Portfolio Management By Jim Reber, ICBA Securities

Mining for mortgages

Small differences in details can affect MBS performance.

If you're a "big-picture" person, you might not feel like diving into an investment column that extols the virtues of comparison shopping. But before you flip the page, let me hurriedly mention that *it could make your community bank more profitable*.

If you're still here, let me explain that you can easily (and quickly) access mortgage-backed securities (MBS) pools that are barely different than generics and have higher cash flow, or predictability or yield.

Given the depth of the MBS market (approximately $8 trillion), portfolio managers can set purchase criteria for their favorite brokers to follow and still be able to purchase mortgage products that are quite attractive.

And it appears that community bankers are investing in amortizing securities like never before. With tax reform having been in play for a full year now, investors are trying to right-size their tax-free portfolios, and on balance, municipal bonds have shrunk by about 18 percent. Most of this runoff has been reinvested into some type of amortizing securities, including MBS.

Turn on the faucets

One simple way to ensure that your pools will throw off certain amounts of principal cash

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Next: Two regulatory relief proposals to push for

flow from the start is to buy "seasoned" pools. Generally, an MBS that came to market 24 to 36 months ago is considered seasoned, and especially if the original term was 15 years or less. A pool with 12 years remaining will have 22 percent more principal returned in the first year than a new 15-year pool, guaranteed. That's the magic of the amortization schedule.

One can also buy above-market (read: "premium") coupons. As of this writing, a new 15-year mortgage loan comes at about 4.25 percent. A mortgage security that has a *net* coupon ("pass-through") of 4.00 percent or higher means the homeowners are still paying an above-market rate and therefore have some incentive to refinance. The offering sheets from your broker should document how much faster these premium pools should run versus generics.

> So if your objective is to lock up your investments for a while and limit the reinvestment risk, ask your broker for some high-loan-to-value offerings.

Size can matter …

There are also pools that are collateralized by jumbo mortgages, which mean the original individual loans were greater than $485,350 if originated in 2019. (The limit is higher in certain states and territories.)

Usually, jumbo pools prepay faster than conforming loans, because borrowers see a greater absolute dollar benefit from refinancing. There's also a school of thought that jumbo borrowers are more affluent and therefore more mobile.

Don't forget to look at the number of loans in a pool. An MBS with 4,000 loans will prepay much more consistently than one with 40, and it will likely have more resale liquidity. The minimum size of a single pool is only $1 million, and there is no minimum loan count.

… as can LTVs

You may recall in the depths of the Great Recession that the federal government launched a dizzying array of assistance programs, some of which were directly focused on keeping at-risk mortgagors in their homes. These went by an alphabet soup of terms like HAMP, HARP and MHA. The upshot is that there are mortgage securities out there in the secondary market backed by loans that are still well over 100 percent loan to value.

The securities backed by these high-LTV loans have never prepaid as fast as conventionals, since the borrowers have had little or no equity. Now that mortgage rates are at their highest levels since these programs were launched, there's even less reason for the homeowners to refinance. So if your objective is to lock up your investments for a while and limit the reinvestment risk, ask your broker for some high-LTV offerings.

To put a wrap on this column, all mortgage securities cost significantly less than they have for years. This has cut down on the premium risk, but the ability to buy "off the run" MBS to your community bank's benefit still exists. Add to that the community bank industry's general shortage of available liquidity, and MBS' cash flow characteristics make them a natural complement. My advice is to investigate some nuances and perhaps demonstrate that you're smarter than the average investor. ■

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