MBS
MBS Mantra, LLC

January 2019 - MBS Mantra MBS High Income/Absolute Return Strategy returns:

- Incubation Portfolios: +0.39% Net, +0.48% Gross; 2018: 4.21% Net
- Aggregated SMAs: +0.84% Net, +0.92% Gross; 2018: 2.81% Net

- Income Aggregated SMAs: Average Income for Jan 2019: 0.68%
- Income Aggregated SMAs: Annualized (BEY) Income for Jan 2019: 8.26%

Hello. Please find attached the January 2019 Fact Sheets for our flagship MBS Absolute Return Strategy. These can be accessed from our website as well. This monthly report is also attached to this email as a pdf file.

There are a number of changes to our Fact Sheets that I will describe below. **The first change is that we are isolating the performance of our Incubation portfolio and producing a second Fact Sheet**. This portfolio is incorporated in the Aggregated SMAs that we continue to report. While they are largely similar, there are slight differences in performance that I will highlight.

The second change is in the simulated fees on our Fact Sheets. Since we manage in SMAs, we customize both portfolios and fees for clients. Our Fact Sheets simulate ‘institutional fees’ to compute Net Returns. Based on some recent conversations with potential allocators, we have decided to change the proposed institutional Fee structure to incorporate a Hurdle Rate for performance fees. Both Fact Sheets are now recomputed with the new Fee Structure.

Market color

Readers of our December 2018 newsletter will have noted that the Price Return attribute of our Total Returns in 2018 was negative (-3.6%), even though we had positive returns for the year. The older purchases also had a greater “mark” decline. Much of this was unrealized price ”mark” declines during 2018, due to market volatility. While most markets, notably High Yield and Equities, have rebounded in Jan 2019, our marks in 2019 are still mostly unchanged, allowing the High Income of our portfolios to be isolated in Jan, and to continue to generate stable monthly positive returns.

In terms of market color, with year-end selling pressures behind us, most MBS are trading firmly, and traders are complaining that they cannot buy bonds anymore at the prices that existed in Q4. We await the awakening of the pricing services.

In the December report, we discussed the range of estimates of prices from different pricing sources. One of our favorite strategies continues to have declining marks, as it appears that the pricing service matrices used for their matrix and model pricing do not appear to be able to distinguish between floating rate bonds off ALT-A collateral (such as we own), and floating rate bonds off subprime collateral (that we shun), and price them around the same levels, in the $50s.

This was the case during the Crisis, resulting in outperformance for those who purchased ALT-A floating rate bonds and shorted ABX, and remains so today. We capture the benefits of this trade by harvesting High Income from such severely discounted bonds, that we believe will be ‘money-good’, and continue to buy more to reinvest, when they are available at cheaper prices (since many market participants only bid bonds in the context of the pricing service marks) from forced sellers. We believe these are mispriced on the cheap side. It is for reasons such as the vagaries of pricing services that we charge performance fees only on Closed Trades.

This is also a good segue to discuss our 2 Fact Sheets.

Fact Sheets: Incubation portfolio and Aggregated SMAs.

Since we only charge performance fees on Closed Trades, we have no incentive to play pricing and performance ‘games’, such as only buying bonds below pricing service marks to show an immediate gain, or to defend marks by overpaying for bonds. Our returns over time come primarily from the Income realized from our client’s bonds, and not from Price Change. We buy bonds based on our models of value and their suitability for the client’s portfolio, and buy such bonds when they become available. Obviously, cheaper is better, but we are not beholden to the marks.

Sometimes we manage to purchase bonds below the marks, and other times we pay higher than the marks. Our portfolios, especially new client portfolios, therefore show pricing volatility in the first few months as new money is being invested during portfolio construction. Sometimes SMAs show net unrealized “gains from marks”, other times, net “losses from marks”, based on where the pricing service has priced bonds, and most of this level change occurs in the first few months of portfolio construction.

2018 was very productive for us. Our AUM more than doubled, almost tripling. However, most of the new clients have not owned their bonds for many months, and have not accumulated sufficient income to overcome the price changes we experienced from marks, both upon purchase when the reported “bond value” resets to the mark, and then again from market volatility in Q4. Currently over half the total bonds in all the SMAs have been owned for less than 6 months. As a result, our Aggregated SMA Fact Sheet is now dominated by Client bonds with short holding periods to date.

Income is a rate while prices are a level, and only Income should be annualized. Price level changes in MBS occur periodically and can be sticky, and should not be annualized. As the new clients own their portfolios for more time, I am confident that the price changes from marks will be overcome by the continuous monthly Income.

In the meantime, we believe that the results on the Incubation Portfolio Fact Sheet are currently more indicative of the longer term performance of our unique High Income strategy. In spite of greater mark declines that the newer portfolios, the Incubation portfolio still outperformed the Aggregated SMAs for the year by 1.4%, due to more Income earned from the full year offsetting the price mark changes.

New Proposed Fee Structure – simulated on the Fact Sheets

We continue with the proposed 1% management fee for Institutional allocations.

We now apply an annualized 6% Hurdle rate on the profit of Closed Trades, with a 25% performance fee on the excess over 6%. A High Water Mark process is computed and tracked for Closed Trades with an annualized Return below 6%. Profit from new Closed Trades has to cover accumulated shortfalls below the Hurdle level, before Performance Fees are due.

Since the 1% management fee is computed monthly based on aggregated balances, and not tracked per bond, it cannot be credited back towards the Hurdle return computation. We chose the 6% gross profit hurdle to generate an effective 5% Net Hurdle Rate after fees.

Based on our historical simulation, this fee structure is cheaper than a 0%/30% structure for an investor, and much cheaper than our previous structure.

Following up on the Yield Curve flattening in October 2018

In MBS Mantra's November newsletter, I wrote the following:

> ***There has also been much prognostication from various sources that the flattening, and indeed slight inversion (to 5 years), of the yield curve portends a recession.***
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> ***We disagree.***
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> ***We believe that the US Treasury market and curve shape stopped having meaningful information starting in 2002, when foreign central banks started implementing their QE and currency activities through investments in US Treasuries. The shape of the curve no longer has meaning. Neither does the difference between TIPs and USTs, as predictors of inflation. Most traditional models of bond valuation taught in textbooks and CFA courses - real returns plus inflation expectations plus liquidity term premiums - are obsolete.***
>
> ***I fully expect that, in two months' time when the data is released, we will discover that the Bank of Japan purchased a significant amount of US Treasuries in Nov/Dec, to offset the Yen strengthening that should have resulted from the equity market selloffs in November and December 2018.***
>
> **…**
>
> ***To me, this smells of a Japanese intervention to keep the Yen weak. We last saw this in 2014.***

This conclusion was reinforced by a simultaneous widening in Swap Spreads that occurred, suggesting overseas UST demand.

The data for November was released on Jan 31, 2018. (Treasury International Capital or TIC data, released by the US Dept. of the Treasury. HOLDJN Index on the Bloomberg.)

As I expected, the BOJ was indeed a net purchaser of US Treasuries in November, by $18.1 Billion, increasing their holdings to $1.036b. This demand for USTs is what flattened the curve, and triggered a lot of business-TV gobbledegook about historical data showing that flattenings usually predicted recessions, etc.

Similar punditry occurs when central bank UST demand is interpreted as increasing Inflation Expectations. I have already written about this in 2016 in Interpreting Benchmark Yields - Separating Inflation Expectations from Central Bank activity.

I will be writing another white paper on this topic, as time permits.

We welcome your questions and comments.

Regards, Samir

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