RoALM investment house

Residential Mortgage-Backed Securities (RMBS) - Emerging from hibernation with improved liquidity

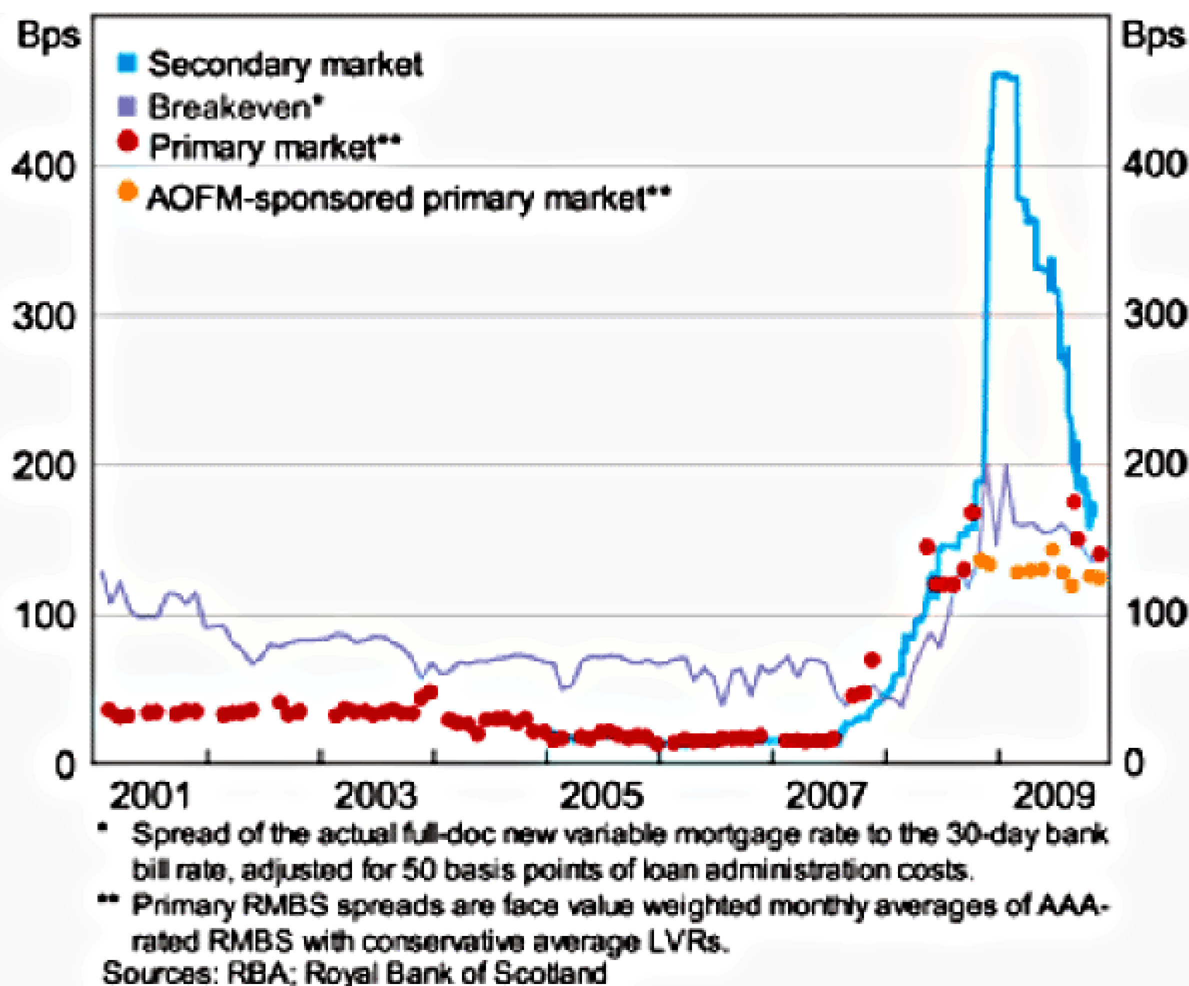
20 September 2017

There has been a marked change in secondary liquidity within the RMBS market, when compared to the last decade. Reviewing the history of how this environment has changed over the last 8 years, provides an important perspective on where we are now.

The Immediate Aftermath of The GFC

Post the events of 2008, Australia saw a mass exodus of market participants. Overnight issuers went from being flush with options, to having their availability of credit heavily rationed, meanwhile RMBS went from a generally accepted and tradeable fixed income product, to an illiquid one. In many instances this wasn't simply an Australian phenomenon as cornerstone supporters walked away.

It was a surreal environment, traders literally went from moving $50 million dollar lines on 1 basis point spreads, to markets going no bid. This initially hit the cash funds after the government guaranteed deposits which saw mass redemptions, at the same time a sharp decrease in prices occurred because of the European selling of high quality Australia RMBS Assets. This bled into other fixed income products, in particular High Yield funds, who were not as liquid and vulnerable to a run on funds. At the same time many non-bank lending programs effectively hit the wall as the foreign banks exited. This forced the survivors to go cap in hand to the investment community. The few traders that were still around at that stage, (post Howard, BAML, Perpetual, Challenger HY all closing due to liquidity runs), effectively decided which non-banks would continue as going concerns.



* Spread of the actual full-doc new variable mortgage rate to the 30-day bank bill rate, adjusted for 50 basis points of loan administration costs.
** Primary RMBS spreads are face value weighted monthly averages of AAA-rated RMBS with conservative average LVRs.
Sources: RBA; Royal Bank of Scotland

As The Dust Settled

In the post GFC period the market became almost dysfunctional, through the period of 2009 to 2011 the RMBS market effectively fell into a state of hibernation. We hardly saw public transactions, until a gentle thawing finally took place into the end of 2011. Those that had survived, however, were still in care and maintenance mode. With debt capital markets for securitised credit still effectively frozen, non-banks and regional banks lost a significant plank of their funding, in the case of the non-banks their only plank.

The Australian Securitisation Forum (ASF), was involved with educating the Treasury and the Australian Office of Financial Management (AOFM), the financial management arm of the Australian Government, about RMBS, the risk, and benefits of supporting the market. This lead to the government directing the AOFM to invest $20 billion AUD of tax payers money into the RMBS market for new loans, to maintain competition, and to buy time so primary markets could re-establish themselves. Through this period repo eligibility rules were advocated by the ASF to further bolster the asset class. This had a meaningful impact on the asset class as it was a precursor to AOFM now having ongoing mandate to invest within RMBS markets.

This was in many ways an ideal period for investors. An absence of any significant liquidity coupled with the fact that issuers went out of their way to forge pristine pools to lure investors (this was driven by the conditions the AOFM imposed on issuers) saw the RMBS market deliver a value for risk that was superior to most other risk markets. That said, the aversion to the asset class was also at its highest, due to the exodus of the cash funds and trustees and investment committees being led by the stigma of the US headlines on the asset class. The RMBS acronym was enough to scare asset allocators into their shell, no amount of pleading to common sense or judgement helped dissipate misplaced falsehoods around the asset class.

The Thawing

For the majority of the market in the period between 2012 and 2016 RMBS was still a taboo of sorts. Investors were mired in a bias created by the post-traumatic stress of the GFC and the contributions to popular culture in the form of “The Big Short” and “Margin call”.

That said for investors who understand the asset class and the fact that RMBS ultimately exposes the investor to the same diversified systemic risk as bank debt, this was an excellent period to put money to work, particularly for hold to maturity investors. At Realm, we started to see a gentle increase in secondary market activity as smaller brokers began to actively broke to family office and high net worth markets.

The ability to earn an intermediation premium as an investor became clearer to us through this time. Essentially our frustration with market perception was what allowed us to make healthy liquidity premium by sitting between buyers and sellers. Equally our flexible mandate allowed us to dynamically manage our exposure to the whole market, thus, giving us the benefit of blending an informed thematic view with a practical and pragmatic approach to trading this market.

The Reversion- Going Back To Where We Started

And here we are, where we started. Japanese, European and American banks are once again actively seeking to re-enter the market to fund non-banks and regionals. This current year is on track to eclipse any in the post crisis period for total issuance, stock is being gazumped here at home and abroad as foreign investors muscle in and swallow whole loan pools. In addition, and this goes directly to the question of market liquidity, we have once again seen the re-entry of several participants into market making. Hundreds of millions of dollars’ worth of foreign investment bank balance sheets has been earmarked and has been allocated to support the RMBS market.

This is on balance a positive for our market, while a good portion of this cash is touristy, absent another tail event a lot of this market making capacity will remain. In our opinion this will have a meaningful permanent impact on the liquidity dynamics of this market. This poses the question to many researchers and participants who have written RMBS off as a fringe asset class on how they perceive these assets going forward.

As liquidity conditions improve RMBS will only become a more meaningful part of allocations in the fixed income market. While this trend reversal plays out, we will see the liquidity premium dissipate, as bid offers tighten to reflect increased market acceptance and contestability. The ability to trade will allow skilled participants to better reflect their own value based and thematic conviction.

Realm's Approach To RMBS

Our approach designed to evolve with market conditions and our unique research, models systematic drivers of risk. This has been driven by extensive research on tail risk experiences and how systems transition from a normal to a stressed state.

The work is proprietary and noted by researchers as well progressed versus our peers, in providing a framework for understanding Australian tail risk and value within RMBS pools more broadly.

On the trading side, we have continued to drive a progressive market leading approach. Portfolio secondary buy/sell turnover is healthy, sitting on average $15mil per month. Our engagement with market participants is constant. We deliver meaningful pricing data to market participants and entrenching ourselves as a key liquidity provider in this market.

In addition, our book positioning, and secondary market pricing reflects our fundamental view, allowing us to more meaningfully and aggressively optimise portfolio composition to drive client outcomes.

Sector View

We are not RMBS zealots, as it is simply one sector out of many that we manage to meet client objectives. At the time of writing this note RMBS makes up approximately 20% of the Realm High Income Fund's asset base down from an average of around 35%.

At the same time the portfolio has increased in credit quality as lower rated tranches are now trading moderately dear. Anecdotally, we are noticing that issuers are using the strength in this market to clear warehouses of interest only and investor loans. In several pools the interest only component have been approaching 50% of total assets. That said, there have been plenty of other investors who have shown a willingness to soak this risk up.

The tide seems to have turned. As such we expect that increased supply in this market, in particular from major banks. APS120 has paved a clear road for regulatory capital transactions, couple this with funding run-offs, capital benefits and a bank levy, more off-balance sheet capital transactions are expected to hit the market.

We are not surprised to see investors soaking up this risk. It is common at the end of a cycle for investors to become price takers because of the fear of missing out. Our experience is that there is always another deal, the economy never stops needing to be funded. It is important to remember this, especially in times like now, where investors are starting to increase their risk seeking behaviour to get set and deliver returns.

Much of this paper will be absorbed by the market, in particular the senior tranches, however, the junior parts of issuance will steepen as big banks crowd out the non-banks in the foreseeable future due to sheer volume.

In the meantime, at Realm we will continue to drive solid client outcomes by increasing stock rotation while constraining our total risk exposure. This is consistent with the funds top down investment process and positioning. Currently the fund's risk is as it's lowest since level the fund's inception.

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