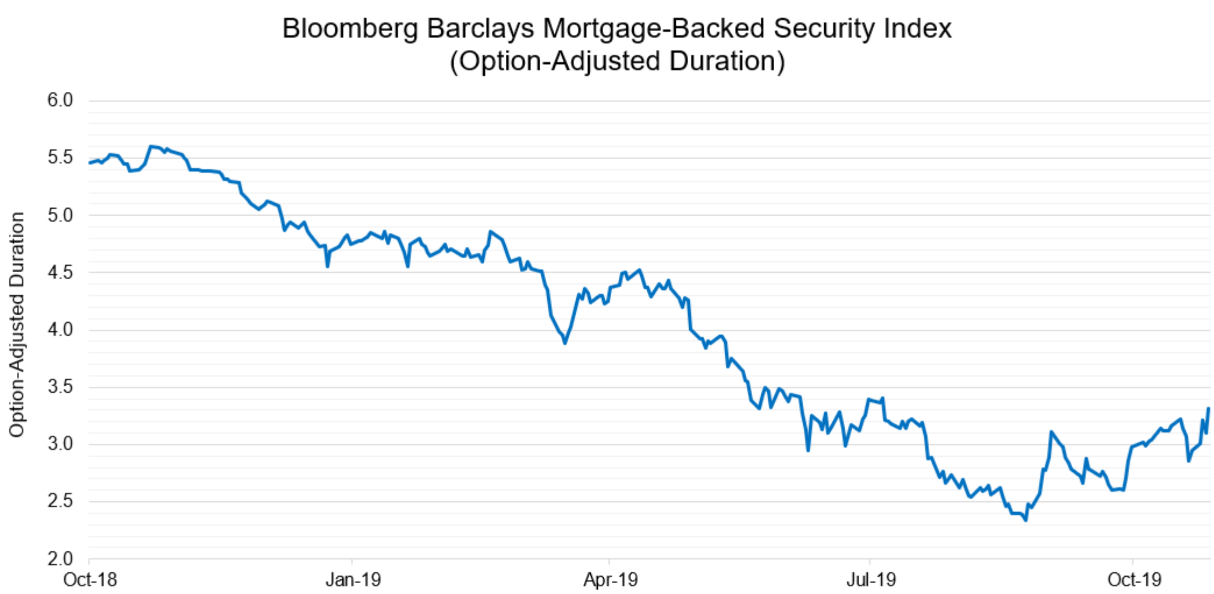
SMITH
CAPITAL INVESTORS

Let Us Not Lose Sight of What Happens to Securitized Assets as Rates Sell-Off

Mortgage assets, especially those guaranteed by the U.S. government, pay additional compensation to investors in the form of a spread above U.S. Treasuries. Unlike corporate bonds where this spread is compensation for default risk, in guaranteed MBS securities this spread is compensation for the uncertainty around the timing of repayment. This leads to MBS securities declining in duration when interest rates fall (increased economic incentive for borrowers to refinance) and vice versa. From a return perspective, this means that an MBS security does not appreciate as much as a similar duration fixed maturity bond when rates rally. The reverse is also true as they underperform when large moves higher from interest rates occur. This highlights one of our favorite bond geek topics: Negative Convexity. This is best illustrated by looking at the duration of the Bloomberg Barclays MBS index over the last twelve months.



Source: Bloomberg Barclays Morgatge-Backed Security Index (LUBSTRUU Index), Bloomberg, data as of 11/7/2019

For background, duration reached a recent peak (along with the peak is U.S. Treasury yields) in Q4 2018 and have been declining in correspondence with the rally from interest rates over the last twelve months. This was the case until very recently. In the last week, ending November 8, 2019, the MBS index has extended in duration by 0.5 yrs or almost 20%, at the same time there has been a fairly dramatic sell-off from interest rates.

Amplifying this impact has been the steepening of the Treasury yield curve as 2s-10s steepened ~30 bps in the last two months. While mortgages are extending in duration with this interest rate selloff, they are also being negatively impacted by the increase from yield premium for longer duration assets.

At Smith Capital Investors we believe in evaluating securities on their risk-adjusted return potential. For MBS, this means we attempt to minimize the amount of negative convexity in our portfolios, reducing the variability on the duration of the bonds we own. This provides a more certain outcome to the portfolio while receiving the same spread compensation.

With cycles compressing and volatility expanding we believe active management and a commitment to individual security selection allow for better portfolio construction and better out-performance opportunities.

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