



Optionality driving RMBS focus

The legacy US non-agency RMBS market is experiencing a 'perfect storm' of events, given the current low rate, low volatility environment. Strong performance and increasing optionality has prompted a renewed focus on the product.

The last 12 months have been stable - with a couple of short-lived bouts of volatility around the Brexit vote and in the run-up to the US election - for non-agency RMBS and the asset class continues to perform well. "While this partly explains the renewed focus on the product, it's largely because the fundamental value of the asset class remains strong. The remaining legacy loans continue to experience house price appreciation and the ability to refinance remains high with low mortgage rates, and therefore the overall performance in these sectors remains high," says Neil Aggarwal, portfolio manager and head of RMBS at Semper Capital Management.

He adds that the development of new product types - such as re-performing/non-performing loan, single-family rental and credit risk transfer deals - has reinvigorated demand by enabling investors to express new views on post-crisis residential mortgages. "Both the entrance of SFR sponsors and the GSEs' introduction of creative structures by transferring credit risk to the private market have been strong drivers of performance. The SFR markets have eliminated certain areas of excess housing supply and the GSEs have created a new way to express credit views in housing today."

Against this backdrop, another main driver of relative value is optionality, according to Aggarwal. "The market is pricing in quite a few interest rate hikes and there are opportunities in both the legacy RMBS universe and these new RMBS sectors to take differing views around these projections - will the projection of the forward curve be realised, or will it come in under or over the projection? It is possible to access different trades, depending on your view of the curve and on the timing of Fed hikes," he explains.

For legacy deals, assumptions around fundamental value, rate hikes and structural optionality were run conservatively immediately post-crisis. This meant that investors were able to make returns north of 20% because the scenario analysis was too harsh.

Whereas in 2010 estimated returns could be 50%-100% higher than base case estimates, within today's estimates there still is room for outperformance of 15%-25% over a period of time. Aggarwal suggests that base-case assumptions in today's estimates are a 4%-7% yield.

"The ability to add alpha requires in-depth analysis of the structure with expertise on the collateral, as well as a significant understanding of the technical nature of these products within overall markets," he concludes.

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