MERGANSER CAPITAL MANAGEMENT

MERGANSER Q & A

WITH ANDREW SMOCK, CFA

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ANDREW SMOCK, CFA
CHIEF INVESTMENT OFFICER,
MANAGING PRINCIPAL

In this Q&A discussion, Merganser CIO, Andy Smock, reviews our current thinking on relative value in the mortgage market. Read on for a detailed discussion of how we are positioning portfolios to capture inefficiencies in both traditional RMBS and Commercial Mortgage-Backed Securities.

Q: Your positioning in mortgages appears unique in the marketplace. Why have you chosen to invest this way?

A: The fixed income mortgage market is dominated by two pillars, residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). At Merganser, we are currently overweight CMBS and very underweight RMBS. We specifically favor the Single Asset Single Borrower (SASB) segment within the commercial mortgage market. The conservative underwriting of the assets and transparency of loans allows us to take very bespoke exposure, such as in deals collateralized by biomedical research and warehouse/distribution space. Unlike in the traditional conduit CMBS segment, which has broad exposure across many property types (some of which are undesirable), we can focus on assets and market segments that are more resilient in what remains an uncertain environment. For example, in conduit deals granular detail on property fundamentals is typically available for just the top 10 loans. In contrast, we get a deep look at every loan in SASB deals. Our boutique size allows us to take meaningful positions in select transactions and participate up and down the capital stack where we have conviction. The SASB market is one of the fastest growing segments of CMBS, and for good reason.

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This contrasts with our underweight to the agency RMBS part of the market. Agency RMBS account for over 25% of the Bloomberg Aggregate Index[1], while Merganser is currently just over 10%. There are three main reasons for this underweight:

1) **Technical Factors**: The largest buyer of RMBS (the Fed) has adversely impacted the return profile of the sector and will likely begin tapering their purchase program which will be a technical headwind.

2) **Relative Value**: The option adjusted spreads provided by RMBS are extremely low right now and unattractive when compared to the more favorable relative value profile available in the SASB segment.

3) **Style**: We don't need to invest in RMBS if valuations are unfavorable because we are an active manager, not an indexer.

1. As of 10/25/21, Agency RMBS accounted for 27.6% of the benchmark. (Source: Bloomberg)

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Most index focused managers will vary allocation to RMBS in the Aggregate by only a few percent. At Merganser, if value is not present, we are comfortable with a meaningful underweight or even zero exposure. In fact, we believe that willingness is fundamental to active management and a strong contributor to our top peer rankings over time. I consider Merganser "benchmark aware" rather than "benchmark focused". It is an important duration and risk guide but a terrible indication of value in the marketplace.

Q: Has this evolved over time?

A: Yes, the overweight and underweight to various mortgage sectors has varied tremendously over time and is driven by relative value. Entering the fall of 2008 (Lehman collapse), we had over 50% exposure to agency RMBS. The government guarantee and liquidity of the sector was extremely valuable as many other sectors were very exposed to the subprime mortgage contagion at the time. As the Fed entered the market in Q4 of 2008, Agency RMBS spreads tightened massively, and the relative value of credit sectors greatly improved. We used the opportunity to sell agency RMBS and reposition into corporate bonds, CMBS and ABS. Our allocation to the sector did not reach that level again over the next decade as we found more compelling investments elsewhere, from agency multifamily CMBS, to subordinated ABS, and our current SASB exposure. Agency multifamily CMBS was an extremely nascent sector pre-crisis. As the sector grew in relevance, it became a very compelling alternative to agency RMBS given the government guarantee and favorable convexity characteristics.

We hold approximately 11% in agency RMBS in Core Bond portfolios right now as there are some examples of securities in the space we like. The best-case scenario for current Merganser portfolio positioning is that mortgage spreads widen over the next 6 months (resulting from the Fed's taper or otherwise) and we use Treasuries and other government guaranteed positions to increase our position at better valuations. The agency RMBS market continues to offer great liquidity and nominal yield opportunities and as soon as the option adjusted spreads become more competitive with other IG markets, we will quickly add exposure. Part of assessing the "true" option adjusted spread is getting comfortable with prepayment speeds at different coupons given the volatility of the ten-year yield.

Q: What about non-agency RMBS?

A: The non-agency RMBS market has evolved greatly since the financial crisis. It is currently dominated by jumbo, prime loans that are reasonably safe from a default perspective, but at great risk of fast prepays and thus underperformance. This is especially true as housing prices have gone up and ten-year Treasury yields (which mortgage rates are tied to) remain low. The last time we added significant non-agency mortgage exposure was after the financial crisis when we were buying bonds at significantly discounted prices. That was a different time and we do not believe that opportunity is likely to present itself again given the unique nature of that crisis.

The Credit Risk Transfer (CRT) market resulted from a 2012 FHFA mandate to reduce the overall risk held by Fannie and Freddie.

A market innovation since then has been the Credit Risk Transfer (CRT) market that resulted from a 2012 mandate by the FHFA to reduce the overall risk held by Fannie and Freddie. Originally, they were derivatives since cash flows were based on a reference pool. Since then, there are dedicated mortgage pools associated with each deal. Even though they are issued by Fannie and Freddie, they are not government guaranteed and expose investors to credit risk (in addition to prepay risk). This is a part of the market that was only recently stress tested (during the COVID selloff) and we consider it part of our opportunity set in certain mandates as relative values change over time.

Q: Is your MBS approach different across fixed income products?

A: The same team invests for both shorter duration and longer duration strategies at Merganser, but the implementation of our best ideas is very different for the two cohorts because of the universe of available bonds and unique risk appetites of clients.

Mortgages do not have a set repayment date but instead cash flows vary due to the prepayment option of homeowners. While this is also true for certain other sectors (e.g., auto ABS) it is much more dramatic for RMBS. In the past 12 months alone the duration of the mortgage index increased from 2 years to over 4 years![2] We do not feel the duration volatility of traditional 30-year mortgages are a good fit for short duration mandates.

However, certain 10- and 15-year mortgages are a very good fit. In fact, at certain points in the past few years our allocation to RMBS was greater in our short term portfolios than in longer duration. This is largely due to the expensive valuations of many competing bonds and the more limited universe of available securities. Our current allocation to RMBS in short term portfolios is ~7%.

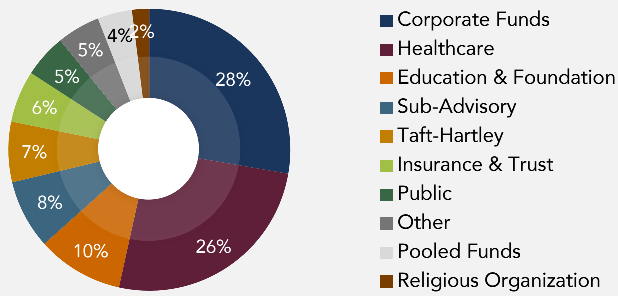
Regarding CMBS, new issue large conduit deals are mostly 10-year loans. Historically, these deals had a short tranche known as "A-1" that was a good fit for short duration accounts that collected amortizing principal payments. However, in recent years there have been fewer amortizing loans (in favor of interest only) and the A-1 tranches have gotten so small they are effectively non-investable. AAA senior bonds that were originally issued as ten-year securities offer opportunities in the secondary market, however they often come with very large mall exposure and other idiosyncratic risks. The SASB deals mentioned previously are appropriate for certain short duration accounts, but they also experience some volatility of cash flow (in the form of extension options). Perhaps the best fit for these accounts is agency CMBS which are government guaranteed multi-family units issued by Fannie and Freddie. The stability of cash flows and government guarantee also means that spreads over Treasuries are fairly thin, but they are a welcome alternative to corporates and ABS in different market environments.

2. The Bloomberg MBS fixed rate index duration was 4.58 years on 10/25/21 and 2.34 years on 10/30/2020. (Source: Bloomberg)

FIRM OVERVIEW

About Merganser

- Formed in 1985, Merganser has been managing institutional fixed income portfolios for over 30 years
- Our strategies are long only, US dollar-denominated and do not utilize derivatives
- The investment team is highly collaborative, and portfolios are managed on a team basis
- As a boutique manager, we embrace portfolio customization and solving unique issues for our clients
- As of September 30, 2021 our AUM totaled $15.3 billion



CONTACT INFORMATION

Merganser Capital Management
99 High Street
Boston, MA 02110
www.merganser.com

Consultant Relations & Business Development
P: 617.528.4863
info@merganser.com