Aug 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	+0.21%	+0.29%	-1.4%	-0.8%	-1.2%
Founder's Portfolio	-0.42%	-0.35%	-0.5%	+0.2%	-0.2%

Aug 2020 Income: +1.38%; Annualized: ~18.3% (Aggregated SMAs @ recent marks)
Aug 2020 Cashflow % of invested value: 2.6% (~ 32% annualized rate)
Aug 2020 Loss rate: -0.1%

Hello.

Our Aggregated SMA's had a portfolio net total return of ~0.2% in Aug 2020.

The Income performance of the MBS was almost identical to July's, returning ~1.4% in Income, ~18% annualized, from 2.6% in cashflow for the month, with only 0.1% in losses.

MBS marks were lower this month end however, lowering the total return, with prices for most of our bonds down slightly. The primary theme of our portfolios has been and will remain the capture of high income, primarily from prepayments on discount seasoned MBS. The pricing service continues to beat down the prices of our floating rate bonds off fixed rate collateral (the Founder's portfolio has an overweight), in our opinion without properly valuing the optionality that the deep discount prices provide – these bonds are benefiting greatly from prepayments due to low rates, as borrowers refinance their mortgages, and are our highest income generators, continually lowering their breakeven prices. At current marks, these are cheaper than POs!

MBS delinquencies are mostly stable, and have started declining in some deals, as some economies 'open up' again, and as employment picks up. Although the delinquencies are not impacting cashflows or pricing on our bonds as the collateral is very seasoned, LTVs are low, and home prices are going up, the recovery is likely to be slow, and delinquencies will take time to decline to pre-2020 levels.

The commercial real estate (CRE) market remains under stress from COVID. The Fed has supported the senior market in CMBS, leaving them low yielding and not interesting, by buying GSE-issued multifamily

CMBS directly and lending for non-GSE senior CMBS deals through TALF. Some CMBS subs remain distressed, but I believe that it is still too early to determine the winners in this sector.

CMBS is a unique asset class in that it rarely defaults, as CMBS servicers prefer not to take possession of a non-performing property and become operators themselves and the deals that own the debt do not have the capital to take over and own the property. In addition, the process of taking "control" of a property by subordinated bond owners is complicated, and the timelines tend to be long. Instead, when a property is under stress, once income flows and cashflows to the deal decline, loans are usually modified and often extended to hopefully allow them perform again.

We have some positions in CMBS IOs, which have performed well for us. We have always (since the late 1990s) invested in CMBS IOs after periods of distress, and like CMBS IOs that can benefit from loan extension or from prepayment penalties when the borrower is able to refinance at lower rates. This is another way to take advantage of distressed markets.

In economics, economists are gradually coming to the realization that the link between the "real economy" and asset prices is broken. This Project Syndicate article is interesting reading.

https://www.project-syndicate.org/commentary/covid19-and-postcapitalist-economy-by-yanis-varoufakis-2020-08?

I've been modelling this for a while now, and need to update the 'injected capital' model for asset Beta that was described in 'Understanding Beta'.

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

Regards, Samir Shah

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