MAY 2022

INVESTMENT UPDATE

This month, we're going to take a break from talking about the Fed, inflation, and the gloom and doom of the US bond market and instead spend some time examining a segment of our market that is often overlooked: mortgage-backed securities. It's not the most exciting area of the bond market, but it's an important one, as it represents nearly one-third of the broad investment grade indexes. Get your slide rules and pocket protectors ready, we're diving in.

For the purposes of this discussion, when we refer to mortgage-backed securities (MBS), we're talking about "pass-through" securities issued by one of three government-sponsored agencies—GNMA, FNMA, and FHLMC; we will set aside other types of MBS, including commercial mortgage securities, as we want to keep the discussion focused on the unique characteristics of US agency MBS.

And when we say "unique," we mean it. MBS are very different from most other bonds. Typically, a bond is nothing more than a formal loan made between the issuer of the bond (the US Treasury, or a corporation, for instance), and the buyer of the bond (typically, a bank, or an investor/fund manager). These conventional bonds are mainly issued to provide funds that the issuer uses for unspecified purposes—funding long-term capital projects, or in the case of the government, military spending or social services. These types of bonds pay the investor a semi-annual fixed coupon, and have a specific maturity date, set in the future, when the principal must be paid to the bondholder. The bond issuer is released from the terms of the bond once the principal is paid, and the bondholder no longer has a claim on the issuer, assuming the coupon and principal payments have been made on time.

MBS, on the other hand, are collateralized securities. Collateralized bonds are backed by specific assets that are bundled together and placed in a trust, and the cash flow generated from this collateral is the source of principal and interest payments used to repay bondholders. In the case of MBS, the collateral is comprised of home mortgage loans, and homeowners' monthly mortgage payments are "passed through" to the bondholder. Mortgage originators (historically, banks and S&Ls, but these days more likely to be internet-based companies like Rocket Mortgage or SoFi), supply the collateral, which are sorted by mortgage rate and term, and securitized by one of FNMA, FHLMC, or GNMA.

New MBS are packaged up and offered every day. They are identified by the issuer, term, and coupon—for instance, most of what FNMA is currently packaging are 30-year pass-throughs that pay a coupon of 4.5%. This 4.5% is the "current coupon" for 30-year FNMAs, which you'll note is 75 basis points or so below prevailing mortgage rates; that difference is retained by the originator to help pay for servicing costs associated with the mortgage. The typical agency mortgage pass-through security has hundreds, if not thousands, of individual mortgage loans bundled together, and is assigned a unique pool number and CUSIP that allows investors to track the broad characteristics of this pool of home mortgages.

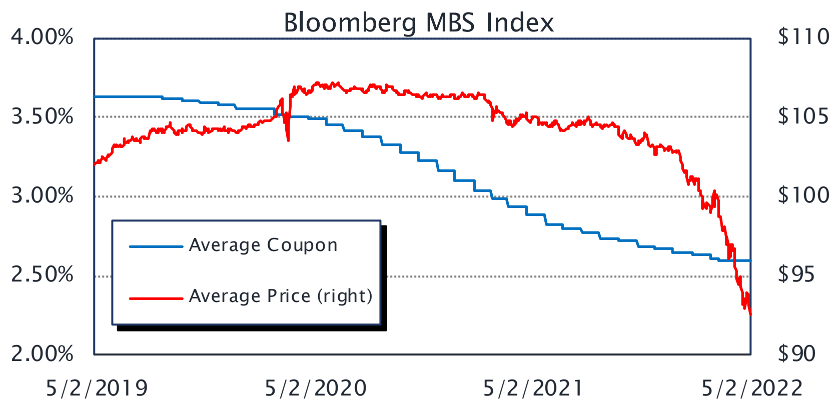
The weird thing about these agency pass-through bonds, and what makes them so different from the garden-variety bonds issued by the Treasury and corporations, is that they don't have a fixed maturity date. They have a stated maturity—the date on which the final scheduled mortgage payment will be made on any loan included in the pool—but, especially for 30-year loans, how many borrowers will own their existing mortgage for the entire term? Very few, as most homeowners will either move, refinance, or otherwise pay off (and in some cases, default on) their mortgage well before the final payment is due.

With all that as background (phew!), how do MBS stack up now from a relative value standpoint? The short answer is, "pretty well, and maybe getting better." The not-so great part comes from the fact that the Federal Reserve, as part of its COVID recovery plans, instituted a massive asset purchase plan that now holds $2.7 trillion of agency MBS (nearly one-third of all MBS outstanding), inflating the prices of MBS while suppressing their yields and relative values. But now that the Fed is in the process of letting its MBS holdings roll off, we expect MBS values to normalize, all else being equal.

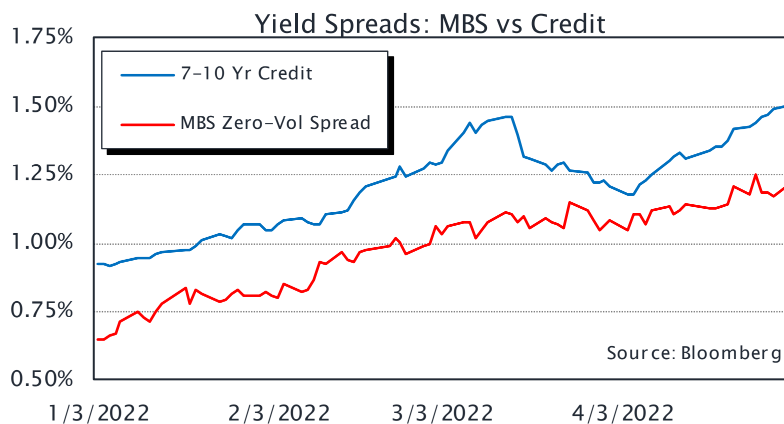
But there are bigger reasons to be optimistic about the potential for good returns in the MBS market, and those have to do with (once again) the unique structure of MBS pass-throughs, and specifically, prepayments. As discussed, MBS' lack of a definitive maturity is due to the fact that most homeowners pay off their mortgages well before their terms are complete, with the primary driving factors being 1) can the homeowner refinance on better terms (i.e., a lower rate), and 2) is the homeowner likely to move. In other words, a mortgage security's effective maturity is highly dependent on the future path

of interest rates, and to a lesser extent, the health of the economy and the housing market. Simply stated, when interest rates decline, the effective maturity and duration of the typical MBS shortens as people pay off their loans; when rates rise, MBS lengthen as prepayments decline.

But, from a total return standpoint (which is what matters most to active bond managers like Agincourt), the last thing you want is a bond that shortens when rates decline. MBS' characteristic early return of principal that takes place in a declining interest rate environment forces the bondholder to invest that principal at increasingly lower rates. Investors want more duration, not less, in their portfolios when rates fall. For this reason alone, MBS have underperformed other bond sectors over recent years as their prices lagged bonds with more conventional, non-callable structures.



So, where's the optimistic case for MBS? A look at the top chart on this page provides some insight. The low interest rate environment which prevailed over the past few years has re-cast the MBS sector, as homeowners retired old, higher interest loans and replaced them with low interest loans. Today, the average MBS has a coupon of just 2.6%—an all-time low in the history of this sector. With current mortgage rates hovering around 5%, the average homeowner with one of these low-rate mortgages is hundreds of basis points away from where their loan can be economically refinanced. For the average MBS pass-through bond, prepayment risk has become a very minor concern in the current interest rate environment.



Not only are the underlying mortgage loans, to use the options traders' term, "well out of the money" from a rates standpoint, the securities themselves are trading at big discounts to par value. As the top chart shows, the recent sell-off of MBS has lowered the price of the average pass-through bond to $93, more than 10 points lower than where prices sat just a few months ago. This combination of low prepayment risk and discount pricing is something we haven't seen in the MBS market in more than 25 years.

In the simplest terms, what it means is that we can analyze one of these low coupon MBS as something more like a Treasury or corporate bond; the maturity is more certain, and prices are so low that even if prepayments kick up, you'll be getting a windfall as each homeowners' principal is returned to you at 100 cents on the dollar, seven points above the market price.

The bottom chart shows that if we look at MBS on a "zero-vol" basis (much like an out of the money callable corporate bond, for instance), MBS yields have climbed to a level 120 basis points above those of like-duration Treasuries, while offering the same backing from the US government that Treasuries have. While not quite at the same levels as corporate yield spreads, they compare favorably with the overall high-grade credit market, and out-yield AA-rated corporate bonds with similar durations by a wide margin. This margin will shrink—and MBS will outperform—if the credit markets begin to price in a growing risk of recession in the coming weeks and months.

MBS are, by their very nature, complicated securities. But they are also inherently safe from a credit risk standpoint. If we can effectively eliminate (or offset with sufficient compensatory yields) the prepayment risk of MBS, they can perform very well and fit into any quality-oriented bond portfolio. They are not the bond for all seasons, but the current environment looks very promising for mortgage-backed securities.

As value investors, we know that volatile markets like the one we're currently experiencing create a fair bit of wreckage, but they also offer opportunities for those with experience and insight. We don't want to overstate the case for MBS—there's always some level of risk, even with government bonds—but they have a lot going for them right now.