

# The Value In US Government Agency Mortgage-Backed Securities (MBS)

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## Overview of Agency MBS

US Government agency mortgage-backed securities (MBS) are bonds where the interest and principal from a pool of mortgages is passed through to investors. These pass throughs are issued by Government Sponsored Entities (GSE's), Freddie Mac, Fannie Mae or Ginnie Mae. During the 2008 economic crisis, much was written about the solvency of these agencies and there was also call for their reform. However, given the overall weakness in the US housing market, combined with the fact that the GSE's back 80% of this market, GSE reform has not been high on the Obama Administration's priority list. In fact, pundits do not expect any changes until 2013, after the next Presidential election. Further, the market expects any future changes to the GSE model to include grandfathering to protect existing MBS investors.

Agency MBS, which are currently trading at their cheapest levels since 2009, have the following attributes:

- Superior credit quality: Ginnie Mae securities are backed by the full faith and credit of the United States Government, while Freddie Mac and Fannie Mae have implied government backing.
- Large and liquid markets: The market for these bonds is nearly as large as the US Treasury market at US \$5.1 trillion.
- Outperformance during credit crises: Holding Agency MBS through some past crises, including the Bond Rout of 1994, the Russian Default/Long Term Capital crisis of 1998, and the Global Credit Crisis of 2008-2009, provided investors with superior returns.
- Unique combination of high credit quality and attractive yield: In addition to credit quality, investors

**FIGURE 1** Cross Sector 10-Year Sharpe Ratios  
 August 2001 - July 2011

	Annualized Return	Annualized Volatility	Sharpe Ratio*
<b>US MBS</b>	<b>5.70</b>	<b>2.78</b>	<b>1.35</b>
US CMBS	6.20	10.88	0.39
US ABS	4.58	4.39	0.60
US Aggregate	5.68	3.78	0.99
US 7-10 Treasury Bond	6.42	7.09	0.63
US IG Credit	6.32	5.86	0.75
US High Yield	8.97	11.14	0.63
S&P 500	2.61	15.82	0.04

Source: Barclays Capital, Bloomberg

are paid to absorb cash flow uncertainty (otherwise known as prepayment risk).

- Ability to monitor investment on a monthly basis: Unlike most fixed income investments, MBS investors can monitor their investments monthly.
- Risk adjusted performance: Agency MBS has had the highest Sharpe Ratio (a measurement of risk-adjusted performance) among all major fixed income sectors over the past 10 years, as shown in **Figure 1**.
- Diversification: Agency MBS is an effective portfolio diversifier, as the asset class has had low correlation to other asset classes such as Commercial Mortgage-Backed Securities (CMBS), High Yield Bonds, and US Equities over the past 10 years, as shown in **Figure 2**.

## Why Agency MBS Tend To Outperform

Some may ask, how has Agency MBS been able to outperform over time? Agency MBS is unique in that it has the yield of a mid-quality corporate bond while having the credit quality and liquidity of a Treasury bond. During periods of low or intermediate interest rate volatility these factors lead to MBS outperformance.

Agency MBS does have prepayment risk, which makes cash flows uncertain. While, valuation calculations are determined through interest rate and prepayment models, valuing the prepayment risk premium can be difficult. Thus during refinancing waves, Agency MBS can underperform. However, over long periods of time, actual volatility has typically been lower than implied volatility.

**FIGURE 2** Cross Sector 10-Years Return Correlation Matrix  
 August 2001 - July 2011

	US MBS	US CMBS	US ABS	US Aggregate	US 7-10 Treasury Bond	US IG Credit	US High Yield	S&P 500
<b>US MBS</b>	<b>1.00</b>	<b>0.16</b>	<b>0.40</b>	<b>0.89</b>	<b>0.85</b>	<b>0.64</b>	<b>(0.04)</b>	<b>(0.19)</b>
US CMBS	0.16	1.00	0.44	0.43	0.18	0.53	0.61	0.35
US ABS	0.40	0.44	1.00	0.50	0.25	0.61	0.47	0.10
US Aggregate	0.89	0.43	0.50	1.00	0.90	0.87	0.17	(0.07)
US 7-10 Treasury Bond	0.85	0.18	0.25	0.90	1.00	0.63	(0.20)	(0.31)
US IG Credit	0.64	0.53	0.61	0.87	0.63	1.00	0.51	0.20
US High Yield	(0.04)	0.61	0.47	0.17	(0.20)	0.51	1.00	0.69
S&P 500	(0.19)	0.35	0.10	(0.07)	(0.31)	0.20	0.69	1.00

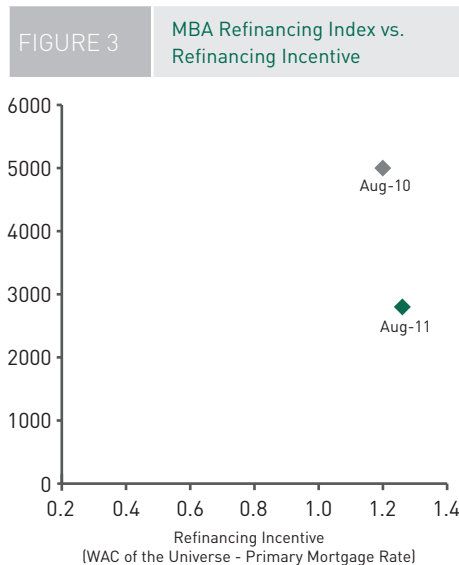
Source: Barclays Capital, Bloomberg

## Agency MBS in Today's Environment

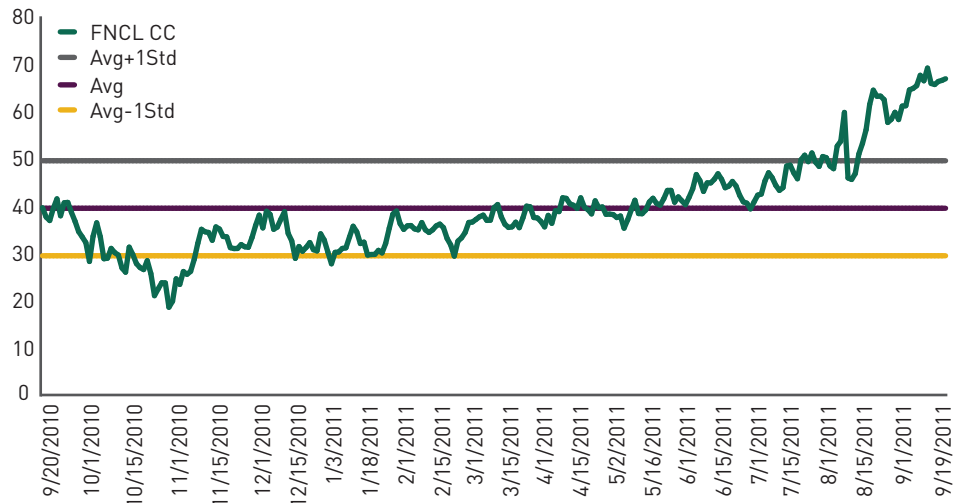
Despite record low mortgage rates and high levels of housing affordability, mortgage refinancing, and thus MBS prepayment risk, continues to be modest. As shown in Figure 3, while the incentive for refinancing (lower rates) remains the same as 2010, the level of actual refinancing is considerably lower than 2010.

Tepid refinancing response is being driven by several factors:

- Weak housing prices due to negative equity problems
- Tight credit markets caused by tighter loan requirements such as full borrower loan documentation
- Ongoing high levels of unemployment or underemployment



**FIGURE 4** FNMA 30 Year Current Coupon OAS



The Obama Administration has shown that it wants to spur homeowner refinancing activity as a way of increasing economic growth. For example, on 24 October, the President announced changes to the existing mortgage refinancing program for Fannie Mae and Freddie Mac loans (called the Home Affordable Refinance Program or "HARP"). The program was modified to make it easier for borrowers with high loan-to value (LTV) ratios, who are current on their mortgages, to refinance. Despite the widespread publicity surrounding the program, pundits expect these program changes to have minimal impact on overall mortgage prepayments. However, the uncertainty surrounding these HARP program changes has led to wider MBS spreads as the current coupon Fannie Mae MBS is now 2.7 standard deviations cheaper versus its one year average.

## Conclusion

1. Agency MBS investments have a unique combination of yield, high credit quality and liquidity.
2. The asset class has had the highest Sharpe Ratio among all major fixed income products over the past 10-years.
3. Agency MBS investors have enjoyed higher-than-historical price appreciation since prepayment, or refinancing risk, is now low. MBS spreads are currently wide due to uncertainties surrounding changes to the HARP program. In our view, agency MBS currently represent a strong buying opportunity. ■

Diversification does not ensure against market loss.

Investment involves risks. Past performance is not indicative of future results.

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