Indirect Litigation Trade

Although ESM is not always a direct party to litigation, they closely follow any litigation that involves non-agency RMBS.

There has been a significant ongoing litigation that involves several trusts that were organized by JP Morgan. This litigation is at its end-stage, and, at this point, there are minor court rulings coming out. The court rulings involve the timing as well as the amount of the settlement that needs to be paid out to each trust by JP Morgan. ESM is constantly looking at these bonds when they are offered into the market.

In January 2020, the court made a ruling that impacted the payout on several of the mortgage bonds involved in the litigation. The court ruling was somewhat difficult to understand for those not familiar with the entire case.

PROCESS

Based on the ruling, a bondholder decided to sell their bonds. Judging by where the bidding was, it was clear that the bondholder and other market participants were misinterpreting the court ruling. They incorrectly understood that this bond was being excluded from any payout. This was not the belief of ESM. ESM was able to purchase the bond at a market yield that assumed there would be no payout on the bond.

Outcome 1 (Limited Downside)
If ESM's interpretation of the ruling was incorrect, the managers acquired a bond at the then current market yield for a generic bond with no asymmetric upside potential. ESM would be able to sell the bond back into the market at a market yield at any time. The downside was limited only to market factors.

Outcome 2 (Asymmetric Upside Potential)
Assuming ESM's interpretation of the ruling was correct, in addition to having a reasonable yielding bond in the portfolio, sometime within the next 6-12 months the managers expected to receive a cash payment from the litigation.

OUTCOME

In May 2020, ESM received a settlement payment that represented approximately 40% of the purchase price of the bond.

Again here, it was ESM's understanding of the details involved in the litigation that allowed them to make this trade. ESM continues to hold this bond, and it continues to yield a good baseline yield.

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.

DR. ERIC S. MEYER

Dr. Meyer has been working in finance since 1995 and he founded ESM Management LLC in January 2009. From 1997 through 2008, Dr. Meyer worked at Susquehanna International Group.

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Glossary

Waterfall - payment structures allow higher-tiered creditors to be paid principal and interest ahead of lower-tiered creditors.