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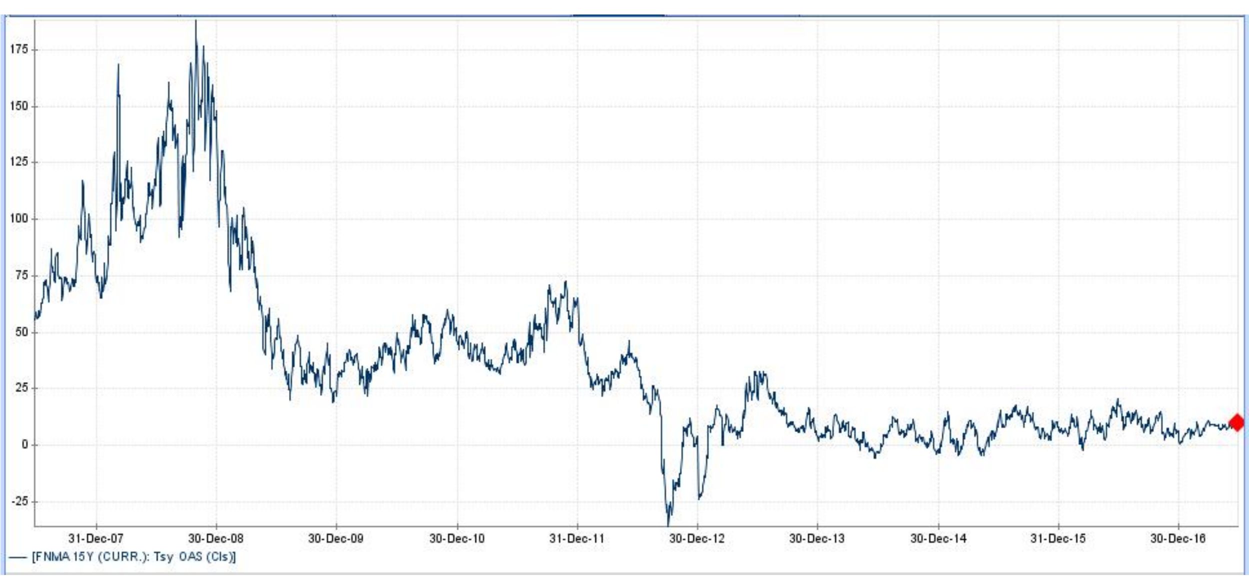
Super seasoned premium MBS, with stripped down coupon: a unicorn of sorts

Mortgage Backed Securities ("MBS") are a type of asset-backed security supported by one or more pool of mortgages. MBS are issued either by a government agency, such as Fannie Mae, Freddie Mac or Ginnie Mae, or by a private financial institution. MBS are structured such that a borrower's mortgage payments (interest and principal) are pooled into a trust and passed through to investors of the MBS security. The MBS security can be offered to investors in essentially two forms: (1) a pass-through that simply passes the coupon, which is the mortgage payment less a processing fee, to investors or (2) a collateralized mortgage obligation ("CMO") that takes the pass-through coupon and breaks it down into different payment structures that a variety of investors may choose. Depending on investors' appetite for risk, they may invest in a tranche that offer higher risk and higher return, or ones that are more well sheltered than the original pass-through from which they derive.

With over $200 billion in daily trading volumes, the MBS market is highly liquid. There are over $8 trillion agency and non-agency MBS pass-through and CMO bonds outstanding, with $2 trillion in new issuance in 2016. Agency pass-throughs trade with a bid/offer spread of .5/32, so are nearly as liquid as treasuries and just as liquid as agency debentures. Unlike treasuries and agencies, however, MBS still expose investors to prepayment risk and, therefore, trade at a wider nominal spread to treasuries. After adjusting for prepayment option cost, the MBS option-adjusted spread ("OAS") is calculated, and serves as a means by which to compare mortgage securities. As shown in the chart below, with liquidity high and spreads tight, the OAS for the "current coupon" 15 year MBS has averaged close to zero over the last 5 years.



This suggests that there isn't much upside to be gained from investing in agency current coupon MBS compared to investing in agency debentures. "Current coupon" MBS pay investors a coupon that yields a price of 100. Presently, for example, a "current coupon" security would either be a 15 year MBS with 2.50% coupon or 30 year MBS with 3.00% coupon. Pass-throughs with higher coupons have higher dollar prices, increasing by about 2 points per .50% in coupon. Due to the low interest rate environment we have experienced in the last decade, pass-throughs with coupons lower than "current coupon" do not exist, or are very few in number and liquidity.

Investors looking to invest in MBS are presented with the following choices when considering pass-throughs:

- Current coupon (3.0%) 30 year security with a price around 100 and average life of 9 years
- Current coupon (2.5%) 15 year security with a price around 100 and average life of 5 years
- Premium coupon securities with prices significantly higher (2-10 points) than 100 and average lives of 2-5 years

With interest rates at record low levels, there is a dearth of refinancing choices for borrowers of mortgages that are pooled into "current coupon" MBS. These securities, therefore, have low stable prepays. On the contrary, borrowers backing up premium securities are certainly presented with prepayment opportunities and consequently investing in these securities may be risky, as the higher coupon premium gets whittled away with potentially higher than expected prepayments.

The predicament arises for a large segment of MBS investors who are seeking securities with average lives well under 5 years, but who prefer low, stable prepayments and are not willing to pay a high dollar price. These investors appear to be looking for the equivalent of a unicorn, however this type of security exists and trades fairly actively. Enter *super seasoned premium* CMOs with stripped coupon. Not only do these securities offer stable low average lives, but we are able to locate some with option adjusted spreads higher than those of current coupon pass-throughs.

Super seasoned premium CMOs are MBS that are comprised of pools of very seasoned mortgages, specifically ones that are paying an above market interest rate. The borrowers of these mortgages have gone through at least one prepayment wave, but have chosen not to refinance either due to apathy because their balance is too low, or inability because their credit is too weak. The average lives of these seasoned mortgages is significantly lower than those of newly securitized mortgages because the final maturity for these mortgages is nearer. Additionally, these prepayments have become stable and the bonds pay down at a consistent rate from month to month. The only concern with this type of security is that the dollar price would tend to be high due to the high coupon. In order to reconcile this issue, some of these super seasoned CMOs are offered with a stripped down coupon. This means that, while the mortgage pools that support the structure may be paying a rate of, say 5%, the coupon for the security is lower, say 2%, and therefore, the price for the security is closer to 100. The combination of super seasoned slow prepayments affords this type of security a stable, low average life, and the stripped down coupon brings the security into a palatable 100 dollar price.

As an example, we recently bought FNR 2015-89 KE at 99-28. Here is a security whose 4,000+ 30-year mortgage pools were, on average, originated 20 years ago, at an average rate of 8%. The security has a coupon of 2%, which allows it to have a dollar price around 100, as opposed to full coupon premium securities, which have dollar prices as high as 110. Although this security has a CMO moniker, it behaves as a pass-through and pays down according to a mortgage style amortization. Prepayments on this security have had a 1 month, 3 month, 6 month, 12 month, and lifetime average of 12 CPR; so it is safe to say that the CPR going forward will remain a predictable 12 CPR. Unlike newer pools, the borrowers within this security have been paying a mortgage rate that they could have refinanced many times over, but have chosen not to, whether due to the small size of their balance or to ultimate apathy. Either way, we find the predictability of the cashflows in this security appealing. As opposed to current coupon MBS, this security does not have negative convexity; its convexity is 0 and its OAS is 23. So while current coupon MBS are offering an option adjusted spread of 0, FNR 2015-89 KE and similar securities offer significantly more spread, even when adjusting for the mortgage optionality.

In the foreseeable future, with interest rates low and MBS spreads tight, super seasoned premium CMOs will provide investors an opportunity to participate in a segment of a highly liquid, well structured agency type market.

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Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as The Journal of Forecasting, The American Economist and The Journal of Fixed Income. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

Emad is an FINRA Arbitrator. He is also a member of the National Association for Business Economists and The Economic Club of New York. Emad served as an adjunct professor at the University of Kansas and St. John's University.

Emad holds a Bachelor of Science from the University of Albany, and a M.A. and Ph.D. in Economics from the University of Kansas.