December 2024 – MBSM High Income Strategy Returns and newsletter

	Dec % Net Return	2024 YTD Net %	1 year Net %	3-year Net	5-year Net	10-year Net	2023 YTD Net %	2022 YTD Net %
MBSM Aggregated SMAs	**+1.86**	**+7.7%**	**+7.7%**	**+15.4%**	**+29.5%**	**+82.9%**	**+11.5%**	**-3.8%**
BB Barc Agg	-1.69%	+1.3%	+1.3%	-6.9%	-1.7%	13.7%	+5.6%	-13.0%
BB Barc MBS	-1.56%	+1.5%	+1.5%	-5.8%	-2.9%	10.5%	+5.1%	-11.7%
BB Barc HY	-0.43%	+0.2%	+1.3%	+9.0%	+22.9%	65.5%	+13.5%	-11.2%

Dec 2024 MBS Income: +1.2% (~15.6% annualized) (Aggregated SMAs @ month end marks)
Dec 2024 Loss Rate: -0.02%
Dec 2024 MBS Cashflow: +1.2%. ~14% annualized
2024 (YTD) Income: 17.1%

Hello. Here is the final MBSM newsletter for 2024. Once again, we outperformed the benchmarks, thanks to the High Income (~17% for the year) of our MBS portfolios.

Our decision to limit purchases and accumulate cash has borne fruit, as our YTD return attests. While our decision was based on Rising Risk (corroborated by the systematic decisions of our other ARAM Systematic Active strategy), and concern about the Yen, this has allowed us to dodge most of the impact of rising yields. Our risk decisions, and portfolio construction, consisting of 60% floaters, 32% fixed, and 8% derivatives (RMBS and CMBS), have buffered this volatility, allowing us to outperform the benchmarks.

It's been over 11 years now since I walked away from the Sell-Side to set up my own Buy-Side firm, knowing that I could do a better job than my former institutional clients, in being a fiduciary, generating returns for investors, and managing risk. The industry was in recession in 1994 when I gave up on the large dealers, and I could not get a job on the buy-side, in spite of interviewing extensively. **If you can't join them, beat them! The table above shows that I have succeeded in this, especially when comparing 3-year, 5-year and 10-year returns.**

A statistic not shown above, but that is on the Fact Sheet, is the number of Months of Positive Returns. The MBSM Aggregated portfolio has 74% months with positive net returns, since our returns are driven by the High Income of our portfolio, which buffers prices risk and creates a right tail. In comparison, the Agg has 53% positive months.

Another way to summarize this, which we did in our white paper, 'The MBS Income Factor', is that our MBS portfolio has positive skewness, unlike almost every other product or Fund in Fixed Income. The Beta and Correlations to Fixed Income are also exceptionally low (0.3 Beta to AGG, 0.2 Beta to MBS, 0.4 Beta to HY).

The core philosophy that has driven my career in Finance and Economics is that a Scientific Approach from First Principles driven by Research creates solutions for problems. This has led to this and many other strategies, with many institutional investors having benefited from my solutions using this framework. **MBS Mantra and Alpha Research and Management are my attempt to broaden the beneficiaries of this process to include end investors**. However, doing things differently, from First Principles of Economics and Finance, and creating a unique investment structure to align with the investors, also makes it harder to raise AUM, as this is different from the training of what most of the gatekeepers and allocators are expecting.

I have been researching Risk as a driver of returns since 1987, and using it to form my relative value research and recommendations for my entire career. The awareness that I should venture out on my own was formed during the GFC, when I anticipated the coming deleveraging in 2007. Institutional buy-side remained not only oblivious to the coming tsunami, but were actively unwilling to even learn about the possibility of a different risk framework, similar to when I was espousing LIBOR OAS starting in 1990, or sounding the alarm in 1997 of swaps spreads widening (which led to the demise of LTCM). I learned then that the buyside was driven by asset gathering and asset retention, and would not risk their AUM and fees to make the hard fiduciary decisions that would serve their investors and protect their capital.

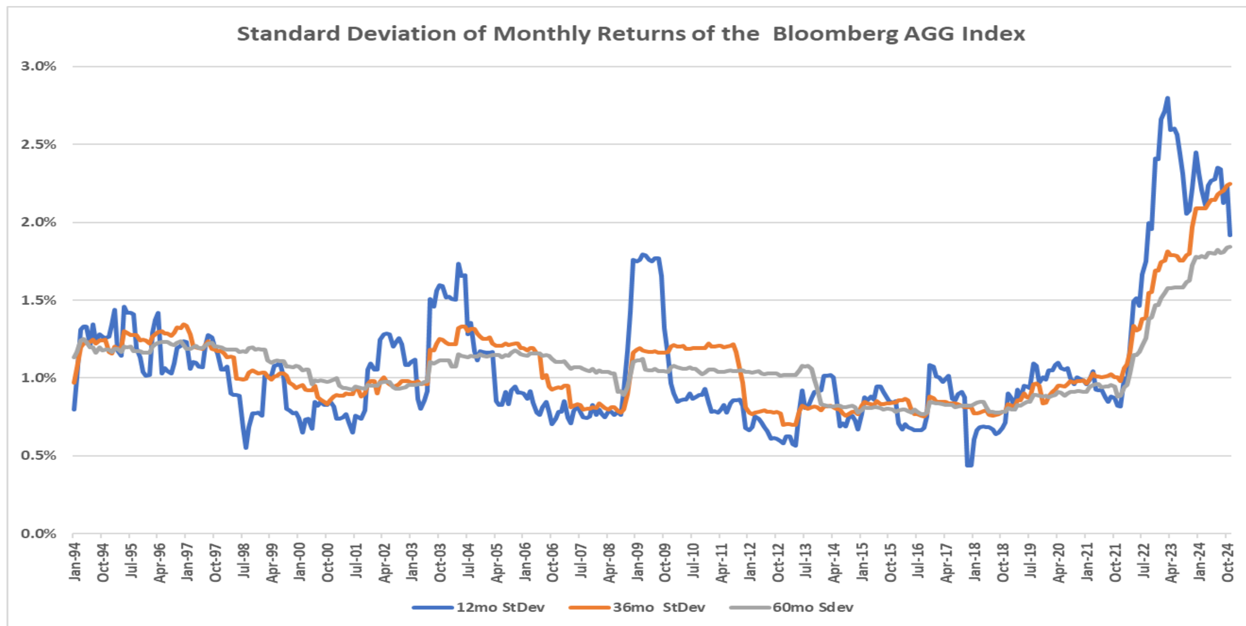
In this newsletter, I want to discuss why almost all Fixed Income Managers and Funds have had poor performance, in spite of 'nice' yields, over the past 3-year (-2.35% annualized), 5-year (-0.35% annualized) and 10-year (+1.29% annualized) windows, especially when compared to what has been possible, especially through Active Management of Portfolio Risk.

It is important to realize that investors eat total returns, not "yields".

The discussion below starts with an understanding of Fixed Income Risk.

When Risk is considered before Return, I've found that portfolio construction becomes more robust, leading to 'All-Weather' solutions.

Fixed Income has Never Been Riskier



The time frame of the chart above covers the work experience of almost all current Fixed Income managers.

<u>Most Fixed Income PMs have never experienced this magnitude of sustained risk</u>, and have no training in portfolio construction and risk management under such a Risk Regime. The implications of their returns, and what I've heard them say when interviewed on TV, suggest that they continue repeating what they have been trained to do – focus on yield instead of return.

<u>I attribute the poor performance of Fixed Income to a continued application of the 1932 Graham-Dodd framework in the book "Security Analysis"</u>, which does not consider risk in portfolio construction, except through diversification. FI managers have not questioned whether the theory they use is still an appropriate framework in a higher risk environment.

Having been a speaker on panels with numerous strategists and quants from large firms, including those involved in applying AI to Fixed Income, I am certain that this continues to be the framework being used.

Graham-Dodd's seminal 1932 book is considered the definitive tome for Securities Analysis for Value Investing, and is often referenced by Warren Buffet. It also provides insights for Fixed Income, to evaluate credit worthiness and risks of individual bonds. **Portfolio construction and risk management under a Graham-Dodd framework is handled through diversification, with <u>no direct focus on constructing a portfolio that is suitable for the level of market risk</u>.**

In contrast to Graham-Dodd, Harry Markowitz, in 1952, wrote "Portfolio Selection", which introduced "Modern Portfolio Theory". This introduced a quantitative approach to Finance and portfolio construction, marrying the concepts of risk, probability, and utility that other economists were also writing about at the time (Samuelson, Arrow, Friedman, etc).

Under a Markowitz framework, the focus is on the Risk of Portfolio Returns, where risk is computed using the Standard Deviation of Portfolio Returns. Individual securities are analyzed through the covariances of their individual securities returns, with their contribution to portfolio risk being the driver of portfolio construction and security selection. **Maximization of Portfolio Returns for a given market or portfolio risk is the objective.**

<u>**The differences in these approaches to portfolio construction can be summarized as 'Individual Security Selection' versus 'Portfolio Risk Targeting'.**</u>

Prior to Markowitz, investing was, and, sadly for fixed income investors still is, largely based on Graham and Dodd – <u>security selection and relative value choices made by Yield, Yield Spread, and Duration of bonds, with spreads and duration indicating Risk.</u>

<u>**When the onion is peeled back, the blame for the poor returns of Fixed Income can be attributed to the apprenticeship model of training in Fixed Income.**</u> Past success in raising capital and generating large fees is the justification for not questioning or changing the status quo. <u>**The bottom line: PMs have not been trained to think in terms of a Risk Framework.**</u>

Graham-Dodd can only work in Fixed Income in the special case of a low volatility environment, where yields can correlate to returns. Even then, yield is a very poor model of return-to-maturity, being dependent on the reinvestment rate. **Yield-driven training has worked in the past, but has ceased to work today.**

There is a role for the Graham-Dodd fundamental analysis process in an Actively Managed portfolio, but it should come <u>after</u> the Risk decisions of the portfolio construction are made to screen or select securities to fit the required risk.

As we have seen over and over, especially during the GFC, when securities and risks are highly correlated, **no amount of "diversification" through increasing the number of securities in a portfolio can save a portfolio.** This is also a flaw in the Rating Agency methodology for Structured Products, including MBS, and we are currently seeing it play out in the CMBS space.

Yet, "diversification" persists as the argument for the ubiquitous 60/40 portfolio, even though Fixed Income has proven not to be a hedge for equities, with examples in 2020, 2008 and other periods!

A First Principles training process to question and forensically analyze poor returns is required in Finance, and especially in Fixed Income.

Fixed Income has tremendous returns potential that is realizable through Active Management of Risk through Risk Targeting, as evidenced by ARAM's PlusAlpha's Active model portfolios that uses our proprietary version of Markowitz. MBS Mantra's MBS portfolios also incorporate this thinking, albeit not entirely systematically.

Alpha Research and Management (ARAM) Update – see our latest newsletter:

We've been further improving our Systematic Active Fixed Income Algorithms for our Model Portfolios, resulting in additional returns improvement AND risk reduction, and have managed to extract Alphas (vs AGG) ranging up to 10% gross from Fixed Income, while reducing drawdowns.

We also recently released Multi-Asset Model Portfolios of S&P500 and Fixed Income, that generate Alpha over 60/40 AND S&P500.

We've also created Advisor Specific Model Portfolios that use the Funds of a specific advisor, which we are hoping will be used in a Sub-Advisory framework as they perform better and generate Alpha over the Active portfolios created by the Advisors.

We think these are ideal for Wealth Managers, but should also be considered by Institutional Investors. They also solve the problem of Fixed Income Illiquidity, in addition to delivering the potential returns of Fixed Income.

Our MBS boilerplate:

MBS is a Variable Income asset class and product, and not Fixed Income, as it is widely viewed and categorized. Unlike traditional managers that understand MBS as Fixed Income and do not differentiate between Low-Income and High-Income MBS, we systematically identify and harvest High-Income MBS to construct portfolios that generate total returns with low correlations to Fixed Income as well as with other assets. High Income MBS can be an Absolute Return component of a portfolio, or a diversifier. High Income also protects capital by lowering Breakeven Prices rapidly. This is explained in detail in our white paper, The MBS Income Factor.

Regards, Samir.

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