



Agency MBS: A broad investment universe

Macquarie Investment Management



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 September 2018

Introduction

The agency mortgage backed securities (MBS) market is often just associated with physical pass through pools, but the universe is much broader extending to structured securities in the form of agency Collateralised Mortgage Obligations (CMO) and forward contracts called To Be Announced (TBA). This diverse universe can provide opportunities and help address some of the challenges investors face in this low yield environment. This insight provides an overview of the investment universe, focusing on the unique features of the underlying security types and how when managed in an absolute return investment style, can help provide an attractive solution to address some of the headwinds in markets today.

Investment universe overview

The agency MBS universe is a diverse opportunity set comprising of physical pools, structured securities and derivatives, each briefly explained below:

- **Pass through agency MBS pools** are constructed by pools of securitised mortgage loans issued and guaranteed by US government agencies. These pooled securities are typically comprised of fixed-rate loans with terms of 30, 20, or 15 years, as floating rate residential loans are less prevalent in the US.
- **Agency CMOs** are constructed from agency MBS pools by redistributing the principal and interest cash flows into tranches. Multiple structure types are available and include basic sequential, interest only / principal only and planned amortisation classes.

- **TBAs** are effectively forward agency MBS where the parties agree to buy or sell on a specific future date. The basic characteristics of the pool to be delivered are agreed upfront with the specific pool announced 48 hours prior to the trade settlement date.

While each of the securities above have different features that can play specific roles in a total portfolio setting, they all exchange credit risk (as the securities are government guaranteed) for prepayment risk. Prepayment risk reflects the optionality of these cashflows as US mortgage borrowers can repay the principal in full or part at any time without penalty. An enhanced yield over the risk-free rate is paid to compensate for this prepayment risk.

Seeking to address the challenges faced by investors

Portfolio diversification

Investors are increasingly seeking additional portfolio diversification tools as we enter the latter stages of an already extended economic cycle, where valuations are stretched, and yields are low.

The agency MBS universe can provide an additional source of diversification, from both a correlation and return perspective. Pass through securities, certain CMO structures and TBA's are uncorrelated to stocks providing total portfolio protection in a risk-off environment. From a return perspective, the universe is unique in that it provides the opportunity to add additional returns from managing prepayment risk.

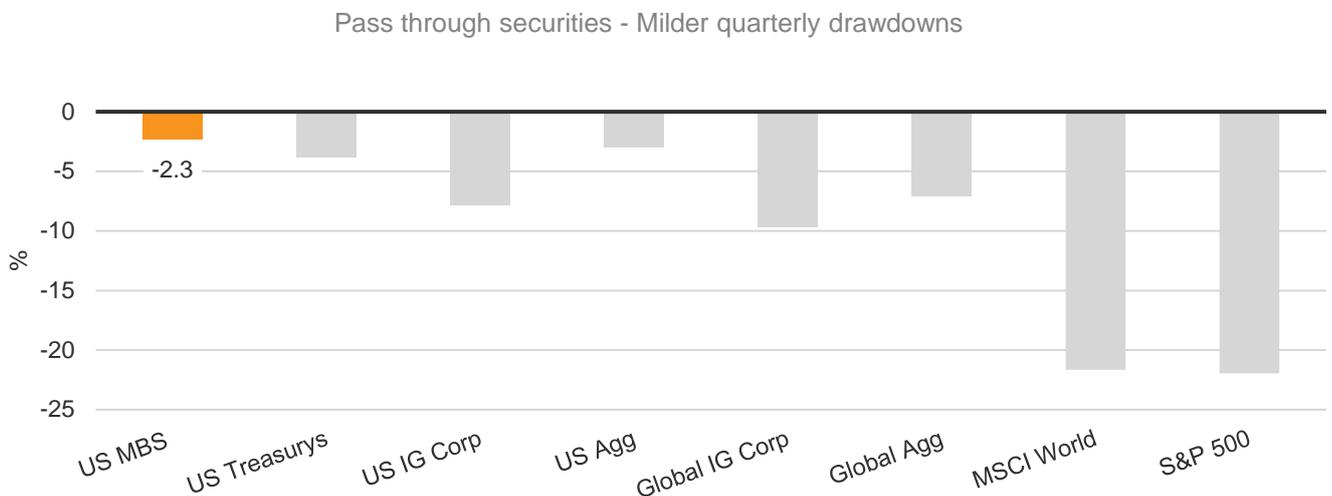
An example of extracting this alpha is when investing in pass through securities, we have identified that pools with low loan balances generally exhibit less prepayment sensitivity (due to the lower dollar savings on rate decreases) and higher returns than equivalent pools with higher loan size balances. In CMO securities when rates are rising, Interest Only (IO) structures tend to perform well as prepayments fall resulting in interest being paid over a longer period on the principal outstanding.

Capital preservation

In this low yield environment, many investors have had to move out the risk spectrum and down the capital structure to generate returns, even in their defensive allocations. The agency MBS universe can provide some relief for those challenged with low returns and riskier holdings.

The asset class is AAA rated, has an implicit and explicit backing of the US government and provides an enhanced yield over the risk-free rate to compensate for prepayment risk.

Focusing on pass through securities, when compared to the other major fixed income and equity indices over a 24-year period, these securities offer less downside risk with milder drawdowns and lower quarters of negative returns as illustrated below. Pass throughs are also very liquid, are the second largest fixed income asset class after US Treasuries and have high daily trading volumes.



Source: Bloomberg and Securities Industry and Financial Markets Association. Monthly Bloomberg Barclays index data 1994-2018 for: 1) US MBS, 2) US Treasury, 3) US Corporate Investment Grade, 4) US Aggregate, 5) Global Corporate Investment Grade, 6) Global Aggregate, 7) MSCI World, 8) S&P 500

The asset class can provide further risk management and protection benefits through the use of TBAs. This forward security allows portfolio managers to increase and decrease exposure to prepayment risk through a single transaction, allowing time to adjust the underlying security selection through fundamental research. This is particularly critical in times of rising prepayment rates.

Attractive return profile

Macquarie uses the agency MBS universe in an absolute return style investment solution (Macquarie Absolute Return Agency MBS) that targets LIBOR +3% through the cycle. The strategy uses a time-tested investment approach and has consistently delivered on this return objective¹ while achieving a high information ratio and low volatility of returns.

The portfolio is constructed with a core consisting of pass through pools and CMOs that have been selected through in-depth fundamental research, an overlay component for hedging and other alpha opportunities, and overall duration management to position for the prevailing interest rate environment. The portfolio capitalises on the management of prepayment risk, which is a differentiation relative to credit investments.

Conclusion

The agency MBS universe is diverse in nature. At the asset class level, it provides a high-quality AAA rated solution to investors with a government guarantee, and an additional alpha source in the form of managing prepayment risk. Each of the underlying security types offer their own unique features; from the highly liquid nature of pass throughs - to the ability to strip out principal and interest in CMOs - to the flexibility of the TBA market to effectively alter prepayment exposure or extract relative value.

Utilising the full spectrum of the agency MBS universe, with a focus on fundamental research and capital preservation can help investors with some of the return, risk and diversification challenges they face today.

¹ Strategy has delivered in excess of LIBOR +3% over 3 and 5 years as at 31 August 2018

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Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt.

The strategy may also be subject to prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity, at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

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September 2018

ID# 601214