June 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	**+1.70%**	**+1.77%**	**-2.9%**	**-2.4%**	**-2.4%**
Founder's Portfolio	**+1.59%**	**+1.66%**	**-1.8%**	**-1.3%**	**-0.6%**

June 2020 Income: +1.03%; Annualized: ~13.6% (Aggregated SMAs @ recent marks)
June 2020 Cashflow % of invested value: 2.0% (~ 24% annualized rate)
June 2020 Loss rate: -0.1%

Hello.

Our Aggregated SMA's had a portfolio total return of 1.70% in June 2020, bringing our YTD return to -2.9%, outperforming the S&P as well as High Yield sectors.

The Income performance was slightly above our expected level (reflecting lower marks), returning ~1% in Income, 13+% annualized, from 2.0% in cashflow for the month, with only 0.1% in losses. Income was slightly lower than in May. Total return was augmented by positive price change of 0.67% on average.

We have cautiously started reinvesting cash into seasoned bonds, mostly matchers, where the prices were lower due to liquidity issues. While marks are rising again, they are not yet back to February levels on most of our MBS. We remain concerned about forbearance risks, and there is evidence that delinquencies are rising, especially in MBS from newer vintages, albeit at a slower pace than in May.

Market color

While most asset classes have rebounded indiscriminately due to the Fed's largess in using its balance sheet to support markets (by replacing the leverage that was lost in March from Risk Parity rebalancing), the fundamentals of COVID-related credit and employment losses remain. This is most obvious in the CMBS markets, where shopping mall, retail, office and apartment deal sponsors will need to rethink their business plans and future earnings streams. This is showing up in volatility in CMBS subordinated bonds, and Real Estate REITs, and the 'CMBX 6' BBB- CDS Index, which had dropped to $65 in March

from $95 at year end, rebounded to $77, dropped again to $62.5 by May, rebounded again to $75 in June, and has dropped once again to $68.

'Distressed investors', PE firms, and 'securitization tourists' are trying to catch a falling sword in this sector! We are not yet ready to buy into this sector – there will be more pain ahead first. The latest casualty is Blackstone which is closing its mostly CMBS fund, the Blackstone Real Estate Income Master Fund, after it declined 24% in March. This will result in a few hundred million or more of CMBS hitting the market.

In seasoned RMBS, such as those we own, prices have been gradually grinding higher. Bonds are getting strong bids relative to marks, and are trading quickly when they are available on dealer inventories. MBS inverse IOs are significantly higher in price due to the Fed's cutting of rates leading to higher coupons, while floating rate bonds are lower. IOs are lower due to prepayment concerns. As such, RMBS prices are very stable day to day, with an upward bias in price.

This is very different from other public markets, especially in equities and high yield. While the recent month-to-month performance appears stable, periodic reports do not show the interday and intraday volatility that the markets are experiencing. Equities especially, but also corporate bonds and high yield bonds, seem to react to every bit of COVID news as they seek justification for their elevated (and in my opinion, non-value based) speculative prices.

The following table summarizes the performance of some of the liquid public markets that have been supported by the Fed. For equities, High Yield bonds and long USTs, the Standard Deviation in June is significantly higher than the average daily return, quantifying the volatility I am referring to.

	June 2020 - Total Return	June 2020 - Average Daily Return	June 2020 - Standard Deviation Daily Returns	TRR YTD to 6/30/2020	TRR Q1 2020	TRR Q2 2020
SPDR S&P 500 ETF TRUST (SPY)	1.8%	0.1%	**1.8%**	-3.2%	-19.4%	20.2%
ISHARES MBS ETF (MBB)	-0.2%	0.0%	**0.1%**	3.5%	2.7%	0.8%
ISHARES CORE U.S. AGGREGATE (AGG)	0.7%	0.0%	**0.2%**	6.3%	3.1%	3.1%
ISHARES IBOXX INVESTMENT GRADE (LQD)	2.1%	0.1%	**0.5%**	6.5%	-3.0%	9.7%
ISHARES IBOXX HIGH YLD CORP (HYG)	-0.6%	0.0%	**0.9%**	-5.1%	-11.6%	7.4%
ISHARES 3-7 YEAR TREASURY (IEI)	0.1%	0.0%	**0.1%**	6.9%	6.3%	0.6%
ISHARES 20+ YEAR TREASURY (TLT)	0.3%	0.0%	**1.0%**	21.9%	22.2%	-0.2%

Many analysts and news reporters have called Q2 2020 one of the best quarters since 1999 for asset prices, especially in stocks, but also in corporate bonds. However, most of these returns were earned during a short period in April after Fed announcements, with recent performance being lackluster and

accompanied by high volatility. Most bonds made their returns through spread tightening, especially on bonds with longer duration, but with most yields now below 1%, there is not much income remaining, and not much more price appreciation can be expected, unless you are willing to bet on interest rates declining further, maybe even into negative yield territory. Offsetting this, it is quite likely that there will be bond selling later this year, as tourists take their gains.

https://www.bloomberg.com/news/articles/2020-07-08/bond-market-tourists-threaten-to-bolt-with-200-billion-at-risk

While equities have had a great quarter, they are still off for the year (as of 6/30), with the majority of the gains having come from a few names. Both equities and corporate bonds are now fundamentally riskier (beyond the risk to earnings from COVID changes in their businesses), as there has been record corporate bond issuance, and leverage is up significantly. While the debt is "cheap", a greater proportion of a declining earnings stream will now have to be diverted to interest payments, leaving less for shareholders. The three major banks have recently significantly increased their loss reserves, as a wave of bankruptcies is expected.

Cliff Asness of AQR recently tweeted, " *I once foolishly thought that price mattered in investing*". In the old days, the supply of money that drove prices came from earnings and retained earnings – ie capital formation. In today's world, in most asset classes, prices and price change primarily reflect external supply of money, either directly from central banks, or from leverage. Neither of these sources of capital are conducive to value investing, but determine the returns for trading strategies, and lead to volatile returns, both high and low. Most asset classes thus need to be traded, not passively invested in. We believe that our unlevered MBS High Income Strategy remains one of the very few investment strategies remaining.

As always, we welcome your questions and comments. Please stay safe.

Regards, Samir Shah

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