Litigation Trade Example

The managers identified a bond where the servicer was not correctly interpreting the payout. In this case, the servicer was paying the principal on the bonds to an insurance company before the senior bondholders. It was paying the insurance company for losses the insurance company had previously paid out on mezzanine bonds. Insurance recovery rights are called rights of subrogation. ESM bought the senior bonds and challenged the servicer.

Outcome 1 (Limited Downside)

The servicer does not change the payout even through litigation, and the senior bonds continue to price as they were before. No losses are incurred because of any litigation failure as it was never priced into the market when the securities were acquired. (Note: other market factors, credit shifts, unexpected losses on underlying loans, etc. may result in negative performance). Litigation costs reduce the carry on the bond.

Outcome 2 (Asymmetric Upside Potential)

After successful litigation, the servicer begins paying out the senior tranches first, and these tranches see significant price appreciation as a result of the new structure.

TRADE PROCESS

Once acquiring the bonds, ESM wrote to the servicer to inform them that they were misinterpreting the waterfall and should not be applying any payments to the insurer ahead of the senior bonds.

In this case, the document was somewhat ambiguous, and the servicer thought that there was more than one way that the waterfall could be interpreted. They decided that it was not appropriate for them to make this determination and that it was more appropriate for a court to interpret the document.

As there were two parties that had opposing interest, the trustee filed an interpleader action in federal court. An interpleader is when one party, in this case the trustee, effectively sues two separate parties (ESM and the insurer) and then drops out of the lawsuit because it has no economic interest in the outcome. It is a legal mechanism used in cases like this as one or both opposing parties may not have standing to initiate litigation. At this point, ESM was now in court against the insurer.

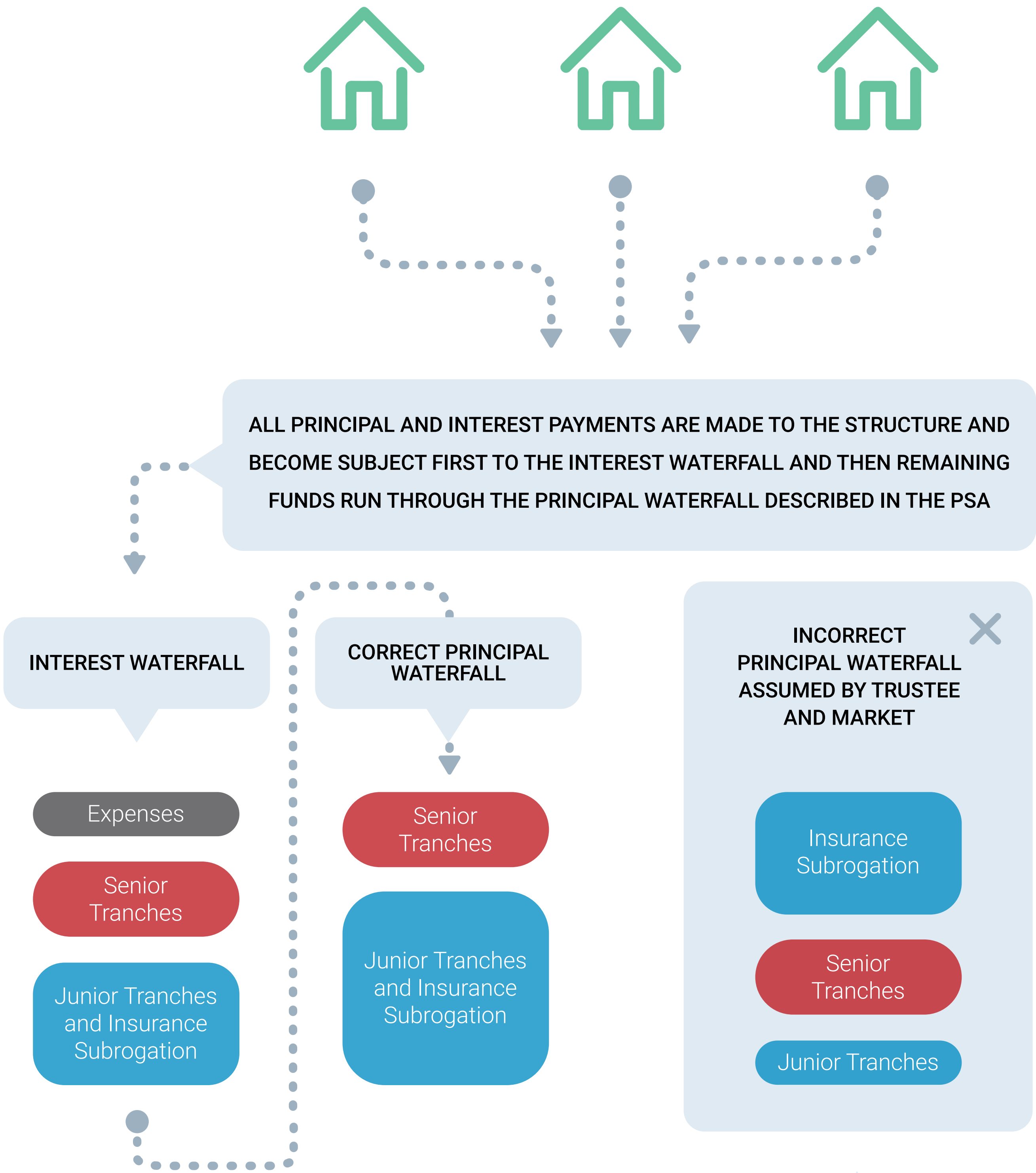
In approximately 15 months, the court ruled in ESM's favor. After the court ruled, but before the payment was issued, the judge in the case retired. A new judge was placed to determine the payout. This delayed the final judgement by about nine months.

After the judgement was issued, the insurer appealed the decision of the court. After about six months, the appellate court heard the case. Within three weeks, the appellate court upheld the lower court's ruling. Within a month of the appellate ruling, the judgement was paid out.

TRADE OUTCOME

After successfully litigating, the servicer corrected the cash waterfall to pay the senior bondholders prior to the insurance subrogation. During the litigation, the servicer had not made any payouts to either party but held the payments in escrow until the court determined who and how they should pay out. Once the market realized the new cashflow structure, the price of the senior bonds increased substantially. **The actual outcome was +158% on the trade, after the price appreciation of the bonds and the legal expenses.**

TRADE OVERVIEW



THE INSURANCE SUBROGATION SHOULD NOT HAVE BEEN PAID BEFORE THE SENIOR TRANCHES. BECAUSE THE MARKET THOUGHT THIS WAS THE CASE, THE SENIOR BONDS REPRICED SIGNIFICANTLY HIGHER AFTER THE LITIGATION AND CORRECTION.

Understanding the Role of the Mortgage Servicer

The primary role of the servicer of these bonds is to collect the monthly mortgage payments of the mortgages underlying the bonds and to pay out the proceeds to the various bondholders in the trust. While not the only source for the special situations, the servicer's misapplication of the payment "waterfall" is a primary place where ESM finds such opportunities.

ABOUT ESM

ESM Management LLC is sub-advisor to an event-driven, non-agency RMBS strategy at Rational Funds. ESM focuses on seasoned, senior, floating rate mortgage bonds, which offer better risk-adjusted returns than corporate bonds and other fixed income investments. This focus also reduces the two primary traditional risks associated with fixed income: credit and interest-rate risk.

Seasoned (legacy) mortgage bonds tend to be superior to newly issued bonds because the mortgages backing these bonds have:

- a proven payment history spanning the last financial crisis through today; and,
- higher home equity meaning a lower likelihood of default.

Within this space, ESM focuses on special situations. These opportunities offer asymmetric upside return potential, meaning that successful actions lead to positive performance, while unsuccessful actions result in baseline asset class returns. Special situations trades could include cases where bonds are being serviced incorrectly or cases where there are unusual features of the bond that the market has failed to value properly.

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