THE CASE FOR MORTGAGE-BACKED SECURITIES

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Executive Summary

Mortgage-backed securities (MBS) make up almost a quarter of the US fixed income market and they offer a less volatile source of returns

MBS fall into one of two main groups: ‘agency’ and ‘non-agency’, with each offering different levels of credit risk and potential rates of return

The asset class has evolved considerably since the global financial crisis (GFC) and seen the issuance of a range of different instruments

New regulations and tighter lending standards post the GFC have improved mortgage credit quality

While many investors will already be familiar with mortgage-backed securities (MBS), there are some particular aspects of the US market which could make it an asset class with appeal to non-US investors seeking to establish a truly diversified global fixed income portfolio.

An MBS is an instrument which is backed by a large pool of mortgages whereby the investor is entitled to the cash flows associated with those underlying mortgages; each pool can include individual mortgages on either residential or commercial properties.

There are two main groups of MBS: ‘agency’ and ‘non-agency’. The former are generally guaranteed or insured by a government agency, and are therefore more secure but offer lower rates of return. The latter are issued by private institutions, are privately insured or not insured at all, and are therefore subject to credit risk, but may potentially deliver greater benefits.

While the MBS market played a central role in the global financial crisis (GFC), the asset class has evolved considerably in the years since, when we have seen the issuance of a range of different instruments. The concept of non-qualifying mortgages was created after the GFC and is an area with a large number of opportunities. The developed market definition is loans made to borrowers whose financial and / or property profiles fall outside of defined guidelines set by a government agency. In addition, a whole specialist area in troubled loans has emerged, such as re-performing loans, where the borrower has been delinquent but has resumed making payments.

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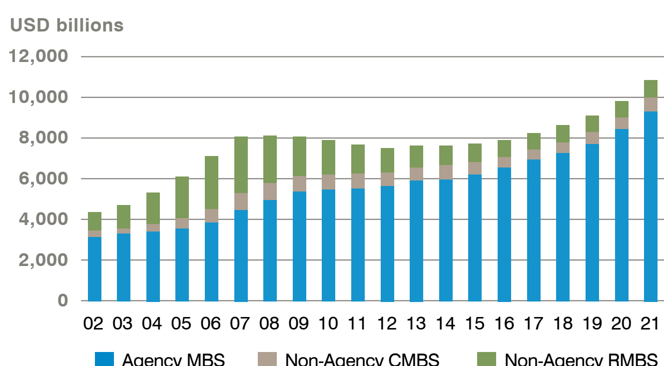
It may be surprising to find that MBS is actually the second largest segment of the US bond market after treasuries, accounting for almost a quarter of the US fixed income market. In our view, there are a number of reasons why an investor may consider US MBS. With mortgages accounting for such a sizeable part of the US bond market it is difficult to have a representative exposure to this market without including mortgages. MBS may offer higher yields than treasuries with similar maturities; this includes higher-quality agency, as well as non-agency, issuance. One reason for this enhanced yield is the risk of prepayment and the associated reinvestment risk that comes with MBS. In the case of Ginnie Mae, and arguably both Freddie Mac and Fannie Mae, this enhanced yield comes with little or no additional credit risk. The combination of high credit quality, large size and a diverse range of investors mean the US MBS market is generally highly liquid

US mortgage-related securities outstanding



Source: Securities Industry and Financial Markets Association (SIFMA) as of Dec 2021. CMBS = Commercial MBS, RMBS = Residential MBS.

Before the boom in sub-prime lending in the early stages of the new millennium, we were comfortable with the concept of judiciously absorbing credit risk in return for the higher yields associated with it. However, sub-prime proliferated incredibly quickly because so many parties had vested interests in its expansion. Government officials used policy tools to gain popularity by promoting home ownership, mortgage originators and investment banks collected large fees, investors overlooked credit standards in exchange for yields that could be levered into high returns on equity, and so on.

As it became clear to us that credit risk was becoming increasingly mispriced, we changed our focus to the agency side of the market which offered a different set of opportunities, by taking mortgage prepayment risk and interest rate risk, but not credit risk. After the subprime bubble burst in 2008, and all appetite for credit risk diminished sharply, we were able to benefit from investing where the fundamental dislocations were attractive.

While other investors were likely suffering large credit losses, we did what any judicious and specialist investor would have done in the circumstances. With the MBS arena in total disarray, this proved a very auspicious time to re-engage in the non-agency segment of the market.

Almost inevitably, the subprime crisis ultimately served as the harshest form of quality control. Since then, only those individuals with the highest credit profiles, in our view, have been able to obtain mortgages.

What does the US mortgage market look like in 2022?

The mortgage market has undergone dramatic change this year. Higher mortgage rates are contributing to declining home sales, which have now fallen to levels consistent with pre-Covid home sales. Despite this, the price of houses in the US is continuing to increase. In June, house prices increased by +0.6% from May, and 18% year-on-year, according to Case-Shiller. We believe that the lack of inventory and strong household formation should continue to provide support for house prices for the foreseeable future.

As the vast majority of mortgages in the US are fixed rate, increasing interest rates do not have a material impact on the credit quality of the outstanding mortgage market. The increase in house prices has in fact improved the loan-to-value ratios on existing mortgages, which in turn has improved the credit profile on seasoned mortgage securities. Loss severities on the seasoned mortgages have steadily decreased as house prices have risen, and the number of mortgage liquidations that have resulted in no-loss has steadily increased over time.

The current higher mortgage rates have also reduced mortgage originations, both for home purchases and mortgage refinancings. Lower originations may lead to lower issuance in both agency and non-agency MBS, which could stabilise MBS spreads due to lower supply.

Roles of different types of securities in MBS portfolios

Pass-throughs	**Agency and Non-Agency**	Typically not held
CMOs	**Agency**	Held when market environment is highly volatile
	Non-Agency	Favoured instrument in normal markets when seeking yield
Stripped instruments	**Principal Only (POs)**	Held when interest rates are falling and/or prepayments increase
	Interest Only (IOs)	Held when interest rates are rising and/or prepayments falling
Derivaties	**Swaps, futures, government, bonds and other mortgage instruments**	Used primarly for hedging purposes

Source: GAM. The mentioned financial instruments are provided for illustrative purposes only to assist the reader in understanding the themes presented and do not constitute a recommendation or an offer to buy or sell securities.

Regulations and tighter lending standards have improved mortgage credit quality in the wake of Fannie Mae and Freddie Mac's well publicised travails in the lead up to and during the GFC, which stemmed primarily from their holding of lower quality mortgages. Consequently, the underwriting criteria for US agency residential mortgages remain fairly tight, although they have been loosened to some extent to help first-time buyers. Non-agency underwriting criteria are also tight, and the amount of capital required by banks to hold them is significantly more than for agency.

Despite concerns about strong inflation and the prospect of a recession, we believe that MBS has the potential to weather the storm. This is because we believe the US consumer will remain resilient due to the tight labour market and the high savings rate during the pandemic. The unemployment rate in August was 3.5%, which we believe should allow the Federal Reserve to act aggressively without crushing the labour market and leaving consumer credit relatively unscathed. Further, the MBS market continues to be supported by strong house prices which, in our view, are unlikely to fall significantly while there is a shortage of homes.

For more information, please visit GAM.com

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