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

- Aggregated SMAs: +0.87% Net, +1.01% Gross; 2019 YTD: +5.1% Net
- Founder's Portfolio: +1.15% Net, +1.42% Gross; 2019 YTD: +4.5% Net

- June 2019 Income: ~0.7%; Annualized: ~8.9% (Aggregated SMAs @ recent marks)

Hello.

The average portfolio income rate of 0.7% for June was within our target range, with some bonds outperforming and others underperforming, as is typical. The monthly income range was -11.64% to 16.48% (non-annualized), while the annualized income range was -104.8% to +300%. One of our largest holdings had 2 loans incur losses, lowering the overall average portfolio income slightly from the previous month.

Some of our holdings, especially Inverse IOs, but also the fixed rate bonds, went up in price as expectations for a rate cut from the Fed increased, with average portfolio price appreciation from marks of +0.6% from 3/31.

We purchased some bonds for the Client portfolios, reinvesting the proceeds from our May sales. We also had a IO mature and did a maintenance cross in the Founder's portfolios, resulting in performance fees being computed for the Founder's portfolios, lowering Net returns by 27 bps.

The rally in rates has shaken loose quite a sizable supply of seasoned Non Agency RMBS of the High Income variety, that are being auctioned this week between the 9th and 11th. Some of these are from liquidation agents, and will likely trade "cheap". Unfortunately we do not have the AUM to purchase these, else we would be aggressively bidding in these auctions. There is plenty of capacity in our strategy, and we are seeking more investors.

Non Agency MBS prices appear to have also recovered from Q4's markdowns, and we received some unsolicited bids for bonds we had already sold that were ~5% higher than prices we received in May (the bonds sold were underperforming, and we reinvested into "better" bonds) – patience and poker playing is needed when selling MBS.

What is MBS "Income"

For many market participants who have been trained to believe that all bonds are "Fixed Income", the concept of MBS as "Variable Income" is foreign, to say the least. This insight, that MBS are Variable Income securities, is arrived at by deconstructing the core concept of Total Returns.

Total Returns are typically attributed to two factors - Return from Price Change and Return from Income. For most bonds, such as corporate bonds or US Treasuries, the Return from Income is correctly understood to be driven by the coupon, and is approximated by "Yield".

MBS returns derive from many additional factors besides the returns from coupon or price change. The cashflows in MBS are not stable, creating additional return or offsetting return from interest, and these additional factors impact MBS cashflows dramatically, both positively and negatively.

Many investors think that prepayment and credit losses are the extent of cashflow variation in MBS, and much effort is expended in MBS Research to identify and model the loan characteristics that impact MBS prepayments.

Examples of such characteristics are loan sizes, FICO scores, geography, type of loan, loan size, LTV, size of servicer, shelf name, shelf type (bank or third party originator), seasonality, etc. I spent much of the early 1990s as head of the MBS Strategies group at Nomura identifying and modeling such factors.

Single factor analysis is easily understandable – for example, fast prepayments on a discount bond will result in higher returns from cashflow, and vice versa. Usually most single factor trades get priced in by the market, and so discount MBS like POs will go up in price as interest rates decline (and prepayments are expected to speed up), and IOs will appreciate when rates rise.

Unfortunately for most MBS investors who view MBS with a Fixed Income lens, there are other many other factors that distort MBS cashflows, and thus returns from cashflows. More importantly, these factors interact with each other to create unstable cashflow events and volatile returns. Factors such as severities, call exercises, yield maintenance payments, subsequent recoveries, other cashflow shortfalls (from servicer misbehavior, curtailments, rate modifications, loan forgiveness, loan extensions), etc., all change the performance of MBS.

As an example of such interactions, there are many discount bonds that do not receive sufficient cashflow to generate much income, in spite of fast voluntary prepayments from many loans in the deal, as other loans in the same deal are defaulting with high severities at the same time. These interactions make bets on single factors non-durable. One could, in theory, compute the attributions of returns for each of these additional factors, not an easy task, and one that I have found is not of much use for making investment decisions.

To allow for comparison to other Fixed Income and Equity Products, we simplify this factor attribution process into the two main attributes of Total Return - we isolate the Return from Price Change from the total return of the bond in a given period, which is easy to do. **The remaining return is thus the Return from Income for MBS, and is the aggregate remaining return from the netting of the return attributions from the multiple factors that impact the MBS' cashflows during a given period, after subtracting the Return from Price**.

MBS Income Returns vary in time for the same bond, and also vary between two similar bonds that "research" MBS models and markets view identically, making similar bonds have very different returns in a given period.

At MBS Mantra, we exploit the Variable Income nature of MBS. We use a systematic process to identify the current state of MBS Income of all the MBS offerings in the market – High, Average, or Low. We have shown examples of the resulting market distribution of MBS Income (previously called Returns from Cashflow) in our previous newsletters, for example in March 2019 and March 2018.

We further screen each High Income MBS by identifying the primary drivers of its Income status, which is sometimes the absence of a driver that is adversely impacting other MBS, and identify bonds with stable High Income trends. Over 25 years of fine tuning and executing this strategy, we have built the tools and processes to efficiently do this. Through sizing and diversification, we create portfolios with stable High Income. The majority (88% in Dec 2018) of our aggregated portfolio has Income over 6% almost all the time, averaging 8% to 10%, even though the monthly and quarterly income of each bond varies significantly over time.

Our process and strategy was initially identified as 1994 as an "arbitrage finder". Surprisingly, the most common drivers of durable MBS High Income are still secondary market "CMO arbitrage" – where the prices of all the bonds in a deal do not add up to the price of the collateral (usually where an incorrect - too high for the risk - discount rate is used to price an individual bond), or "document arbitrage" – where prospectus reading will result in the use of different inputs and scenarios than typically used to model returns and identify risk. Both types of arbitrage are represented in our portfolios, partially explaining our low turnover – we let such bonds 'run' and usually mature. An arbitrage that I identified is 1994 is still active, and is a part of our portfolios.

We welcome your questions and comments.

Regards, Samir

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