MERGANSER
CAPITAL MANAGEMENT

INVESTMENT MEMO
DEI CONSIDERATIONS IN AGENCY CMBS INVESTMENTS
FALL 2021

MERGANSER TODAY

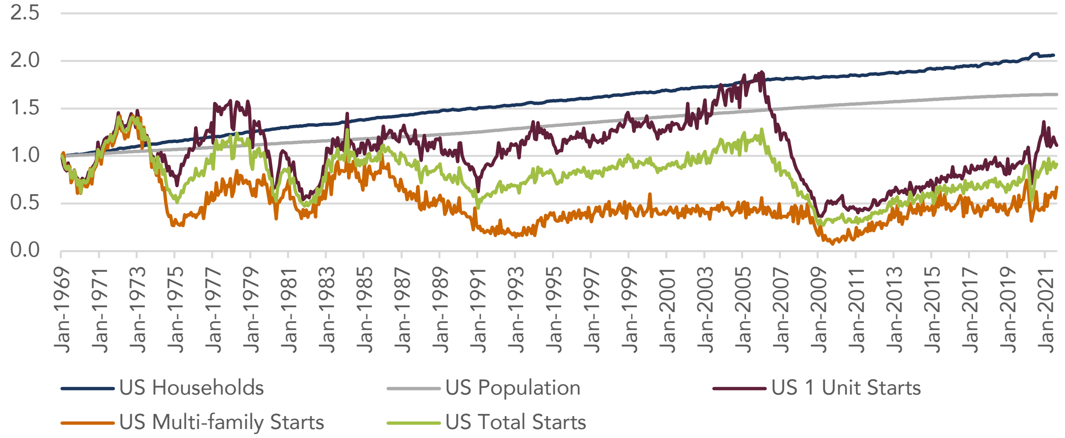
Merganser prioritizes diversity, equity, and inclusion in all interactions, both internal and external, while also working to meaningfully incorporate ESG risk-factor analysis across all its asset sectors.

The housing market has had a remarkable recovery since the depths of its collapse over ten years ago. Record home values have been fueled by low interest rates, a shortage of housing stock and a fundamental increase in housing's intrinsic value brought about by COVID-19 (Covid). Gains in apartment values have followed a similar trajectory, due to limited supply and soaring rents. In both cases, a lack of supply is to blame for soaring prices, which means that housing continues to be a significant financial burden for much of the U.S. population. As investors considering fundamental risk, we are forced to face the dichotomy of booming markets and deteriorating social welfare. In this white paper, we discuss how we are considering the housing shortage and affordability problem as investors in commercial mortgage-backed securities (CMBS).

HOW DID WE GET HERE?

When millions of homeowners and renters lost their jobs as a result of Covid, a quick and flexible policy response allowed the nation to avoid a repeat of the foreclosure crisis of 2008. Yet discussions about housing policy too often focus only on single-family home ownership dynamics. The role of rental housing is not given the same attention. Eviction moratoriums and forbearance programs put in place at the onset of the pandemic allowed for similar compassionate handling of impacted renter households. As the moratoriums and extended unemployment benefits come to an end, we believe more scrutiny of multi-family housing is likely, given the imbalance of supply/demand dynamics. In the graph below, note that all housing, particularly multi-family housing, has not kept pace with a growing population. The gap is even wider when looking at households rather than population.

EXHIBIT 1: U.S. POPULATION AND HOUSEHOLDS VS. HOUSING STARTS INDEX JAN 1969



Source: JPMorgan

It is hard to imagine any quick changes that would significantly increase housing supply by relaxing land use restrictions.

Supply and demand dynamics have not been improved by government stimulus. Without increasing the supply of housing, improvements in the labor market are likely to further exacerbate the problem of affordability, as stable-to-rising incomes drive household formation and increased demand for housing. Furthermore, many communities oppose the development of lower-income housing and/or the construction of multi-family rental housing. The Not in My Back Yard (NIMBY) attitude was an impediment even before politics became so polarizing; it is hard to imagine any quick changes that would significantly increase housing supply by relaxing land use restrictions. This is the critical problem. We need more units to lower the cost of housing.

TWO SIDES TO CONSIDER

In the following paragraphs we present a choice of how to view multi-family rental housing finance in America in 2022 and beyond and the likelihood that more units will be delivered.

The first viewpoint is as follows: low default rates, strong Environmental, Social and Governance (ESG) scores, flexible eviction moratoriums and unemployment benefits show the housing finance system is working well. At Merganser, we support this school of thought and espouse the ESG bona fides of multi-family finance vis-à-vis agency commercial mortgage-backed securities (ACMBS). Green lending programs, strong social purpose, and strong governance with low credit losses are evidence for high ESG marks for the sector. Furthermore, lending by government-sponsored enterprises (GSEs) provides capital to continuously improve the rental housing stock which allows for job mobility, a critically important feature of a labor market in transition due to Covid. Continuing the ACMBS market 'as-is' will allow for continued capital to flow to the rental housing market, slowly increasing the stock of housing units. These features are additional benefits to the role ACMBS provides fixed income portfolios through its positive convexity, strong liquidity, and stable spreads. As such, investing in ACMBS is a prudent and attractive fixed income tool. It is also an efficient way to contribute to equitable housing policies for the less fortunate. ACMBS promotes ESG initiatives while generating stable excess returns for client portfolios. Agency-insured and uninsured credit exposures have played a large role in our portfolios with the growth of this sub-sector during the past market cycle.

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An alternative perspective, and one we would be remiss to ignore, is that local, state, and national housing and lending policies have a troubled history of perpetuating inequality in America. Segregation; red-lining neighborhoods; denying mortgage insurance for minorities; restrictive covenant deeds; construction of urban ghettos; destruction of minority neighborhoods for highway construction; zoning for purposes of segregation; and under-investment in public housing are all part of our nation's history, the negative effects of which have compounded over generations. Today, inequality is perpetuated by preserving our housing finance system, which limits creation of housing units and drives up the cost of the existing supply. This an affront to the Diversity, Equity and Inclusion (DEI) efforts underway across the country. Too little of the GSE, Treasury or Fed balance sheet is used for construction of new units in support of their mission to boost affordable housing. The Federal Reserve has spent $120 billion per month since the onset of Covid purchasing mortgage-backed securities (MBS) and U.S. Treasury securities (UST). This expenditure has lowered borrowing costs across the economy, pushed investors out the risk spectrum in search of returns, and driven up asset prices without sufficiently increasing the supply of housing. Higher apartment asset values are justified by ever-increasing rents, which effectively serve as a tax on less fortunate tenants. RealPage (a property management software company) recently announced that rents rose 10.3% year-over-year in August 2021 despite the pandemic and a year-long eviction ban. We need a new system for rental housing finance, starting with policies that create more units. We are beginning to see that the impact of ACMBS on attaining affordable housing goals is nuanced rather than solely beneficial.

As part of our DEI initiatives, we are learning more about systemic racism in our nation's housing policy.

There are likely better ways to reach these goals than the current approach, which has failed to improve affordability. The Color of Law by Richard Rothstein is an excellent resource for those looking to learn more about this topic. The book argues that "African Americans were unconstitutionally denied the means and the right to integration in middle-class neighborhoods, and because this denial was state-sponsored, the nation is obligated to remedy it." We all have an obligation to remedy structural racism begun generations ago, the effects of which continue today.

Both perspectives can be true at the same time, which speaks to the challenges in front of us, the limits of ESG investing as a panacea, and possible conflicts between ESG and DEI initiatives. While ESG benefits have been well documented, DEI considerations have received less publicity. As part of our DEI initiatives, we are learning more about systemic racism in our nation's housing policy. Naturally, the role of ACMBS comes into question.

HOW WE ARE INCORPORATING BOTH SIDES INTO OUR FUNDAMENTAL ANALYSIS OF CMBS

With spreads at very tight levels, we have been less inclined to add ACMBS during 2021. Where guidelines allow, we have preferred the relatively more attractive X1 interest-only (I/O) bonds which reference the guaranteed, senior A1/A2 classes. As A1/A2 balances are reduced via amortization, paydowns or liquidation, so is the income to the X1. Hopefully, new policies that evolve over time will create more housing units, however this is not expected to occur rapidly. A significant increase in new units could lead to lower rents and thus lower asset values. That could make refinancing existing assets more difficult, leading to loan and security extensions. Such an outcome is a positive for I/O securities that trade to a scenario that assumes efficient refinancing. In the meantime, we continue to expect very low volumes of credit events in this stable sector. Default risk on the X1 I/Os could also increase should rental rates fall below a level that supports debt service. Rents that fall from today's levels are not as concerning given the recent increase in rents. Eventually, upon resolution, the size of the referenced classes is reduced by the recovery amount and the available interest is reduced; i.e., a 10% loss recovers 90% and reduces the size of the referenced A1/A2 classes.

Where guidelines allow, we have expanded investments into multifamily-only securities offered in the non-agency market.

We have also pursued alternative CMBS investments that support rental housing. Where guidelines allow, we have expanded investments into multi-family-only securities offered in the non-agency market; for instance, 100% apartment deals that look similar to agency multi-family collateral, and single-family rental (SFR) offerings. Each of these benefits from continued strong demand for rental housing. SFR transactions finance large portfolios of single-family rental units; a sector that emerged after the Great Financial Crisis (GFC). This sector has expanded over time to encompass multiple issuers with nationwide platforms and offers an alternative to apartment communities. Should the relative value of ACMBS become more attractive, we could again increase our involvement given their strong fixed income and ESG characteristics. In the meantime, in addition to new issuers and related housing products, we are exploring investments in multi-family-only commercial real estate collateralized loan obligations (CRE CLOs). These deals finance transitional collateral, including recently constructed units. Aiding the development of new rental units is currently the best option we have as an investment grade fixed income investor to lower the burden of high rents, assuming the relative value is supportive of such investments. CRE CLO investment risks to consider beyond the 'transitional' nature of the collateral include manager selection and their ability to trade. This may alter the composition of the transaction in the same way corporate CLOs operate and thus increase surveillance requirements.

We hope to bring awareness to the issue and question assumptions about the status quo of multi-family finance.

WHAT MIGHT BE DONE TO CHANGE RENTAL HOUSING FINANCE POLICY?

It is up to all of us to "think globally but act locally" to support the development of new rental units. By exploring the different perspectives of the housing finance system, we hope to bring awareness to the issue and question assumptions about the status quo of multi-family finance: namely, providing subsidized mortgages to stabilized assets rather than encouraging additional construction. Financing new construction, encouraging local leaders to support multi-family development and asking leaders in our state capitals and Washington D.C. to fund new construction are three actionable steps that we as a fixed income community can take, as firms and/or as individuals, to effect change and work toward achieving a more equitable country.

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Charts may not foot due to rounding.