MBS
MBS Mantra, LLC

March 2020 –Risk Parity Review and 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	-12.7%	-12.6%	-10.4%	-10.1%	-7.9%
Founder's Portfolio	-12.6%	-12.5%	-9.3%	-9.1%	-5.8%

Mar 2020 Income: +0.94%; Annualized: ~11.9% (Aggregated SMAs @ recent marks)
Mar 2020 Cashflow % of invested value: 1.8% (~ 21.6% annualized rate)
Mar 2020 Loss rate: 0.1% (0.4% YTD)

Hello.

March was and is still shocking - we had the largest drawdown we have ever had. The week from 3/18/2020 to 3/25/2020 was among the most volatile in bond market history. In less than a week we saw declines in prices that would normally take months of grinding down to accomplish, such as between 2007 and 2009. These violent moves resulted in margin calls for REITs, hedge funds and other funds, de-leveraging sales, and a massive race for cash, with T-bills being offered at negative yields. Any asset class that could be sold, was sold, and by many, often at a steep discount.

Our MBS aggregated portfolios were down -12.7% in March, and -10.4% YTD. Over the past month and YTD, we have outperformed many MBS and Corporate/High Yield bond funds, as well as most equities, most of which were down between -12% and -80% in the 3rd week of March. The Fed's intervention to buy Agency MBS, corporate bonds, and High Yield bonds did however lead to a partial rebound in the final week of March.

The key to our relative outperformance has been our unique High Income MBS strategy, which, unlike most MBS funds, has allowed us to generate attractive Income and returns without resorting to either explicit leverage to boost returns, or owning subordinated bonds with credit leverage.

Our Income for March, at 11.9% annualized, was better than average, especially since cashflows (1.8%) were lower than in February (2.0%). In our opinion, our negative Total Return performance for March is not based on the current fundamentals of our portfolio, but on illiquidity. Even if prices do not recover, the High Income of our bonds keeps reducing the Breakeven Prices of each position, and we expect to recover this unrealized loss by around year end. The first two weeks of April suggest that prices on Senior Bonds have stabilized, and many bonds are trading above their March end marks, which will further reduce the months required to breakeven.

We have added another line item to our reporting: the loss rate on our Aggregated MBS portfolio. For March, it was only 0.1%, and 0.4% YTD. This is part of our 'secret sauce' – we select MBS that have low losses, even if their prepayments are similar to those of other bonds, resulting in their High Income.

Most MBS funds and hedge funds bet on a continuation of a low volatility environment, and they model and market the future as static and benign. As a result, their favorite trades to generate Income and return are:

- credit leverage (mutual funds and hedge funds)
- explicit leverage (mREITs and hedge funds)
- MBS with negative convexity for extra 'yield' (most/all).

All three strategies stopped working in March 2020. Over 30 years, this story has repeated many times – it is cyclical. Since 1993, when I ran the MBS Strategies Group at Nomura, I have been recommending positive prepayment and credit convexity to clients, and have focused on these in my own and client's portfolios.

MBS Mantra does not use explicit leverage. We only invest in credit leverage when it is priced attractively relative to seniors i.e. distressed, with positive 'credit convexity'.

In our March 2019 newsletter, we performed a 'competitor analysis' on five funds of varying sizes that we viewed as our competitors in the Non-Agency MBS marketplace. By analyzing the Non-Agency MBS holdings in their publicly disclosed portfolios as of 12/31/2018, we determined the extent to which each of these funds used MBS Credit Leverage to generate 'Income'. This is one of the tables from the March 2019 newsletter.

	MBS Credit Leverage as of 12/31/2018					
	Inception Date	**Income**	**Avg Coupon**	**% Non Agency MBS**	**% Mezz**	**% Subs**
MBS Mantra High Income Strategy	Nov-14	**10.1%**	4.9%	100%	**0.0%**	**0.8%**
Fund 1	Jan-16	**5.6%**	5.7%	96%	**21.0%**	**34.8%**
Fund 2	Jul-13	**4.3%**	4.4%	80%	**23.1%**	**35.8%**
Fund 3	Apr-07	**4.3%**	3.9%	19%	**12.0%**	**1.2%**
Fund 4	Oct-15	**3.4%**	4.0%	77%	**50.1%**	**15.1%**
Fund 5	May-15	**2.1%**	3.7%	88%	**85.5%**	**9.5%**

We recently updated the performance of these funds to assess how well their MBS credit levered strategy worked in March 2020. We also included 3 REITS, that use explicit leverage.

		Annualized Return		Absolute Return			
	Inception Date	11/1/2014 or Inception to 2/29/2020	11/1/2014 or Inception to 3/31/2020	11/1/2014 or Inception to 3/31/2020	2/29/2020 to 3/23/2020	2/29/2020 to 3/31/2020	YTD to 3/31/2020
MBS Mantra High Income Strategy	Nov-14	7.3%	**4.5%**	26.9%	**-10.8%**	**-12.8%**	**-10.5%**
Fund 1	Jan-16	9.4%	**2.2%**	12.4%	**-17.8%**	**-23.6%**	**-22.4%**
Fund 2	Jul-13	6.3%	**2.3%**	-0.7%	**-16.2%**	**-22.2%**	**-20.8%**
Fund 3	Apr-07	5.2%	**3.4%**	20.4%	**-12.4%**	**-8.2%**	**-7.9%**
Fund 4	Oct-15	7.6%	**3.4%**	16.1%	**-19.2%**	**-16.4%**	**-14.7%**
Fund 5	May-15	11.3%	**0.7%**	3.3%	**-42.2%**	**-39.2%**	**-37.4%**
AGNC - Agency MBS REIT	Jan-07	6.5%	**-2.3%**	-12.0%	**-38.7%**	**-37.1%**	**-38.3%**
RWT - Non Agency MBS REIT	Dec-95	5.6%	**-15.3%**	-59.6%	**-74.5%**	**-69.6%**	**-68.6%**
CLNY – CMBS REIT	Jan-13	-19.3%	**-29.6%**	-85.0%	**-64.4%**	**-53.2%**	**-60.9%**

The table above shows that our High Income MBS strategy had outperformed most of the 'competitors' from Inception to 2/29/20. Once the volatility of March 2020 hit, the levered funds showed their true risks, and we outperformed all the competitors from 2/29/2020 to 3/23/2020. It was only the Fed's intervention and largess in the last week of March that brought Fund 3 to the forefront for the month, as only 19% of their portfolio (as of 12/2018) were Non-Agency MBS – they have significant Agency MBS and corporate bond holdings that were 'bailed out' by the Fed. On an annualized basis, from our Inception date to 3/31/2020, we have the highest annualized return of any of the competitors.

I am not quite sure why most mREITs exist – they have mostly served to destroy capital over the past decade. For Agency MBS REITS, after the Fed's latest QE, 'yields' on most Agency MBS are under 1% - there is no yield advantage over funding costs left to leverage to generate future high dividends. CLNY's price has been declining since 2015 and it has not had a positive total return month since Aug 2015 while paying high dividends – the definition of a value trap.

I sent out additional comments on the market and performance in my 3/23/2020 mid-month letter to my clients. A version of it can be viewed here.

Market Color from March

The market color we can share is that, while March had unprecedented MBS BWIC volumes, only a few very large portfolio sales occurred, by asset managers that received margin calls or were forced sellers due to redemptions. These included Mutual Funds, Hedge Funds, and REITs. Many more hedge funds ‘dropped gates’, suspended redemptions and/or are closing down, hoping for an orderly return of capital. Many funds and products with explicit leverage, such as REITs, or levered Credit exposure, such as High Yield bonds and levered MBS Credit (subordinate and mezz bonds), took massive > -50% dives. Large bond ETFs, like the AGG, ended up at significant discounts to NAV, as investors sold and shorted ETFs to sell the risk of the bonds they could not sell. (See “AGG Equity NAV <GO>” on Bloomberg).

Many of the bonds that had to and did get sold were credit levered bonds, which took substantial hits – especially given the risks to subordination from COVID-19 shutdowns. My opinion is that most of the price declines for credit levered bonds are justified, but not sufficient, and they should have more downside. It is too early to catch ‘falling swords’ given the uncertainties of whether borrowers will still have jobs to support their mortgage payments, or when the economy will restart. **Credit levered MBS are facing a credit crisis, not a liquidity crisis.**

Many MBS BWICs in March did not receive bids, or received ‘vulture’ bids that were not hit. In general, outside of liquidations and margin calls, not much traded or is trading. However, the few vulture bids that were hit have resulted in markdowns for entire MBS sectors. Outside of the bond market sectors that the Fed is now supporting, illiquidity prevails, and marks often have no correlation with fundamentals.

MBS derivatives too did not have much transparency or liquidity. All derivatives are also marked down as a result. OAS and prepayment models have been tweaked to guess the COVID impact on cashflows, an imprecise and pointless endeavor in my opinion, as the information changes daily – witness stock market volatility.

Floating rate Non-Agency MBS, even if derived from Fixed Rate collateral (POs with coupons in my lingo), have been tainted by the performance of floating rate funds that are chock full of levered loans and CLOs. While CLOs risks and pricing are justified, in my opinion, these senior MBS floaters are now trading well below ‘reconstitution’, having been marked down an additional 15% to 30% in March. This has been the cheapest MBS sector of the past 3 years, and is now even cheaper, negatively impacting our performance in March. Our diversification protocols prevented us from being solely invested in this highly valuable sector, else our returns would have been worse due to marks.

To date, the Fed has announced QE Infinity and supported the following sectors:

- US Treasuries – direct purchases
- Agency MBS – direct purchases
- High grade corporate bonds and ETFs – direct purchases
- Corporates that were BBB rated on 3/22/2020 even though they have been subsequently downgraded to Non Investment Grade – direct purchases
- Loans to Municipalities – direct purchases
- Junk bond ETFs – direct purchases
- AAA rated CMBS, through TALF
- Student Loans and new issue ABS, through TALF

- New issue AAA rated CLOs with newly originated levered loans – through TALF

Out of a total US bond market size of approximately $50T, over $40T of bonds have been supported.

In April, due to Fed support for High Yield, bidders have reemerged especially for Fixed rate Senior Non-Agency MBS. While forced sellers are met with Vulture bids, if you have patience, it is possible to sell bonds above the marks, and we are seeing marks recover gradually. A number of the cusips we own have already 'TRACED-ed' above our marks. A quote from a trader: "Good bid to the market".

We have started marketing our Distressed MBS Strategy, which will add an allocation of Credit Levered MBS to our High Income MBS portfolios. Prices for Credit Levered MBS still have more to decline, and we have not added any. We expect more selling from fund redemptions and are monitoring prices and sales. It is still too early to catch the 'falling sword' in MBS Credit, as the impact of high unemployment and business closings has not been fully reflected in prices and risk, and most of the deals are very 'thin'. Most of the 'securitization tourists' that have purchased portfolios of MBS in March's liquidations have never experienced a true MBS Credit Crisis.

Why did bond markets fail in March 2020? A Review of Risk Parity.

It bothers me to lose money for my clients, and it is important for me, as it must be for my clients and other investors, to understand the why for the extreme drawdown in the month. Understanding asset prices and their movements has been something I have focused on since 1988, and I have developed a unique toolkit for this purpose, that I shared in 'T-Leaf Reading' (2/2019).

I needed to identify the root cause behind the market losses in our MBS portfolio, and who was responsible. For that reason, I am sharing the analysis below, and my conclusions.

Numerous news outlets have blamed the breakdown of Risk-Parity ("RP") strategies for the volatility in bond markets in March 2020, resulting in massive selling that overwhelmed the ability of dealer balance-sheets to absorb the sales. Fixed Income as a volatility reducer and hedge for equities broke down in March, with both asset classes declining. Both US Treasuries and S&P Equity futures, normally the two most liquid assets, showed terrible liquidity in March, leaving other asset classes including MBS hanging, begging for bids that did not materialize..

https://www.ft.com/content/3ab66a1c-6578-11ea-b3f3-fe4680ea68b5

"Risk parity funds, automated investment vehicles pioneered by the hedge fund manager Ray Dalio and designed to do well in almost any market environment, were among the big casualties of financial markets' wild week, suffering their worst performance since the depths of the credit crisis and the second-worst on record... Like many funds, risk parity vehicles invest in a broad array of assets but they get their name because they try to keep the relative volatility of each component equal and constant. Bonds are less volatile than stocks or commodities, so risk parity funds typically use leverage to increase their exposure to safer fixed income, which should act as a counterweight if equities are rocky."

https://www.aqr.com/Insights/Research/White-Papers/Understanding-Risk-Parity

https://www.aqr.com/Insights/Perspectives/Risk-Parity-Why-We-Fight-Lever

https://us.spindices.com/documents/methodologies/methodology-sp-risk-parity-indices.pdf

https://supplements.pionline.com/uploads/supplements/SPIndices_Research-Indexing-Risk-Parity-Strategies.pdf

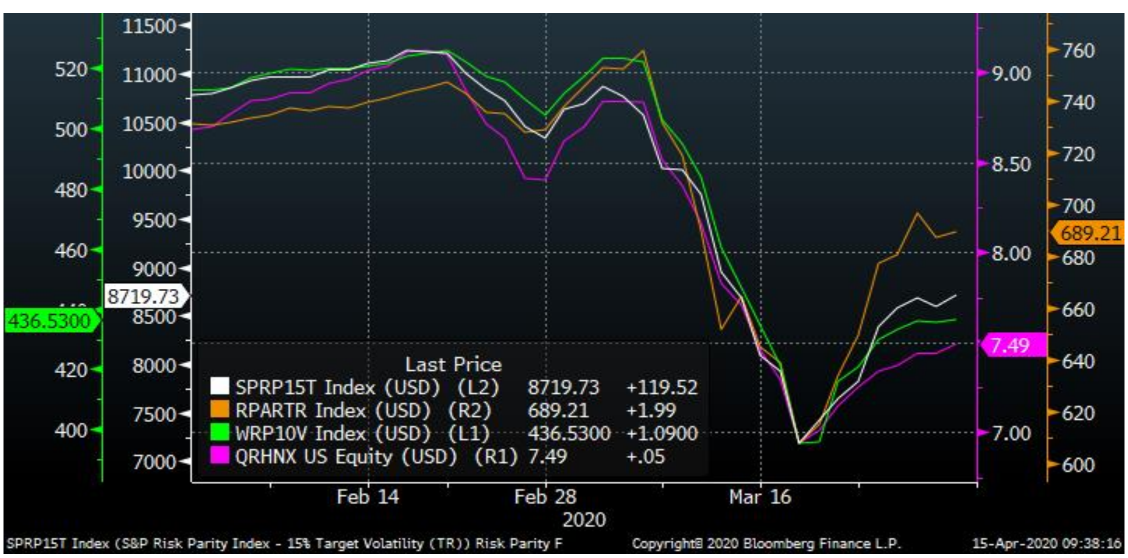
The typical RP fund will own long levered exposures via Futures in Global Equities (111%), Global Fixed Income (250%) and many Commodities (95%).

Bridgewater and AQR are probably the largest managers of Risk-Parity Strategies. Many other managers also have Risk-Parity funds. It is estimated that $300b to $400b in AUM is in RP. With bonds having 250% allocations, my guess is that over $1T in bonds are held by RP funds.

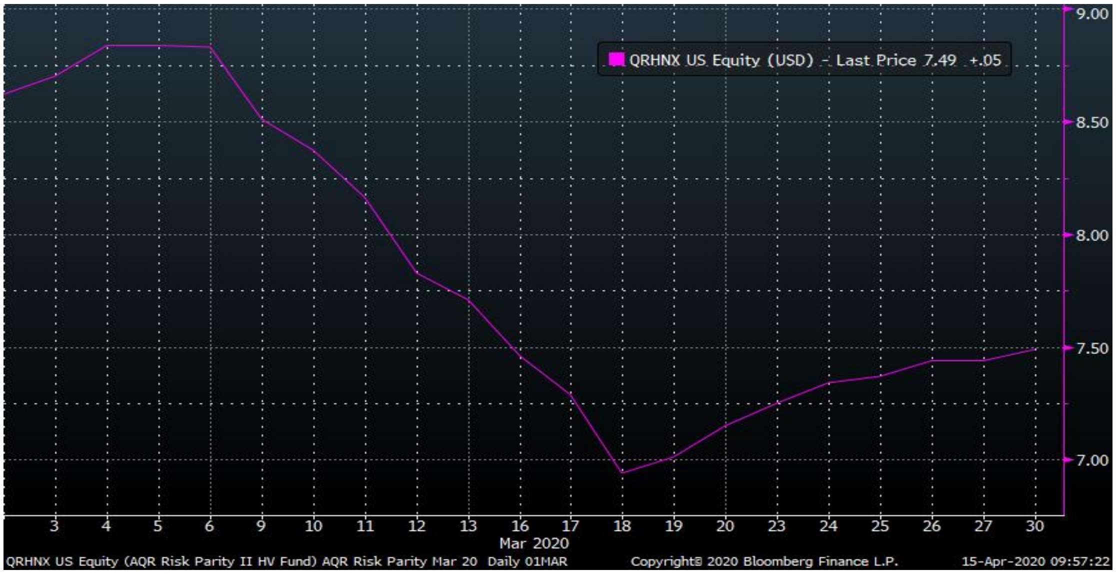
Due to the high levels of leverage involved in the bond allocations of Risk Parity funds, it is plausible that their selling of bonds used up the dealer liquidity and resulted in the subsequent forced deleveraging by other players. The blame for the lack of liquidity that exists in the market can be partly attributed to the misguided and flawed Dodd-Frank Wall Street Reform and Consumer Protection Act, which crippled the ability of even well capitalized banks to provide liquidity through market making, as Dodd-Frank effectively outlawed 'prop-trading'. Banks now reach out to their customers for bids, which does not work in times of deleveraging, as the clients are all sellers with the same kind of bonds.

Assuming that the Risk Parity is to blame, this still does not explain <u>why</u> the Risk Parity portfolios sold of bonds in the first place in March.

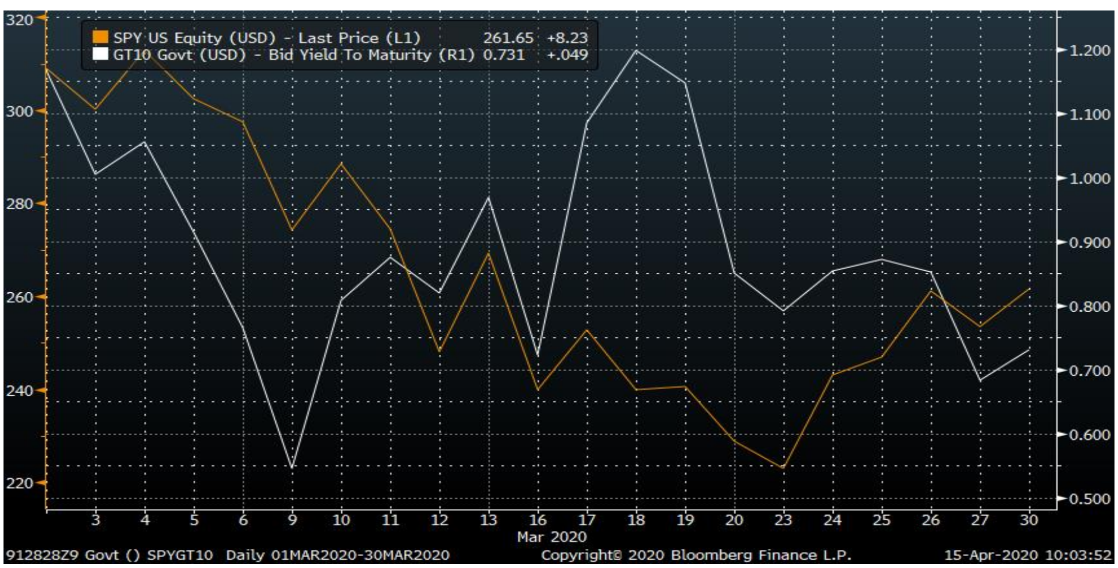
Risk Parity ("RP") had a horrible month, especially for an 'asset class' that is meant to be stable. I suspect the various fund providers are all highly correlated. (Graphed are 3 different Risk Parity indices and one of AQR's Risk Parity funds).



A closer look at March 2020: March 9th is when RP returns started declining, till March 18th.



Equities had already been declining in February, and continued declining from March 1 through March 23. Bonds exhibited inverse correlations (declining yields) only till March 9th, when yields spiked upwards by 25+bps in 1 day, and 65bps by the 18th! **Certainly, the inverse correlation between stocks and bonds broke for 2 weeks.**

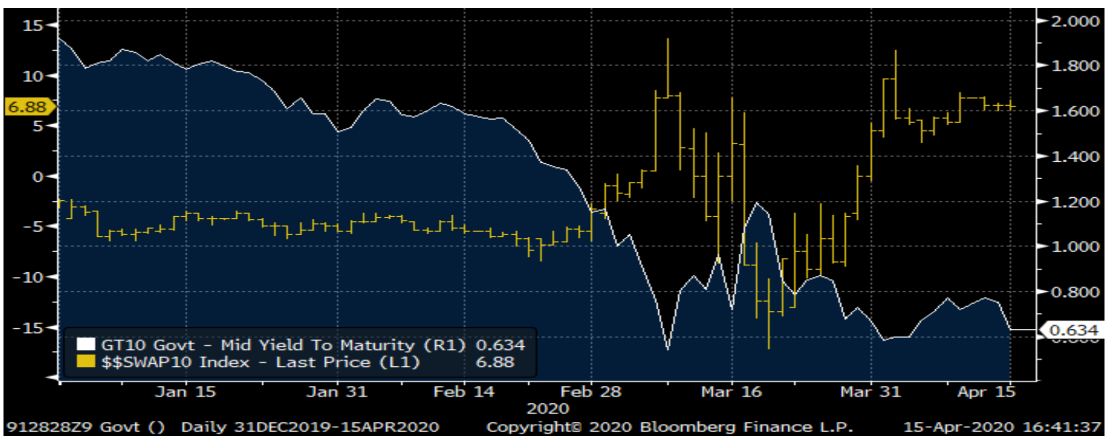


The spontaneous rise in rates on March 9th did probably result in the declines in Risk-Parity and a failure of its core thesis, and it is possible that the subsequent deleveraging of their bond portfolios further accelerated the decline in bond prices.

<u>But, did RP cause the rise in rates?</u>

A closer look at March 9th shows two jumps in UST 10 year yields – at 3:23am and 9:45am EST.

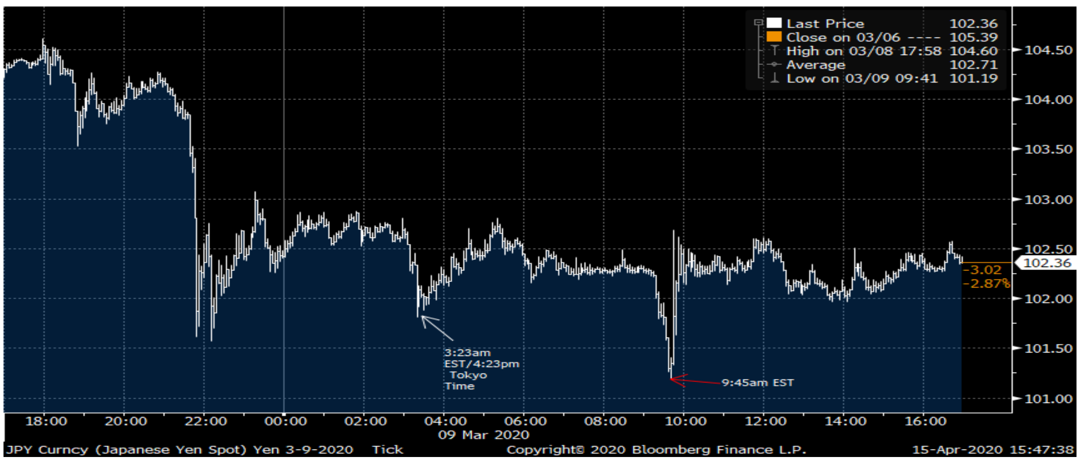
Swap spreads verify that USTs were being sold. Volatility in swap spreads implies flows in USTs.



Swap spreads traditionally represent the yield premium over USTs required for high grade credit. They tend to be relatively stable. When USTs are sold, swap spreads tighten. However periodic central bank UST activity makes them very risky to use as benchmarks or hedges. (I have been writing about the relationship between bonds and swaps since the 1980s – see the Analysis section of our website).

A number of key events occurred on March 9^{th}:

- **<u>An oil price war started, with the biggest drop in oil prices since 1991 (see graph below)</u>**
- **<u>The UST 10 year (above) gapped up in response to the increased risk on the 9^{th} – as expected</u>**
- **The Yen had broken 104 on the 8th, (from 112.1 on Feb 20), and broke through 102 on the 9^{th} – as expected**
- **At precisely 3:23am, the Yen suddenly weakened from 101.86 to 102.81**

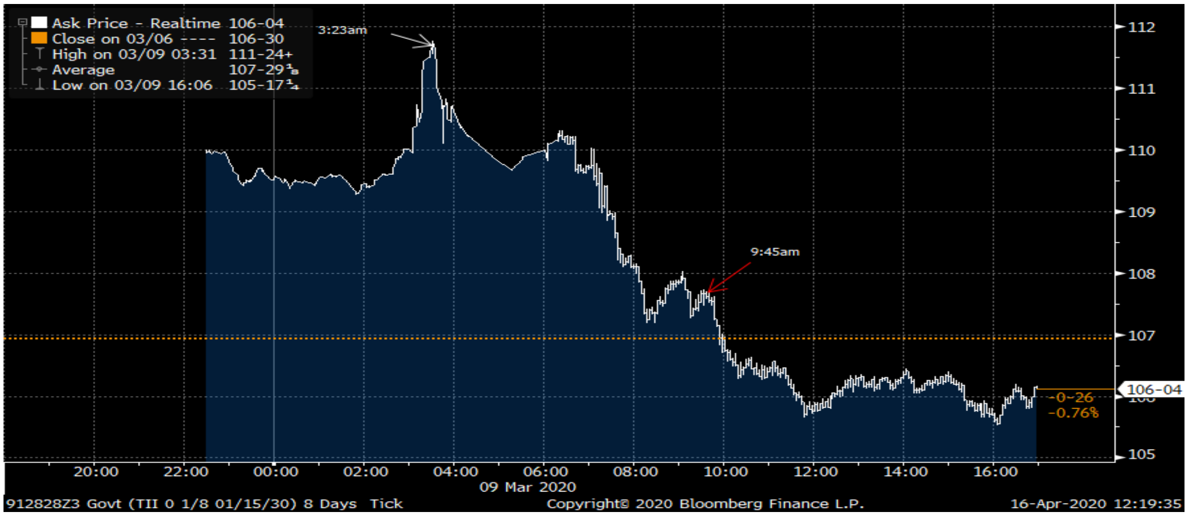


- **When the US stock market opened on 3/9/2020, Equities plummeted (<7%) from the start of trading, triggering circuit breakers, after declining 8% in Feb**
- **The Yen strengthened with the selloff in equities from 102.23 to 101.19 as Yen-Carry-Levered quants delevered**
- **At 9:45am, the Yen suddenly weakened again, from 101.19 to 102.65**

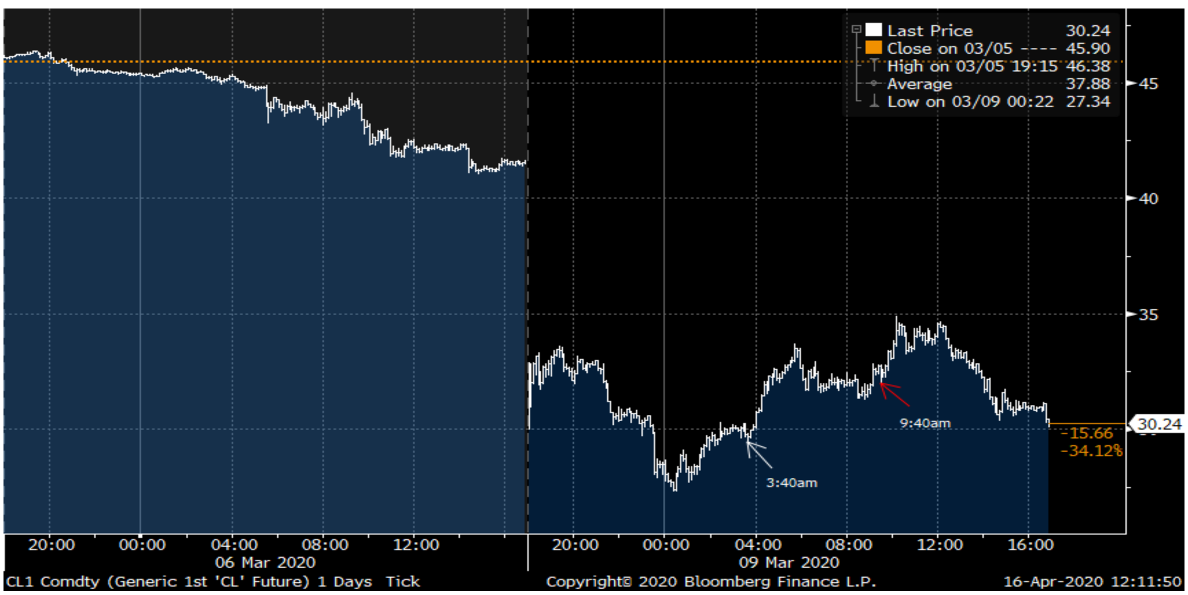
<u>The reaction of the Yen was strange.</u> The BOJ is usually the marginal buyer and seller of USTs, but if Japan sold USTs**, the Yen should have strengthened, not weakened**. **<u>So someone else sold both USTs and Yen!</u>**

If the bond market selloff was caused by RP automatically delevering, many other typical assets owned by RP funds would also be sold at the same time. So we checked a few other assets to see what else was being sold at the same times on March 9th.

<u>TIPs</u> – check – sold off at 3:23am and 9:45am



<u>Crude Oil – Aha – a smoking gun? The CL futures rallied at both 3:40am and 9:40 am on March 9th.</u>



As markets opened on 3/9/2020, USTs and Yen had gapped up while Crude had gapped down.

<u>At 3:23am and 9:45am, someone automatically purchased Crude and sold USTs and Yen.</u>

<u>Risk Parity Rebalancing Process</u>

RP funds can differ in their rebalancing process (the underlining and bolding in the quote below is my emphasis).

https://investresolve.com/blog/risk-parity-isnt-the-problem-its-the-solution/

> *While all RP implementations apply the concepts described above, they can implement them in more than one way. For example, the progenitor of RP products is Bridgewater's All Weather Portfolio. Bridgewater analyses the fundamental relationships between assets and different economic regimes to construct a strategic RP allocation**. In other words, the All Weather fund has a relatively static asset allocation, and rebalances back to this allocation on a regular basis.** As such, it acts counter-cyclically **by buying assets that have gone down the most and selling assets that have gone up the most**. This implementation actually moderates the behavior of market...*
>
> *Other RP methodologies are more dynamic. Portfolios are altered regularly in response to changes in observed correlations and risks across global asset classes. All things equal, if an asset class starts to exhibit higher risk, and/or higher correlations with other assets in the portfolio, **these dynamic approaches will reduce exposure to this asset class in favor of other assets in the portfolio.***

My suspicion is that a static asset allocation RP algorithm rebalanced their risk allocation into underperforming assets – Oil - and out of outperforming assets – Bonds and Yen - and set the ball rolling to demolish the liquidity in Fixed Income markets in the following weeks. If the information above is correct, it could be Bridgewater's All Weather Fund; I could not find information on AQR's rebalancing process.

The selling of Yen and USTs continued into the following week, from March 17th to the 19rd, the week in which the bond markets broke **– both USTs and Yen were both being sold.**

Conclusions

The Oil Price War between Saudi Arabia and Russia was the triggering event for the failure of the Bond Market via the rebalancing actions of Risk Parity. Without Risk Parity, this could have been a good thing globally, as low oil prices imply low inflation. Outside of oil-patch employment, GDP growth is usually correlated with cheap energy.

Risk Parity is an interesting investment and asset allocation concept that has been executed by the quant firms in a flawed manner using correlations based on decades of old historical data. The framework they use has not adapted to the dynamic changes in global markets and macro-economics that began in the 1990s. **Their automated and AI driven strategies, with significant leverage and without a human hand on the wheel, have created systemic risk.**

Institutional Asset Allocators – primarily Pension Plans and Endowments – should reconsider their allocations to Risk Parity and similar automated strategies. Their 'small' percentage allocations to 'hedge funds' or 'alternative assets' have resulted in a 20% to 30% drop in the value of their entire portfolios, many tens of Trillions of dollars, a risk and correlation that they never imagined. Their ability to meet their future obligations is now also at risk.

The losses in asset valuations in bond markets and equities are now significantly greater than what the COVID related losses would have been, due to the forced deleveraging that has occurred. Employment losses will also be greater as the economy has lost the currency that has facilitated growth and innovation – high PE stocks. This will snowball into many other asset classes, such as Real Estate and Venture Capital. Global Central banks have instituted unlimited QE and helicopter money

in response, creating debt that future generations will struggle to pay off. Finance and the discipline from markets have been obliterated.

The fundamental problem remains leverage. Central banks continue to use their balance sheets to re-leverage economies after the every crisis . Every time a central bank responds to a crisis by providing the balance sheet to replace lost leverage, facilitating re-leveraging, the next crisis becomes larger, since most resulting earnings tend to be artificial, and the debt is never paid down. Even the act of paying down debt creates risk – for example when the Clinton T-Bill supply reduction in 1997 led to LTCM failing, and another bailout. While bailouts and artificial money supply can lead to long periods of "good times", when the good times end, the subsequent crash is always mightier than the prior one! Our current crisis is a result of the cumulative central bank supplied leverage growth in response to Japan's bank failures in the 1980s, LTCM (1997-98), Dot-com/2001-2002, GFC (2007-2011), and Taper Tantrum (2013), plus the ECB (2012-present) and Japan's (1990-present) ever-growing QE and balance sheets, with each subsequent crisis requiring an even larger bailout and debt and leverage creation. This central bank derived money supply has supported asset inflation in every asset class that can be leveraged, most notably equities, corporate bonds, and real estate, creating expectation of bailouts (the Fed "Put") and impunity in risk taking (not to mention social problems such as income inequality).

Just like in 2007, the initial deleveraging in equities was triggered by the rate cuts of our central bank, this time in response to COVID-19. Powell, just like his predecessors, continues the tradition of not understanding how interest rate policies work in a world of free global capital movements, and how they impact money supply, asset prices and leverage.

The first Powell emergency rate cut on March 3rd pushed equities off the edge, and the Yen started strengthening, and, as expected, US Treasuries received a flight to quality bid. The March 15th 1% cut added more fuel to the fire, with RP rebalancing once again on the 16th and 17th, and again breaking the Equity-Bond correlation. **Had rates not been cut, then equities would not have sold off as much, then rates would have not rallied in response to the equity selloff, and maybe Risk Parity might not have sold bonds**. Powell too has responsibility here.

The Fed has made financial markets and wall street employees obsolete, and markets no longer serve a price discovery and risk pricing function. Expect banks to roll out Level 3 assets once again.

As always, we welcome your questions and comments. Stay safe at home, wear a mask and gloves when venturing out, and re-read my Crisis Notes, The Failure of Macro Economics, and T-Leaf Reading if you have time.

Regards, Samir Shah

April 16, 2020

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