Structural Inefficiency Trade

Most MBS securitizations contain a call right that is vested with the servicer of the bonds. Imagine a pool of 4,000 30-year mortgages. By the time year 29 comes around, there may be less than 50 mortgages remaining. So the servicer is not stuck collecting from 50 mortgagees and applying those payments to various bonds, the call right allows the servicer to call the outstanding bonds and possibly re-securitize the remaining mortgages with other mortgages from other trusts that may have also been called. Typically, these call rights trigger when there is less than 5% to 10% of the original principal value of the trust remaining.

BACKGROUND

ESM studies the patterns of servicers calling bonds, and, based on the patterns, creates a watch list of bonds it believes are likely to be called by a servicer soon.

In October 2019, the managers saw a bond that it believed was likely to be called in the market. Before bidding on the bond, ESM reviewed the documents to determine if there were any issues that might arise from the bond being called. The MBS structure was atypical due to a loss recoupment feature, which means that previous losses would be paid out to bondholders upon the bond being called. Loss recoupment features are not common for mortgage bonds. ESM identified that this added significant value to the bond.

The managers believe this case illustrates their unique combination of expertise, financial and legal, that includes actually reading the documents for each of the bonds they might acquire. In contrast, the "normal" market participant primarily relies on generic pricing models to determine bond prices.

Outcome 1 (Limited Downside)

If the bonds are not called and other market participants fail to notice the unique feature of the bonds, then the bonds are likely to trade in line with the asset class, which may have been a reasonable return given the performance of the asset class.

Outcome 2 (Asymmetric Upside Potential)

If the bonds are called or other market participants notice the feature, the bond prices increase to reflect the value of the loss recoupment feature.

PROCESS

The aggregate return on the trade was a +97.9% from purchase in October 2019 to the bond being called in November 2019.

Through the investment process, ESM identified bonds with a pricing anomaly in their review of the bonds' governing documents. Based on ESM's understanding of the loss recoupment feature and the price of the bonds relative to the asset class, ESM believed that the market was missing the fact that the bonds possessed this feature. The market was not valuing the loss recoupment feature in the bonds. Therefore, the bonds were trading at a significant discount.

ESM was able to purchase the bonds around $92. This price reflected a market interpretation that the bonds were likely to be called within the next three years and, when called, the bondholders would be paid par ($100).

OUTCOME

In November 2019, the bonds were called, and ESM was paid approximately $180, not the $100 par value expected by the market. The recouped losses were paid out in addition to the par value of the bonds. The aggregate return on the trade was a +97.9% from purchase in October 2019 to the bond being called in November 2019. Had any other market participants understood the loss recoupment feature, the bonds would not have traded at a discount to par, but rather at a discount to par plus the losses, which could be recouped upon being called.

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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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