January 2020 - MBS Mantra MBS High Income/Absolute Return Strategy returns:

	% Net Return	% Gross Return	2020 YTD Net	2020 YTD Gross	Trailing 1 year Net
Aggregated SMAs	**+1.54%**	**+1.62%**	**+1.54%**	**+1.62%**	**+6.2%**
Founder's Portfolio	**+1.96%**	**+2.05%**	**+1.96%**	**+2.05%**	**+7.4%**

Jan 2020 Income: +0.85%; Annualized: ~10.6% (Aggregated SMAs @ recent marks)
Jan 2020 Cashflow % of invested value: 1.9% (~ 22.6% annual rate)

Hello.

2020 has started off well for us. The average income rates for December were slightly higher than in recent months, with fewer bonds underperforming than in the recent past. As will be described below, we attribute this to our systematic High Income MBS Process inherently functioning as a risk management process, identifying bonds that should be sold (in addition to spotting bonds to purchase).

The weighted average income for the Aggregated SMA portfolio was 0.85% for Jan, ~ 10.6% annualized, in line with our targeted income range (8% to 10%). The monthly income range was narrower than in recent months, -3.7% to 32.6% (non-annualized), without any MBS with significantly negative income. This helped raise our average income by 0.15% (non-annualized) over last month's income.

The portfolios also benefitted from increases in marks for most of the fixed rate bonds and many of the MBS derivatives. The pricing service is catching up to the secondary market trading levels we have observed for the past few months that have been mostly at higher levels than their marks. While these gains were offset by continued small declines in the marks on the floating rate bonds, the net effect was that about half the total return of the aggregated portfolio came from increases in marks.

Total cashflow received was 1.9% of the portfolio value at the start of the month, around 23% if annualized, implying a portfolio average life (duration proxy) of around 2.5 years.

Severities in Countrywide NY Loans:

Starting in September 2019, in our monthly portfolio income and surveillance runs, we noticed some dramatically large negative Income Returns, -8% to -30% annualized, on some MBS we owned (that we reported in our newsletters). These were mostly Countrywide bonds that, until then, had been behaving and performing very well. However, not all Countrywide bonds were exhibiting this negative manner.

Our analysis showed that the reason for the negative income was a significant jump in Severities, to over 150%, on loans that were in foreclosure and were being 'resolved'. Severities over 100% should not occur given the housing recovery we have had over the past decade. We attributed this to aberrant servicer behavior, and started surveilling the deals more closely.

After tracking these bonds for a few months, we realized that a new factor was at play. In December 2019 we sold the Countrywide bonds we owned that were realizing negative Income returns, including some we had purchased just a few months prior, and are monitoring the others.

In January 2020, Amherst Pierpont Securities (I was a partner at the predecessor firm, Amherst Securities Group, until 2005) published a research report providing an explanation for the surge in Countrywide severities – it had to do with NY state loans that were in 'special servicing'. The research is linked in the title above.

This is an unintended consequence of the Financial Crisis. As part of the Countrywide RMBS settlement, servicing was mandated to be transferred from Countrywide/Bank of America to 'special servicers' that are now mostly owned by large hedge funds and private equity firms. These new owners of servicing rights are motivated to maximize for their own benefit at the expense of bond holders, increasing the volatility of Income Returns to MBS. It is unlikely that such servicer behavior can be modelled or predicted.

It would be nice if some of the larger deep-pocketed bond holders would take legal action against the special servicers that are not aligned with bond holders, to prevent such behavior in the future and to compensate us for losses, but I am not waiting for that. The solution for my clients is to sell.

Investors that rely on models of MBS "yields" based on historical data would not have captured this event, as such high severities are significantly out of the norm. Indeed, the market – primarily model driven - continues to price and trade these specific bonds without penalty or differentiating them from others that are performing significantly better.

I am highlighting this to explain one of the core benefits of our process – at a bond level, our High Income MBS analytics also serve a risk management and monitoring function, and often capture turns in fundamental behavior before researchers or markets catch up, both on the upside and downside. Since our process focuses on attributing returns, it captures all the information that impact returns, allowing us to identify risk (as well as opportunities and arbitrages) faster than modelers, and to react appropriately.

Coronavirus and the rally in USTs

Punchline: In March, we will discover that Japan bought $50bb to $100bb or so more of USTs in January 2020 to keep the Yen weak, when the US stock market sold off by 100 points in the last week of January in response to the Chinese coronavirus. This resulted in the 10 year rally from 1.8% to 1.5%.

Please see our some of our newsletters from 2018 and 2019, or ***T-Leaf Reading***, to understand why. This Yen/UST action has been the primary determinant of the returns from the AGG over the past 6 months. The response from Japan has become so predictable that one can trade the US 10year as a macro strategy.

The coronavirus is an unexpected event, but by no means is it a 'Black Swan' event as far as asset prices are concerned, as Barron's and others were suggesting last week. The history of so-called Black Swans is all about declines in money supply or leverage that result in changes in asset prices, brought about by the unintended consequences of central bank or governmental policies. I go into this in much detail in ***T-Leaf reading***.

Purchasing of USTs by foreign entities is a form of QE to the US. As long as central banks keep money supply flowing through QE and QE-like actions, I do not expect asset prices to go into free-fall. The Yen is back to 109.90, with leverage flowing to support asset prices.

We welcome your questions and comments.

Regards, Samir

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