May 2022 – MBS Mantra MBS High Income/Absolute Return Strategy returns

	% Net Return	% Gross Return	2022 YTD Net %	2021 YTD Net %	Trailing 1 year Net %
Aggregated SMAs	**-1.00%**	**-0.93%**	**-0.6%**	**+10.0%**	**+5.5%**
Founder's Portfolio	**+0.50%**	**+0.57%**	**+0.5%**	**+10.1%**	**+6.5%**

May 2022 Income: +1.15%; Annualized: +16% (Aggregated SMAs @ recent marks)
May 2022 Cashflow: +1.6% (~20% annualized rate)
May 2022 Loss rate: -0.6%

Hello

Another mixed month, with most Non Agency MBS being marked down further in spite of rallying rates, nice cashflows, high income, and negligible losses. Fixed rate Non-Agency MBS marks were especially dinged by many percent, while floaters had mixed price performance, mostly unchanged on average.

Some of the bonds we purchased this month were at higher prices than the marks, resulting in an immediate MTM loss, which should be made back in Total Return from Cashflow/Income within a month or two. However, some of the negative return this month was also a result of these purchases.

We are slowly changing our fixed/floater weightings by purchasing attractive High Income floaters when available and selling Fixed MBS when bids are reasonable. Liquidity is low, and not much is trading, and bids from vulture investors are mostly not very attractive. Adding floaters while letting fixed rates run off is shortening our overall duration even further than the <2 year average life implied by our high portfolio cashflows.

Our benchmarks outperformed this month, as rates rallied for most of the month, and both corporate bonds and high yield ETFs also had positive total returns. Agg: +0.76%; MBS: +1.04%; HY: +0.25%; S&P: +0.23%. For the year however, we are outperforming all of these benchmarks (YTD: Agg: -8.7%, MBS: -6.9%, HY -8.0%, S&P -12.8%). Looking at the returns of the funds we consider competitors that also invest in Non Agency MBS, most of them fared worse than we did – the average May return of 11 funds we track was -1.84%.

Our boilerplate: MBS is a Variable Income asset class and product, and not Fixed Income, as it is widely viewed and categorized. Unlike traditional managers that understand MBS as Fixed Income and do not differentiate between Low-Income and High-Income MBS, we systematically identify and harvest High-Income MBS to construct portfolios that generate total returns with low correlations to Fixed Income as well as with other assets. High Income MBS can be an Absolute Return component of a portfolio, or a diversifier.

Inflation

Our Jan 2022 newsletter has extensive analysis of Inflation. What's changed since then is the war in Ukraine, which has accelerated the rise in prices for Energy and various other commodities. However, the fundamentals have not changed.

- There is inherent deferred demand left over from 2020's supply shortage/stimulus combination – GDP is still lagging.
- The inflation we are experiencing is primarily Supply chain driven.
- Energy and Materials inflation is structural and took 8+years to set up, largely from a dearth of Capex, which now limits Supply. The lack of Capex was not limited to Energy – see this FT article, *"Supply is Coming"*, https://www.ft.com/content/36ca03ea-8ce4-4a6c-a148-6c9f04c9d348, and also "BEPMCAPX Index" on Bloomberg.
- Demand for Energy is inflexible and growing. While Energy supply in Europe was already constrained due to ESG-driven shutting of coal and nuclear plants and unreliance of wind, the reduction in Russian energy has worsened the situation. Supply, which was already suspect and lagging, will now take years or decades to catch up.There is no end in sight to Energy inflation.
- The post-March22 Ukraine war drove up Energy prices – Oil ~30%, US Natgas ~100% - leading to domestic inflation in fuel costs. However, this was an acceleration of a trend that had already started in 2021. European Nat Gas prices had risen considerably in 2021 due to ESG-driven reduction in energy supply capacity in Europe, with huge gaps between US and European prices due to limited LNG importing capacity in Europe (see Netherlands TTF Natgas prices – divide by 5 to approximate US prices - $181 in Dec21, $213 in Mar22, but more recently $84). The war merely accelerated the reduction of the gap between European and US prices, which would have closed more slowly without the war.
- The Food inflation from blockades of Ukraine wheat, sunflower oil, and potash exports is new, another Supply Chain holdup.

The Fed can only impact demand driven inflation. It hopes that Supply Chain constraints will solve themselves. Mr. Bernake admits as such when discussing the possibility of a soft landing: *"Such a landing, however, would depend on supply-side inflation pressures improving, Bernanke said on CNN's "Fareed Zakaria GPS," Bloomberg reported."*

The Fed acts to tighten monetary policy as it must politically, even knowing that it will not have much impact on Supply Chain issues. As I have discussed many times before, Velocity of M2 is at an all time low, since 2020. Easy money has not resulted in Economic growth and demand for C&I loans (or Capex investment). Easy money has however led to Asset Inflation, and the hope is that demand destruction will be driven by Asset Value destruction as the asset-rich stop consuming discretionary and luxury items and services with declines in their portfolio valuations. In such a scenario, will companies invest in Capex to grow supply?

The likely outcome is Stagflation.

Inflation Protection Strategies:

We are proposing 2 different Inflation Protection strategies, one using MBS and the other in Equities. We can provide these in both SMA and fund formats. Please contact me for more information on either strategy.

The MBS Inflation Strategy is a subset of our current strategy, focusing on negative duration MBS with High Income. We have been investing in such bonds for decades as part of our construction of stable low duration portfolios.

The Equities Inflation Strategy, which we have been working on since late 2021, is primarily focused on Energy and Materials public equities. We've been investing some personal money, and are happy with the results, stock selections and fundamental strategy.

MBS Inflation Strategy

As you know, we create low duration portfolios using MBS with High Income, with low credit risk. Typically the portfolio consists of Fixed Rate seasoned Non Agency MBS, which have positive duration, combined with certain MBS assets, such as IOs and some Floating rate MBS (that are structured off Fixed Rate Alt-A Non Agency MBS collateral) that have negative duration. This combination of positive and negative duration MBS creates stable portfolios with High Income, that compound and grow during periods of low volatility, and protect capital through offsetting price changes during periods of high volatility.

The negative duration floaters are hard to come by, as they are a fraction of the Non Agency MBS markets and were only created between 2005 and 2007. They only come out sporadically into secondary markets, and I have been buying them since 2016 whenever they become available.

In the past few months a number of these have become available, and I've purchased more this year. Currently there some offered in the secondary market. I don't have sufficient cash in my client accounts to purchase more – I would buy them all. I'm looking for more investors that would like to take advantage of this opportunity. There are many million available.

I consider the subset of Floating rate MBS that I invest in to be the most mispriced asset class in the markets. This is a value trade first, and a directional trade second. Simplistically, negative duration assets have negative yields (e.g. at the extreme, shorting US Treasuries results in a negative yield). However, due to insufficient understanding of MBS structure by most traders, these trade with highly positive Income and current yields. (There are multiple other ways to come to the same conclusion, for example, by using non-arbitrage MBS pricing of the various bonds in the structure.)

With rates rising, building a portfolio of only Negative duration floaters is very attractive, and is the single best trade strategy in MBS if not in all bonds. It is a terrific way to protect against inflation, besides being an Absolute Return strategy.

Later on in the year, or next year, once the Fed is done raising rates, it would make sense to complete construction of the portfolio with the addition of Fixed Rate High Income MBS. I am currently refraining from buying Fixed Rate bonds while they are being marked down due to rising rates, and letting them run off.

The main risk to such MBS is liquidity. The market misunderstands and therefore misprices them, and I do not expect the prices to rise to their non-MBS-arbitrage-condition price. The prices are only gradually rising as a handful of other buyers compete, and are not going down like fixed rate bonds. Often offer prices are significantly higher than the marks. The cheapness is therefore primarily captured through harvesting of monthly cashflows and Income, and compounding through reinvestment, sometimes with initial month MTM losses if purchased at a price that is greater than the pricing service mark.

There is negligible credit risk - the loans are mostly from 2005-2007, with <50% LTVs, and experience low credit losses. Prices range from $10 to $50, further reducing credit exposure. To the contrary, as these borrowers sell their homes, often there are gains from credit, as forebearance modifications are paid off on sale, with huge gains from prepayments as the bonds are purchased at deep discounts. They bonds also generate a lot of cashflow, and the WALs are less than 2 years as a result, which reduces breakeven prices and protects the capital.

Summarizing recent returns performance of the subset of such negative duration bonds in our portfolios, the average (unweighted) total return for 2021 was +21%, with Income of +21%. Prices were unchanged on average.

In 2020, the total return was -10% in spite of 2020 Income of +16%. Prices went down dramatically in March/April 2020 when the Fed cut rates, exhibiting negative duration.

In 2022, from 12/31/2021 to 4/30/2022, the total return average has been +8.45%, +31% annualized, with Income of +4.5%, +17% annualized. Prices have started going up, in spite of rising rates, as more investors realize that these are negative duration, (or are securitaztion tourists that just want floaters and don't understand the structure). The loss rate was -0.33% - a TRR gain from credit!

Again, I am looking for investors that can move quickly to open an account at my custodian to buy the bonds that are currently available. Later on, we can move these into a fund, if the investors require a fund investment. Or, we could open a fund if a long-term minded anchor investor steps up.

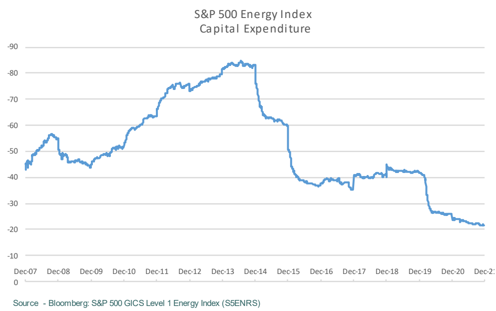
Equities Inflation Strategy

We started working on this strategy in 2021 and the results have been shocking. The core thesis is driven by the imbalance between growing Demand and constrained Supply, a result of declining Capex since 2014, which will result in a surplus of Free Cashflow and high returns for Energy (and Materials) equities over the next 5 year to 10 year period. As described above, the war in Ukraine has accelerated the timing of some of the returns, as speculators and momentum investors have entered the markets. Protected by a combination of low valuations and structural constraints to supply, we believe this is a long term opportunity however, and only the tip of the iceberg (in terms of returns) has been exposed.

The following graphs tell much of the story:

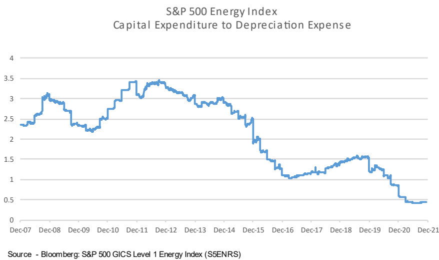
Energy companies are being starved of access to capital markets by ESG mandates, and having been burned by over-growth and excess capacity in 2014, are leery of investing in Capex again, after being saddled with debt from the last cycle. Instead, they are being disciplined this time around as energy prices rise, harvesting free cashflows and returning capital to investors through debt reduction and dividends. Even with energy prices higher, energy supply is limited its ability to grow to meet demand, as investments take years, there are political constraints on plants and pipelines, and there are shortages of skilled labor and materials to develop additional energy patch infrastructure.

Energy Capex is at a record low…



5

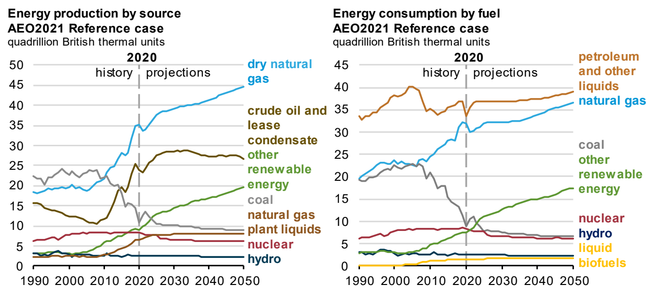
…and assets are not being replaced



6

Renewables cannot grow fast enough to replace the loss of energy supply from Coal and Nuclear plant closures. They too are constrained by lack of Capex as well as Supply Chain shortages in their materials supply, combined with contradictory political and social requirements.

U.S. Energy production and consumption



Source: U.S. Energy Information Administration, Annual Energy Outlook 2021 (AEO2021) www.eia.gov/aeo

10

Energy demand will be driven by Non-OECD countries, with poor populations, that cannot afford expensive and unreliable energy. As populations grow and more people enter the middle class, energy consumption will only keep increasing. Demand for fossil fuels, especially Nat Gas, even possibly coal, will continue to grow.

Energy Consumption is a driver of Human Development and GDP

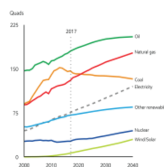
A significant part of the world does not have access to reliable and sufficient electricity

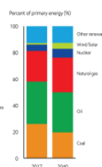
13

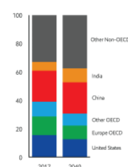
Unrealistic Green Hopes: Natural Gas Will Help Fossil Fuels Maintain Share

Global Energy mix is shifting to lower carbon fuels

Energy demand led by non-OECD
Percent of primary energy (percent)





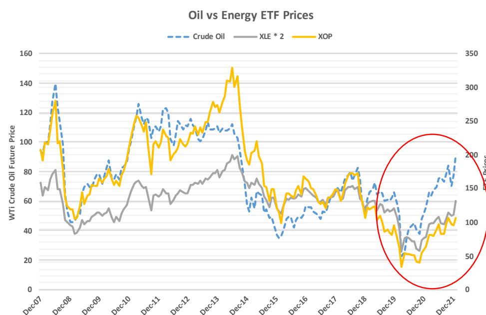


Source: ExxonMobil.com Outlook for Energy

11

Energy Equity prices are still a fraction of where they were the last time Energy prices were at this level...

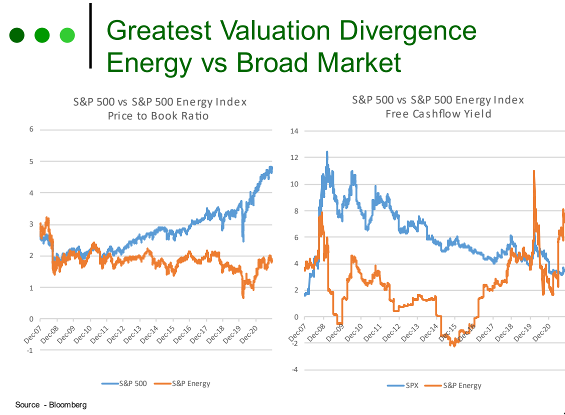
Energy Equities have lagged Energy Prices



Source: Bloomberg

16

…Leading to the greatest Valuation Divergence with other equities, and growth in Free Cashflow.



Our equity selections are driven by DCF valuations from our friends at Rationalinvesting.com, which suggest significant model to market discounts. The recent volatility suggests to us that the current Energy investor base is still small, with lots of 'tourists' trading momentum, as Energy equities are still a small percentage of the S&P index. As more real investors enter the space, and realize that energy demand is not going away, we expect the model to market discount for energy stocks to diminish.

We specified a model portfolio on Dec 31, 2021, and rebalanced it on May 5th 2022 after the Fed meeting, putting some personal assets to work at this time as well. Here is a summary of the recent performance (unlevered).

	Periodic Total Returns	
	12/31/2021 to 05/04/2022	**05/04/2022 to 6/12/2022**
Model Portfolio 1, 33 stocks, 12/31/2021	**52.33%**	
Portfolio 2, 23 stocks, 05/04/2022		**12.23%**

The combination of free cashflows, dividends, and price appreciation should more than protect against inflation.

While we are currently investing in SMAs, we are also looking for an anchor investor for a fund, and have a team lined up.

Regards, Samir Shah

June 12, 2022

Samir Shah
President and CIO
MBS Mantra, LLC (a CT Registered Investment Advisor)
"Alpha Through Analysis"®

203-388-8356 P
203-273-0360 C
sshah@mbsmantrallc.com
https://www.linkedin.com/in/samir-shah-6a9096a
Please visit our website https://www.mbsmantrallc.com for important disclosures.

Important Notice - Disclaimer

This overview is being provided to you by MBS Mantra, LLC ("MBS Mantra" or the "Firm" or the "Adviser"), for informational purposes only, on a confidential basis and is intended solely for use by the company or individual to whom it is being delivered. Potential investors are advised to request and carefully read and review MBS Mantra's Firm Brochure (Form ADV Part 2), and other documents, if any, provided by MBS Mantra (the "Documents"). Under no circumstances should this overview be used or considered as an offer to sell, or a solicitation of any offer to buy, interests in any securities, funds, other financial products or investment strategies managed by MBS Mantra, nor shall it or its distribution form the basis of, or be relied upon in connection with, any contract for advisory services or otherwise.

The information contained with this brochure has not been audited and is based upon estimates and assumptions. No reliance should be placed, for any purpose, on the information or opinions contained in this overview. The information contained in this brochure is based upon proprietary information of MBS Mantra and public information, but it may not be comprehensive, and it should not be interpreted as investment advice. No representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this overview by MBS Mantra or by its affiliates and any of their principals, members, managers, directors, officers, employees, contractors or representatives.

Investors must make their own investment decisions based on their specific investment objectives and financial position. Charts, tables and graphs contained in this overview or in the Documents are not intended to be used to assist an investor in determining which securities to buy or sell or when to buy or sell securities. While this overview may contain past performance data, PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS, WHICH MAY VARY. There can be no assurance that any investment strategy will achieve its investment objective or avoid substantial or total losses. Except as required by law, MBS Mantra assumes no responsibility for the accuracy and completeness of any forward-looking statements. Further, MBS Mantra does not provide legal and tax advice; MBS Mantra recommends that investors consult with their own independent tax and legal advisers.

Any example represents an actual trade made by Samir Shah, MBS Mantra's principal, and/or MBS Mantra; any hypothetical represents a possible trade. None of the examples, whether actual or hypothetical, contained in this overview and the Documents should be viewed as representative of all trades made by MBS Mantra, but only as examples of the types of trades MBS Mantra expects to complete for its customers. None of the examples provided can in and of themselves be used to determine which securities to buy or sell, or when to buy or sell them. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities used as examples in these Documents. To the extent that this document contains statements about the future, such statements are forward looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, product demand and market risks, fluctuations in operating results and other risks. (A complete list of trades made by Samir Shah and/or MBS Mantra is available upon request.)

This overview and all Documents provided by MBS Mantra should only be considered current as of the date of publication without regard to the date on which you may receive or access the information. MBS Mantra maintains the right to delete or modify the information without prior notice; MBS Mantra undertakes no obligation to update such information, including, but not limited to, any forward-looking statements, as of a more recent date, except as otherwise required by law.