AAM
Insurance Investment Management

Agency CMBS/MBS: A Value Proposition With Low Volatility

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Agency Mortgage Backed Passthrough Securities have underperformed relative to other spread products for nearly a decade as the Fed has been involved in that market via asset purchases to support the housing sector and economy in turn keeping the spread low. In 2008-09, it was part of their quantitative easing program after the housing crisis and then the Fed implemented program again in 2020 during the pandemic. When the Fed makes purchases in the sector as part of their quantitative easing program, they are a buyer at any price and at times were buying in excess of the market supply. This drove valuations in the sector to what AAM felt were unattractive levels and caused AAM to be underweight in client portfolios vs their benchmarks for the last decade. This strategy has worked well as the mortgage index in the Bloomberg aggregate has underperformed Treasuries on an excess return basis in 6 of the last 9 years.

Bloomberg MBS Index Excess Returns (Bps)								
2023	2022	2021	2020	2019	2018	2017	2016	2015
68	-223	-68	-17	61	-59	52	-11	-5

Source: Bloomberg

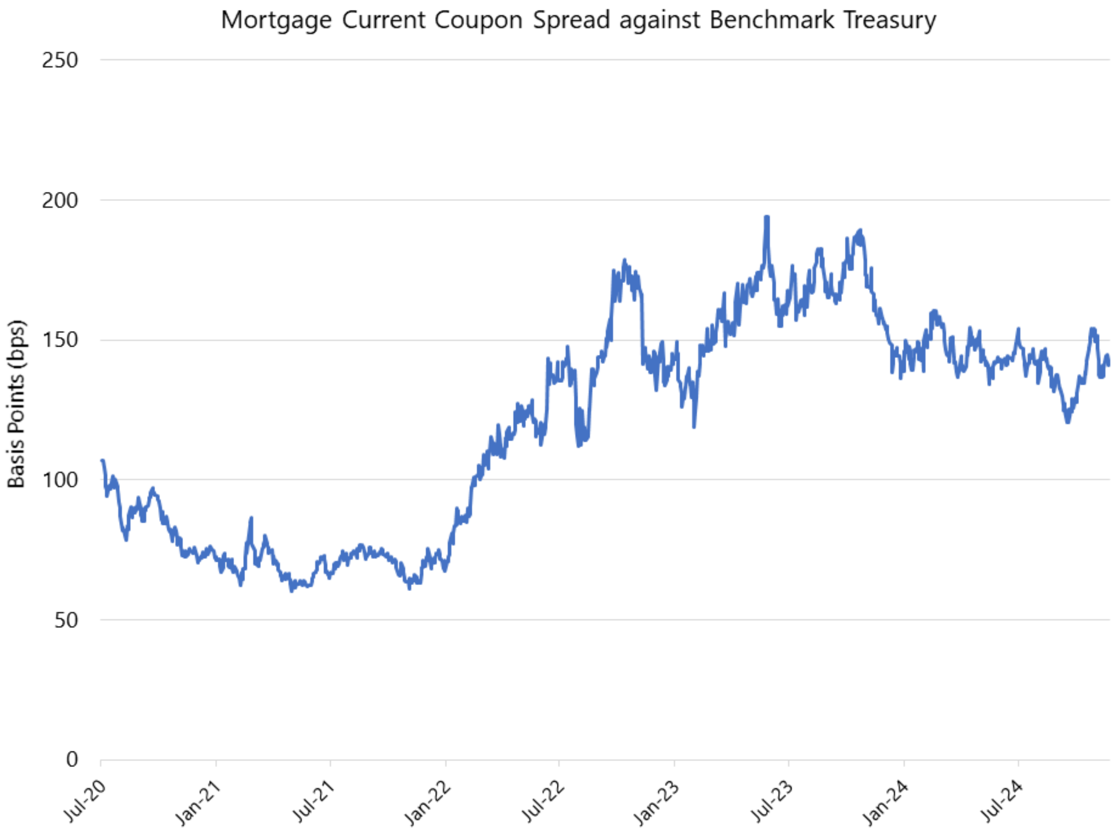
Now that the Fed stopped making purchases in the MBS market in 2022, valuations have become much more attractive. This paper defines the different type of Agency Mortgage Backed Securities (MBS) that AAM invests in for their clients and where they find value today.

First, let's look at Agency Mortgage Backed Securities (MBS). Agency MBS are bonds backed by cashflows from mortgages that are issued by a Government Sponsored Enterprise (GSE) or "Agency" such as Fannie Mae, Freddie Mac, or Ginnie Mae. The principal and interest payments from these mortgages are passed on to the investors and each agency guarantees all principal and interest payments by the borrower.

Residential MBS are pools of individual single family home loans with similar interest rates in which the investor is paid principal and interest based on the repayment of the underlying loans. Since these payments are "passed through" to the investor, these pools of loans are commonly referred to as Agency MBS Passthroughs. The underlying interest rate on the underlying mortgages will dictate how susceptible they are to prepayment risk as borrowers can refinance or voluntarily prepay the loans with no penalty. Other factors influencing loan repayment are the sale of the property or loan default, or more involuntary factors such as death, divorce, and taxes in the lives of the borrowers. AAM invests in specified pools of loans which have certain characteristics such as lower loan balance and loans in certain geographies, that can provide better cashflow profiles with lesser prepayment risk than generic agency residential pools. Another type of security investors buy that are backed by Agencies are Collateralized Mortgage Obligations (CMO). These are securitized pools of Agency MBS passthroughs in which each deal divides up the principal and interest payments on the underlying loans into different securities that investors can buy.

Agency commercial MBS is a similar concept as the residential MBS but the collateral is loans on commercial properties such as multi-family properties, low income housing, and hospitals. These loans have lesser cashflow variability as the loans are structured with a balloon payment at maturity, and have a prepayment window of 6-36 months prior to scheduled maturities. The prepayment protection is in the form of a "lock out" meaning the underlying loans cannot be prepayed for a certain amount of time. Some deal structures require the borrower to pay prepayment penalties that are passed on to the investors if the borrower elects to prepay their loan. The prepay penalties are equivalent to the amount required to maintain the expected yield through maturity. The loan can also be replaced with U.S. Treasury Bonds that match the payment schedule of the underlying loans. Due to this short prepayment window and protections, the prepayment risk in minimal and earned yield would not vary much from expected yield at purchase throughout the life of the bond.

With credit spreads in other credit sectors such as corporate bonds near 10 year minimums, AAM has been finding value in Agency MBS passthroughs. With the Fed no longer purchasing securities, current coupon spreads have moved higher from their April 2021 minimum of 60 over Treasuries to levels AAM views better reflect the prepayment risk embedded in the security.



Source: Bloomberg

We favor the current coupon mortgages as they have the most spread with the expectations for mortgage rates to remain higher for longer time period with prepayments remaining in the current range.

Along with the Agency MBS passthroughs, AAM favors the Agency CMBS and certain Agency CMO types such as VADMs (Very Accurately Defined Maturity) that have less prepayment risks. Both of these types of these securities have more bulleted cashflows and tend to outperform Agency Passthrough Securities in periods of falling interest rates. Within the Agency CMBS sector, there are less liquid smaller deals that are backed by hospital loans that have additional yield (bps) over more on the run larger deals. In a period of when credit spreads in other credit sectors are near 10 year minimums, high quality Agency MBS can offer value for client portfolios.

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