframe (i.e., the settlement occurs three days after the trade is made), must be treated like a futures contract. The regulators' thinking is that, with many billions of dollars in pending MBS trades each month, there is system-wide risk from price changes in the days and weeks between trade and settlement, and that if the price change is big enough, either the investor (on one side of the trade) or the broker (on the other side of the trade) may not have the funds available to stand by the terms of the trade when settlement day comes around, causing the trade to fail.

It doesn't matter if (as Agincourt does) we take the ultra-conservative route of always maintaining cash equivalents equal to the full principal value of the trade in our clients' portfolios in the period between trade and settlement; we will be treated just like a hedge fund who uses leverage and has insufficient funds to cover all their open trades at any given time. Money managers like Agincourt who don't employ leverage should—but won't—be exempt from these margining requirements. What this means operationally is that our clients' custodians will have to maintain a separate margin account for each client, and will have to monitor every outstanding MBS trade with any brokerage firm we execute MBS trades with; if the market price of the bond moves outside a specified range, the broker will either have to wire funds to the custodian on behalf of the client, or the custodian will have to wire funds to the broker, depending on whether the market value of the bonds in question have moved in our clients' favor or against them, prior to the trade settling. In plain English, this means a ton of extra work will be laid at the feet of plan sponsors' custodians, who will need to set up margin accounts just to settle MBS trades.

These guidelines are still in the "recommended best practices" stage, but the NY Fed wanted procedures to be in place by year-end 2013. That has not happened, as many (maybe even most) of the custodians we deal with have no such procedures in place, and brokerage firms are still developing their own standards for these settlements. Agincourt, for its part, would love to see these rules applied only to hedge funds and other levered buyers; our conservative approach (no use of leverage, and ample, un-invested cash equivalents equal to more than the value of the trade) poses no counterparty risk to any broker who is waiting to "get paid" for an outstanding trade. Likewise, we perform our own due diligence in determining the creditworthiness of the brokers we deal with, and therefore we require no margin account to offset the possibility of the broker failing on a trade. But it doesn't matter what our opinion is; these changes are coming soon to every broad-based bond portfolio in the US.