MBS

MBS Mantra, LLC

MBS Mantra MBS High Income/Absolute Return Strategy December 2018 returns: -0.18% net, +0.0% Gross, +2.19% YTD

Hello. Please find attached the Dec 2018 Fact Sheet for our flagship MBS Absolute Return Strategy. This can be accessed from our website as well.
Below you will find some very detailed analysis of our unique strategy and returns, reviewing our performance since 2016.

We have completed this volatile year outperforming all our benchmarks, by between 1.2% (MBS Index) to 6.75% (S&P 500). We beat the AGG by 2.1% and HY by 4.3%. It is worth noting that the S&P exhibits almost 3x the volatility of our strategy, while HY volatility is almost 2x. This can be viewed on the 'Risk vs Return' graph in our Fact Sheet.

Our strategy of investing and reinvesting in High Income cashflowing MBS continues to grind out monthly returns from realized Income, offsetting some of the volatility of MBS prices from marks and markets. This allows our portfolios to compound and reduces portfolio value volatility. As interest rates stop rising, we expect our portfolios valuations to stabilize and to start growing again, after stalling in 2018.

Our returns this month were hurt by an almost 80% mark down of a GNMA IO bond by our custodian's pricing service, that in mid-Dec priced it to 'call'. This is a new risk – the calling of seasoned agency bonds - that took the market by surprise. It is to protect against such random risks that we diversify our portfolios through many holdings. The tradeoff that we accept to diversify is relatively lower liquidity, as our position sizing results in majority 'odd-lot' holdings in our separate accounts.

Over time, the realized High Income of our portfolio bonds protects us against this liquidity risk, as the 'Breakeven Price' of each position declines monthly (see graph below). It has been rare for MBS that we have owned for more than 2 years to take an absolute return loss upon sale (not that we sell much). However sales within a year of purchase do face exposure to negative returns from realized price change, as not enough Income has accumulated to offset bid-offer spreads or market price declines.

The 'Trump Trade' (or Momentum trade) appears to have run its course, and our only benchmark with cumulative returns that had exceeded our cumulative returns from our inception date - the S&P - had given up those gains at year end after overtaking our returns in 2017. While it is still above our Net returns, it has now crossed our cumulative Gross return line, this time on the way down. As would be expected, High Yield has declined along with Equities. This can be seen on the 'Cumulative Return Comparisons' graph on the Fact Sheet.

Some aggregated portfolio trading statistics for 2018

Each account holding and trade date is considered to be a separate position.

Current aggregated portfolio: 320 separate positions; 192 unique bonds
Purchases 2018: 235 positions; 135 unique bonds
Sale or Maturities 2018: 39 positions, 24 unique bonds
2018 Purchases Sold or Matured: 10 positions

Weighted Average Income* (Annualized) of 2016 to 2018 MBS purchased holdings (284 holdings)

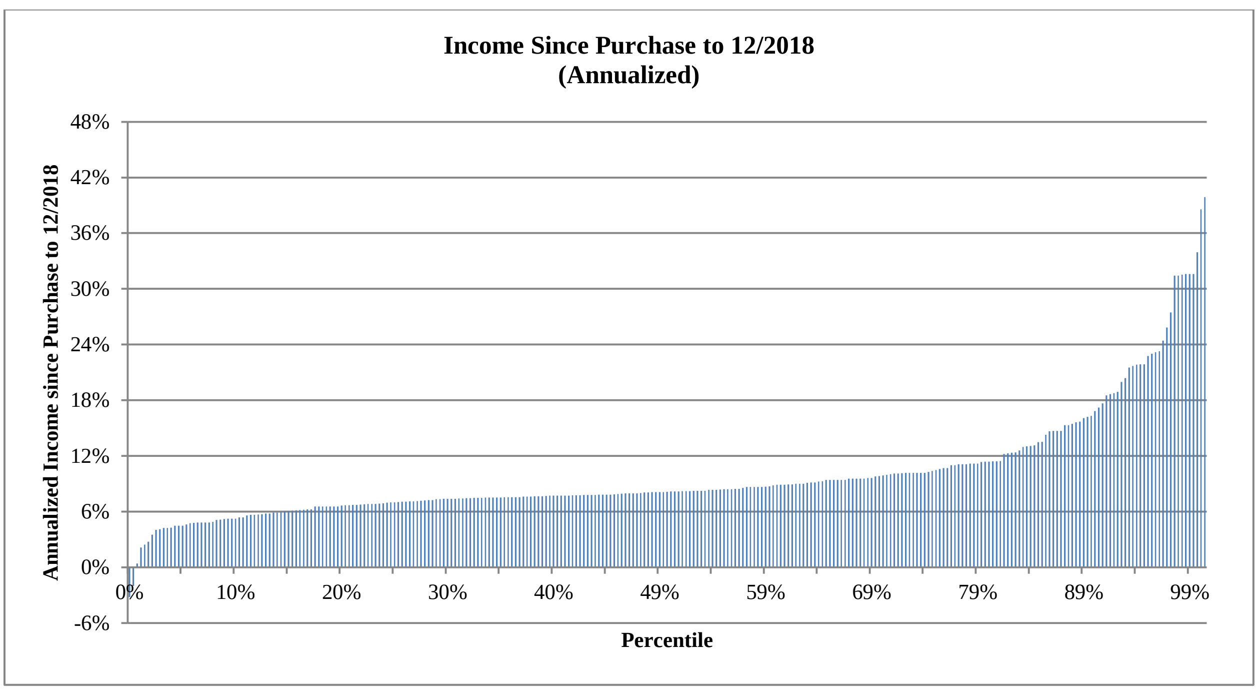
Aggregated Portfolio as of 12/31/2018

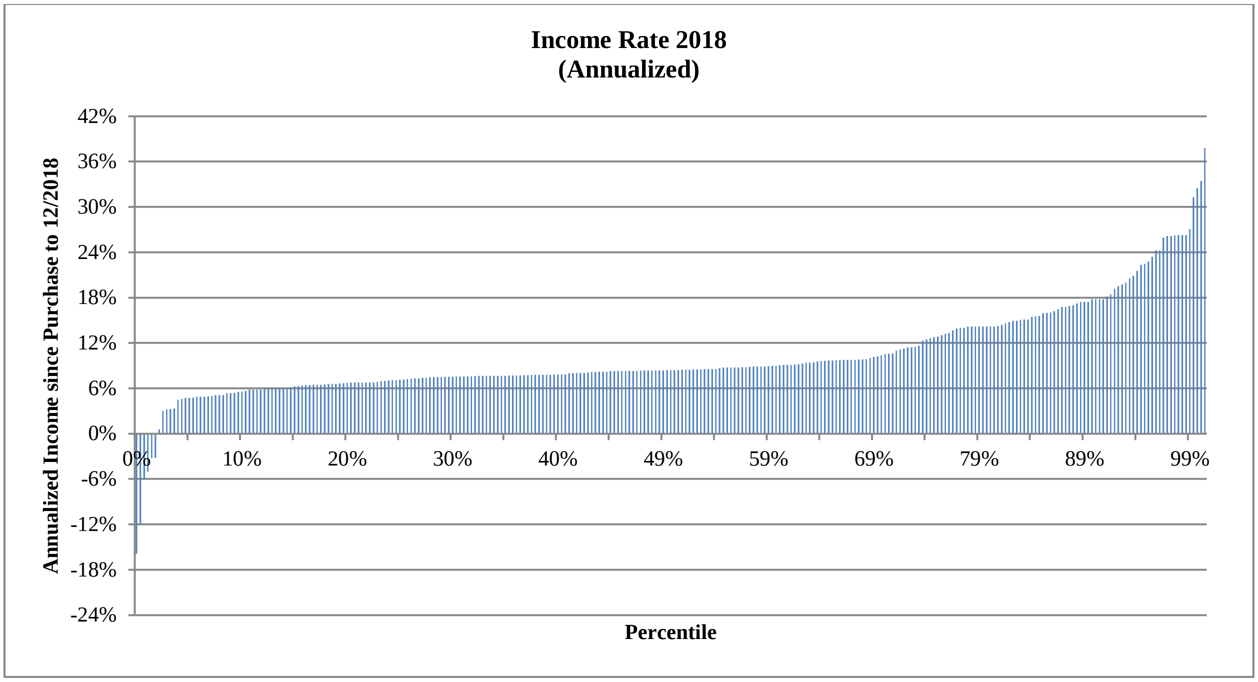
	Purchase to 12/2018	2018	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Average	10.0%	10.2%	12.2%	13.2%	11.1%	10.1%
Wted Avg	**9.1%**	**9.3%**	**10.9%**	**12.6%**	**9.4%**	**8.6%**
Min	-3%	-16%	-40%	-82%	-47%	-109%
Max	40%	38%	123%	102%	200%	193%

*Note: based on cashflow received, weighted by original invested amount; no amortization of IO cashflows; full 2018 and quarterly returns for each bond to demonstrate stability of Income

The weighted average realized income (annualized) was 9.1% for recently purchased current holdings.

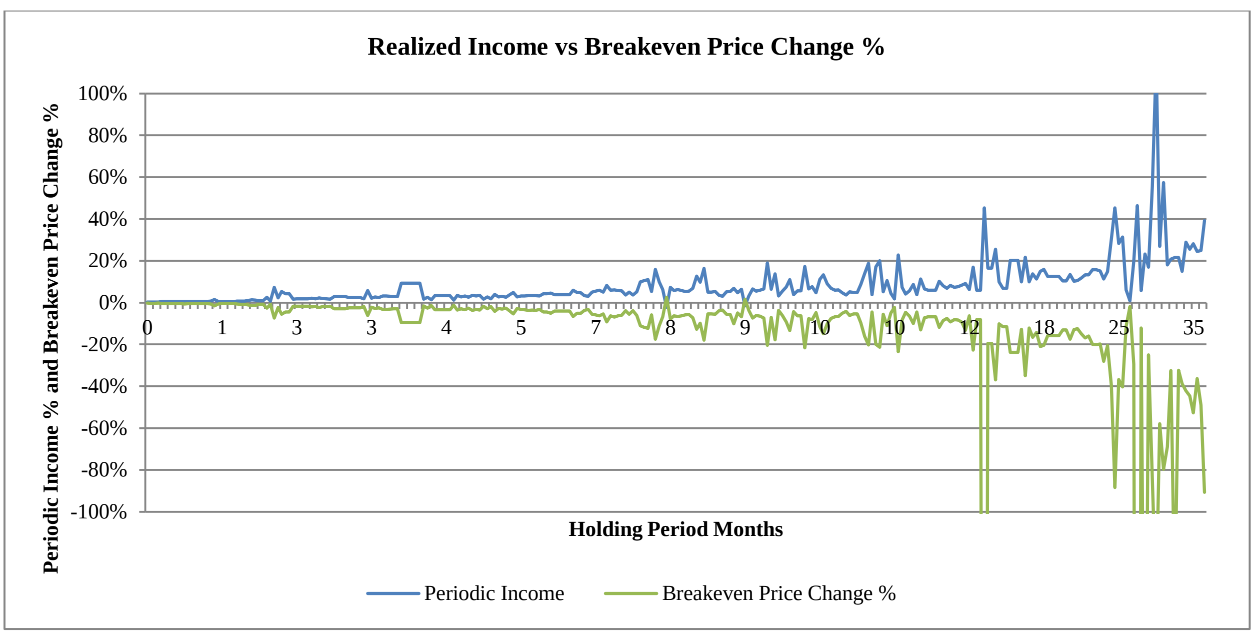
Over 80% of our holdings (only 2016 to 2018 purchases analyzed) earned Income over 6% annualized, in 2018, as well as since purchase.





Realized Income vs Breakeven Price – 2016 to 2018 purchased holdings

As more MBS Income from cashflow is realized over time, a bond can absorb greater price change before the position realizes a negative total return (not including reinvestment). We quantify this using Breakeven Prices and Breakeven Price Change percentages. The Breakeven Price is the price where the TRR would be 0% upon immediate sale. The following graph was truncated at ±100% for legibility. A breakeven price change less than -100% implies that full repayment of the invested principal has already been realized.

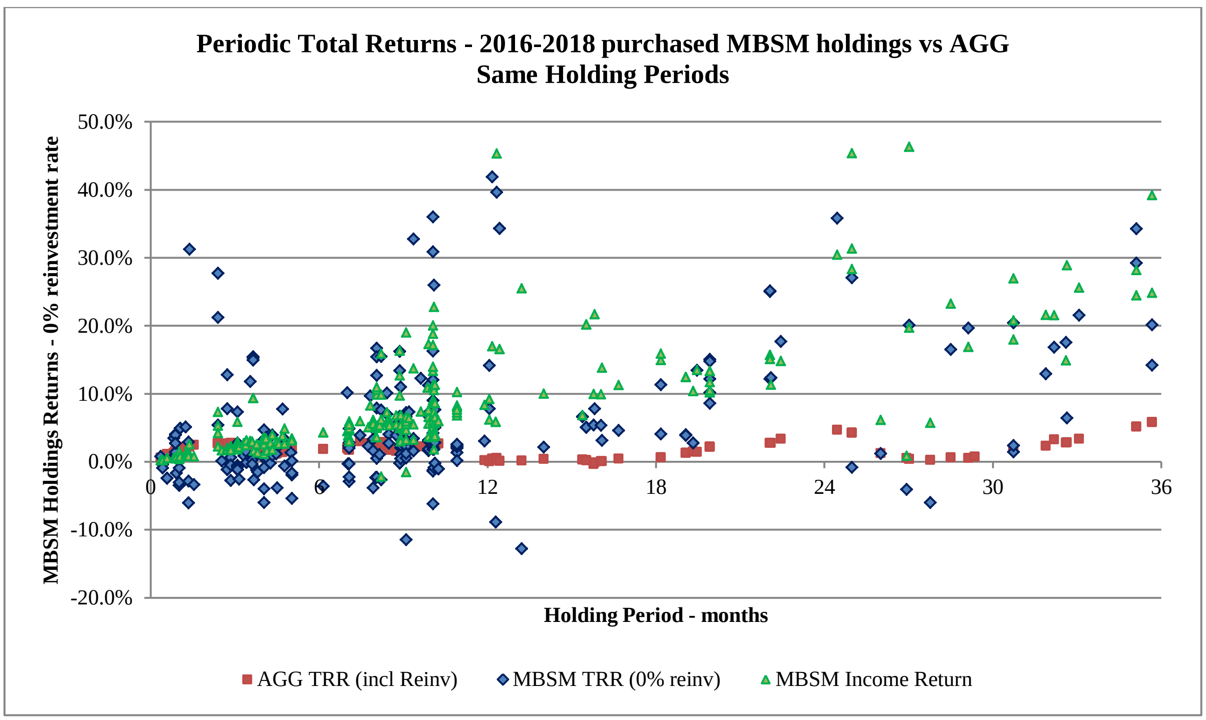


MBS Mantra MBS Holdings Returns (gross) vs the AGG

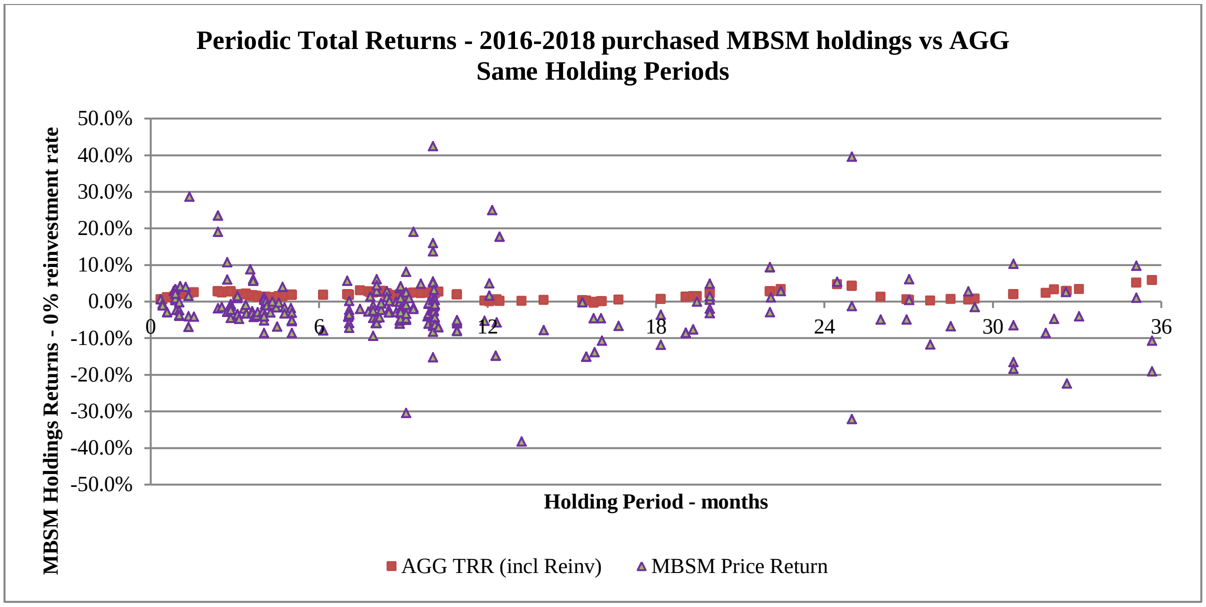
The next two charts show the powerful impact of realized High Income returns on Total Returns. **As more Income is harvested, over time, Income Returns dominate the Price Returns attributes of Total Return.**

For every MBS bond we own, we compute the Total Returns from each purchase date to 12/31/2018, and also compute TRRs for our primary benchmark, the AGG, for the same holding periods. The AGG computation includes reinvestment in the AGG, the MBS TRRs assume 0% reinvestment, and no fees per bond (ie gross returns).

This chart compare the periodic (non-annualized) AGG Total Returns (red) with the comparable Total Return for every MBS (blue), including price change using IDC marks, as well as to the Income-only Return for each MBS bond (green). For short holding periods, namely 2018 purchases, a number of our holdings have underperformed the AGG. However, it can be seen that the Return from Income has grown with time. **For bonds owned for greater than one year, the Total Return has outperformed the AGG's total return, as the realized Income Return has continued growing.**



In the next graph, we can see that the outperformance over the AGG of MBS held for greater than 1 year cannot be attributed to positive Returns from Price. In fact, most of our MBS positions have been marked down by IDC over the past 6 months, as rates have risen, and Price Returns have underperformed the AGG.



High Income Returns dampen the volatility of Price Returns. This table shows these attributions, and summarizes our performance relative to ETFs for various benchmarks.

Weighted Returns of MBS Mantra holdings as of 12/31/18 from purchase date to 12/31/18

	MBS Mantra Periodic Returns (non Annualized)			Comparable Period Benchmark Returns			
	MBS Mantra TRR	**MBSM Income Return**	**MBSM Price Return**	**AGG TRR**	**MBB TRR**	**HYG TRR**	**SPY TRR**
2016-2018 purchases	**4.7%**	**8.3%**	**-3.6%**	**1.9%**	2.1%	-0.3%	-1.6%
2016 purchases	**17.2%**	**24.1%**	**-6.9%**	**3.4%**	2.8%	11.6%	27.0%
2017 purchases	**8.1%**	**13.2%**	**-5.2%**	**1.0%**	1.3%	-0.7%	4.4%
2018 purchases	**1.5%**	**4.1%**	**-2.6%**	**1.9%**	2.2%	-2.4%	-8.3%

Weighted by the invested size of every MBS Mantra MBS holding; 0% reinvestment rate for MBS Mantra returns; Price return assumes IDC pricing; Benchmark returns are reinvested in the ETF stock.

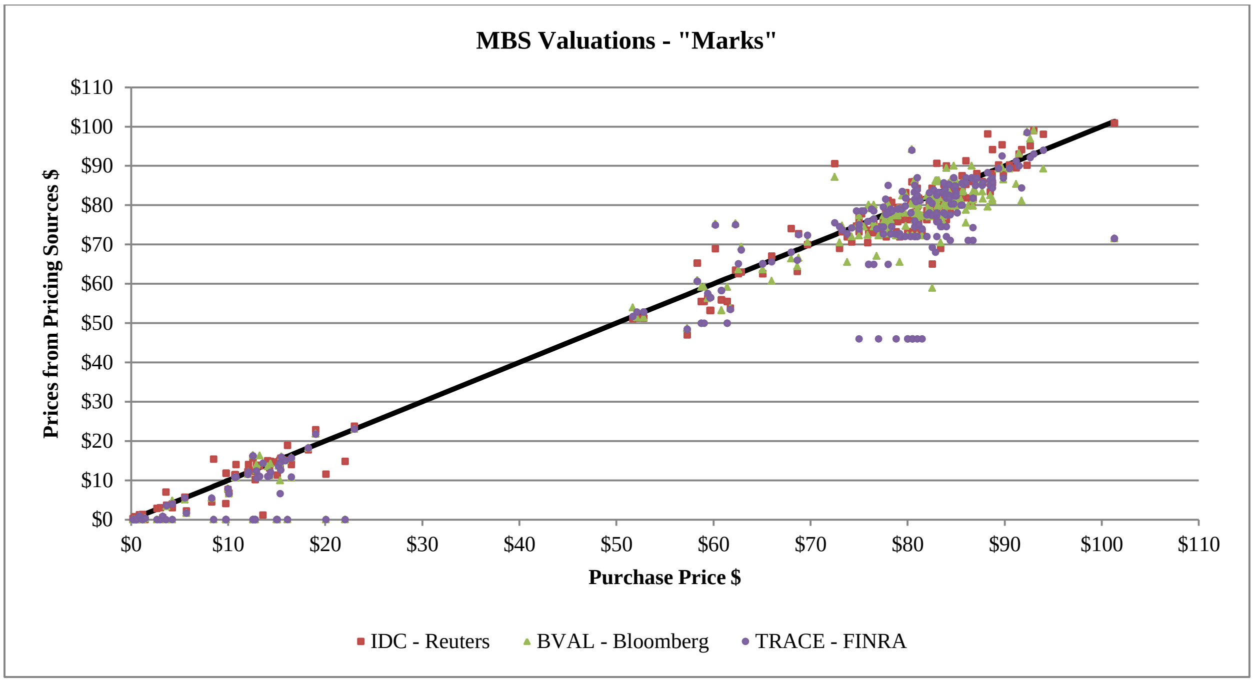
We outperform the AGG and other benchmarks by harvesting High Income from MBS, and reinvesting cashflows into other High Income MBS. Returns from Income dominate risk from price change.

Valuation, "Marks", and Total Return Estimates

Bonds trade over the counter, and are not exchange traded. Bonds do not trade frequently, and there are over a million individual bonds outstanding. As a result, bond prices for the valuation of portfolios are imprecise and, at best, indications. With MBS, that are more complicated than other types of bonds, valuation estimates from different sources can differ dramatically, by as much as 30% or more in some extreme cases, due to differences in the models used by valuation sources.

Without actually selling bonds one cannot know the total return performance of a bond or a portfolio, and precise fund valuation is actually impossible. Fund managers regularly get into trouble with the SEC over pricing as a result, since fees are usually based on valuations. We have written about this problem extensively, including to the SEC, in an attempt to educate about the flaw in market structure that leads to this inefficiency. This link might be of interest: Letter to the SEC.

This graph shows the range of prices for our portfolio from 2 different independent pricing sources (IDC – Reuters, used by our custodian, and BVAL – Bloomberg's MBS pricing model), as well as the latest prices reported on TRACE (Trade Reporting and Compliance Engine) – FINRA's oddlot transparency price reporting system.



The average pricing range across all our holdings as of 12/31/18 was 17%! Our custodian uses IDC-Reuters pricing, and the average price change from our MBS purchase prices was -2.7%.

The FINRA TRACE pricing should be taken with a grain of salt, as the average size of all the TRACE trades matching our portfolio was less than $10,000, with many trades smaller than $1,000. However, based on mark changes that we have observed, we suspect these micro TRACE trades are being reflected in the pricing service valuation process, as they are sometimes the only recent trades in a bond (80+% of all bond trades are oddlots).

Similar to the TRRs computed above that used IDC marks from our custodian, we use the high (Max Pricing) and low (Min Pricing) marks for every bond to compute total returns for the holding periods from purchase to 12/31/2018 to estimate a range of return estimates for each bond.

Weighted Returns of MBS Mantra holdings as of 12/31/18 from purchase date to 12/31/18

	MBS Mantra Periodic Returns (non Annualized)			Comparable Period Benchmark Returns			
	IDC Marks	Max Marks	Min Marks	AGG TRR	MBB TRR	HYB TRR	SPY TRR
2016-2018 purchases	**4.7%**	7.3%	**1.8%**	**1.9%**	2.1%	-0.3%	-1.6%
2016 purchases	**17.2%**	19.5%	**16.2%**	**3.4%**	2.8%	11.6%	27.0%
2017 purchases	**8.1%**	10.1%	**4.1%**	**1.0%**	1.3%	-0.7%	4.4%
2018 purchases	**1.5%**	4.3%	**-1.4%**	**1.9%**	2.2%	-2.4%	-8.3%

Weighted by the invested size of every MBS Mantra MBS holding; 0% reinvestment rate for MBS Mantra returns; Price return assumes IDC pricing; Benchmark returns are reinvested in the stock.

In spite of this downward pressure on marks from the pricing process, which can reduce estimates of TRR, our 'Min Marks' return estimates show that our High Income MBS strategy can still protect capital over intermediate and longer terms, even if we realize the Min Prices.

Sold or Matured Trades (including called bonds)

We typically only sell bonds when Income Return declines below a hurdle rate, typically 6% (due to either adverse performance or when prices have appreciated), or when changing bond fundamentals might impact future Income or Price Returns. Such sales are usually reinvested into other High Income MBS. Some of our closed trades, however, are also involuntary, such as when bonds get called by the trustee of the deal. (This is ironic and the opposite of a credit default – bonds get called when you select a bond or collateral too well!).

The following table compares the realized returns of bonds we sold to the returns of our benchmarks for the same holding periods as the sold bonds.

Weighted Realized Returns of MBS Mantra Sold or Matured MBS

	Periodic Returns (non annualized)			Comparable Period Benchmark Returns			
	MBS Mantra TRR	MBSM Income Return	MBSM Price Return	AGG TRR	MBB TRR	HYB TRR	SPY TRR
2016-2018 purchases	**8.6%**	**8.2%**	**0.4%**	**0.7%**	**0.6%**	**4.7%**	**12.9%**

Weighted by the invested size of every MBS Mantra MBS holding; 0% reinvestment rate for MBS Mantra returns; Price return assumes IDC pricing; Benchmark returns are reinvested in the stock.

Market and Economic Risk: Equities and Yen

Jan 3rd 2019 was notable, as there was a sudden 4% strengthening of the Yen in the middle of the night when there were no human traders around. The talking heads on TV could not stop talking about it, labelling it as another 'tantrum', as their usual 'haven trade' Yen-demand narrative could not be justified. Some of them finally speculated that it might have been an 'algo' that pulled the trigger.

It has been 12 years now since I started discussing the relationship between US asset prices and the Yen, and the market action on Jan 3, 2019 provides support for my thesis. **It continues to be**

my contention that the Yen is not a 'Haven currency', but is instead a Funding Currency for levered investing. This has resulted in a strong relationship, that is visible even intra-day, between US equities and the Yen. I believe that this is driven by the algorithmic levered trading activities of large hedge funds. With negative rates in Japan and other parts of the world, and a substantial interest rate differential to the US, it appears that interest rate parity is routinely ignored, to create the leverage and capital flows that have driven up US asset prices for decades.

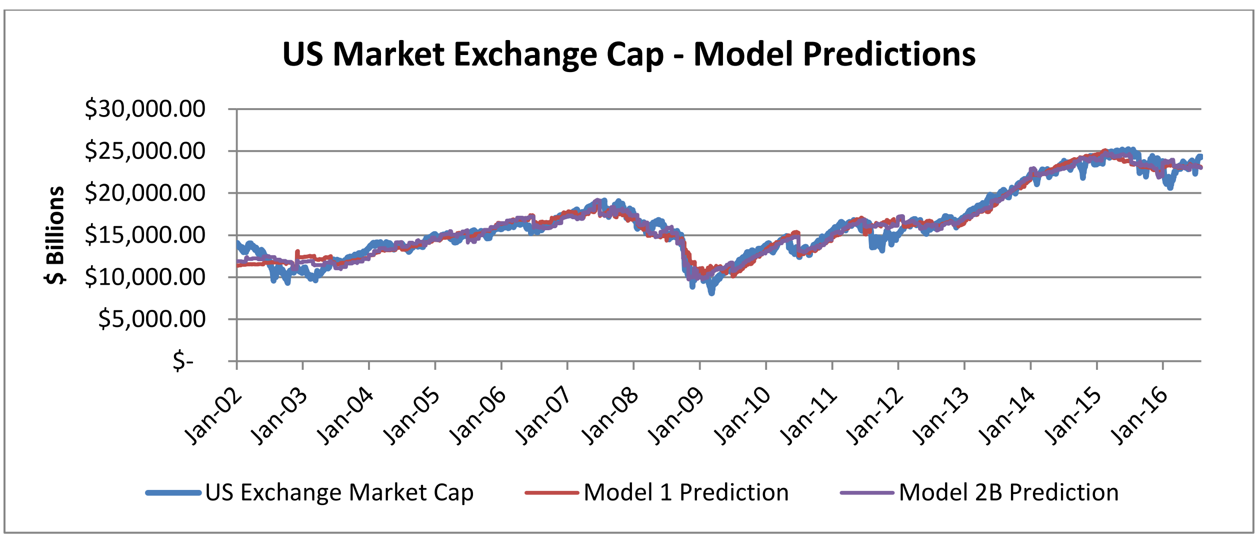
This should raise the questions of whether many US equities can even be called investments when the primary determinant of their price level is the supply of money to buy them. What can the investment thesis for a stock be if it can decline by 33% (AAPL) or 52% (NVDA) in only 3 months? Is a 0% discount rate sufficient to justify all valuations? Is Momentum the 'factor' to monitor, or is it expectations of interest rate differentials between central banks? Is 'Buy the Dip' prudent advice? Is the correct theory for Finance currently the 'Greater Fool Theory'?

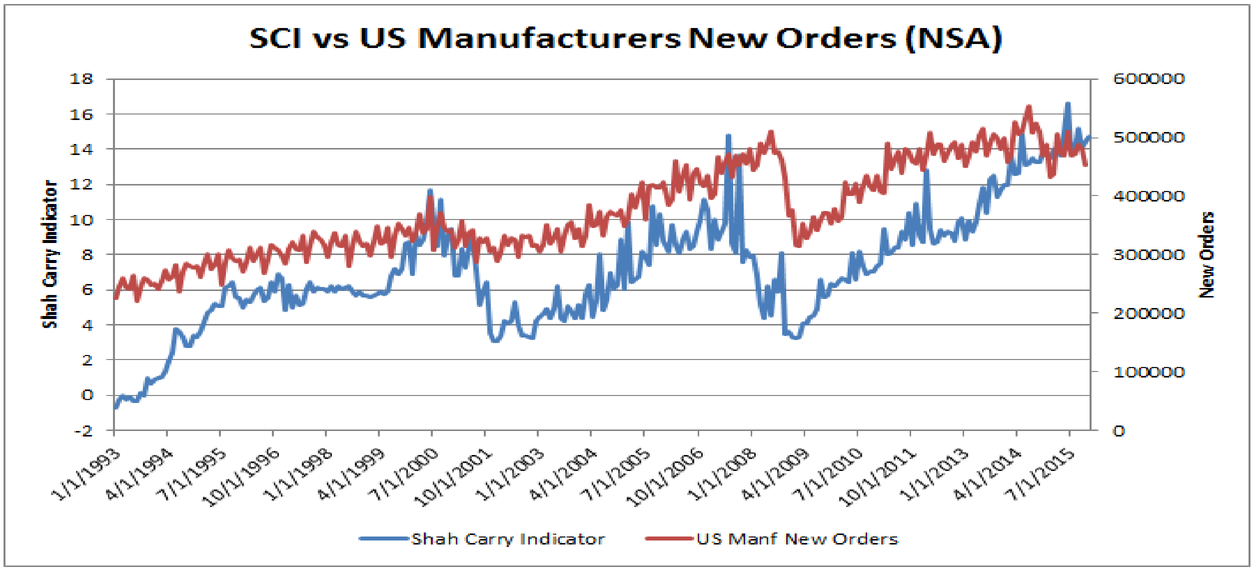
For us, the Yen serves as the canary in the coalmine, as it did in 2007, able to signal global risk-off. Following the Yen is an important part of our risk-management process. The Fed embarking on QT increases the systematic risk of another global financial deleveraging, if our leverage suppliers - global savers - decide one again to protect their capital, such as they did in 2007. This will be telegraphed in the FX markets first.

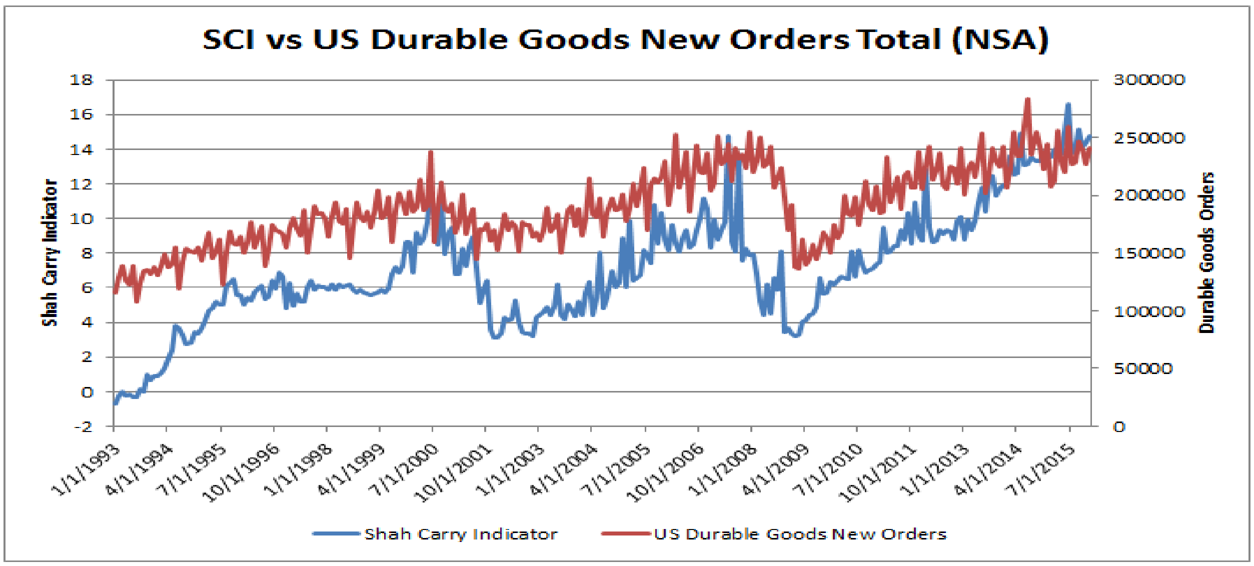
After 20+ years of levered asset growth from imported money supply, we believe that the US economy is driven by asset prices, with the tail wagging the dog. The stock market is one of the Conference Board's ten Leading Indicators. However, 'Injected Capital' and the Yen lead them all.

There is much on my website if you would like to read more. If you are quantitative, I would recommend 'Understanding Beta: Determinants of the US Stock Market', that has modelled the pre-Trump market valuation in 2016. For even greater depth, please try 'The Failure of Macro Economics – Carry Trades, Money Flows and the Pricing of Assets'.

Here are some graphs from these articles to whet your appetite:







We welcome your questions and comments.

Regards, Samir

January 10, 2019

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