MBS Mantra, LLC

July 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	**+1.28%**	**+1.36%**	**+20.8%**	**+6.1%**	**+6.7%**	**+10.0%**
Founder's Portfolio	**+1.18%**	**+1.26%**	**+21.5%**	**+6.6%**	**+7.2%**	**+10.2%**

Annualized 2021 net returns to date: 10.7%
June 2021 Income: +1.56%; Annualized: ~20.5% (Aggregated SMAs @ recent marks)
June 2021 Cashflow % of invested value: +3.9% (~46% annualized rate)
June 2021 Loss rate: -0.2%

Hello.

Another positive month, making it 16 in a row since March 2020. Income was even higher than in previous months at 1.56%, with small losses including some from some deals that got called, while marks were down slightly on average (some up, some down), resulting in a +1.3% average total return.

Once again, our High Income (1.56% in July, 20% annualized) allowed us to significantly outperform our fixed income benchmarks (B-AGG +1.12%; B-MBS +0.64%; B-HY +0.38%) in spite of slightly lower marks.

YTD, at +6.1% net return, 10.7% annualized, we are outperforming High Yield as well (B-HY +4.0%, B-AGG -0.6%, B-MBS -0.1%).

Since March 2020's deleveraging selloff our net return has been 20.8%. By comparison, over the same period, the B-AGG has returned 3.7% while B-MBS has returned 0.6%.

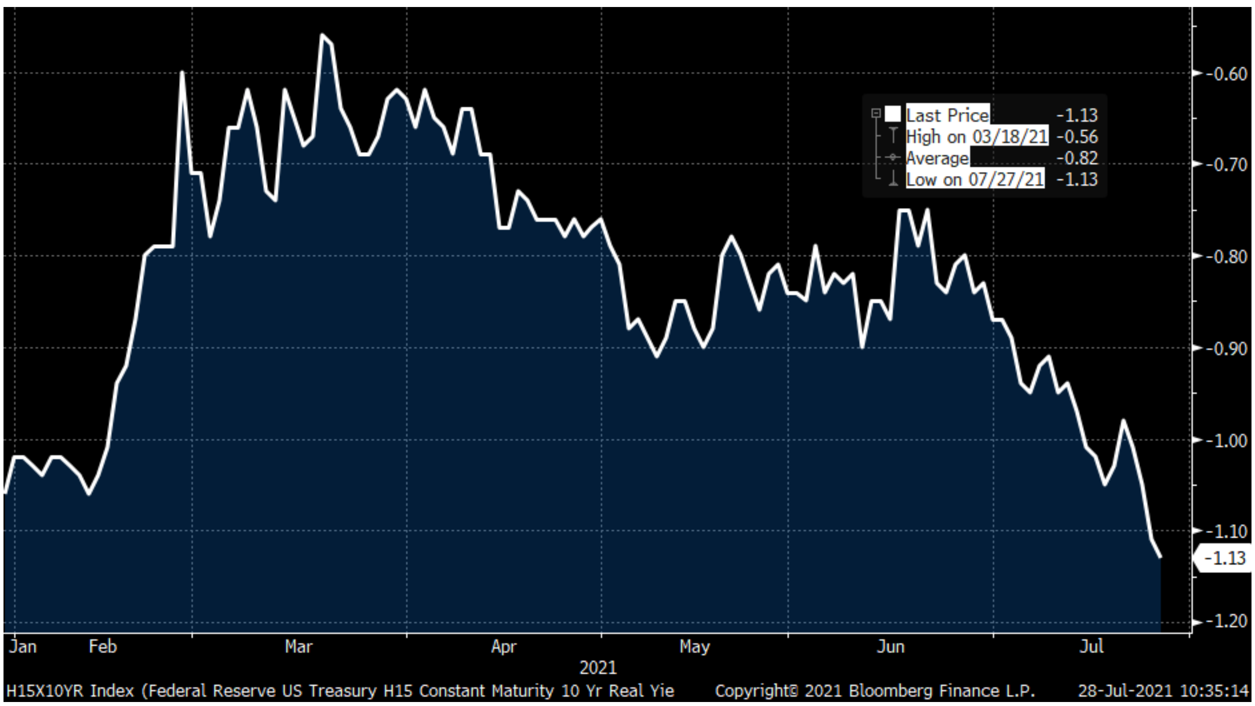
Portfolio cashflows were higher than normal, at 3.9% of the portfolio (46% annualized), reinforcing our contention that our portfolio's duration is short and that our strategy thus maximizes risk adjusted returns.

We will reiterate that <u>we are NOT a Fixed Income strategy</u>, as the returns comparisons above demonstrate**.** Our research has demonstrated that MBS is a Variable Income bond product, and we therefore focus on the 'right tail' of the MBS Income distribution, creating a unique High income strategy and product. Our current high Income of 19% annualized allows us to overcome significant price declines and creates self-healing portfolios, as the breakeven prices of our holdings continually decline monthly with realized MBS income. This allows us to reinvest and compound over long periods – a very old-school investing process.

While we are acutely aware of MBS credit and opportunities, unlike typical MBS Credit strategies that invest in low income/low yield bonds with leverage, we mostly invest in senior bonds and have very low loss rates, creating an unlevered portfolio with lower volatility that most other MBS portfolios (see our March 2019 newsletter for a comparison to the credit risk of other MBS funds).

Finance and Economics – Looking Forward or Looking Back?

Talking heads, journalists, and CIOs went all atwitter over the past week, as rates gapped down last Sunday night/Monday early am (July 18/19, 2021) to new recent lows on the 10yr UST, hitting 1.17% at 10am on Monday morning, from 1.33% on Friday afternoon (July 16th). Simultaneously, equities declined.



The rationalization by those that are paid to explain such moves was that the market suddenly woke up to the risks of the Delta variant, which would lead to a slowdown in economic activity and a reduction in inflation expectations. (An example, Barrons: *"amid growing but belated recognition of the spreading Delta variant of COVID-19 and its potential impact"*.)

Rates strategists, especially, are still pondering and pontificating about negative 'real rates' and 'inflation expectations', TIPs, and the meaning of low rates.

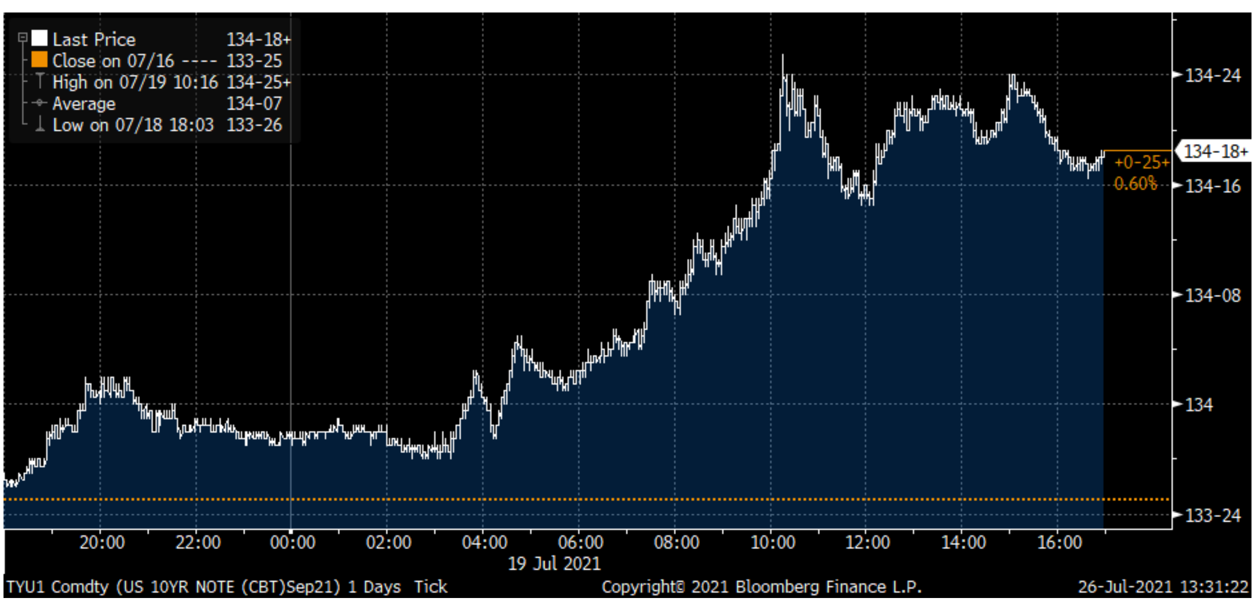
In my view, these explanations about the moves in rates and equites are fantastical. The equity markets concurred, and over the following week, the market recovered and made new highs, while Treasuries sold off, but are still at low yields.

It does not take much work to analyze the markets to understand the drivers of the dramatic moves, but it appears that the training to identify the causes of market moves is systematically lacking. "Experts" are relying on their B-school educations, which are dated, instead of questioning and trying to understand how market prices actually work from first principles of economics: demand and supply.

First, let's see what happened last week. One has to look at the futures markets.

At 3am Monday morning (July 19), the S&P future started selling off. The graphs below show July 19th futures prices for Sep contracts.

Around 3:20am, the UST 10yr future started rallying.



Oil futures also sold off around the same time ~ 4am.

While Yen futures started rallying around 3am (Yen is often used to fund equities and the Equity-Yen pair has been closely tied together since the mid-1990s).

There are no economic releases at 3am on Sunday night for market participants to suddenly start discounting new information. London is 5 hours ahead of New York, so it was around 8am in London, not the usual time for new information in Europe either.

This should be obvious: prices go up when someone buys and exceeds the available supply, and prices go down when someone sells, and overwhelms the ability of liquidity providers (buyers) to buy. Since securities dealers are hobbled by Dodd-Frank from providing liquidity through speculation with their balance sheets, such selling and buying can move markets, as investors tend to move in tandem, often responding to momentum. **The only real information in these price moves is that someone bought USTs and Yen and someone sold Equities and Oil. Given the unusual timing of these movements, during a time with low liquidity in the US night sessions, it is likely to have been the same entity behind all these transactions.**

To me, this is very similar to the March 23, 2021 market moves, that started at a similar time, 3:23am, (that were then incorrectly attributed to COVID), when a large Risk Parity manager rebalanced its portfolios, resulting in a selloff in stocks as well as in bonds. **At the time, I did a detailed analysis of the movements in markets (click the link for the analysis) blaming Risk Parity for the moves.**

While it is likely that the trader behind the initial moves is an automated computer system or algo executing trades for a Risk Parity fund, it could also be a large European or Asian investor given the time of the trades. Subsequent moves were probably momentum investors or trend following algos that piled on, exacerbating the moves.

Finance and Economics - Looking forward or Looking Backwards.

The Finance and Economics that I learned at the University of Chicago in 1987 was **forward looking** – market participants are assumed to use available information to project earnings and cashflows forwards, and discounted them back to the present using projections (forwards yields) of UST or swaps rates, to come up with a price for an asset. Value investing is a form of forward-looking finance. Many Active investment strategies are forward looking as well.

With the creation of some seminal finance papers in 1993, Factor investing became the shiny new thing, and subsequent MBA programs incorporated "quant" training and "financial engineering", which are largely driven by historical statistical analysis. Numerous ETFs were formed around factors. I consider this change in Finance, especially Momentum Factor investing, as **backwards looking, as they largely focus on past performance and rely on statistical measures to quantify risk**. Backward looking finance is responsible for such strategies as Buy-the-Dip and trend following, as well as Passive investing. Many "quant" strategies are based on this as well. Record High P/E ratios can also be blamed on backwards looking finance that drives prices higher without regard to valuations.

Backward looking strategies are not new. Dogs of the Dow, for example, uses high dividend yields to identify 'oversold' stocks. However, **Indexation, ETFs, Passive investing, and leverage have taken backwards looking finance to new heights, and it now appears to dominate forward looking finance.**

Risk Parity is an extreme case of a backwards looking strategy, as it typically uses an extraordinary amount of leverage, especially in USTs. The concept, rebalancing to reduce weightings of your best performing assets, as their weights increase from price appreciation, in order to increase the weightings of poor performing assets to bring the 'risk' weightings back into line, epitomizes backwards looking finance, as **the rebalancing trades required to get to the target weightings are driven entirely by the past performance.**

To get a more realistic, non-Delta-variant, explanation of why Risk Parity rebalanced on Monday morning, you can blame the equity market itself for hitting new highs (probably due to momentum or trend following strategies), which triggered the rebalancing due to the portfolio weight of equities exceeding some target range.

This implies a new form of risks that market participants are not aware of – that of backward looking strategies, and specifically of Risk Parity, which has driven the two big market down moves of the past year and a half. If only one could predict when Risk Parity rebalances. Anyone with an understanding of their rules, please contact me.

Unfortunately, market participants are too specialized and rarely look at markets beyond their own specialization. They miss relationships and flows between markets, and especially between countries. By being unaware of connections between markets, market participants do not know to look for such connections to explain price movements.

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Backward looking strategies have eliminated the signaling power of information that was formally gleaned from the bond markets. For example, in the rates markets, inflation expectations and real rates are a thing of the past. Trying to make sense of current yields is pointless, as they are not determined by fundamentals. One needs to use new tools and thinking to identify the sources of demand and supply in the markets, which in turn can allow an investor to decide whether to buy or sell. I have described a such a tool kit to identify connections in the bond markets in T-Leaf Reading (which needs to be updated to incorporate Risk Parity Risk).

Please stay safe, and wishing you good health.

Regards, Samir Shah

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