

## Residential Mortgage Backed Securities (RMBS as of March 2014)

### General:

RMBS Bonds are the securitized equivalent of Commercial Mortgage Backed Securities (CMBS). There is a 10 Trillion Dollar U.S. Mortgage Market overall. In 2005, RMBS Bond sales and Securitizations were a 2.8 Billion market. Now; most securitized bonds have been sold and is a currently a 850 Million market in 2013. However, it has every potential to grow into a 250 Billion Dollar residential secondary mortgage market in the next 3 years.

In 2005, Fannie and Freddie Mac were only 60% of the secondary mortgage market and private equity was the other 40%. Now Fannie and Freddie are 90-95% of this residential market. For FNMA underwriting, they now require a minimum 20% cash down and a solid 720+ minimum credit score. Edward DeMarco is now the Fannie/Freddie spokesperson as of March 2013.

It is anticipated by some (Alliance/Bernstein Wealth Managers for example) that Fannie and Freddie are phasing out of their primary financial risk position in these secondary markets and will now shift into more of a more passive re-insurance role instead. A grand merger of Fannie and Freddie is currently being seriously discussed to combine both their back office operations and to then provide the market less risk guaranties of these securities in the future. They are looking to the private market to intercede to a much greater extent than it has. Any bonds that are issued or guaranteed by Freddie and Fannie or its future combination thereof have been, and are known "Agency Bonds" (GSA's).

Hedge Funds, Sovereign Funds, and Private Wealth Management Organizations (like Bernstein) throughout the U.S. are eagerly entering this 850 Million dollar Residential Secondary Market to buy blocks of these "Legacy" (Pre-existing) bonds that will be package by Government and Private conduits. The difference in these new financial slices to be purchased is that they will be comprised of pre-existing borrowers whose credit score is 680-720 versus 720 to 800 as required by the Fannie and Freddie Bond packages. Also, borrow leverage may be higher than 80%. 20% of these packaged securities already have loans that are already in default and another 40% are about, or likely to go into default. These securitized packages however are mostly bonds that contain existing securitized mortgages in Non-Judicial States so as not to allow these



*Baner Financial Interests*

defaulted mortgages to remain in default indefinitely and unduly delay the foreclosure process. This strategy thereby increases investor return, as the underlying asset is resold and mortgage paid off in a shorter period.

The anticipated RMBS fund term is 6-7 years with anticipated loan rollovers in 4-5 years. Rates of return are estimated at 7%-10% with a average mean of 5% and a worst case return of 1-2% over the term with all principle returned.

Early redemption of investment is under a 1 year lock-in; then a 1/3-1/3-1/3 quarterly distribution to their investors based upon Net Asset Value (NAV) which value is assessed daily by a third, independent party. Two thirds of the return is the loan ratio and one third, return of capital. There is a 1% management fee plus a 5% carried interest return to issuer after the investors get a 6% cumulative return.

These existing bond issues are part of a potentially shrinking supply which can serve to enhance liquidity. Nonetheless, as the nascent housing market grows over time, RMBS could easily grow from a 30 Billion to a 250 Billion secondary private mortgage market.

## Investments Fund Construction (February 2014)

The terms “Alpha”, “Beta” and “Smart Beta” are now an ingredient in the Wall Street and Pension investment language lexicon.

**Alpha** is defined as the skill required of the fund custodian or investor, to successfully identify, select and choose specific investment assets that will hopefully outperform the market. It’s a value added fund portending positive tactical investment bets.

**Beta** is defined as the rate of return received or achieved from those selected assets and their respective allocation.

**Smart Beta** is a strategic deviation from the standard investment approach strategies that attempt to enhance the return even more than prevailing standard expectations.

**What then is the standard benchmark?** The most common one is the Cap-Weighted approach. This is where the custodian or investor buys stocks and/or bonds in proportion to their market value at the time (i.e. 60% stocks and 40% bonds prevalent mostly within index funds where stocks have 90% of Volatility and Bonds have 10%).

This cap-weighted fund approach is still the norm however because of the current (2013) pension underfunding issue with many *investor groups*, smart beta is becoming an investment matrix to be aware of. This phenomenon is coming to the forefront because these underfunded (cash shortfalls) have to be made-up achieve the funds’ ultimate investment objectives for the future.

Here are a few of the *smart-beta* approaches some are using to achieve the catch-up funding goals:

### Smart Beta

1. **Basic Indexing:** This approach gives each market constituent equal weight as a percent of total regardless of value. If there are 100 stocks, then each would have a weighting of 1% each. This approach takes advantage of the belief that small stocks tend to outperform large ones.
2. **Fundamental Indexing:** This process requires weighting of each stock (or bond) as to it’s fundamental financial characteristics as a investment measurement. For example, the fund can be strategically weighted as to its sales, dividends, assets, diluted earnings or it’s cash flows. This approach depends on large cap value stocks to beat small cap growth stocks since small caps can be perceived to be illiquid and risky.
3. **Volatility Weighting:** The custodian or investor weights the index balance based upon the past and anticipated volatility of the stock or other targeted asset. For example, large cap-value or small cap growth stocks or bonds. The heaviest favored weighting goes to the least volatile and more stable stocks (or bonds). This approach empirically and historically does very well over the long term (10-20 years\_ . Nonetheless, there isn’t always a free lunch here. If you push down on one risk, another pops up elsewhere (utility stocks in an increasing interest rate environment are an example).

4. Momentum Weighting: Weight the portfolio with stocks that have recently risen in price and appear to continue to do so. This approach is based on the theory: the riskier the asset, the higher the potential returns. This approach does the worst of them all, not only because more risk doesn't always equal more reward but also that fees are higher because of the churning required to constantly pick the right investments over a specific term to maintain yield expectations.

5. Risk Parity: This is a strategy originated by James Tobin (and Martin Feldstein) in 1958 and marketed by Ray Dalio of Bridgewater Hedge Fund in 1995-1996.

Risk Parity portfolios are based on multiple risk measures and then strategically allocated into a multiple grouping of investments.

The first grouping allocation goes to asset classes that do not correlate with, or to each other (i.e. stocks, bonds versus real estate and commodities).

The second allocation grouping goes to choosing assets of varying higher risk plus lower risk returns, wherein some of these higher risk assets can be enhanced by financial leverage where appropriate and if necessary.

In other words you will have assets in your fund that respond to Inflation, Deflation, Stagflation, high interest rate and growth markets and low interest rate and growth markets.

This unique strategy not only incorporates a menu of investment strategies (Alpha), it locks in sustainable rates of return (Beta) because the assets don't correlate (they offset risk of the unknowns). Some assets provide a dividend return and deflation protection no matter what (Treasury Bonds), others provide dividends plus growth and inflation protections (real estate) and yet others provide dividends and growth in a non-inflationary market (stocks).

There are many fund managers taking a hard look at this strategy although care must be taken here not to be caught with an overloaded "fixed return" bond portfolio in a rising interest rate environment or, overleveraged in stocks within a rising interest environment.

## Portfolio Balance Summary

High and Low Inflation  
(Long Term-30 Years)

|    | <u>Tips</u> | <u>Real Estate</u> | <u>Commodities</u> | <u>Stocks</u> | <u>Gold</u> | <u>Success Ratio</u> |
|----|-------------|--------------------|--------------------|---------------|-------------|----------------------|
| 1. | 48%         | 17%                | 15%                | 14%           | 6%          | 75%                  |

*Caveat: Considerable directional risk in either extreme.*

|    | <u>Tips</u> | <u>Real Estate</u> | <u>Commodities</u> | <u>Stocks</u> | <u>Gold</u> | <u>Success Ratio</u> |
|----|-------------|--------------------|--------------------|---------------|-------------|----------------------|
| 2. | 54%         | 14%                | 22%                | 6%            | 3%          | 75%                  |

*Caveat: More stable-Less directional risk in the extremes.*

|    | <u>Tips</u> | <u>Real Estate</u> | <u>Commodities</u> | <u>Stocks</u> | <u>Gold</u> | <u>Success Ratio</u> |
|----|-------------|--------------------|--------------------|---------------|-------------|----------------------|
| 3. | 5%          | 39%                | 55%                | 1%            | 0%          | 78%                  |

*Caveat: Use this allocation in High Inflation semesters. Characterized by short term leases and rent link to revenues.*

## Best Inflation Protections

### Best:

General Commodities-Success Rate = 70% in high inflation periods.

Energy Commodities-Success Rate = 75% in high inflation periods.

Non-Energy Commodities-Success Rate = 61% in high inflation periods.

### Next Best:

Real Estate-Success Rate= 65% in high inflation periods.

### Average:

Real Estate Stocks-Success Rate= 60% in high inflation periods.

### Below Average:

Tips -Success Rate= 54% in high inflation periods.

### Poor:

Gold Commodities-Success Rate= 43% in high inflation periods.

*Source: Wharton School of Economics and Financial Management-University of Pennsylvania*