Jan 2021 – MBS Mantra MBS High Income/Absolute Return Strategy returns:

	% Net Return	% Gross Return	Since 4/1/2020 Net %	2021 YTD Net %	2021 YTD Gross %	Trailing 1 year Net %
Aggregated SMAs	**+1.14%**	**+1.21%**	**+15.1%**	**+1.14%**	**+1.21%**	**+1.7%**
Founder's Portfolio	**+1.10%**	**+1.18%**	**+15.2%**	**+1.10%**	**+1.21%**	**+2.5%**

Jan 2021 Income: +1.41%; Annualized: ~18.6% (Aggregated SMAs @ recent marks)
Jan 2021 Cashflow % of invested value: +3.0% (~ 36% annualized rate)
Jan 2021 Loss rate: -0.06%

Hello.

We've started the year well, outperforming all our benchmarks in Aggregate for January. Our Aggregated SMA's had a portfolio net total return of ~+1.1%.

The Income performance of the MBS portfolio was higher than recent already-high levels: 1.4%, over 18% annualized! Marks were down slightly (-0.3%), with some recent purchases at levels above the marks. However, the income dominated and delivered total return performance that beat all our benchmarks: January returns for the AGG were -0.74%; MBS +0.07%; HYG +0.33%; S&P -1.02%. We had almost no losses in our bonds during the month.

Our net return since March 2020's selloff has been around 15.1%, in spite of marks that have not recovered from March's selloff.

Whether or not our vintage MBS get marked back up, our higher-than-market income continues to overwhelm markdowns over time. The high cashflow percentage also implies a short duration for the portfolio. The High Income continues to reduce the breakeven prices for each bond we own, and allows us to reinvest and compound over long periods. The High Income investment process that is fundamental to our strategy protects capital, creates durable self-healing portfolios, and is responsible for the non-normal distribution of our returns with positive skew and high kurtosis that makes our strategy unique (please see our paper 'The MBS Income Factor' from 10/2019 for details).

Review of 2020 and some market commentary

2020 was the trickiest year in MBS in my 30+ year experience. In 2007, we saw the deleveraging coming, as it was a result of Japanese capital flight after the Fed cut rates in August 2007. However, in March 2020, the violent deleveraging was sudden and a result of computer-driven Risk-Parity funds automatically rebalancing their levered portfolios in the middle of the night in response to an oil-war driven crash in oil prices (see our March newsletter for a recap), a rare and true Black Swan event.

The deluge of MBS at the end of March 2020 from levered investors, such as REITs and hedge funds that got margin calls as their hedges failed to work, resulted in a -12% to -13% decline in the marks of our MBS portfolios. As the year had started out well, the net result was a -10.4% Q1 return, significantly outperforming most MBS funds and hedge funds whose primary strategy was using explicit leverage or credit leverage.

Our portfolio consists of a diversified collection of mispriced convexity – we own options with positive carry, with high enough Income that we do not need to use any leverage. The knee-jerk reaction of the Fed by cutting rates has brought many of our options into the money, and the Income return rate of our portfolio from April onwards has almost doubled (10+% from April to Dec; 14+% annualized, compared to 7%-8% in 2019). While prices for our off-the-run MBS portfolio have only partially recovered their losses, (and declined again in Q4), this enhanced income return has allowed our portfolios to self-heal, making back the losses from March's selloff. We ended 2020 slightly up for the year as a result.

We were very cautious reinvesting after the March selloff, as we wanted more clarity about the impact of foreclosure moratoriums, buybacks, and delinquencies before investing. As a result, we had a higher-than-normal cash percentage for most of the year, dragging returns lower slightly.

Our positions with negative total returns since purchase are primarily floating rate bonds that I consider to be the most attractive sector in the marketplace and most undervalued. With rates rallying, there is very little demand for floating rate assets, making these bonds undervalued by 25% or more by our estimation, as the pricing services and the market view them as "floaters" and have marked them down significantly over the past year. They are missing and not valuing the "super-PO" characteristics that such discounts and the structural evolution have endowed to these bonds. Such bonds should be generating 2% to 3% income, and instead are generating income in the 15%-40% range due to their mispriced convexity. Unfortunately, the decline in marks has contributed to lower-than-expected Total Return performance for 2019 and 2020. With a long term view, I expect these to outperform over time.

Over time, Income has dominated the negative Price change experienced by some of the portfolio. Price change for 2019 and pre-2019 vintages is similar, around -10%. However, Pre-2019 purchases have over 20% cumulative Income return vs 2019 vintages having ~10+%, reflecting the difference in holding periods, giving the longer holding periods both positive and higher total returns. Income harvesting is a core feature of our portfolio and strategy, and we expect the dominance of Income over Price change to continue.

Looking at 2020 Quarterly returns, Q1 had negative returns, while Q2 made back a significant percentage of the loss through price change and income. Q3 and Q4 did not see much overall price appreciation, with price gains in some months and declines in others, and Income return provided most of the positive return in the second half of the year.

We believe that our MBS Income driven strategy offers considerable absolute and relative value compared to other bond market sectors. This is an even stronger belief now after the US 10yr Treasury dropped to below 1%, and is now slightly over 1% yield.

The majority of returns for most generic bond funds, as well as the AGG and MBB, were realized in Q1 and Q2 when the Fed cut rates and decided to buy and support 80+% of the bond market. (AGG returns Q1: 3.1%, Q2: 3.1%, Q3: 0.4%; Q4: 0.1%).

Once rates bottom, there is very little room for further price appreciation in most bond categories, and at such low rates, very little income as well. Q3 and Q4 returns for most bond sectors were marginal, and we expect this to be the case going forward, as it was in January. While it is possible for rates to go negative in the US as well, and corporate yields to be negative as well, these potential price change returns are likely to be one-time, and limited by the duration of the bonds.

Currently the risk in the markets (misplaced in my opinion, we've seen this movie before) seems to be concern about higher rates due to inflation, which implies such bond sectors will lose value if this occurs. Barring any major liquidity dislocations in the future, now that the Fed is on guard, we expect our portfolio to continue to perform strongly as it has in the Q2, Q3 and Q4 of 2020.

Please stay safe, and wishing you good fortune and health in 2021.

Regards, Samir Shah

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