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INVESTMENT GRADE FIXED INCOME

When MBS Benchmarks Go Low, Active MBS Managers Go High

By: Andrew Szczurowski, CFA | & Chip Driscoll, CFA | September 19, 2022

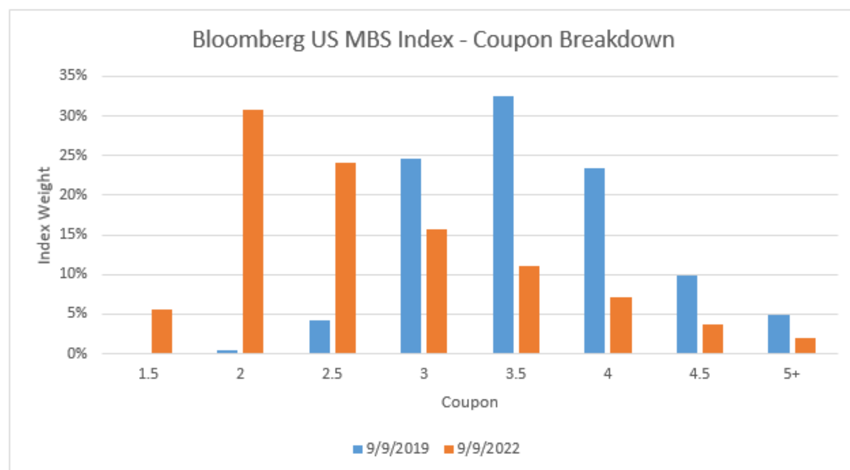
Boston - When we borrow Michelle Obama's famous catchphrase, we aren't talking about politics in the run-up to the midterm elections. What we mean is that active investors may be able to capture attractive opportunities by migrating up in coupon in the agency mortgage-backed securities (MBS) market.

A quick glance at the Bloomberg U.S. MBS Index may not necessarily jump off the page for a passive fixed income investor. Yields have risen to roughly 4.2%, which is about in line with the Bloomberg U.S. Aggregate (Agg) Index. Duration has extended to 5.9 years, slightly shorter than the Agg's 6.4 years, as refinance activity has slowed and home sales have cooled modestly. Lastly, the average spread of the MBS Index is right in line with the long-term average.

All these factors would make an index-based portfolio an *OK* option for someone looking to get cheap exposure to the agency MBS market. However, if an investor were to take an active approach by diving a bit deeper into the composition of the index, they may find opportunities to both add value and reduce risk in the sector.

As mortgage rates plummeted in 2020, eventually hitting all-time lows in 2021, refinancing activity spiked and the housing market took off. This led to a surge in agency MBS supply, and the vast majority of new issuance was in lower coupon bonds. As the outstanding MBS universe became increasingly dominated by 2% and 2.5% coupon bonds, so too did the MBS Index. In fact, before COVID, "2s" and "2.5s" accounted for less than 5% of the Bloomberg US MBS Index; today, those coupons make up nearly 60% of the index.

Agency MBS coupon distribution has shifted since COVID



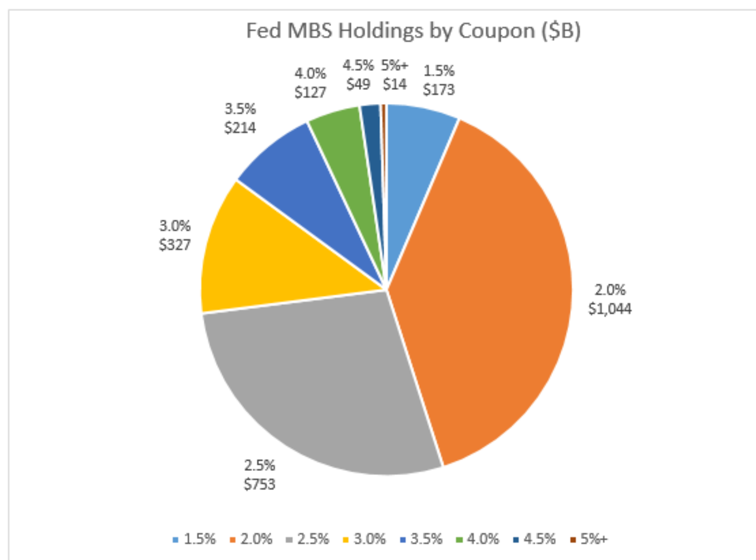
Source: Bloomberg as of September 9, 2022.

Why are we singling out 2% and 2.5% coupon bonds? With the average 30-year fixed rate mortgage now above 5.5%, 2s and 2.5s are so far out of the money that we would be hard pressed to find anyone looking to refinance out of their loan. As a result, we've seen a significant amount of extension on these bonds.

According to Yield Book, for example, 2.5% coupon bond durations have extended from 4.6 years in September 2019 to 7.1 years today. Unless an investor had been actively monitoring those changes, the interest rate risk profile of their MBS portfolio would have changed dramatically over that period.

And just as the index composition changed to include more low-coupon bonds, so did the U.S. Federal Reserve's balance sheet. As the Fed generally focused its quantitative easing (QE) purchases on the coupons where origination was the highest, that caused the Fed's ownership of 2% and 2.5% coupon MBS to balloon in 2020 and 2021. The Fed's MBS holdings grew from $1.4 trillion in early March 2020 to more than $2.7 trillion today, with 2s and 2.5s now accounting for $1.1 trillion and $756 billion, respectively.

Coupons of 2% and 2.5% account for larger share of Fed MBS holdings



Source: Bloomberg as of September 9, 2022.

Now that the Fed has begun letting its MBS paydowns roll off its balance sheet — with many market participants concerned about the potential for outright MBS sales — what they own has become an increasingly important consideration. The lower-coupon MBS that the Fed has been hoarding could feel the brunt of its balance sheet reduction, and that may create a difficult environment for investors and indexes that hold these low-coupon securities.

We believe that higher-coupon MBS appear much more compelling in today's environment than their low-coupon counterparts for several reasons that are detailed in the chart below:

Fannie Mae 30-Year MBS

Coupon	Price	Duration (yrs)	Yield	Spread (bps)
1.5%	$ 80.41	7.72	3.99%	63
2.0%	$ 84.75	7.12	3.99%	65
2.5%	$ 88.11	6.66	4.05%	70
3.0%	$ 91.45	6.14	4.06%	70
3.5%	$ 94.42	5.31	4.26%	92
4.0%	$ 96.95	4.57	4.43%	109
4.5%	$ 98.96	3.79	4.66%	129
5.0%	$ 100.66	2.93	4.89%	151
5.5%	$ 102.26	2.35	4.97%	155

Source: Yield Book as of September 9, 2022.

- Higher coupon bonds tend to have much less interest rate sensitivity, which may benefit investors if inflation remains sticky and interest rates move higher. The duration on a Fannie MBS at 5% is 2.9 years versus 7.1 years for a Fannie MBS at 2%.
- The Fed holds almost no MBS with coupons above 4.5% because mortgage rates only recently began rising significantly — well after the Fed had finished adding MBS to its portfolio. That's not to say that Fed MBS sales would make no difference to higher coupon MBS. But the impact of any Fed sales would likely be much more muted.
- Spreads on higher coupon bonds are meaningfully wider than spreads on low coupon bonds. For example, "Fannie 5s" have a spread of 151 basis points (bps) over Treasurys, while "Fannie 2s" have a spread of only 65 bps over Treasurys.

Bottom line: We would argue that higher coupon MBS currently offer a much more attractive risk-reward tradeoff than lower coupon bonds. Compared to a passive, index-oriented approach, an active investment approach that seeks to add value by taking advantage of these market dynamics may prove beneficial.

The index performance/characteristics are provided for illustrative purposes only and are not meant to depict the performance/characteristics of a specific investment. **Past performance is no guarantee of future results.**

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