Article from:

Small Talk

March 2014 – Issue 41

Mortgage-Backed Securities Can Be a Valuable Addition to U.S. Treasury Bond Portfolios at Small to Mid-Sized Insurance Companies

By Mark Whitford

Defining MBS

The U.S. agency mortgage-backed security (MBS) market is one of the largest and most liquid fixed income markets in the world. Within the United States, it is second only to the U.S. Treasury in size, with approximately $5.8 trillion outstanding (source: Securities Industry and Financial Markets Association). At that size, the market provides a high level of liquidity and depth. This is suggested by the very low transaction costs as highlighted by the tight bid/ask spread levels in MBS, which can be comparable to U.S. Treasury levels under normal market conditions.

The three main issuers of mortgage-backed securities are the Government National Mortgage Association (Ginnie Mae), Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Officially chartered as government-sponsored enterprises (GSEs), U.S. mortgage agencies Fannie Mae and Freddie Mac were established to facilitate U.S. home ownership by helping to broaden the mortgage lending landscape through the securitization process. Similarly, Ginnie Mae was established as a government-owned corporation within the Department of Housing and Urban Development to facilitate U.S. home ownership while focusing on low- to moderate-income households. Because Ginnie Mae is wholly owned by the U.S. government, the MBS it issues are the only ones to carry a full faith and credit guarantee by the U.S. government and are equal in seniority of payment with U.S. Treasuries.

These agencies seek to provide stability and affordability to the mortgage market by effectively collateralizing mortgage loans and selling them in the fixed income market. Over time, this segment of the market continued to grow and was a natural fit for some of the largest and most sophisticated investors looking for a better potential return than U.S. government bonds. Agency mortgages continue to comprise the most significant component of the U.S. MBS market and are the major source for U.S. residential mortgage funding.

The Potential Benefits of Adding MBS to a Portfolio

Many small to mid-sized insurance companies have significant U.S. Treasury portfolios. Historically, U.S. agency MBS have consistently provided a yield advantage over U.S. Treasuries. Although the amount of yield advantage changes over time, this advantage has persisted and provided fairly consistent excess returns over U.S. Treasuries.

I believe the data are even more compelling when comparing the return profiles of U.S. Treasuries to agency MBS, potentially creating a more efficient portfolio and enhanced risk/return profile.

Risks and the Value of Active Management

Since mortgage borrowers have the ability to prepay their mortgage loans, prepayment risk is generally a primary risk when investing in MBS versus U.S. Treasuries. This leads to an inverse relationship between implied U.S. Treasury volatility and excess returns in the MBS market.

U.S. agency mortgage analysis focuses on a variety of factors that determine how quickly the borrower is likely to prepay the obligation relative to anticipated future levels of interest rates and underlying home valuations. Hence, one of the important dynamics for insurance companies to understand when building an MBS portfolio is the complexity of modeling mortgage prepayment speeds and managing the portfolio around these assumptions. This is a complex process requiring dedicated quantitative research and experience effectively managing portfolios of MBS through market cycles. In addition, significant qualitative assessment is also needed to properly position portfolios as other factors can also impact prepayment speeds. Carefully weighing and incorporating a variety of potential issues, such as employment trends, political issues related to the housing market, the potential for additional unconventional monetary policy action, a continually changing landscape within the housing finance market, and

Continued on **page 16**

the relative value dynamics within the market itself, may alter prepayment expectations and expected returns across the MBS opportunity set. Hence, I believe the portfolio allocation can be optimized and implemented using both prepayment model outputs as well as a host of qualitative factors. I believe that only by combining all of these inputs and factors can investors be successful in navigating today's mortgage market.

Going Forward in a Changing Market

More so than ever before, changes to the structure as well as the role of the government in the U.S. mortgage finance industry are being discussed. The major themes include lessening government support for GSEs while still maintaining a stable mortgage finance market. Most believe that an inevitable outcome is that both Fannie Mae and Freddie Mac will be downsized as their balance sheets are shrunk in an orderly fashion. Given the GSEs' large presence in the mortgage market, the current regulatory and political environment and the goal of maintaining reasonable levels of mortgage financing, I believe that the implementation of any major change will occur over a long period of time. However, in the longer term, I could see a move toward a market with more private involvement and less government participation. It is hard to envision an environment without some sort of government involvement, as the immediate impact could be an increase in mortgage financing costs. In the meantime, I expect the government will continue to have an active role in the market as it has a vested interest in supporting the overall U.S. housing market. I will be following any changes very closely, but in the interim, I continue to believe in the inherent value of this asset class. It offers potential benefits for investors who seek to broaden beyond traditional Treasury and agency debt without having to significantly sacrifice liquidity, yield and safety.

It is hard to envision an environment without some sort of government involvement, as the immediate impact could be an increase in mortgage financing costs.

Adding Significant Value to a U.S. Treasury Allocation

With yields I feel are attractive, liquidity and risk-adjusted returns, I believe U.S. agency MBS can be a valuable addition to insurance general account portfolios invested in U.S. Treasuries. Due to the complexity involved, I also believe that comprehensive research and asset-class expertise is critical in the management of these securities.

IMPORTANT NOTES

Mark W. Whitford, FSA, CERA, MAAA, is senior insurance investment strategist at Franklin Templeton Institutional in New York. He can be reached at *Mwhitfo@frk.com*.